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A Renewable Approach To State-Imposed RPS

Law360, New York (February 03, 2010) -- At present count, 31 states and the District of Columbia have adopted legislation imposing some form of renewable energy objective, often referred to as Renewables Portfolio Standards (RPS), or Renewable Energy Standards.

Generally speaking, most state RPS programs require electricity supply companies to either (1) provide a percentage of energy sales, calculated in megawatt hours (MWhs), or installed capacity, calculated in megawatts (MWs), from renewable energy sources (such as wind, solar, biomass and geothermal), or (2) pay a predetermined penalty. The required percentages of renewable energy increase incrementally on an annual basis, beginning from a base year, until an ultimate RPS target is reached.

Renewable Energy Credits or Certificates are a critical component of many successful RPS programs. An REC is tradable documentation that a specific amount of electricity has been generated by a renewable energy source.

Electricity supply companies are required to show compliance with RPS requirements by demonstrating that they have supported an amount of renewable energy generation equivalent to a set percentage of their total annual sales in kilowatt-hours (kWhs).

Electricity supply companies must demonstrate such compliance by taking ownership of a specific number of RECs, either through generating RECs from their own renewable energy projects or purchasing them from renewable energy sources owned by others.

Examples of State RPS

RPS programs vary from state to state. States with the most aggressive RPS include[1] California at 33 percent by 2020, Arizona at 15 percent by 2025, Pennsylvania at 18 percent by 2020-2021 and New York at 24 percent by 2013. New Jersey can also be counted among these renewable energy progressive states.

In New Jersey, renewable energy is regulated by the New Jersey Board of Public Utilities (NJBPU). Pursuant to New Jersey's Electric Discount and Energy Competition Act (EDEC),[2] NJBPU adopted RPS regulations[3] that are among the most aggressive RPS in the nation, requiring New Jersey electricity supply companies to produce 22.5 percent of their electricity from renewable energy sources by 2021.

New Jersey's aggressive approach to renewable energy development is clearly revealed in the solar electric generation portion of its RPS, which until recently required electricity supply companies to generate 2.12 percent of the 22.5 percent 2021 renewable portfolio target from solar energy sources.

On Jan. 18, 2010, the Solar Energy Advancement and Fair Competition Act (the ”Act”), amending the EDEC, was signed into law. Assemblymen Upendra Chivukula and Wayne Deangelo sponsored the Act.[4] The Act imposes significant changes to solar electric generation portion of New Jersey’s RPS structure. These changes include:

- Making RPS a statutory requirement rather than an administrative regulatory obligation;

- Substantially increasing the solar portion of the RPS over prior NJBPU regulatory requirements;

- Extending the solar portion of the RPS for an additional five years beyond prior NJBPU requirements to 2026, with a goal of nearly 5,000 MW of installed solar electric generation;

- The addition of an accelerator provision: If the solar supply exceeds the RPS target for each year for a three-year period all future RPS annual requirements automatically increase by 20 percent.

To comply with the solar electric generation portion of New Jersey’s RPS regulations, electricity supply companies obtain and use a form of RECs offered in New Jersey called Solar Renewable Energy Certificates (SRECs). An SREC represents the environmental benefits or attributes of one MWh of solar electric generation.[5]

Solar electric generation facilities can produce SRECs for a period of 15 years and each individual SREC has a trading life of up to two years before it expires. SREC generators use a Web-based electronic bulletin board platform to sell SRECs to buyers. Interested SREC buyers can also use the trading platform to request an SREC purchase.

Buyers and sellers view postings online and contact each other offline and execute the SREC sale. After the sale is executed, the seller uses the Web site to transfer SRECs to the buyer’s online account. Electricity supply companies also use the Web site to retire SRECs that have been used to meet their RPS requirements.

An electricity supply company that does not pose a sufficient number of SRECs to satisfy the requirements set forth in the solar portion of the RPS must make up for its shortfall by paying a penalty termed a "Solar Alternative Compliance Payment" (SACP).[6]

To further support the increased solar RPS established under the Act, the Act also requires the NJBPU to establish a 15-year SACP. By doing so, the Act provides motivates electricity suppliers to purchase more SRECs over longer periods of time, which in turn strengthens the SREC market and encourages additional solar projects.

Development of a Regional Hybrid Approach to Achieving RPS

Clearly, economics are key driver behind nearly all renewable energy projects. In addition to RECs other economic drivers associated with renewable energy projects include a 30 percent federal Investment Tax Credit (ITC)[7] and a federal Modified Accelerated Cost Recovery System (MACRS) advanced depreciation that allows for a five-year advanced depreciation on 25-year assets.[8]

While these incentives are significant, they are minor in comparison to the value added by RECs under several states’ RPS programs. In New Jersey when SRECs are combined with federal tax benefits (i.e., the 30 percent ITC and five-year MACRS advanced depreciation), the economic viability of many solar energy projects significantly increases.

Even in light of these economic benefits, it seems unlikely New Jersey can achieve its solar RPS goals without an innovative approach to implementation.

One such approach is being undertaken by certain New Jersey counties through the implementation of a regional, public-private partnership to developing renewable energy projects for local government buildings. Local governments generally include municipalities, school districts, counties and municipal or county or other regional sewerage or water utilities, depending on applicable state law.

Morris County, N.J., has taken the lead — and other New Jersey counties are following — in developing a hybrid approach where the county would provide the financing to a private solar developer through a bond issuance.

A conduit county agency, in the case of Morris County — the Morris County Improvement Authority (MCIA), issues bonds supported by the full faith and credit of the county, thereby significantly lowering the cost of capital for these projects.

This is basically a hybridization of the turnkey approach, with financing being provided by the government at the lower cost of capital than a private solar developer would be able to obtain in the private market. Not only does this provide cheaper financing for the solar development community but it preserves their capacity to borrow from their private capital lending sources for other projects.

This regional approach is governed by a public procurement process known as competitive contracting. In Morris County, the MCIA solicited proposals from the solar development community to design, acquire, construct, install, operate and maintain solar systems for the designated local government buildings.

Among other things, the proposals set forth the PPA price that would be charged by the prospective solar developer to the MCIA, which in turn passes on such cost directly to the participating local governments through the license and access agreements.

MCIA then selected the solar developer under a number of evaluation criteria, including lowest PPA price charged to the local governments, ability to perform, financial strength and the degree of security offered back to the MCIA and the county under the program.

By issuing the bonds, the MCIA owns the solar panels for New Jersey law purposes, but structures a lease purchase agreement whereby the benefits and burdens of ownership are passed on to the winning solar developer with the intent that the lessee solar developer qualifies as the owner for federal tax purposes.

If the lease purchase agreement is structured properly, the solar developer, as lessee of the panels for state law, but as owner of the system for federal tax purposes, is entitled to take the 30-percent investment tax credit and advanced depreciation.

The license and access agreement, along with the lease purchase agreement, also provide that the solar developer receives all SRECs generated by the program. In return, the solar developer will make lease payments under the lease purchase agreement in an amount sufficient to amortize the MCIA's bond issue.

Along with the lease purchase agreement, the solar developer enters into a PPA with the MCIA, setting forth the PPA price or prices that are assigned through to the participating local governments, by the MCIA, under the license and access agreements.

Should the solar developer walk away before the end of the transaction — state law permits a 15-year deal — the MCIA, as the direct party to the license and access agreements, receives what the solar developer was previously entitled to (i.e., the PPA price and the SRECs). Note again, that governments can't receive any federal tax benefits.

Consequently, solar developers also are required to put up some sort of security to cover the deficiency between the residual value to the MCIA in such a potential walk-away situation, and the county guaranty, so the county recovers, to the fullest extent possible, any draw on its guaranty.

To the extent all parties perform, the MCIA raises the funds for the solar project, drawn down by the solar developer to design, construct and install the project within the allotted construction period (i.e., approximately one year in the MCIA pilot program, with the queue of projects on the 19 buildings left up to the winning solar developer).

Once the solar project is installed and operational, the solar developer is entitled to the federal tax benefits, and to sell the energy produced from the solar panels through the MCIA to the participating local governments at the PPA price, paid monthly.

The solar developer also can take the SRECs, and if dealing with an electric utility, apply them to meet RPS requirements, or if not, monetize the SREC flow through a contract with one or more electric utilities looking to meet the RPS requirement.

Benefits of the Regional Hybrid Approach

The regional renewable energy pilot program for Morris County is nearing its implementation phase, with proposals having been submitted by the end of November 2009, while several other New Jersey counties are actively pursuing similar endeavors (e.g., Passaic, Somerset and Union), and it is possible that the program could expand statewide. It is also conceivable that, under certain circumstances, the program could be modeled in other states.

This regional hybrid approach to developing renewable energy projects represents possibly the best hope for achieving RPS in New Jersey. Even though the MCIA pilot program involves only solar projects, the hybrid approach can accommodate other forms of renewable energy as well.

Although this hybrid program was structured in New Jersey, to the extent other states with RPS requirements have regional bond-issuing entities and mandatory local government procurement laws, some form of this program might be contemplated by other states as a more efficient model for meeting the various goals and needs of local government, state RPS, the solar development community and the electric utility industry.

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[1] Database of State Incentives for Renewables & Efficiency (DSIRE), Summary Maps, Renewable Portfolio Standards (Oct. 2009), www.dsireusa.org/documents/SummaryMaps/RPS_map.ppt.

[2] Electric Discount and Energy Competition Act, 1999 N.J. ch. 23 (codified at N.J.S.A. 48:3-49 et seq.).

[3] N.J.A.C. 14:8-2.1.

[4] Bill text, as adopted, is available at www.billtrak.net/bt213/billtext/A_3/A_3520I1.PDF.

[5] N.J.A.C. 14:8-2.2.

[6] N.J.A.C. 14:8-2.3(e); N.J.A.C. 14:8-2.10.

[7] The Treasury Department has initiated a program that now allows renewable energy project owners to obtain a grant, in lieu of the ITC, equal to 30 percent of the cost of eligible projects that start construction in 2009 or 2010. Program Guidance, Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009, at § I. Overview (U.S. Treasury Dept. Jul. 2009), www.treas.gov/recovery/docs/guidance.pdf.

[8] Pursuant to the American Recovery and Reinvestment Act of 2009 a 50 percent bonus depreciation is available for eligible renewable energy systems (50 percent of the adjusted basis of the property can be claimed in 2009). See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2009). To qualify for the bonus depreciation a project must: (1) have a recovery period of 20 years or less under normal federal tax depreciation, (2) commence operation at the same time the taxpayer claims the deduction, (3) have been acquired during 2008 or 2009, (4) have been placed in service in 2008 or 2009.