Ontario Energy Association

121 Richmond Street West, Suite 202
Toronto, ON M5H 2K1
416.961.2339
oea@energyontario.ca

BRIEFING NOTE

To: IESO LRP Group

From: Offices of the OEA

Date: Monday, March 9, 2015

cc: Shawn Cronkwright
JoAnne Butler

Subject: OEA COMMENTS ON LRP I VOLUNTARY TERMINATION PROVISIONS

INTRODUCTION

The OEA wishes to offer comments on the outstanding concerns we have in regards to the voluntary termination provisions set out in article 9 of the draft LRP I contract. The nature of our concern and a proposed solution is described below.

OEA'S CONCERN ON LRP I VOLUNTARY TERMINATION PROVISIONS

As it currently stands in the draft LRP I contract, the IESO may terminate an LRP I contract at any time, including once the facility has reached commercial operation. The details of this provision are highly problematic from the perspective of both third-party lenders and equity owners; voluntary termination with no cause at any point in the life of a project is inconsistent with infrastructure practice around the world, and the OEA would like to know if there are precedents the IESO can point to of these provisions elsewhere. The OEA has received a **financial opinion from Mr. Pelino Colaiacovo from Morrison Park Advisors** (*enclosed herewith*) that lays out these concerns in more detail. In brief, the **current provisions will result in added costs being built into the LRP I RFP proposals** as both lenders and equity owners seek to protect themselves in the event of voluntary termination – costs that will ultimately be borne by the province's ratepayers. As the opinion makes clear, it is questionable whether the voluntary termination provisions – whose presumed purpose is to maximize the IESO's flexibility in efficiently managing contracts for the benefit of ratepayers – actually succeeds in doing so when compared to the alternative or status quo options. The OEA emphasizes that **it is not reasonable to believe that the proposed voluntary termination provisions would be a cost-free addition to the LRP**, and that it is not at all clear what benefit for ratepayers is being purchased at this cost.

OEA'S CONCERN ON CONSULTATION PROCESS

The industry has not had sufficient opportunity to consult with the IESO on means to resolve this critical issue and is still awaiting further information from the IESO on its rationale for including the proposed voluntary termination provisions. In particular, there have been various groups and Qualified Applicants who have raised questions with the IESO about:

- References IESO staff have made regarding how voluntary termination provisions in other sectors are worded so as to not interfere with the ability to raise capital (or negatively impact the associated cost of capital);
- The specific reasons the IESO feels the kind of language used in the draft LRP I contract is necessary; and
- What the IESO's expectations are in terms of how generation owners will be fairly compensated for all costs plus lost revenues and profits under the contract in the event of voluntary termination.

Answers to these questions would have been extremely helpful to enhancing the sector's understanding of how the IESO reached the conclusions it did with regard to voluntary termination, and it is regrettable that this information has yet to be provided.

RECOMMENDED SOLUTION

The OEA respectfully requests that the draft LRP I Contract **provisions permitting voluntary termination at any time be replaced by an approach substantially similar to that of the FIT contract, which allows for termination only until the IESO issues notice to proceed** to the supplier. This change would be the easiest way to assuage the concerns of both lenders (whose financing would be made contingent on NTP being issued) and equity partners (who would receive far greater assurance that, once built, their project could operate commercially and potentially be monetized), and would ultimately be beneficial to the ratepayers of Ontario. Recognizing the need to move forward with the finalization of the LRP I RFP and contract, the OEA recommends that the IESO proceed to issue these documents on March 10 as scheduled, and then use addenda to resolve outstanding issues (such as the precise wording of the voluntary termination clause) through consultation with the Qualified Applicants.

MPA Morrison Park Advisors

150 York Street, P.O. Box 21,Suite 1610,
Toronto, ON, M5H 3S5
T: 416.861.9753 **F:**416.861.9614
www.morrisonpark.com

Memo

To: Tina Arvanitis, Ontario Energy Association

From: Pelino Colaiacovo, Morrison Park Advisors

Date: March 3, 2015

Re: Comment on proposed "Voluntary Termination" clause in the Draft LRP, from a financial point of view

---

Morrison Park Advisors was asked to review the Voluntary Termination clause of the proposed contract for the LRP (s. 9.6 of the November 17, 2014 draft of the Large Renewable Procurement I Contract). We considered the proposed terms and conditions from a financial point of view – relating to both debt and equity financing – based on our experience with electricity generation development projects and the market for electricity generation assets.

Summary

- Debt providers should be concerned about the clause in its current form. While the Voluntary Termination clause as written suggests that the IESO has taken into account the economic interest of secured lenders, the clause as written does not guarantee that these lenders will *actually receive* their amounts owing in the event of Voluntary Termination, since all payments are made to the project owners, who may or may not be able or willing to pay secured lenders 100% of their amount owing (e.g., in the case of insolvency of the project owner upon Voluntary Termination). Failure to address this issue in the final version of the contract could mean that secured lenders may be unwilling to finance LRP projects, may require dramatically more onerous covenants for the protection of their investment which hinders the ability of developers to complete efficient projects, or could mean that LRP projects would not have access to the low-cost debt that would otherwise be expected.
- Equity providers face even more significant challenges arising from the Voluntary Termination clause. While the clause as written states that compensation will be paid to equity owners according to the Financial Model used for the purpose of securing debt financing, this outcome may in fact be punitive to equity investors, and incent them to significantly increase their required levels of return, and hence the price of their LRP projects. Three issues are of particular concern: the Financial Model used for the purposes of debt typically does not include any project value beyond the expected length of the secured financing; the model does not address the

opportunity for the project developer/owner to monetize some or all of the project post-COD at a higher level of return than included in the financial model; and it assumes that project owner(s) at the time of any Voluntary Termination has the capability to efficiently manage the winding up and decommissioning of the project.

- The sharp distinction drawn by the proposed Voluntary Termination clause as written as between secured lenders and equity providers creates the incentive to maximize the amount of secured lending in a project, and minimize equity. This would particularly be relevant to the allocation of capital as between junior secured lenders and equity. This incentive created by the Voluntary Termination clause could result in projects which are financially weaker and less stable, and in fact more prone to insolvency than would otherwise be the case.
- Assuming that the purpose of the proposed Voluntary Termination clause as written is to maximize the Buyer's flexibility to manage contracts in an efficient manner for the benefit of ratepayers, it is questionable whether the clause succeeds in fact as compared to the alternative status quo (e.g., either no clause, or the version of the Voluntary Termination clause embedded in the FIT contract, which applied only until NTP). Contracts can always be terminated by one party, given reasonable compensation (whether resulting from amicable negotiation, arbitration, or court decision). The codification of contract termination through the proposed Voluntary Termination clause creates the perception that termination is more likely than it otherwise would be, which will result in all stakeholders taking steps to minimize their future exposure. Those steps *must be assumed* to be costly to the LRP process as a whole. It is not reasonable to believe that the proposed Voluntary Termination clause would be a cost-free addition to the LRP, and it is not at all clear what benefit for ratepayers is being purchased at this cost.

Overview

The LRP process is intended to procure a number of renewable energy-based electricity generation projects for the Province of Ontario. The most recent version of the draft contract proposed to be used in this process is dated November 17, 2014, and was reviewed for the purpose of this note.

A new feature in this draft contract as compared to previous electricity generation procurements in Ontario is the proposed Voluntary Termination clause (s. 9.6 of the draft contract). While a termination clause was included in the FIT contract, that clause was limited in application to the period prior to a contract holder having been given Notice to Proceed ("NTP"). After NTP, termination of a contract was only allowed based on defaults specified in the contract. Any other termination would rely on typical common law provisions dealing with contract breaches and breakdowns, and might encompass negotiation, arbitration or court actions, on a case-by-case basis.

The proposed Voluntary Termination clause in s. 9.6 is much, much broader than the clause in the FIT contract. Termination by the buyer is proposed to be allowed at any time during the life of the contract, for any reason at the sole discretion of the Buyer (i.e., the IESO). Since termination could occur after NTP, either during construction or after completion of the project and commencement of operation, the clause would affect not only the interests of a project developer, but also project lenders, construction equity providers, and future potential buyers of equity or debt securities in a project.

Given the scope of the Voluntary Termination clause, it is considerably more detailed than the termination clause in the FIT contract, and goes to some length to specify its operation with respect to different possible stakeholders (e.g., senior secured lenders, junior secured lenders, project suppliers, project employees, equity holders, etc.).

This proposed clause, like all terms and conditions of a contract, affects the balance of incentives, risks and potential rewards created by the contractual arrangement. It affects the value of the assets in question, and the cash flows that should be expected, as well as the market for securities that might arise from the contracts. As a result, the clause also has an impact on the expected cost of the generation projects that will be developed by the contract, and hence it has an impact on the ratepayers who will ultimately pay all of the costs.

Impact on Debt Providers

Renewable energy projects over the past ten years have benefited from a healthy debt market where lenders have provided very low cost long-term financing for many projects contracted by the Ontario Power Authority/IESO. Debt providers have considered such projects to be safe and attractive investments because of the credit quality of the Buyer, the long length of term, and the well-understood nature of the construction and operation risks of the various renewable energy technologies in question. Debt providers have accepted both construction risks and long-term operating risks by providing packaged debt arrangements, and have protected themselves through a variety of typical covenants and restrictions on developer and operator behavior.

In the case of RFP and FIT contracts, debt providers benefited from the certainty of their investment terms, since contracts could only be terminated upon project default, and debt covenants typically contained provisions which would help prevent default conditions from arising (by, for example, allowing secured creditors to take over troubled projects at a point prior to contractual default).

The proposed Voluntary Termination clause upsets this debt market by introducing an unknown and arbitrary risk: contracts could be terminated for any reason, at the whim of the Buyer, at any time during the term of the contract. Debt providers can no longer count on a long-term arrangement, but in fact could be forced to exit a project at any time, based not on the economic failure of a project but on any other factor outside the project's or lender's control.

The Voluntary Termination clause seeks to minimize disruption to the secured debt market by providing for compensation in the event of termination (see s. 9.6(b)). The "Voluntary Termination Sum" would specifically include both outstanding "Debt Amounts", but also "Makewhole" amounts (which are penalty clauses for early termination typically built into debt arrangements). Presumably, these provisions are meant to reassure debt providers that the impact on them of the Voluntary Termination clause would be minimal.

However, a critical issue is that the debt portion of the Voluntary Termination Sum is paid **NOT** directly to debt providers, but to the project owners. This is in keeping with the overall restriction in the proposed contract on any direct relationship between the Buyer and debt providers (see Article 11 in general, and s. 11.1 (c) and (d) specifically). This indirect relationship between the Buyer and secured lenders for the purposes of the Voluntary Termination clause creates a risk that the lenders may not receive their compensation for termination of the contract, for example if voluntary termination were to create an insolvency of the project owner. In such a case, the secured lender would become part of an insolvency process with unpredictable results.

If this lack of certainty is not cured, it could lead to lenders dramatically revising their view of the credit quality of LRP projects. They could choose to not fund such projects, or to dramatically increase their costs of credit in order to insure against such events of default. In either case, the impact on the cost of the LRP process could be significant.

Even if this issue were addressed in a future draft of the LRP contract (and a specific provision for direct payment of secured creditors is included), voluntary termination would still be a significant inconvenience to lenders who had planned on a long-term arrangement (presumably, lenders are entering into these arrangements because they have a need for the length of term being offered in the contracts). Since the existence of a Voluntary Termination clause makes it appear that early termination is more likely than it otherwise would be, this may cause lenders to protect themselves by tightening the terms or increasing the price of their debt, or enlarging the penalties in their Makewhole provisions.

Impact on Equity Providers

Equity providers are treated as a single group by the proposed Voluntary Termination clause, but comprise at least three flavours: development equity, construction equity and long-term equity (with a fourth possible group being redevelopment equity). Sometimes all three types of equity are provided by a single investor, while in other instances a group of equity providers may be involved either simultaneously or at different times through the life of a project. In the pre-NTP phase of a project, only development equity is at stake. During the construction phase of a project both development and construction equity are involved, while after COD long-term equity may replace the first two categories in whole or in part.

The Voluntary Termination clause includes a proposed payment to equity, as it does for debt providers. The calculation of this depends on a variety of factors, each of which is enumerated in the clause. Three aspects of this calculation are particularly challenging.

First, the basic assumption is that the equity component of the Voluntary Termination Sum will be based on the equity IRR calculated by the Financial Model used for debt purposes at the time of Financial Close of the project. Financial models for financial close are designed to satisfy debt providers that their investment in a project is sound and secure. The models typically cover the life of the debt instrument, and are not necessarily designed to calculate the expected return on the full life of the project itself. Projects can have lives which are longer than the debt arrangement (and in fact can be longer than the contract as well), and which would then return additional value to equity holders.

Second, the Financial Model used for debt purposes is not necessarily representative of the expectations of any specific equity provider (whose identity may change over the course of the project, as discussed above). For example, development equity providers may expect to earn a much higher return by developing the project and then monetizing their investment post-COD, when the project has been substantially de-risked. At best, the Financial Model represents an average equity return over the life of the debt instrument (which might also not be representative of the full life of the project). In the event of an early Voluntary Termination, the development or construction equity providers might therefore be under-compensated by the calculation, while after COD and the entry of a long-term equity investor, the calculation may provide compensation that is greater than the expectations of the then current equity provider. A further complication is that in most instances returns to equity are uneven over time, because of the effect of various tax benefits. As a result, using the average equity IRR from the debt model would provide an unpredictable relationship to the actual equity return to the project to date at the time of the Voluntary Termination.

Third, the calculation called for in the proposed Voluntary Termination clause calls for the owner of the facility at the time of termination to reduce the net amount payable by providing Fair Market Value for all of the assets of the project that are released for other uses by the termination of the contract. This implies, for example, salvaging and reselling equipment from the project, selling land or land rights, etc. While it may be reasonable to assume that development equity investors may be able to perform such functions efficiently, it may not be a fair assumption that a long-term equity investor would be in that position (particularly if the project has changed hands after COD). The risk of this occurrence becomes a value issue for any potential long-term investor (whether part of the initial investor group or a future buyer), and goes directly to the issue of market value and expected return on the asset.

It should be clear from this analysis that the existence of the proposed Voluntary Termination clause creates incentives for changed behavior by equity providers, and higher prices for LRP projects. Increased risks for long-term equity providers may significantly reduce the number of investors interested in buying projects post-COD, which would in turn reduce opportunities for development and construction equity providers to monetize their assets at attractive valuations, which would force them to seek higher prices for the projects as a whole in order to meet their investment objectives.

Impact on Capital Allocation

As discussed above, capital for renewable energy projects can come in a variety of flavours, not only divided between debt and equity, but also including various types of debt and equity (senior vs. junior, development vs long-term, etc.). For any given project, the most efficient allocation of capital requirements among these categories results from the free interaction between the owners of the project and the capital markets: buyers willing to pay the highest price for a particular slice of the capital are likely to be the most efficient users of that project interest.

The proposed Voluntary Termination clause, by specifically identifying various types of capital and placing different benefits and burdens on them, rearranges the financial incentives for projects, with potential consequences for project cost and efficiency. For example, by creating a strong distinction between junior debt and equity (with junior debt having a far stronger degree of protection under the proposed clause), project developers/owners are incented to maximize the amount of junior debt in the project. This may cause the project to be financially less stable than it otherwise would be, and could increase the likelihood of insolvency in the event of a Voluntary Termination (which will complicate the orderly winding up of a project in those circumstances, and could create complications for the IESO). Depending on specific circumstances, projects could be incented to develop “creative” refinancing strategies with exotic securities to take advantage of the incentives created by the Voluntary Termination Sum formula, which may not be to the benefit of the Buyer or the Province as a whole.

Cost Implications for the Buyer

All contracts can be terminated at any time. An established body of law and practice surrounds contracts, and there are proven and sound mechanisms available to manage contract breakdown and termination, including negotiation, arbitration and court action. These processes are not necessarily easy, and are often expensive, which creates incentives for both parties to a contract to fulfill their obligations and avoid contract breakdown. The proposed Voluntary Termination clause seeks to make the process of contract termination much easier and transparent for the Buyer. The consequences of contract termination, in the form of the Sum to be paid by the Buyer, may or may not be greater or lesser than what would result in any specific case of contract breakdown managed through traditional means, but the process to get there would undoubtedly be faster and simpler. The perception of this change is unavoidable: the proposed Voluntary Termination clause makes it appear that contract termination is more likely than it otherwise would be. The developer community and the capital markets *WILL* adjust to this perceived change, in a variety of ways including those outlined above, many of which could result in the contracts being more expensive than they otherwise would be absent the proposed clause.

Presumably, the purpose of the proposed Voluntary Termination clause is to maximize the ability and flexibility of the Buyer to efficiently manage the contracts, and minimize the total cost to ratepayers. However, it is not at all clear that the proposed clause is actually cheaper than the alternative of no clause, or a clause similar to the FIT termination clause (which applied only to the pre-NTP period).

The proposed clause can be thought of as a form of insurance for the Buyer with respect to contract termination. Without the proposed clause, the Buyer would have to accept the consequences of traditional mechanisms related to contract termination (such as court costs and the judgments of courts with respect to compensation in any given case). With the proposed clause, the Buyer faces an easier process should it choose to terminate a contract in the future, but in the meantime the Buyer must face the costs and consequences of every developer and capital provider adjusting to the existence of the clause. Like any form of insurance, the Buyer is paying up front in real current dollars for an eventuality which may or may not occur.

Insurance is considered well-priced if the up-front payment is equal to the costs of the insured event multiplied by the risk of occurrence of the event (plus administrative costs for the insurance). In the case of the proposed clause, there is no way of knowing what any of these terms actually are: it is not clear what the total costs to the projects will be as developers and capital providers adjust to the reality of the proposed clause, and there is no way of knowing the risk of the Buyer actually making use of the clause in the future. Any observer would be concerned that the proposed clause has absolutely no limits, and that renewable energy is currently subject to politically charged debates. It would not be unreasonable to conclude that in the future a different political environment could result in a desire to terminate contracts en masse or in particular regions of the province, and the proposed clause would provide a procedurally easy way to accomplish that outcome (if expensive given the Termination Sums that would have to be paid). Given the uncertain future, and the impossibility of measuring or quantifying the risk of future termination of contracts, capital markets would have little choice but to assume that the risk is significant, and act accordingly.

From the perspective of the Buyer, the immediate cost of the proposed clause is uncertain and cannot be properly estimated, because it depends very much on how project developers and capital providers react to its imposition in their pricing behavior (which will not be known until project bids are submitted). However, it is clear that there *will* be costs from the imposition of the proposed clause, based on the analysis above.