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Impact of the Delayed PJM Base Residual Auction on Excess Cash Flow Sweeps Under Construction Financings

In a July 25, 2019 order, the Federal Energy Regulatory Commission ("FERC") directed PJM Interconnection, L.L.C. ("PJM") not to conduct the Base Residual Auction ("BRA") to procure capacity for the 2022-2023 delivery year in August and instead to wait until FERC prescribes a remedy for the flaws in PJM's buyer-side market mitigation rules identified in its June 2018 order.[1] The delay of PJM's BRA may have unintended—and, from a sponsor's perspective, unfortunate—implications under existing construction financings for certain recent gas-fired combined-cycle generation projects in PJM, and may force the postponement of new financings and refinancings for projects in PJM. The absence of PJM's BRA results also has potential implications for valuing acquisitions and valuing bilateral capacity trades that have fixed or floating swap components.

Over the course of the past year, we have seen certain transaction documents that contain market disruption provisions addressing a scenario in which PJM's BRA results are not available, but such provisions appear to be much less prevalent in credit agreements. The absence of PJM's BRA results for purposes of calculating the "target debt balance" under such credit agreements may result in "artificially" increased excess cash flow sweeps starting with the third quarter of 2019 when the rolling three-year aggregate projected capacity revenues include the first material period impacted by the delay. Proactive sponsors and lenders will review their credit and hedge agreements with their counsel to ascertain the potential impact on excess cash flow sweep obligations and valuations and will initiate discussions to discuss and resolve (by amendment or otherwise) any unintended consequences resulting from the delay in (or suspension of) PJM's BRA.

BACKGROUND

In its June 2018 order, FERC found PJM's capacity market rules to be unjust and unreasonable because they did not adequately address the price-suppressive effect of subsidized new and existing resources. FERC established a "paper hearing" to consider changes (*i.e.*, a "replacement rate") that would remedy these flaws.[2] That paper hearing concluded with the filing of responsive pleadings and testimony in early November 2018. In a separate order issued in August 2018, FERC granted PJM's request to delay the 2022-2023 BRA, originally scheduled to be held in May 2019, until August 2019.[3]

FERC has not yet issued an order on the merits of a potential replacement rate, and the July 25th order gives no indication as to when it may act, stating only that "delaying the auction until the Commission establishes a replacement rate will provide greater certainty to the market than conducting the auction under the existing rules."[4]

EXCESS CASH FLOW SWEEP BASED ON DYNAMIC TARGET DEBT BALANCE CALCULATIONS

Recent term loan A construction financings for projects in PJM determine the amount of excess cash flow applied to prepay the loans for a given quarter using a dynamic calculation based in part on the results of PJM's BRA. The excess cash flow sweep is typically equal to the amount required to achieve the lesser of a target debt balance of outstanding term loans based in part on (a) the "base case" BRA results set forth in the agreed-upon financial model at closing (often called the "Target A Debt Balance" or something similar) and (b) the actual BRA pricing results (often called the "Latest BRA Results" or something similar), which are used to determine the rolling three-year aggregate projected capacity revenues of the project and calculate a dynamic target debt balance of outstanding term loans (often called the "Target B Debt Balance" or something similar).

Lenders treat PJM's BRA results as a three-year rolling capacity contract with a creditworthy offtaker. However, if PJM's BRA results produce aggregate projected capacity revenues that are worse than the "base case" reflected by the Target A Debt Balance, then the target debt balance toggles to the Target B Debt Balance calculation and the excess cash flow sweep increases to reflect the deterioration of the project's revenue outlook (*i.e.*, more cash flow is used to repay debt and less cash flow is available for distributions).

CALCULATION OF TARGET B DEBT BALANCE IN THE ABSENCE OF BRA RESULTS

As noted above, the credit agreements that feature Target B Debt Balance mechanics do not typically address a situation where PJM's BRA results are unavailable.

Without PJM's BRA results to "plug into" the calculation, the determination of the Target B Debt Balance and therefore the amount of the excess cash flow sweep for a given quarter are, at best, uncertain and, at worst, artificially increased (*e.g.*, zero capacity revenues might be attributed to the affected period, resulting in a lower Target B Debt Balance, or the Target B Debt Balance might be indeterminate, an outcome that is not addressed under the credit documentation).

Depending on whatever replacement rate FERC eventually approves, the clearing prices may or may not be higher than such capacity prices would have been under PJM's existing capacity market rules. Since it seems almost certain that PJM's BRA will eventually be run, attributing zero capacity revenues to the affected period or concluding that the Target B Debt Balance is indeterminate could result in artificially increased excess cash flow sweeps beginning with the third quarter of 2019. The payment for such amounts at the level in the cash flow waterfall for mandatory prepayments means less funds for the subsequent levels of the waterfall—notably, less funds available to sponsors as returns on their equity investment.

CONCLUSION

In light of the potential issues described above, sponsors, lenders, and counterparties to derivative and hedging transactions should proactively discuss the impact of the delay of PJM's BRA and work towards a consistent approach across the affected construction financings of projects in PJM.

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[1] See *Calpine Corp. v. PJM Interconnection, L.L.C.*, 168 FERC ¶ 61,051 (2019) (July 2019 Order).
[2] See *Calpine Corp. v. PJM Interconnection, L.L.C.*, 163 FERC ¶ 61,236 (2018).
[3] See *PJM Interconnection, L.L.C.*, Order Granting Waiver, 164 FERC ¶ 61,153 (2018).
[4] July 2019 Order, 168 FERC ¶ 61,051, at P 14.