

## Client Alert

April 12, 2017

“Although SREC-backed loans share many similarities with traditional asset-based financing, the complex nature of this asset class presents unique risks to lenders.”

## Encouraging Solar Development Through SREC Financing

By Jennifer K. Grady and Kevin Rubinstein

The promotion of renewable energy has been an important policy goal at the state and federal levels in recent years, and public support for solar energy in particular has driven a significant increase in installed solar capacity across the United States. There are numerous federal, state and local tax incentives which encourage consumers, businesses and utilities to increase renewable energy consumption, and solar developers offer attractive financing opportunities for consumers and businesses considering the installation of solar panels to reduce their electricity costs. More recently, solar developers themselves have begun to explore financing opportunities related to another solar incentive program, Solar Renewable Energy Certificates/Credits (“SRECs”), which can provide a valuable source of liquidity for developers and other owners of solar projects. In this article, we discuss the use of SRECs as a source of financing, and we explore the key legal and business issues raised by such a financing structure.

### BACKGROUND: WHAT IS AN SREC?

An SREC is a tradable regulatory commodity created as part of an incentive program developed in certain states to promote the development of solar energy capacity. These states have enacted Renewable Portfolio Standard (“RPS”) legislation, which mandates that electric utilities obtain a specified portion of their energy from solar or other renewable energy sources. Utilities that are unable to meet the RPS requirements through the production of their own renewable energy must either purchase SRECs to fulfill those requirements or pay a fee to the state equal to the then-current “alternative compliance payment”.

In participating states, the state renewable energy authority will grant the owner of a certified and registered solar project one SREC for each 1,000 kilowatt hours of electricity generated by that project. SRECs are generated, or “minted”, electronically into an account maintained with the relevant state authority. SRECs, like certificates representing other types of renewable energy, can be sold separately from the electricity generated by the solar power project and are typically traded on established regional markets throughout the United States. Utilities subject to RPS requirements provide a ready market for SRECs, with the price of an SREC largely determined through market forces and typically capped at the relevant state’s then-current alternative compliance payment.

Solar developers or other project owners often enter into long-term forward sale agreements (“SREC Contracts”) with utilities pursuant to which the project owner agrees to deliver SRECs in the future at prices agreed upon at the time of execution of the SREC Contract. SREC Contracts therefore generate a predictable stream of income for the developer and facilitate the utility’s compliance with its state’s RPS requirements. They also represent an asset against which some lenders are willing to extend credit.

## SREC FINANCING STRUCTURE: KEY ISSUES

Over the past few years, certain lenders have developed a sophisticated understanding of SRECs and RPS programs and have begun financing SRECs on a standalone basis. Under an SREC-backed loan, lenders are repaid as the solar developer sells SRECs and receives payments under the related SREC Contracts. SREC financing can be attractive to solar developers because it allows them to retain traditional corporate and project-based financing secured by the underlying solar projects and electrical output, while accessing an independent source of liquidity. Although SREC-backed loans share many similarities with traditional asset-based financing, the complex nature of this asset class presents unique risks to lenders.

- **BANKRUPTCY ISSUES**

As in a traditional asset-backed financing, the solar project owner will typically form a special purpose bankruptcy-remote entity to act both as borrower under the SREC-backed loan and seller of SRECs under the SREC Contracts. The project owner or its affiliates will transfer SRECs and the right to receive future SRECs from specific solar projects to the borrower while, in some cases, retaining ownership of the underlying solar projects and electrical output. Separately, all rights under existing SREC Contracts will be assigned to the borrower entity. It is critical that lenders take all steps necessary to ensure that the right to receive future SRECs, and

the right to receive payments under SREC Contracts, have been irrevocably transferred to the borrower in order to mitigate any risk that a bankruptcy at the parent company level will impact the lender’s rights with respect to its sole source of payments. Lenders will typically request a true sale opinion to reinforce the expectation that SRECs will be treated as property of the borrower in any bankruptcy of the affiliated entity that has transferred SRECs or SREC Contracts to the borrower, as well as a non-consolidation opinion with respect to the borrower and the affiliated project owner to support the argument that the bankruptcy remoteness of the borrower will be respected in any affiliate bankruptcy. The unique nature of SREC collateral weighs in favor of taking additional steps to support the “true sale” nature of the transfers are respected, including the implementation of irrevocable forward transfers and direct minting under the relevant electronic tracking system.

- **SECURITY INTEREST PERFECTION ISSUES**

Under an SREC-backed loan, SRECs generated by the applicable solar projects along with the rights to payment under the SREC Contracts are pledged as collateral to the lender. Although not specifically addressed as an item of collateral under the Uniform Commercial Code, an SREC likely constitutes a “general intangible”, which is a category of personal property covering assets such as contract rights and certain other assets not specifically enumerated under the code. A lender will enter into a security agreement pursuant to which the borrower grants a lien on its rights to the SRECs and the proceeds thereof. Although the steps to create and perfect a security interest in the SREC collateral are similar to a typical “all assets” financing, lenders should have familiarity with and knowledge of SREC markets and trading to ensure that appropriate steps are taken to protect their security interests beyond the initial loan documentation.

- DILIGENCE ISSUES

As part of the initial due diligence process, lenders and their counsel should carefully review any existing debt facilities at the project owner level and the corporate parent level to ensure that SRECs produced by the relevant solar projects are not subject to existing liens. In addition, lenders and their counsel should review the documentation governing the chain of title to the applicable solar projects in order to confirm that the entity purporting to transfer SRECs to the borrower actually has clear title to the SRECs and the authority to make such transfer, especially given the typically complex nature of various financings supporting the underlying solar projects. Finally, lenders should understand the terms of SREC Contracts, including the circumstances under which utilities may be able to terminate the contract or request additional credit support from the borrower.

- MAINTENANCE AND SERVICING

Borrowers generally rely on their parent companies for maintenance of the underlying solar panels, reporting of electricity production to regulators, monitoring of SREC production, delivery of and invoicing for SRECs, and other administrative services. This creates a tension between lenders who depend on the parent entity to facilitate production and transfer of SRECs to generate revenue and the project owners who expect non-recourse financing at the borrower level. Lenders and project owners may resolve these competing concerns through limited recourse or limited guarantee arrangements which ensure that the lenders have some recourse against the parent entity for specified breaches of its servicing obligations or lack of production while simultaneously limiting the overall exposure outside of the borrower entity. Lenders should be sensitive to the risk that a bankruptcy or other business disruption at the parent level could impede the production of SRECs if the parent fails to perform maintenance or reporting obligations.

- BORROWING BASE

SREC-backed loans are typically funded and maintained in accordance with a borrowing base calculated based on SREC prices established in the market or under SREC Contracts. An advance rate for borrowings will be determined based, among other things, on the creditworthiness of the counterparty to the SREC Contract. From a business perspective, lenders must be comfortable that the expected SREC production level, expected cash flows under SREC Contracts or future SREC sales, and the advance rate under the financing, together create a structure that supports the lender's investment.

## CONCLUSION

The unique nature of SREC collateral weighs in favor of a careful re-examination of traditional financing structures in order to ensure that lenders maximize their rights and minimize their risks in a downside scenario. The time horizon of this asset class may be limited, given that most states intend to phase out SREC incentive programs as solar installation continues to increase. However, in the interim, SRECs can be a valuable source of current liquidity for solar project owners who are willing to spend time and resources to establish best practices that will support multiple financings, and can provide attractive investment opportunities for lenders with the capacity and willingness to understand and invest in the asset class.

## QUESTIONS

If you have questions regarding the matters discussed in this client alert, please call your usual contact at Kibbe & Orbe LLP or the person listed below.

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