Staff Report Item 14

TO: East Bay Community Energy Board of Directors

FROM: Howard Chang, Chief Operating Officer

SUBJECT: **Prepay Transaction (Informational Item)**

DATE: May 19, 2021

Recommendation

Receive an overview of energy prepay transactions and an update on the preparation for a prepay.

Background and Discussion

Prepay Overview:
An energy prepayment – or 'prepay' – is a long-term financial transaction available to municipal utilities and tax-exempt entities such as CCAs that enables a meaningful power procurement cost savings opportunity. Utilizing the municipal bond market, a tax-exempt Load Serving Entity (LSE, also called "Prepay Buyer") and a taxable financial counterparty (bank, called "Prepay Supplier") enter into a 30-year agreement through which the LSE assigns existing power supply contracts to the Prepay Supplier. The Prepay Supplier pays the contract price to the PPA provider, while the LSE pays the Prepay Supplier at a discounted rate. The discounted rate is agreed upon in the prepay documents and is based in part on the spread between the taxable and tax-exempt bond interest rates. The market availability of this interest rate spread is critical to the savings opportunity available to an LSE through a prepay.

Tax-exempt bonds are issued by a third-party conduit to raise funds for the prepay transaction, which flow to the Prepay Supplier. The LSE does a limited assignment of the PPA to the Prepay Supplier. The LSE is required to continue to perform under the contract, while maintaining rights to the electricity and attributes under the PPA. The Prepay Supplier utilizes the bond funds and provides a discount on the PPA to the LSE based on the spread between the taxable and tax-exempt rates. The discount is estimated at 5-15% but is subject to change based on market conditions. The bonds are also repriced and reissued every 5-7 years to optimize the spread over the 30-year life of the transaction. This process exists to maximize the available discount over the 30 years.

The total combined notional value of the assigned contracts flowing through the prepay over the 30 years is typically in the range of $600-$800MM, though may be higher dependent upon the California bond market appetite; these contracts can be long-term renewables PPAs or commodity supply contracts. While the contracts are assigned to the Prepay Supplier, the LSE continues to ultimately take and pay for all the energy and attributes delivered through the contract; all other terms of the PPA remain unchanged. If the prepay program terminates early for any reason – either the Prepay Supplier or the LSE fail to perform – the LSE forgoes future savings and the assigned PPA is put back completely to the LSE.

Two key features of the municipal bonds utilized in a prepay greatly reduce risk to the LSE. First, the bonds are non-recourse to the LSE, meaning they are neither secured nor guaranteed by the LSE; in other words, EBCE will at no point be responsible for repaying the bonds. Secondly, prepays are off balance sheet for the LSE as the bonds are issued by a third-party conduit.

Ultimately, prepays are employed to save ratepayers money while maintaining both (a) the economics for the PPA provider and (b) the terms of the energy supply contract. They have been used for natural gas transactions in the US since the early 1990s, with over 90 transactions completed nationwide ($50+ Billion) and 11 transactions completed in California ($5.7 Billion). The same tax law[1] and similar transaction structure that enables the natural gas prepays enables the program for electricity, and specifically renewables contracts, creating an opportunity for CCAs to provide renewable energy at a lower cost than the IOU competition.

Solicitation Processes:
EBCE and Silicon Valley Clean Energy (SVCE) jointly issued a solicitation in November 2019 to identify potential Prepay Suppliers, through which Morgan Stanley was shortlisted and selected. The two CCAs also jointly issued a solicitation in June 2020 for the counsel roles, through which Orrick, Herrington & Sutcliffe and Chapman & Cutler LLP were selected. Both firms have significant experience representing parties on prepay transactions since the market inception in the 1990s, and both firms are industry leaders in serving the roles for which they've been selected for the EBCE-SVCE prepay. Lastly, to advise on this complex financial structure and to ensure compliance with Municipal Securities Rulemaking Board (MSRB) requirements, EBCE and SVCE issued a solicitation for a municipal financial advisor in September 2020, through which PFM Financial Advisors was selected. PFM also supported staff in the scoping, issuance, and interviews for the Prepay Supplier solicitation.

[1] Codified in US Tax Law. Since first prepayments of natural gas were done in the early 1990s, the IRS issued rules allowing tax-exempt prepayments and Congress enacted legislation specifically allowing the transactions (National Energy Policy Act of 2005; Section 1327).

Prepay Parties:
The prepay transaction requires the selection and involvement of multiple parties. Names and functions are as follows:

Prepay Buyer: East Bay Community Energy and Silicon Valley Clean Energy, jointly

- Role: Provide energy contracts to flow through prepay

Prepay Seller: Morgan Stanley

- Role: Structure transaction and pay contract price to PPA provider
- *Note: No legal obligation or liabilities are being entered into currently; approval of counsel allows EBCE to negotiate documents with Morgan Stanley for which staff will later return to the Board for approval of the official prepay transaction and associated bond issuance.*

Financial Advisor: PFM Financial Advisors, LLC

- Role: Advise Prepay Buyer in negotiations

Bond Counsel: Orrick, Herrington & Sutcliffe

- Role: Represent bondholders

Tax Counsel: Orrick, Herrington & Sutcliffe

- Role: Provide tax opinion on transaction

Issuer's Counsel (*also known as Prepay Counsel or Prepaid Counsel*): Chapman & Cutler LLP

- Role: Represent issuer's interests, supporting drafting and negotiating terms of prepay agreement and associated energy supply agreements

Disclosure Counsel: Chapman & Cutler LLP

- Role: Prepare Official Statement / Prospectus

Bond Issuer: California Community Choice Financing Authority JPA

- Role: Issue municipal bonds for prepay
- *Note: This is the JPA of which the EBCE Board approved formation and membership in the April 2021 regular board meeting. It will initially consist of the four Founding Members of EBCE, SVCE, Marin Clean Energy, and Central Coast Community Energy.*

Timeline:
Since Fall 2020, staff has been working with SVCE, PFM, and counsel on structuring a prepay transaction and negotiating documents with Morgan Stanley. Documents should be prepared for a deal execution in the coming months, seeking Board approval as soon as June.

Two factors may delay or extend this timeline, however. First, market conditions must enable a meaningful spread between taxable vs. tax-exempt bond interest rates to achieve the discounts we are seeking. The marketing and execution of the prepay will be dependent upon the appropriate market conditions which have started to improve after nearly a year. Second, power contract assignment consents will need to be executed by PPA providers. Once the transaction structure is determined, staff will identify contracts to assign and go to the respective counterparties for assignment consent; should the counterparties be slow to consent, this could extend the timeline of deal execution.

Financial Impacts

There are no financial impacts associated with this informational item.

It is important to note, however, the financial benefit available through the prepay. It is estimated to achieve an 5-15% discount per year on power quantities delivered under the structure, compared to the assigned contracts. The savings are net of all the transaction fees, fees which are also contingent on the deal closing. The exact discount will be dependent on the spread between taxable and tax-exempt debt rates. While savings are not guaranteed in the structure, there is no negative financial impact associated if the deal does not produce targeted savings levels.

The specific details of the prepay agreement currently being negotiated with Morgan Stanley will be brought to the Board when staff seeks approval of the transaction.

Attachments

A. Presentation

Attachment Staff Report Item 14A

MAY 19, 2021

Prepay Transaction Overview

EAST BAY COMMUNITY ENERGY

Prepay Overview

- An energy prepayment is a long-term non-recourse financial transaction between a tax-exempt Load Serving Entity (LSE) and a taxable financial counterparty (bank, called “Prepay Supplier") utilizing the municipal bond market.
  - Bond notional is expected in the ~$600MM-$800MM range
  - LSE utilizes prepay in order to lower customer energy costs
- Municipal utilities (and tax-exempt entities such as CCAs) in the US can prepay for a supply of electricity or natural gas from a taxable entity and fund that prepayment with tax-exempt municipal bonds. The LSE must sell the commodity to their retail end-users residing within their traditional service area.
  - This structure is well known and regularly used for gas and is now being applied towards renewables PPAs and source specified power contracts
  - Codified in US Tax Law. Since first prepayments of natural gas were done in the early 1990s, the IRS issued rules allowing tax-exempt prepayments and Congress enacted legislation specifically allowing the transactions (National Energy Policy Act of 2005; Section 1327)

Prepay Overview

Structure:

- Term: Typically 30-year term with repricing periods every 5-7 years due to the optimal taxable vs. tax-exempt spreads
- Transacting Parties:
  1. Tax-exempt Load Serving Entity (LSE, also called “Prepay Buyer”) - EBCE
  2. Taxable financial counterparty (bank, called “Prepay Supplier”) - Morgan Stanley
- Process:
  1. Prepay Supplier is assigned the existing energy supply contract(s) held by LSE through a limited assignment agreement
  2. Municipal bonds issued by conduit, amounting to combined notional value of assigned contracts
  3. Prepay Supplier pays the contract price to PPA Seller, immediately transferring all electricity and attributes to LSE
  4. LSE pays the Prepay Supplier at discounted rate, achieving procurement cost savings
- Takeaway: Prepay Supplier is effectively the energy supplier and is prepaid for future energy deliveries. The prepay supplier holds and utilizes capital and provides a discount to the Prepay Buyer that is enabled via the spread between the taxable and tax-exempt borrowing costs.

Benefits:

- Lower energy procurement costs: Savings over 30-year term estimated to be 5-15% per year on power quantities delivered under prepay, compared to spot market purchases and current contracts; subject to change based on market conditions at the time that the bond is issued.

Risks:

- Regulatory: Addressing risks related to compliance with RPS, SB350, and Emissions Performance Standard (eg. retaining the 10-year long-term contracting requirement)

EAST BAY COMMUNITY ENERGY

EBCE Prepay Parties

Attachment Staff Report Item 14A

Joint Prepay Buyer: Silicon Valley Clean Energy

- EBCE and SVCE issued the RFP together, are preparing a joint transaction in which both CCAs assign contracts, share costs and benefits

Counsel: Orrick, Herrington & Sutcliffe (Bond & Tax) | Chapman & Cutler LLP (Disclosure & Issuer's)

- Both firms selected through solicitation issued June 2020

Prepay Supplier: Morgan Stanley

- Selected through solicitation issued November 2019

Municipal Financial Advisor: PFM

- Selected through solicitation issued September 2020

Bond Issuer: California Community Choice Financing Authority

- 3 of 4 Founding Members have received Board approval for JPA formation (EBCE, MCE, SVCE)
- 3CE seeking Board approval mid-May

EAST BAY COMMUNITY ENERGY

Key Elements of a Prepay Transaction

Power Contract Assignment:

- Existing renewable/power PPAs are assigned to the taxable Prepay Supplier. The LSE continues to ***take and pay*** for energy and attributes delivered through the contract at a discount.
- The assignment is a limited assignment of rights and energy products whereby the LSE continues to serve as scheduling coordinator to the extent applicable and all operational requirements continue to remain.
- All other terms of the PPA are unchanged.
- If the prepay program terminates early, Prepay Supplier fails to perform, or LSE fails to perform, the LSE forgoes the future savings and the assigned PPA contract is put back to the original LSE.

Debt:

- Non-Recourse: Prepays utilize non-recourse municipal bonds and are ***not*** secured or guaranteed by the referenced entity (i.e. the CCA). Rather the debt is recourse to the Prepay Supplier. This significantly protects the CCA and mitigates risk related to the payment of power contracts novated through the prepay.
- Off Balance Sheet for LSE: Bonds are issued by a municipal bond conduit.

Prepay Sizing and Discount

- The total bond notional may be as high as $1.5bn and will be dependent on the CA bond market appetite. The expected notional is in the $600-800MM range.
  - EBCE will seek the maximum bond raise while maintaining the optimal bond rates
  - The amount represents the present value of the PPA cashflows over the 30-year life of the transactions

- This initial transaction is being split between SVCE and EBCE and will amount to approximately $12-16MM of annual procurement costs running through the prepay and translate to $1.2-1.6MM of annual savings for each CCA.
  - The transaction assumes an increase in the cashflows running through the prepay over the 30-year life reaching $20-25MM in annual procurement costs running through the prepay by the end of the transaction.
  - As the transaction moves forward, the arbitrage value goes down since the present value benefits reduce with a shorter remaining tenor. The future discount rates will be reset every 5-7 years and be dependent on future bond market conditions, but this puts downward pressure on the future discounts.
  - There is a negotiated minimum discount that, if not met by the Prepay Supplier, allows the LSE a walkaway right.

- Ultimately the discount is established by the spread between taxable and tax-exempt rates and deducts all transaction related costs, which include fees associated with bond underwriting, counsel (bond, disclosure, underwriter's, prepay), financial adviser, swap counterparty, credit rating, etc.

- 5-7 years is the optimal bond spread tenor currently. Maintaining this spread over a 30-year transaction life maximizes the available discount. This requires a repricing and re-issuance of bonds every 5-7 years. This allows for a re-pricing and a reset of the discount rate. In general, a high interest rate environment will lead to a higher discount rate.

Key Documents

Prepaid Agreement

- Details the flow of power and payments between the parties (Prepay Supplier, conduit issuer, and the CCA)
- Lines out all scenarios in which the deal might terminate early
- Similar terms to Power Supply Contract

Repricing Agreement

- Sets forth terms for remarketing, repricing for future interest rate periods

Power Supply Contract

- Sets forth terms for which CCAs receive energy for 30-year terms
- <u>1 of 2 documents signed by CCAs directly</u>

Letter Agreement

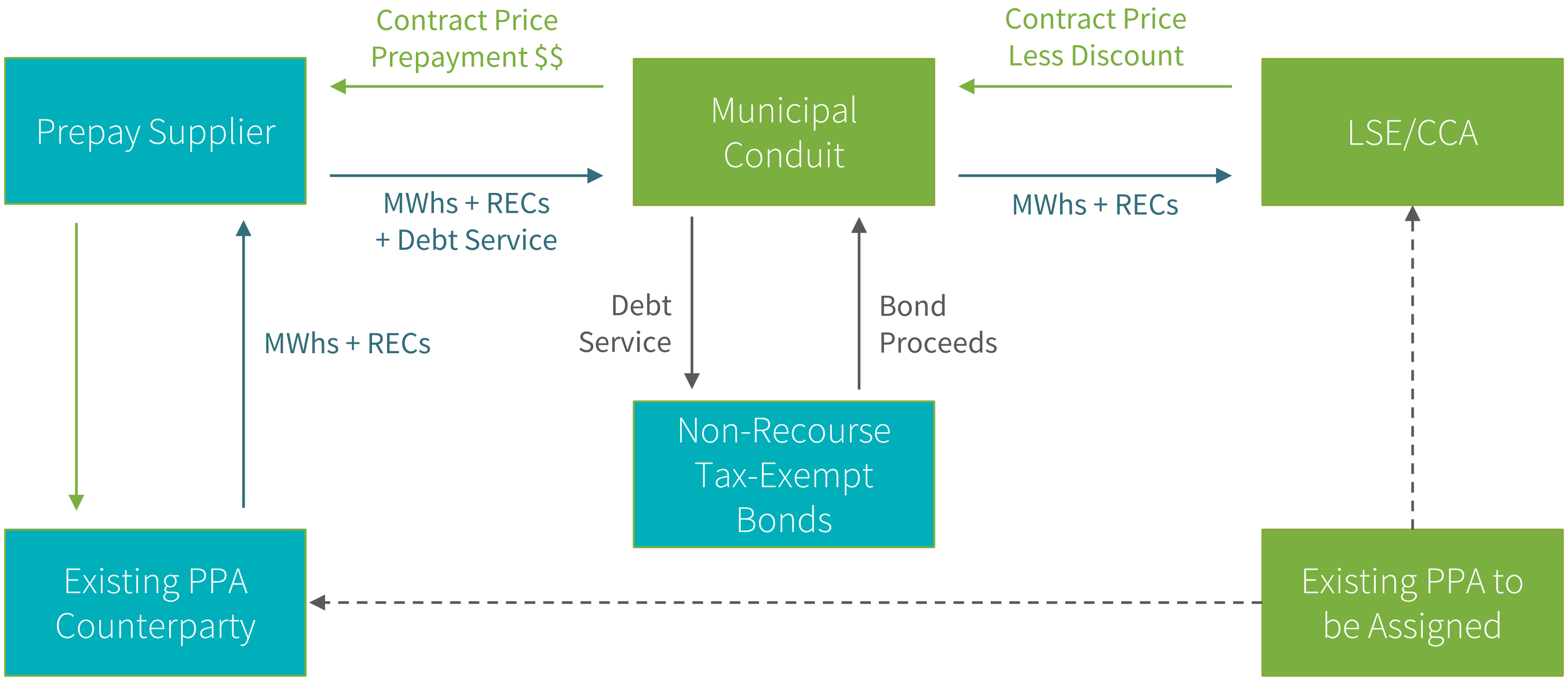
- Sets out terms for future assignments by CCAs
- <u>1 of 2 documents signed by CCAs directly</u>. Signed by Prepay Supplier, CCAs, and CCCFA (conduit issuer JPA)

Commodity Swap Documents

- Documents pursuant to which the price of the commodity is hedged with a 3rd-party swap counterparty (to insulate transaction from market variations)
- Dormant for initial bond period, but turns on when transaction moves from fixed to floating pricing after initial period

Prepay Structure

Attachment Staff Report Item 14A



EAST BAY COMMUNITY ENERGY

Benefits

- Savings over the 30-year term expected to be 5% - 15% per year on power quantities delivered under the prepay structure compared to spot market purchases / current contracts. Discount rates may fluctuate up or down in future years.
- EBCE can continue to enter into similar transactions in future years to increase procurement cost savings. It is foreseeable that EBCE enters into 5-10 prepay transactions to achieve annual savings of $10-20MM. The limitations are based on the bond market investor appetite, market conditions with meaningful taxable and tax-exempt spreads, and the available headroom to ensure that EBCE will have the procurement related costs to safely assign in for a 30-year transaction life.
- Favorable risk allocation where EBCE only pays for energy that is delivered (same as contracts today)
- Debt is non-recourse to EBCE
- Rating agencies comfortable with comparable deals at SMUD, SCPPA, others

Risks

- If this transaction does not materialize: Loss of out-of-pocket costs $25-50k and staff time
  - Consultants all contingent on successful deal
  - Consultants are all paid from deal proceeds vs. EBCE directly
- Opportunity cost of higher savings through a prepay transaction or alternative structure initiated at a different time
- Regulatory risk related to reclassifying a long-term PPA as a short-term PPA, making it ineligible for SB350 qualification
- Political risk associated with a transaction collapsing due to non-compliance to tax codes

Timeline

November 2019 through September 2020:

- Got enabled with legal and advisory representation
- Began structuring and document negotiations with Morgan Stanley

Oct. – June 2021:

- Continued document negotiations, preparation
- Identification and preliminary assignment discussion of power supply contracts
- Documents ready to execute in June/July timframe

Bond raise and initiation of prepay could occur anytime in next 3-6 months

Factors That May Impact Timing:

- Markets: Taxable vs. tax-exempt spreads need to exist in a meaningful way to achieve discounts we are seeking, and current rate environment is not optimal though market conditions are rapidly improving. Important to get docs in place to be able to transact quickly when markets open back up, though market conditions could delay timeline of deal execution.
- Assignment Consents: Still need to identify commodity transactions for assignment, and timeliness of consents could extend the timeline of deal execution.

Market Statistics

- Nationwide: 90+ municipal transactions
  - $50+ Billion combined notional contract value
- California: 11 municipal transactions
  - $5.7 Billion combined notional contract value
- Active Suppliers: Goldman Sachs, Morgan Stanley, Royal Bank of Canada, Citi, TD Securities
  - All investment grade rated financial institutions
- Resource Types:
  - Majority of transactions to date have been exclusively for natural gas, remainder including an electricity 'switch' at a certain year.
  - The same tax law and similar transaction structure enables the program for electricity from renewables contracts, as well. The market is seeing activity and preparation for these transactions, particularly from CCAs.