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# Is Your Energy Contract At Risk In Texas?

Craig R. Enochs

Law360, New York (May 01, 2014, 2:25 PM ET) -- In wholesale physical energy commodity trading agreements it is customary for buyers and sellers to incorporate liquidated damages clauses. In many cases such clauses are not heavily negotiated or even given much thought because they are commonplace both in industry-standard master agreement publications and in stand-alone agreements bilaterally negotiated by industry participants.[1]

Despite the fact that liquidated damages clauses are routinely included in, and sometimes an afterthought to, physical energy trading contract negotiations, they nonetheless serve an important function: providing a contractual measure of damages to compensate a nonbreaching party after the other party fails to deliver or receive all or any portion of the relevant commodity being sold.

Even if arms-length, sophisticated parties negotiate a liquidated damages clause into their agreement, the calculation of such contractual damages is not without limitation. In the recent case of FPL Energy LLC v. TXU Portfolio Management Company LP, the Texas Supreme Court analyzed such limitations on enforceability and ultimately held that a liquidated damages provision in a renewable energy contract was unenforceable because it operated as a penalty without having any reasonable relationship to actual damages.[2]

## Background

In 2000, two wind farm subsidiaries of FPL Energy LLC, a predecessor of NextEra Energy Inc. (collectively “FPL”), entered into renewable power supply contracts with TXU Electric, a Texas retail electricity provider. Later that same year, FPL acquired rights to a similar renewable power supply contract with TXU Electric involving a third wind farm. TXU Electric subsequently assigned these power supply contracts to its power marketer affiliate, TXU Portfolio Management Company LP (“TXUPM”). Under all three contracts, FPL had an obligation to sell and deliver, and TXUPM had an obligation to purchase and receive renewable electricity generated from the wind farms along with the renewable energy credits (“REC’s”) derived from the electricity sold.

If FPL ever failed to satisfy its delivery requirements, each contract included a liquidated damages provision whereby FPL would pay TXUPM damages calculated according to a predetermined methodology. The liquidated damages clause in each of the supply contracts stated the following in relevant part:

> “If there is a [n]et [d]eficiency for a year ... [FPL] shall pay [TXUPM] a [d]eficiency [p]ayment equal to the product of (i) the difference in MWh between (a) the [n]et [d]eficiency, and (b) the MWh of [t]ransferred REC’s, times (ii) the [d]eficiency [r]ate. The [d]eficiency [p]ayment is intended to be liquidated damages and not a penalty.”[3]

Under the contracts a “[n]et [d]eficiency” would arise if FPL failed to deliver its “[a]nnual [q]uantity” of REC’s to TXUPM; however, FPL’s annual quantity would be reduced to the extent certain events prevented REC generation and thus excused a party from paying penalties to the Public Utility Commission of Texas ("PUCT") for deficient REC's.[4] For example, at the time FPL and TXU Electric initially entered into the contracts, the PUCT excused compliance penalties if sufficient REC's could not be generated because of: (1) a lack of transmission capacity for renewable generation, (2) curtailment orders issued by the Electric Reliability Council of Texas ("ERCOT") or (3) other events beyond the reasonable control of the provider.[5]

The "[d]eficiency [r]ate" initially agreed by the parties was $50 per MWh, which at the time the contract was executed was the statutory penalty per REC imposed by the PUCT for any REC deficiencies below compliance thresholds.[6] However, the contracts went on to state the following:

> "To the extent that the [PUCT] determines the annual average market value of REC's applicable to [TXUPM] for a year, then the [d]eficiency [r]ate for that year will be the lesser of (i) $50 per MWh (as it may be later amended), and (ii) twice the annual average market value of REC's applicable to [TXUPM] as determined by the [PUCT] ... For a year in which there is a [d]eficiency [p]ayment due, [TXUPM] shall make reasonable efforts to obtain a determination of the annual average market value of REC's by the [PUCT]."[7]

Over a period of approximately four years, FPL consistently failed to deliver required quantities of electricity and REC's to TXUPM. As a result, TXUPM brought suit against FPL for breach of contract and claimed damages under the liquidated damages provisions. FPL counterclaimed, arguing that TXUPM breached a contractual obligation to provide sufficient transmission capacity for all of FPL's wind farm generation. According to FPL, TXUPM's breach resulted in grid congestion and curtailment by ERCOT, which, in turn, reduced the quantities of electricity and REC's that FPL was able to supply from the wind farms.[8]

The Texas Supreme Court analyzed three issues: (1) whether TXUPM was contractually obligated to provide sufficient transmission capacity for FPL to meet its delivery obligations to TXUPM; (2) whether the liquidated damages provisions in the contracts applied to both electricity and REC's or, in the alternative, to REC's only; and (3) whether the liquidated damages provisions were enforceable.[9]

After investigating Texas jurisprudence on contract interpretation matters, the Texas Supreme Court ruled that TXUPM was not contractually obligated to provide adequate transmission capacity and the liquidated damages provisions applied only to REC's and not electricity.[10] The Texas Supreme Court then turned to the critical issue in the case directly impacting TXUPM's damages: whether the liquidated damages provisions agreed to by the parties in the supply contracts were enforceable.

## Enforceability of Liquidated Damages Clauses

According to the Texas Supreme Court, contractual liquidated damages provisions survive judicial scrutiny under Texas law only if a court makes two critical findings:

1. "the harm caused by the breach is incapable or difficult of estimation"; and
2. "the amount of liquidated damages called for is a reasonable forecast of just compensation."[11]

Texas courts analyze both prongs of this test as of the time the relevant parties entered into the contract.[12]

## Damages Must be Difficult to Estimate

First, an enforceable liquidated damages provision in Texas contracts must relate to a breach where resulting damages are difficult to estimate at the time the parties entered into the contract.[13] The Texas Supreme Court acknowledged that when FPL and TXU Electric originally entered into the supply contracts in 2000 the Texas Legislature's regulatory scheme for REC's was only one year old and there was no market for trading REC's and determining transparent pricing.[14]

Even if a market for trading REC's did exist, the fact that FPL was obligated to deliver REC quantities on an annual basis made it difficult for TXUPM to determine at what point during such year a REC deficiency existed and, in turn, the spot market price for such deficient REC's.[15] Based on these factors, the Texas Supreme Court held that the parties' liquidated damages clause satisfied the "difficulty of estimation" prong of the test.[16]

## Calculation Must Yield a Reasonable Forecast of Damages

Second, the Texas Supreme Court focused on whether the liquidated damages provisions yielded a reasonable result in light of actual damages.

According to TXUPM's calculations, FPL failed to deliver 580,000 REC's to TXUPM over a period of four years.[17] At the time TXUPM calculated the liquidated damages payment allegedly owed by FPL, TXUPM claimed that it used reasonable efforts to seek a REC market value determination from the PUCT as required by the liquidated damages clause; however, the PUCT declined TXUPM's request to perform such a determination.[18] Basing its liquidated damages calculation on the $50 per REC deficiency rate and 580,000 REC net deficiency, TXUPM claimed that FPL owed $29 million in damages.[19] FPL argued that such damages calculation was inflated, claiming that the net deficiency was much lower and the $50 per REC deficiency rate was punitive because it was not tied to REC market values.[20]

At the outset of its analysis, the Texas Supreme Court acknowledged that the liquidated damages clause appeared to be a reasonable forecast of damages "on its face" because it attempted to tie the damages calculation to the PUCT's regulatory scheme for REC's.[21] However, the court ultimately concluded that the liquidated damages clauses yielded an unreasonable result and thus were unenforceable.[22] In reaching its determination, it focused on two fact issues directly impacting the liquidated damages calculation: (1) the quantity of REC's that constitute the net deficiency and (2) the price of REC's that constitute the deficiency rate.[23]

In analyzing whether the net deficiency was properly calculated at 580,000 REC's, the Texas Supreme Court noted the status of TXUPM vis-a-vis PUCT rules relating to REC compliance.[24] At the time the liquidated damages clauses were negotiated, FPL contracted with TXU Electric — a retail electric provider subject to the PUCT's REC compliance scheme. If FPL had failed to deliver 580,000 REC's to TXU Electric under the contracts, TXU Electric would have been excused under PUCT rules from paying penalties for approximately 360,000 of those deficient REC's because transmission congestion and associated ERCOT curtailment orders prevented REC production.[25] Under the contracts, such reduction in FPL's annual quantity would have, in turn, reduced FPL's net deficiency from 580,000 REC's to 220,000 REC's.

When the contracts were assigned from TXU Electric to TXUPM, however, TXUPM — as a power marketer — was not subject to PUCT penalties for deficient REC's.[26] So when FPL failed to deliver 580,000 REC's to TXUPM, the PUCT regulatory scheme — including statutory excuses for deficient REC's — did not apply, and therefore TXUPM and the court of appeals determined liquidated damages based on a net deficiency of 580,000 REC's without offset.[27]

Although the Texas Supreme Court recognized the TXUPM was not subject to REC compliance obligations under PUCT rules, the court found that application of the liquidated damages clauses using a net deficiency of 580,000 REC's without any offset would yield a result contrary to the parties' intent at the time the contract was negotiated between FPL and TXU Electric.[28] Instead, the court noted that if TXUPM were actually subject to PUCT penalties for deficient REC's (as TXU Electric was at the time of contract formation), such penalties would be based on a net deficiency of 220,000 REC's — not 580,000 REC's — because 360,000 REC's would otherwise be excused under PUCT rules.[29] Based on this analysis, the court held that applying a net deficiency of 580,000 REC's in the parties' liquidated damages calculations would yield an unreasonable result.[30]

With respect to TXUPM's calculation of damages based on a $50 per REC deficiency rate, the Texas Supreme Court held that such approach also was unreasonable.[31] Although TXUPM may have used reasonable efforts to obtain a market rate determination from the PUCT, as required by the liquidated damages clause, the fact that the PUCT declined such request did not justify using a flat $50 deficiency rate without any nexus to actual market value.[32] According to the court, the market rate for REC's at the time of FPL's under-deliveries fluctuated between $4 and $14 per REC.[33] If these values were doubled according to the terms of the liquidated damages clauses, this would have yielded a deficiency rate in the range of $8 to $28 per REC instead of $50 per REC, as used in TXUPM's calculations.[34]

If TXUPM had calculated liquidated damages based on a net deficiency of 220,000 and a deficiency rate of $28 — the upper bound of the possible range — then FPL would have owed TXUPM a payment of $6.1 million — not the $29 million alleged by TXUPM and approved by the court of appeals.

According to the Texas Supreme Court, if "liquidated damage provisions operate with no rational relationship to actual damages, thus rendering the provisions unreasonable in light of actual damages, they are unenforceable."[35] Because the Texas Supreme Court found that the application of the liquidated damages provisions were unreasonable and operated as a penalty, it ultimately held that the provisions were unenforceable and remanded the case to the court of appeals to determine damages consistent with its own findings.[36]

Notably, the Texas Supreme Court acknowledged that Texas courts do not have the "broad power to retroactively invalidate liquidated damages provisions that appear reasonable as written," and the it did not create that power in the FPL decision.[37] However, "when there is an unbridgeable discrepancy between liquidated damages provisions as written and the unfortunate reality in application, [Texas courts] cannot enforce such provisions."[38]

## Lessons Learned From the FPL Decision

The FPL decision serves as a reminder that contractual parties should be cautious when drafting liquidated damages provisions to ensure that the damages calculation includes a readily ascertainable fair-market mechanism that would not be construed as a penalty payment, but instead evidences a rational relationship to actual damages incurred. Even if a liquidated damages clause appears reasonable on its face, Texas courts still may hold it unenforceable if there is an "unbridgeable discrepancy" between the language in the clause itself and the application of such clause in practice.

If a liquidated damages clause strays too far outside the boundaries outlined in FPL and the clause is challenged, parties risk the possibility that Texas courts may find the clause unenforceable, thus potentially reducing the contractual damages available to the nonbreaching party, or otherwise compelling the nonbreaching party to rely on remedies available at law rather than contractual remedies.

In that regard, it is important for attorneys to advise clients of this risk so that when a client analyzes and models a transaction's payment, credit and legal risks, such modeling acknowledges that an improperly drafted liquidated damages clause may preclude the realization of liquidated damages under Texas law. Depending on the nature of the transaction, the ability or inability to enforce a liquidated damages clause may significantly influence commercial decisions, such as pricing and collateral requirements.

The FPL decision also reminds practitioners that deviating from market-standard liquidated damages clauses in physical energy commodity trading agreements may create enforceability risk. Liquidated damages provisions in contracts, such as the EEI or NAESB, typically compare the parties' agreed-upon contract price to a designated market index price to ensure that resulting calculations bear a rational relationship to the actual damages a nonbreaching party would incur by covering in the marketplace. Industry-standard contracts do not typically adopt a fixed-price liquidated damages methodology, whether a fixed price per unit or a fixed lump sum, nor should they according to the FPL decision because such amount may be deemed unreasonable in light of actual damages incurred.

This case illustrates that crafting a liquidated damages provision can be difficult if the commodity traded cannot be tied to a readily-ascertainable index price. At the time the FPL parties entered into their supply contracts, they did not have the benefit of referencing a REC's index price in their liquidated damages clause because the REC's trading market in Texas was nascent. Although the parties drafted the liquidated damages clause with the PUCT's regulatory scheme in mind, including an obligation by TXUPM to use reasonable efforts to obtain a market price from the PUCT, the parties' fallback of $50 per REC may have seemed reasonable at the time because it was the penalty assessed by the PUCT for deficient REC's.

Regardless of what contracting parties believe to be a reasonable estimation of damages, the FPL decision indicates that a Texas court will not blindly defer to the parties' agreed-upon calculation methodology if the application of such methodology bears no rational relationship to actual damages.

In FPL, the Texas Supreme Court looked beyond the $50 per REC deficiency rate agreed to by the parties and instead relied on actual market prices of REC's to ultimately conclude that the effect of the clause yielded an unreasonable result. In light of this, when drafting liquidated damages clauses practitioners should be careful in relying on a proxy market value — even if agreed to be reasonable at the time of contract formation — in lieu of actual market prices. If a market price for the relevant commodity is not readily ascertainable, an alternative methodology for determining a reasonable market price may be useful, such as seeking price quotations from arm's length buyers/sellers applicable to the relevant deficiency period.

—By Craig R. Enochs and Kevin M. Page, Reed Smith LLP

*Craig Enochs is a partner and Kevin Page is an associate in Reed Smith's Houston office.*

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[1] E.g., Edison Electric Institute's Master Power Purchase and Sale Agreement ("EEI") and the North American Energy Standards Board's Base Contract for Sale and Purchase of Natural Gas ("NAESB").

[2] FPL Energy, LLC v. TXU Portfolio Mgmt. Co., L.P., No. 11-0050 (Tex. Mar. 21, 2014). Slip opinion available online at https://www.supreme.courts.state.tx.us/historical/2014/mar/110050.pdf

[3] Id. at 12.

[4] Id. at 16.

[5] Id. at 15-16.

[6] Id. at 20-21.

[7] FPL, No. 11-0050, slip op. at 21.

[8] Id. at 4.

[9] Id. at 5.

[10] Id. at 5-17.

[11] Id. at 18.

[12] FPL, No. 11-0050, slip op. at 18.

[13] Id. at 19.

[14] Id.

[15] Id.

[16] Id. at 20.

[17] FPL, No. 11-0050, slip op. at 21-22.

[18] Id. at 22.

[19] Id. at 4, 23.

[20] Id. at 21-22.

[21] Id. at 21.

[22] FPL, No. 11-0050, slip op. at 24.

[23] Id. at 21-22.

[24] Id. at 22.

[25] Id.

[26] Id.

[27] FPL, No. 11-0050, slip op. at 23.

[28] Id. at 22.

[29] Id.

[30] Id. at 23.

[31] Id.

[32] FPL, No. 11-0050, slip op. at 22-23.

[33] Id. at 22.

[34] Id. at 22-23.

[35] Id. at 24.

[36] Id.

[37] FPL, No. 11-0050, slip op. at 23.

[38] Id.

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