CLIMATE RISK
REVIEW

Pleas of "force majeure" offer no protection from climate financial risks

The case of a Texas wind farm operator that failed to deliver power during February's storm should be taken as a warning

Louie Woodall

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"Unprecedented" is an adjective that's losing its impact in the era of climate change. Earlier this year, it was used liberally by politicians, bureaucrats and journalists alike to describe the

Texas winter storm, which brought fierce blizzards and freezing temperatures to the Lone Star State.

Still, just how unprecedented it truly was is up for debate. While this may be a low-stakes thought exercise for opinion writers, in the world of high finance such nitpicking can have multi-million dollar ramifications.

Take the case of Stephens Ranch Wind Energy, LLC et al v. Citigroup Energy Inc. et al, heard at the Supreme Court of New York last Thursday. It's one climate risk wonks should study carefully, as going forward it may change how financial institutions deal with energy clients in regions vulnerable to extreme weather — the kind that will only become more common as the world heats up.

Put simply, Stephens Ranch had two Power Purchase Agreement (PPA) with Citi to deliver certain amounts of power from its 210 turbine, 376 megawatt wind farms over a thirteen-year period. The bank promised to pay Stephens Ranch a fixed amount per megawatt regardless of the market price.

February's winter storm encased the turbines in ice, knocking them offline. Unable to generate the energy promised Citi, Stephens Ranch claimed force majeure to justify its failure to honour its contract — its lawyers stating that it was "one of many blameless victims of a once-in-generations winter storm that devastated Texas".

Short the many megawatts it was owed from the wind farms, but committed to deliver power itself to other clients, Citi spent $113 million buying up electricity itself from ERCOT, Texas's grid operator, at the hugely inflated price of $9,000 per megawatt hour — a level set by state regulators to try and stoke production and halt rolling blackouts.

Disagreeing with Stephens Ranch that the blizzard amounted to an 'act of god' under the terms of the PPAs, Citi then sent the wind farm operator a bill to cover the cost of its nonperformance. Stephens Ranch refused to pay, triggering the legal imbroglio.

On April 8, Justice Robert R. Reed ruled against Stephens Ranch, paving the way for Citi to seize the wind farms as redress for its loss.

Why? Reed sided with Citi on two of its key arguments.

First, that the winter storm was not an unanticipated event that met the standard of force majeure. The Federal Energy Regulatory Commission (FERC) had issued a report in 2011 that studied prior occurrences of extreme winter weather in Texas and concluded that such events were likely to take place in future, too. The report urged wind farms to take preventive measures by "winterizing" their turbines.

Sure, the storm may have been a once-in-a-generation events, but the FERC report shows the effects of a deep freeze had been anticipated, and could have been mitigated by Stephens Ranch had it taken steps to properly safeguard its turbines. As Citi noted, other wind farms that adopted the lessons of the FERC report were able to continue operating throughout February.

Interestingly, Judge Reed cited climate change explicitly when questioning the wind farms' weather arguments:

> *"You got a couple of things going on here: terrible weather, weather we've never seen, and outrageous rates. One, we knew that the weather was going to get bad. People were talking about climate change and all that everywhere...We know that things are progressively getting worst* [sic]. *And FERC, in 2011 said, get ready. Bad things are coming to Texas and to Texas wind farmers, in particularly* [sic]*".*

What Reed's dismissal of the force majeure defence here implies is that once-imagined epochal storms offer no escape from contractual obligations in the era of climate change.

Here's Edward Ivey, counsel in Moore & Van Allen's financial services group:

> "*Remember how 100-year environmental events are something we normally think of as 'Don't worry, that is why there is a force majeure provision'? Well, as this judge points out, when those events are tied to climate change, it may get harder to claim the force majeure as unforeseeable. As a result, maybe parties will start identifying (or excluding) specific environmental events as a force majeure (e.g., floods, ice storms, forest fires and/or other extreme climate events that are more likely to occur now, due to climate change). This increasing awareness may also push parties to start considering ways to better mitigate*

these climate risks, whether through building turbines that operate in lower temperatures or ESG hedges"

Increased take up of climate scenario analysis, physical risk modelling and disclosure by energy firms may also shrink the universe of natural disasters that could be captured through a force majeure clause. As forward-looking physical risk assessments improve in depth and detail — and the vendors of these increase their market penetration — it'll be harder for firms to brand super storms, blizzards and other disasters as unforeseeable 'acts of god'.

The other argument that torpedoed Stephens Ranch concerned the exact *type* of contract it had entered into with Citi. As the defendants explained, the PPAs tied Stephens Ranch to schedule a power product known as "Firm (LD) Energy" ('LD' standing for 'liquidated damages') for delivery to Citi at a specified ERCOT hub. Crucially, it did not state that the power had to come from its own wind turbines. Essentially, Citi was agnostic as to where the power came from, as long as it received its expected quota.

From the standpoint of Stephens Ranch, these PPAs were intended to secure a guaranteed market for the power generated by its own turbines. Indeed, the contracted amount of power to be delivered was calculated to correspond with the wind farms' generation capacity.

But while this may have been the firm's intention, it did not align with its obligation to Citi. As the bank's lawyers explained:

> *"If they wanted to sell power that was tied to their own generation, they would have sold something called unit firm power, which is tied specifically to a generation facility, or they would have delivered it at the resource node, which is basically where the power plant plugs into the grid. That's not what this contract was. It was a wholesale contract for generic power, and it says nothing more than that".*

Interestingly, the lawyers added in their written memo that Citi does not offer these kind of "Unit Firm Energy" contracts. Perhaps for good reason. After all, these agreements concentrate a counterparty's exposure to a single source of power. A Firm (LD) Energy

contract, in contrast, offers a measure of diversification — if, of course, the counterparty looks beyond its own generating capacity to source the promised electricity.

In the wake of the Texas storm, it may be that energy firms become more discerning as to the PPAs they strike, to ensure they only promise counterparties power that they can generate directly. Of course, this may shrink the pool of dealers they can do business with, and perhaps lower the fixed price they can get out of such PPAs. Alternatively, it's possible banks will elect to bundle PPAs with weather derivatives that offset both parties' exposure to physical hazards.

After all, it can't be said that the Stephens Ranch debacle ended up benefiting Citi. Yes, the bank is free to take control of the wind farms' assets, either to sell them off or operate itself in a bid to recoup its $113 million. But Citi *does not want* to run a wind farm! As the bank's lawyers made plain, Citigroup Energy Inc "buys and sells power in the ERCOT market, but does not generate, transmit, or distribute power".

So while the bank won this case, it too incurred damages linked to climate risk along with Stephens Ranch. The outcome should prompt banks and energy firms alike to think carefully about the financial contracts they have in place today, and how they could be upgraded to safeguard each side from the physical climate risks that will only become more common as the century marches on.

Please send questions, feedback and more to louie.woodall@climateriskreview.com

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40 Park Avenue, Apt 4F, New York 10016