

How Policy Shapes Projects: Understanding Washington's Cues

Current U.S. policy conditions have created uncertainty in solar project finance deals.

■ Edward V. Kayukov & Henry T. Scott

Recent political change in Washington, D.C., and in statehouses throughout the country means that federal and state lawmakers may soon revisit the policies designed to spur investment in solar energy and other forms of renewable energy. At the same time, the ability to qualify for the cash-grant program for renewable energy projects provided by the American Recovery and Reinvestment Act (ARRA) will soon expire.



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This article explores how government policy affects deal structures in today's changing market, explains how well-structured deals are financed today and provides insight on how policy-makers may change the financing landscape yet again.

Like the development of other energy sources, the development of renewable energy projects benefits from government support. These policies have included both direct subsidies - in the form of cash grants and tax credits - and indirect support, chiefly by means of renewable energy procurement requirements.

Despite continued technological advances, the vast majority of renew-

able energy projects are not considered to be economical without some level of governmental support. At the federal level, investment in renewable energy has traditionally been supported by favorable tax policies, including a regime of tax credits and accelerated depreciation for qualifying projects. Traditionally, developers of renewable energy projects have monetized these tax benefits by partnering with tax-advantaged investors - principally large and sophisticated financial institutions.

In an effort to spur investment in renewable energy projects and create jobs at a time when tax-advantaged investors had a limited tax appetite and millions of Americans found themselves without a job, ARRA effectively monetized the investment tax credit (ITC) for developers by providing a cash grant.

The majority of developers have elected to claim the cash grant in lieu of the ITC. As of Nov. 8, the cash-grant program has provided over \$5.4 billion to nearly 4,000 projects in 48 states, Puerto Rico and the District of Columbia. The program is widely seen as among ARRA's most successful programs in terms of de-

veloping stimulus dollars quickly and in its support for renewable energy projects.

At the same time, the cash-grant program has also been an expensive endeavor. It was criticized by budget hawks, and the original Congressional Budget Office estimate that the program would provide \$3 billion in cash grants could be exceeded several times over. Supporters of the program point out that it is budget-neutral, as the net effect on the federal budget of a tax credit or a cash grant is the same.

The cash-grant program was intended as a temporary solution to stimulate the economy - and the renewable energy sector, in particular - during the economic downturn. To be eligible for the grant, a project must commence construction on or before Dec. 31, 2010, and must file a preliminary application for a grant no later than Sept. 30, 2011. The commencement-of-construction cutoff date is fast approaching, although some members of Congress have advocated extending the program or making the ITC refundable.

A recently leaked memo to President Obama from White House officials Carol Browner, Ron Klain and Lawrence Summers suggested transferring funds appropriated for the Department of Energy's (DOE) loan-guarantee program. The lame-duck session of Congress may take up the extension of the cash-grant program, but any extension is likely to face some opposition from Republican members of Congress concerned about government spending in a time of record budget deficits.

For solar developers, the surest way to ensure federal support is to commence construction of a qualifying facility prior to Dec. 31. The Treasury



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Department, which administers the program, published guidance defining what is required to “commence construction” and has candidly responded to inquiries regarding the requirements.

Fortunately for developers, the Treasury guidance provides for a 5% safe harbor for qualifying expenditures incurred in connection with projects. Alternatively, projects may qualify for the cash grant with “physical work of a significant nature” at the project site. For projects relying on the 5% safe harbor with an estimated eligible cost basis of \$1 million or more, an independent accountant’s report on the eligible costs of the specified energy property paid or incurred by Dec. 31 is required.

Another important requirement of the program is that construction be “continuous.” Although the scope of the “commencement of construction” and “continuous construction” requirements are beyond the scope of this article, suffice it to say that billions of dollars worth of renewable energy projects are racing to satisfy those requirements.

Political uncertainty in Washington, D.C., occasioned by the recent midterm elections (see Policy Watch on page 24) may add even greater urgency to the need to qualify for the grant.

Bank financing options

The bank lending market for renewable projects has rebounded considerably since the credit freeze of late 2008 and early 2009. At first, bank lenders returned to the marketplace looking to finance only the best projects from the strongest sponsors with the most proven technologies.

Competition among lenders, however, has gradually broadened the range of the project sponsors and technologies that bank lenders are willing to finance. Tenors for term loans have lengthened to approximately 12 to 16 years, and pricing has improved markedly for developers,

with the best projects being priced at 200 to 250 basis points over LIBOR.

With trust among the lending community restored, we have seen a gradual return of partially syndicated deals (as opposed to the club deals that dominated the market in late 2008 and 2009). As the cash-grant program deadline approaches, though, the flood of projects seeking financing ahead of the December cut-off means that bank lending terms may begin to tighten as a reflection of increased demand for capital.

After a particularly bad year for wind resources in 2009 underscored lenders’ exposure to wind resource variability, many investors expressed an interest in adding solar projects to their energy portfolios. At the

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same time, the steep decline in the price of photovoltaic modules and the up-sizing of solar PV projects in the Western U.S. have made many of these projects attractive investment opportunities.

Many of these projects benefit from higher electricity prices with attractive time-of-use factors that reward energy production during peak hours, which typically coincide with peak energy production for PV projects. The coincidence of peak energy production and peak electricity prices typical of solar projects contrasts with the energy production patterns of most wind projects, which often crest in the early morning hours, when electricity usage is at its nadir.

In the solar sector, lenders have been willing to lend to projects deploying modules from a variety of manufacturers and technologies, including thin-film technologies. Still, module and inverter warranties - and the strength of the credit behind

those warranties - remain of crucial concern for lenders.

Thus, developers must balance a desire to contain project costs by deploying low-cost modules or newer technologies with the need to use “bankable” equipment. With the up-sizing of solar PV to the true utility scale, lenders’ diligence increasingly focuses on risks associated with the deployment of PV technology on a much bigger scale, including supply-chain risks.

Solar power projects in the range of 10 MW to 20 MW may present attractive investment opportunities for financiers and equity investors. Execution risk is relatively low, and the construction period is often quite short for projects of this size. In ad-

dition, these types of projects often do not require the costly and time-consuming network upgrades typical of larger power projects. Packaging several medium-size projects with similar documentation can provide economics of scale and access to capital normally reserved for much larger projects of 100 MW or more.

Lending niche

A new lending space is also emerging for solar projects in the 1 MW to 5 MW range. Although these projects often enjoy the best offtake prices, they are typically too small for traditional project finance lenders to consider, given the diligence and transaction costs associated with nonrecourse or limited-recourse project loans.

However, local banks have yet to acquire the experience and institutional knowledge required for transactions of this type. New participants are arriving to fill the vacuum in this

space, including hedge funds and several commercial banks that see the space as an opportunity to grow relationships with customers, including module manufacturers, construction contractors and project developers.

In California, several of the large investor-owned utilities have unveiled special PV offtake programs, and the California Public Utility Commission is in the process of developing a reverse auction protocol for 1 MW to 5 MW projects. This development suggests that this mid-size project space should be expected to grow considerably in the coming months and years.

Beginning with the publication of the Treasury's Cash Grant Guidance in July 2009, which specifically permits the assignment of cash grants to financial institutions, a market has developed among lenders for cash-grant anticipation financing. Lenders have been willing to provide as much as 95% of the expected cash-grant loan amount to developers in anticipation of the cash grant (or 100% with a shortfall guaranty from a creditworthy sponsor).

Often, the cash-grant loan is provided by the same construction lenders and term lenders as separate loan facilities documented in a single credit agreement. With a number of projects commencing construction or seeking to qualify within the 5% safe harbor or the "significant work of a physical nature at the project site" safe harbor before Dec. 31, the market for cash-grant loans can be expected to be particularly active in the weeks ahead.

Large concentrated solar power projects, many of which are in line to receive public financing from the Federal Financing Bank, in connection with the DOE's loan-guarantee program, are expected to seek financing in anticipation of cash grants.

For these multibillion-dollar projects, the expected cash-grant amount is in the hundreds of millions, meaning that the ability to syndicate these

loans will be crucial. Priority issues with respect to the cash-grant proceeds may prove to be particularly difficult to overcome.

In making cash-grant anticipation loans to projects, lenders must be cognizant of the technical requirements of safe harbors and bear in mind that the level of scrutiny by the Treasury with respect to eligible project cost amounts has increased as the cash-grant program has matured. As the number of dollars awarded increases, additional audits and increased scrutiny should be expected. Pricing and availability of cash-grant loans will be affected by the dynamics of supply and demand.

In sum, the cash grants amounting to 30% of qualified project costs have been crucial to the development of solar projects in the wake of the financial crisis. Although the lending market has recovered and the number of tax-equity investors returned to near pre-financial-crisis levels, the tax-equity market is still relatively shallow, given the amount of investment required to build the many gigawatts of renewable energy projects in the development pipeline.

In addition, many tax-equity investors were monetizing cash grants along with Modified Accelerated Cost Recovery System depreciation - as opposed to the ITC - and the failure to extend cash grants would lead to a significant reduction of capital in the tax-equity market. Given these capacity constraints, for most solar projects, the ability to "commence construction" prior to year's end and qualify for the grant will be crucial.

Pursuing the agenda

The Obama Administration's goal to double renewable power generation within three years faces a number of challenges. With the economy still mired in a sluggish recovery, electricity usage and electricity prices have declined. This means that in many parts of the country, higher-priced renewable energy is less cost-

competitive with the market price for electricity than it was just a few years ago. Most of the nation's renewable resources remain stranded, requiring billions of dollars in transmission investments in order to be successfully integrated into the grid.

Moreover, the administration's decision this year to address health-care and financial regulatory reform ahead of energy means that comprehensive energy legislation with a climate-change component is unlikely. As a result, the externalities associated with fossil-fuel electricity sources remain unpriced.

Still, the development of renewable energy projects maintains large public support, as evidenced by the convincing defeat of Proposition 23 in California, which would have overturned the Golden State's global-warming initiative, and electricity consumption should be expected to return to pre-recession levels as the economy recovers.

Support for renewable energy is increasingly tied to a desire to grow the domestic manufacturing in the sector. Macroeconomic realities and the short-term nature of the tax-credit subsidies in the U.S., however, have made this a particularly difficult sector for U.S. companies to penetrate and to gain and maintain market share.

Competition for solar modules is particularly fierce, with Chinese manufacturers rapidly expanding market share. The desire to support the development of this sector, though, remains a commitment of both political parties, and a broad spectrum of interest groups. Labor, business and environmental lobbies have rallied behind the notion of green-collar jobs. This momentum suggests that the Section 48D manufacturing tax-credit program for renewable energy manufacturers may be extended in the coming months.

The cash-grant program underscores how government support for renewable energy projects can have

unintended consequences. Because the cash-grant program is tied to the amount of qualifying investment - as opposed to the amount of energy produced by qualifying projects - it is a relatively inefficient form of subsidy that tends to reward less-productive energy projects and creates an incentive to increase projects' costs, because one-third of qualifying costs are borne by taxpayers.

Prior to the introduction of the cash-grant program, wind projects were limited to earning a production tax credit (PTC) of \$0.02/kWh, as opposed to the ITC based on the amount of project costs rewarded up-front to solar and other renewable projects. The rationale for the ITC for solar projects, rather than the

PTC for wind, reflects policy-makers' belief that the relatively higher capital costs associated with solar projects warrant (or require) an up-front credit.

As the market for solar PV matures, this rationale may no longer make sense, at least for solar PV. If and when Congress revisits the tax subsidies for renewable projects, given the current budget situation, one may anticipate that some in Congress will support production-based incentives for a wider range of renewable projects, including solar. Coincidentally, such production incentives may also indirectly support U.S. panel manufacturers, whose equipment often is more efficient than that of less-expensive overseas competitors.

In conclusion, deal structures today directly reflect the policy decisions made by legislators. Until renewable projects can compete with fossil-fuel projects, or the carbon externalities of fossil-fuel projects are reflected in electricity prices, project financing is likely to continue to be subject to changing political winds. ☞

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