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Navigating Capital Markets Amid Turbulent Waters

After 2012's record-breaking levels of installed capacity, where and when will wind developers seek capital for projects this year?

BY ALLAN T. MARKS

Despite ample sources of capital, transaction volumes for wind projects are lower than in the recent past. While the prevailing business cycle is an important macroeconomic factor in valuations, the single biggest determinant of the level of activity for new wind energy investment in the U.S. remains regulatory policy – or, more precisely, uncertainty over regulatory policy. And this uncertainty looks to remain a factor for some time to come, chilling investment and creating an artificial boom-and-bust cycle in the wind power industry.

2012 was a record year for new investment in U.S. wind energy generating capacity, as the scheduled expiration of the production tax credit (PTC) spurred a rush of projects to beat the end-of-year PTC deadline. In addition, many other wind energy projects, which had technically started construction before 2012, reached financial close and came online last year in order to retain eligibility to receive the Section 1603 cash grant in lieu of the investment tax credit from the U.S. Department of the Treasury. The cash grant expired at the end of 2011 but remained available for grandfathered projects that started construction before the expiration and reached commercial operations by the end of 2012.

All of those new wind projects in 2012 had a noticeable effect on the nation's economy. The government revised its estimate of the growth of the nation's economy in the fourth quarter of 2012 from 0.1% to 0.4%. Analysts credited the upward revision, in part, to the December rush to beat the PTC expiration, which was evidenced in the substantial uptick in real nonresidential fixed investment.

Marks

Historically, wind power installations have peaked just before scheduled PTC expirations, with a drop-off in the following year even when the credit has been extended or subsequently renewed. Therefore, despite last year's successes, the numbers at the end of 2013 could tell a different story, as the wind industry's cycle has turned to planning the next round of projects, and the sector faces the challenge of financing new installations, possibly without the aid of the PTC beyond this year.

Nonetheless, 2013 started out strong: The Federal Energy Regulatory Commission says January featured nearly 1,000 MW of new wind installations in the U.S. – a pace that, if sustained, would nearly keep up with the 2012 pace of installations. That rate of installation, however, almost certainly will not continue, because many of the installations were likely spillover from the December 2012 rush. Vic Abate, vice president of General Electric, told Bloomberg Businessweek in January that he expected the 2013 total of new installations to reach 5 GW to 6 GW – equating to about half of last year's total.

Access to capital

For projects with believably robust projected cashflows, capital remains plentiful. Capital – both debt and equity – remains available for new project financing. Depending on the balance of supply and demand for capital and a potential increase in interest rates later this year, pricing (fees and spreads) and terms for project financing this year are expected to be fairly consistent with 2012. Also, typical tenors, which came in last year on bank loans, are unlikely to be reduced further.

Although many European bank lenders exited the renewable project finance space in the past few years due to the credit crisis and capital adequacy issues, other European banks remain active in the U.S. market. And Japanese, Canadian and some regional American banks have largely picked up the slack, providing ample liquidity to the market.

In addition, institutional investors, such as insurance companies, private equity funds and pension funds, are dedicating debt capital to finance wind energy projects through private placements of notes (often for investment-grade projects, with project bonds still being relatively rare in the wind space), term loan B transactions (often for riskier projects with hedged merchant risk) and even hybrid transactions alongside commercial banks (to reduce negative carry during construction).

Cash equity from strategic investors and investment funds remains available. It can sometimes be supplemented by mezzanine debt or, following commercial operations, back-leverage or debt at the parent- or holding-company level. On the margins, sales of existing assets (e.g., BP's announced intention to sell its wind energy portfolio and the sale of Edison Mission Energy's projects through the bankruptcy process) may compete to a limited extent with investments in new projects.

However, valuations of existing projects remain challenging, especially for those projects that have less reliable technology or merchant risk.

Between 10 and 20 tax equity investors are active in the market, of which fewer than 10 are really active in multiple transactions. Because of the end of the Treasury's cash-grant program in 2011 and the wind industry's continued reliance on the PTC in 2013, demand for tax equity may increase this year. If so, pricing for tax equity could trend higher and availability lower as tax equity investors fill their capacity to take on more investments throughout the year. It remains to be seen whether these attractive returns will entice more tax equity investors to participate in the market.

Key considerations

Many new projects face other challenges. Transmission access remains difficult in various parts of the country, and more upgrades are needed to handle intermittent power, especially in remote locations. Co-location with other power sources, such as natural gas or solar power, provides some new opportunities to rationalize transmission upgrades consistent with system stability.

In addition, the recession has dampened enthusiasm for renewable portfolio standards (RPS) and other state-level mandates. It has been easier for many utilities to achieve their RPS targets because load growth has been outpaced by new renewable installations, and in some places, demand for energy has actually been reduced as a result of economic decline and increased energy efficiency. Furthermore, cheap natural gas puts downward pressure on wholesale power prices, and consequently, the market clearing price for long-term contracted power purchases in recent utility procurements has been significantly lower than in past years.

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Thus, entering into a new power purchase agreement on terms that are economically viable – even with the PTC – has become much harder than before.

Boom-and-bust cycles

This compression in the investment cycle and the acceleration of some projects to beat the regulatory clock at the end of 2012 mask a deeper challenge: Many additional projects were deferred or cancelled due to the lack of a timely extension of the PTC. Although Congress approved a one-year extension of the PTC for 2013 as part of the year-end package to prevent going over the fiscal cliff, it may have been too little, too late. By waiting until the last minute to extend the PTC, it was as if the PTC had lapsed for purposes of planning private investment in projects that depend – at least, in part – on the PTC for economic viability.

Yes, the extension was far better for the wind industry than letting the PTC expire; for projects that were already far enough along in development or construction, the PTC extension will enable them to achieve financial close and reach commercial operation this year. But for others, development was suspended or slowed in 2012 due to doubt about whether the PTC would be extended.

A one-year extension is not long enough to remove uncertainty about federal incentives for new wind energy investments going forward. In order for developers to commit resources to projects that are still in earlier stages of development or that require a longer development schedule, a PTC extension of more than one year is necessary to spur new investment. Each time that the PTC has been renewed or extended, new investment has substantially increased, only to collapse when the PTC was allowed to expire or when an extension was late or uncertain.

The recurring uncertainty about whether the PTC will be allowed to expire discourages investment and makes the PTC less effective than it otherwise could be to spur investment in longer lead-time development activity and associated manufacturing capacity for wind turbine generators and other components. During the peak in new investment, demand for equipment can outstrip manufacturing capacity, which either drives up construction costs – and, indirectly, the cost of power – or delays projects. Absent a more stable incentive regime, large and sustained investment in expanded U.S. manufacturing capacity may not be justified given the unpredictable

nature of the market that has historically depended so heavily on PTCs and other incentives.

Last year of the PTC?

President Barack Obama recently released his "Blueprint for a Clean and Secure Energy Future." His goal is to double generation from wind, solar and geothermal by 2020 (as compared to 2012 levels). The proposal calls for a permanent and refundable PTC as one way to reach that goal.

A permanent PTC will not be adopted in the current political environment, and indeed, it may not be warranted. A finite extension is useful to create a perceived urgency to invest, which stimulates investment over the short and medium terms. An extension of the PTC for more than one year – for instance, a three- to six-year extension – would provide a more stable regulatory environment that would stimulate longer-term development of wind energy projects, increased investment in domestic manufacturing capacity to meet more stable demand for wind turbine generators and other components, and more rational planning and construction of transmission lines and interconnection facilities to accommodate new growth in wind energy generation.

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The American Wind Energy Association has indicated industry support for a possible trade-off: a longer extension of the PTC, after which the credit would be allowed to expire. Such a plan would replace the boom-and-bust cycle of short-term PTC reliance with a measured, predictable phaseout of the credit over a period of up to six years, ultimately allowing the credit to lapse for good.

Other proposals may make the PTC more valuable and decrease the cost of capital by making it easier to monetize the credits. For instance, there are legislative proposals to make PTCs refundable and amend the tax code to allow renewable energy producers to receive master limited partnership status. But strong opposition in Congress may prevent any of these proposals from being adopted, and even the future extension of the PTC remains in doubt.

In short, this looks to be a year of continued regulatory uncertainty, gradually improving access to capital and somewhat reduced investment. Beyond that, the forecast is less clear and depends greatly on congressional action and the pace of the broader economic recovery. WP

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