

Financing Wind Projects In Volatile Times

As banks slowly begin to reassess lending to wind power projects, project finance uncertainty remains the order of the day.

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Photo courtesy of Innergex Renewable Energy Inc.

After several years of breakneck growth, turmoil in the global credit markets has disrupted the U.S. wind power industry. But with aggressive government support and a confluence of political, environmental and technological factors at its back, the industry may still recover to achieve the goal of 20% wind by 2030. Expanded government incentives will help, but projects still depend on credit market participants' willingness to lend.

State of the credit markets

Credit markets effectively shut down for new debt deals in the fourth quarter of 2008 and the first quarter of 2009. Normally, equity is the marginal dollar in a transaction and, accordingly, earns a significant premium. In the current market, debt is the marginal dollar, which is harder to find than equity.

In other words, in economic terms, the marginal dollar is the last dollar obtained from investors. The cost of the marginal dollar can increase greatly when demand for capital outstrips supply, but it becomes relatively cheap when credit is looser. As such, returns on investment for strategic equity investors have dropped, while debt spreads have widened considerably, more than offsetting any gains from lower interest rates.

Now, lending windows at some banks are cautiously reopening. Although banks are starting to lend, they remain reluctant to take on underwriting risk. Syndication will remain difficult until the banks regain confidence in one another, which will require both bolstered capital positions and more transparent balance sheets.

Today's deals are being run on a "club basis," with little or no underwriting. So-called club lending happens when two or more banks join together to make a loan, forming a "club" before loan closing. Hold positions, defined as the amount of commitments and loans that a bank will keep, rather than selling to another bank, are declining, and the

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maximum deal size is about \$200 million to \$300 million.

As credit markets begin to reopen, only the projects with the strongest metrics are being considered. Lenders are looking to finance projects with stronger sponsors, better power purchase agreements with financially strong parties, limited or no financial hedges, lower technology risk, and significantly higher debt service coverage ratios.

Lenders are again looking at the P-99 stress test, a sort of sensitivity analysis assessing the strength of a project's financial projections. As such, lenders are accepting less wind resource risk and favoring projects with higher capacity factors.

Structurally, bank debt in the current marketplace consists primarily of project-level loans, with seven- to 12-year tenors, although some back-leveraging is still being done. Up-front fees have risen to anywhere from 2.5% to 5%, and margins on project-level loans are over 300 basis points. Even with these wider spreads, banks are worried about covering volatile funding costs. Accordingly, LIBOR market disruption and pricing protection clauses are also common, passing some funding cost risk from banks to borrowers.

Until recently, it was customary for wind developers to obtain turbine supply loans (TSL) to finance purchases of wind turbine generators for future projects. In the current market, equipment loans have virtually disappeared. This shift has created more demand for financially stronger manufacturers to provide vendor financing.

Notably, due to credit constraints and the extended window for new projects to qualify for tax credits, demand has softened for new turbines, and the value of turbines in secondary markets has fallen somewhat. Minimum loan-to-value ratios will likely drop when the market for TSLs returns.

Banks are also scrutinizing credit analysis and commercial terms. Intercreditor agreements are moving against tax-equity participants. Lend-

ers are increasingly gaining control over the commercial terms of the deal, as project developers consider alternative financing structures permitted by the American Recovery and Reinvestment Act of 2009 (ARRA).

Government to the rescue?

The enactment of ARRA in February 2009 evidenced a significant commitment to the renewable energy sector, and to the wind industry in particular. The economic stimulus for renewable energy has twin goals: green energy and job creation. Most government tax incentives, such as the extended production tax credit (PTC), investment tax credit (ITC) and accelerated depreciation, are meant to encourage equity investments. With credit markets pinched, other govern-

In connection with the Section 1705 program, the DOE is expected to establish a delegated lender program whereby by the lender – not the project – applies directly to the DOE for a loan guarantee. This will allow the DOE to leverage private-sector experience in evaluating the credit quality of potential projects. It is expected that this delegated lender program will be used primarily for loans to so-called proven renewables, such as wind projects.

Project developers should be aware that projects funded by Section 1705 guaranteed debt are subject to prevailing wage requirements, and that “Buy American” restrictions will apply to public projects.

A number of other unresolved issues associated with the Section

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ment programs, such as loan guarantees and cash grants, are meant to attract or supplant scarce debt, bridging the gap in fund availability.

It remains to be seen whether government subsidies will be timely or sufficient. Wind power participants have been eagerly anticipating Treasury guidance on the new cash grants (see sidebar: A Few Thoughts About Those Cash Grants). Likewise, lenders and developers are awaiting details on ARRA's promise of federal loan guarantees for shovel-ready renewable energy projects, including wind projects.

The wind industry also awaits guidance on ARRA's revisions to the Title XVII loan guarantee program and establishment of the Section 1705 program for the rapid deployment of renewable energy resources. Application guidance from the Department of Energy (DOE) is expected later this month.

1705 loan guarantee program remain outstanding. Likely questions center around how the program deals with the non-guaranteed portion of the debt, required levels of equity and sponsor support, as well as how the loan guarantee program treats the ITC grant.

Private-sector involvement in the loan guarantee program as holders of guaranteed loans and assessors of credit risk is essential to the success of the program and the Obama administration's ambitious goals for wind power.

The legacy loan guarantee program's reliance on rating agencies as credit assessors has been time-consuming and costly. A delegated lender approach in the new program should help to achieve the goal of guaranteeing loans in the near term. And the loan guarantee program is key to bringing additional participants,

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like pension funds and life insurance companies, to the project finance marketplace.

The loan guarantee program has the potential to address deficiencies in today's constrained credit markets. Projects with a loan guarantee should be able to price their debt at a small spread over U.S. government bonds, giving projects the benefit of debt financing with longer tenors and lower rates.

But the four-year-old program has been burdened by regulatory red tape and institutional inertia. Hopefully, new leadership will transform the program and make it live up to its promise and potential.

Tax equity's return?

Depending on project specifics, the PTC partnership flip structure may remain the optimal investment vehicle for wind projects. Indeed, projects with higher-capacity factors (greater production per capital cost) may prefer the PTC because of the higher value of the PTC in a high-capacity factor project (compared to the ITC, which is based on the capital cost of the project). This means that the best wind projects still seek tax-equity investment.

The tax-equity market peaked in 2007, with about \$6 billion in volume. But today's market is a shadow of its former self. Tax-equity investor deals are rare, as developers are find-

ing it harder to monetize commercially acceptable terms with regard to depreciation and tax credits.

At about six, the number of active tax-equity investors today is less than half of the 18 or so pre-crisis participants. In the past eight months, a contraction in the supply of tax-equity capital resulted in calls by tax-equity investors for higher after-tax internal rates of return, ranging from 9% to 15% (up from 5% in 2007).

For the tax-equity market to become robust again, more potential tax-equity investors will need to have earnings to generate an appetite for the tax benefits afforded by new wind energy projects. Until then, wind energy developers backed by utilities or other large corporations with strong balance sheets will have a comparative advantage in funding projects. Further consolidation of the industry may well result.

The reduced roster of tax-equity participants is still dominated by financial institutions and life insurance companies, but the tax-equity marketplace has seen growing interest from utilities, which have been significantly less affected by the financial crisis.

Utilities, however, tend not to be pure passive tax-equity participants, desiring instead to be joint-venture partners, often with operational roles. New entrants, such as tech-

nology companies, remain a possibility, but the return expectations and strategy of high-tech enterprises are not consistent with the passive, debt/investor-like role of tax-equity participation.

Wind projects' proven track record means that these projects will be among the first to receive financing in the post-financial-crisis renewable energy space. And government programs will continue to affect the financing landscape. Over time, the bank market will recover as financial markets stabilize.

As deals get done, financial institutions will begin to trust one another again. This will allow deal size and volume to grow. In the meantime, more innovative deal structures, such as the inverted lease or the traditional sale-leaseback, will emerge as means to optimally allocate depreciation with ITC election and the Treasury grant. In addition, capital markets and project bonds may emerge to fill gaps in the financing landscape, perhaps in 2010. **SNP**

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