

Smoother Sailing For Project Finance Predicted This Year

Federal government incentives stabilized wind energy project finance in 2009 and will fuel its re-emergence.

BY ED FEO



Photo courtesy of AlltaGas

Financing of wind energy projects made a comeback in 2009. The American Recovery and Reinvestment Act of 2009 (ARRA) provided a number of incentives for renewable energy, including an expanded U.S. Department of Energy (DOE) loan-guarantee program under Title XVII, tax credits for manufacturing, leasing for wind projects and the Section 1603 Department of the Treasury grant program, commonly referred to as the cash-grant program.

The most beneficial of these programs was the Section 1603 grant program, with \$2.3 billion issued in the first six months since its launch. The grant program provided a cornerstone for additional debt-and-equity funding. The questions for this year are, can the momentum of wind energy financing be sustained, and will additional federal legislative action be required?

The ramp-up in 2009

In the first quarter of 2009, the tax-equity and debt markets were at a standstill following the 2008 financial crisis. The tax-equity market, which had peaked at nearly \$6 billion in 2007, suffered a rapid demise as financial institutions, which are the principal investors, imploded. The debt market shrank as banks dealt with issues related to subprime loans. More importantly for the wind sector, the financial chain broke down.

Equipment supply loans, which had seen a high watermark in late 2007 as sponsors made significant forward commitments on turbine purchases, were stranded as construction financing commitments melted away.

Construction loans, made with the expectation that tax equity would refund the construction financing at commercial operation, were stranded when the tax-equity investors backed away. The deals that were done in late 2008 and early 2009 were largely rollovers of financings that did not include significant new money refinancing.

Section 1603 proved to be an effective stimulus for new financing. Under Section 1603, owners of wind proj-

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ects commencing construction in 2009 and 2010 may elect to apply for a grant from the Treasury in lieu of claiming a production tax credit (PTC) or investment tax credit (ITC). The grant is in the amount of 30% of qualified costs.

While the guidance from the Treasury regarding the rules of the program took several months to be issued, the potential availability of a grant program from the federal government led sponsors to explore debt financing of projects that entered (or were to enter) construction or operation in 2009.

The structure put forward by several sponsors combined the grant, sponsor equity and debt, and no tax equity. While this structure was not as efficient from a tax perspective (in that accelerated depreciation likely could not be used), it was seen as necessary given the impairment of the tax-equity market.

Debt providers initially responded to major sponsors with nearly uniform product offerings. Construction financing was offered for up-front fees of 3% and loan margins over LIBOR of 3% or more). Term financing was offered with a tenor of five to seven years, with loan margins starting at 3% and escalating from there.

In a number of these transactions, the sponsors elected to take the Treasury grant, provide sponsor equity and fund the remainder of the capital costs with term debt. This approach was remarkably different than the wind project financing in prior years, where the term financing was largely provided by unleveraged tax equity.

A number of lenders offered an equity bridge loan based on the expected level of the grant program with an advance rate of 95% of the expected Treasury grant. However, most of these facilities required a sponsor guarantee. The terms of the guarantee covered the repayment of the loan if the grant was not paid by a certain date, al-

though in future deals, the scope of the sponsor guarantee might be limited to specific risks, such as disallowance due to ownership issues or the failure to file a qualifying application.

Level of funding

The capacity of the debt market was clearly constrained. While the number of participants remained significant, even in early 2009, the level of funding by each institution was dramatically reduced. Underwriting of transactions (where one institution commits to the full amount of the loan and takes the risk of selling down to other banks) was nonexistent. Instead, institutions would commit no more than \$50 million, requiring sponsors to put together "clubs" of lenders. Even with the club approach, the maximum size transaction in the first two quarters of 2009 was under \$400 million.

The club structure presented challenges for sponsors and lenders alike. Unlike an underwriting transaction, in a club transaction, there is no single institution responsible for negotiating the transaction. As a consequence, sponsors found that they were subject to a lowest-common-denominator form of negotiation, where the requirements of each lender would need to be satisfied on each issue.

As the year progressed, some lenders offered limited, best-efforts syndications, with full flex terms. Under flex, the debt arranger can change the terms of the financing as necessary to bring other lenders into the transaction. Most sponsors did not accept these proposals, given the risk of materially changing terms. Instead, sponsors developed strategies to deal with clubs.

One strategy was to identify one lender as the lead, and perhaps the sponsor would negotiate terms with that lender first. Second, the sponsors would include more potential lenders in the club than the sponsor would need for the transaction. This

approach was used to dismiss a recalcitrant lender and as insurance if any lender were to not obtain credit approval.

The terms of debt financing liberalized during the course of 2009 in favor of the sponsors. The number of project-finance lenders increased to more than 20. Tenors on debt term sheets increased to 12 to 15 years for select transactions, while the interest-rate margin was headed below 3%. By year-end, 25 wind debt financings had been closed.

The tax-equity market in 2009 started slowly, as the number of investors shrank to fewer than six. As a result, the target rate of return on the reduced supply of tax equity rose to over 12% on an unleveraged basis. The combination of reduced volume and higher cost meant that sponsors chose to do without tax-equity participation. As the year progressed, the tax-equity providers adapted to the availability of the Treasury grant and proceeded to close 18 transactions (according to a major tax-equity participant), although about half of those transactions were commitments made in 2008.

Tax-equity transactions used the partnership-flip structure common in wind projects. In many of these transactions, the Treasury grant was used in lieu of any tax credits. Where the Treasury grant was used, the tax-equity investor funds were based on a value including the grant, and it received the Treasury grant proceeds. The tax basis of the tax-equity investor will then include one-half of the amount of the grant. Of course, there were transactions closed in 2009 that relied on the PTC instead of the grant program, where the capacity factor of the project made the PTC more valuable than the cash grant.

Looking ahead

The amount of wind project financing this year will be dependent on the continuation of the Treasury

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grant program, the potential of the DOE loan-guarantee program and the continued improvement of the health of financial institutions.

The debate has already started regarding the extension of the Treasury grant in light of this year's required construction commencement date. Policy-makers have generally looked favorably upon the grant program, which has awarded approximately \$2.3 billion to over 240 applicants in less than six months. The current discussion is regarding whether and how the program might be extended.

A simple fix would be to extend the date for commencement of construction to the end of 2011 or 2012, and to otherwise leave the Treasury grant as currently in effect.

Another approach is to convert the grant program into a refundable ITC. This approach is currently a part of H.R.4599, known as the Renewable Energy Expansion Act of 2010. The bill would make the ITC refundable and available to projects in 2011 and 2012.

The refundable credit would be tied to a tax filing. This means that refunds under the new program would be paid after the annual tax return is filed for the year the project is completed. Refunds would also be subject to offset if the taxpayer has unpaid taxes or debts owed to the government. It is also anticipated that refunds of at least \$2 million will be subject to a higher level of scrutiny.

H.R.4599 carries forward the provision in Section 1603 specifically excluding the Treasury grant payment from gross income. Whether the refundable tax credit may be treated as an increase in a partner's outside basis is not addressed, although many advisors have adopted that view with respect to the Treasury grant program. Depending on whether a particular state tax regime conforms to federal tax law, the receipt of the refund might be subject to tax on the state level.

H.R.4599 does clarify Section 1603 in several respects. Notably, Section

1603 disqualified all Section 501(c) organizations; the proposed bill clarifies that Code Section 501(c) organizations that pay unrelated trade or business income tax are not disqualified from receiving the refundable tax credit.

However, the bill would extend the disqualified non-taxpayer rules to cover stock bonus, pension and profit-sharing plans. In addition, Sec-

equity investor may be willing to fund against the refundable tax credit, as long as it is the entity claiming the refund.

The Title XVII loan-guarantee program may also make an impact on wind energy financing this year. Applications under the innovative technology solicitations include wind projects with new storage technolo-

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tion 1603 provided an "all or nothing" rule for partnerships (and other pass-through entities) with disqualified partners. H.R.4599 changes this rule, providing that partnerships and subchapter S corporations will be disqualified only to the extent of the proportionate shares owned by the disqualified partners. The proposed bill would eliminate restrictions on the ability of real estate investment trusts to utilize the refundable tax credit.

Rush to financing

The extension of the grant program or its replacement by a refundable tax credit is welcomed. The grant program has had a positive impact on the financing of wind energy projects. The requirement for commencement of construction in 2010 means that this year will see a break-neck rush to financing, unless the program is extended. One concern is that the extension will not occur until late in the year, and sponsors will have no alternative but to rush transactions to close this year.

Lenders may be unwilling to provide the same level of financing for a refund that will take many more months to be paid than the current cash grant. On the other hand, a tax-

gies. Section 1705 of ARRA includes commercialized technologies, and the first solicitation for such technologies was issued in October 2009.

Several wind projects have applied to the Section 1705 program, in which up to 80% of the debt would benefit from a DOE loan guarantee. There is significant political pressure, both from members of Congress and from within the Obama administration, to issue guarantees as a means of facilitating construction jobs.

The program has been subject to a fair amount of criticism regarding its cost and complexity. A number of statutory requirements restrict the DOE's flexibility with respect to the issuance of guarantees. For example, Section 1705 loan guarantees must commence construction by the end of September 2011.

The list of ideal changes to the loan-guarantee program is lengthy. These changes include the extension or elimination of the construction commencement date, simplification of the application process, streamlining National Environmental Policy Act compliance and eliminating the need for credit ratings. Such changes are not likely to help with additional financing this year but may be of benefit in later years.

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More lenders are writing bigger “tickets,” resulting in increased transaction size. The terms being presented in term sheets for 2010 deals are showing improved pricing and tenor for sponsors. Lenders are also beginning to pursue transactions with smaller sponsors, where the hope is that better pricing may be obtainable.

The tax-equity market is also showing improvement, albeit at a slower pace than the debt market. The combination of improved profit-

ability of financial institutions, the continued availability of the Treasury grant or a refundable credit, and the possibility of lease financing is likely to lead to more transactions at a lower cost than seen in 2009. In particular, a number of financial institutions and advisors are pursuing lease financing of wind projects with the objective of bringing in new investors familiar with the leasing market but who were previously not willing to invest in partnership structures.

The prospects for financing this year are promising. From the perspective of project sponsors, the combination of continued – if not expanded – stimulus programs, growing debt markets and recovering tax-equity markets should make for an active 2010. **NP**

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