The Solar Power International conference held in San Diego this past October was attended by over 23,000 people. Enthusiasm about the prospects for solar energy could not have been higher, especially in light of an eight-year extension of the investment tax credit, including an increase of the credit for homeowners, and the expansion of the credit to include utility owners.

Unfortunately, that enthusiasm was somewhat dampened by the somber panels on financing issues. The word from lenders and tax equity providers was that the credit crisis had reached the renewable energy sector. Banks were not funding and investors were pulling back. Some of the better-known casualties of the credit crisis (such as Lehman Brothers and AIG) had been participants in the renewables tax equity market. Still, other institutions were ramping down because they were being acquired, preserving capital, or were simply unable to price accurately given the chaos in the credit markets.

More than one solar energy developer was caught in the credit maelstrom – with projects in construction and tax equity investors bailing out pre-completion.

The next week, I had the opportunity to moderate a panel on financing at the Roger Williams University School of Law Marine Law Symposium on: “A Viable Marine Renewable Energy Industry: Solutions to Legal, Economic, and Policy Challenges.” The attendees were focused on offshore wind and hydrokinetic projects. Although several offshore wind projects are being pursued in the northeast, not one has been built and the construction funding remains a future goal.

At this meeting, there was a noted degree of optimism. Chris Brown, CEO of Deepwater Wind (recently selected as the prime bidder in the RFP for offshore wind by the state of Rhode Island), put it best by noting that they were confident capital would be available when the time for construction occurred a few years hence.

The conclusion of these tales: severity of a credit crunch very much depends on one’s proximity to it. So, I offer a few thoughts on where we are and where we are likely to go from here...
As I have written in this column before, the renewables business has enjoyed remarkable growth of debt and equity in just a few years. New Energy Finance reported that the level of renewable project financings last year had grown to $148.4 billion, an increase of over 344% in just three years. The renewable energy tax equity market, which involves the investment by taxpayers in project companies monetizing tax credits and depreciation, had grown from non-existent in 2002 to $5.2 billion in 2007, with the prospect for growth to nearly $10 billion in 2008. The credit crisis did not arrive in the renewables sector in force until late this summer. There was some use of “market flex” in debt financings earlier in the year, as lead arrangers found syndications to be challenging. Interest rates and tax equity returns edged up slightly. But nothing compared to the price increases and ultimate unavailability of capital that had been visited upon the acquisition finance market months before.

September was not a kind month to the renewable energy finance business. The rapid contraction of liquidity in the financial sector led to the demise of Lehman and AIG, two active players in the tax equity market (Lehman is the owner of SkyPower, a Canadian wind and solar company). Other tax equity players stopped taking on new deals and even backed out of committed deals. The debt markets contracted as banks stopped issuing term sheets for new deals. New Energy Finance reported that renewable energy project financings fell from $23.2 billion in the second quarter to $17.8 billion in the third quarter. The end result was a game of financial musical chairs: lenders on turbine supply loans waited for construction loans that were slow in funding, and construction lenders waited for tax equity takeout financings that were slow to materialize. The cost of financing at each level went up.

As an example, the tax equity market, which had hit a low of under 6% on an unleveraged, after-tax internal rate of return in 2007, climbed to eight percent and even higher on especially troubled deals or especially desperate sponsors, in late 2008.

With that said, the debt and tax equity markets are still in business in the fourth quarter. Some banks are continuing to write new business, though volume is down. New debt financing is also being provided by private equity funds, although at rates well in excess of traditional bank rates. A number of new tax equity deals are being done by the likes of JP Morgan, Bank of America, MetLife, and New York Life. The prospect of higher returns is drawing interest from other investors, which have not been in the market previously.

What are the prospects going forward? Next year will be a period of recovery. I expect that liquidity will ease into the financial markets in the first half of the year. The renewable energy project finance business should be an attractive place for capital, at least for deals that are well structured – good equipment with strong warranties, minimal construction and operation risk, and robust purchase agreements with credit-worthy parties. The beauty of the project finance model in the electric sector is that market risk is largely squeezed out. The ultimate risk of failure is that a load serving entity cannot pay for the power being produced, and that should only be a risk arising from demographics of the service territory (putting aside side bets made on commodities, acquisition of unrelated businesses, or war with regulators – all of which utilities have from time to time managed to do).

Tax equity will be the most challenging capital given that the Internal Revenue Code effectively limits use of the credits to large, tax paying US corporations. In addition, the tax equity market has been dominated by financial institutions, which as a class may not be as interested in tax credits. So, the market needs to expand to other corporates, which likely means higher yields and more structuring to mitigate project level risks for investors not as versed in the energy business. The law might also need to change to open the scope of qualified investors. Trade organizations and others are currently working on proposed amendments to the Code to reduce the limitations on the use of tax credits in hope that more taxpayers will qualify to use the credits and, in turn, be willing to invest in tax equity transactions.

I also expect some of the renewable energy developers will have a rough ride in this period of financial uncertainty. Projects will certainly be deferred. And, in some cases, projects that are caught in financings with failed take-outs will see asset sales as the avenue for repayment. In this environment, those with strong balance sheets will gain over those without them. The bottom line: 2009 will be a transition year for renewable energy finance. We will see liquidity return, but prices will be up and volume down. New finance parties will emerge. One thing I am confident of, consistent with the sentiments expressed in Providence: the money will certainly be back by the time offshore wind needs it.

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