



LAW JOURNAL
NEWSLETTERS

LJN's

Equipment Leasing

Newsletter®

An ALM Publication

Volume 30, Number 4 • May 2011

Machinery and Equipment Supply Contracts

Back to the Basics

By John L. Watkins

Machinery and equipment suppliers manufacture and sell the machinery that other manufacturers use to produce all manner of manufactured goods. The “Great Recession” has been, in general, a very bad time for machinery and equipment suppliers in North America. However, there is reason for optimism in 2011.

The tax package recently enacted into law includes a provision allowing customers to write off many machinery purchases immediately. Machinery and equipment orders in Germany (a major supplier of machinery and machine tools) surged in 2010. Many international companies are recognizing that it is economically viable (if not economically superior) to establish manufacturing operations in the United States rather than manufacturing goods overseas and then transporting and importing them to the United States and Canada.

Machinery sellers typically sell equipment with a long expected-useful-life that will allow the customers to manufacture and sell their own products — and hence make a lot of money — for many years. Machinery and equipment sellers are often smaller than their customers and operate at modest profit margins.

This does not stop many customers from proposing terms and conditions that ask their suppliers not

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How Leasing Can Maximize Benefits in Wind Power Project Financings

By Allan Marks and Alyssa Frederick

Building wind farms is big business. The Global Wind Energy Council reports that wind power installations in 2010 represented \$65 billion worth of investment, and expanded global wind energy capacity by 22.5%. From 2005 to 2009 the world saw an average annual increase in installed wind capacity of 27%, with a high of 32% in 2009. Those new wind farms helped boost renewable energy to account for fully one quarter of global power generation capacity in 2010.

A growing share of new wind projects are being built in developing countries, which are rapidly adopting pro-renewables policies. In 2010, China surpassed the United States in total installed megawatts (“MW”) of wind energy capacity. But even in the United States, where electricity demand fell during the 2008/2009 recession, aging power plants and a suite of policies that support a shift toward cleaner energy sources continue to drive investment in wind power. In 2008 and 2009, the construction of wind power projects in the United States added 8,500 MW and 10,000 MW, respectively, to our national electricity grid. That accounts for 40% of all new electricity-generating capacity to come online during that period; a bigger share than any other technology. In 2010, 5,100 MW of new wind power projects were constructed. Meanwhile, the size and complexity of projects increased, capped with the financial close on Dec. 16, 2010 of the largest land-based wind farm in the world — the \$1.3 billion, 813 MW Shepherds Flat project in Oregon.

One key driver of this growth during the recession has been the popular federal Section 1603 cash grant program. Passed as part of the American Reinvestment and Recovery Act of 2009, the Section 1603 program allows certain renewable energy project developers to receive a grant from the U.S. Treasury Department equal to 30% of the capital costs of the equipment used to make electricity (which, for

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Wind Power

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a wind project, tends to be about 90-95% of total capital costs). The cash grant can be elected in lieu of the previously (and still) available 30% investment tax credit or the production tax credit. The cash grant provides a lump sum of cash to the owner of the facility, monetizing the benefit previously only available as a shield or offset to future tax liability. The cash grant thus provides additional liquidity to finance construction of new renewable power projects. Absent the Section 1603 stimulus, tax credits alone would have been insufficient to enable so much new investment. In any market, energy project developers typically do not earn significant enough profits during the early years of operation to be able to use tax credits themselves, and during the recession the outside tax equity investors who stepped in to buy those benefits became scarce.

The cash grant was set to expire at the end of 2010, but at the 11th hour Congress renewed it for one more year. The bill that extended the grant, The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, enacted on Dec. 17, 2010, also created a new tax incentive of 100% bonus depreciation for qualifying capital investments placed in service between Sept. 8, 2010 and the end of 2011. During 2012, the depreciation bonus is scheduled to continue at a decreased level of 50%.

Now that Congress has renewed the cash grant, and as the U.S. economy tacks toward recovery in the wake of the financial crisis, growth

in the construction of wind energy projects appears to be rebounding above 2010 numbers. Credit markets have loosened up since late 2008 and 2009, and term lending has increased. Nonetheless, in 2010 we still saw the demand for tax equity from wind power projects exceed supply. Access to some sources of capital is especially constrained for riskier projects using newer technologies or a larger scale. Leveraged lease structures can help by both: 1) efficiently employing federal and state incentives for wind projects; and 2) leveraging predictable cash flows to attract additional sources of institutional capital.

THE BENEFITS OF LEASING STRUCTURES IN WIND PROJECT FINANCE

In a traditional project financing structured to monetize tax incentives, such as the investment tax credit and bonus depreciation for renewable energy projects, the developer shares ownership in the project venture with tax equity investors seeking to offset profits from other unrelated business. In such a structure, a developer and a tax equity investor purchase interests in a joint venture created to own the project assets and take on long-term non-recourse debt from lenders. The project assets serve as collateral for the debt. In a wind deal the project assets typically include wind turbines and related electrical equipment, long-term agreements for the sale of power and possibly its monetizeable renewable energy attributes (renewable energy credits), all project cash flows, and rights to the real property on which the turbines are installed.

In the finite period during which a wind project provides a tax shield, the tax equity investor is allocated a large majority — often over 90% — of the project's income, loss and tax attributes. After the investor earns a specified rate of return from cash distributions and tax allocations, the ownership of the joint venture “flips” so that the developer holds 90% or 95% of the ownership interests, with the tax equity investor's

stake accordingly reduced. After the flip, the developer often retains an option to purchase the tax equity investor's remaining interest at fair market value, which can be exercised at predetermined times.

Using a lease structure can benefit wind project financings in either the cash grant or tax incentive context. A lease structure will not always be preferable, of course — the legal framework of the particular policy incentives used to aid financing, and the unique characteristics of the project itself, such as its construction timeline, size and goals of its developer, will determine how to best expand the pie. Navigating the applicable tax rules requires care. For instance, wind power developers may not use a sale leaseback structure and receive the production tax incentive, because such projects must be owned and operated by the taxpayer.

In a typical sale leaseback structure a tax-advantaged equity investor buys a qualifying wind facility from a developer, and immediately leases the facility back to the developer (or to a special purpose vehicle owned by the developer). The lessee must pay fixed rent (or a fixed termination value in the event of loss of the assets) to the investor/lessor, for the term of the lease. The lease payments are typically due come “hell or high water,” despite any glitches in the project's performance or force majeure events. The developer lessee bears all of the operating costs, which are typically paid ahead of rent. At the end of the lease term, the investor/lessor still owns the facility, but the developer/lessee usually retains an option to buy it from the lessor at fair market value.

In a deal that uses either the cash grant or a tax incentive like the federal investment tax credit, fixed rent payments offer the prospect of

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predictable long-term revenue for the equity investors. This can expand the pool of institutions attracted to the transaction, including those that would not normally purchase membership interests directly in a project venture. For a project developer, while the risk of defaulting on its loans may increase due to the rigidity of the lease payments to the lessor, the upside also improves, because the project developer immediately captures any profits that rise above those lease payments. In order to manage fluctuating revenue flows that mirror the natural intermittency of wind, leveraged leases in wind financings can be structured with quarterly or semi-annual rent payment periods (rather than monthly), and built-in cash reserves to be funded during high-production times.

Due to the regulations governing the use of federal renewable energy incentives, a lease structure can lend some extra flexibility in timing. A sale leaseback transaction can close up to 90 days after the facility is placed in service and still receive the cash grant or investment tax credit, whereas a traditional “partnership flip” tax equity investment must achieve financial close before the facility is placed in service. The sale leaseback structure also allows a project to be up to 100% financed by a combination of tax equity in the lessor and debt, whereas in a partnership the developer must often fund a portion of the equity interests.

For developers applying for a cash grant another benefit of the sale leaseback structure is that the value of the property that forms the basis for the grant amount is the independently appraised fair market value of the facility when transferred to the lessor, rather than its original cost basis. Thus, once the

project has been packaged by the developer and sold to the lessor, the eligible cost of the facility becomes the price of the whole package. If the fair market value is higher than the original cost basis of the facility’s equipment, this can potentially result in a larger cash grant award.

HATCHET RIDGE: A CASE IN POINT

Hatchet Ridge, a 101.2 MW wind project developed by a subsidiary of Pattern Energy LP, became operational in October 2010, and less than 90 days later closed a refinancing using an innovative sale leaseback structure. The project, located in the mountains of Shasta County in northern California, was the only large-scale wind farm to come online in California in 2010. It was also the first leveraged lease transaction closed since the 1980s to refinance a wind farm already producing and selling power.

The project company, Hatchet Ridge LLC, entered into a power purchase agreement with Pacific Gas & Electric Company to buy the facility’s electricity — the power equivalent needed to serve 44,000 homes — for 15 years. The project generates electricity from forty-four 2.3 MW wind turbines made by Siemens Energy.

The innovative structure of the deal attracted both equity and debt from various institutional investors, each of whom provided funds to the owner/lessor. The owner/lessor used that money to purchase the project from the developer, with an agreement to lease it back. Crédit Agricole Corporate and Investment Bank (“CA-CIB”) provided a letter of credit facility. Crédit Agricole Securities acted as sole placement agent for debt securities in the project in the form of Pass-Through Certificates designed with a term longer than the project’s power purchase agreement and an attractive coupon. A consortium of insurance

companies bought \$143 million worth of Pass-Through Certificates, demonstrating the depth of the institutional private placement debt market for renewable energy deals, while another institutional investor acquired the equity in the lessor.

From the beginning, the developer had planned for Hatchet Ridge to elect the Section 1603 cash grant in lieu of the investment tax credit. This meant that the deal required only enough tax equity to take advantage of depreciation benefits. The lessor received a cash grant, reducing the effective amount needed to fund the sale leaseback. But by structuring the deal as a sale leaseback transaction, the developer was able to maximize the value of the project’s cash flow to its equity investors as well as to its lenders. Thus, the leveraged lease was the perfect device to attract institutional capital, reducing the developer’s need to tie up its own cash, which can now be redeployed to build other projects.

WHERE NEXT?

With the extension of the full suite of federal incentive programs for wind energy projects — this year with increased depreciation benefits — and tax equity still elusive, well-structured sale leaseback transactions may continue to help wind projects get financed. For the right projects, sale leaseback structures can efficiently employ many of the incentives designed to spur renewables, while drawing in capital-rich institutions that have not traditionally participated in energy project finance. In today’s policy and market landscape, the leveraged lease has become a valuable tool in the toolboxes of renewable energy developers and financiers.



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