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Stimulus and Response

The loan guarantee program moves ahead

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The renewable energy finance story of the year is the emergence of the federal government as the financial prime mover. The Treasury grant program in Section 1603 of the American Recovery and Reinvestment Act ("ARRA") has proven to be a powerful tool in leveraging new investment and financings. The Department of Energy ("DoE") has accelerated its grant program for new energy technologies with funds being provided for new generation, smart grid, energy efficiency, and fuels solutions. And, finally, the DoE loan guarantee program under Title XVII of the Energy Policy Act of 2005 has gained momentum with new solicitations in July and early October.

Last column addressed the DoE loan guarantee solicitations issued in late July. These solicitations were for large transmission projects and innovative technology generation projects. At that time, the initial filing dates under the July solicitations had not yet occurred. With those dates now passed, sponsors with qualifying projects are queuing up by the dozens at the DoE's door. The definition of "new or significantly improved technologies" is especially helpful to technologies that have been deployed outside of the United States on a commercial basis, but not yet so deployed here. Expect to see a number of large-scale solar projects benefitting from this program.

The DoE offers 100% loan guarantees under July innovative technology solicitation. Funding will come from the Federal Financing Bank ("FFB"). In those transactions, the DoE and FFB are the only credit parties and perform their own due diligence, credit assessment, and underwriting. This program does not have to deal with the intercreditor issues arising under the new Section 1705 program implemented under ARRA—the partial guarantee of loans to commercial renewable energy technologies.

On October 7th, 2009, DoE issued its first solicitation under Section 1705 for guarantees of up to 80% of the debt financing for commercial renewable energy technology projects. Manufacturing facilities are not included in this solicitation. The solicitation establishes a series of ten application dates, starting on November 23rd, 2009. The program will apply $750 million of funds allocated under ARRA to pay for the credit subsidy costs of the loan guarantees. The credit subsidy cost is the premium paid to DoE to issue the guarantee. Estimates of the amount of guaranteed loans vary widely, based on the assumed amount of the credit subsidy cost—some industry experts suggest as high as $15 billion.

Both project level and corporate level financings will qualify for this program. Guarantees generally are available only for construction projects, although a take-out financing of another construction loan might qualify if there is no other term financing available to the project.

The new solicitation defines "commercial technology" as technology in use in three or more projects anywhere in the same or substantially similar application for a period of at least two years. The time periods and geographic scope are different than the innovative

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technology definition for the July solicitation (requiring no more than three projects in operation in the US for more than five years). A technology could qualify as both innovative and commercial under the different solicitations depending on the extent and timing of deployment.

Under the October solicitation, DoE will work directly with qualified financial institutions in the Financial Institution Partnership Program ("FIPP"). Under this program, eligible lenders (not the borrower) will apply to the DoE for the loan guarantee. The lender applicant is obligated to perform a due diligence review and credit assessment consistent with its standard internal policies applied in making loans where no guarantee is issued. The lender applicant (and each proposed other entity providing financing) must provide a financing commitment as part of the guarantee application. The solicitation is geared to a simple senior secured bank or institutional financing. However, the definitions of "lead lender" and "holder" of the guaranteed obligations are sufficiently flexible to contemplate capital markets and securitization structures.

One objective of the FIPP is to underwrite transactions that have credit ratings of BB or the equivalent. The lender applicant must obtain and submit a credit rating for the proposed transaction as part of its application. This level of credit rating is typical for most senior secured debt financings, although it is not market practice to obtain credit ratings in privately financed debt transactions.

Applications will be evaluated by DoE on a competitive basis and scored for programmatic factors (especially readiness of the project for financing and simplicity of structure), creditworthiness (financial strength and security of revenues), and financing and funding plan (ability of the financing parties to close the deal). The solicitation goes to great lengths to emphasize that simple financing structures and "shovel readiness" are critical factors in light of the ARRA requirement for construction to commence by September 30th, 2011. Commencement of construction means the borrower has completed all engineering and has obtained all permits, engaged all contractors necessary to build the project, and commenced physical construction on the site.

Title XVII requires a project obtaining the benefit of a loan guarantee comply with the National Environmental Policy Act ("NEPA"). The new solicitation notes that, given the outside date for commencement of construction, projects requiring an environmental assessment (instead of a full environmental impact statement) are more likely to qualify for a loan guarantee. Many projects that have not previously had to do a NEPA review will be doing one now.

The loan guarantee will cover no more than 80% of the debt. This program will require the holders of guaranteed loans to keep the uncovered portion as well, with transfers requiring DoE consent. Any transfer must maintain the *pro rata* relationship between guaranteed and unguaranteed obligations. DoE also makes all decisions as to the guaranteed obligations (including the exercise of remedies), except for a consent right of holders as to amendments of basic financial terms and the right of two thirds of the holders to direct remedies on an extended borrower event of default if DoE fails to act.

This new solicitation presents a narrow gate in terms of readiness, creditworthiness, and environmental compliance, but has the potential to be of great benefit to qualifying projects. The firmness of the requirements of this program is remarkable given the flexibility on "readiness" evidenced in the prior solicitations. But this program is all about stimulus and the ability to get construction moving. Although initially skeptical about the likelihood of sponsors wanting to go through this program, given its stringent requirements, we are seeing a tremendous amount of interest from sponsors in getting the 'part one' applications on file as soon as possible.

Of course, the stimulus effect here is not to finance projects that would not otherwise be financed. In fact, the effect is quite opposite: projects that will qualify for this program will likely qualify for financing in the private market. The stimulus effect should come, if at all, from the potential enhanced equity returns afforded to qualified projects, as well as from greater leveraging of private debt financing sources. One could say the program makes the rich richer, but the policy decision to support that outcome was passed with ARRA earlier this year.

The benefit to equity from the program will come from the reduced debt cost and greater tenor of financing capable with a loan guarantee. The net present value of the project to the equity sponsor improves with lower debt service payments. That improved equity return means more cash flow to the sponsor, or a higher price on the sale of interests in the project. Presumably, those additional funds can be used for other renewable energy project investments.

Leveraging the private finance market will occur in two ways. One is that more lenders will participate in renewable energy finance given the availability of the guarantee. This seems somewhat at odds with the notion that the deals should be underwritable without the guarantee (in effect, the lenders are being asked to evaluate the credit blind to the guarantee). But, as a practical matter, we are seeing new funding sources being attracted because of the potential guarantee. The effect of the guarantee cannot be isolated in a vacuum. The other benefit will be that lenders will have more capital available given the lower reserve requirements of a guaranteed loan. So, we should expect growth in the capacity of the debt markets as a result of the program.

It has been an interesting year. The year commenced with the financial markets in disarray. ARRA was passed in February and commenced the new era of federalization of renewable energy project finance. The Treasury grant has shown the potential to completely change the basis for federal support from a tax subsidy to a cash subsidy. Finally, we are seeing the DoE loan guarantee program with the potential to finance billions of dollars of projects in 2010. Amazing change in a short period of time.

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