

FEDERAL LOAN GUARANTEES, GRANTS, TAX LAW MODIFICATIONS, AND THE ECONOMY'S IMPACT ON WIND POWER PROJECT FINANCING

Kimberly E. Diamond

On October 14, 2009, project developers, equity providers, and debt providers shared their insights about the project finance market landscape for wind power projects at the AWEA Wind Power Finance & Investment Workshop in New York City (the conference). A recurrent theme among conference speakers was the substantial impact on preconstruction completeness levels, access to capital, and financing structures that economic conditions, U.S. Department of Treasury (Treasury) grants, a U.S. Department of Energy (DOE) federal loan guarantee program called the Financial Institution Partnership Program (FIPP), and recent modifications to U.S. Internal Revenue Service's (IRS's) Revenue Procedures are having on these projects. This paper discusses these issues and summarizes the current state of wind power finance according to information provided primarily at the conference.

I. Current State of the Wind Industry

Wind is now a leading form of renewable energy in the United States. Conference speakers from the American Wind Energy Association (AWEA), including AWEA's CEO, Denise Bode, and its Director of Industry Data and Analysis, Elizabeth Salerno, indicated that U.S. wind power is now a \$17 billion industry, experiencing a fifty percent growth in 2008 and constituting forty-two percent of all new capacity installed in 2008 (second only to natural gas installations). They also indicated that as of 2008, the United States had surpassed Germany to become the top country in the world for the total amount of wind power megawatt (MW) installations, that there is growth in the wind industry on the demand side, and that the wind industry is now viewed as a bright spot in the U.S. economy—something that the federal

government does not want to lose during the current financial crisis.

Statistics from AWEA, however, are also revealing with respect to the current state of domestic wind power financing and project development relative to 2008 levels. These statistics show that the U.S. wind energy industry installed approximately 1,600 MW of new power-generating capacity in third quarter 2009, bringing total capacity added during the first three quarters of 2009 to over 5,800 MW. Inhospitable economic conditions, though, caused wind power construction in 2009 to be substantially lower than in 2008, with the 5,000 MW of projects under construction in fourth quarter 2009 being nearly thirty-eight percent lower than the more than 8,000 MW that were under construction during fourth quarter 2008. (See AWEA News Release at http://www.awea.org/newsroom/releases/10-20-09_AWEA_Q3_market_report.html.) According to information AWEA received from its project developer members, as of October 2009, approximately 60 wind power projects were under construction for completion in 2009 or 2010. (See AWEA's Third Quarter 2009 Market Report, <http://www.awea.org/publications/reports/3Q09.pdf>.) Access to financing will play a critical role in determining the number of these projects that will be completed timely, or at all.

II. Programs Currently Available for Wind Projects

A. U.S. Department of Treasury Section 1603 (Section 1603) Grants vs. Production Tax Credits and Investment Tax Credits

Treasury is offering the Section 1603 grant program to wind farm developers in lieu of the investment tax credit (ITC), a provision included in the American Recovery and Reinvestment Act of 2009, P.L. 111-5 (Recovery Act). By receiving payments for property used predominantly inside the United States in a trade or business or held for the production of income under Section 1603 of the Recovery Act, applicants may elect to forego production tax credits (PTCs) or ITCs

under Sections 45 and 48 of the Internal Revenue Code (IRC) with respect to such property for the taxable year in which the payment is made, or any subsequent taxable year. Treasury will make grants under Section 1603 to qualified applicants, in the amount of thirty percent of the cost basis of the property for large wind projects. Treasury will extend grants to qualified applicants within 60 days of Treasury's receipt of the completed application. To be eligible for a grant, a large wind project must be originally placed in service between January 1, 2009, and December 31, 2010 (regardless of when construction on the project begins), or have started construction during 2009 or 2010 and have been placed in service after 2010 but before the January 1, 2013, credit termination date (as such term is defined in the program guidance for the grant). (See <http://www.treas.gov/recovery/1603.shtml>; <http://www.treas.gov/recovery/docs/guidance.pdf>.)

B. DOE's FIPP Loan Guarantee Program and Application

Federal loan guarantee programs such as DOE's FIPP are also available for wind farm projects. Programs such as FIPP are intended to assist renewable energy projects—including certain wind projects—on their road to completion by providing them with a monetary boost. As background, Section 406 of the Recovery Act amended Title XVII of the Energy Policy Act of 2005, 22 U.S.C. 16511–16514, as amended, to create Section 1705 (Section 1705). Section 1705 authorizes a new program for rapid deployment of renewable energy projects, related manufacturing facilities, and electric power transmission projects, among other things.

To be considered for FIPP, a lender-applicant (a financial institution, or group of financial institutions chosen to represent the other financial institutions for purposes of the FIPP application, that serves as “lead lender” as such term is defined in the FIPP application) must submit a lengthy, two-part application. Notably, the lead lender must remain lead lender throughout the term of the FIPP loan, unless such lender obtains DOE consent to discontinue holding such role. Part I of the application requires an executive summary, initial project information, and a project overview to help

DOE and borrower gauge how successful the project will be. Part II of the application—the first portion of which was due November 23, 2009, and the second portion of which was due January 6, 2010—provides more detailed information than Part I, and requires, among other things, in-depth cost estimates; financial plans (including sources of funds, financial statements, collateral, and preliminary credit assessment); key contracts and agreements; a summary of project sponsors' capabilities; a summary of each project participant's prior experience as relates to the proposed project; a list of federal, state, and local permits and approvals required; engineering and construction plans; environmental reports indicating the status of National Environment and Planning Agency review/approval and environmental impacts; and other technical and financial information relating to the project. In fact, the depth of disclosure necessary to complete Part I of the application has deterred certain project developers from applying for FIPP, as they do not want to disclose proprietary engineering and other information in their filing. The take-away from the FIPP application is that, in terms of preconstruction completeness, a wind project must be almost fully “baked,” or, rather, have most of its preconstruction components in place already, to be a viable candidate for a FIPP loan guarantee.

According to the Commercial Renewable Power Generation Solicitation for Part II of the FIPP application (reference number DE-FOA-00000166), issued on October 7, 2009 (the solicitation announcement), on which speakers at the conference focused, of the approximately \$3.9 billion available under the Recovery Act, DOE will make \$750 million available to pay the credit subsidy costs of loan guarantees made for commercial technology renewable energy generation projects selected to participate in FIPP. Conference speakers emphasized that wind power finance dominates all other forms of alternative energies in terms of the finance market's involvement in renewable energy projects. The amount of funding and access to capital that FIPP provides, therefore, is significant both for the state of domestic alternative energy projects generally and for the wind industry specifically.

DOE will engage in a rigorous selection process to determine to which projects FIPP loan guarantees will be given. Only those projects most likely to commence construction no later than September 30, 2011, will be issued a loan guarantee. Other factors DOE will consider are to be assigned weighted values. These factors include the simplicity of the project, the project's financing structure, legal and regulatory matters, the creditworthiness of the project based on security of revenues and expenses, the lender-applicant's ability to satisfy DOE's underwriting criteria, and the probability of successfully executing the proposed financing and funding plan for the guaranteed obligation, including the proposed borrower's ability to repay both the face value of the debt DOE will guarantee under Section 1705 (the guaranteed obligation) as well as other project debt. For each project, the guaranteed obligation is limited to no more than eighty percent of the total project costs for a particular project. The guaranteed obligation is also expected to be a "traditional" senior secured debt, structured in accordance with customary market terms applicable to a high-quality, limited, or nonrecourse, long-term energy project finance transaction that is not modified to accommodate tax-oriented investment structures. (See FIPP description at www.energy.gov/recovery/print/renewablefunding.htm; <https://www.fedconnect.net/fedconnect/?doc+DE-FOA-00000166&agency=DOE>.)

C. How FIPP and the Section 1603 Grant Program Square with Current Economic Conditions and the Status of the Debt Market

Large wind project developers at the conference lauded the benefits that both the Section 1603 grant program and FIPP provide. These developers agreed that for purposes of access to capital, the availability of grants has been extremely helpful. In their opinion, grants are more efficient than PTCs in terms of deal finance because tax credits are comparatively more expensive; as these speakers explained, only a fraction of the money received from tax credits may be applied as payment toward the project's cost of completion goal, whereas 100 percent of the grant money may be applied as payment toward such goal. Speakers also found the grant preferable because it is insulated from other types of financial risks. The obvious, yet

unspoken, benefit of the grant is that grant recipients do not need to amass as much additional financing for their projects as do those whose projects cost approximately the same amount but are not awarded such grants. The cost savings over both the long and short terms make the Section 1603 grant a highly attractive option in a market where financing is difficult and expensive to acquire.

Developers at the conference believe that FIPP is important for two main reasons. First, similar to the grant, it ranks as one of the biggest, most positive short-term steps for project development during the economic downturn. Second, FIPP's message that capital is available for projects that are structured well is indicative of the status of liquidity generally in the current debt markets. Conference speakers noted that, comparatively, liquidity in fourth quarter 2009 was more accessible than it was in early first quarter 2009 because banks (as of fourth quarter 2009) are starting to fund projects, particularly well-structured ones.

Conference speakers made clear, though, that overall, there was not a substantial change in the amount of liquidity available in the financial markets between first quarter 2009 and fourth quarter 2009. This is likely why numerous wind power projects have not been coming to market, even though many deals are in the pipeline. Conference speakers estimated that liquidity conditions would improve by the end of 2010, but predicted that available liquidity would increase to a level of only seventy-five percent of what it was in mid-2008. They also agreed that increased liquidity will enable people to obtain loans, but not at lower interest rates, at least in the short term.

III. Large Wind Projects: Obstacles to Obtaining Financing from Lenders in Today's Marketplace

A. Cost of Capital and Appetite for Risk

A key reason why banks are not financing various wind projects, as conference speakers noted, is because their risk appetite has contracted dramatically from what it was in 2007. Compared to 2007, the cost of capital for banks today has increased tremendously, causing banks to want higher rates of returns. Conference speakers indicated that given banks' risk-

adverse lending stance, it is not possible to borrow a term loan in a classical sense now. Similar to the FIPP application process, a bank will consider extending bridge loans for turbines and the wind project overall only if the project is relatively far along in the preconstruction completeness process at the time the bank receives the loan application. Even if the level of preconstruction completeness for a project is high, due to the risk-adverse climate permeating the lending arena, many U.S. banks are still hesitant to provide such loans and are not participating in project financing. Developers are hoping that this will change because U.S. banks' participation in this space is needed. Foreign banks, therefore, are currently dominating the U.S. finance arena for larger wind projects.

Large wind project developers face other challenging issues prior to approaching banks for loans. For instance, developers must show that the project has raised sufficient capital so that it appears to have adequate financial backing. This task is rather difficult to accomplish in today's marketplace. As conference speakers indicated, because it is generally impossible to raise capital from a single source, projects need to "stack capital" from a variety of sources to have any chance of being viable. Amassing a sufficient number of committed sources to raise enough capital during the preconstruction phase can be difficult, and can impede the bank loan or FIPP application process, as applicable.

B. Challenges with "Club" Transactions in the Face of the "Death of Underwriting"

Conference speakers also discussed the difficulties both lenders and borrowers are facing due to banks participating in "club" deals with other banks, rather than in underwritten deals. According to a representative from Invenenergy LLC, large project developers witnessed the "death of underwriting" in 2009. In an underwritten deal, the lead arranger takes the project risk and can list the project on its balance sheet. This is not the case in a club deal. Also, banks may hesitate to join certain clubs because they are concerned about taking on counterparty risk from other participating club members. These risks collectively deter banks from participating in a particular club and from wanting to be the lead bank in

such club, causing the documentation drafting process and the transaction overall to progress in a very chaotic manner.

Moreover, borrowers are highly interested in the quality of lenders being approached to join the clubs for their respective deals. Borrowers seek to assemble clubs composed of lenders that have the strongest reputations and highest prestige levels in the marketplace. Projects with smaller deal sizes require fewer club members, making it comparatively easier to assemble a club for such transactions. This is because lenders who may be interested in participating in a club, or who may be needed for purposes of assembling enough lender participants for a viable club, may not be attractive to a particular borrower. Such a borrower has the power to prevent a lender from joining that club. Together, these factors make it difficult to assemble a club for projects with large deal sizes.

IV. Types of Wind Projects Finding Favor in the Marketplace

In addition to those wind projects in advanced stages of preconstruction completion noted above, there are several other categories of wind projects that are faring relatively well under current market conditions. One such category features Tier 1 turbine manufacturers and involves large project developers. According to conference speakers, these are known as "high class projects." Demand for Tier 1 manufacturers' turbines is increasing in international markets. Such high demand is fueling banks' propensity to lend money for these deals because, as noted above, banks are more willing to lend to developers whose projects have a greater likelihood of being completed. As a result, debt deals for these projects can be accomplished.

Projects that certain mid-sized wind developers are handling constitute another project category faring well in this economy. Mid-sized projects, in conference speakers' opinions, have been relatively insulated from the financial crises. Unlike large project developers, mid-sized project developers are seeing an entire gamut of deals being executed, including those with more unusual, less basic deal structures.

V. Current Deal Structures

A. *Simplicity Is Preferable to Creativity*

Certain mid-sized wind project developers hoped that the project success they are enjoying would help garner acceptance in the marketplace for more creative, alternative, and new deal structures, and that this in turn would enable both medium- and large-sized projects alike to obtain project financing in the near future. Unfortunately, this has not occurred. Simplicity in deal structures is now preferable for lenders and will likely remain that way for some time. Less creative and more basic deal structures mean lower execution risk and business risk. In this inhospitable lending climate, banks do not want to take the risk that a sponsor may do something to collapse the deal's structure. As one mid-sized developer indicated, the "memory of term sheets abandoned" and numerous workouts during early 2009 still scare people. In this market, developers and banks alike want to be as certain as possible that projects in which they are involved are going to "cross the finish line." Conservative deal structures and longer amortization periods of 10–15 years, particularly for larger projects, help minimize completion and other risks. These risks would increase substantially if cutting-edge structures and shorter amortization periods were used. Consequently, the success mid-sized developers have experienced with various types of deal structures most likely will not be transferable to large project deals in the near future.

B. *Three Common Financing Structures*

The focus on structural simplicity for large projects has resulted in three (3) basic project financing structures that large wind project developers are seeing in the marketplace currently: (1) project debt (discussed above); (2) traditional partnership flip; and (3) sale-leaseback. Conference speakers indicated that the partnership flip structure is the most prevalent financing structure in today's market. Such structure involves a partnership between a developer and a tax equity investor, wherein the latter receives income, PTCs, and losses up to an agreed-upon internal rate of return on its cash investment in the project, and the former receives the majority of the project's upside. Once the tax equity investor's internal rate of return is reached, the structure "flips" so that the developer then receives

the project's income, PTCs, and losses. Recent modifications to the IRS's Revenue Procedure 2007-65 (Rev. Proc. 2007-65), released in Announcement 2009-69 on September 21, 2009 (Announcement 2009-69), make the partnership flip structure even more attractive, due to the loosening of conditions under which the IRS will respect the partnership's allocation of PTCs. This is because Announcement 2009-69 modifies Rev. Proc. 2007-65 to (1) eliminate language indicating the IRS will scrutinize wind projects that do not satisfy all safe harbor requirements, and (2) allow the partnership parties the ability to contractually agree upon a fixed price purchase option strike price at the beginning of the transaction, so that such price, rather than the fair market value of the property, may be used on the "flip date" for a party who wants to purchase the wind farm, any property included therein, or an interest in the project company. (*See* http://www.irs.gov/irb/2009-40_IRB/ar16.html.)

In a sale-leaseback structure, a company sells an asset to a buyer, and then leases the asset back from the buyer. This structure is viewed as a single transaction in which the sale and the leaseback are negotiated as a package. Conference speakers indicated that the advantage of a leaseback structure is that it can potentially attract additional players. Issues arise, however, if there is debt that needs to be refinanced during the middle of the lease term. Those who use this structure need to be comfortable managing the tax risks so that they can own the project at a reasonable price. The leaseback structure, which has been used primarily for financing solar projects, generally has not been used for wind project financing. Possible reasons for this are that the tax/equity portion of the marketplace has been reduced as a number of banking institutions do not have tax capacity currently, and the debt portion of the market has grown. As a result, the number of debt investors in wind projects is greater than the number of tax investors.

VI. Conclusion

While conference speakers provided an interesting snapshot of the wind power financing arena, it became evident that federal assistance through grant and loan programs, as well as through the loosening of tax-

related restrictions on commonly used project finance structures, is helpful but is insufficient to give many large projects the monetary boosts they need to become viable. This is because the federal initiatives discussed above are aimed at assisting the developer (the casualty of hard-to-obtain liquidity), rather than at targeting the banks and their highly conservative lending practices. Clearly, large wind projects that have simple transaction structures, as well as their contracts and financing lined up and in place, will fare better than those projects that do not. However, access to liquidity from lenders—particularly domestic lenders—remains a major bottleneck for the vast number of these projects in the pipeline. As a matter of policy, it may be beneficial for federal policymakers to analyze (1) whether existing federal incentives such as grants, loans, and more favorable tax treatment, while helpful, are truly providing significant enough breath to resuscitate domestic wind project financing transactions, (2) whether additional federal programs are needed, or (3) whether such federal actions and programs are merely the equivalent of bandages applied to a much greater economic problem that must heal itself primarily through the workings of market forces. Presuming that it is in our country's best interest to see large wind projects survive, the federal programs discussed at the conference do encourage and advance domestic alternative energy development. However, until such time as banks are willing to take the proverbial jump into the project finance pool, many large domestic wind power projects will be treading water until liquidity becomes more readily available.

Kimberly E. Diamond *is counsel in the Corporate Department of Lowenstein Sandler PC in the firm's New York City office. She is a Vice Chair of the ABA's Carbon Trading and Energy Finance Committee.*