

Post Cash Grants, Developers Mull Financing Options

*The popular cash-grant program expires at the end of the year.
If it is not extended, what can take its place?*

BY EDWARD D. EINOWSKI & DAVID L. BENSON



Photo courtesy of Horizon Wind Energy

Following the financial collapse in 2008, the wind industry appeared poised to take a step back from the 8,500 MW of new generation that was installed that year. Despite those fears, 2009 was a record year, with nearly 10 GW of new wind capacity installed.

Many projects were able to proceed because of the cash grant that was made available through Section 1603 of the American Recovery and Reinvestment Act (ARRA), even though there was a severe drop in the number of tax-equity investors. In fact, traditional production tax credit (PTC) tax-equity structures have been rare since then, with the cash grant dominating the marketplace.

The cash grant will expire at the end of this year, so the industry is focusing on the prospects for 2011 and beyond. Several ideas have been floated in Congress to amend the cash grant, but the political environment makes predictions difficult, and certain proposals seem problematic. The wind industry is at a similar crucial juncture to when the stop-and-start cycle characterized previous efforts to extend the PTC. Whenever extension of the PTC was in jeopardy, project development was severely disrupted. What are the prospects for surviving this next turn of the wheel?

How it has worked

The cash grant has certainly sustained the industry, delivering about \$2.35 billion in grants to 49 wind projects as of March 18. By providing a cash payment, it obviated the need for traditional tax-equity investors. Comfortable with the certainty provided by the program rules, lenders have been providing construction financing against the cash grant at modest “haircuts,” generally lending up to 95% of its face value.

Although the value of depreciation still calls for tax-equity investors to optimize the financing, many

Cover Story

developers discovered that they could proceed without one by carrying forward the depreciation to offset project income in later years. This is not optimal, but it is workable.

The problem with the cash grant is that it was established as a short-term expedient to overcome problems in the financial markets. The cost disparity between wind energy and fossil-fuel energy is such that wind cannot yet compete without significant subsidies. The recession has worsened this situation, because utility loads remain stagnant or have decreased, adversely impacting demand. Meanwhile, prices for traditional energy – particularly natural gas – remain weak.

As a consequence, 2009 proved to be a buyer's market for wind energy, with long-term forward wind prices dropping significantly throughout the country. If load growth and/or fossil-fuel prices were to move significantly upward, it could bring the price of wind to levels that might enable it to compete without subsidies. But because the market does not seem to be moving in this direction, the industry must continue to focus on legislation to counteract the forces that make brown energy the dominant choice.

To date, government subsidies (in the form of grants or tax benefits) and renewable portfolio standards (RPS) are the tools that have proven to be effective. While a properly structured federal renewable electricity standard (RES) might be sufficient in itself, its prospects in Congress seem far from certain. Therefore, government subsidies continue to be the best near-term hope.

Proposed legislation

One solution would be an extension of the cash grant in order to buy more time for tax equity to return. Currently, the cash grant requires a project to be in service by the end of this year in order to qualify. A project can also qualify if it begins construc-

tion by Dec. 31, 2010, and is placed in service by Dec. 31, 2012. The U.S. Department of the Treasury's guidance (including a recent update) on the "begin construction" requirement, is helpful for more advanced projects, but it leaves great uncertainty in the industry beyond this year. Thus, the industry is pushing for congressional action to maintain the momentum.

S.B.2899 keeps the cash grant but extends the begin-construction deadline by two years. Another bill, H.R. 599, would, among other things, eliminate the begin-construction requirement but change the grant to a refundable tax credit.

While preferable to expiration, the refundable-credit approach decreases the value of the grant by delaying the time until which the grant is paid, because the payment would be made after the filing of the tax return for the fiscal year. Rather than receiving the grant within 60 days of final submission, the refundable credit would not be paid for at least 150 days, and up to as much as 15 months. A further risk to banks is that the refundable credit may be subject to offset if the taxpayer has other tax liabilities.

Another proposal, S.B.3069, could weaken the cash grant by subjecting it to the discretion of the Treasury, which would conduct an analysis of the "domestic job preservation and creation provided by" the project and require compliance with the Buy American requirements of ARRA.

These changes would add significant costs, time and uncertainty to all projects, which would make borrowing against the grant very difficult. At a minimum, lenders would significantly further reduce the grant-to-loan ratio, putting more stress on the ability of developers to obtain construction financing.

Financing without the grant

Although a workable legislative solution is the clear preference, it is possible that no changes will be

forthcoming in this midterm election year. As a result, developers are currently rushing to begin construction this year. Indeed, the need to qualify for the grant by year-end has caused some developers to sell ready-to-build projects to buyers who have the means to finish them. Developers of projects that are too far from the finish line may struggle to keep their projects afloat and be forced to sell at fire-sale prices.

Without a cash grant, quality projects with high-capacity factors, strong developers, long-term power purchase agreements with good pricing and a creditworthy power purchaser should still be able to find financing. However, the project economics will be more stressed.

If tax-equity investors do not come back and wind energy prices remain depressed, developers will be forced to consider inefficient financing structures, such as retaining the PTCs and depreciation to offset income in later years. Under such conditions, operational risk and thin margins reduce the project's capacity to ride out problems that might be encountered.

For lower-quality wind projects, hope seems to rest on the efficacy of the RPS to deliver power prices that can support the project. State RPS programs have, in effect, sparked demand for wind projects. However, last year's falling prices for wind in the face of diminished utility loads and cheap fossil fuels indicate that an RPS alone cannot maintain the industry at satisfactory levels.

An effective federal RES – especially coupled with an effective carbon cap-and-trade program – could change this. But whether politics will permit this remains an open question.

Financing provided by turbine manufacturers may also provide some relief. Ten years ago, vendor financing was common, but it declined as the industry matured and other forms of financing developed. Today,

Cover Story

the soft new turbine market may lead financially strong turbine suppliers to again offer this type of financing. This could be especially true for turbine suppliers that are just entering the U.S. market.

While vendor financing from a new entrant in the U.S. turbine business is helpful, it may also make it more difficult to obtain the balance of the financing needed if the new turbine is perceived by the lender to have any technology (or reliability) risk.

Who is left?

In a financing market with no cash grants, depressed wind energy prices and a weak tax-equity market, the wind industry could change dramatically. Such an environment

would favor domestic developers that are subsidiaries of enterprises with substantial balance sheets, tax appetites and capital to deploy.

Currently, all but one of the largest wind developers in the U.S. are foreign-owned. As a result, most of the country's largest developers do not have the U.S. tax appetite needed to efficiently absorb the tax benefits. Unregulated affiliates of domestic utilities generally do not suffer from this problem.

While there is a limit on the tax appetite of even large utilities, there is still significant capacity that could carry the industry for a number of years. Utilities are increasingly committed to wind as a primary business.

This would not necessarily mean an end to small and midsized inde-

pendent developers. Even before the downturn, many small and midsized developers found it difficult to bring projects to fruition, due primarily to capital restraints. They often made profits not by building the project themselves, but by bringing it to a ready-to-build point and selling it to another entity that had the resources to complete it. This develop-and-flip model has worked in the industry for a number of years. There is no reason to believe it would not continue going forward. **WPP**

Edward D. Einowski and David L. Benson are partners at Stoel Rives LLP. Einowski can be reached at eeinowski@stoel.com, and Benson can be reached at dlbenson@stoel.com.



About the Authors



Edward D. Einowski
503-294-9235
eeinowski@stoel.com

Ed Einowski specializes in project finance and development, representing developers, investor-owned utilities and their unregulated subsidiaries, biofuel producers, investment banking firms, commercial banks and other financial institutions, and state and local governments. He has handled project financings throughout the United States, from West Virginia to California. He also regularly represents biofuels and electric industry clients in such matters as the negotiation of long-term power purchase agreements for the output of wind powered, gas-fired and coal-fired generation facilities, and the buying and selling of biofuel plants and electric generation projects. He received his law degree, *cum laude*, from University of Michigan Law School, and his B.A., *summa cum laude*, from University of Michigan Residential College. Ed is admitted to the state bar of Oregon and Michigan.



David L. Benson
206-386-7584
dlbenson@stoel.com

David Benson is a partner in the Corporate, Securities and Finance practice group and a member of the Renewable Energy group. He leads the firm's Biofuels Initiative and Biomass Initiative. He represents clients in public and private transactions, including debt and equity financings, merger and acquisition transactions, joint ventures and other strategic alliances. David also has experience in structuring and advising on international transactions, primarily in Europe, Asia and the Middle East. He represents alternative energy and clean technology clients in biofuels, biomass, wind, solar, geothermal, ocean energy and other energy related areas. His clients are also engaged in fuel cell and other storage technologies, smart grid and energy efficiency and other technologies focused on alternative energy markets. He received his law degree, *summa cum laude*, from Michigan State University of Law, and his B.S., finance, Arizona State University. David is admitted to the state bar of Washington and Michigan.