

Tax Credits Drive Innovative Finance Structures

“Flip” structures and increased foreign participation maximize value of tax credits.

BY JENNIFER DELONY

Investment in the wind power industry has been secured temporarily by the extension of federal production tax credits. The benefits of tax credits are enticing greater numbers of corporate investors for small-scale projects and enabling large equity investors to support large-scale wind power projects through structured equity finance deals. Furthermore, international organizations that cannot benefit from tax credits by traditional methods are arranging deals with organizations that can take advantage of the credits, thereby bringing more investment funds into the North American wind power market.

However, members of the wind power industry believe the positive effects of recent tax credit extensions will lose their influence without a much longer extension from the government – an extension that should allow the market to work up a momentum that will ease constraints on the supply chain and lower wind power prices over the long term.

Midwest Wind Finance LLC is a Minneapolis-based specialty finance firm for renewable energy projects that exemplifies the variety of financing available to developers. Midwest has more than 23 current wind power finance packages ranging from \$6 million to \$75 million that are approved or being considered for a blend of debt and equity

financing. The wind farm developments that these finance packages support will range from 4 MW to 60 MW and are located throughout the U.S.



Photo courtesy of Invenergy LLC

Announcements in the North American market for much larger wind energy installations with equally large debt and equity finance packages are made to the public regularly by developers and their partners. For example, enXco Inc., a North Palm Springs, Calif.-based developer and operator of wind energy projects, closed a deal recently with finance partners GE Energy Financial Services (EFS) and Union Bank of California for Minnesota's largest wind farm – the Fenton Wind Energy Center – at \$385 million for 205 MW.

The good news, industry representatives say, is that the financial resource is available to keep announcements coming for new wind energy projects in North America, spurred by the recently extended U.S. federal production tax credit (PTC) and the revised Canadian incentive, now called the ecoENERGY for Renewable Power initiative.

The length of the recent PTC extension in the U.S., however, remains a concern to some.

“Costs have escalated, driven by supply constraints, driven by the slow pace of investment, driven by the fact that the PTC periods tend to be short lived,” says Timothy Howell, managing director for renewable energy at Stamford, Conn.-based EFS. “There is a lot of discussion in Congress right now about a longer-term extension that would bring more stability and enable the supply chain to invest in capacity to keep wind power pricing going down.”

A five-year extension of the PTC, which provides an adjusted 1.9 cent/kWh credit to qualified electricity generators, is being considered by the 110th Congress in a bill (H.R.197) introduced January 4.

EFS, which counted the Fenton project as its sixteenth equity investment, plans to build its renewable energy portfolio to \$3 billion by the end of 2008, a goal that will double its portfolio from its current \$1.5 billion

and will depend largely on the current PTC extension.

EFS is as dedicated to wind power investment as any investing organization in the marketplace. In April 2006, EFS expanded its renewable energy structured project finance team to grow its renewable energy investments. Included in the company's renewable portfolio are investments in 47 wind power projects, and there is no foreseeable downturn in its wind power investment activity.

"We found quite a few deals that we wanted to invest in during 2006, and we are working hard on quite a few deals already in 2007," says Howell, "The extension of the PTC through the end of 2008 has enabled the industry to maintain its momentum."

As a rule, EFS enters projects as either an equity investor or a debt investor. "We have deals where we are investing structured equity in the U.S.," says Howell, "and deals where we're investing common equity in project financing in Europe. We also have deals where we are acting as a regular lender in wind farms and wind portfolios through senior debt project finance."

EFS takes advantage of an equity agreement that Howell describes as a flip structure, in which EFS invests in the capital structure in order to achieve a greater return on investment through tax benefits.

In an equity flip structure, a project developer enters into an equity partnership with an investor. The investor owns a percentage of the project for the life of the tax credit and is the recipient of most cash distributions from the wind power project as well as the benefits of the tax credit and depreciation. When the equity investor reaches a predetermined rate of return, the majority ownership flips to the project developer. In order for the tax credit to be available to an investor, the investor must have an ownership interest in the project.

The flip structure used by EFS is common in the wind power industry, says Tom Woolsey, a partner with Washington, D.C.-headquartered Hogan & Hartson LLP. "If the equity

investment of the sponsor has not been paid back at a predetermined point, there will be a cut-off and all of the cash flows will flip over to the equity investors," explains Woolsey.

"The investor typically targets an internal rate of return, and at that point, there will be a second flip where the sponsor and the equity investors take percentage interests in the cash flows of the project," he says. Furthermore, the internal rate of return of the equity investor is driven by the investor's ability to use the tax benefits of the project.

While obtaining equity investments in wind projects has been a challenge for Midwest's clients with smaller MW projects, Valley sees this changing for the better.

"Many large corporations and financial institutions, whose primary operations have nothing to do with the energy business, have figured out a way to use the tax credit equity for an investment," says Valley. The number of large corporate investors has increased significantly over the last year and will continue to increase in 2007, he adds. The tax benefits and potential returns are providing enough incentive for these investors to outweigh turbine supply issues, which industry representatives expect to last through 2008.

"We have hundreds of millions of dollars in projects, and every one of them is still waiting to get their turbines," says Valley. "But turbine availability is not hindering the developers from seeking and finding money."

Even organizations that cannot take advantage of tax credits directly because they have no, or too little, U.S. or Canadian income are not being deterred from seeking wind power finance deals in the North American market.

In fact, these organizations are arranging wind power finance deals with companies that can benefit from federal tax credits, and their deals will bring money from other markets into North America over the next two years, says Karen Wong, partner with Milbank, Tweed, Hadley & McCloy LLP, a global law firm that represents

energy organizations.

"Companies outside our market are definitely adding to the money pool [in North America] because a construction loan does not usually have 100 percent financing," says Wong. "The typical rule of thumb is 80/20 or 75/25, so the equity piece is coming from the project sponsors." Dublin, Ireland-headquartered Airtricity, for example, recently had an equity financing to raise money in the European capital market, and they will use that source of funding to fulfill their equity requirements on North American projects, adds Wong.

The Irish wind project developer announced it had raised 120 million euros at the end of 2006 through a third tranche of its Development LoanNote. The proceeds will be used by Airtricity's development division for new projects worldwide, including in the U.S. and Canada.

The North American wind power market also will see funds introduced through the activities of Spain-headquartered wind power developer Iberdrola, as well as global energy provider BP.

"Iberdrola has made several [wind power] acquisitions in the U.S.," says Woolsey, "and they have an interest in growing their U.S. portfolio." A February 1 statement from Iberdrola details the company's plan to invest 3.25 billion euros in renewable energy worldwide over the next three years, with the U.S. set as a "strategic priority" due to its wind power market potential and favorable tax regime for renewable energy.

"BP also has made significant acquisitions in the U.S.," he says. BP Alternative Energy has slated \$8 billion for renewable energy development worldwide, with a five-year investment plan for 2,015 MW worth of wind power projects in New York, Texas and South Dakota.

"So long as the industry is growing, and perhaps with a different view of climate change coming from the government, there should be more opportunities for these companies in North America in the future," says Woolsey. **SYIP**