

Cash options

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In late September the European Parliament voted to adopt recommendations made in a report on the increased deployment of renewable energy sources. The report calls for a mandatory 20% of all electricity generation to come from renewables by 2020, rising from a meagre 6% in 2001, which could even increase to 25% under the condition that increased renewables efficiency measures are taken.

Few have taken more advantage of the current climate than the Irish energy company Airtricity. In the six years since start-up – with a Eu10 million (£6.8 million) bank loan to build an 18-turbine wind farm in Donegal – Airtricity has grown into one of Europe's leading fully integrated renewable energy companies. With £800 million slated for wind farms in Scotland and a further £800 million committed for the Greater Gabbard project in the Thames estuary, company growth shows no signs of abating.

However, if Airtricity is to keep to its plan of continued UK expansion, coupled with a bold \$1.5 billion US investment programme by 2010, it may well have to look beyond project finance to fund these programmes successfully.

UK: onshore or offshore?

2005 has been a bumper year for the UK wind industry: the gigawatt barrier has been broken, with 1,000MW (megawatts) of wind being installed, and 19 new wind farms, totalling some 500MW will be commissioned by the year-end. High profile projects such as Cefn Croes in mid-Wales and ScottishPower's 97MW Black Law projects have gone some way in helping the Government get closer to its revised target of 15% of renewable electricity by 2015.

In the next few years, there will be two key areas for renewable energy. First, the UK Government's overall energy policy and where the energy mix ends up; i.e. renewables, coal generation, gas and nuclear. Second, there is the question of cost, which renewables developers are working hard to try and trim.

In terms of renewables, wind will drive the market in the UK. With Germany and Denmark both saturated, the UK has a lot of untapped potential both on and offshore – especially in Scotland, which may prove to be the biggest driver.

The majority of UK projects to date have been onshore, and not without reason. Certain players have shied away from offshore projects, citing poor infrastructure and grid access as nigh insurmountable problems. Moreover, there is the question of costs, with offshore projects costing up to 50% more than onshore.

Nevertheless, Airtricity is attempting to keep a diverse a portfolio as possible with its £800 million Greater Gabbard offshore project as well as the £800 million five-year investment programme for onshore sites in Scotland.

According to Torben Andersen, head of Offshore at Airtricity, "If you want to meet the renewable targets, you will have to go offshore. Some players, for instance, will be driven strategically by offshore projects, but we realise that there are still higher returns to be made from onshore developments in the UK."

Of the eight Airtricity wind farms, totalling 700MW, slated for operation in Scotland, five are still in the planning stage (Clyde Valley, Greenock, Kilpatrick Hills, Dalswinton, and Minsca) and are dependent on planning permission. The £480 million 500MW Clyde Valley wind farm, situated between Biggar and Moffat, has needed 'delicate steering', though

planning permission is now expected to go through. And Airtricity has one farm already in operation in Scotland at Ardrossan.

The investment for the programme is expected to come from a number of existing investors including NTR, Ireland's leading developer of infrastructure, and a host of banks. By mid-October, the energy company had already received some €150 million in commitments.

On the 500MW Greater Gabbard offshore wind project Airtricity has teamed up with Fluor as joint venture partner. In October, Greater Gabbard Offshore Winds Limited (GGOWL), the joint venture entity, submitted an application for development consent for an offshore wind farm to be located 25km off the coast of Suffolk around the Inner Gabbard and Galloper sandbanks. The Crown Estate had already awarded a licence to the sponsors in December 2003. Consent is expected to be secured next summer.

Royal Bank of Canada has been appointed as financial advisor on Gabbard. The mandate includes both debt and equity, along with offtake contracts. Although transaction details are sketchy, it is expected that around £450 million of the total will be project financed, which leaves, as one industry source called it, "a hell of a chunk of equity". Most likely a third party will provide the bridging equity. The sponsors may also try to tap pension funds, potential investors in renewables given their penchant for longer-life assets that are resistant to inflation.

There are also rumours that the project will be floated on AIM, though whether this happens remains to be seen. Although in its early stages, the deal is likely to be one of the first of a host of project financings for offshore wind projects in the UK. Financial close is expected in mid-2007.

Although Greater Gabbard is set to incur higher costs than a typical onshore project, Airtricity sees it as a question of trade-offs.

"To get 500MW or 1,000MW consented onshore you need in general to be thinking about a significant number of relatively small projects – 25MW to 50MW each, typically. That's a lot of exposure to a consenting process and will take time, effort and very precious equity," says Fintan Whelan, corporate finance manager at Airtricity.

"Conversely, with offshore, projects come sized in the 500MW to 1,000MW range. But there are different risks. In the end, it's all about trade-offs. Offshore you get scale and in the right place a more consistent wind resource, but at present you incur higher capital and running costs to harvest it."

Airtricity also has ideas for a mammoth £16 billion offshore project in the North Sea. The wind farm would supply the UK and northern Europe. Although this is a logical step for ensuring security of supply and further European integration, it looks to be some way off: For the project to get off the ground would necessitate the cooperation of a host companies and several governments

Big in the US

In June, Airtricity announced its investment plans for expansion in the US. An initial investment of \$270 million has been slated for developing wind farms in Texas, Idaho and New York. However, with Texas becoming increasingly congested, Airtricity is expected to diversify its portfolio up to the Pacific north-west. By 2010, the energy company's total investment portfolio could well be over the \$1.5 billion mark.

Having established a presence in the US two years ago, Airtricity went through a process of filleting the states in which it could not do business and came up with a short-list. Although there is limited wind capacity in the US at present, Airtricity expects there to be an increased awareness of the viability of renewables coupled with a growing demand, especially for wind energy.

According to the AWEA (American Wind Energy Association), some 2,500MW of wind capacity is scheduled to come on line this year. Over the next five years, Airtricity is planning to have the US account for 50% of its overall revenues and to become the largest private, renewable energy developer in the country.

The initial investment will install turbines, which were contracted before the extension of the PTC (Production Tax Credit) scheme, with a capacity of 125MW, in Abilene, Texas, and 90MW in Idaho. Siemens Wind Power Company will supply the turbines for the Texas project, while the projects slated for construction in 2006 will be supplied by Gamesa.

Although Airtricity has got off to a relatively quick start in the US, the company still has qualms about the volatility of the renewables market.

"The US is a classic boom-bust scenario, effectively driven by tax breaks. But for us, as an annuity-type developer, it creates uncertainty post-2008. This on-off situation causes difficulties for turbine manufacturers in managing their capacity. The solutions may suit the very large balance sheets, but it's more difficult for us. We manage this risk by diversifying across markets and we get significant advantage through that process," adds Whelan.

As yet it is unclear as to whether the PTC extension will be effective beyond the 2007-deadline. The PTC, which was due to expire at the end of the year, provides a 1.9 cent-per-kilowatt-hour (kWh) tax credit for electricity generated by wind turbines over the first ten years of a project's operations. This has proved invaluable in financing new wind farms.

For its US programme, Airtricity has opted for a 'back leveraged' structure where tax investors put money up front in to the operating company in return for the right to the production tax credits. The equity enters the operating company from the holding company, where it is part funded by project finance, which takes a share pledge over the operating company as its security. The structure, therefore, allows the two sources of funding to be kept separate and avoids the intercreditor issues that tend to hamper transactions.

Babcock & Brown has been lined up to find tax investors for the first project, which the arranger should have few problems doing, having built up a substantial client-base during the heyday of the lease-in lease-out (Lilo) structure. JP Morgan is also being considered for future transactions.

It is rumoured that HVB is awaiting final confirmation for the underwriting mandate to the fund for turbine deposits, construction and the five-year operating term loans. Airtricity is currently sourcing turbines for 2007, which will be built on their remaining available sites.

Turbulent turbines

With the turbine manufacturing industry currently on an upswing, especially with terms of trade tightening, there is a certain but limited amount of capacity for developers to absorb higher turbine prices while electricity prices are rising. Otherwise, project economics are likely to be impaired and the demand for turbines curtailed.

Long term, however, developers have a vested interest in a healthy turbine manufacturing base, as do the banks who provide so much of the funding. According to Whelan, the cycle is expected to correct itself once the second-tier manufacturers become more attractive and production capacity increases.

Sponsors, such as Airtricity have begun to feel the bite with turbine manufacturers demanding substantial upfront deposits for turbine orders. According to sponsors, this has little to do with credit management and is unnecessary for funding the work in progress represented by the order. Moreover, it ignores the value of secure advance orders for production line management.

In future, one of the challenges that sponsors will have to face is getting banks comfortable with helping to cover that funding strain. This is expected to test both the relationships of the manufacturers and developers and the resolve of the banks.

The shape of financings to come

According to last month's UK DTI report, 'Investing in Renewable Energy – a Survey of Investors', there was a general consensus that the UK Government needed to adhere to a stable regulatory regime, including tax incentives, in order to attract more investment in to the sector.

Even so, Airtricity has a history of successfully attracting bank debt from a variety of international players, including Bank of Scotland and Barclays. This has been partly due to a diversified business model and ability to build generating capacity and sell electricity at a profit. In addition, banks have been willing to lend in to a relatively predictable and controlled environment.

However, as wind deals – especially offshore projects – increase in size, so too will the need for sophisticated financings. Whether Airtricity will follow in the footsteps of Astraeus's portfolio financing or Breeze One's structured basket bond (SSB) remains to be seen. For Airtricity, however, it is not wanting of offers.

"We've even looked at cross-border lease structures. However, if you talk to bank executives who have given up more than 18 months of their life for one particular deal, it really needs to offer more than an incremental NPV of 4 to 5% of original capex. I'd prefer to put the effort into getting the gearing up by that amount," says Whelan.

For the moment, Airtricity is taking a pragmatic view: comfortable with non-recourse project debt, but on the look out for innovative structures to suit its growing portfolio.

"Project finance imposes a very good discipline on a company and its projects; it's essentially a quality control mark. I really see no better way so far of funding for the early stages," says Whelan.

"Nevertheless, once projects are up-and-running, then it makes sense to bundle a number of seasoned projects, refinanced either as a securitisation or project bond or whatever the latest effective vehicle is. Investors tend to have an appreciation for that kind of diversified risk, especially in a relatively new asset class. And project finance banks see it as a route to recycling their capital rather than a loss of opportunity."

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