Wind bagged

01/09/2003

Even in an environment of low interest rates, FPL Energy's project bond for part of its wind portfolio impressed the market. The first half of 2003 has been an excellent time for strong project credits to come to the capital markets. But even if Credit Suisse First Boston, written off as the US power market turned sour, has won some impressive mandates this year, FPL Energy American Wind stands out as a true first.

FPL Energy American Wind LLC, underwritten by CSFB, sold down strongly, and gained a BBB-/Baa3 (Moody's/S&P) rating. The deal featured strong support from FPL, and relied on its experience as by far the largest developer in the US. The portfolio also features a wide degree of diversity.The 685 turbines in the special purpose vehicle are of five types and come from four different manufacturers - NEGM, Vestas, Enron Wind and Zond, the last two of which are now part of GE Wind Energy. The Enron turbines are covered by a GE warranty, while the Zond turbines are not. Such considerations are important - wind turbines are still relatively untested technologies.The farms included in the portfolio are High Winds (California, 145.8MW, Vestas V47, selling to PPM, part of Pacificorp), Cerro Gordo (Iowa, 41.2MW, NEGM 750, to Interstate Power & Light), Hancock (Iowa, 97.7MW, Vestas V47, to Interstate),Lake Benton II (Minnesota, 103.5MW, Zond Z-50), to Northern States Power, part of Xcel), Montfort (Wisconsin, 30MW, GE 1.5, to Wisconsin Electric), New Mexico (204MW, GE 1.5, to Public Service Company of New Mexico) and Southwest Mesa (Texas, 74.9MW, NEGM, three offtakers).Two of the projects - HighWinds and New Mexico - are still under construction, and are also the largest in the portfolio, accounting for just over half the portfolio's capacity. The deal was the first chance to see some public research from the agencies on their views of the wind credit. Several sources close to the deal suggest that they treated the deal fairly harshly, especially given the diversified and strong offtake credits in the deal.The agencies' rating incorporates a fair degree of scepticism regarding the concentration of the portfolio in a small number of regions, and the financial health of several of the manufacturers. Moody's also believes that "wind assessment risk... is among the most significant risks with this technology." More operational hours, as well as the completion of construction, should give them a good enough excuse for an upgrade, according to one source close to the issue. Despite the volumes that have been amassed in the European bank finance market, the continent has yet to see a project bond by a wind farm. And while the ratings agencies stress that they have done analysis on wind farms privately, as part of their measurement of a growing section of participants' portfolios, they had yet to issue anything in public.FPL's $380 million financing is a neat riposte to European arrangers who felt that the emerging US wind market was theirs for the taking. Their assumption, in many ways similar to that of prospective US PPP bankers, was that there were few US lenders familiar enough with the risk. Fortis Capital, in particular, with an impressive record, looked set to dominate.This is partly on the back of last year's Desert Sky financing for AEP, like FPL, a large utility with a growing wind portfolio. Fortis underwrote the $178 million project's $120.7 million debt, and achieved a 15-year tenor. The deal pulled in Royal Bank of Canada, Rabobank, Dexia, NIB, ANZ, and Landesbank Baden-Wurttemburg as participants - a distinctly US-free list.The competitiveness of wind generation is starting to approach that of gas-fired plants, particularly with spark spreads at their current levels, and the reputational benefits of backing a wind farm are considerable. Moreover, some financings from the mid-to-late nineties have been reasonably profitable. Nevertheless the tenors involved, as well as the fact that it is difficult to come up with an asset that is large enough to attract big players, have so far confined wind finance to a market niche.In the US, additionally, several factors have conspired to drive away willing lenders. These are partly related to the previous generation of wind farms. The first is the stringent local opposition that many farms face. The experience of the Altamont Pass farm in California led opponents of a Nantucket project to dub wind turbines the 'Cuisinarts of the air', a reference to the potential (limited, most proponents say) for poorly-sited farms to act like blenders on bird populations. The second has been a historically lax and muddled regulatory and tax environment for financing farms. Several banks lost money on Californian wind deals in the early nineties, largely because these plants relied on a tax regime based on installed wind capacity, rather than production. The incentives to maintain turbines, or even site farms in the best places,

simply did not exist. As a result, several sponsors, having already taken their tax depreciation up front, decided to walk from unproductive projects.The new package of incentives, named after Section 45 of the federal tax code, works by applying a 1.8 cent per kW/h tax credit to production. It therefore aligns economic and tax incentives, and recognises how close turbine manufacturers are to matching gas-fired technology. The catch? A developer needs a tax bill to use the credits.So, since the economics of a wind project are not quite sufficient to cover the cost of capital, it is the two large and well-capitalised utilities - FPL and AEP - which are leading the pack. And even FPL decided to offer lenders a backstop against any change in tax legislation by providing an equivalent payment to the project itself, rather than expose them to the risk of a change in regime. The challenge for lenders is to find a way to structure deals so that smaller developers can benefit from the credits.The most obvious solution would be to find a well-capitalised partner that is able to lend a developer its tax bill and act as a passive investor. This approach tends to dampen the returns available to developers, and such investors tend to be thin on the ground. Only those paying standard tax, and not subject to the alternative minimum tax, are eligible.Hendrik Vroege, managing director at Fortis Capital in Stamford, Connecticut, says: "the challenge is definitely to find silent equity with the appropriate tax position on a project, and we would look to act as matchmakers for interested parties. But banks will also be equally focused on the credit quality of offtakers, particularly in the current environment." GE Structured Finance, the backer of a number of late 90s wind farms, is now in the wind business through its parent's purchase of the assets of Enron Wind. The move rescued developers such as AEP, whose Desert Sky project was reliant upon Enron turbines, but may limit, if only for risk management purposes, the ability of GE Capital to support other developers.It may be, as Standard & Poor's wrote in October 2002, 'tempting to argue that the days for the small wind developer are numbered.' The S&P report was more a reaction to the mergers and acquisitions wave of that year than a look at sponsor tax capacity. Some utilities, after all, have better tax positions than others. Those that made ill-advised forays into unregulated markets have plenty to charge against tax before looking for renewables credits.Another potential solution is to make the tax credits tradable, a mechanism that would enable sponsors without tax bills to sell them to those with the necessary capacity. It might also bring finance lease players into the market. The difficulty here, as Jaime Steve, legislative director at the American Wind Energy Association, is that Congress has adamantly opposed making such credits transferable. "That such a mechanism is referred to as tax credit trafficking gives you an idea as to the strength of opposition," he says.The most likely outcome for producers is that the section 45 Credit will be extended by between three and five years, according to Steve. He notes that these are the lengths cited in the house and senate versions of the Energy Bill in front of Congress. The two are set to be reconciled in a conference session, which with luck could start in September. The Energy Policy Act and Energy Tax Incentives act from the senate, and the Energy Tax Policy Act will ultimately see the incentives package subsumed within larger questions of the direction of US energy policy. While the tax credit arouses little opposition, it tends to take a back seat to issues like nuclear power and drilling for oil in Alaska, which do. The recent blackout complicates the picture further. Sponsors should be able to count on an extension of the in-service date for qualifying for the credits, but the continued uncertainty, which needs to coincide with financing timetables, the needs of utilities, and available debt and equity capacity, makes it hard for any but the largest players to plan effectively. Making the credit permanent is also not an option.The other incentive, one with a more tentative chance of passing, is the Renewable Portfolio Standard (RPS), which would mandate that utilities purchase a certain proportion of their power from renewable sources. The senate bill has the figure at 7.5% by 2011. The future of this section is less clear, but, even if it passes, developers should not expect a scramble by utilities to sign generously-priced power purchase agreements.According to Edward Sledge, a partner in the Baltimore office of Hogan & Hartson, which advised FPL on its bond deal, the most likely result of any RPS provision would be more generous scheduling treatment by offtakers for wind farms. "Scheduling is one of the key issues for wind projects to deal with - even a day-ahead system is very difficult to work with. If scheduling risk is placed on the offtaker in the PPA, then power must be paid for as soon as it hits the wires," he says. West Texas is an area where transmission constraints could be most severe, and is also home to one of the best wind resources in the US.This provision is important, since few projects will receive money unless the wind is blowing - capacity payments, of the type familiar for peaker plants, are rare for wind farms. An RPS will likely not spur utilities to make such a concession. Nevertheless, there remains the possibility that states, and their regulators, will be able to provide concessions to homegrown developers.Several of FPL's projects, for instance, benefit from just such incentive packages, including state-wide RPS equivalents. Iowans get to choose to purchase green electricity from 2004 and MidAmerican and Interstate, the state's two utilities, must buy 105MW of alternative energy. New Mexico, Wisconsin, Minnesota and Texas all have RPS requirements of varying degrees of

severity.FPL's New Mexico project is also the subject of a conduit bond financing, which closed in December 2002. This project is slightly separate to the other assets, since the project owners are the counties in which it is located, which then lease it back to the operator. Since the lease payments back bond issue of which a company affiliate subscribed the entirety, the net effect upon the deal, aside from a generous tax benefit, is minimal.Sledge at Hogan and Hartson notes that not all lease arrangements will allow the sponsor to get financing. Those looking to put in place a project deal will have to check that assets and, more importantly, the land on which they are sited, are not previously encumbered. Potential lenders will not be happy if the landlord's mortgage lender can foreclose on land on which there are turbines. Given the complexity of land right arrangements on wind farms this is a real concern.And it is here that the smaller developers still have a role to play. Michael Midden, an assistant vice president at Dexia Credit Local in New York, likes to divide the players into three - "the small-scale developers, which are likely to sell up to a bigger players after they have secured land leases and collected sufficient wind data from a viable wind site, the second stage developer, that which might be able to negotiate a power purchase agreement, and then will look for an equity partner with a tax bill, and the large utilities." It is upon these which most of the banks' business will depend, unless suitable third party players arrive. EnXco, a developer that often largely retains operations and maintenance functions, is looking for equity partners for a farm it is developing. Bank One is believed to be considering injecting some financing into it. And Invenergy, the distressed asset buyer and wind developer that is now leaning heavily towards the latter activity, is also looking for funds for the Buffalo Mountain expansion (for more details, see Project Finance, June 2003, p.6) In the meantime, the latest project from AEP, the 150MW Trent Mesa project, is set to hit the market soon. Fortis Capital, the arranger of the Desert Sky project, has snagged the mandate, although the deal is likely to be much smaller than its predecessor. The arranger will have done its client proud if it manages to take the debt out to fifteen years again.

Desert Sky Wind Farm LP

Status: Closed 12 November 2002

Size: $180 million

Location: Pecos County, Texas

Description: 160MW wind farm, comprising 107 turbines

Sponsor: American Electric Power

Debt: $121 million

Lead arranger: Fortis Capital

Tenor: 15 years

Pricing: 162.5-200bp over Libor

Lawyers to the sponsor: Jones Day Reavis & Pogue

Lawyers to the lenders: Milbank Tweed Hadley & McCloy

Insurance: Marsh

Technical: Garrard Hassan

FPL Energy American Wind

Status: Closed June 2003

Size: $380 million

Location: United States

Description: 692MW wind farm portfolio financing

Sponsor: FPL Energy

Underwriter: Credit Suisse First Boston

Coupon: 6.639%, or 295bp over the ten-year Treasury

Maturity: 2023

Lawyers to the underwriter: White & Case

Lawyers to the sponsor: Hogan & Hartson

Wind resource consultant: Garrard Hassan