Desert Sky: A blow out wind deal

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American Electric Power has closed financing on a 160MW wind farm, the first such deal in over two-and-a-half years. It promises to be the start of a series of such financings to hit the market in the next 12 months - before the US tax authorities look at renewing the renewable rules. It also confirms AEP in its strategy of selective raids on the non-recourse debt markets - the deal sold down in a terrible market.

Desert Sky's main claim to fame before this was as a former Enron Wind property - part of the suite of assets that the troubled energy trader divested during Chapter 11 proceedings. It was formerly called the Indian Mesa wind farm, and is located in Pecos County, in Texas. It covers an area of around 8000 acres, split between a number of large landowners, although the remote and barren landscape makes it ideal for wind production.

AEP Resources bought the wind farms on 31 December 2001, and kept the plants on balance sheet while it could arrange financing. Not all of Enron Wind's assets have been carved out, but GE acquired a substantial portfolio, and has assumed the warranties associated with these turbines. AEP now wants to become a substantial player in the business - one to rival FPL Energy, the current market leader.

The chief difficulty in financing wind plants lies in the fact that they are essentially at the mercy of the weather and require a creditworthy offtaker, one whose load centres are at some distance from the generation site. Desert Sky benefits from a 20-year power purchase agreement (PPA) with City Public Service of San Antonio, a AA+ rated municipal energy agency.

For San Antonio, the benefits of using wind power are clear, since in Texas the renewable standards portfolio programme is in place, requiring utilities to source 2% of their capacity from renewable resources. Even if, like San Antonio, an entity is exempt, it can sell on this power at a premium to a utility that is unable to meet the requirement. The City of Austin is also interested in examining the programme.

However, the PPA, while take-or-pay, still exposes lenders to wind risk. This means that both sponsor and lenders must get comfortable with the meteorological reports, and the level of windpower on top of the mesa. According to Randy Boteler, director of wholesale finance at AEP, the project has eight years of data from a similar site, and is in an unobscured, largely barren tabletop rock formation.

Boteler adds that, "the contract does not have a minimum requirement, which can lead to problems in getting financing. But we and the banks are comfortable with the wind risk under this contract." While weather derivatives products were considered for the financing structure, the premiums make it difficult for sponsors to harvest the benefit - although their uses at a corporate level are more pronounced.

But the main underpinning of the project's economics is the provision of a Section 45 tax credit from the Federal government, the second generation of an incentive scheme that originated in the 1980s. This was not held to be a great success ? and explains why many US institutions are unwilling to play in the renewables market. As one put it, "I don't like financing projects at the mercy of the Internal Revenue Service".

These tax credits are available at the corporate level, and cannot be stripped out of ownership of the assets. This is why despite experiments with synthetic structures, which are prone to leakage, tax leases are not possible on wind farms. The US incentive is much less extensive than the European version, largely because wind resources are better. There is a 6-7 cent cost difference between the two.

The tax credit is collected at the corporate level and then channelled back to the partnership that owns the farms. While the sponsor is not required to inject all of the tax credits back into the project, participants say that it is a true non-recourse deal. Moreover, the new allowances, which tie tax benefits to production rather than to simply existing, are a more attractive and rigorous way for plants to gain finance.

The sponsor chose Fortis to lead the deal, in part because of its ability to underwrite an entire financing package, but also because of the experience of the team from MeesPierson that joined the bank after its former parents merged. It arranged $121 million in debt, with the sponsor providing a further $59 million in equity. A large factor in the appointment was the insistence by other institutions that in the current market a best efforts syndication was the only possible route. Nevertheless, AEP's request for proposals was declined by only two banks.

The loan has a 15-year tenor - considered the minimum length to get economic value and useful leverage from a 20-year PPA. Pricing on the loan starts at 162.5bp over Libor, and steps up in 12.5bp increments to 200bp. This level was slightly higher than the sponsor and arranger had wished, and is perhaps the main manifestation of the nervousness pervading the US power market.

Nevertheless, the deal attracted senior level commitments from Dexia Credit Local, Rabobank (both major European wind players) and Royal Bank of Canada. It also received participations from ANZ Investment Bank, Landesbank Baden-Wurttemberg and NIB Capital. These tickets are believed to be in the $15-20 million range.

Coming up from AEP is a financing for the 150MW Trent Mesa wind farm. This plant is understood to have a minimum production level in its PPAs, which should create additional challenges for financiers. This, like several of the upcoming candidates for financing, will need to have all of its turbines installed by the end of 2003, when Section 45 comes up for renewal.

Desert Sky
Status: closed 12 November 2002
Size: $180 million
Location: Pecos County, Texas
Description: 160MW wind farm, comprising 107 wind turbines
Sponsor: American Electric Power
Debt: $121 million
Lead arranger: Fortis Capital
Tenor: 15 years
Pricing: 162.5 - 200bp over Libor
Lawyers to sponsor: Jones Day Reavis and Pogue
Lawyers to lender: Milbank Tweed Hadley and McCloy
Insurance: Marsh
Technical: Gerrard Hassan