Offshore wind's cloudy interface

11/10/2011

Not so long ago the prospect of banks financing any construction risk for European offshore wind projects would have been unthinkable. Sponsors bore potentially expensive unknowns like completion delays and new technologies or third parties failing to deliver. Fast forward a few years and todays clutch of projects currently in the debt market with construction risk are indicative of increasing levels of lender comfort, despite offshore wind being one of the most unpredictable frontier markets.

In fact when it comes to risk, offshore wind is about as fraught as it gets. There is little track record only six offshore wind projects have reached financial close in Europe to date and the pool of banks with experience is still small. Every deal that the bank market looks at has a new feature that advances on what has gone before. But the slow deal flow belies the pace of change beneath the surface as banks increasingly analyse and accept risk with greater willingness than they would in other sectors.

The pressure for lenders to take on more risk has never been greater. As the industry moves offshore, with ever more ambitious wind farms involving the installation and operation of turbines far out to sea, projects can no longer be funded on utilities balance sheets. Yet the UK says it plans to increase offshore wind generation to 33GW by 2020, leaving an estimated funding gap of over £200 billion ($315 billion) over the next decade. In Germany, where the government plans to have 10GW of offshore wind power capacity installed by 2020, the pressure on banks to lend is just as acute. France is expecting bids in by January 2012 for its first five offshore projects.

Mitigating the risk

Bankers are taking on construction risk by incorporating structural enhancements, or asking for limited and contingent sponsor guarantees. These range from debt service undertakings and completion guarantees or, depending on sponsor balance sheet capacity, contingent equity to support any cost overrun during construction. This increased flexibility is giving new impetus to the market, evident in Blackstone and Windlands 288MW Meerwind project, located 80km off the north German coast. Here, banks lent on the condition that Siemens, the supplier of the projects 80 3.6MW turbines, make its turbine supply contracts more lender-friendly. The deal marks the next stage in bankable turbines as the first project using Siemens 3.6MW turbines to place construction risk with the banks.

It is a similar story at Centrica, Dong and Siemens £1 billion Lincs offshore wind project in the UK out to the bank market for the second time with construction risk still part of the deal. This time contingencies have been boosted to £100 million under the original deal there were £180 million of contingencies included in the loan package but they formed part of the loan itself, as opposed to additional funds and sponsors are putting £400 million of equity into the project.

Another complicating factor in deals is the prevalence of multi-party contracts, where different sub-contractors operate independently and created increased scope for disputes. One of the reasons Lincs stalled in 2010 was because of the bankruptcy of a sub-contractor. Deals with several contractors are most likely to close if they are managed by a utility, which is best-placed, given its size and history of working with contractors, to coordinate the different contracts, identify problems and deal with them early on. Banks like the credit strength of big utility sponsors that can put equity into projects but are also responsible for overall management and construction.

Engineering, procurement and construction contracts that shift the risk from the sponsor to a contractor can help, although they may not always be the solution. EPC contractor premiums in risky markets also push up the cost of projects adding an estimated 15-20% onto costs. Although pricing on deals sits above more established areas, it is these kinds of de-risking structures that have kept pricing reasonably stable at between 200-300bp, say bankers.

Elsewhere, bankers predict a steady deal flow as utilities sell off part shares in projects and move away from financing wind farms themselves. As projects get bigger even the larger sponsors are starting to seek bank debt over balance sheet funding. They also want to free up capacity for future project development. So far many sponsors have been able to absorb funding requirements internally and the cost and time implications of securing project finance has made balance sheet financing easier. But it has also bought rating implications for utilities and ties up capital that they could be using elsewhere.

Dongs sale of a minority stake in UK offshore wind project Gunfleet Sands 1 and 2 is a case in point. Japanese trading company Marubeni will buy Dongs 49.9% stake for an estimated £160 million ($255.9 million). Marubeni has mandated SG as structuring bank and has started project documentation for around £140 million of debt, structured as either a long-term deal or bridge then long-term take out. A bank club will be formed imminently and Japanese ECAs could be involved.

Diversifying funding

In Germany the deal pipeline will grow on the back of state-run development bank KfWs plans to invest Eu5 billion in wind projects. Ten projects will be eligible for financing and Meerwind was the first to benefit when the KfW board approved a Eu300 million ($420 million) loan under the programme. Meerwinds debt requirement, including contingencies, is around Eu900 million and the term loans have a 15-year post-construction tenor, in line with the old German offshore feed-in tariff regime. There are now seven banks involved, with a third of the debt covered by Danish export credit agency EKF.

KfW can lend a maximum of Eu 400 million to any single project although its financing share cant exceed 50% of the total capital requirements. The bank will also extend an additional direct loan of up to Eu 100 million if contingent additional costs arise during the installation phase of the wind farm.

KfW also participated in the debt for the Eu1.175 billion ($1.66 billion) 400MW Global Tech I deal, which closed at the beginning of August with seven lenders. Banks leading the deal are BTMU (documentation), Commerzbank, Dexia, KfW-IPEX (technical and facility agent), Santander (insurance), Siemens and Lloyds. Debt margins start at around 300bp over Euribor in construction, decreasing to around 280bp and rise to around 320bp though operation. While the European Investment Bank was ultimately unable to participate in the deal, KfW has emerged as the lynchpin of German offshore.

The UKs Green Investment Bank, with roughly £3 billion ($4.87 billion) in capital wont have the same kind of clout as KfW. Its a drop in the ocean in terms of the liquidity we need to raise, said one banker. Its also doubtful it will take risks commercial banks are unwilling to take. The new institution wont venture into offshore wind so early on in its life cycle, but it could play a valuable role providing seed capital to some of the newer technologies.

Regulatory unknowns could also stall the market. The UKs electricity market reform promises the introduction of a feed-in tariff (FIT) that is supposedly more stable and transparent than the existing renewables obligation certificates (ROCs) subsidy. The reform process could rob the market of the confidence it needs to invest the huge sums referenced. The white paper has given comfort to existing deals but the process could mean new deals further out take longer as sponsors struggle to make projections without assurances on revenue. Bankers say they can work with different regulatory programmes but that the industry had got used to ROCs, which, administered by Ofgem rather than the treasury, hadnt provided government with a fiscal incentive to meddle. It is one reason for the delay in the project financing of Masdars 20% stake in the 650MW London Array scheme. Masdar is currently negotiating joint operating agreements with the other shareholders in the project, E.ON and Dong and is aiming for financial close at the end of the year.