

Sound Bites from WindPower 2016

Last week's American Wind Energy Association's annual conference, WindPower, was informative and useful as it has been in the past. Below are sound bites from panelists. The quotations have been edited for clarity and are divided by topic.

The State of the Tax Equity Market

We have seen modest growth in the tax equity market with several new investors as entrants.

- CFO of Privately Held Energy Developer

If I were to start a new business, I would pick tax equity. It has a great risk/reward profile.

-CFO of the Development Subsidiary of a European Utility

Commentary: The first sentence of this comment highlights the fundamental challenge of tax equity. Even with capital and expertise, one cannot merely start in the business of tax equity investing because such a new business would not have tax appetite (i.e., predictable profits) to absorb the tax benefits. Thus, a tax equity investment business must consolidate for tax purposes with a business with other significant operations that generate taxable income.

Tax equity investors have become more competitive. There is more opportunity to tailor deals to meet your particular needs.

-CCO of the American Subsidiary of a European Utility

The exotic stuff is out. Back to basics: commercial bank debt, other nonrecourse financing and tax equity.

-CFO of a Wind Developer

The cost of capital generally is going down, but it is a little bit frustrating that we are not seeing the cost of tax equity come down more. Tax equity is mispriced at an 8% after-tax return.

- CFO of Privately Held Energy Developer

The new financial product that is missing: a better structure to monetize tax credits.

- CFO of Privately Held Energy Developer

Why in America do you have to raise a financing in order to monetize tax credits?

-CFO of the American Subsidiary of a European Utility

I would like to see every American be able to buy production tax credits (PTCs) in an online auction.

-CCO of the American Subsidiary of a European Utility

Commentary: Congress has at times considered transferable tax credits but certain politicians are uncomfortable with the concept. Some of that discomfort is attributable to is a perception of a windfall for the taxpayer that buys the credits at a discount to face but did not actually put any capital at risk with respect to a renewable energy project. Oregon permitted its state renewable energy tax credits to be transferred, and the program had several problems leading to an investigation and hearings.

In the United States, we use the tax code to direct investment to activities that Congress seeks to support. But using the tax code is not efficient and is expensive. In Europe, they use feed-in tariffs that are not as complicated.

-CCO of the American Subsidiary of a European Utility

Tax Equity Structuring

In our projects, the only types of capital we have now are tax equity and our sponsor equity. We try to minimize the amount of cash that must be distributed to the tax equity investor. Our pre-flip cash distribution sharing is typically 70% to us and 30% to the tax equity investor.

-CCO of the Development Subsidiary of a European Utility

The most cash that has been distributable to us as a developer during the pre-flip period is 70%, but in the US Bank investment tax credit (ITC) structure that amount is higher.

-CFO of a Wind Developer

Commentary: The referenced structure has been used mostly for solar projects; however, wind projects are permitted to elect the ITC in lieu of the PTC, and some wind projects have been financed with the referenced structure.

We are seeing the percentage of the tax equity in the capital stack for wind projects creep up with higher capacity factors. Some projects have over 50% capacity factors.

-CCO of the Subsidiary of a European Utility

Nonrecourse means nonrecourse. Parent guarantees should be few and far between. We have tried to be disciplined about that.

- CFO of Privately Held Energy Developer

Cost of Capital

Our weighted average cost of capital has been trending downward due to borrowing costs at historic lows and renewables becoming an investment grade class of asset.

-CFO of the American Subsidiary of a European Utility

We have been in a tremendously low interest rate environment. I think we are all taking that for granted.

- CFO of a Privately Held Energy Developer

There is a big difference in the cost of capital during the development period and the construction/operating period. Development equity is high risk and requires high returns, while *permanent* equity has a lower risk level and a lower return level.

-CFO of a Wind Developer

Development capital needs to earn a *multiple*. It is such a short duration that an internal rate of return is not that meaningful.

-CFO of a Wind Developer

The cost of sponsor equity for a wind project is 9% to 13% [pre-tax], depending on the quality of the power purchase agreement.

-CFO of an American Wind Developer

The cost of sponsor equity for a wind project is 8.5% to 9% for a levered, [pre-tax] internal rate of return.

-CCO of the American Subsidiary of a European Utility

Pure developers need to be sensitive to their fixed costs because their capital inflows are lumpy and volatile. The development business needs to be run lean. Any fixed costs need to be matched with reoccurring cash flows.

-CFO of a Wind Developer

The investment banks are open to financing merchant projects [(i.e., projects without power purchase agreements)] with very conservative assumptions. Power prices in the spot market have been anything but predictable.

-CCO of the American Subsidiary of a European Utility

The main issues to be negotiated with back-leverage lenders are change of control provisions and the extent to which the tax equity investor can be provided the right to sweep cash from the project to satisfy indemnities.

- CFO of a Privately Held Energy Developer

There is no substitute to dealing with experienced lenders. If they are provided information, they can make decisions in a reasonable time period.

-CCO of the American Subsidiary of a European Utility

The State of the Power Purchase Agreement (PPA) Market

- Commercial and industrial (C&I) off-takers are creating demand for wind.
- C&I off-takers are harder to contract with than utilities: utilities often merely view the PPA cost as a pass-through to their consumer ratepayers.
- C&I off-takers want projects to take the risk of variation in pricing between the node and the hub. But we just did a deal with an industrial offtaker that will take the power at the bus bar, which is what utilities do.

-CCO of the American Subsidiary of a European Utility

Most C&I PPAs allocate basis risk [(i.e., the risk that the difference between node and hub energy prices)] back to the sponsor. We have to price that in and think about how to hedge it.

- CFO of a Privately Held Energy Developer

I would love to see a more tailored hedge for the wind industry that better addresses the basis risk between the node and the hub.

-CFO of the American Subsidiary of a European Utility

PPAs are very different than they were five to ten years ago in terms of the risks that generators must take.

- CFO of a Privately Held Energy Developer

There is more to consider in a C&I PPA, than a utility PPA: are you getting the credit of the parent company or a non-rated subsidiary? If you only have the subsidiary, what sort of collateral do you need?

-CCO of the American Subsidiary of a European Utility

For utilities, we are seeing a trend in favor of ownership of projects, rather than signing PPAs.

- CFO of a Privately Held Energy Developer

Ten to 12 years is the typical term of a C&I PPA.

-CFO of a Wind Developer

Ramifications of IRS Notice 2016-31

Background: The IRS in Notice 2016-31 issued rules for determining if a wind project has “started construction” as required to qualify for the extension of the PTC. The best year for a wind project to start construction is in 2016. If a project starts construction in 2016, it has until the end of 2020 to be complete and qualify for a 2.3 cent per KWh PTC. If a project starts construction after 2016, the amount of the PTC ratchets down progressively each year. If a project started construction before 2016, then it only has until December 31 that follows the fourth anniversary of the date it started construction to be complete and qualify for the maximum PTC (e.g., if the project started construction in 2015, it must be complete by the end of 2019 in order to qualify for the maximum PTC).

The Notice is overall good for the industry due to the four year period to complete construction.

-CFO of the American Subsidiary of a European Utility

Very shortly, the interconnection queue will be getting very long [due to all the wind and solar projects that will be developed].

-CCO of the American Subsidiary of a European Utility

The downside of the Notice is we are being asked if we started construction before 2016. We have to look at each project and have a customized solution.

-CFO of the American Subsidiary of a European Utility

A much lower standard is being applied [in the market] to determine if construction started on a project before 2016 than is applied to determine if sufficient physical work was done for a project to start construction in 2016. The tax equity ask “did you put a shovel in the ground a few years ago?”

-CCO of the American Subsidiary of a European Utility

Rise and Fall of YieldCos

Capital sources are filling in after the retraction from the market of the YieldCos. Those sources of capital are utilities, private equity funds, pension funds, insurance companies and REITs.

-CFO of a Wind Developer

The last major investment banking product was the YieldCo. We didn't participate in it. We haven't been pitched the next megatrend yet.

-CFO of the American Subsidiary of a European Utility

We didn't use the YieldCo because didn't understand the model that promised future growth, [when projects by their nature are a depreciating asset]. Also, we are a private company and want to stay a private company, so we didn't want a public vehicle.

- CFO of a Privately Held Energy Developer

A development property is much different than an operating project, so separating those two cash streams as the YieldCos do makes sense. When you look at how capital is organized and the risk profile, it makes sense to split development cash flows from operating cash flows as the YieldCos do.

-CFO of a Wind Developer

Energy Storage

We are starting to work on storage. As renewables become a bigger portion of the electricity supply, the marriage with storage becomes necessary. Batteries are very expensive still. If batteries come down in cost, it could get interesting to add batteries to existing projects.

-CCO of the American Subsidiary of a European Utility