Renewable Energy Alert

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The Department of Energy's FIPP Solicitation: The Fine Print

The Financial Institution Partnership Program and Commercial Renewable Energy Generation Solicitation announced by the DOE on October 7, 2009 (the "FIPP Solicitation") presents developers of conventional renewable energy projects with a valuable opportunity to combine private debt and equity with government guaranteed financing. The terms of the DOE's FIPP Solicitation have been generally summarized by Nixon Peabody and were also the subject of a recent Nixon Peabody Webinar which remains available for replay on our website. [1]

Here, we seek to address some of the key issues raised by the FIPP Program. It is expected that the rules governing implementation of the FIPP Program will continue to evolve as the program matures.

1. **Credit Subsidy Cost**—The DOE estimates that, because the projects involve commercial technology and will be rated at least "BB," the credit subsidy cost will likely be less than such costs for innovative projects, thought to be in the 10% range. Assuming a significant number of investment-grade projects, the $750 million of funds appropriated in respect of the FIPP Solicitation to pay Credit Subsidy Costs is estimated to support approximately $15 to $18 billion in guaranteed debt—a much higher figure than earlier published estimates.

2. **Notice of Proposed Rulemaking—**On August 6, 2009, DOE issued proposed changes to the October, 2007 Final Regulations implementing the Title XVII Loan Guarantee Program. The changes principally provided for the possibility of collateral sharing among multiple secured creditors, including DOE, as guarantor, subject to a satisfactory intercreditor agreement. The comment period for the proposed changes ended on September 22, 2009; all comments received were supportive of the proposed changes. The changes would alter the existing program rules to allow, *inter alia*, for *pari passu* treatment of swap counterparties and lenders extending a so-called "bridge-to-1603 grant" loan. Issuance of the final changes to the regulations is imminent, with no changes from the August 6, 2009 proposed text expected.

[1] This client alert assumes that the reader is familiar with the basic terms of the FIPP Solicitation.

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3. **Use of Tax Motivated Structures under FIPP**—Many renewable energy developers have been concerned, based on language in the FIPP solicitation, that the DOE would disfavor a project that made use of tax motivated structures. Given the significant equity that can be raised from the sale of the tax credits and accelerated depreciation in renewable energy projects, this presents a Hobson's choice to developers.

    - We have learned that while the DOE favors simple senior secured finance structures given their relative ease and speed of execution, it will not disfavor or reject projects with passive tax equity investors provided their involvement does not materially affect the position of the debt holders.

    - The DOE recognizes that, even in the simplest of structures, there will typically be negotiations with equity; it will therefore entertain discussions with tax equity investors seeking independent cure rights or other "minor modifications."

    - Tax equity investors have sought forbearance agreements from project lenders to (x) avoid recapture of the investment tax credit (Section 48) or (y) allow passage of the ten-year statutory production period associated with the production tax credit (Section 45). Project owners that choose to take advantage of the 1603 grant-in-lieu of the investment tax credit generally do not face similarly broad recapture issues. We note that the 1603 grant-in-lieu may be subject to recapture if ownership of the project is transferred, in whole or in part, to a tax-exempt entity (such as the DOE) or if the project is taken out of service, in each case during the 5-year recapture period. The DOE may be willing to discuss structures and arrangements to address recapture concerns such as foreclosure through a non tax-exempt nominee and continued future use of the property. Note that there may be project owners, including geothermal or high capacity wind installations, that would benefit more from the PTC rather than a 1603 grant, in these instances, further conversation with DOE will be necessary.

    - The DOE may be open to sale-leaseback structures at the holding company level, which would allow for a lease equity investor to take advantage of depreciation associated with the asset and would avoid the need to alter existing project-level guaranteed debt.

4. **Treatment of 1603 Grant**—In general, the Loan Guarantee Program limits the amount of debt guaranteed to 80% of Project Costs, as defined in the program rules. The FIPP Solicitation further restricts the amount of debt guaranteed to 80% of the amount of any Guaranteed Obligation. The DOE has further taken the position that funds received from the Treasury as a 1603 grant should be deducted from Project Costs for purposes of establishing the amount of debt that can be supported by a loan guarantee. This position is based upon, and serves as a proxy for, the definition of "Equity" under the program rules, which specifically excludes the value of any form of government assistance or support. Thus, if a facility with an Original Project Cost of $1,000,000 has a $300,000 1603 Grant (in most cases

the 1603 Grant is 30% of eligible basis or the Original Project Cost), then the maximum Guaranteed Obligation is $700,000 times 80%, or $560,000, and the maximum guarantee is 80% of that amount, or $448,000.

Because the 1603 Grant is not received until after the facility is placed in service, two different ratios will apply to a project that is constructed in anticipation of qualifying for a 1603 grant. First, during the construction period (prior to receipt of any grant funds) the DOE guarantee may be a maximum of 64% of Project Costs (i.e. 80% of 80% of "Original Project Costs"), as described in the first paragraph. Second, at the point that a project receives a 1603 grant the maximum amount of debt under the FIPP Program that can be supported by the guarantee falls to 44.8% of the Original Project Cost (i.e. 80% of 80% of 70% of the Original Project Costs), as described in the second paragraph.

Given the stapled nature of the Guaranteed Obligation, repayment of the unguaranteed portion must occur if there is to be a repayment of the guaranteed portion. Thus, in a transaction where there was 20% equity and 80% Guaranteed Obligation (of which only 80% was guaranteed), the maximum outstanding Guaranteed Obligation would be required to be reduced to approximately 55.2% of the Original Project Cost. Presumably, this would be done using the cash received from the 1603 Grant. In the illustrations above, where the amount of the Guaranteed Obligation was reduced from $800,000 to $560,000 (due to receipt of the 1603 Grant), this means that $240,000 of the $300,000 1603 Grant would be used to pay down the Guaranteed Obligation. The balance, or $60,000, could be used for other purposes, or to reduce equity. We note that the figures used in the above examples set forth the maximum permitted debt thresholds, specific project economics may dictate lower leverage.

Given the complexities and possible variations, details will need to be worked out based on individual project financing structures. Tranching should be provided for in the financing structure to permit such expected pay down upon receipt of the grant proceeds without penalty.

5. **Voting Rights**—The DOE's position with respect to voting matters is that as unconditional guarantor of a supermajority of the debt it should control most decisions with respect to the underlying loan documentation. It should be noted however, that DOE intends to delegate certain of its decision-making authority to the Administrative Agent with respect to routine matters. Lender-Applicants may suggest project-specific changes or additions to the list of unanimous vote decisions currently specified in the solicitation, although the DOE has indicated that this current list is not subject to negotiation.

6. **Guaranteed Obligation Flexibility**—We learned that there may be additional flexibility in the "Guaranteed Obligation" concept.

    - While no more than 80% of any tranche of a Guaranteed Obligation may be guaranteed by the DOE and the guaranteed portion and the unguaranteed portions may not be sold separately (the Treasury's so-called "Stapling Policy"), portions of each such tranche may be assigned a different interest rate (fixed or floating) thereby facilitating loan stripping in the secondary market. It is expected that financial institutions

will create separate legal entities that would issue structured "AAA" products secured by the guaranteed portion of the debt.

- Additionally, different tranches of loans can be floating during the construction period, with fixed interest rate tranches and loan stripping after the project's commercial operation date ("COD") to facilitate longer term tranches after COD or repayment of a portion of the debt upon receipt of 1603 grant proceeds (discussed below).

- To facilitate a broad range of potential lenders with different risk profiles, structures using multiple tranches incorporating both long-term insurance company debt and shorter term bank debt, such as mini-perms, are possible. DOE requires that within each tranche, however, the co-alignment of risk between the public and private sector (i.e. 80:20) be maintained.

- In the case of shorter term Guaranteed Obligations where there is a "bullet" due upon maturity, although the DOE guarantee will pay out on the guaranteed portion of such Guaranteed Obligation upon a default resulting from the borrower's inability to refinance, the DOE will not agree at the time the loan is made to an extension of the term of the debt, nor is there any assurance that any extension or refinancing of such debt will be guaranteed by the DOE, although the DOE may at the time of the default agree to terms of a work-out of the loan. At such time, parties would also have no assurance that the DOE would have statutory authority to extend its guarantee beyond its original tenor or would have received an appropriation for any incremental credit subsidy cost that may become due in connection with an extension of an existing loan guarantee.

7. **Construction Financing/Term Loan Commitment and Project Eligibility**—The FIPP Solicitation makes clear that projects which hold a commitment for post construction financing will not be eligible for the loan guarantee program. However, commitments from project finance lenders for construction projects typically include a take out. In order to facilitate back-up arrangements with respect to term period financing, the DOE will not exclude projects where a sponsor has a liquidity facility available at a holding company level that may be used to retire construction debt in the event that a DOE guaranteed financing is not achieved.

8. **Subordination of Swap Termination Payments**—The DOE guarantees principal and interest, but not termination payments (breakage) upon termination of an interest rate swap. Under the terms of the proposed form of Guaranty, upon default the DOE will make a lump sum payment on the guaranteed portion of floating rate debt, likely triggering an early termination under a standard interest rate agreement. The DOE has indicated that Title XVII currently requires that an interest rate swap counterparty's lien securing breakage be subordinated to a lender's lien in respect of principal and interest on any Guaranteed Obligation. The DOE is considering whether, under current regulations, it may treat swap breakage relating to the unguaranteed portion of a Guaranteed Obligation as a *pari passu* senior claim. Swaps are not entered into with respect to fixed rate debt and, upon a default on guaranteed fixed rate debt, DOE will pay out the guaranteed fixed rate debt over

time (rather than in a lump sum), so no payment of any prepayment or make whole premiums would be required. We note that issuance of final revised regulations as discussed above may preempt the issues addressed in this paragraph.

9. **Junior Debt—**Pending approval of proposed changes to the October 2007 regulations implementing the original Title XVII loan guarantee program discussed above, the DOE will not entertain collateral sharing as between Holders of the Guaranteed Obligation and junior creditors. Subordinated or mezzanine debt will be permitted solely on an unsecured basis. Alternatively, sponsors can pursue "holdco" financings which are secured by equity and project distributions. This structure, when coupled with an appropriately crafted covenant package, presents a reasonably equivalent alternative to secured subordinated project-level financing.

10. **Administrative Agent Indemnity**—Section 4.07 of the proposed form of Guarantee contains a very broad indemnity from the Administrative Agent to the DOE. Concerns raised in discussions regarding the terms of this indemnity may lead to a modification which may bring it in line with the form of indemnity commonly found in a US EXIM Bank guaranty, limiting liability to certain bad acts and gross negligence and excluding consequential or indirect damages.

11. **Equity Source**—Project Equity may be obtained by the Sponsor through holding company financings.

12. **Portfolio Projects under the FIPP**—Portfolio transactions are not excluded from the program and may present significant economies of scale. Each of the constituent projects however, must have undergone a NEPA review, must commence construction no later than September 30, 2011, and, as a practical matter, the projects being financed will likely need to commence construction reasonably close in time with each other. There is no policy relief under NEPA (or the FIPP) for smaller distributed generation projects.

13. **Timing of the DOE's Part I Review**—Lender Applicants should hear back from DOE within a "couple of weeks" following submission. The fundamental economics will likely be reviewed by one of the consultants engaged by the DOE with NEPA review to be performed in-house.

14. **Timing of Incurrence of Project Costs—**Questions have been raised with respect to whether the DOE will consider costs incurred by project developers prior to submission of a Part I Application as "Project Costs" as defined under the FIPP Solicitation. While the DOE is continuing to analyze these issues, it is likely that costs incurred following February 16, 2009 (the date the Recovery Act was signed into law) using funds obtained from a development loan or corporate level financing will be considered as an eligible "Project Cost." DOE is less likely to consider such expenditures as "Project Costs" if funded prior to such date or, if funded following such date, entirely by equity, although the issue continues to be considered.

15. **Clarifications**—Following Thanksgiving, the DOE is planning to hold an additional webinar on this subject and will post answers to frequently asked questions relating to this Solicitation on its website; the DOE has already posted such questions as they relate to other DOE solicitations. There is a certain amount

of "tweaking" required to the terms of the Solicitation itself. The DOE has discovered a typo on page 130. The language should have indicated that the DOE's subrogation rights attach solely to the guaranteed portion of the Holder's interest in the Guaranteed Obligation, not the entire Guaranteed Obligation.

Nixon Peabody LLP, an active participant in the energy and project finance sector, will continue to monitor and report significant developments involving the FIPP Solicitation and would welcome the opportunity to discuss specific questions or concerns. Inquiries should be directed to either:

- Deborah DeMasi at 202-585-8194 or ddemasi@nixonpeabody.com
- Ellen Friedman at 212-940-3053 or efriedman@nixonpeabody.com

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