market intelligence

Volume 2 • Issue 2

Project Finance

Phillip Fletcher and Aled Davies lead the global interview panel covering key economies, regional analysis and PPP

Energy market conditions to increase M&A opportunities?

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GETTING THE DEAL THROUGH

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Welcome to *GTDT: Market Intelligence*.

This issue focuses on the global project finance markets.

Getting the Deal Through invites leading practitioners to reflect on evolving legal and regulatory landscapes. Through engaging and analytical interviews, featuring a uniform set of questions to aid in jurisdictional comparison, *Market Intelligence* offers readers a highly accessible take on the crucial issues of the day and an opportunity to discover more about the people behind the most interesting cases and deals.

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David Armstrong

PROJECT FINANCE IN THE UNITED STATES

Skadden partner David Armstrong and associates Adam Griffin and Megan Kultgen focus primarily on the representation of commercial and investment banks, as well as borrowers and issuers, in leveraged and other finance transactions, including project financings, acquisition financings, leveraged leases and other senior secured lending transactions, with a principal focus on the energy and industrial sectors.

GTDT: What have been the trends over the past year or so in terms of deal activity in the project finance sector in your jurisdiction?

David Armstrong, Adam Griffin & Megan Kultgen: Skadden's energy and infrastructure projects group advises clients with respect to all aspects of project finance transactions in the United States, and we also work on a large number of international transactions. We will focus here on project finance transactions in the United States, rather than on US investing and lending worldwide, but we note that US investment in international project finance transactions remains strong. 2014 was an active year for project finance in the United States, as total loan volume (about $60 billion) for the year was approximately double that in 2013. The oil and gas sector accounted for approximately one-third ($20.7 billion) of total loan volume valued in US dollars, and the power sector accounted for another third (with approximately one-third of that total in loans for solar and wind energy projects). The European commercial banks that were dominant in the US project finance lending market prior to the financial crisis, but less so in recent years because of liquidity and capital restraints imposed by Basel III, were very active, and the term loan B and

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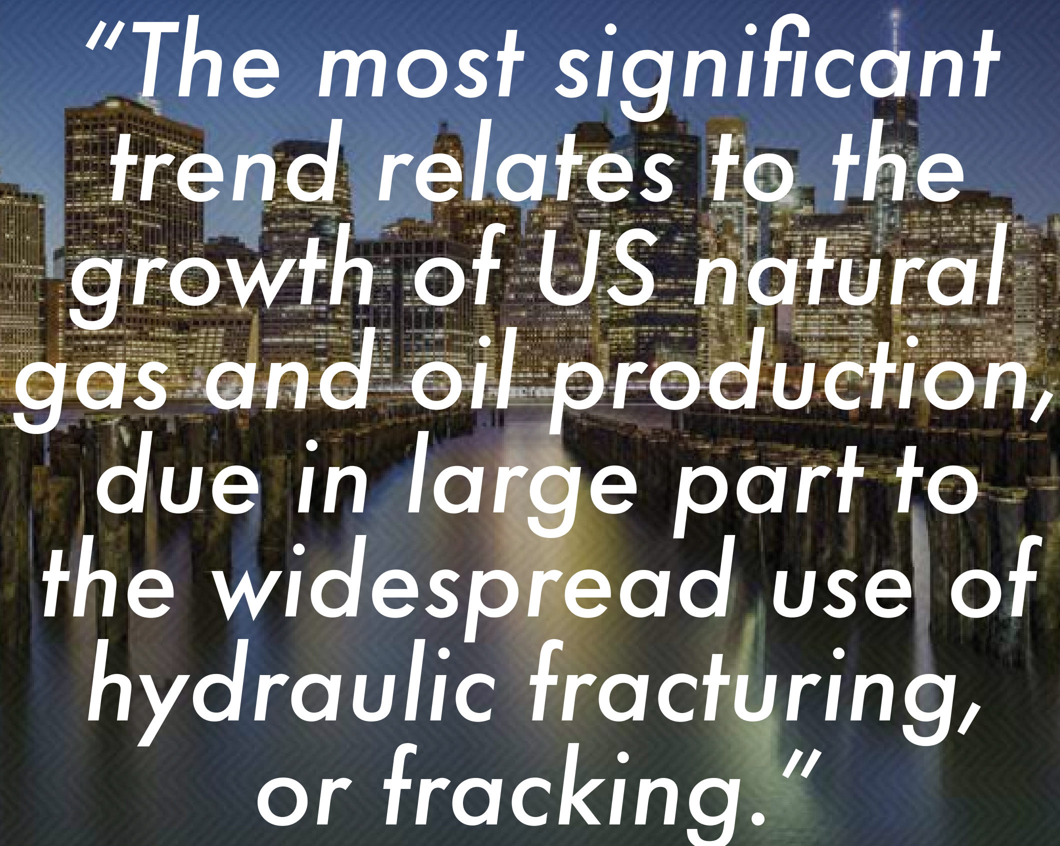

project bond markets were also consistent sources of liquidity. This environment led to many project finance transactions being oversubscribed, and much lower pricing and less stringent covenants available to project sponsors. Though still robust, the term loan B market actually saw decreased activity, and much lower yields, than 2013 because of the increase in commercial bank lending.

The most significant recent trend in the United States relates to the growth of US natural gas and oil production, due in large part to the widespread use of hydraulic fracturing, or fracking. Although the impact of the recent drastic drop in the price of oil remains to be seen, there has been a considerable increase in activity for projects with a significant natural gas component, including petrochemicals projects, liquefied natural gas (LNG) export projects and gas-fired generation projects. For instance, low natural gas prices as a result of increased domestic production, combined with increased liquidity in the project finance debt markets, drove large financings for projects such as the Sasol petrochemicals project and the Freeport LNG and Cameron LNG export projects. These factors also drove financings for the construction or acquisitions of gas-fired power projects. Natural gas-fired plants accounted for 49 per cent of new generation capacity in 2014 (though, on an overall basis, it still lags behind coal, the primary source of US power generation).

Turning to a second identifiable trend in US project finance, building from the success of NRG's 'yieldco', NRG Yield, which priced in 2013, there was a flurry of yieldco activity in 2014. 2014 saw the launch of three more yieldcos from Abengoa, SunEdison and NextEra, all of which hold renewable generation assets, though Abengoa's yieldco also holds conventional power, electric transmission and other contracted assets.

The proliferation of renewables projects generally, including as the main source of yieldco assets, also continued in 2014. One of the drivers of that proliferation is the renewables sector's continued reliance on tax incentives. In 2014, tax equity investors looking to capitalise on the production tax credit (PTC) (available to projects that are placed in service before 31 December 2015) and the investment tax credit (ITC) (which remained at 30 per cent in 2014) invested more than $10 billion in 2014. The widespread use of tax equity has made holding company loans more common in the project finance space, as it is difficult to balance the requirements of tax equity investors with the restrictions lenders require to be placed on projectcompanies obtaining debt financing.

In addition to tax equity sources of capital, the solar industry has also found innovative ways to continue to attract cheaper sources of capital, as SolarCity was able to complete approximately $271 million worth of Rule 144A securitisation transactions in 2014, and other solar developers have been looking to capitalise further on securitisations as a source of ready capital to fund project development, particularly with respect to smaller-scale, and even residential, photovoltaic solar projects.

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Finally, the project bond market also remained stable, with approximately $12 billion in total volume in 2014, including bond issuances by Cheniere's Sabine Pass Liquefaction and by NRG Yield and Abengoa Yield.

GTDT: In terms of project finance transactions, which industry sectors have been the most active and what have been the most significant deals to close in your jurisdiction?

DA, AG & MK: As noted, driven by the growth of US natural gas production, two of the most active sectors in the US project finance market in 2014 were the petrochemicals and LNG export sectors. On the petrochemicals side, Skadden represented the lenders in connection with the most significant transaction to close in 2014, the Sasol petrochemical project in Louisiana. In that transaction, Sasol Chemical raised $4.4 billion of debt financing for its project, a financing that was named PFI Americas Petrochemical Deal of the Year 2014. On the LNG export side, Cheniere's Sabine Pass Liquefaction, which closed bank debt financings in 2012 and 2013, raised approximately $2.5 billion in project bonds last year, and two of the largest project finance deals in 2014 were the financings for the Cameron LNG and Freeport LNG projects. With these large transactions and others, the US market saw an influx of development bank activity in 2014, largely to support the involvement of overseas companies (as equity holders, off-takers or large equipment suppliers and contractors) in large US projects. For instance, Japan Bank for International Cooperation was involved in both the Cameron and Freeport LNG projects, which have Japanese equity holders and off-takers, respectively. The Korea Development Bank was involved in the Sasol petrochemical project, as well as the financing for the Mississippian Lime project and OCI Solar Power's Alamo project. KfW-Ipex, a German export credit agency, was also involved in the Sasol project financing.

As mentioned earlier, the yieldco trend also dominated headlines in the US project finance market, particularly in the renewable energy sector. Abengoa raised $720 million for its Abengoa Yield, which holds generation and transmission assets in North America, South America and Europe. SunEdison's subsidiary, TerraForm Power Inc also launched a yieldco IPO that raised total gross proceeds of $500 million in July. TerraForm initially had a portfolio of 524 megawatts of solar farms in the United States, Canada, the United Kingdom and Chile. Additionally, NextEra launched a yieldco that raised total gross proceeds of $406.3 million in June, and initially held 990 megawatts capacity of wind and solar assets. Cumulatively, the four US yieldcos hold assets with an installed capacity of approximately 6000 megawatts. Two Canadian yieldcos also hold US assets, and further yieldcos are expected to be launched in 2015.

GTDT: Which project sponsors have been most active in driving activity? Which banks have been most active in providing debt finance?

DA, AG & MK: The US energy and infrastructure sector features a broad range of both domestic and international investors and sponsors. In the LNG export industry, Cheniere Energy, Inc is based in Houston, Texas. Sempra Energy, the sponsor of the Cameron LNG project, is based in San Diego, California, but internationally based corporations such as GDF Suez and Mitsubishi Corporation are also investors. The Freeport LNG project is also domestically owned and has a Japanese limited partner. Several domestic sponsors in the power industry were very active in 2014, including NRG Energy, NextEra and SunEdison, all whom have launched power yieldcos and were also active in the debt markets. NRG, for instance, obtained a $1 billion loan to finance the acquisition of Edison Mission

Adam Griffin

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Energy's generation assets, Dominion's retail electric assets and Roof Diagnostics' solar assets. Abengoa, which launched the fourth US yieldco, is a Spanish sponsor. Several other domestic sponsors participated in significant power project financings. These included regular power market participants, such as Tenaska Energy (which closed a $455 million construction financing for its 150 megawatt Csolar IV West solar project in 2014), LS Power (which acquired and financed several generation assets from Calpine in 2014, and RJS Power Holdings (which issued $1.25 billion in unsecured notes to refinance the Topaz and Raven term loan B deals that it had completed in 2013). SolarCity has been a leader in innovative financing transactions in the solar industry, completing the first securitisation related to solar projects and the first ever crowdfunded solar project in 2014.

Among the commercial banks involved in US project finance, Mitsubishi UFJ Financial Group (MUFG) dominated the league tables as lead arranger of 34 transactions in the United States for a total deal volume of approximately $3.698 billion. Rounding out the top 10 most active commercial banks were Sumitomo Mitsui Financial Group (Sumitomo), Citigroup, ING Group, Mizuho Financial Group, Morgan Stanley, Deutsche Bank, Société Générale, Crédit Agricole Group and JPMorgan. Several of these banks were arrangers on the most significant transactions of the year, and all of MUFG, Sumitomo, Mizuho, Crédit Agricole, ING, Société Générale and JPMorgan were arrangers on the Cameron LNG project financing. All of the major banks participating in the US project finance market in 2014 were involved in a broad variety of deals across the oil and gas, power and infrastructure sectors. The large US insurance companies and pension funds are also active in the project bond market, both in Rule 144A/Reg S transactions and in more traditional private placements.

GTDT: What are the biggest challenges that your clients face when implementing projects in your jurisdiction?

DA, AG & MK: The continued robust project finance activity in the United States in 2014 was a welcome sign after decreased deal volume in the aftermath of the financial crisis. The US economy seems to be on relatively stable ground heading into 2015, though it remains to be seen what effect economic and geopolitical uncertainties, such as oil and natural gas price volatility, slowed economic growth in Asia and other regions and political instability regarding Russia will have on the energy sector over the medium to long term. For instance, assuming oil and natural gas prices remain depressed for the medium to long term, exploration and development in the United States will likely slow, much as mining development has experienced a decline in the face of persistently low metals prices across the global economy.

While the United States is a mature project finance market, the energy and infrastructure sectors in which project finance is most prevalent are heavily regulated and increasingly complex. In the LNG export sector, recent legislative action has led to increased optimism that future LNG export projects may be expedited, but the various approval processes relating to LNG export facilities remain a major obstacle to further development in that space. More generally, in the oil and gas sector, fracking has been the greatest driver of growth in US production in recent years. However, increased scrutiny from the general public and, in turn, legislators is likely to yield new regulations regarding techniques, approval processes and fracking as a general matter. In all sectors, including the oil and gas sectors, sponsors must navigate federal, state and local laws and regulations. For example, in December 2014, the State of New York banned fracking because of concerns over perceived health risks as a result of the practice. On the other hand, in June 2014, North Carolina lifted a state-wide ban on fracking, which also included protections for oil and gas companies who have been vigilant regarding their fluid compositions used in the practice, which they regard as vital trade secrets.

In the power sector, natural gas and renewable energy electric generating capacity have grown significantly in recent years. As in prior years, increased regulatory scrutiny due to environmental concerns has tempered coal generation, and even led to the closure of some facilities. The renewable energy sector has benefited greatly from tax incentives such as the PTC and the ITC, which tax equity investors have utilised to provide developers with increased access to capital. The tax regulations that drive tax equity transactions are complex, and changes to the PTC and ITC will likely impact the feasibility of renewable projects.

GTDT: Are there any proposed legal or regulatory changes that may give rise to new opportunities in project development and finance? Do you believe these changes will open the market up to a broader range of participants?

DA, AG & MK: The LNG export and solar power generation industries have been two of the more active industries within the US project finance market recently. Each of these industries is subject to considerable regulation, and each is subject to recent proposed legislative changes that may significantly impact the development of projects within those industries. Turning first to the LNG export industry, in late January, the US

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Megan Kultgen

House of Representatives passed the LNG Permitting Certainty and Transparency Act (LNG PCTA), designed to expedite regulatory approvals for LNG export to countries that do not have a free trade agreement with the United States The US Department of Energy (DOE) has issued a final decision on a very small percentage of the applications for such approvals, thereby limiting the number of countries and customers to which LNG exporters can sell their product. Although DOE approval is a necessary step in the development of an LNG export project, it is one of many. Accordingly, the LNG PCTA, will not have a dramatic effect on the development of LNG export projects. However, it could lead to earlier investment decisions by potential exporters and may be a signal of further legislative changes to come. Even with the recent decline in oil prices, the combined effect of such legislative changes could expedite projects and open the market to new participants, domestically and internationally.

Turning next to the solar power generation industry, there are several ongoing legislative initiatives that affect the utility scale, commercial and industrial and residential solar industries. For instance, President Obama's 2016 Budget Proposal includes a permanent extension of the ITC (which gives purchasers a tax credit equal to 30 per cent of their basis) used by the solar industry. To the extent those credits, set to expire in 2016, are extended, we expect enthusiasm for investment in solar to continue at, or expand from, its current levels. Additionally, some states have enacted legislation requiring utilities to produce a certain percentage of generation from solar energy. As such, some utilities are investigating both development and acquisitions of utility-scale solar farms, as well as less capital-intensive investments in commercial, industrial and residential projects.

A second example involves ongoing regulatory battles over net metering and rate structures. Net metering, where, for instance, excess solar energy generated during daylight hours by a residential customer from his or her rooftop panels is delivered to the local grid at retail rates and used to offset energy provided by the utility to the residential customer at night, is one approach that makes using solar panels economically appealing. However, utilities contend that net metering is unfair because the system decreases the amount of energy sold by the utility, while the cost to maintain infrastructure and the grid are not incorporated into what rooftop solar customers are charged. As such, the argument is that homeowners without solar panels bear the cost of maintaining the grid, without receiving the economic benefit seen by solar participants. Since credit scores are a primary component of eligibility for residential panels, the utilities' position is that low-income customers are subsidising the wealthy. To the extent that rate battles between the utilities and solar industry fall in favour of the utilities, expansion of the solar market may be adversely impacted.

A third example involves the increased participation of banks as tax equity investors. With banks entering the market as tax equity investors, thereby increasing the number of players, we expect to see the deal volume continue to the extent the ITC is extended beyond 2016. That said, the Bank Holding Company Act and, specifically, the Volcker Rule, which prevents banks with nationally federally insured deposits from participating in proprietary trading and investing in a covered fund, has made it challenging for banks to invest in renewable energy on the equity side. While certain structures [*discussed later*] are being used to comply with the Volcker Rule while still capitalising on the benefits of the ITC, to the extent new interpretations of Volcker arise or further restrictions are enacted, this could have a dampening effect on investment.

GTDT: What trends have you been seeing in terms of range of project participants? What factors have influenced negotiations on commercial terms and risk-allocation? Are there any particularly innovative features?

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DA, AG & MK: As previously mentioned, the US project finance market was very active in 2014 and remained strong throughout the year. On the lending side, the sources and structures of funding remain diverse across all industries in the project finance space. In addition to the return of European commercial banks, which were much more active in 2014 than in the past few years, the funding sources that had increasingly filled the gap left by the European commercial banks remained strong in 2014. This includes ongoing activity from commercial banks as a whole, with Japanese, Canadian and US regional banks taking a more prominent role, and increased activity from term loan B lenders, project bond investors and tax equity investors. In addition, we have seen increased roles for export credit agencies (particularly in the LNG export and petrochemicals sectors), and the DOE's Loan Guarantee Program and other government programmes have provided critical funding.

Perhaps the greatest determinant of commercial terms and risk allocation in US project finance is the lending market in which a project is being financed. For instance, in commercial bank transactions, the covenant packages and deal structures tend to be tighter than in term loan B and Rule 144A/Reg S project bond transactions. Among the rationales for this distinction is that amendments and waivers are more manageable in commercial bank transactions because of the traditionally closer relationship between sponsors and bank lenders. Accordingly, although covenants may be tighter, sponsors believe they have greater flexibility to seek amendments and waivers to such covenants. Commercial banks also tend to have less appetite for risk than term loan B lenders (which is reflected in the rates and fees paid by borrowers), which results in riskier projects (including less sponsor support, increased merchant risk and heightened technology, permitting or other risks) being financed in the term loan B or high-yield bond markets, particularly at times when there is high liquidity in those markets.

Given the breadth of the US project finance market, it is difficult to discuss with any specificity the innovative structures and relevant risk allocations being used and applied. Instead, we will focus for illustrative purposes on solar tax equity, where we have seen a great deal of innovative activity, with both partnership flip structures and, more recently, inverted (or pass-through) leases with an eye toward future asset securitisation. In a partnership flip, the solar developer and the tax equity investor form a joint venture and the allocation of upside (profits, cash, tax benefits) flips between the parties during the life of the investment. With an inverted lease, the developer leases projects to the tax equity investor, assigns its rights under the power purchase agreement and related agreements to the investor, who then contracts the servicing of those projects back to the developer or its affiliate.

The inverted lease is more attractive than the partnership flip in a scenario where owner-level debt is contemplated as a foreclosure on a project owned by a partnership utilising a flip structure during the ITC recapture period would result in recapture, so tax equity investors would seek complete forbearance from the lenders. In contrast, a foreclosure on a project owned by a lessor in an inverted lease during the recapture period results in recapture only if the project is transferred to a disqualified person, so tax equity investors seek a limited forbearance, which has been viewed more favourably by market lenders.

As noted, financial institutions (including banks) have played an increasing role as tax equity investors. As such institutions enter the tax equity market, there is often a necessary shift in how they analyse acceptable risk. Such investments have all the features of equity, including equity-type risks. A financial institution may be more accustomed to providing financing in a debt position with all the protections that debt affords, so the risk assessment is very different when they enter the tax equity market.

GTDT: What are the major changes in activity levels or new trends you anticipate over the next year or so?

DA, AG & MK: The decrease in oil prices is likely to diminish short-term interest in certain types of projects, which may create opportunities for companies in the right position to capitalise. Many oil and gas companies are scaling back their 2015 capital spending estimates, looking to divest non-core assets, cutting expenses and streamlining their businesses, in an effort to weather the negative impact of the current low price of oil. These sales, however, create opportunities for companies and private equity firms whose balance sheets are in order to make asset purchases at extremely attractive prices.

"The sources and structures of funding remain diverse across all industries in the project finance space."

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THE INSIDE TRACK

What three things should a client consider when choosing counsel for a complex project financing?

First, clients should consider breadth of expertise. In addition to project finance, complex financings often require tax, real estate, environmental, regulatory, cross-border and intellectual property specialists, to name a few. Thus, it is imperative that the firm has wide-ranging experience. Secondly, specific industry knowledge and understanding of the core business is important. This applies on the lender side (where designing covenants to address industry-specific risks is essential) and on the sponsor side (where ensuring the company has flexibility to run its business effectively is a must). Finally, clients should consider whether the firm's style aligns with the client's approach to the transaction.

What are the most important factors for a client to consider and address to successfully implement a project in your country?

While it is difficult to narrow the factors in a market as diverse as the United States, we consider the following to be among the most important: knowledge of, and adequate legal counsel in respect of, regulations at all levels (federal, state and local) applicable to the project; adequacy of funds to support project development, particularly given the long lead time in many industries; understanding of the debt market in which the project is expected to be financed, and structural considerations to ensure that risks associated with that project will be financeable; and tax considerations, to ensure the project achieves optimal tax savings.

What was the most noteworthy deal that you have worked on recently and what features were of key interest?

Our ongoing work on Cheniere's Sabine Pass project is our most noteworthy recent project. When completed, this will be the first LNG export facility constructed in the United States in over 40 years. We have represented initial purchasers in six Rule 144A/Reg S bond offerings (totalling $6.5 billion) for Sabine Pass. As a landmark transaction, there are many notable features, including Sabine Pass's ability to incur billions in additional debt without bondholder consent. This is a departure from traditional project finance, but a feature essential to the transaction and one that we designed with sufficient flexibility and adequate protection for bondholders.

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In addition to the direct impact on the oil industry, we may see a tempering in the recent enthusiasm for domestic LNG development, as the cost-related benefits of domestic LNG diminish significantly with oil at $50 a barrel. Project finance projects in deep-water and pipeline development are also likely to slow in the short term, though the Energy and Commerce Chairman, Fred Upton, has identified pipeline infrastructure as a core area of focus for later in the year, so that slowing may be short-lived.

We do not, however, expect the decrease in oil prices to negatively impact the domestic enthusiasm for investments in the renewable sector. In the United States, there is strong support for energy independence, as well as for protecting against climate change, as evidenced by governmental policies to support investment in the renewables sector. In addition to President Obama's 2016 Budget Proposal's permanent extension of the PTC used by the wind industry and the ITC used by the solar industry, the Proposal outlines a plan to increase investment in clean energy and a fund to encourage cuts to power plant emissions. The White House has said that it is launching a Clean Energy Investment Initiative and has set a goal of raising $2 billion from private investors and philanthropists for investment in clean energy. We believe that this support from the administration has the potential to translate into further investment in the space.

While not a new trend, there has been increased yieldco activity in 2014 and at the beginning of 2015. Yieldcos are formed as corporations or limited liability partnerships, the only asset of which is an operating company that owns renewable energy assets that generate cash. The yieldco structure is attractive because it capitalises on accelerated tax depreciation and certain other tax benefits, decreases corporate-level income tax and provides an income stream. We expect the trend to continue to expand.

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