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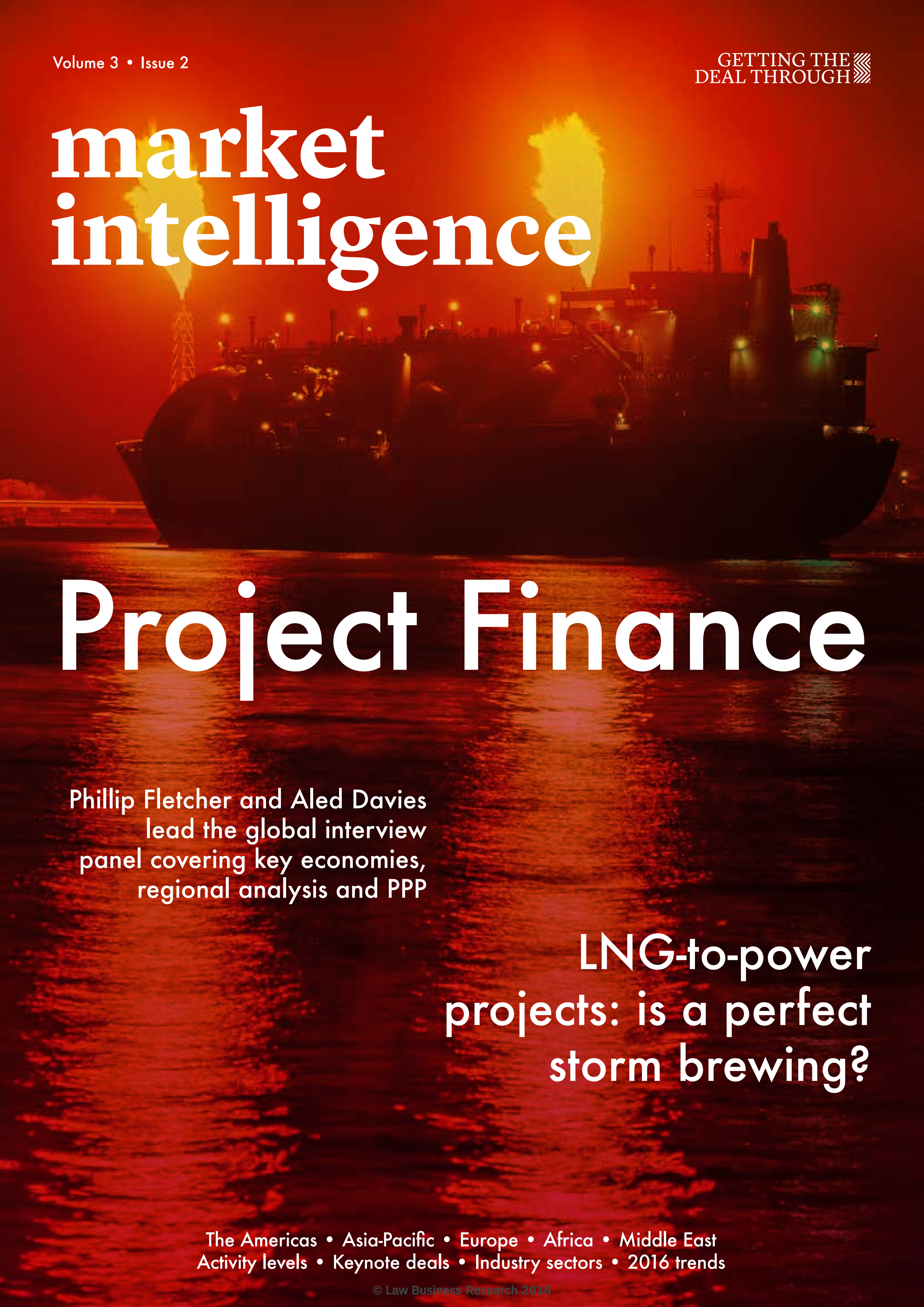
GETTING THE DEAL THROUGH

market intelligence



Project Finance

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

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GETTING THE DEAL THROUGH

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Welcome to GTDT: *Market Intelligence*.

This is the second annual issue focusing 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.

Market Intelligence is available in print and online at www.gettingthedealthrough.com/intelligence.

Getting the Deal Through
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In this issue

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 on a broad range of project finance and other energy-related transactions in the United States, as well as in international markets. We will focus here on project finance transactions in the United States, as opposed to US investing and lending worldwide, but we note that, in 2015, US investment in international project finance transactions remained rather robust. According to *Project Finance International*, US project finance bank loans totalled approximately US$56.5 billion in 2015, which represented a slight drop from the US$60.1 billion of bank loan financings reported for 2014, but was still robust compared to the years subsequent to the financial crisis. The continued activity in 2015 of the commercial banks in US markets led to a large collective drop in project bond and term loan B project financings. In the US, there were approximately US$10.8 billion of project bond issuances (down from approximately US$12.3 billion in 2014), and, in North America, there were 10 total term loan B project finance transactions for a total of US$3.3 billion (as opposed to approximately US$9 billion in 2014). Market volatility in the latter half of 2015 also caused a significant slowdown in transactions, and some of the figures from 2015 are bolstered by very large liquefied natural gas (LNG) export facility financings, most of which closed in the early months of the year.

Across all US project finance transactions in 2015, the oil and gas sector accounted for almost 40 per cent of the total transaction value (both debt and equity) by dollar volume, and the power sector accounted for approximately 45 per cent of the total transaction value (approximately US$33.7 billion of the total deal volume), with renewables accounting for the largest portion of that share (approximately US$20.6 billion in deal volume), in each case as reported by *IJGlobal*. The transportation sector accounted for approximately 13 per cent of the total transaction value of US project finance transactions, with mining, social defence, telecoms and water accounting for the remainder of all transactions. As in 2014, a deep field of commercial banks was active in the US project finance market, including many European commercial banks, which had returned to active roles in US project finance in 2014 and in the immediate prior years.

Broadly, slumping oil prices throughout 2015 and the general market volatility in the latter part of the year affected all areas of the US project finance sector – from oil and gas to renewable power. That said, a few major trends for the year were the continued development of LNG export facilities, increasing investment in natural gas-fired power generation facilities, particularly in the high-demand markets of PJM and ISO New England, and the continued growth and proliferation of renewable energy, which experienced some significant setbacks in 2015 but remains a robust market for investment in the long term.

Turning first to the oil and gas sector, 2015 turned out to be a turbulent year for many oil and gas developers, as increasing downward pressure on those commodities affected all areas of the sector. However, while several industry players have begun to experience financial difficulty, the LNG export facilities, which have garnered much attention in recent years and are both long-term and large-scale in nature, continued to be a primary driver of the US project finance market. Cheniere Energy continued development of its Sabine Pass project and commenced construction of its Corpus Christi LNG export facility, including an US$11.5 billion debt financing that closed in May 2015. Additionally, the debt financings for the Cameron LNG and Freeport LNG projects were two of the larger and more novel project financings completed in 2015.

In addition to the US's transition to being an exporter of natural gas, increased domestic supplies of the commodity coupled with capacity performance rules and the coming retirement of many coal-fired power generation projects in high-demand power markets such as PJM and ISO New England has led to increased activity in M&A transactions related to, and development of, natural gas-fired power generation facilities. Several natural gas-fired power generation facilities are under construction or in development stages in these markets, including the planned CPV Towantic facility. Several experienced project sponsors, including LS Power, Panda Power Funds and The Carlyle Group, bought or sold projects, began development of new projects or refinanced existing projects in 2015. For example, The Carlyle Group purchased the 583MW Rhode Island State Energy Center from Entergy in December 2015, which was financed in the term loan B market. In October, Panda Power Funds closed a hybrid US$710 million debt package (consisting of both a term loan A and a term loan B facility) for the 1GW natural gas-fired Hummel project in PJM.

In the renewable energy sector, several trends from 2014 continued into 2015. Throughout the first half of 2015, developers continued to rely on yieldcos, which are public holding companies that rely on steady cash flow generated by stable operating renewable energy projects to provide yield to their investors, as a source of capital and growth. Solar industry developers SunPower Corporation and First Solar formed the first joint venture yieldco, 8point3 Energy Partners, in May, and, throughout the first half of 2015, the yieldcos that were launched in 2013 and 2014 soared to new heights and several other developers continued to explore the model. Additionally,

'warehouse' facilities (which were originally developed solely as a mechanism to house pre-COD projects that sponsors planned to sell to yieldcos) began to take on a life of their own. In May, SunEdison worked with First Reserve Corporation and a group of lenders to create a US$1.5 billion warehouse to fund construction of clean energy projects acquired from First Wind. Subsequently, SunEdison and several other developers have explored or closed warehouses and similar facilities that hold renewable energy projects that often have project-level debt or tax equity financings associated with them. However, in the latter half of the year, market scepticism regarding the ability of yieldcos to continue to source quality, cash-flow generating projects, increasing downward price pressure coming from depressed commodity prices and decreasing costs associated with renewable energy development, and general market volatility placed significant strain on yieldcos and on sponsors and developers of renewable power generation projects. This was despite the permanent extension of the investment tax credit (ITC) in late 2015, which was very well received in the solar industry.

Finally, the decreased volume of term loan B transactions is seen as, at least partially, a result of increased use by purchasers of balance sheet cash to finance acquisitions and the increased availability of bank debt, particularly with respect to quasi-merchant natural gas-fired power generation projects.

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: The US energy and infrastructure sector features a broad range of both domestic and international investors and sponsors. As previously mentioned, the financings for the large LNG export facilities being developed in Texas and Louisiana were also some of the largest transactions of 2015 (this was the case in 2014 as well). Freeport LNG closed a series of debt and equity financings in 2015 for three liquefaction trains with a total project cost of US$14 billion and total commitments (across no fewer than seven separate transactions) in excess of US$15 billion. Cheniere Energy's Corpus Christi debt financing totalled US$11.5 billion, and the project is expected to have a total capital cost of US$15.4 billion. The expansion and related refinancings of Cheniere's Sabine Pass LNG facility totalled US$4.6 billion, and Cheniere also closed a working capital facility for the project of US$1.2 billion in 2015.

Turning to the renewable energy sector, the US$420 million IPO of the 8point3 Energy yieldco was a novel transaction, as it was the first yieldco to be formed as a joint venture between SunPower Corporation and First Solar. Additionally, as we previously noted, warehouse financings (in their various forms) became increasingly popular in 2015. SunEdison's warehouse facilities with First Reserve and Goldman Sachs each contain a total capacity of over US$1 billion. Several developers have turned to various forms of warehouse financings as an additional source of capital – and they range from holdco and portfolio financings to mezzanine debt transactions that provide back-leverage for multiple projects, which often already have some combination of project-level debt and tax equity. Finally, residential and small commercial or industrial solar developers have continued to find creative ways to finance transactions that would otherwise be too small to interest the large commercial banks that are accustomed to utility-scale power and project finance transactions. For example, many of these developers, including SolarCity, Vivint Solar and others, have been able to take advantage of both economic and geographic scale to form tax equity funds with investors, which house operating residential or small commercial or industrial solar projects. The total investment by tax equity investors in these transactions, which customarily take the form of several tranches as projects reach operations, is typically in the US$50 million–US$100 million range.

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

DA, AG & MK: Not surprisingly, the sponsors of the large LNG facilities discussed above were some of the largest US project finance market participants in 2015. Cheniere Energy led all project finance sponsors, with a total deal volume of approximately US$21.7 billion spread across four transactions. IFM Investors and Freeport LNG Development, both of which are investors in the Freeport LNG project, were the second- and third-largest sponsors by dollar volume in 2015, and their total transactions accounted for approximately US$6.6 billion and US$4.6 billion of financing, respectively.

> *"2015 turned out to be a turbulent year for many oil and gas developers, as increasing downward pressure on those commodities affected all areas of the sector."*

Several domestic sponsors in the power industry were active in 2015. In the renewable space, SunEdison continued its rapid growth from 2014 throughout the first half of 2015. Its total volume of project finance transactions in 2015 was just shy of US$2.5 billion, spread across several transactions, and SunEdison and its yieldcos were also involved in a number of M&A and other notable transactions. First Solar and SunPower combined forces to form the 8point3 Energy yieldco, and other traditional players in the renewable energy markets, such as SolarCity in residential solar, have continued to play a large role in renewable energy development. However, as widely publicised, all of these solar developers have experienced significant headwinds in the latter part of 2015 and into 2016. In fact, NRG Energy, which was an early entrant into utility-scale solar and other forms of renewable energy development and which launched the first yieldco in 2013, spun off its green energy assets into a separate public company in autumn 2015.

In the traditional power sector, several seasoned sponsors were active in the market, as LS Power and Panda Power Funds closed a number of financings and refinancings throughout the year, including Panda's US$718 million combined term loan A/term loan B facility for the 1GW Hummel project in PJM (which is, interestingly, on the site of a retired coal-fired power generation facility).

Among the commercial banks involved in US project finance, MUFG continued to dominate the market, with over US$3.6 billion in transaction volume spread across 43 transactions, according to *IJGlobal*. Rounding out the top 10 most active commercial banks were ING Group, Sumitomo Mitsui Financial Group, Crédit Agricole Group, Mizuho Financial Group, Santander, Société Générale, Morgan Stanley, Goldman Sachs and Bank of America Merrill Lynch. Several of these banks were arrangers on the most significant transactions of 2015. For instance, MUFG, Sumitomo, Mizuho Financial Group, ING Group, Crédit Agricole Group, Morgan Stanley, Société Générale, Goldman Sachs, BAML and several other large banks involved in US project finance were involved in Cheniere's Corpus Christi project financing. All of the major banks participating in the project finance market in 2015 were involved in a broad variety of deals across the oil and gas, power and infrastructure sectors. The large US insurance companies, pension funds and institutional investors are also active in the project bond market, both in Rule 144A/Reg S transactions and in more traditional private placements, and institutional investors provide capital for the term loan B market, which saw much less activity in 2015 as compared to 2014.

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

DA, AG & MK: As mentioned earlier, 2015 began with a continuation of the robust activity from 2014 across the oil and gas (particularly LNG), power and infrastructure sectors. However, in the latter half of 2015 and going into 2016, the energy sector has begun to feel the effects of sustained low prices for oil and other commodities, increased uncertainty regarding global economic and geopolitical conditions, and the market volatility that has created turmoil across all sectors, notably in the oil and gas and renewable energy sectors.

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 oil and gas sector, sustained low prices for oil have strained many companies that were able to turn profits in the upstream and midstream sectors due to fracking innovations in recent years, and some have even begun to seek bankruptcy protection.

In the power sector, the introduction of capacity performance rules in markets like PJM and ISO New England, which is an outgrowth of the polar vortex of a few years ago, and the continued emphasis on developing cleaner energy have led to increased investment in natural gas-fired generation. Similarly, despite the challenges faced by yieldcos and renewable energy companies in general in the latter part of 2015 and early 2016, the extension of the ITC and increasing reliability of these forms of power generation will likely lead to continued, albeit possibly more subdued, growth in industries such as wind and solar electric generation.

All sectors of the US market must navigate increasingly complex regulatory structures, which exist at the federal, state and local levels of government. In addition, as evidenced by the advent of yieldcos and warehouse financings in the renewable energy industry, increased innovation across all platforms in the energy industry has led developers and sponsors to seek out increasingly creative and complex means of financing their projects. That complexity, while creating large opportunities, comes with its own challenges, and companies must continue to strike a balance between growth and sustainability in what has become a rather challenging market environment.

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: As noted, the LNG export and solar power generation industries were two of the more active industries within the US project finance market in 2015, particularly in the first half of 2015. 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 2015, the US 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 US. 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 but one of many. Accordingly, the LNG PCTA (and corresponding bills in the US Senate) 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. That said, given the extreme decline in oil prices, the sustained level of those low prices and the lack of movement on the legislation in the US Senate, it no longer looks like such legislative changes will expedite projects and open the market to new participants in the near future. Nevertheless, Cheniere Energy became the first US exporter of shale gas as LNG in February 2016. Additionally, the Federal Energy Regulatory

"We anticipate the continued spread of activity in the distributed generation energy space and for community solar to increase in popularity."

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 have wide-ranging experience. Secondly, specific industry knowledge and understanding of the core business are 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?

One of the more noteworthy (particularly at the time of its closing) transactions we have worked on recently is the US$1.5 billion SunEdison warehouse facility with First Reserve that was designed to finance the construction of development assets acquired by SunEdison from First Wind. One of the novel features of this warehouse was the ability to incur debt to finance an open-ended pool of assets, with the financing of projects being subject only to majority lender approval if they met prescribed criteria. Since the closing of the SunEdison/First Reserve warehouse, there have been many variations on the structure in the market, and it can certainly be considered a trend for 2015.

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Commission's Office of Energy Projects recently approved the expansion of Cameron LNG's liquefaction project.

Turning next to the solar power generation industry, as discussed, the permanent extension of the ITC (which gives purchasers a tax credit equal to 30 per cent of their basis) used by the solar industry has provided a good deal of stability to the market and should result in a return in focus on domestic development rather than a shift in spending to emerging markets. That said, however, ongoing regulatory battles over net metering and rate structures remain, and investors are increasingly focused on state-by-state net metering policies given the growth in installed residential capacity and corresponding sales back to the grid as a large part of the positive economics for participating. 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. That said, potential changes in the net metering rules could reduce the rates at which power is sold back to the grid. Nevada and Hawaii already have reduced rates from 100 per cent of prevailing retail rates to wholesale pricing, which many analysts think will be the trend over the long term. California regulators, on the other hand, have voted to keep retail rates in place, but to revisit the decision in 2019, and Pennsylvania recently finalised rules to allow customers to produce up to 200 per cent of their annual electricity consumption and receive retail rates for electricity they send back to the grid. As additional states consider their net metering policy, there is also a question as to whether states will make any revised policies retroactive or will exempt customers who already have solar panels from the regulation.

A third example is the Clean Power Plan, which President Obama announced in August 2015, but which the Supreme Court stayed implementation of in February 2016, pending further judicial review. The Clean Power Plan sets emission standards for power plants, and specific goals for states to decrease use of coal-fired electricity generation and increase reliance on renewable energy and natural gas. Originally, states were supposed to provide the Environmental Protection Agency with their compliance plans by autumn 2016; however, with the legality of the Clean Power Plan under judicial

review, some states are choosing to refrain from creating such a compliance plan for the time being.

GTDT: What trends you have 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?

DA, AG & MK: As previously mentioned, the US project finance market remained strong in 2015, with loan volumes at approximately US$56.5 billion, dropping only 6 per cent from 2014 (which was a very robust year). Power deals led the activity. On the lending side, the sources and structures of funding remained diverse across all industries in the project finance space, with strong involvement from both European commercial banks and Japanese banks, as well as Canadian and US regional banks taking a continued prominent role.

Perhaps the greatest determinant of commercial terms and risk allocation in US project finance is the lending market in which a particular 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 commercial bank lenders. Accordingly, although covenants may be tighter, sponsors believe that 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 in each of those markets), 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 a lot of 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 yieldcos and tax equity, where we have seen a great deal of innovative activity, with yieldcos, warehouse facilities, partnership flips, inverted (or pass-through) leases and a few securitisations. The first half of 2015 saw the continued rise of yieldcos, with solar developers using them as a way to fund project development. However, as discussed above, the market turned away from yieldcos in the second half of the year. There was also a rise in the use of warehouse facilities as a capital source for renewable energy projects, which were intended to be a shorter-term means to provide construction financing or hold projects before dropping them down into yieldcos; however, with the yieldco market drying up, warehouse structures are beginning to be used for other purposes.

Additionally, in 2015, partnership flips and inverted leases continued to provide a consistent source of tax equity investment into the solar space. 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 solar developer leases projects to the tax equity investor and 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 solar developer or its affiliate. Historically, the inverted lease structure has been 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 flip during the ITC recapture period would result in recapture, so tax equity investors would typically 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 investors seek a limited forbearance, which has been viewed more favourably by lenders in the market. That said, in 2015, several solar securitisations were completed, including in a partnership flip structure. Some of the risk in the partnership flip structure was mitigated by the introduction of insurance to cover tax basis risk. This insurance covered one of the major risks in the deal, which arguably made investors more comfortable in opening themselves up to another risk – foreclosure exposure. Furthermore, with basis risk covered by insurance instead of the sponsor interest in the partnership to indemnify for that risk, more money remains in the system and lessens the chance of default on debt (therefore indirectly mitigating foreclosure risk).

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

DA, AG & MK: With the aforementioned extension of the renewable tax credits and the Clean Power Plan (if the regulation goes forward) setting state targets for carbon emission reductions, there is more certainty in the renewables sector, though uncertainty with respect to how each state will address net metering remains. Nevertheless, with the extension of the tax credits, we anticipate activity levels in the solar and wind tax equity space to remain similar to 2015 levels (as opposed to the flood of deals we would have expected in 2016 had the credits not been extended) and for the partnership flip to remain the most popular structuring tool. That said, we do think it is possible that the tax credit extension may attract new tax equity investors into the market. Furthermore, we anticipate the continued spread of activity in the distributed generation energy space (with low natural gas prices having a dampening effect on utility-scale project activity, but not impacting distributed solar) and for community solar to increase in popularity. In the commercial and industrial space, investors are becoming increasingly more comfortable with commercial PPAs and finding more efficient ways to diligence the projects. In addition, we expect a trend toward greater standardisation to the documentation and diversity in the pools to allow some noninvestment-grade credits to participate. Also, individual states are continuing to pass legislation permitting community solar, which opens up the market to a great number of additional participants.

As discussed, 2015 saw a large number of LNG export terminal financings. While we anticipate some power plant financings in 2016, we expect the trend to be much more toward the renewables sector.

The year 2015 was a strong one in the bank debt market and we expect that trend to continue in 2016. Likewise, we expect the term loan B market to remain less active and the investment-grade project bond market to remain constant.

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