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Niche Is Name Of The Game For Project Finance In 2013

By **Kelly Rizzetta**

Law360, New York (January 01, 2013, 4:29 PM ET) -- U.S. developers can only hold their breath for so long, and 2013 looks to be the year they finally let it out, experts say — maybe not all at once, but slowly, via thoughtful projects and quirky financing structures that allow the sector to put some real distance between itself and the bad old days of 2008.

Oil and gas certainly aren't going anywhere in 2013. Despite sluggish demand, the ExxonMobils and Chevrons of the world will continue to hunt down and pump oil, and trade stakes in plays around the globe. The North American shale boom — and the attendant legal and policy battles over fracking — will continue to grab headlines in the U.S.

But project finance attorneys say the real action is in power — think transmission projects and renewables — and infrastructure tied to the explosion of the domestic natural gas industry, like LNG export facilities and gas-fired power generation facilities. These projects are in demand and under pressure to get off the ground in a less-than-ideal economic climate, producing a strong market for selective projects that maximize the potential to monetize the operating asset.

That market is attracting all sort of new niche players, from backers on down to developers, and in 2013, they will experiment with a panoply of niche financing solutions that were either born or evolved dramatically in 2012.

“It's a fascinating time, though it will be a challenging time,” said William D. DeGrandis, an energy transactions and regulatory specialist in Paul Hastings LLP's corporate department. “There won't be a lot of run-of-the-mill projects that people who aren't thinking creatively can make money on.”

Here are the trends that project finance experts will be tracking in 2013:

First Things First: Power Transmission

Transmission projects are at the top of just about everyone's to-do list for 2013.

“The transmission infrastructure in this country is so antiquated — most of it goes back to the New Deal and the Roosevelt administration,” said Tara A. Higgins, who co-chairs Bingham McCutchen LLP's energy and project finance group.

The U.S. electric grid, which is notoriously inefficient, requires a major overhaul, and transmission infrastructure needs to be upgraded to withstand the environmental and economic stresses of the 21st century, Higgins told Law360 recently.

Plus, as new types of power generation projects take hold, they're going to need a way to connect to the grid.

All of that costs a lot of money, especially when the vast majority of sites that provide easy access to existing grid interconnections have been built out, leaving cash-strapped utilities to go after lower-hanging fruit, DeGrandis noted.

“To the extent that your project generates significant interconnection costs, those projects are subject to a lot of pressure and may not get developed,” the Paul Hastings partner said. “But if you can identify a transmission system where your project will not result in an expensive network upgrade and you can tap into existing substations and transmission infrastructure, those projects will be prized.”

As a result, DeGrandis predicts an uptick in power projects built along seams between regional transmission organizations, a strategy that gives the project sponsor the option to sell to more than one RTO and thereby leverage value from the power asset.

From Exports To Excess: Natural Gas

Transmission is also a high-priority issue in the fuel sector. American shale producers are currently harvesting a bumper crop of natural gas with no means to ship it to the European and Asian markets that are hungry for it thanks to a U.S. Energy Department moratorium on licenses needed to export to non-free trade agreement countries.

There has been a resurgence of interest in natural gas-fired power plants as a way to put that fuel to use here at home. Since such projects are difficult to finance, developers have begun incorporating gas-based backup systems into renewable energy operations, a move that solves the energy storage issue that often trips up wind and solar farm developers.

With a solution in place for days that the sun doesn't shine or the wind doesn't blow, energy companies have the freedom to work on clean power storage solutions like compressed air or zinc battery systems, DeGrandis said.

Winds Of Change: The Production Tax Credit

The renewables sector stands to get another boost in 2013 from the extension of the popular production tax credit, or PTC, which offers a credit of 2.2 cents per kilowatt-hour for the first 10 years of a wind farm’s production. Supporters say it has been instrumental in helping wind energy developers attract financing for commercial-scale projects.

The PTC was set to lapse Dec. 31. With Congress mired in political gridlock, the wind industry ground nearly to a halt midway through 2012 as nervous investors held onto their money and waited to see if an extension would be granted. Late on New Year's Day, the U.S. House of Representatives adopted a Senate-approved bill to avert the hyped fiscal cliff with a deal that included a one-year extension of the PTC.

Even if the PTC hadn't been renewed until the first or second quarter of 2013, the wind sector was already set to soar, said Edward W. Zaelke, a renewable energy guru who co-chairs Akin Gump Strauss Hauer & Feld LLP's global project finance practice.

“I think we're probably going to have a very busy first half of 2013, even if the PTC isn't extended until later [in the year],” Zaelke told Law360 in late December. “I still see a lot of activity going on behind the scenes that indicates to us a pretty robust year.”

Lawyers' involvement is a leading indicator, the first step in a project development process that takes months, Zaelke noted.

“In 2013, lawyers are going to be busy as soon as ink is put to paper to get the PTC extended,” he said.

Before the PTC question was settled, two small trends emerged in 2012 that could continue to have an impact in the wind energy space in 2013, experts said. Some wind developers who were sidelined by uncertainty over the PTC extension packed up and moved their projects to Mexico, observed Wayne W. Song, a partner in Morgan Lewis & Bockius LLP's business and finance practice. And in another twist, some renewable energy companies migrated to solar, noted Daniel A. Mathews, who co-chairs Orrick Herrington & Sutcliffe LLP's energy and infrastructure group.

“Lots of the investors in solar are investors in wind,” Mathews told Law360 recently. “They're thought of as niche [industries], but they're connected to each other.”

Footing the Bill: Project Bonds and Private Equity Dollars

Most of the creativity in the project finance sector may come from the finance side as project sponsors struggle to fill the void left by the withdrawal of troubled European banks, previously a mainstay of American infrastructure and power projects.

Domestic private equity firms, large utilities and foreign sovereign wealth funds stepped into the vacuum in 2012. They will very likely stay active in project finance in 2013, particularly with respect to low-risk, larger-scale renewables projects, Zaelke predicted.

“If you have a solar project using a good supplier or a wind project using a tier-one [turbine manufacturer], and you combine that with a long-term power purchase contract from a utility, ... you can do the math,” Zaelke said. “The revenue stream coming off that project should be relatively stable for the next 15 or 20 years.”

This is music to the ears of cash-rich American companies, private equity firms under pressure to deploy dry powder and sovereign wealth funds looking for a place to park their money.

“You can put [that money] in the bank at 1 or 1.5 percent or buy a government bond — or you can get a substantial return, 7 to 10 percent, let's say, in wind and solar projects,” Zaelke said.

On the debt side, expect to see the expanded use of project bonds to finance larger-scale projects, many experts said.

“Capital markets are pretty hot,” Mathews said, though he quickly added that Japanese and American banks have done just fine in their European counterparts' stead.

Public-private partnerships will continue to gain traction in 2013, Mathews estimated, citing the recent pushes to privatize Chicago's Midway Airport and the Luis Munoz Marin International Airport in San Juan, Puerto Rico.

But both private equity and PPPs come with limitations.

Given that PPPs are typically used for large projects with long tenors and gestation periods — highways in the U.S., schools and hospitals in Canada — Mathews expects to see fewer of them in 2013. On the other hand, private investors might not have the resources to invest in technology research and analysis the way a big European bank would, making private equity backers less willing to invest in untested but potentially revolutionary technology like new turbine designs, Zaelke pointed out.

So what are small, niche projects to do? They need to find small-scale, niche answers to their financing dilemmas.

Morgan Lewis' Song ran across two in 2012, both of which he said could come in handy in the new year: vendor and distributed generation financing.

Citing the solar sector as an example, Song said upstream producers like panel manufacturers tend to be willing to pick up part of the construction check if they have a guarantee that their technology will make it into the project. Some technology companies, like turbine giants General Electric Co. and the like, have gone whole hog and bought out downstream developers to ensure a delivery route for their products.

Small-scale solar projects have also found success with the distributed-generation financing model, which aims to attract tax equity investors by grouping tiny assets to make a more substantial investment target.

“Somebody who has a solar installation on his home, that in and of itself wouldn't really be an asset class,” Song said. “But if you pool a lot of these smaller rooftop solar installations, ... you can kind of scale them up in a portfolio manner that makes them attractive.”

Whether all of these niche trends actually take root and flourish or fizzle out in 2013 only time will tell, but one thing is certain, experts say: It’s an exciting time to be a project finance lawyer.

Whereas financing tightened up and became formulaic — even rote — in the wake of the global financial crisis, the trend now is moving back toward complex multisource financing, according to Philippa Chadwick, the former head of Berwin Leighton Paisner's project finance team.

“One of the really interesting things being involved in project finance at the moment is that there are lots of really clever people ... coming up with innovative solutions all the time,” said Chadwick, who recently joined Squire Sanders’ London office. “There are lots of exciting structures and products coming through. Really, all we need now are projects.”

--Editing by Elizabeth Bowen and Sarah Golin.