Haynes Boone Talks Funding for Renewable Energy Project Developments

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PRACTICES Renewable Energy

Renewable energy project developers, like developers of all types of infrastructure projects, all have one thing in common. As they move down the path from ideation through development and ultimately to construction of their projects their capital outlay grows while the prospect of generating revenue remains some way off.

Although a developer could use its own cash reserves to fund a project's development and construction costs many developers consider it to be inefficient to use cash in this way, on an unlevered basis. As such, it is common for developers to enter into arrangements with third parties to help cover their development and construction costs.

Three of the most common options for developers who wish to raise funding to develop and construct projects are to: i) sell shares (equity); ii) take loans (debt); or iii) issue bonds (fixed income).

Navigating early-stage project developments

Where a project has substantial upfront pre-construction costs either due to the size of the project or due to the commitments required to secure access to land or, commonly for UK renewable energy projects an electricity grid connection, a developer may seek a joint venture partner to share these costs.

The joint venture (JV) partner will commonly be a utility company or a financial investor with a mandate to invest in the kind of project being developed. In order to document their arrangement, the developer and the JV partner will establish a limited liability company to develop one or more projects on the basis of an agreed development plan, and agree the terms of a joint venture shareholders' agreement.

The developer will normally be responsible for the day-to-day activities needed to achieve pre-agreed development milestones and the JV partner will commonly release funding for the next phase of development as each milestone is reached. Such funding is usually provided either by way of shareholder loans to the JV company (JVCo) or by subscribing to preference shares issued by the JVCo. Financial investors in a JVCo will require a substantial amount of control over the JVCo's business including the right to appoint board members (or observers) and the ability to decide when to terminate an investment and exit the arrangement.

Equity investments of this kind require a substantial amount of expertise and patience from JV partners and a higher level of involvement than a debt provider such as a bank would expect to commit to monitoring an equivalent loan.

JVs are well suited for early-stage development of projects where the certainty required for a "bankable" project may not yet exist but the opportunity is there for a substantial return on

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investment for both a developer and their JV partner if the project is successful.

Creating bankable projects

Banks do not generally make loans to a project company to cover the cost of early-stage development works such as the work needed to obtain real estate, planning and other regulatory rights and approvals.

The outcome of such early-stage development work is uncertain and lends itself better to equity investors, as set out above.

However, once a project is ready to build and the early-stage development works are complete then banks (or non-bank lenders) may be willing to provide debt to cover some of the cost of construction works for a project. Leverage ratios vary widely from <50% debt to equity to >80% debt to equity depending upon a number of factors including technology type, contractual protections and market factors.

Funders may make a loan to a developer or preferably, for the developer, to a project company: i) for the period up to the completion of construction work (known as a construction bridge loan); or ii) for a period of up to 3 – 5 years after construction work is completed (known as a mini-perm); or iii) a long-term loan to be repaid over the majority of the life of the project e.g. 10, 15 or 18+ years (project finance).

For a project to be considered bankable the funders will need to be satisfied during a due diligence review process that the project company has the necessary contractual undertakings from suitable counterparties to ensure that construction, operation and maintenance and, crucially, payment for the project company’s end product are reasonably certain.

Leaning on the bond market

For developers of large projects, historically those with a debt requirement of >£50m, an alternative to long-term bank debt is the institutional debt market which may be accessed by issuing a project bond. It should be noted that in recent times lower value project bonds have been successfully issued both on a private placement basis and as listed bonds in the renewables space.

One key feature of project bonds that appeals to many developers is the price certainty they offer as the coupon or margin that is paid on the bond is typically fixed over the life of the bond (which is why they are referred to as fixed income investments).

This is in contrast to bank loans which generally include a floating interest rate consisting of a fixed margin (which may include a step-up) over a variable benchmark such as SONIA or SOFR, even if a portion of the floating rate risk is generally hedged on long-term project finance loans.

One consideration for developers is that bond holders are not generally open to taking construction risk which means that project bonds are ideally suited to utilization as part of a hybrid structure, often with a construction bridge loan covering the construction period and a project bond then replacing the bank debt with long-term institutional debt once the project has been de-risked and commercial operation has begun (a bridge-to-bond).

In summary, the question of which source(s) of capital a developer chooses to access may be driven as much by the stage of their project’s development as by the third party’s expectations of a financial return.

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There are no hard and fast rules regarding the provision of development and construction funding and there are JV arrangements under which financial investors provide both early stage development funding and construction funding as well as a mix on some projects of equity investors and bank/non-bank lenders funding different stages of a project's life.

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