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Renewables RFP II

Comments on Financial Requirements

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On April 22, 2005 the Ontario Ministry of Energy released its draft Request for Proposals for up to 1,000 MW's of Renewable Energy Supply. This release of RFP II, as it is called, was followed by the release of Appendices F-M on April 29. The purpose of this note is to point out to Ortech clients some significant differences between RFP I and RFP II in the area of financing. It should be noted that in Ortech's opinion the financial segment of RFP I was the single most problematic area of the process.

General

As in RFP I, each Proponent must set out a financial plan for the project. The format is a questionnaire set out as Appendix D to RFP II. While Appendix D has not yet been released and will not be released until the final version of the RFP is released, it is possible to gain insights to the Ministry's approach through the commentary contained in the draft RFP II.

Equity

The emphasis in the financial evaluation of a project is clearly on the equity component with particular requirements to identify for those that have not yet raised equity, the source and financial stability of 35 per cent of the total project equity. For the purposes of the financial provisions of the RFP, it should be noted that all funding that is not primary debt is classified as equity. All equity participants must supply a commitment letter containing an "agreement in principle" to fund the project. In addition, the major equity participant, that is the supplier of at least 35 per cent of the equity, must meet certain tests. This major equity participant must have a tangible net worth that varies according to the level of equity that is intended to be used in financing the project. The tangible net worth requirements of the major equity provider range from \$125,000 per MW where the project is 25 per cent financed by equity to \$500,000 per MW where the equity component of the financing is from 75 to 100 per cent of the project financing. Where the major equity participant is supplying equity for more than one project, the major equity participant must show that it has a tangible net worth sufficient to meet the aggregate requirements for all such projects.

Tangible Net Worth Calculations

There are also requirements for the major equity supplier to prove past tangible net worth as well as certify as to expected future financial conditions. Calculations of tangible net worth are to be supported by financial statements for the last financial year or for the most recently completed four quarters. The financial statements should be audited, but if no audited statements are available, then an officer's certificate must be provided stating that the financial statements have been prepared in accordance with GAAP. Further an officer's certificate must be provided

setting out that there have been no material adverse changes in the financial condition of the equity provider since the date of the statements or, if there have been such changes, a statutory declaration must set out the circumstances of such expected change and recalculated expected tangible net worth. The equity provider may also state any circumstances which are expected to materially improve the financial condition of the equity provider.

Creditworthiness Test

A second requirement concerns debt levels of the major equity provider. To qualify, the major equity provider may (i) have an investment grade credit rating, (ii) submit a confirmation letter from a financial institution stating that it has credit available to fund its equity contribution or (iii) provide an officer's certificate based on its financial statements that its debt to EBITDA ratio is not greater than 7:1. Again, where financial statements are used, an officer's certificate is required stating that there are no expected material adverse changes that would affect operating revenues from cash flows, or if such exist, a statutory declaration containing a revised calculation of debt to EBITDA. Where circumstances exist that would materially improve the debt to EBITDA ratio of the major equity participant, a statutory declaration may be used to set out these circumstances together with calculations of the improved debt to EBITDA ratio. Material submitted in support of the tangible net worth requirements need not be resubmitted in support of the debt to EBITDA calculations.

Debt

Where the debt facilities are in place a confirmation letter is required from each debt provider. Where the credit facilities for the project are not in place, each lender must provide a commitment letter. The form of the commitment letter varies depending on whether a lender is classified as a Category A or B lender. A Category A lender is listed in Schedules I or II of the Bank Act or has an acceptable credit rating. The Category A lenders, which would include most major financial institutions, must state that they are highly confident that they will advance, provide or underwrite the debt financing subject only to specific objective conditions. A Category B lender is not a Category A lender, but has a tangible net worth of at least \$1,750,000 per MW of the project in question. The obligation is on the proponent to supply financial statements for the most recently completed fiscal year of the B lender or the last four completed financial quarters. In both cases the financial statements must be audited. The B lender must provide an agreement in principle to advance or provide the debt financing.

Other

RFP II also contains a miscellaneous category for funding that is neither debt nor equity. These funding providers must supply commitment letters setting out an agreement in principle. A number of examples are given for this miscellaneous category – government grants and cooperatives and unincorporated associations where contributions are to come from members.

Observations

There are several observations to be made on the financial information requirements:

“Agreement in principle”: RFP II attempts to define “agreement in principle” which is applicable to equity providers, Category B lenders and the miscellaneous category of funders. This agreement in principle can only be subject to specific objective conditions. A specific objective condition cannot be an amendment to the RES contract inconsistent with Section 11.3 of that contract. That section deals with force majeure events. It is not immediately obvious what the reference to force majeure is meant to accomplish.

“Specific objective conditions”: Again, there are no concrete examples of “specific objective conditions”. The proponent or debt or equity providers are left to use their own judgment. Some conditions would obviously fall within the specific and objective categories such as a cap on the price of steel, the Canada-US dollar exchange rate to be within a particular range or the 10 year Government of Canada bond rate not to exceed a specific rate. Conditions of this sort would protect the proponent and its investors against unforeseen, adverse fluctuations in commodity pricing, exchange and interest rates. Other conditions such as approval by a credit committee are in a grey area; while the condition is specific and objective, it constitutes a “soft market out”, which the Ministry appears not to condone. In short, confusion still exists in this area.

Use of Flow-Through Shares: The financing conditions are not helpful for the use of flow-through shares as part of the capital structure since each equity participant must provide an agreement in principle to advance or provide capital for the project. There are two approaches which would permit a proponent to issue flow-through shares in the event of a successful bid: (i) obtain a commitment from a flow-through share fund to acquire flow-through shares or (ii) reserve the right in the event of a successful bid to replace some of the committed equity financing with flow-through share financing. Flow-through share funds generally have limits on the amount of investments they can make in any one project. Accordingly, it may be necessary to have commitments from several funds. With the second approach, there is market risk. While this approach would permit the proponent to do a project specific flow-through offering along the lines of Creststreet and Airsource, there is no guarantee at the time of the proposed issue that market conditions would be favourable.

As a general comment, much of the difficulty with the financing section is derived from the use of conflicting terms. A “commitment letter” is an agreement from a lender or investor to provide funding subject to certain terms and conditions. An agreement in principle is not a recognized financial term and seems to suggest something approaching a non-binding term sheet. By coupling a commitment letter with an agreement in principle, confusion is introduced into the RFP process. What the Ministry appears to want is a commitment letter with specific objective conditions, not an agreement in principle whatever that phrase means. The same confusion exists with the use of “highly confident”. That term was previously used in “junk bond” financing. It did not denote a commitment to finance but merely an indication that there was a good possibility that financing could be raised. This is not the certainty that the Ministry appears to want in the financing arrangements for a successful project.

Clarity could be introduced into the financing section if two things were to occur: (i) the phrases “agreement in principle” and “highly confident” should be eliminated from the RFP; and (ii) the Ministry should publish examples of what it considers “specific objective conditions” or set up a mechanism whereby proponents could obtain an advance ruling as to whether a condition was acceptable, as in the case of advance tax rulings. In the absence of these changes, the financial portion of the RFP process remains a minefield for proponents that are not large, publicly traded corporations and favours, as shown by the outcome of RFP I, those that are.

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