Bonds Could Inject Funds into Biofuels

A team from the investment bank Stern Brothers, the law firms Mintz Levin and Kreig DeVault have developed a bond-oriented approach that has received favorable initial reaction from the USDA, and may well break the logjam in financing the commercialization of biofuels.

“The news is there has been a paradigm shift to the bond market,” said John May of Stern Brothers, “with recognition from the USDA that this does not pose any greater risk. This opens up hedge funds, pension funds – who have much more sophistication with the credit quality issues than the small system of Ag banks that have adopted the [Business & Industry] program.

“The concept was presented two months ago to transform the 9003 Advanced Biofuels loan guarantees from relying on bank debt to the bond market,” May added. “The bank market simply isn’t there. The biggest untapped market is the bond market – taxable and tax-exempt, that [currently] use the same regulations that the B&I program has.”

“To keep this on a timeline for this year, we designed it so that there is no exception or change in regulations required. We acknowledge that there is an exception required to eliminate entirely the role of the bank as the lender of record, in 9003. The single biggest hurdle in moving from bank to bond – is that we have to keep the bank as the applicant of record, for underwriting, servicing the loan, and as a the party that will take the lead in a default. So, we have retained a bank as the applicant, but with at most a small amount of money.”

About Section 9003

Section 9003 is found in Title IX of the 2008 Farm Bill. Section 9003, the Biorefinery Assistance Program, provides loan guarantees [1] for the development, construction and retrofitting of commercial-scale biorefineries, and grants to help pay for the development and construction costs of demonstration-scale biorefineries. Provides $75 million in FY 2009 and $245 million in FY 2010 for commercial-scale biorefinery loan guarantees. It also authorizes funding of $150 million per year starting in FY 2009 and continuing through FY 2012 for both demonstration- and commercial-scale biorefineries.

2007-2008, the Market Slows, Then Stalls

As SynGest CEO Jack Oswald described it, “SynGest had been unable to locate a commercial lender to finance the debt portion of the project despite the 9003 loan guarantee program. We have contacted numerous banks and insurance companies. Although the financial market conditions of the past 18 months have contributed to some degree to this challenge, the lack of available lenders has less to do with the

recent debt crisis and more to do with structural issues with the program."

Arnie Klann of BlueFire ethanol agreed, the the Digest report *Waiting for Godot: the financing of commercial scale advanced biofuels* [2]. "Its the guarantee of repayment that is the problem," Klann says.

"Other renewables markets have 15-20 year power purchasing agreements. With ethanol, we are trading into a merchant market that is at best going to provide prices 2-3 years out – there are no long-term contracts. How do you ameliorate the risks? Some companies are building out hedging strategies for 5 years, but it's difficult to do. That offers something different in case DOE can't get its arms around the risk, for some reason.

"So far, loan guarantees have provided close to zero," Klann added. "So far, only one or two projects have received a term sheet, and those are, I believe, off the 1703 program that dates back to 2007 — in a case like Range, that's over two years to secure a loan guarantee."

Spring-Summer 2009: The Big Freeze Out

"I have been working with the DOE & USDA for about 4 years now," entrepreneur Jim Pittman told the Digest last fall [3]. "More than a year ago, I received a Fact Sheet from the USDA titled 2008 Farm Bill Renewable Energy Provisions. This Fact Sheet came from the USDA Headquarters in Washington, DC. I was told to contact the USDA office in Montgomery, Alabama for additional help with applying for funding.

"The man I spoke with at the USDA office in Montgomery, Alabama was Quinton Harris and I seemed to know more than he did," Jim added. "I had to give him the copy of the Fact Sheet and forward the email to him. All Mr. Harris provided me with was an out of date list of banks who would provide loans under the USDA program and a referral to another USDA office down the hall who told me I could apply for as much as $200,000 in grant funds to purchase land to grow crops on.

"I asked what did I need to do to apply for this funding and the men in the office told me I could not apply for the funds. I asked for a clarification and was told the USDA offered up to $200,000 to purchase land to grow crops on, however no one could apply for the funds. I went back down the hall and told Mr. Harris what I had been told.

"He said I must have misunderstood. Mr. Harris went up the hall and came back in a few minutes saying he was told the same thing. A few weeks later, Mr. Harris called to tell me I needed to apply for a USDA guaranteed Business Loan with a maximum of $250 million.

"This was incorrect. I should have applied for a USDA guaranteed Biorefinery Loan with a maximum of $250 million. A USDA guaranteed Business Loan only has a maximum of $25 million. The only other problem was that neither Congress nor the USDA had notified the banks of the change. The banks were only willing to loan

about $2.5 million which I am told was the old number.

“I received a huge amount of incorrect information & misinformation, including a list of 39 banks which is supposed to be willing to make loans under this program. Most of the banks said they had not made this kind of loan in the past 5 years, with the rest saying they had stopped supporting this kind of loan more than 10 years ago. When I did find a bank willing to work with me on this kind of loan, the USDA refused to communicate with them at all.”

Syngest’s Oswald pinpoints difficulties in the historic structure of the 9003 program. “The 9003 Biorefinery Loan Guarantee program as it exists today, is modeled after the B&I program and requires a commercial lender to apply for the guarantee. This model has worked fine for B&I because the typical loan size is sufficiently small. There are hundreds if not thousands of small rural banks that can fund small guaranteed loans. The 9003 program, targeted at much larger projects with debt components that start at $70M and go up from there, quickly outstrips the capabilities of rural and even regional banks. The remaining lenders are “too big to fail” sized banks that have little, if any, experience with USDA programs. The only way for Wells Fargo, and even Rabo Bank, to fund one of these loans, requires a high level executive decision to create a whole new line of business. So far that has not happened and expectations are that not much progress will be made in this arena.

Fall 2009: A Fix Begins

Jack Oswald of SynGest commented, “We engaged with Stern Bros. and John May last Fall to help us with the debt component of our project. We signed an engagement agreement and they have been working on it. We needed to get clarification that the bond market could be used as usual with the 9003 loan guarantee program. [Kreig DeVault partner] John Kirkwood was engaged to research and write the supporting brief.”

Winter 2009-10: Cellulosic Ethanol Gets Organized

BlueFire Ethanol and a group of 30 other companies began the process of opening up another avenue in february. They signed a petition in support of an investment tax credit for advanced biofuels. An investment tax credit, as structured for renewable energy, allows Treasury to pay out the cash for the total value of the tax credit at the beginning of the project (rather than waiting to earn out the credit over the life of the project), and that cash can be applied as a sweetener to reduce debt, and thereby reduce risk.

“We got together with 6 other companies to talk about legislation – EPA, the language issues,” Arnie Klann recalled at what evolved into the loosely-structured Bioenergy Alliance and the The Cellulosic Coalition. “Congress leaves out the details when it makes legislation , and agencies and staff work it out. We had a common interest. For example, the definition of MSW was unclear. It started with us, Enerkem, Fulcrum, and Coskata, and a few others. We had an email list and a weekly call, no chairman or even a scrivener – whoever wanted to lead on an issue

did the follow up."

April 2010: A False Spring

According to Jack Oswald, "We had a meeting on April 2nd with Undersecretary (Dallas) Tonsager, his Chief of Staff, Bill Smith, the Director Of USDA Rural Energy and several other key staffers as well as the point person in USDA OGC. We were represented by Stern, Mintz Levin, Wilson-Sonsini . We reviewed the material with everyone and at that meeting the OGC person stated that as proposed, the current rules would not allow it. We were told that the proposed final rule would be coming out soon but we believe has still been held up at OMB. With the bond approach proposals submitted as part of the rules making process, USDA can include it in the final rule. We were told that it could take up to 12 months to complete that process from the date that the proposed rule was published.

May 2010: The Fix Appears

Mark Riedy described the package that the SynGest team developed. "We developed with Stern Brothers/Kreig DeVault a new and unique bond financing proposal, to replace hard-to-find and expensive/short term commercial debt for renewable energy projects.

"The lender steps outside of its traditional role of lending its funds to an eligible borrower. Instead, the lender (we expect to use a commercial/investment bank and have a top 5 major commercial bank working with us) acts as a trustee.

In this role," Reidy explained, "the project company issues taxable corporate bonds (placed by Stern Brothers) to accredited investors (but $1 million net worth investors–under SEC rules– would represent the floor, while generally the bonds will be placed/sold to institutional investors) who place the purchase/sales proceeds into an account with the trustee bank. The trustee bank then on-lends the bond proceeds into the project. The USDA and/or DOE, as part of the financing, places the loan guarantee(s) over the bonds. Thus, the generally low-rated bonds essentially would become AAA-rated under the full faith and credit of the US government.

"The trustee bank would hold legal title to each of the bonds, mortgages and other required project security during the entire term of the bonds and loan guarantee(s). The bond holders similarly would hold beneficial title to the bonds during the same periods.

"The bonds approximately would have up to a 2% lower interest rate than the 7% plus currently available as commercial lending rates. They would have maturities of 15-25 years, instead of the 1-7 year tenures which banks currently are forcing renewable energy projects generally to accept (and which shorter tenures will not permit the proper amortization of such projects).

"Only the Treasury's Federal Finance Bank, at interest rates of 22-75 basis points over Treasuries (or approximately 4%) and tenures of 20-30 years, available solely for the DOE Section 1703 Loan Guarantee Program (for certain new and unique

technologies) and only when DOE agrees to 100% coverage of up to 80% of total project costs, offers better terms. Notwithstanding, if the DOE does not permit 100% loan guarantee coverage in that Section 1703 program, or permits 100% coverage but at less than 80% of total project costs, then our bond proposal also would work in that program.

“Bond financing is also much more flexible than commercial debt. It does not run into many of the problems/regulatory restrictions facing lenders who will agree to look at and participate in these loan guarantee programs at the USDA and the DOE. It also permits the trustee bank to participate with very little risk. Further, if additional costs or CAPEX-bearing applications/equipment/build-out must be considered in the project, the project company would not need to increase an existing loan or locate an additional loan, rather it merely must place additional bonds to secure additional proceeds.

Syngest CEO Jack Oswald agrees. “Bond investors provide “patient” capital that provides term lengths that match the project life better than a commercial loan. Bonds do not include “sweep” provisions whereby the commercial bank lender “sweeps” any excess cash generated to reduce the principal of the loan. When this happens, it reduces the returns to equity investors and thereby makes it much more difficult to attract equity capital.The bond market is 10X larger than the commercial debt market. Higher levels of due diligence are performed than is true with small lenders because a professional investment bank performs the underwriting and the bond investors also do similar due diligence. Loan servicing is performed by a trustee that has a higher level of professionalism and process technology to assure greater compliance and overall loan processing. In the worst case scenario, a liquidation, these trustees are far more capable of making debt holders whole than is a small lender.”

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