FINANCIAL CONSIDERATIONS IN THE DEVELOPMENT OF SOLID WASTE/RESOURCE RECOVERY FACILITY

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Discussion by

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This morning’s discussion of solid waste/resource recovery facility project financing has highlighted the essence of successful project financing — the allocation of risks among participants in a manner which not only comports with all necessary regulatory and tax requirements, but also distributes the risks among the participants in a manner which somehow is related to the rewards expected by them.

Counsel to either a municipality or private developer/contractor is faced with negotiating and drafting contracts which not only satisfy these often opposing priorities, but which also preserve the underlying cash flow of the project. Maintaining this delicate balance in an environment which is clouded by ever-changing federal and local regulations and legislation, and also by the financial uncertainties of an essentially developing technology, is a complicated matter at best, resolution of which can only be achieved through the development of a solid contractual and legal framework.

From a practical standpoint, counsel for a developer often enters the scene at a point at which the principals have already begun to strike a business deal. In fact, contractors (and therefore, counsel) may be presented with draft service agreements, leases, and power contracts as part of an RFP. As counsel for a municipality, counsel may be in a rather more advantageous position by having actually participated in the drafting of these model contracts. Such models are only a starting point, however, from which the final contracts will ultimately be developed.

Although the types of agreements required by solid waste projects are traditional in nature, the basic contractual business terms in fact provide the primary vehicle for implicitly shifting credit risks. As a result, negotiation is often protracted, as parties such as construction firms, which traditionally accept only the most well-defined risks, find that they are pressured to provide not only conventional insurance and bonds, but also extraordinary types of insurance — such as project efficacy — and “deep pocket” letters of credit or corporate guarantees to support the project warrantees that both municipalities and equity or lenders demand.

Clearly, a municipality is caught between its understandable reluctance to take massive financial risks, beyond the guarantee of a waste stream and tipping fee, to ensure the viability of a project which is intended merely to provide a service to that municipality, and its equally understandable desire to exercise sufficient control over a project to guarantee that its waste will be processed reliably. And, depending upon the financing structure utilized, there will be little or no true risk-sharing equity in the transaction, as compared to the simpler situation where a company finances a plant for its own use. In a leveraged lease transaction, for example, equity will demand protection not only of its tax benefits, including protection against recapture of ITC and ACRS, but also a guaranteed lease rate of return. The timing of equity injection, whether in a leveraged lease or limited partnership, is another sensitive issue, since the IRS requires equity to be in place by the facility’s “in service date,” a definition which varies according to the technology of each project.
The distribution of the risk that the project will not proceed as scheduled must assure that cash flow will be maintained, despite cost overruns, project performance below projected levels, facility shutdowns, interruptions in the flow of waste into the facility, or even the breach or unenforceability of the project contracts.

The speakers this morning have already outlined some of the major “sticking points” in the various contractual underpinnings of solid waste projects. I would add that obviously the facility must be “qualified” in order to guarantee the enforceability of power contracts and the preservation of tax benefits, and that those tax benefits must be transferred to an “at-risk” equity owner in a timely manner. Performance bonds and insurance must address those risks which the parties are reluctant or unable to assume, and even those risks which may not be insurable (or are not economical to insure), such as force majeure and change of law, must be addressed and allocated. Matters which might appear to be purely “business points,” such as priorities of payment from project receipts, must be recognized to be essential elements of a financible project.

Counsel’s active participation during the negotiation of the contracts will insure that tax and regulatory matters are addressed, that technical legal requirements relating to enforceability are observed, and that corporate due diligence is completed, as well as that business issues are equitably resolved.

Given the sensitive and often protracted negotiation of the various contract terms, counsel must necessarily keep a constantly updated form of risk allocation and distribution at hand. Before the parties sign off on the contract package, a final cross check between all documents will insure consistency and coverage of all of the risks. Successful risk allocation through contracts will go far towards achieving the ultimate financing of the project.

Discussion by

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Written materials distributed in connection with this session of the ASME conference indicate that the inability of project sponsors to utilize Federal tax benefits associated with a resource recovery project, among other things, has led to the financing of such projects by leveraged leasing. The motive of sponsors to finance a project by leasing is thus couched in negative terms.

Stated more positively, Congress has recently supported the resource recovery industry in legislation related to tax benefits and leasing. Furthermore, institutional investors which function as equity participants in tax leveraged lease transactions have recently become interested in investing in projects such as resource recovery facilities.

Before elaboration on these phenomena, there follows a brief discussion of basic principles of lease financing.

BASIC LEASING PRINCIPLES

In a lease financing, the lessor provides a portion of the cash for the payment of the cost of the facility and borrows the balance, usually an amount ranging from 65% to 80% of the cost, from a bank or other commercial lender. The lender may also be an issuer of tax-exempt bonds if the facility qualifies under appropriate statutes. The lessor owns the facility for tax purposes and is entitled to deduct from his taxable income depreciation and interest expenses and to credit against his tax bill the investment tax credit associated with the facility. The lessee leases the facility from the lessor for a fixed period, has the right to use it for the production of income and will profit from its successful operation.

This arrangement is satisfactory to lessees who are “developmental stage enterprises” serving as project sponsors, as the written materials make clear, but, in addition, the arrangement appeals to more mature enterprises which are either unable currently to utilize tax benefits because of low profits or are unwilling to encumber their balance sheets with an additional financing liability.

More importantly, the principle of “full tax benefit utilization,” the hallmark of leasing, is vital in a project financing where projected revenue from operation of a facility must pay for its operation and maintenance, as well as the cost of financing. The lessor’s “contribution” towards the cost of the facility, in exchange for the right to the tax benefits, reduces the amount of the cost which is borrowed from a lender and subject to debt service.

Finally, the principle of “full tax benefit utilization” need not necessarily take the form of a tax leveraged lease transaction. A variety of other structures can accomplish the same result of lowering the amount of debt to be serviced by virtue of full utilization of tax benefits. These include: (1) limited partnerships, where private individuals use the tax benefits; (2) management programs, where a manager may operate a facility on behalf of a tax owner without assuming all of the responsibilities of a lessee in a lease transaction; and (3) vendor financings, where tax ownership and operating responsibilities reside in the same entity.

CONGRESSIONAL ACTION

Congress has encouraged this system of finance as it applies to resource recovery facilities, both in the Tax
Equity and Fiscal Responsibility Act of 1982 and in the current bills in the House and Senate which affect leasing.

TEFRA amended the Internal Revenue Code by the addition of Section 168(f)(12) which permitted accelerated depreciation to be taken with respect to a facility financed in part by tax-exempt bonds only if the facility were one of four types, including "solid waste disposal" facilities serving the general public. All other facilities were subject to an "anti-double dipping" rule which would substantially reduce tax benefits available in conjunction with bond financing.

On another point of tax law, Section 48(a)(5) of the Code denies investment tax credit where a facility is "used by" a governmental unit. In regulations interpreting this section, "used by" means "owned by or leased to" a governmental unit.

In resource recovery facility financings, a troublesome legal issue as to whether a city is a "user" is presented by tipping contracts where the city exercises substantial control over the facility. Tax lawyers are concerned that the Internal Revenue Service may recast as leases the tipping contracts by which a city in essence buys waste disposal services. The city would be deemed to be a "user" of the facility for tax purposes. This would result in loss of investment tax credit, a valuable asset in the financing.

Without significantly clarifying the circumstances which would result in loss of investment tax credit in the governmental "user" situation, the Pickle Bill, introduced in Congress in May 1983, threatened to result in the additional loss of accelerated depreciation in this situation. However, both the House version of the bill (H.R. 4170) and the Senate version (S.2062) contain, at the time of this writing, specific exemptions for solid waste disposal facilities serving the general public and meeting certain criteria consistent with private ownership.

LESSOR MOTIVATION

The tax leveraged lease transaction is new in the history of American finance relative to debt and equity offerings, the traditional methods employed by corporations to raise capital. Leasing has been widely employed to finance movable personal property and has more recently been employed to finance fixed facilities. Leasing is being increasingly used now in project financings, where the investors look to the projected revenues from the successful operation of a facility for their return, rather than looking to a creditworthy obligor.

As the leasing business has become more competitive, yields to lessors have been reduced in the traditional personal property equipment markets. Accordingly, lessors have become more willing to evaluate complicated risks, such as the risk of nonpayment under tipping contracts and power sale contracts associated with resource recovery projects, and to assume greater risks where the rewards, in the form of higher yields, are commensurate.

In the case of resource recovery in the United States, a primary concern of investors has been the risk that the technology was not reliable. However, as the resource recovery industry matures in the United States and the track record of the European technologies becomes more familiar in domestic applications, institutional investors will be increasingly willing to invest in resource recovery project financings involving tax leveraged leasing.

CONCLUSION

Congress is continuing to provide incentive in the tax laws for the lease financing of resource recovery facilities and institutional investors increasingly are receptive to proposals for these financings. Engineers and developers involved in resource recovery may take comfort in these developments.