



## The Role of Lease-Financing within Energy Projects:

### Module B: Energy Generation Projects

Heavy equipment and machinery, significant expenditures for design, engineering, permits and other soft costs related to the project, and long lead times and construction cycles are just a few of the characteristics of large scale energy generation projects. In some instances, it may take up to 24 months before a plant is made fully operational, and another 30 to 60 days before energy production reaches levels sufficient to sustain project operations. Many components and numerous expenditures made through a capital budget which requires stringent protocols in order to track expenses and control disbursements.

In the context of energy-generation projects, lease-financing enables a municipal organization to secure a funding commitment at fixed rate pricing well in advance of a project's start date.

The lease-financing product commonly utilized in large scale energy generation projects is the lease-purchase agreement; functioning as a conditional sales contract which can draw upon to:

- (a) fund individually approved supplier invoices, or
- (b) capitalize an escrow account created to hold the funds needed to pay construction and equipment acquisition costs which arise throughout the course of a project's development.

#### **One Lease-Finance Product; Two Funding Approaches**

The primary difference between the funding methods utilized is based on: (1) the economics of the project; (2) the amount and timing of funding disbursements needed; and (3) the objectives of the municipal organization.

##### *Disbursements Against Invoice(s)*

Individual disbursements against invoices made for supplier progress payment requirements, or the acquisition and installation cost of a single asset, (or group of assets), are accommodated through a series of draws against the total amount of financing capital committed to a project. Interest begins to accrue when funds are expended through the lease-finance vehicle, and only upon the amount drawn. This serves to keep financing costs low relative to a project's overall development.

##### *Full Disbursement Into Escrow*

With an advance funded equipment acquisition lease, funding occurs once when the total amount of committed financing capital is deposited into an escrow account. Interest begins to accrue upon funding and upon the total amount of capital advanced. However, the municipal organization is entitled to receive the benefit of any earnings resulting from the investment of the moneys deposited into escrow which may offset any accumulating interest expense; but only to the extent the investment earnings do not create an arbitrage rebate liability. Advance funded leases facilitate the flow of funds to be expended for equipment acquisition and installation costs in capital intensive projects that are scheduled to be developed in concurrent or overlapping phases.

Regardless of the funding methodology employed, the organization controls the timing and amount of funds disbursed, and payment of the periodic lease obligation can be structured to minimize capital outlays until sufficient cost savings have been realized, or in the case of income producing energy-generation projects, until sufficient revenue is built-up.

#### **Tax-Exempt or Taxable**

A critical question underlying the use of lease-finance proceeds to capitalize an energy-generation project is whether the financing will be structured utilizing tax-exempt or taxable (non-tax-exempt) interest rates. From a taxation standpoint, Section 141 of the Internal Revenue Code sets forth a series of tests aimed at providing guidance in the determination as to whether an issuance falls under the auspices of a governmental bond (for broader purposes, this also includes lease finance arrangements), which allows the interest component of the periodic payments to be computed at tax-exempt interest rates, or whether a financing is deemed to accommodate a private business activity, which requires the interest component to be computed at taxable interest rates.

If the lease-finance proceeds are used to pay for the construction and acquisition costs of equipment and machinery that will ultimately generate electricity that is used within a municipal organization's operation, and if the funds used to make payments of principal and interest on the underlying lease-finance obligation are derived from an organization's internal resources with the ultimate intention being to own the asset in due course, then the financing will more than likely qualify for tax-exempt status.

Conversely, if assets acquired with proceeds from a lease-financing are principally used by a non-governmental entity in a trade or for-profit business activity and, if more than 10 percent of the payments made to principal and interest on the underlying financing are: (a) secured by property operated in a private business use, or (b) derived from payments received for use of the asset by a non-governmental entity, then the financing would more than likely be deemed to be a private activity issue and fail to gain tax-exempt status.

---

Commentary within Modules is intended to communicate the basic concepts behind the use of an alternative form of capital to fund energy projects and the acquisition of energy-efficient equipment only. It is not intended to be a substitute for consultation with a professional.

For additional information, contact  
Providence Capital  
(877) 776-2271  
[www.procap-slg.com](http://www.procap-slg.com)