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What is 'Subordinated' Capital? *And Why Is the Weatherization Program Mentioning It?*

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Subordinated-senior capital loan structuring means a project's financing is comprised of at least two separate loans (senior and subordinated). Subordination refers to the order of, or priority for, repayment. The senior lender gets paid first. Subordinated debt is structured so that repayments come from project revenues after the project operating costs and senior debt is paid. The subordinated lender assumes greater risk, but still has a claim on project revenues before others who have equity in the project, like shareholders.

DOE top managers have mentioned at several public events that the Department is considering policy changes to allow WAP funds to be used for loans or revolving loan funds. For example, in a multifamily rehab project with subordinated/senior structured financing, WAP funds might be loaned to pay for the portion for energy efficiency improvements, but the owner's repayment of the WAP-funded loan is made subordinate to the senior loan. Upon repayment, the lending WAP agency could either use the funds for another loan or put them into a pool of grant funds.

Subordinated debt is typically in the range of 10% to 25% of a project's sources of funds. The amount of senior debt can be reduced by substituting subordinated debt. This will likely improve the loan-to-value ratio and the debt service coverage ratio for the senior lender; that has two benefits: 1) it reduces overall lender risk and 2) strengthens the project's financial structure from the senior lender's perspective. The subordinated lender takes on much greater risk than the senior lender, absorbing all losses up to the total subordinated loan amount. However, this allows the senior lender to put in more capital and charge a lower interest rate than the subordinated lender because they are absorbing most of the risk.

There are other credit enhancements for projects like a loan loss reserve, a loan guarantee, and debt-service reserves.

Clean Energy Retrofit Loans under ARRA SEP and EECBG

Credit enhancements have been a priority that DOE has been promoting as a use of SEP and EECBG ARRA funds. DOE regulations already permit state and local governments to use ARRA SEP and EECBG funds for subordinated-senior capital structuring. Grantees receiving EECBG funds (formula and competitive) can use them for credit enhancement as subordinated capital) at a below-market rate and reduce costs of capital for the project. For example, the State of Washington is using ARRA SEP funds in this manner (see example in next section).

Loans and the WAP

No regulation or policy has been issued that permits lending WAP funds to owners of eligible buildings as of May 15, 2011.

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Weatherization agencies that are also owners of affordable housing developments or group living facilities as well as any commercial property should be interested in whether the state or local energy programs have additional funding to commit to such projects in these last month of their ARRA programs.

Community-based organizations that are considering projects that install renewable energy may also find source of subordinated capital from remaining ARRA or other state funds.

Project Examples and More Resources

The following examples specifically address residential structuring subordinate-senior capital financing and loan programs for clean energy finance and have been highlighted by DOE

- The State of Washington is using ARRA State Energy Program funds for subordinated-senior capital structuring. [The Energy Efficient Finance Corporation](#) is working with The Washington State Housing Finance Commission (WSHFC) in instances where ARRA funds are being used as a debt service reserve.
 - Example: The WSHFC has recently launched a program, [Energy Efficiency Loan Program](#), to offer tax-exempt bond private placement financing of EE/RE projects for nonprofit and multifamily housing borrowers. Marketed in cooperation with a local energy service company, the financing program can support up to \$10 million in project loans. The minimum loan size is \$250,000, and a 10- to 15-year fixed-rate financing in the range of approximately 4%–5.5%. State ARRA SEP funds of \$1 million have been allotted for credit enhancement and program implementation support. The Commission has arranged for a single bond purchaser to approve the credit of borrowers case by case, and streamlined bond documentation has been developed to manage transaction costs. The WSHFC is the state charter bond authority that can issue tax except bonds for qualified low-income multifamily housing as well as other borrowers like nonprofits.
- The following State clean energy funds specifically offer financing in the commercial sector and have also been highlighted in [DOE's Clean Energy Finance Guide](#). These non-residential models can provide informative summaries and detail on program design/structure and can assist on gathering information on financing administration.
 - [Vermont Clean Energy Development Fund](#)
 - The Vermont Clean Energy Development Fund (CEDF) uses subordinated debt financing. Established in 2005 by state statute, the fund receives between \$4 million and \$7 million per year from the Department of Public Service and the utility Entergy. It has a fund manager who, with an investment committee of expert stakeholders, identifies and allocates funds to subordinated debt investments.

- The Delaware Sustainable Energy Utility (DSEU) is using subordinated debt financing alongside other options for their [Non-Residential Efficiency Plus Financing Program](#)
 - State-wide fund (501c3) for financing energy efficiency/renewable energy which provides market and project development services
 - Funding sources:
 - Industrial development bond for \$30 million with tax-exemption. A system benefit charge funding mechanism is in place with revenues deposited to a Green Energy Fund. There is not a state credit and no new taxes. A state appropriation is considered for credit enhancement as well as a regional greenhouse gas auction allowance.
- The state of Alabama has a large commercial sector program that is considering a subordinated-senior capital structure for its large commercial sector energy efficiency program. Commercial end-uses for energy such as space heating and cooling, water heating and lighting, are covered by federal efficiency standards, however Alabama has yet to implement state-level commercial building efficiency codes. At the point where Alabama does implement such codes, demand for retrofit upgrade financing could increase.

Resources

- EPA has created [The Clean Energy-Environment Guide to Action](#). The Guide provides an overview of clean energy supply technology options and, in addition to clean energy funds, presents a range of policies that states have adopted to encourage continued growth of clean energy technologies and energy efficiency.
- The [Database of State Incentives for Renewable Energy \(DSIRE\)](#) is a comprehensive source of information on state, local, utility, and selected federal incentives that promote clean energy. State level clean energy fund programs can be found here.
- The [Clean Energy States Alliance \(CESA\)](#) is a nonprofit organization that provides information and technical services to state clean energy funds and works with them to build and expand clean energy markets in the United States. They have authored a report on [State Clean Energy Fund Support for Renewable Energy Projects](#) that details key findings from their 2009 national database

Links

[National Governors Association – State Clean Energy Financing Guidebook](#)

This guidebook helps states consider three key elements of a clean energy financing program: sources of capital, program selection and design, and implementation strategy.

[Vermont Clean Energy Development Fund \(Strategic Plan\)](#)

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Provides a framework for the Vermont Clean Energy Development Fund (CEDF), including how the funds will be managed and how they will be distributed to meet the goals of the Fund. The plan was designed to be flexible, to be able to respond to an evolving energy environment. A program plan and budget is incorporated and redeveloped each year to identify the financing initiatives and programs that the Fund will pursue in the coming year, and establish target dollar allocations for the initiatives.

[Case study: Use of Low-Interest, Subordinated Debt to Finance a Wind Project in Pennsylvania](#)

Four Pennsylvania funds collaborated to offer \$3.6 million in low-interest, subordinated debt to a 9 MW wind project. This offering represents the first use of low-cost debt by a state clean energy fund to support a large-scale wind project in the U.S., and marks a significant departure from standard grant-based project support. This case describes the structure of the incentive and how it has impacted the project, and identifies several caveats to keep in mind.

[Lawrence Berkeley Labs Case studies of State Clean Energy Funds to Support Renewable Electricity](#)

A brief overview on the innovative programs and administrative practices of state (and some international) clean energy funds, highlights on additional sources of information and to identify contacts. The case studies might be useful for stakeholders that are interested in learning about the pioneering renewable energy efforts of newly established clean energy funds.

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