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Synthetic Lease Financing for the Acquisition and Construction of Power Generation Facilities in a Changing U.S. Energy Environment

Thomas R. Fileti and Carl R. Steen

Abstract

This Essay will describe synthetic lease financings and provide an analysis of the advantages and disadvantages of these transactions for the acquisition or construction of a power generation facility. During the past two years, several leading players in the power generation industry have used “synthetic” leases to finance both the construction and acquisition of power generation assets, as well as bulk purchases of combustion turbines. Synthetic leases can offer a tax and balance sheet efficient alternative for the acquisition and construction of a power generation facility and related equipment (collectively referred to in this Essay as a “power generation facility”). A synthetic lease (also known by other names such as “off-balance sheet financing” or “tax oriented operating lease”) is a financing transaction structured through a lease that satisfies the requirements for characterization of a lease as an operating lease set forth in the Financial Accounting Standards Board (“FASB”) Statement 13 (“SFAS 13”) and related accounting rules. Because a synthetic lease allows a project sponsor to enjoy operating lease accounting treatments and avoid depreciation charges attributable to the leased asset, power producers employing this technique may obtain tangible economic advantages in the current market-driven environment. Synthetic lease financing may also allow a project sponsor greater financial flexibility to participate in a number of large scale projects and equipment purchases while mitigating the adverse credit impact of any particular project or transaction. The execution of synthetic leasing transactions in the power generation industry by leading players during the past two years may encourage others in the industry to consider such innovative approaches.

SYNTHETIC LEASE FINANCING FOR THE ACQUISITION AND CONSTRUCTION OF POWER GENERATION FACILITIES IN A CHANGING U.S. ENERGY ENVIRONMENT

*Thomas R. Fileti & Carl R. Steen**

INTRODUCTION

The power industry in the United States is in the midst of both fundamental change and new growth. The de-regulation movement, which began in California in the mid-1990s¹ and has swept across the United States,² has caused a shake-up in the industry, including an unprecedented wave of utility mergers and consolidations³ and divestitures of utility-owned generation

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1. De-regulation in California began with Assembly Bill 1890 (AB1890), which was signed into law on September 24, 1996. The new law established a four-year transition period designed to implement competition in the energy sector. Rates were frozen at the levels in effect as of June 10, 1996, and a ten percent rate reduction was guaranteed for commercial and residential users, whose rates are to remain frozen until March 31, 2002. The new law also established an independent system operator and a legally separate power exchange. CAL. PUB. UTIL. CODE § 9600 (Deering 2001).

2. As of March 5, 2001, the following 23 states (and the District of Columbia) had enacted some form of restructuring legislation: Arizona, Arkansas, California, Connecticut, Delaware, Illinois, Maine, Maryland, Massachusetts, Michigan, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Texas, Virginia, and West Virginia. In addition, New York had issued a comprehensive regulatory order and 18 states had ongoing commission or legislative investigations, including Alaska, Colorado, Florida, Indiana, Iowa, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, North Carolina, North Dakota, South Carolina, Utah, Vermont, Washington, Wisconsin, and Wyoming. See ENERGY INFORMATION ADMINISTRATION, STATUS OF STATE ELECTRIC INDUSTRY RESTRUCTURING ACTIVITY AS OF MARCH 2001, at http://www.eia.doe.gov/cneaf/electricity/chg_str/regmap.html. Although recent difficulties with the deregulated market in California appear to be, at least in part, unique to the deregulation program in California, it remains to be seen how much these difficulties will result in a long-term retrenchment from deregulation in other states.

3. From 1992 to April 2000, 35 mergers or acquisitions have been completed (and 12 were pending as of October 2000) between investor-owned utilities ("IOUs") or between IOUs and independent power producers ("IPPs"). These include such recent deals as the US\$33.3 billion American Electric Power Co., Inc./Central and South West Corp. merger, the pending US\$24.8 billion Consolidated Edison, Inc./Northeast Utili-

plants.⁴ State de-regulation laws in some cases have mandated the sales of utility-owned generation plants as a device to ensure competition in the wholesale and retail electricity markets.⁵ The favorable results of the initial divestitures, in which utilities were able to monetize depreciated, old generating plants for high multiples of book value, have provided a sufficient incentive seemingly to open the floodgates.⁶ As a result, in the last several years, generation assets have changed hands at unprecedented levels.⁷

De-regulation has also led to entry and growth of many new players in the power industry. Through development of new power stations and acquisition of existing power generation, the so-called independent power producers ("IPPs") have grown into giants, which in many cases now rival or surpass the "regulated" utility companies from which they were considered "independent." Electric utility companies, while divesting assets in their own service territories have, through affiliates, invested in existing and new generating assets in the service territories of other utilities.

What the architects of de-regulation seem not to have expected, as the recent problems with de-regulation in California have underscored, is how acute the nation's need is for new generating capacity.⁸ Although the jury is still out as to whether the

ties merger, the US\$42.2 billion Unicom Corporation (a holding company for Commonwealth Edison)/PECO Energy Co. merger, and the US\$15.1 billion New Century Energies/Northern States Power merger. ENERGY INFORMATION ADMINISTRATION, UNITED STATES DEPARTMENT OF ENERGY, *THE CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY 2000: AN UPDATE* (2000).

4. From late 1997 to April 2000, 51 IOUs had divested or were in the process of divesting electricity generation assets for a total of 156.5 gigawatts of capacity, which represents 22% of U.S. capacity. It is predicted that over the next 10 years, 50% of U.S. capacity (approximately 364 gigawatts as of 1998) will change hands. *Id.* at 105.

5. This phenomenon may be tempered by the reaction of politicians to the recent power crisis in California. On January 18, 2001, in response to the power crisis, the Governor of California signed a bill into law prohibiting the sale of power generation facilities owned by public utilities in the state until January 1, 2006. Ass. 6, 2000-2001 (Cal. 2001).

6. For example, in California, as of January 2000, IOUs had sold a total of 20,187 megawatts of generation assets for US\$3.274 billion, a significant amount above their book value of US\$1.818 billion. CALIFORNIA ENERGY COMMISSION, *ELECTRIC GENERATION DIVESTITURE IN CALIFORNIA*, at <http://www.energy.ca.gov/electricity/divestiture.html>.

7. See generally McIsaac et al., *Financing the New Merchant Power Business*, 6 J. PROJ. FIN., Spring 2000, at 13.

8. The North American Reliability Council ("NERC") recently estimated that more than 10,000 megawatts of capacity nationally will need to be added annually between

de-regulation effort in its present form will survive, one point is abundantly clear: there is a desperate need for new power generation in the United States.⁹ Demands for new capacity have led to a surge in the planning and development of new power generation facilities in the United States, ranging from dispersed small, “peaking” generation programs and cogeneration or similar “distributed generation” facilities for self-supply to large-scale natural gas-fired power stations in excess of several hundred megawatts and costing hundreds of millions of dollars.¹⁰

Industry restructurings often have led to financial innovations, and the power industry is no exception. The model for financing the development and acquisition of power plants has changed significantly as the wholesale and retail power markets have evolved during the more than twenty years since the passage of the Public Utility Regulatory Policies Act of 1978.¹¹ The “project financing” model—once characterized by long-term commercial bank and bond financings (e.g., twenty years) based on similarly long-term, guaranteed-price power purchase agreements entered into with creditworthy utilities—has evolved.¹² With the rise of more volatile market-based pricing systems and the onset of so-called “merchant” power plants¹³ during the past

the years 2000 and 2008 in order to keep up with a 1.8% annual growth in demand for power. EDISON ELECTRIC INSTITUTE, MAKING COMPETITION WORK: BUILDING ELECTRIC GENERATION AND TRANSMISSION TO MEET SPIRALING DEMAND, at http://www.eei.org/issues/comp_reg/price_volatility01.pdf.

9. The Energy Information Administration (“EIA”) in the Annual Energy Outlook 2001 projected that 1,310 new plants with a combined total of 393 gigawatts of capacity will need to be built by 2020. ENERGY INFORMATION ASSOCIATION, UNITED STATES DEPARTMENT OF ENERGY, ANNUAL ENERGY OUTLOOK 2001 WITH PROJECTIONS TO 2020, at 73 (2000).

10. It is estimated that the merchant generation market will grow to 160 gigawatts before the end of 2001, with US\$20 billion being slated for investment in power projects through 2001 and about six to 10 deals worth US\$5 billion expected to be closed each year. See Andreas Campomar, *The Shape of Synths to Come*, J. PROJ. FIN., July 1, 2000, at 37.

11. Public Utility Regulatory Policies Act of 1978, Pub. L. No. 95-617, 92 Stat. 3117 (1998).

12. Through the 1990s, new power generation assets were developed using the traditional project finance model. In a basic project finance transaction, the financing is non-recourse or limited recourse with the lenders looking principally to the cash flow of an individual project as security for their loan. See Michael J. Schewel, *Jurassic Sparks! Project Finance Revives Extinct Deals*, 12 APR. PROB. & PROP. 26, 26 (Mar./Apr. 1998).

13. The term “merchant power plant” refers to the project that largely or entirely depends on the wholesale or retail marketplace to sell power, rather than one or more long-term power purchase agreements.

decade, financing the acquisition and construction of power generation facilities has come to include a range of products and transaction structures involving varying degrees of "recourse," including cross-collateralized portfolio financings, quasi-public offerings of debt and equity, securitizations, and leveraged and other lease financings.¹⁴

The confluence of increased merger and acquisition activity, new players, and the demands for new generating capacity has created a tremendous need for new capital and innovative financing products and structures. As the power industry has become more competitive, project sponsors are interested in exploring ways to enjoy economies of scale, reduce equipment and financing costs, and, where possible, take full advantage of favorable accounting and tax treatment. In addition, in light of price volatility and possible supply interruptions, end users may be interested in developing their own sources of generation. This particularly may be the case for large energy users (such as chemical concerns, oil refiners, paper makers, semiconductor manufacturers, and others) that are seeking to supply some portion of their electrical needs outside the market-based pricing system and without risk of costly power interruptions, but which are not principally engaged in the business of energy production.¹⁵

During the past two years, several leading players in the power generation industry have used "synthetic" leases to finance both the construction and acquisition of power generation assets, as well as bulk purchases of combustion turbines. Synthetic leases can offer a tax and balance sheet efficient alternative for the acquisition and construction of a power generation facility and related equipment (collectively referred to in this Essay as a "power generation facility"). A synthetic lease

14. See McIsaac et al., *supra* note 7; Watkins, *Cross Dressing*, J. PROJ. FIN., Nov. 1, 1999.

15. This Essay focuses on the use of synthetic leasing by IPPs and end users, as opposed to regulated utilities. Although the use of synthetic lease financing by regulated utilities may be appropriate in some instances, the special regulatory and accounting concerns that relate to capital investments and leases by regulated utilities raise potential issues that are beyond the scope of this Essay. In addition, this Essay focuses on the use of synthetic leasing as a means of financing electric generating facilities, as opposed to transmission or distribution facilities. Transmission and distribution services continue to be highly regulated and the regulatory and accounting regimes that govern those services raise issues that are beyond the scope of this Essay.

(also known by other names such as “off-balance sheet financing” or “tax oriented operating lease”) is a financing transaction structured through a lease that satisfies the requirements for characterization of a lease as an operating lease set forth in the Financial Accounting Standards Board (“FASB”) Statement 13 (“SFAS 13”) and related accounting rules.¹⁶ Because a synthetic lease allows a project sponsor to enjoy operating lease accounting treatment and avoid depreciation charges attributable to the leased asset, power producers employing this technique may obtain tangible economic advantages in the current market-driven environment. Synthetic lease financing may also allow a project sponsor greater financial flexibility to participate in a number of large scale projects and equipment purchases while mitigating the adverse credit impact of any particular project or transaction.¹⁷ The execution of synthetic leasing transactions in the power generation industry by leading players during the past two years may encourage others in the industry to consider such innovative approaches. This Essay will describe synthetic lease financings and provide an analysis of the advantages and disadvantages of these transactions for the acquisition or construction of a power generation facility.

I. RECENT SYNTHETIC LEASE TRANSACTIONS IN THE POWER INDUSTRY

Starting in the 1990s, public companies in the high-tech and biotech fields financed the acquisition of manufacturing plants, headquarters buildings, corporate campuses, and other “strategic” real estate assets using synthetic lease financing. Other public companies involved in manufacturing, retail, and other lines of business have also used this technique.¹⁸

Recently, synthetic lease transactions have been employed in the power industry, including the following transactions:

16. SFAS 13 and other Statements of Financial Accounting Standards are published in FINANCIAL ACCOUNTING STANDARDS BOARD, ORIGINAL PRONOUNCEMENTS, FASB STATEMENTS OF STANDARDS 1-100, Vols. I & II (2000) [hereinafter ORIGINAL PRONOUNCEMENTS]. A comparison publication, CURRENT TEXT, GENERAL STANDARDS AND INDUSTRY STANDARDS, Vols. I & II (2000) [hereinafter CURRENT TEXT], integrates currently effective accounting and reporting standards.

17. See Campomar, *supra* note 10.

18. See Andrew Ratner & Steve Marcussen, *The Synthetic Lease Strategy*, CORP. REAL ESTATE EXECUTIVE (Sept. 1996); David Holmes, *The Use of Synthetic Leases to Finance Build-to-Suit Transactions*, REAL ESTATE FIN. J. (Winter 1996).

- PG&E National Energy Group ("PG&E") completed synthetic lease financings of two large-scale, merchant power projects. The first, in September 1999, was a well-publicized US\$490 million project-financed synthetic lease of the "Lake Road" project, a 792 MW natural gas-fired power station in Killingly, Connecticut.¹⁹ This project-financed synthetic lease included a US\$227 million securitized commercial paper facility, a US\$219 million term loan, US\$15 million in working capital, a US\$15 million letter of credit, and US\$13.8 million in certificates.²⁰
- PG&E completed a second similar US\$730 million project-financed synthetic lease for its 1,048 megawatt La Paloma generating facility in Kern County, California, in March 2000.²¹ The financing included a US\$25 million debt service reserve facility, US\$15 million in working capital, US\$374 million in PG&E Corporation-backed commercial paper, US\$295 million term financing, and US\$21 million in certificates.²²
- Prior to PG&E's transactions, Mississippi Power, a subsidiary of Southern Company, completed a US\$406 million synthetic lease financing in April 1999, the commercial paper for which was immediately oversubscribed.²³ The deal was broken down into four tranches, consisting of a fixed-rate 22.5-year bullet at US\$270 million, a US\$71 million floating-rate piece with a 12.5-year final maturity and a 7.5-year average life, a 12.5-year bullet US\$50 million piece, and a subordinated tranche for US\$15 million issued as a 22.5-year bullet.²⁴

19. The transaction's Lead Arranger was Citibank, and Arranger and Co-Arranger were Société Générale and Deutsche Bank, respectively. There were 17 additional lenders, contributing to an oversubscription in syndication. See Press Release, PG&E Generating (Sept. 8, 1999), at http://www.usgen.com/news/Lake_Road_Financing.htm.

20. The commercial paper is acting as an equity bridge with PG&E guaranteeing roughly 50% of the total debt. The commercial paper facility is expected to be renewed annually and to eventually be taken out with equity from PG&E. The US\$219 million term loan has a tenor of construction (two years) plus sixteen years. See *Lake Road Oversubscribed*, PROJ. FIN. INT'L, Sept. 8, 1999, at 33.

21. The transaction's arrangers were Citibank, Société Générale, and Deutsche Bank. Co-arrangers were BNP Paribas Group, Credit Lyonnais, and Dresdner Kleinwort Benson. There were 23 additional lenders, contributing to an oversubscription in syndication. See Press Release, PG&E Generating (Mar. 30, 2000), at <http://www.usgen.com/news/033000finance.htm>.

22. See Campomar, *supra* note 10.

23. See *Mississippi Power Turns Market On*, 9 PRIVATE PLACEMENT REP., Apr. 5, 1999, at 2.

24. *Id.*

- In May 1999, KeySpan Energy Corporation announced a synthetic lease financing for the Brooklyn Union Gas Ravenswood generating facility in Queens, New York.²⁵ Under the terms of the transaction, the bondholders obtained a secured interest in the lease for the facility, with the deal being broken down into two tranches: a US\$412.25 million senior portion and a US\$12.75 million equity tranche, having an initial term of five years with an option to renew.²⁶ Although Brooklyn Gas leases the facility, KeySpan guaranteed the lease.²⁷

Synthetic leases have also been used recently to finance advance purchases of turbines and other major equipment items.²⁸ In October 2000, PG&E announced a US\$7.8 billion synthetic lease financing in a "master turbine trust" transaction involving the purchase of forty-four turbines and the construction of fifteen associated projects, representing a total of 13,700 MW.²⁹ The transaction combined a synthetic lease with a trust structure, aggregating PG&E's financing needs into a single vehicle.³⁰ Under the terms of the transaction, the turbines will be warehoused and owned by a trust (one trust for twenty-three General Electric turbines and one trust for twenty-one Mitsubishi turbines), with the turbines pledged to the lenders as collateral against any uncovered risks.³¹ PG&E was hired by the trust as the construction agent to build the plants that will house the turbines.³² The trusts have a US\$7.5 billion tranche that is backed by U.S. Treasuries pledged by PG&E, a smaller tranche based on PG&E Corporation-backed credit, and an equity tranche represented by certificates of ownership for the turbines.³³

The magnitude and variety of the synthetic lease transactions that have been consummated to date in the power industry

25. See *KeySpan Raises the Bar*, 11 PRIVATE PLACEMENT REP., May 3, 1999, at 1.

26. *Id.*

27. *See id.*

28. Dynegy Inc. completed a US\$200 million synthetic lease for the purchase of turbines and Enron completed a similar US\$500 million synthetic lease. *See Turbine Deals Oust the Lease*, PROJ. FIN. INT'L, July 26, 2000, at 11.

29. *See Innovative Financing Highlights PG&E's \$7.8 Billion Deal with Société Générale*, ELECTRIC UTILITY WEEK, Oct. 2, 2000, at 9.

30. *See id.*

31. *See id.*

32. *See id.*

33. *See id.*

reflect the potential viability of this form of financing for the acquisition and construction of power generation facilities.

II. THE BENEFITS OF SYNTHETIC LEASING

The benefits of off-balance sheet financing to the lessee, as compared to traditional debt arrangements, are several-fold. These benefits primarily result from differences in how leases are characterized for tax purposes under the Internal Revenue Code and for book purposes under the standards of the Financial Accounting Standards Board ("FASB"). In general, and as discussed more fully below, for tax purposes, the lessee of an asset that is financed under a synthetic lease is treated as the owner of the asset for tax purposes and the lease is viewed as a financing for tax purposes. Thus, the lessee will enjoy the cash flow benefits of tax depreciation deductions on the leased asset and can deduct the interest component of the rent it pays under the lease. However, for accounting purposes, the lessee is viewed not as the owner, but merely as a lessee renting an asset. In its income statement, the lessee thus avoids the reduction of earnings that would be attributable to book depreciation of the leased asset. Both the leased asset and the liability of the lessee under the lease remain off the lessee's balance sheet, the book depreciation of the asset remains off the lessee's income statement, and the lessee's rental payments will be reflected as operating expenses on its income statement. (However, the transaction may be footnoted in the lessee's financial statement³⁴ and, if the lessee is a reporting company, it may have certain disclosure obligations relating to the transaction under the Securities Exchange Commission rules if the lease represents a material transaction.³⁵) In addition to these tax and accounting benefits, a synthetic lease, like other lease financing transactions, represents an opportunity to finance one hundred percent of acquisition or construction costs.³⁶

34. H. Peter Nesvold, *What are you Trying to Hide? Synthetic Leases, Financial Disclosure and the Information Mosaic*, 4 STAN. J.L. BUS. & FIN. 83, 93 (1999).

35. See Securities Exchange Act of 1934 §§ 13 and 15(d), 15 U.S.C. §§ 79a *et seq.* (1934). Rule 13a-11 and Rule 15d-11 were issued by the Securities Exchange Commission and Form 8-K promulgated thereunder. See *id.*

36. Leveraged leases are also a financing technique that has been employed in connection with the acquisition of power generation facilities. In a leveraged lease, unlike a synthetic lease, the lessor will be viewed as the tax owner of the asset and thus a

The tax and accounting benefits of synthetic lease transactions can be very attractive to "balance sheet-sensitive" companies, particularly those that can make efficient use of the tax benefits of the asset. A public company or a company that is seeking to go public and that has entered into a synthetic lease will be able, when it sells its stock, to avoid the depressive effects on its earnings of book depreciation of the leased asset, and thereby enhance book income and the price that it may obtain for its stock, since that price is usually expressed as a multiple of earnings.

Companies (whether public or private) that are subject to financial covenants in indentures or credit agreements (e.g., such as requirements for minimum net worth, maximum ratio of debt to net worth, minimum profitability, or a minimum ratio of earnings to fixed charges or of liquid assets to current liabilities) also find synthetic leases attractive. They may be able to engage in a synthetic lease financing without running afoul of such covenants, whereas a financing that would be regarded as a liability under generally accepted accounting principles ("GAAP") might result in a violation of those covenants or "use up" capacity under those covenants, since those covenants are usually constructed based on GAAP classification of earnings, assets, and liabilities. In addition, companies seeking to preserve their corporate cash or revenues for their core lines of business will benefit from the one hundred percent financing features of the transaction.

These transactions are not without disadvantages, however. The typical synthetic lease is a medium-term financing, and fi-

leveraged lease will involve a lessor entity that can use tax benefits such as depreciation more efficiently than the lessee can. The lease may or may not qualify as an operating lease, depending on whether it satisfies the operating lease tests in SFAS 13 and whether the lease is the result of a sale-leaseback transaction. Leveraged lease transactions involving power generation facilities include transactions entered into by PG&E Generating New England (lease of the Bear Swamp pumped storage facility acquired from New England Electric), AES Eastern Energy (acquisition of NYSEG coal plants), PP&L Montana (acquisition of fossil and hydro plants in Montana), and Edison Mission Midwest Holdings (lease of the Collins plant, which is part of the US\$4.8 billion acquisition of 9,510 megawatts of fossil assets from Commonwealth Edison, the largest generation acquisition in the United States to date). See McIsaac, *supra* note 7. CIT Group recently structured a US\$400 leveraged lease financing for Calpine Corporation for both Phase I and Phase II of its Pasadena, Texas cogeneration project. See *CIT funds Calpine*, PROJ. FIN. INT'L, Sept. 20, 2000, at 21; see also Eric Lammers, *De-regulation Reinventing Generation Planning and Finance*, ELECTRIC LIGHT & POWER (Nov. 1999).

nancing a long-term asset such as a power generation facility with a medium-term liability flies in the face of conventional wisdom that a long-term asset should be financed with a long-term liability. Additionally, synthetic leases can involve high up-front advisory, accounting, and legal fees and other transaction costs. Structuring a synthetic lease for *construction* of a power generation facility requires compliance with a myriad of accounting rules, which can make underwriting the transaction difficult from the financing sources viewpoint.³⁷ Further, because a synthetic lease (especially one in which real estate improvements, rather than equipment, form the primary asset) can involve relatively low amortization, the lessee may need to seek to “refinance” a substantial balance upon the expiration of its term. Although this feature in certain respects is not substantially different from the need to refinance the unpaid balance of a financing at its maturity, certain accounting challenges and additional transaction costs can be encountered in refinancing or unwinding a synthetic lease that would not necessarily arise in traditional financings, especially if the lessee seeks to preserve the off-balance sheet treatment of the asset in a new transaction. Some of these disadvantages are addressed more fully below.

III. *FASB REQUIREMENTS FOR THE CHARACTERIZATION OF LEASES*

The accounting benefits of synthetic leasing depend upon characterization of the transaction as an operating lease—and not a capital lease—under SFAS 13 and related accounting standards that set forth the criteria that apply to the characterization of a lease for book purposes. Under SFAS 13, accounting for leases is derived from the view that a lease that transfers substantially all of the benefits and risks of ownership should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee (a capital lease), and any other lease should be accounted for as an operating lease (that is, the rental of property).³⁸

In determining whether a lease transfers all of the benefits and risks of ownership to the lessee, however, SFAS 13 adopts a “cookbook” approach, rather than an “all the facts and circum-

37. See Healey, *Turbine Deals Oust the Lease*, PROJ. FIN. INT'L, July 26, 2000.

38. See CURRENT TEXT, *supra* note 16, at 29141.

stances"-type test. In particular, SFAS 13 identifies several criteria that are solely determinative of the characterization of a lease. If a lease meets *any* of the criteria identified in SFAS 13, it will be classified as a capital lease. If a lease is characterized as a capital lease, the leased asset and the lease obligation are recorded as an asset and a liability, respectively, on the lessee's balance sheet and depreciation of the leased asset will be reflected on the lessee's income statement. Thus, from an accounting standpoint, in order to qualify as an operating lease, the transaction must be structured to avoid *all* of the SFAS 13 criteria. A description of the primary SFAS 13 criteria, and how they are avoided in a typical synthetic lease transaction, is set forth below.³⁹

SFAS 13 CRITERIA FOR LEASES	APPLICATION TO A SYNTHETIC LEASE
If the lease transfers ownership of the leased asset to the lessee at the end of the leased term, the lease will be characterized as a capital lease. ⁴⁰	This criterion is not met in a synthetic lease because the lease will not provide for the transfer of ownership of the property upon the expiration of the term of the lease.

39. The description of the SFAS 13 tests in this Essay is summary. The tests include some requirements that are very technical in nature. The full text of SFAS 13 can be found in 1 ORIGINAL PRONOUNCEMENTS, *supra* note 16, at 98-145. In addition to SFAS 13, there are several other Statements of Financial Accounting Standards, bulletins, and pronouncements that FASB or its Emerging Issues Task Force ("EITF") (a key working group that studies and addresses concerns of the financial accounting community) have issued that impact the accounting for synthetic leases. These include (i) Statement of Financial Accounting Standards 94 (1987)—Consolidation of all Majority-Owned Subsidiaries, (ii) Statement of Financial Accounting Standards 98—Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sale-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases, (iii) EITF Bulletin 90-15—Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions, (iv) EITF Bulletin 90-8—Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities, (v) EITF Bulletin 96-21—Implementation Issues Associated with EITF 90-15, (vi) EITF Bulletin 97-1—Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special-Purpose Entities, (vii) EITF Bulletin 97-10—The Effect of Lessee Involvement in Asset Construction, and (viii) Financial Accounting Series No. 194-B—Proposed Statement of Financial Accounting Standards, Consolidated Financial Statements: Purpose and Policy (Exposure Draft) (Feb. 23, 1999).

40. See Accounting for Leases, Statement of Financial Accounting Standards No.

SFAS 13 CRITERIA FOR LEASES	APPLICATION TO A SYNTHETIC LEASE
<p>If the lease contains an option to purchase the leased property at a bargain price (i.e., a price that "is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured"), the lease will be characterized as a capital lease.⁴¹</p>	<p>This criterion is not met in a synthetic lease because the lessee will not have a bargain option.</p>
<p>If the lease term is equal to or greater than seventy-five percent of the estimated economic life of the leased property or more of the useful life of the leased property, the lease will be characterized as a capital lease.⁴²</p>	<p>This criterion is not met in a synthetic lease because the lease will include a sufficiently short term.</p>

13, § 7a (Financial Accounting Standards Bd. 1976); ORIGINAL PRONOUNCEMENTS, *supra* note 16, at 101.

41. SFAS 13, §§ 5d, 7b. See ORIGINAL PRONOUNCEMENTS, *supra* note 16, at 99, 101. In applying the bargain option test, some accounting firms take the view that a bargain option for certain real estate assets can be avoided only if the lease term has a minimum length, even if the purchase price for the asset equals its cost or objectively-determined fair market value. For example, in the case of a manufacturing plant, some accounting firms take the view that the lease term must be at least five years in order to avoid a bargain option. The principle at work in this analysis appears to be that a manufacturing plant that is important to the lessee's business may have a subjective value to the lessee that is greater to it than the fair market value or cost of the asset would indicate. Thus, unless the lease term is sufficiently long, the accountants would be concerned that exercise of the option would, as of the inception of the lease, be "reasonably assured" and the bargain option test would not be satisfied.

42. SFAS 13, § 7c. See ORIGINAL PRONOUNCEMENTS, *supra* note 16, at 101.

SFAS 13 CRITERIA FOR LEASES	APPLICATION TO A SYNTHETIC LEASE
<p>If the present value at the beginning of the lease term of the "minimum lease payments"⁴³ equals or exceeds ninety percent of the fair value of the leased property to the lessor at the inception of the lease, the lease will be characterized as a capital lease. (This test is referred to in this Essay as the "Ninety Percent Test.") The lessee computes the present value of the minimum lease payments using its incremental borrowing rate (i.e., the rate that, at the inception of the lease, the lessee would have incurred if it had borrowed over a similar term the funds necessary to purchase the leased asset).⁴⁴</p>	<p>The lessee's rental payment obligations and end-of-term purchase and residual value guaranty obligations (described more fully below) in a synthetic lease will be structured to avoid this criterion.</p>

Certain special rules apply in the case of a lease involving both land and improvements if the fair value of the land is twenty five percent or more of the total fair value of the leased property at the inception of the lease. These rules make avoidance of capital lease classification more difficult in these circumstances.⁴⁵ Special rules also apply where the lease involves both

43. SFAS 13 defines "minimum lease payments" as the payments that the lessee is obligated to make or can be required to make in connection with the leased property. However, the lessee's obligation to pay executory costs such as insurance, maintenance, and taxes in connection with the leased property is excluded. Minimum lease payments include the minimum rental payments called for by the lease, plus any guarantee by the lessee (or a third party related to the lessee) of the residual value at the expiration of the lease term and any payment that the lessee is required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the guaranty or such other payments are structured as consideration for the purchase of the leased property. SFAS 13, § 5j. See ORIGINAL PRONOUNCEMENTS, *supra* note 16, at 100.

44. SFAS 13, § 7d. See ORIGINAL PRONOUNCEMENTS, *supra* note 16, at 101-02.

45. SFAS 13, § 26. See ORIGINAL PRONOUNCEMENTS, *supra* note 16, at 107-08. In this Essay, we will assume that the value of the land leased with the power generation facility does not exceed this 25% threshold. Separate "land only" or "improvements

real estate and equipment (which would not be unusual in a synthetic lease, particularly one involving a power generation facility), but these rules generally do not impede the classification of the lease as an operating lease.⁴⁶

In addition to the SFAS 13 tests, under FASB consolidation principles, if the lessor is a "non-substantive lessor" or is a special purpose entity that will be consolidated into the lessee for accounting purposes, the assets and liabilities of the lessor will be included on the lessee's balance sheet, thereby eliminating the favorable accounting treatment. To avoid characterization as a "non-substantive lessor," the lessor must be capitalized with a minimum, subordinate equity capitalization of at least three percent.⁴⁷ Under recent proposed accounting standards concerning consolidation, even if the lessor is initially a single asset entity, consolidation may be avoided if the lessor has the organizational powers (whether or not exercised), without a veto right on the part of the lessee, to engage in transactions other than ownership of the leased asset.⁴⁸ FASB continues to review consolidation issues, however, and thus this area remains an area of potential risk in structuring transactions.

Despite FASB's "cookbook" approach to the characterization of leases, the accounting profession has subjected synthetic leases to significant scrutiny. FASB's Emerging Issues Task Force ("EITF") has reviewed several issues arising from synthetic lease transactions. EITF 97-1 provides that leases that include "subjective" events of default, the occurrence of which could trigger an obligation on the part of the lessee to make a one hundred percent guaranteed residual value payment (rather than the less-than-ninety percent payments permissible under the Ninety Percent Test absent a default), must be characterized as capital

only" leases can sometimes be utilized to address the constraints introduced by this 25% test.

46. SFAS 13, § 27. See ORIGINAL PRONOUNCEMENTS, *supra* note 16, at 108.

47. See EITF Bulletins 9-15, 96-21, 97-1; EITF Topic No. D-14.

48. See Financial Accounting Series No. 194-B, Proposed Statement of Financial Accounting Standards, Consolidated Financial Statements: Purpose and Policy (Exposure Draft) (Feb. 23, 1999), Example 8 (Creation of a Special-Purpose Trust to Invest in (Lease) Real Estate) §§ 141-52. FASB has received extensive comments on the Exposure Draft and has made certain tentative decisions in the course of its deliberations concerning that draft. The FASB website includes certain information concerning the status of the Exposure Draft. The website is available at www.fasb.org.

leases rather than operating leases.⁴⁹ EITF 97-10, which is described in more detail below, requires characterization of a lease as a capital lease if the lessee has borne substantially all of the risks of the construction of the leased asset. The impact of the current consolidation project involves a further effort to ensure that the lessor party and its funding sources bear some risk in these transactions, in order for the lessor to be considered the "true" owner for book purposes.⁵⁰

IV. TAX CHARACTERIZATION OF SYNTHETIC LEASES

The courts and the Internal Revenue Service ("IRS") have addressed many times the question of whether a transaction denominated as a lease will be treated as a "true lease" (in which the party denominated as lessor is treated as the owner/lessor of the equipment and the party denominated as lessee is treated as the lessee) or as a financing, i.e., a loan or conditional sale (in which the party denominated as lessor is treated as a secured lender or secured vendor and the party denominated as lessee is treated as a borrower that owns the equipment). The IRS and the courts have generally applied a substance-over-form analysis in determining who is the owner of the leased asset in a purported leasing transaction. The principal test applied in determining ownership for tax purposes is which party bears the economic benefits and burdens of ownership.⁵¹ The IRS has issued published guidelines describing situations in which an agreement that is in the form of a lease will be treated as a conditional sale.⁵² Revenue Rule 55-540 sets forth a list of conditions, which, if *one or more* are present, absent compelling contrary persuasive factors, warrant the conclusion that the parties intended to enter into a conditional sale rather than a true lease. The factors include whether (i) some portion of the periodic payments is specifically designated as interest or is otherwise readily recogniza-

49. Emerging Issues Task Force of the Financial Accounting Standards Board Issue No. 97-1: Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special-Purpose Entities [hereinafter EITF 97-1].

50. Emerging Issues Task Force of the Financial Accounting Standards Board Issue No. 97-10: The Effect of Lease Involvement in Asset Construction [hereinafter 97-10].

51. See generally *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Hilton v. Commissioner*, 74 T.C. 305 (1980), *aff'd per curiam*, 671 F.2d 316 (9th Cir. 1982); Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 IOWA J. CORP. L. 445 (2000).

52. See Rev. Rule 55-540, 1955-2 C.B. 41.

ble as the equivalent of interest and (ii) the rental payments and any option price payable in addition thereto approximates the price at which the leased asset could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges. In a synthetic lease transaction, both of these factors are present.

Many transactions denominated as leases are triple-net leases, in which, during the lease term, the lessee bears all the economic burdens of ownership (i.e., maintenance and repair, expense of operation including insurance, risk of casualty, indemnification for tax, and other liabilities arising from ownership or operation). The lessee also realizes the benefits of ownership through the use of the property in its business while the lessor's benefit from the property is limited to the receipt of fixed rental payments. In analyzing triple-net leases, the courts and the IRS have focused on whether a substantial anticipated residual value of the leased property is available to the lessor at the end of the lease term, so that the lessor's actual economic return from the transaction will be influenced by the property's actual residual value.⁵³ These Revenue Procedures consider, among other factors, whether the lessor or lessee has a substantial investment in the property, whether the property is expected to have a substantial residual value and remaining useful life at the end of the lease term, and whether purchase options, put rights, or renewal rights at the end of the lease term impair the lessor's right to enjoy the residual value or transfer to the lessee the risk of any decline in the expected residual value.

Determining who bears the economic benefits and burdens of ownership requires an examination of the entire transaction. This examination will reflect that in a typical synthetic lease transaction, as will be indicated in more detail below:

- The lessee makes rental payments that are the equivalent of interest payments.
- The lessee has operational control over the property and assumes nearly all of the economic risks and burdens inherent in the property.
- The lessee has an option to purchase the property at its cost (and not a nominal amount). While the absence of a bargain option would normally indicate a "true" lease, the

53. See Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Proc. 75-28, 1975-1 C.B. 752.

option amount recovers for the lessor all unamortized principal it has advanced. If the lessee does not renew the lease or exercise its purchase option, it is required to arrange for a sale of the real estate. If the real estate is sold for more than the amount of the purchase option, the lessee receives the excess. If the property is sold for less than the amount of the purchase option, the lessee is required to make a substantial residual value guaranty payment so that the lessor bears only a ten percent residual value risk. Thus, the combined effect of the option, renewal rights, and residual value guaranty obligations of the lessee allocate to the lessee the benefits of upside appreciation and the risks of a decline in the residual value of the lease asset, except to the extent of a decline in the value of the property to ten percent or less of the property's original cost.

In light of these features, tax practitioners active in this area seem comfortable in concluding that the lessee should be respected as the owner for income tax purposes. Certainly, the tax characterization of the transaction as a financing would be enhanced if the documentation for a synthetic lease reflected an express intent of the parties to treat the lessee as the tax owner, and obligated all parties to report the transaction consistently.

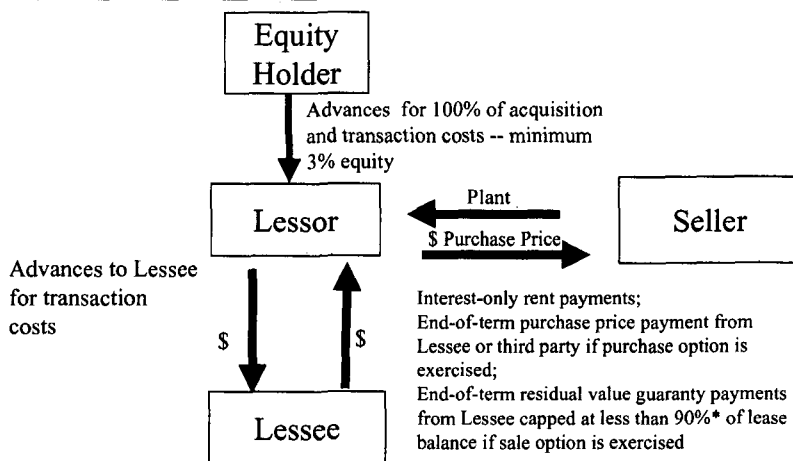
V. TYPICAL STRUCTURE OF SYNTHETIC LEASES

In its simplest form, a synthetic lease can be structured as a "single investor" lease, involving the acquisition of the power generation facility by an investor and the lease of the power generation facility to the lessee. While single investor transactions may be appropriate for certain equipment transactions and have been used for certain real estate facilities, a single investor transaction is unlikely to be the primary form for a synthetic lease involving a power generation facility, as the costs involved in the acquisition or construction of a power generation facility will exceed the amount that one investor likely would be prepared to commit to a transaction. Because these costs are substantial, the more likely form for a synthetic lease involving a power generation facility will be a syndicated transaction, in which a group of different funding sources collectively will provide the debt and equity needed for the transaction. Although a single investor lease is unlikely to be encountered in connection with the acqui-

sition or construction of a power generation facility, this Essay will describe the basic structural elements first of a typical single investor lease and then of a typical syndicated transaction, as they share many common structural features, and understanding how a single investor lease operates will facilitate the understanding of the syndicated transaction.

In a typical single investor lease involving a real estate facility, the lessor entity will acquire the facility and all associated personal property and then lease it to the lessee for a specified term. If the transaction is being used for construction of a new facility, the lessor will acquire an interest in the land and make advances to the lessee during the construction period for construction costs (including, in certain cases, capitalized internal labor costs), construction-period carrying costs (including interest or rent), and transaction costs and then, once the facility is completed, lease the facility to the lessee for a specified term. Synthetic leases typically involve medium-range terms.

“Single Investor” Structure for Acquisition of Plant



*See footnote 18.

The lease will include terms standard for a "hell-or-high-water" triple-net lease. Thus, the lessee will be obligated to pay all property and other taxes on the facility; to insure the facility; and to pay for all utilities, maintenance, and repairs; and the

lessor will disclaim any warranties regarding the condition of the facility. In addition, the lease will typically include certain financial, affirmative, and negative "enterprise" covenants that would be typical for an unsecured corporate credit facility. Depending on the particular case, these financial and enterprise covenants could include such covenants as a minimum net worth requirement, a maximum ratio of debt to net worth, minimum profitability, a minimum ratio of earnings to fixed charges or of liquid assets to current liabilities, as well as limits on investments, asset sales, mergers and acquisitions, liens, and changes in the control of the lessee. The lease will include obligations on the part of the lessee to deliver quarterly and annual financial reports and other periodic information. The lease will also typically include garden-variety covenants regarding corporate housekeeping, such as those requiring the lessee to pay income and other taxes assessed against the lessee, to remain in good standing, to comply with all applicable laws, and to maintain customary insurance for the lessee's business. If the true creditworthy party in the transaction is a parent corporation of the lessee, the parent corporation will provide a guaranty of the obligations of the lessee, and these financial and enterprise covenants would be applicable to the parent. The lease may also include cross-default provisions under which a default under other material credit agreements of the lessee would result in a default under the lease.

VI. RENTAL AND RESIDUAL VALUE GUARANTY OBLIGATIONS OF THE LESSEE

The lessee's rental payment obligations are typically the equivalent of debt service payments (frequently based on a spread over the London Inter-bank Offered Rate ("LIBOR") or a comparable index) on the acquisition and other costs advanced by the lessor. In large transactions, it is possible to obtain sub-LIBOR pricing using commercial paper funding vehicles, and private placements involving longer-term fixed interest rate rental terms have also been consummated. The lessee's debt service-equivalent rental payments are frequently interest-only payments, although they may include an amortization component to the extent that the leased asset suffers true economic depreciation over the life of the lease. The implicit interest rate embedded in the periodic rental payment will generally match the dis-

count factor used in calculating present value under SFAS's Ninety Percent Test. Thus, that portion of the lessee's periodic rental payments that are attributable to interest will have a zero present value for purposes of the Ninety Percent Test.

In addition to the lessee's obligation to make periodic payments of rent, the lease typically will also include certain payment obligations of the lessee that must be performed at the end of the lease term. In order to obtain the desired off-balance sheet treatment, both the lessee's periodic rental payment obligations and its end-of-term obligations must comply with the accounting rules in SFAS 13. However, these end-of-term obligations can be designed to assure that the funding source receives a recovery of its principal to the fullest extent permissible under the accounting rules. The obligations of the lessee under the lease to pay rent during the term of the lease and to make the end-of-term payments based on the amounts that the lessor has advanced can be analogized to the obligations of a borrower to make, respectively, debt service payments during the term of the loan and a balloon payment of unpaid principal at the end of the loan term. However, unlike a borrower, the lessee's obligation to make the end-of-term payments must be limited in order to comply with the accounting rules and, in particular, the Ninety Percent Test set forth in SFAS 13.

At the end of the lease term, the lessee typically will be obligated to perform one of two alternative obligations: either the lessee must purchase the property at a fixed price equal to one hundred percent of the aggregate unamortized amounts advanced by the lessor (the "purchase option") or must market the property on behalf of the lessor and cause the property to be sold to a third party buyer for a price equal to its fair market value (the "sale option"). If the lessee has not duly performed the obligations incident to the sale option and a sale of the property to a third party has not been consummated by the end of the lease term, then the lessee forfeits its right to exercise the sale option and must exercise the purchase option. In addition, if the lessee is ever in default under the lease, then the lessee loses its right to exercise the sale option and the lessor has the right to "accelerate" the lessee's obligation to purchase the property pursuant to the purchase option. As indicated below, the lessee may pledge collateral (other than the leased property) to secure all or some portion of its end-of-term obligations.

In the case of the purchase option, the lessee will purchase the property for an amount equal to one hundred percent of the amounts advanced by the lessor for acquisition costs and any additional advances made by the lessor (such as for construction costs, carrying costs, or transaction costs), less previous rental payments attributable to amortization of principal. An appraisal would be obtained at the inception of the transaction in order to confirm that the purchase option price is not a bargain option price (i.e., the amount to be paid would not be less than the projected fair market value of the project at the end of the lease term). Thus, if the lessee exercises the purchase option, the lessee will be obligated to make payments to the lessor that will make the lessor completely whole. The lessee usually has the right to assign its option to purchase to any other person (so long as the lessee is not relieved of its obligations). This is a valuable right, as the ability to assign the option permits the lessee to undertake a further synthetic lease financing with a new lessor entity, whom the lessee would designate as its assignee. The lessee could thus avoid taking the power generation facility onto its books at the end of the lease term.

In the case of the sale option, the lessee typically agrees to undertake to market the property to third parties during a specified marketing period for a price equal to the then-fair market value of the property. If a third party buyer is identified and if the purchase price paid by the buyer in connection with the sale is less than one hundred percent of the outstanding lease balance, then the lessee is obligated to make certain supplemental payments to the lessor. This payment obligation is usually referred to as the "residual value guaranty." Under the Ninety Percent Test in SFAS 13, in order to avoid capital lease treatment, the discounted present value of the "minimum lease payments" owed by the lessee under the lease (i.e., both normal, periodic rent payments and payments pursuant to the residual value guaranty) may not equal or exceed ninety percent of the fair market value of the property determined as of the commencement of the lease.⁵⁴ Thus, the maximum amount payable under the

54. In practice, the maximum amount guaranteed by the lessee pursuant to the residual value guaranty is normally in the range of 81-87% of the amounts advanced by the funding source. This is because a number of the costs that are financed—such as financing costs, transaction expenses, or other soft costs—may not be reflected in the fair market value of the property. Thus, if the lessee's obligation to make the residual

residual value guaranty will be structured so that, after taking into account any previous rental payments attributable to amortization of principal, the lease complies with this Ninety Percent Test.

Because the residual value guaranty limits the lessee's liability to less than ninety percent of the amount advanced by the lessor, if the third party sale option is exercised, the lessor accordingly bears the residual risk that the value of the property may drop below the unguaranteed portion of the amount advanced by the lessor. Thus, if the lessee's guaranty equaled ninety percent of the amounts advanced by the lessor, the lessor would bear the risk of loss resulting from the difference between the ten percent "unguaranteed" portion of the aggregate amount advanced and the price paid by the third party buyer. If the aggregate amount advanced by the lessor was US\$100,000,000 and the property has declined in value to US\$15,000,000 by the end of the lease term, the lessor will recover its entire US\$100,000,000 investment if the third party sale option is exercised, since the third party buyer will pay the US\$15,000,000 value and the lessee will pay US\$85,000,000 under its residual value guaranty (this would represent eighty five percent of the amounts advanced, which is within the Ninety Percent Test). If the property has declined in value to US\$5,000,000 by the end of the lease term, however, the lessor will not recover its entire US\$100,000,000 investment if the third party sale option is exercised, since the third party buyer will pay the US\$5,000,000 value and the lessee will pay only US\$90,000,000 of the US\$95,000,000 deficiency under its residual value guaranty (since a payment over US\$90,000,000 would exceed the maximum amount payable under the Ninety Percent Test). Thus, in this example, the lessor would bear the risk of a US\$5,000,000 loss (US\$100,000,000 - [US\$5,000,000 price plus US\$90,000,000 residual value guaranty payment]).

Under the typical synthetic lease, regardless of whether the

value payment is expressed in terms of an obligation to pay a percentage of the amounts advanced by the lessor, and if the amounts advanced by the lessor exceed the fair market value of the property (because they include soft costs that do not translate into an increase in the value of the property), the percentage of those costs that the lessee is obligated to pay as part of its residual value guaranty must be reduced to less than 90% to account for that fact. (For simplicity, this Essay presumes a 90% limitation.)

purchase option or sale option is exercised, the lessee receives the benefit of any sale price for the property that exceeds the amount advanced by the lessor. Thus, the lessee will have the ability to retain any appreciation in the value of the property over the lease term.

While nominally the transaction is in the form of a lease, the lessor's (and other funding sources') willingness to enter into the transaction is based upon an underwriting of (i) the creditworthiness of the lessee or a parent corporation that provides a guaranty of the lease (since the lessee or the guarantor will be obligated either to pay the purchase price for the leased property, or to pay the residual value guaranty), (ii) the income-producing potential of the leased property over the term of the lease (as that income will be available to make rental payments, which are attributable to interest and amortization), (iii) the residual value risk that the limitations on the lessee's residual value guaranty introduce, and (iv) the availability of collateral (independent of the leased asset) to secure the lessee's obligations. In light of these underwriting considerations, a synthetic lease can be viewed as a hybrid credit transaction involving elements of non-recourse project financing as well as recourse elements that depend in part on the creditworthiness of the lessee or its parent and in part on the availability of independent collateral.

VII. "A-B-C" SYNDICATION OF THE SYNTHETIC LEASE

Because the acquisition or construction costs involved with a power generation facility will be substantial, a synthetic lease involving a power generation facility is likely to be a syndicated transaction, in which a group of different funding sources will collectively provide the debt and equity needed for funding the transaction.

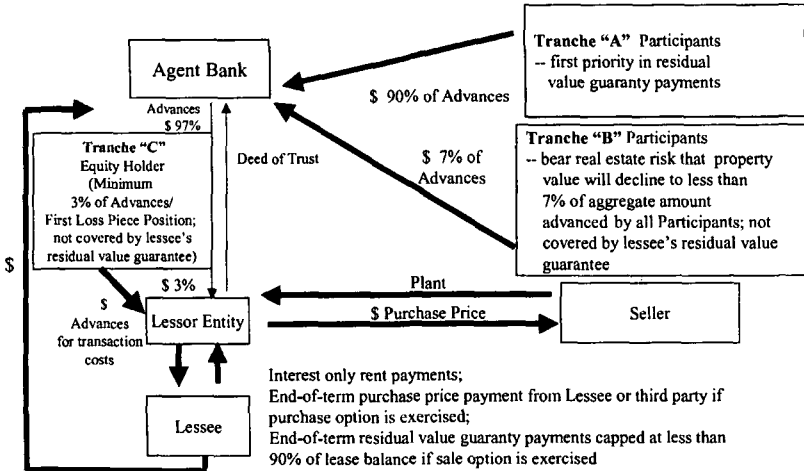
The most common form for a syndication involves the formation of a lessor entity organized as a trust and stratification of the financing for the transaction into at least three separate tranches: (1) the "A" tranche, representing the portion of the transaction that is covered by the lessee's residual value guaranty, which can range up to an amount just less than ninety percent, (2) the "C" tranche, representing the three percent minimum required equity injection into the lessor under the consoli-

dation rules, and (3) the "B" tranche, representing the remainder, and which, together with the "C" tranche, must be recovered exclusively from the proceeds of the sale of the leased property if the lessee exercises the sale option.⁵⁵ In the classic "A-B-C" structure, the A, B, and C tranches represent 90%, 7%, and 3% of the lease balance, respectively. The obligations of the lessor entity in respect of the "C" tranche are represented by certificates of beneficial interest in the lessor entity, and the "A" and "B" tranches are represented by evidence of indebtedness of the lessor entity. The holders of "A," "B," and "C" tranches are frequently commercial banks or their leasing company subsidiaries. (Although the A-B-C structure is common, there is no requirement that the tranches must equal the ninety percent, seven percent, and three percent amounts described above or that there be three classes of interests. So long as a minimum subordinate equity injection of three percent is made, the lessee's minimum lease payments do not exceed the Ninety Percent Test in SFAS 13, and the other SFAS 13 tests are satisfied. Additionally, the parties generally have the flexibility to structure the financing in multiple tranches having varying priorities in the lessee's residual value guaranty obligations and the assets pledged as security for the lease and financing.)

In a syndicated transaction, the lessor entity leases the property to the lessee under terms similar to those described above (i.e., pursuant to a "hell or high water," triple net lease, which requires the lessee at the end of the lease term either to purchase the property or to cause a third party to purchase it, in which case the lessee is obligated under its residual value guaranty). The lessor assigns the lease to the participants and may grant a deed of trust on its fee estate as security for its obligations to the participants.

55. As indicated above, the lessee's residual value guaranty must be pegged at less than 90% and is typically in the 81%-87% range. If the residual value guaranty was limited to 83% in an A-B-C transaction, the "A" tranche would equal 83%, the "B" Tranche would equal 14%, and the "C" tranche would equal three percent.

Classic "A-B-C" Syndication Structure Involving Borrowing by a Lessor Entity



In the classic A-B-C format, the "A" tranche is designed to have primary recourse to the lessee's residual value guaranty and the "B" and "C" tranches are designed to have primary recourse to the residual value of the leased property and thus bear the risk of declines in the value of the property to below the amount guaranteed by the lessee, with the "C" tranche bearing the first-loss position of three percent. The return to which the investors in the "A," "B," and "C" tranches will be entitled will reflect the higher risk associated with the "B" and "C" positions.

Investment-grade companies seeking synthetic lease financing for a power generation facility may also consider utilizing their creditworthiness to obtain better pricing for the "A" and "B" tranches than might be available under the typical LIBOR-based pricing offered by commercial banks. For transactions of a sufficient size, these companies might seek to access the commercial paper markets for the financing of certain tranches. A group of commercial banks will need to provide liquidity backup for the commercial paper. This type of transaction may also provide an alternative pricing mechanism so that the lessee has the option at any time to elect to pay rent based upon either the interest rate that the commercial paper issued under the program would yield, LIBOR, or the prime rate.

VIII. *COLLATERALIZATION OF THE LESSEE'S OBLIGATIONS;
"SELF-FUNDING"*

Independent collateral (other than the leased asset)—such as Treasury securities, cash deposits, or the build-up of a cash collateral “sinking fund” from excess project revenues over time—can be used in synthetic lease transactions to achieve several possible objectives. If Treasury securities or cash deposits are pledged by the lessee, a bank or other regulated funding source will be able to reduce the reserves and risk-weighted capital it must maintain for the transaction and may be prepared to pass this savings along in the form of a lower interest rate for so long as the collateral is maintained. Also, the funding source might be prepared to underwrite a longer term for the transaction or might be able to underwrite otherwise marginal lessee credit if collateral other than the leased asset is pledged. Regardless of the purpose for which the Treasury securities or cash collateral has been posted, in order to obtain the desired off-balance sheet treatment, the collateral can secure only the lessee's obligations under the lease—even if one hundred percent of the transaction is collateralized. Thus, if the lessee exercises the third party sale option, the Treasury securities or cash deposits can be used only to discharge the lessee's obligation to make the residual value guaranty payment (less than 90%) and will not be available to cover any remaining unpaid lease balance. (To the extent the collateral is actually employed to discharge the lessee's residual value obligation, of course, the full residual value of the leased property would be available as a source for the repayment of the unguaranteed tranches.) Moreover, in construction transactions, the accounting rules do not permit the lessee to deposit cash collateral directly with the lessor or lenders during the construction period, although the pledge of collateral to a third party trustee during the construction period may be permissible.⁵⁶

Lessees that are cash-rich or that have significant investment portfolios may still desire to obtain the accounting benefits of a synthetic lease even though they may not necessarily need to raise financing from outside sources to acquire or hold an asset. For these types of companies, a “self-funded” transaction can be

56. See Financial Accounting Standards Board, Emerging Issues Task Force, 97-10, § 9(a) (1998).

explored, where the lessee, in effect, will purchase all or a portion of the Tranche A interest in the lease facility and thereby use its own funds to provide a significant part of the financing. The portion held by the lessee may bear a nominal—or even a zero—rate of interest. It would still be necessary, however, to place the Tranche B and Tranche C interests with true third parties in order to preserve the desired accounting treatment. In addition, outside financing would need to be obtained even for the Tranche A position during the construction period for the asset.⁵⁷

IX. SYNTHETIC LEASES AND SALE-LEASEBACKS

Under SFAS 98, a lease of real property resulting from a sale of that asset by the seller-lessee and leaseback of the asset to the seller-lessee can be booked as a sale of the asset and an operating lease only if (i) the lease is a “normal leaseback” without continuing involvement in the leased asset by the seller-lessee that would result in the seller-lessee not transferring the risks or rewards of ownership of the leased property to the buyer-lessor (“continuing involvement” would include an obligation or *option* on the part of the seller-lessee to repurchase the property or a guarantee of the buyer-lessor’s investment or a return on that investment for a limited or extended period of time) and (ii) the lease contains payment terms and provisions that adequately demonstrate the buyer-lessor’s initial and continuing investment in the property. Because the lessee’s purchase option and residual value guaranty under a synthetic lease will comprise “continuing involvement,” synthetic leases cannot be structured using previously-owned improvements, and instead are consummated in connection with the acquisition of new sites or formerly leased locations.

It is possible, however, in the case of unimproved land owned by a putative lessee to structure a transaction involving a ground lease of that land to a synthetic lessor and a lease back of that land to a lessee as part of the synthetic lease. This type of ground lease/synthetic leaseback structure can offer significant benefits, in that (i) the lessee needs to raise financing only for the construction of improvements, (ii) through the retention of the lessor’s interest under the ground lease, the lessee retains

57. *Id.*

long-term control over the site, and (iii) by eliminating the land value as part of the leased asset, the lessee may position itself more readily to refinance the initial synthetic lease with additional synthetic leases going forward, without distortions to the accounting tests that appreciation in the land value may introduce. Some of these aspects relating to refinancing the synthetic lease are described more fully below.

X. *LESSEE INVOLVEMENT IN CONSTRUCTION OF THE LEASED ASSET*

FASB's Emerging Issues Task Force issued a pronouncement in 1998, EITF 97-10, that concerns the effect of lessee involvement in the construction of an asset on the accounting classification of a lease. This pronouncement addresses such features as lessee construction completion guarantees, the lessee acting as the general contractor or agent for construction, the lessee having the obligation to fund cost overruns, and lessee indemnification for construction period risks. Under these rules, a lessee will be considered to be the owner of an asset during the construction period if the lessee has substantially all of the construction period risks. (For accounting purposes, note that the term of the lease does not commence until the completion of construction or commencement of occupancy by the lessee.)⁵⁸ If the lessee is considered the owner of the asset during the construction period, the lessee's commencement of occupancy of the constructed asset pursuant to the lease following completion of construction will be considered a *sale-leaseback*, which will fail to satisfy the requirements for operating lease treatment under SFAS 98.

EITF 97-10 sets forth certain rules for determining whether the lessee has substantially all of the construction period risks and, therefore, should be considered the owner of the project during the construction period. Under the "Maximum Guaranty Test," the lessee will be considered the owner of the project during the construction period if at any point during the construction period, the sum of

58. See Financial Accounting Standards Board, Emerging Issues Task Force, 97-10, § 4 (1998).

- (a) the “accreted” value of any project costs previously made by the lessee,⁵⁹ plus
- (b) the present value of the maximum amount of project costs the lessee can be required to pay as of that point in time,

is ninety percent or more of the total project costs incurred to date (excluding land acquisition costs, if any).⁶⁰ Probability is *not* considered in the Maximum Guaranty Test. Thus, a transaction in which the lessee provides a full guaranty of completion or a guaranty to pay all cost overruns will not qualify for off-balance sheet treatment.

Under Sections 6 and 7 of EITF 97-10, the “project costs” that are included in the Maximum Guaranty Test include:

- (a) lease payments that must be made regardless of when or whether the project is complete (a “date-certain” lease),
- (b) payments under guarantees of the construction financing,
- (c) equity investments (or an obligation to make equity investments) in the owner-lessor,
- (d) loans or advances made to the owner-lessor or any party related to the owner-lessors, including time deposits pledged to the owner-lessor as security for the Lessee’s obligation,
- (e) payments made by the Lessee in the capacity of a developer, a general contractor, or a construction manager/agent that are reimbursed less frequently than is customary,
- (f) primary or secondary obligations to pay project costs under construction contracts,
- (g) an obligation to purchase the real estate project under any circumstances,

59. The project costs paid by the lessee are “accreted” (i.e., their value grows over time) based on the same discount rate that is used by the lessee to determine the net present value of the minimum lease payments under the Ninety Percent Test for purposes of SFAS 13 if that rate is known; otherwise the applicable construction borrowing rate is used. *Id.* at § 5.

60. *Id.*

- (h) an obligation to fund construction cost overruns, and
- (i) rent, transaction costs, or fees of any kind paid during the construction period.

Project costs do not include “normal tenant improvements.” EITF 97-10 expressly excludes from “normal tenant improvements” all structural elements, electrical wiring, HVAC systems, and elevators.

EITF 97-10 also sets forth certain additional indicia of project ownership by the lessee during the construction period, apart from the Maximum Guaranty Test. If these indicia of project ownership are present in a given transaction, the lessee will be deemed to own the project during the construction period and the subsequent lease will be a sale-leaseback, which will fail to satisfy the requirements for operating lease treatment under SFAS 98. These indicia include the following:

- (a) direct responsibility on the part of the lessee to pay any cost of the project other than pursuant to a “committed” right of reimbursement (note that a right of reimbursement may not be considered “committed” if the funds can be withheld for any reason other than misappropriation, willful misconduct, or bankruptcy on the part of the lessee),
- (b) indemnification for preexisting environmental risks that are more than remote,
- (c) lessee indemnities in favor of any party other than the owner-lessor or for third-party claims not caused by the lessee’s own actions or failures to act, and
- (d) if the lessee owns the land, construction commences before the lessee has ground leased the land to the synthetic lessor.⁶¹

EITF 97-10 has resulted in a number of structural changes in synthetic leases of assets to be constructed. As a result of the Maximum Guaranty Test, during the construction period all rent, carrying costs, and transaction costs must be capitalized and cash collateral cannot be directly held by the lessor. The lessee must have a “committed” right of reimbursement in place pursuant to the lease before it incurs project costs. In addition,

61. *Id.* at §§ 6 and 7.

“self funding,” in which the lessee holds the Tranche A position, is not available during the construction period and lessees cannot provide full guaranties of completion or against cost overruns.

The typical “post 97-10” synthetic lease will approach the construction period risks of delay, failure to complete, and cost overruns with provisions that, while not obligating the lessee to pay all project costs or complete by the scheduled completion date (for that would violate the Maximum Guaranty Test), provide incentives and disincentives for the on-time, on-budget completion of the project. Thus, if cost overruns are incurred or the project cannot be completed on-time, then (unless the lessor agrees to increase its funding commitment or to extend the completion date to address these problems) the lease will require the lessee at that time either to exercise the purchase option for one hundred percent of the lease balance or to “walk away” from the project (i.e., terminate the lease), forfeit its purchase option, and pay an amount that is defined to equal the maximum amount that the lessee may pay under the Maximum Guaranty Test. This amount will be equal to 89.9% of the “project costs” incurred to date, less the accreted value of any project costs previously made by the lessee. (To avoid the reduction in the lessor’s recovery that would result under the Maximum Guaranty Test from the accretion of project costs paid directly by the lessee, the lease documentation normally will prohibit the lessee from paying any project costs directly, and will require all project costs to be funded exclusively through advances by the lessor.)

Under Emergency Issues Task Force 00-13, “integral equipment” is considered real estate for purposes of lease classification. If the lessee makes a payment towards the purchase of integral equipment (which, in the case of a power plant, may include equipment such as turbines) in connection with the construction of a plant before it has a “committed” right of reimbursement, its ability to maintain off-balance sheet treatment for the plant will be compromised.⁶²

62. See Healey, *supra* note 37.

[T]he key is to get the synthetic lease structure in place before any payments of any kind have been made on the project, and since the long lead time from turbine order time to delivery time has now grown to as much as three years, the financing begins prior to the order being placed. It is often done before

XI. ADDRESSING INVESTOR RISKS

Investors interested in providing funding in the form of synthetic leases are concerned with the potential scenario under which the lessee exercises the third party sale option and causes the property to be sold to a third party for less than the amount not covered by the residual value guaranty. It is customary for numerous hurdles to be imposed upon the lessee's exercise of the third party sale option, such as burdensome notice provisions, conditions relating to the lack of any default, or conditions relating to the requirement for maintenance of the asset and requiring the price to be no less than the asset's fair market value. These conditions may make the exercise of this option unattractive or may simply make it easy for the lessee to "trip up" in attempting to exercise the sale option. These conditions will not necessarily affect the viability of the sale option from an accounting standpoint. In addition, the lender will usually expect an appraisal to be obtained, at the inception of the transaction, which indicates that the fair market value of the property, as of the expiration of the lease term, will exceed the unguaranteed residual amount at risk by a substantial coverage factor (such as 3:1). Additionally, in construction projects, it is not uncommon to find features that are designed to deal with the construction risks introduced by EITF 97-10 and that require the lessee to exercise its purchase option. The lessee can also "walk away" and pay the maximum amount payable under the Maximum Guaranty Test based on "hair trigger" determinations that cost overruns may be incurred or that the project may not be complete by the scheduled completion date.

In a synthetic lease for a power generation facility, it may be possible to enhance the security for the lessee's obligations with respect to some or all of the tranches of financing by folding into the transaction structure some of the types of collateral and revenue streams that have traditionally been used to credit-enhance project finance transactions. Thus, to the extent that some portion of a merchant power plant's output has been sold

the sites for plants have been selected, which results in somewhat of a leap of faith from bankers who are not privy to make decisions based on the lengthy due diligence process which accompanies more traditional deals. It does however guarantee that an off balance sheet financing can be done and offers flexibility for the specifics to be worked out down the road.

Id.

to a purchaser under a long-term power purchase agreement, a portion of the financing might be structured to have the primary security interest in the rights to payment to which the lessee is entitled under that agreement. To the extent that a merchant plant generates revenues in excess of the periodic rental payments, the lessee might be required to set aside reserves for fuel, scheduled maintenance, unanticipated maintenance, and future rent or residual value guaranty payments before it is allowed to distribute those excess revenues to its investors. The lessee of the plant might be established as a single purpose, bankruptcy-remote entity in order to insulate the financing sources from the risk of a bankruptcy triggered by problems with other assets or businesses of the lessee group, with the credit support for the transaction provided through a guaranty of that entity's obligations given by its creditworthy parent entity.

Depending on the structure of the transaction, investors may bear certain environmental risks or other risks of property ownership. These are covered by special lessee indemnification obligations, although in construction projects those indemnification obligations must be deferred until after the construction period except for limited indemnities for the lessee's own acts that are permissible under EITF 97-10.

A synthetic lease transaction involves certain legal issues and risks relating to characterization, since the lease may be viewed, either in bankruptcy, in a default proceeding, or for other purposes (such as compliance with applicable state usury laws), as a disguised mortgage.⁶³ Parties that enter into these transactions should understand that the lease may be treated for legal or bankruptcy purposes as a mortgage.⁶⁴ The lease documents may even include language granting to the lessor a mortgage on the lessee's interest in the property and other lender remedies, including, in deed of trust states, a power of sale. Moreover, in transactions involving one or more tranches of debt, the lessee itself might deliver a guaranty of the lessor entity's obligations to the funding source (again capped by an amount sufficient to comply with the SFAS Ninety Percent Test), in order to attempt

63. See John C. Murray, *Off-Balance-Sheet Financing: Synthetic Leases*, 32 REAL PROP. PRO. & TR. J. 193 (1997); Thomas R. Fileti, *Real Estate Off-Balance Sheet Financing (Synthetic Leasing)* 418 PLI/Real 1021 (Order No. N4-4603), 1997.

64. Bruce H. White et al., *Recharacterization of Synthetic Leases: How a Lease Becomes a Secured Claim*, 1999 AM. BANKR. INST. J. 20 (Nov. 1999).

to address concerns relating to the rejectability of a lease in a bankruptcy proceeding. In states such as California, which limit deficiency judgments or impose procedural hurdles upon the recovery of deficiency judgments, characterization of the transaction as a mortgage for state law purposes will impose a number of substantive and procedural limitations on the ability of the lessor or lender to recover the "guaranteed" portion of the transaction and may require the lessor or lender to look to the real property first for satisfaction of the lessee's obligations before pursuing a deficiency judgment against the lessee, which, if obtained, might be executed against other unencumbered assets.⁶⁵

XII. *LEASE MODIFICATIONS; UNWINDING OR REFINANCING THE SYNTHETIC LEASE*

Since synthetic leases typically are entered into for a medium term, the lessee must plan for the need to "refinance" or otherwise retire the synthetic lease at its expiration date. That refinancing or repayment can occur through (i) an extension of the term of the synthetic lease then in effect, perhaps with modifications to financial or other covenants, (ii) the sale of the leased property to the lessee pursuant to its purchase option, or (iii) the transfer of the property to a new purchaser designated by the lessee, with whom the lessee would intend to enter into a new operating or synthetic lease.⁶⁶

One of the problems associated with unwinding or refinancing a synthetic lease transaction, if the lessee intends to continue an off-balance sheet arrangement with respect to the leased asset, arises because the new lease arrangement resulting from either a modification of the existing lease or a new lease will re-

65. See CAL. CODE CIV. PROC. §§ 580(a), 580(d), 726 (commonly known as the "fair value," "anti-deficiency," and "one-form-of-action" rules).

66. A true sale to a third party, in which the lessee does not continue as the synthetic lessee under a new synthetic lease—either because the lessee no longer intends to use the premises or because the lessee intends to remain in occupancy under an operating lease that will be regarded as such both for tax and accounting purposes—will have tax consequences to the lessee, as the sale will be treated as a sale for income tax purposes, and thus could trigger gain if the price paid exceeds the lessee's basis and to the extent depreciation must be recaptured under Internal Revenue Code Section 1245 or 1250. While these tax consequences may be expected in the case of a complete divestiture by the lessee, they may be more surprising in the situation where the lessee retains an interest in the property under a lease characterized as an operating lease both for tax and for accounting purposes.

quire a new analysis as to whether that new arrangement constitutes a capital lease or an operating lease under SFAS 13.

If the value of the leased asset has increased over the term of the initial lease transaction and the new lease transaction is intended to involve simply a refinancing of the existing lease balance under the existing lease arrangement with no increase in the amount financed, the lease might violate the bargain option test under SFAS 13, because the lessee would have the right, in the new lease transaction, to purchase the property based on the amount financed in the initial synthetic lease even though the fair market value of the property at the time the new lease is entered into has increased beyond that level. The potential for appreciation in the value of the leased asset thus represents an impediment to the ability to maintain the property off-balance sheet over a long term.

One way to address this risk is to structure the initial lease (or subsequent leases) so that they involve a lease of improvements or equipment only, and do not involve a lease of land, as improvements and equipment will depreciate in economic value over time, whereas the land component typically involves the potential for appreciation in value. This structure would involve a ground lease of the land to the lessor and ownership of the improvements and equipment by the lessor. The improvements and equipment would be leased and the land would be subleased to the synthetic lessee. The purchase option of the lessee under the synthetic lease would involve the option to purchase the improvements and to step into the shoes of the lessor as the lessee under the ground lease. The rent payable under the ground lease would need to be a fair market ground rent so that the purchase option of the lessee to acquire the ground lessee's interest would not be viewed as involving an option to acquire the interest in the ground lease at a below-market rate. This can be handled by including in the ground lease periodic rental adjustment requirements so that the rent under the ground lease is reset at fair rental value from time to time, and thus would not represent at any time a bargain rent.

Another challenge that must be addressed in the context of refinancing the synthetic lease is whether the refinancing or repayment of the synthetic lease will introduce transaction costs that might be substantial. These costs might include documentary or similar transfer taxes on the transfer of the interest in the

land or improvements by the lessor to the purchaser (whether the lessee or the lessor under a new synthetic lease) and sales tax on the sale of equipment or other personal property by the lessor to the purchaser (again, whether the lessee or the lessor under the new synthetic lease). With structuring, some of these costs might be avoided. For example, if the lessor entity is a trust, it might be possible, in certain jurisdictions, to avoid certain of these costs by structuring the transfer not as a direct transfer of the leased asset, but rather as a transfer of the beneficial interests in the trust.

XIII. *SPECIAL ISSUES FOR DEVELOPMENT OF POWER GENERATION FACILITIES*

Although synthetic leases may provide power project sponsors with several advantages over more conventional forms of project finance, they also carry certain limitations and present special issues or complications when used to finance the acquisition or development of power generation facilities.

One limitation presented by synthetic leases as compared with other forms of project finance is their tenor. As the examples discussed above illustrate, synthetic lease financings tend to have a shorter term than traditional project financings, which can have a term of twenty years or more. The trend toward shorter-term project debt also has coincided with the movement of the electricity markets over the past several years away from long-term power sales contracts and toward a short term or "spot" market power sales by merchant or quasi-merchant plants. If the de-regulation problems experienced in California surface in other jurisdictions and fossil fuel costs continue to rise, financial institutions and public and private bulk power purchasers will become more wary of the market risks. Accordingly, the pendulum could again swing toward longer-term power sales arrangements as a hedge against market risk and increasing power production costs. This, in turn, could re-invigorate the demand for longer-term project debt.

Another issue concerns the collateral package supporting the financing. Project financings depend on a complete collateral package, which includes the plant and all of its tangible and intangible assets, including all contract rights, permits, accounts, and other assets. In a power generation project, the assets neces-

sary to make the project work would typically include intangible property, such as critical project contracts, including fuel supply and transportation agreements, energy sales agreements, if any,⁶⁷ and interconnection and transmission agreements,⁶⁸ as well as permits, licenses, and other governmental approvals that are necessary to operate the power plant. These project contracts and permits usually are not freely transferable or assignable. For example, although the assignment provisions of a given energy sales agreement may allow assignment to an affiliate of the project company or a collateral assignment to the project lenders, such provisions usually require the counterparty's consent for transfer to an unaffiliated entity. To the extent a synthetic lease financing requires a transfer of the project assets to a party (the lessor entity), the project sponsor or acquirer may have to obtain the counterparty's consent. Having to request such consent after the deal has been negotiated places the project sponsor or acquirer in a difficult bargaining position and may allow the counterparty to extract concessions. In order to preserve to the fullest extent the ability to finance the project on an off-balance sheet basis, the project sponsor should attempt, in negotiating project contracts, to include broad language in the assignment provision permitting assignments as required to enter into a synthetic lease.

67. Until recently, it has been fairly common for even "merchant" plants to enter into bi-lateral contracts for the sale of a certain portion of their electric or thermal energy output in order to support the revenue projections and facilitate financing. For example, Calpine's Pasadena Power Station sells a significant amount of energy to Phillips Petroleum, which owns the project site. See *CIT Funds Calpine*, PROJ. FIN. INT'L, Sept. 20, 2000, at 21. During the past few years an increasing number of "pure" merchant plants have been developed, which rely entirely on spot market transactions. It remains to be seen whether sure "pure" merchant plants will continue to be developed at the same pace in light of the de-regulation experience in California, where the new legislation again authorizes the creation of bi-lateral, long-term power sales agreements with generators as a price stabilization mechanism. On February 1, 2001, the California legislature passed a bill providing the necessary funding for the California Department of Water Resources to enter into long-term contracts for the purchase of energy for electric customers in California. CA A.B. 1a, 1st Extra. Sess. (Cal. 2001).

68. "Interconnection Agreements" between the project company and the local distribution company govern the operation and maintenance of equipment and facilities by which the plant is physically connected to the local distribution company's electrical system. "Transmission" or "wheeling" agreements set forth the pricing and other terms and conditions of the transmission service or transportation of power generated by the plant over the electrical transmission system of one or more electric distribution companies to purchasers at distant locations.

A similar problem arises with respect to the critical permits already in the name of the project sponsor. Once issued, such permits typically are not freely transferable. This could require the project sponsor or seller to make a filing with the applicable agency, comply with certain notice and procedural requirements and in some cases provide detailed financial and organizational information about the transferee. There is also a risk that this re-opening of the permitting process could result in the imposition of additional or different conditions based on changed circumstances or legal requirements since the permit was issued.

A further issue concerning the use of a synthetic lease may arise when the project sponsor has already incurred significant development or construction costs prior to financing. Sponsors of power projects often undertake significant activity in the name of the project company or proposed lessee during the development and construction period prior to financing. Power projects in particular are characterized by long development periods during which the project sponsor undertakes a variety of pre-financing activities, such as acquiring land rights, negotiating key project contracts, including fuel supply, energy sales, transmission and interconnection agreements, and obtaining permits, including conditional land use permits and air permits needed before construction can begin. If the development of the project has been costly or takes a long time, there is a risk that the soft development costs incurred by the sponsor (without a right of reimbursement) with respect to which such pre-construction or pre-financing activities may create problems under EITF 97-10 for the subsequent ability to finance the asset through a synthetic lease.⁶⁹ While it may be possible to avoid these accounting problems by transferring the project's assets to an unrelated entity at the time the synthetic lease is arranged, such a transfer may raise the same transferability problems noted above regarding permits and key project contracts in connection with acquisitions of existing power plants.

Further, as with any innovative financing technique that is based on tax and accounting rules and their interpretation, there is a risk of challenges or changes in law, regulation, or applicable accounting rules.

69. See *supra* note 62 and accompanying text.

CONCLUSION

Although the fate of energy de-regulation remains uncertain, demand for additional power generation capacity in the United States continues to surge. The boom in power project development has already created a need for new sources of capital and innovative project finance structures to meet the challenges of the rapidly changing energy market.

No one financing structure, no matter how new or innovative, is a panacea. Despite their complicated nature and inherent limitations imposed by the accounting rules, synthetic leases may be a project financing structure worthy of further consideration by power project developers and lenders exploring new sources of capital. The favorable tax and accounting treatment that synthetic leases offer may provide a valuable competitive edge to players in a maturing power game, as they confront the multiple challenges of containing financing costs, preserving equity, enhancing earnings, and maintaining balance sheets that will preserve their options to participate in a dynamic market where there is much demand for the development of new power plants.