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Stakeholders Say Scarce Renewable Energy Tax Equity Spurs Innovative Financing

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Expiration of the renewable energy production tax credit (PTC) at the end of 2013 and the anticipated step-down of the investment tax credit (ITC) from 30 percent to 10 percent after 2016 have set the stage for interesting changes in the renewable energy market, even while the fight to secure the future of these government incentives in discussions of potential tax reform remains in the national spotlight. Tax credit proponents have long argued that the renewable energy market has tremendous potential for continued growth, but that legislative unpredictability makes it difficult for developers and investors to plan ahead. "The biggest enemy to tax credits is uncertainty, it's the number one enemy," said Robert Cudd of Polsinelli.

However, renewable energy stakeholders argue that the industry's considerable challenges have also opened the door to great opportunities. Market participants are working on innovative ways to bring potential investors off the sidelines and to make financing renewable energy projects as cost-efficient as possible.

Debt and Tax Credit Equity

Lenders report an "abundance" of debt available. Andrew Redinger of KeyBanc Capital Markets said KeyBank provides senior debt to a variety of wind and solar projects that range from distributed generation to utility scale. Chris Diaz of Seminole Financial Services said that Seminole transitioned from financing 100 percent real estate to 90 percent renewable within the past few years, resulting in half a billion dollars in renewable energy debt financing since 2009.

Tax credit equity is a different story. "Lending has never been the issue," said Redinger. "There's more debt chasing projects than there has ever been; the issue is [tax credit] equity." Dick Rai of PNC Energy Capital agreed. "It's always been a constrained market and not one where tax equity has been freely available," said Rai.
Market participants estimate that while there are about 20 to 25 currently active renewable energy tax credit investors, only about 12 to 15 do multiple deals a year. Actively engaged investors include U.S. Bank, PNC, Bank of America, Wells Fargo and JPMorgan Chase. For smaller projects, the investor pool is even more limited. Experts estimate that only about four or five investors regularly invest in smaller transactions. "There are some new entrants, but largely in the $50 million plus range," said Rai, adding that PNC is one of the few investors committed to projects below that range.

Corporate investors in renewable energy include Google and Honda, but for the most part, the renewable energy tax credit equity market is still dominated by large banks and insurance companies. Marc Schultz of Snell & Wilmer said some banks that provided debt financing to renewable energy projects under the Section 1603 grant are now considering becoming renewable energy tax

continued on page 2

continued from page 1

credit equity investors. "These folks aren't necessarily the usual suspects for tax credit investing," said Schultz, differentiating them from investors who are already experienced in low-income housing tax credits (LIHTCs), new markets tax credits (NMTCs) and historic rehabilitation tax credits (HTCs). "It's a good sign that there's interest out there in the marketplace, but it takes some education to get [investors] comfortable with different tax equity structures."

Yuri Horwitz of SolSystems added that there are ample opportunities and reasons for new investors to get off the sidelines. "This is a compelling industry and we're providing investors the opportunity to participate in our growth," he said. Stakeholders reported that the ITC fetches about $1.30 per credit, with lows around $1.20 and highs up to $1.35. The internal rate of return (IRR) is typically 8 to 12 percent, or sometimes as high as 14 percent.

Yield Cos

Faced with the constrained availability of tax credit equity, industry participants are exploring other financing options. The yield co is one tool that has received considerable attention. Yield co investors buy shares of a portfolio of projects already in operation. Part of the cash flow is then paid out to the shareholders as dividends, while the rest can be used to finance future assets. NRG Yield, TransAlta Renewables, Pattern Energy Group and SunEdison were among the first to list their own portfolios of energy assets.

"Yield cos are an elegant solution to the lack of tax equity since they combine renewable resource projects generating depreciation and ITC with conventional generation projects producing cash flow but no tax benefits," said Cudd. "In effect, the renewable energy projects shelter the income from the conventional generating projects so that no 'tax equity' is required since it is internally generated by the portfolio."

Eli Katz of Chadbourne & Parke LLP agreed. He said, "The development of these public funding vehicles might change the industry, a sort of one-stop shop."

Diaz cautions that not every project is a fit for the yield co, and that investors will want to see "the best of the best" credit-worthy transactions in the pool of deals. "The downside is as yield cos become more popular, there will be fewer transactions that meet the tight credit requirements," said Diaz. "If some people are not as sensitive to credit, this could dilute the quality of transactions in the yield cos, and if that were to happen, it would hurt the overall market."

Project Types and Deal Structures

The solar photovoltaic (PV) industry continues to skyrocket. Experts attribute this growth to a variety of factors, including dependable technology and reduced system costs. "This is a compelling industry with a technology that is incredibly stable," said Horwitz. "The technological and tax risk in these investments is extremely low."

Distributed solar generation in particular is thriving, especially for school districts and small municipalities. "The migration from stationary utility scale power to distributed power is a major theme in energy markets right now," said Katz.

Rai called solar technology a "natural" fit for distributed generation because it is one of the few technologies that can be installed on-site. "Its growth is inevitable," said Rai. "I imagine the majority of transactions done, not necessarily in dollars, but in units, are in distributed generation."

In terms of project size, James D. Howard Jr. of Dudley Ventures said that there is a "tremendous amount of appetite" for bigger projects and "potential" for projects between $10 million and $20 million. He said smaller projects, however, remain a challenge to finance because they typically are not as cost-efficient for many investors.

Deal structures vary. Cudd added that collateralized loan obligations (CLOs) remain attractive for owners and sponsors of smaller projects because they can pool loans in an efficient structure. Others said the master tenant structure is becoming an increasingly attractive option, in part, because of the HTC safe harbor guidance the Internal Revenue Service (IRS) issued in Revenue Procedure 2014-12. Although the guidance is specific to single-tier or master tenant structures in HTC investments, Howard said it is still relevant to renewable energy and that it clarifies acceptable partnership structures.

continued on page 3

continued from page 2

Looking Ahead

Stakeholders said that, in addition to reauthorization of the PTC and extension of the 30 percent ITC, a handful of other legislative changes could support renewable energy growth by broadening the investor base. Cudd said that passing the proposed Master Limited Partnerships Parity Act (S. 795) would give renewables the same ability as the oil and gas industries to raise equity in public markets through master limited partnerships (MLPs). "It would open up a whole new arena of investors, namely the public," said Cudd.

The next step would be to pass legislation that would adjust passive activity loss rules and the at-risk rules that prevent the tax credits and depreciation deductions from being beneficial to individual investors. Though passing any legislative challenges is difficult, Schultz said the expanded investor pool would have an immediate effect on the industry, especially for smaller projects.

As legislative and regulatory changes are discussed in Washington, industry participants across the country continue to find more effective and efficient uses of financing resources currently available, while exploring new areas of potential growth. "The continued interest of more and more banks, insurance companies and corporations to both invest in and utilize the cost savings in their operations from renewable sources gives me a lot of optimism in the marketplace," said Howard. "It seems like [renewable energy] has been around for a while, but we're really at the beginning of all of this." ❖

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