How Yieldcos are Re-Shaping the Tax Equity Market

by Eli Katz and Michael Masri

The recent proliferation of yieldcos has begun to change the renewable energy landscape by ramping up the demand and price for renewable energy operating assets and accelerating a long-anticipated consolidation in the sector. The growth of this investment vehicle is also reshaping traditional project finance capital structures, most notably the tax equity structures used by yieldcos to monetize the tax benefits from their renewable energy assets. When choosing tax equity structures, we expect yieldcos to gravitate towards lease pass-through transactions and modified partnership flip structure, while largely avoiding sale-leaseback transactions.

This article explores some of the factors contributing to the growth of the yieldco vehicle, the tax profile of these entities and how tax equity structures are being redesigned to accommodate the needs of this new investor class.

For a host of reasons, yieldcos are a prime customer for tax equity investors and likely to continue to grow in importance in the foreseeable future. First, yieldcos generally do not have the ability to make optimal use of the tax credits and depreciation deductions generated by renewable energy projects. Second, yieldcos are, for the most part, power developers with significant and growing asset pipelines and strong access to the project debt and equity markets needed to round out a project's capital structure. Lastly, yieldcos or their sponsors generally have the experience to supply reliable asset management and operation services to its asset portfolio and the financial stability to provide the necessary guaranties and indemnities sought by tax equity investors.

The key tension point in structuring tax equity arrangements with yieldcos is the need to preserve a steady and predictable cash flow to the shareholders of the yieldco. This need for predictable and unimpeded cash flows means that yieldcos will generally gravitate towards tax equity products that are structured so that most of the project cash flow is distributed to the sponsor. Additionally, yieldcos are most sensitive to any feature in a tax equity arrangement that can divert cash flow away from its shareholders, such as project underperformance or the occurrence of indemnity events. Finding the right balance between the investment needs of yieldco shareholders and tax equity investors continues to be one of the principal challenges to the growth of yieldcos.

BACKGROUND ON YIELDCOS

Over the last 18 months, six yieldcos have gone public. NRG Yield was the first to access the public markets, followed by TranAlta Renewables, Pattern Energy, Abengoa Yield, NextEra Energy Partners and TerraForm. Initially designed as investment vehicles to acquire and hold operating projects developed by its sponsor, yieldcos have quickly morphed into acquisition vehicles, buying an increasing share of operating renewable energy assets. According to Bloomberg New Energy Finance, yieldcos already hold more than 7,000 MW of operating power assets, including hydro, small PV, wind, utility scale PV, solar thermal, gas and thermal energy. Based on planned expectations, operating assets held by yieldcos could exceed 15,000 MW in the near future. Some analysts are predicting the launch of up to 10 additional yieldcos in the next two to three years.

A confluence of market forces have resulted in a significant portion of yieldco holdings being concentrated in renewable energy assets. First among those is the high demand for dividend yielding assets in today's low interest environment. Also, renewable energy assets comprise a growing share of newly built power assets in the U.S., far outstripping the growth of other power sources. Yieldcos are a natural owner for renewable energy assets given their need to acquire a portfolio of long-term operating assets. Further, yieldcos solve a challenge for the renewable energy

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industry that has been struggling to access the capital markets through a tax-efficient vehicle. Industry groups have been actively lobbying for the expansion of real estate investment trusts and master limited partnerships. REITs and MLPs enable specialized industry groups (real estate in the case of REITs and oil and gas pipeline assets in the case of MLPs) to access the capital markets through a funding entity that is not subject to the corporate income tax. Without the benefit of a special funding vehicle, renewable energy developers seeking to access the capital markets would subject themselves to tax at both the entity and shareholder level significantly eroding the benefit of a lower cost of capital.

Despite some recent favorable U.S. Department of Treasury regulations and legislative initiatives, the renewables industry has largely come up empty on this front. Yieldcos can then be viewed as a self-help measure where sponsors use the tax benefits from renewable energy assets to synthetically create an entity that is not burdened by the corporate income tax. In their offering documents, most yieldcos have promised their shareholders a 10-year income stream that will be free from corporate level taxes.

YIELDCOS AND RENEWABLE ENERGY TAX BENEFITS

The tax benefits available to most renewable energy projects include tax credits and accelerated depreciation. Solar projects are entitled to an investment tax credit equal to 30% of project cost in the year it is placed in service. Wind, biomass, geothermal and other projects that began construction by the end of 2013 are eligible for either the investment tax credit or the production tax credit, a credit based on the amount of power produced. Most renewable energy projects are also eligible for accelerated depreciation, permitting a deduction for almost all of the cost of these projects over the first five to seven years of operation.

Most developers are unable to use all of the tax benefits and commonly finance their projects through various tax equity investments where they effectively barter these tax benefits to banks and insurance companies that can use them on a current basis.

As explained previously, yieldcos cannot trade away all the tax benefits from their assets because they need enough to shelter their income from the corporate tax. Yieldcos therefore are typically interested in holding some of their assets outside of tax equity financings, or structuring tax equity arrangements where some share of the tax benefits are retained.

Most renewable energy assets currently held by yieldcos have largely avoided the challenges of tax equity by acquiring projects that previously claimed the Treasury cash grant. The Treasury cash grant program expired at the end of 2011 with generous grandfathering rules. While this program was in effect, most developers elected to take a cash grant from the Treasury equal to 30% of the cost of a solar or wind project rather than entering into complex tax equity transactions with banks and insurance companies. A project that claimed the cash grant is ideal for a yieldco because the tax credit has already been monetized through the grant program, but the depreciation tax benefits remain available to the yieldco to shelter its income from the corporate tax. When the yieldco acquires the project, it will typically step-up the tax basis of the assets to its purchase price and then write off the purchase price over the next five to seven years. These assets are also not subject to the tax credit recapture rules that apply to projects that claimed the investment tax credit, making them easier to move in and out of a yieldco.

While yieldcos are expected to continue acquiring projects that claimed the cash grant, the availability of these projects are rapidly drying up, forcing yieldcos to find suitable investment products within the tax equity markets.

WHICH TAX EQUITY STRUCTURES WORK BEST FOR YIELDCOS

The three most common tax equity structures are the partnership flip, the lease pass through and the sale-leaseback. Yieldcos are likely to gravitate towards lease pass-through structures and modified partnership flip transactions while largely eschewing sale-leasebacks.

In a lease pass-through structure, the developer owns the asset and leases it to a tax equity investor. The tax equity investor typically agrees to make a large upfront rental payment to the developer and to then pay periodic rental payments under the lease as the project generates free cash flow. The developer and tax equity investor then elect to pass the tax credit thorough to the tax equity investor. While the tax credit may be passed through with this election, the depreciation deductions remain with the lessor who is considered the asset's owner for tax purposes. In some variations of this structure, the tax equity investor may also acquire an ownership interest in the lessor entity, thereby enabling it to claim some portion of the depreciation deductions.

The popularity of the lease pass-through structure has been increasing among yieldco investors. This structure fits well with the yieldco because it enables the yieldco to monetize the tax credits while retaining the less valuable depreciation deductions that can be used to shield its investors from the corporate income tax. In situations where the yieldco does not require all the depreciation deductions, it can divert some of these tax deductions to the tax equity investor by selling a share of its interest in the lessor entity. Moreover, the lease pass-through structure enables the yieldco to rely on a steady and predictable stream of cash flow from the rentals paid under the lease, with little risk of the cash being diverted away to service the tax equity investor.

The partnership flip structure has also drawn considerable interest from yieldcos, although the structures have changed somewhat to accommodate the needs of yieldcos.

In a typical partnership flip transaction, the investor is allocated 99% of the tax benefits during the first six years of operation, which amounts to nearly all of the tax credits and depreciation deductions available to the project. After the investor achieves an agreed upon yield, or in some deals, after a set period of time, the investor's share of the tax benefits is reduced to

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as low as 5%. Cash flow from the project is distributed among the tax investor and sponsor according to a specified formula that may vary widely from deal to deal. In some transactions, it is common for the developer to take 100% of the cash distributions until it recovers its capital investment after which 100% of the cash is distributed to the tax equity investor until it reaches a target yield. In other deals, the tax equity investor may take a specified share of the cash flow, say 40%, or a preferred distribution expressed as a percentage of its investment (say, 2% of its capital investment each year).

Historically, partnership flip transactions have been structured with sponsor "dry periods" during which most or all of the cash flow from the project is used to repay the tax equity investor's preferred return. Also, these transactions often contain cash override provisions, where the tax equity investor can sweep all or most of the cash flow upon the occurrence of certain specified events, such as project underperformance, change in tax assumptions or a breach of the sponsor representations or covenants. These dry periods typically don't work well for yieldcos that require a steady and predictable cash flow stream to pay dividends to its shareholders. Compromises emerged where tax equity investors have begun to structure transactions with cash sharing provisions that pay the sponsor some significant percentage of project cash flow and do not permit cash diversions to the tax equity investor beyond a certain cap, say 50% of project cash flow, regardless of circumstance. Some yieldcos have offered upstream guaranties to tax equity investors as a tradeoff to preserve consistent cash flow from their project companies.

Sale-leaseback transactions are likely to be the least hospitable tax monetization structure for yieldcos. In a sale-leaseback transaction, the developer sells its project to a tax equity investor and immediately leases it back. The sale transfers to the tax equity investor all the tax benefits associated with the project. The tax equity investor compensates the developer for these tax benefits in the form of reduced rental payments throughout the lease term. Sale-leasebacks are typically structured with long-term leases to permit the maximum tax deferral period and price based on a rent coverage ratio that requires most of the project cash flow to be used to make rental payments under the lease. Most sale-leasebacks in the market are sized in the neighborhood of 1.2 to 1.4 rent coverage ratios, resulting in little excess cash flow available to the sponsor. Yieldco investors looking for a steady stream of cash flow are therefore likely to be less enthused with this financing structure. Some sale-leaseback structures, however, particularly those with very high-coverage ratios may allow for sufficient sponsor cash flow far a yieldco. High-coverage leases, however, generally correlate with lower purchase prices, creating a less than optimal tax structures to the seller/lessee (e.g., lower tax basis and investment tax credit).

Yieldcos can therefore be expected to build asset portfolios that provide for steady cash flow and shelter from corporate income tax. The balance of their tax benefits are likely to be monetized with tax equity investors using structures that permit maximum cash flow certainty to its shareholders.

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