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Tax cut talk complicates renewable deals

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President Donald Trump's administration promised corporate tax cuts in hopes of stimulating business. In certain sectors, such as renewable energy, the tax cuts are actually posing more complications than benefits. Renewable industry players are now working out ways to structure deals to shift risk away from tax equity investors.

When Donald Trump was elected president, it wasn't his fossil fuel-friendly campaign promises that troubled the renewable project investors. It was his promise to reduce corporate taxes.

Trump proposed to reduce corporate tax to 15% from 35%. While many industry participants think the tax rate will ultimately end up at 20-25%, the reduction is expected to decrease tax equity returns on wind and solar investments.

Renewable projects are especially sensitive to tax reform because tax equity makes up roughly 50% of any given financing.

Renewable tax equity investors use either the production tax credit (PTC) or the investment tax credit (ITC) alongside the Modified Accelerated Cost Recovery System (MACRS) depreciation to reduce tax liability. With reduced corporate tax rates, tax equity investors will achieve lower tax benefits from depreciation.

This has led to two main changes in the way deals are structured.

First, tax equity investors are adding provisions in deal agreements to protect their returns under the reduced corporate tax rate scenario. These provisions have shifted risk to cash equity investors, some of whom are then offloading that risk to power purchase agreement (PPA) counterparties. It has also reduced the sizing of debt for renewable project financings.

Second, more tax equity investors are considering bonus depreciation with MACRS over standard MACRS. Standard MACRS spreads the deduction out more evenly over a multi-year period, while bonus depreciation with MACRS concentrates that deduction most in the first year of investment.

The possibility of a tax cut has delayed some financings but has not killed any deals, Conor McKenna, managing director at CohnReznick Capital Markets, told *InfraAmericas*.

Shifting risk

The prospect of decreased tax benefits has led tax equity investors to request provisions to guarantee their returns.

EverPower CEO James Spencer told *InfraAmericas* that these provisions shift risk away from tax equity investors to cash equity sponsors. A number of advisors said that investors began asking for such provisions after Trump was elected.

One such provision could, for example, extend the “flip date” for US renewable deals by one or two more years so that the tax equity investor can achieve its target after-tax internal rate of return (IRR).

US renewable deals are typically structured as a partnership flip, in which typically 99% of the wind or solar project’s tax benefit flows to the tax equity investor for the first 10 years before flipping to the cash equity investor.

Tax equity investors’ target IRRs for utility-scale wind and solar projects generally range anywhere from 7.25% to 8.5%, according to Vadim Ovchinnikov, managing director at Alfa Energy Advisors LLC. Mayer Brown Partner David Burton pegged that range at 6.75% to 9%.

The tax equity investor under another provision could also request a cash sweep provision where the investor is entitled to a larger share of the project’s distributable cash before the IRR is achieved. IRR would then be achieved over the originally-expected period.

Another variation of the provision is an indemnity supported by a guarantee, where the tax equity investor requires the cash equity sponsor to make a payment in the event a tax rate cut reduces the tax equity investor’s IRR. This option tends to be less popular with the cash sponsors because it means they must reserve balance sheet cash to prepare for this contingency, advisors said.

“The market practice is still sorting itself out,” Burton said, noting that he has seen all three variants.

Cash equity sponsors or developers are in turn responding to this shift in risk by changing the terms of power purchase agreements.

“Most developers have an adjustment mechanism in their [PPA] pricing which keeps them whole under various lowered tax rates,” Spencer said. “The only way to make up for this risk is through an increase in power purchase rates.”

All three provisions have repercussions for renewable project lenders because they size their debt commitments based on the revenue received by the cash equity sponsor, advisors said. Provisions protecting tax equity returns have caused lenders to decrease the percentage of senior debt on a given wind or solar project.

Bonus depreciation’s appeal

The possibility of a corporate tax decrease has also made bonus MACRS depreciation more attractive to tax equity investors compared to standard MACRS.

MACRS depreciation is an IRS provision that allows corporations such as Google or JP Morgan to deduct a greater value of their investment in wind or solar assets during the first few years of the assets’ life. It effectively creates a tax shield in addition to the PTC and ITC.

A reduced tax rate would decrease that tax shield in any given year, according to Burton.

For example, if a tax equity investor wants to depreciate a USD 100m wind project in the first year of investment the bonus with five-year MACRS schedule allows the investor to deduct 60% of the tax basis of the project, or USD 60m.

At a corporate tax rate of 35%, that tax benefit converts to USD 21m. But if tax rate decreases to 20%, the tax benefit decreases to USD 12m.

Before tax cut talks, tax equity investors could be assured of the same cumulative tax shield using either regular MACRS or bonus depreciation, according to Burton.

Year	Standard 5-year MACRS	Tax rate if no tax reform	Tax benefit
1	15%	35%	5.25%
2	25.50%	35%	8.93%
3	17.80%	35%	6.25%
4	16.66%	35%	5.83%
5	16.66%	35%	5.83%
6	8.33%	35%	2.92%
		Total tax benefit	35%

Year	Bonus w/5-year MACRS	Tax rate if no tax reform	Tax benefit
1	60%	35%	21%
2	16.00%	35%	5.60%
3	9.60%	35%	3.36%
4	5.76%	35%	2.02%
5	5.76%	35%	2.02%
6	2.88%	35%	1.01%
		Total tax benefit	35%

Source: Burton

Burton said that investors have tended to opt for standard MACRS because they preferred to use their tax capacity against tax credits that would provide a financial statement earnings benefit. Depreciation from a financial statement perspective would only provide a timing benefit.

However, a decrease in tax rate would raise the tax shield under bonus MACRS compared to the standard MACRS. Assuming a tax cut to 20% starting in 2018, a given investor gains USD 6.76m more in tax benefit from bonus MACRS compared to standard MACRS.

The tables below demonstrate how bonus MACRS yields higher tax benefits compared to standard MACRS if tax rates decrease.

Year	Standard 5-Year MACRS	Tax Rate if Tax Reform in 2018	Tax Benefit
1	15%	35%	5.2500%
2	25.50%	20%	5.1000%
3	17.80%	20%	3.5600%
4	16.66%	20%	3.3320%
5	16.66%	20%	3.3320%
6	8.33%	20%	1.6660%
		Total tax benefit	22.24%

Year	Bonus w/5-Year MACRS	Tax Rate if Tax Reform in 2018	Tax Benefit
1	60%	35%	21.0000%
2	16.00%	20%	3.2000%
3	9.60%	20%	1.9200%
4	5.76%	20%	1.1520%
5	5.76%	20%	1.1520%
6	2.88%	20%	0.5760%
		Total tax benefit	29%

Source: Burton

Tax equity appetite

Tax equity investors don't only rely on renewable projects to reduce tax liabilities. So an overall decrease in corporate tax rates could mean reduced appetite for renewable tax equity. Industry advisors, however, said they do not foresee diminished demand from tax equity investors – many of which are financial institutions or insurance companies with large tax liabilities.

"We've seen [the tax equity pool] expanding," said McKenna. "More new participants are coming in because there are more taxpayers interested in investing in the renewables market," he said.

Ovchinnikov said that the firm has seen an increasing number of European companies with US taxable income showing interest in renewable tax equity. "The US is always considered a safe haven for capital, and those investors seem to like US renewable projects," he said. "I don't think there will be any shortage in capital."

McKenna characterized the tax cuts as a short-term market disruption. "I think there is a fair amount of capability on the part of the market to be resilient after [tax] adjustment," he said.

The potential for lower tax rates have generally led M&A deal participants to scrutinize deals more

Effect on M&A transactions

before closing, said McKenna.

“In some of our most recent sell-side advisory mandates, we calculated multiple tax rate change scenarios to determine the right transaction terms and address buyer risk concerns,” he said.

Keith Martin, partner at Chadbourne & Parke, said some buyers in M&A transactions are requesting “schmuck insurance,” a one-time price reset on the asset in case tax cuts are enacted.

A renewable M&A advisor told *InfraAmericas* that smaller developers will find it harder to meet the demands of tax equity investors considering tax reform uncertainty. This could lead to more consolidation, the advisor said.

“Smaller developers struggle anyways and oftentimes end up selling to larger developers,” Burton said. “Certainly the [tax reform] is not going to make life any easier for them.”

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