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Renewable Energy

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Questions & Answers

Below are responses to questions we were unable to answer during the Structuring, Modeling and HLBV Accounting for Tax Equity Webinar on June 29, 2016.

1. **QUESTION:** What gives large balance sheet players an advantage in obtaining workable power purchase agreement (PPA) prices for utility scale solar?

ANSWER:

The short answer is there at least five factors:

1. They have more employees and consultants looking for PPAs in more geographies;
2. Each offtaker has its own PPA bid process, but if deposits or fees are required to bid on a PPA or to be awarded a PPA, large players can more easily meet such financial requirements;
3. Some of these “large players” are manufacturers, or affiliates thereof, so they may be open to accepting a lower PPA price in light of the profit they will make manufacturing modules for the project (or the cost they would avoid by otherwise having a factory operating at sub-optimal levels);
4. If everything else in two bids is equal, the offtaker will almost always select the larger and better known bidder; and
5. If the large player has sufficient tax appetite that it does not require a tax equity investor, it can save the considerable expense associated with tax equity and accept a lower PPA price.

2. **QUESTION:** What size of transaction supports the cost of the work needed for pass through and inverted leases?

ANSWER:

That varies by situation. For instance, some of the larger institutions only consider transactions in which they can make at least a $25 million investment. Further, the transaction costs can vary based on factors such as whether the tax equity investor requires a tax opinion and whether the parties have “precedent” documentation they have previously agreed to.

Small transactions already have a strike against them, as from the financier's perspective it requires the same amount of work to underwrite and close a small transaction as it does a large transaction, so it is more efficient for the financier to pursue larger transactions. A developer may not want to further saddle a small transaction with one of the less common structures.

3. **QUESTION:** Is there clarity as to a "reasonable" level of developer, project management, legal fees and finance costs as a percentage of the cost of the project?

ANSWER:

The first item referenced in the question is *developers fees*. Developer fees are a complex topic.

A comprehensive discussion of the issue is available at https://www.taxequitytimes.com/2014/11/project-finance-developer-fees-explained/. Here are some highlights: Treasury more than five years ago published guidance for the, now lapsed, Section 1603 cash grant program that advised that a developer fee of 10 to 20 percent of the cost of the project was appropriate. The cash grant program generally follows the investment tax credit rules, so it is logical that Treasury's guidance would also apply to the investment tax credit. That guidance still appears on Treasury's web page, but in awarding cash grants Treasury for some projects awarded less than 10 percent and informally advised certain applicants that the 10 to 20 percent was no longer its guideline. The appropriate size of developers is one of the issues being litigated in the Court of Federal Claims by certain cash grant applicants who are asserting that Treasury inappropriately paid them a smaller cash grant than they had applied for. Aspects of that litigation are discussed at https://www.taxequitytimes.com/2016/02/court-federal-claims-fumbles-section-1603-discovery-dispute/.

Project management fees vary by technology and geography. For instance, a wind project is more labor intensive than a solar project. Further, the cost of project management per Kilowatt declines as projects are larger. Also, labor costs vary by geography. For instance, labor costs are higher in Hawaii than they are in the Midwest.

In terms of legal fees, the operating agreement for a limited liability company in a flip transaction takes the same amount of time to draft and negotiate for a $2 million transaction as it does for a $200 million transaction. Factors that can lead to efficiencies and lower legal fees are using precedent papers and agreeing to a detailed term sheet.

In terms of finance costs, of course, those are set by the capital markets. Other than macroeconomic factors, the financing costs will vary based on the nature of the financing and the quality of the offtake arrangements and equipment. If the project owner requires only senior secured debt for a project using "tier 1" equipment and an investment grade offtaker, the financing costs are going to be much lower than a project owner who requires construction financing, tax equity and back leverage for a merchant project using "tier 2" equipment.

4. **QUESTION:** For SolarCity stated tax equity returns in 2015 referenced in the presentation, in your experience, what have you generally seen the range of allocations for returns to be?

ANSWER:

The question uses the term "allocations." In tax parlance and as used in partnership and limited liability company agreements, "allocation" refers to the sharing of tax attributes. Typically, the tax attributes (*i.e.*, the allocation of profit and loss) are shared 99 percent for the tax equity investor and one percent for the developer prior to the flip and then after the flip five percent for the tax equity investor and 95 percent for the developer.

However, the context of the question suggests that the reference to “allocation” is intended to refer to the sharing of available cash flow. Partnership and limited liability company agreements refer to this as the “distribution” percentages. Cash distribution percentages vary greatly by transaction. Generally, the more cash in excess of the value of the tax credits that the tax equity investor contributes to the transactions, the greater the tax equity investor's cash distribution percentages will be. The flip partnership safe harbor in IRS Revenue Procedure 2007-65 mandates that the tax equity investor's share of post-flip cash cannot be less than 5 percent.

The SolarCity investor presentation that our materials quoted refers to the tax equity investors having the right to 30 to 40 percent of the cash pre-flip and 5 to 10 percent of the cash after the flip. That presentation is available here: http://files.shareholder.com/downloads/AMDA-14LQRE/0x0x830612/1A32ABBC-4024-44B9-8F81-1B5BD77DD00B/2016.06_SCTY_Investor_Presentation.pdf