Production Tax Credit Extension Means Greater Short-term Investment

But does it mean a more likely phase-out?

By John Marciano

Congress finally got around to extending the production tax credits (PTCs) and investment tax credits (ITCs) for wind, geothemal, biomass, marine, landfill gas, and hydro projects. That is not news. However, in extending these credits, a precedent was set for future tax credit policy. Developers can prop open a closing tax credit window by starting construction of a project this year. This is a double-edged sword. It will spur investment in the short-term, but it could also provide Congress with a palatable pathway to ramp down these incentives.

Ineffective carrots

Tax credits are carrots that spur development of a nascent industry. However, Congress wants incentives with large, short-term gains, but little long-term budgetary effect. When it comes to renewable projects, this is a real dilemma.

Wind power provides an easy example. Under the old rules, if a project was placed into service by "X" date, you received a tax credit. In the most recent iteration, wind projects placed in service in 2012 generated a 2.2¢ credit for each kilowatt-hour (kWh) sold to a third-party for 10 years. Congress used the in-service deadline to prod early investment. Granted, the policy had good intentions, but it was flawed.

Using an in-service deadline does create a sense of urgency if the deadline isn't too far down the road. But it often fails to provide a sufficient runway to get project development up to speed. The tendency has been for Congress to extend the deadline until the end of the current year.

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These intentions are good. The problem is that credits have been needed to make projects economical. Most developers couldn't start developing a project until they had certainty around tax credits. A one-year deadline gives a windfall to projects under development; it does little to help new projects move from planning to implementation. Perhaps more importantly, the uncertainty prohibits new investment in manufacturing. That keeps costs high, limits job creation, and stunts the industry's development.

Back in 2009, Congress did extend the tax credit deadline by four years for wind (and five for other technologies)—which was effective in promoting short-term investment in new project development and manufacturing, at least temporarily. However, as the deadline approached for wind last year, we saw investment in new projects fall off a cliff. There wasn't enough runway to get to completion. Plus, because the deadline for wind differed from that for other technologies, it meant investment flowed downhill to easier, more certain opportunities.

A working carrot

The latest extension sticks with the theme of creating artificial urgency to invest. But Congress did it right this time, albeit a two-year extension would have been better. The urgency is coupled with a goal developers actually can meet. This time, wind, geothermal, biomass, landfill gas, hydro, and marine projects that are under construction by year-end will qualify for 10 years of PTCs, or a 30% investment tax credit.

Moving away from the completion hurdle permits an exponential expansion of development. A little spending today buys access to certainty on a project that could take years to develop (producing many jobs along the way), if certain benchmarks are met. It also means all development won't cease at the same time as the deadline approaches. Projects will be completed over the next few years on a staggered basis.

This has the effect of phasing out the credits. Each year, fewer and fewer projects will get access to the credits. Congress' hope is that this gradual ramp-down of credits will give the industry time to reduce costs, save jobs, and remain viable.

Starting construction

Now that the tax credits are back in place, starting construction must be defined for new projects. Sources say the government is leaning toward a start of construction definition that's similar to the one used for Treasury's 30% cash grant program. This should mean a developer would start construction by beginning physical work on a site, or start work offsite under a binding contract. The IRS is also expected to adopt a similar safe harbor that deems construction to start if the owner "incurred" more than a set percentage (five percent under the grant rules) of a project's costs by the end of the year.

The main issue at this point is whether any parts of the Treasury cash grant rules fail to translate for use with production tax credits. It's worth noting that PTCs are tied to a "facility." The cash grant program focused on "units of property." For instance, each wind turbine (and its tower and pad) is a unit. The Treasury's cash grant rules permitted project owners to treat all of a wind farm's units (turbines) as a single facility. The industry is hoping for a similar rule under the new PTC regime. If granted, the rule would permit spending on a single turbine to count toward an entire project's start of construction analysis.

Investor demand

The owner of a wind, biomass, geothermal, marine, landfill gas, or hydro project can claim production tax credits, or a 30% investment tax credit *in lieu* of PTCs, and also depreciate—or deduct—all, or most, of the cost of the project. Most developers try to barter tax benefits to large corporations in exchange for cash infusions because they cannot use the benefits efficiently.

There are three common ways to barter tax benefits and still retain control over the facility: partnership-flip, sale-leaseback, or inverted lease. All three are available for ITC deals. Only partnerships are available for PTC deals. One would think that an investor would prefer ITCs because the benefits are immediate. However, while the ITC does have its advantages, many investors prefer the PTCs.

Given the recent recession, many investors have limited capacity to allot to tax benefits. Because PTCs accrue over 10 years, investments in these tax credit deals make a smaller dent in an investor's tax capacity than ITC deals. This levelizes the yields and permits an investor to spread risk among several projects. PTCs also permit flexibility to invest in a project over time. Making only part of its investment up-front reduces the extent to which the investor will face operational risks.

Lease transactions often provide an opportunity to increase the value of ITCs. However, they are not available for PTC transactions.