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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Tax Equity Financing Lures Corporations To Renewables

By **Liz Hoffman**

Law360, New York (March 06, 2012, 3:33 PM ET) -- In December, a utility-scale solar project in California got a $94 million lifeline to help it finish construction and plug into the Sacramento municipal grid. The money didn't come from a deep-pocketed Wall Street firm but from tech giant Google Inc., under a little-used tax structure that could be the next boost for renewable energy development.

Hoping to spur more corporations to follow in Google's step, the White House will host representatives next week from 79 of the country's biggest companies to discuss the investment structure, called tax equity financing, which allows businesses to offset their federal taxes by investing in clean energy.

It may not be an easy sell, experts say. Tax equity is complex and offers modest returns. It's also way outside the comfort zones of many Fortune 500 retailers or manufacturers.

But industry observers say it could provide badly needed financing for renewable energy projects, which are reeling from the expiration of the federal cash grant program, and offers clear benefits to companies willing to invest.

“There's a hole in the capital structure, and I think we'll see a whole bunch of nontraditional companies come in to fill it,” said Allan Marks of Milbank Tweed Hadley & McCloy LLP, which represented Google in the Sacramento investment. “I think the industry is counting on it.”

Renewable developers are facing a financing crunch, even as demand for their power grows. The Section 1603 cash grants, which reimbursed up to 30 percent of a project's cost, expired at the end of 2011. Certain wind tax offsets will run out at the end of this year without congressional reauthorization. Credits for geothermal and biomass will follow in 2013.

“Financing is still very tight and very expensive,” said Arnie Grant, a tax partner at Reed Smith LLP's Chicago office. “The sector needs a spark."

The Obama administration is hoping corporate America can provide it. The invitees to the March 13 White House summit reportedly include Exxon Mobil Corp. and The Walt Disney Co., according to a copy of the invitation obtained by the Wall Street Journal. The U.S. Department of Energy confirmed the meeting, but declined to name any invitees.

Energy Department senior adviser Richard Kauffman said the meeting is meant to connect companies that have already invested in renewable tax equity with “a promising list” of companies that have not. The agenda includes talks by executives from Google, JPMorgan Chase & Co. and U.S. Bancorp., all big tax equity investors.

“There's no inherent reason why this should just be an investment opportunity for financial firms, and we'd like to spread the word a bit,” Kauffman said.

Tax equity financing works by shifting tax breaks from developers, who usually don't have enough profits to use them, to investors who do. Investors also get a share of future revenues or an equity stake in the project, which usually generates returns of between 8 and 10 percent. The annual tax benefits can run in the tens of millions of dollars.

The market has historically been dominated by about a dozen financial institutions, including JPMorgan, Bank of America Corp., GE Capital and insurance giant Metlife Inc.

But experts say more cash-rich businesses should consider it, especially technology or energy companies whose expertise or corporate personalities are good matches for clean energy. A company that already knows how to evaluate an energy asset, like Exxon, or one that is committed to zero-waste factories, like carmaker Subaru, could be a good fit.

So could America's biggest company, Wal-Mart Stores Inc., which has installed rooftop solar panels on stores in Arizona, California and Puerto Rico, and has $7 billion cash on hand, according to regulatory filings.

“These investments are a way for companies to lessen their tax burden and boost their green credentials,” Marks said. “For a company that cares a lot about both of those things, it's a win-win.”

Consider Google. The $200 billion tech giant has made eco-friendliness a centerpiece of its operating credo, powering its data centers with wind energy and using goats to cut the lawns of its Mountain View, Calif., headquarters.

In 2011, it invested $542 million in three large-scale solar projects. These investments will shave millions off its federal tax bill come April, and also include some portion of the projects' annual cash flows, under terms a spokesman declined to comment on.

The upside for all parties involved is clear: Investors get tax breaks, developers get enthusiastic corporate partners and the Obama administration gets to support renewable energy without having to make or guarantee loans, which has proven politically dicey, as in the case of Solyndra LLC, the solar panel manufacturer that went bankrupt last summer.

But the group of tax equity investors has remained stubbornly small, mostly limited to the traditional project finance banks and financial firms.

It got even smaller during the recession, as banks' need for offsets evaporated alongside their profits. In 2007, 20 financial companies made investments worth about $6.1 billion, according to the U.S. Partnership for Renewable Energy Financing. In 2009, half of those investors were gone and total transactions were just $1 billion.

The investment pool has rebounded slowly, and falling profits in 2011 from several major Wall Street firms likely won't help, according to experts.

“I don't think you're going to see huge new investments from the same group of companies that's been doing this for years,” Grant said. “You need to broaden the investor base.”

Tax equity financing is complex and technical, which makes it expensive. Due diligence, tax work and negotiating equity stakes and sell-back provisions can quickly run up legal bills, Akin Gump Strauss Hauer & Feld LLP tax partner David Burton said.

Other companies may have better things to do with their profits. Capital spending fell during the recession as businesses shelved plans for new stores or product rollouts. As profits bounce back, these companies may prefer to invest internally, according to Burton.

“For a financial company that borrows at 3 percent and can earn 8 or 9 percent on tax equity, that's a pretty nice deal,” he said. “But if you're a manufacturing or a retail company and you think you can make 20 percent on a new store or a new factory, it makes less sense.”

In addition, tax equity relies on sustainable, predictable profits, which have been in short supply since 2008. The production tax credit, which rewards each kilowatt of power produced, runs for 10 years; if an investor only has enough profits in six of those years, the value of the deal drops.

John Hancock Financial, Prudential Financial Inc. and Citigroup Inc. were all driven out of tax equity financing by falling profits, and their experiences could be a cautionary tale, experts say.

Kauffman said the Obama administration is well aware of some of the challenges, but thinks the benefits outweigh the costs for some of the U.S.' biggest companies.

“This is a chance for a company to take some of its cash and in a relatively low-risk way, support the renewable energy sector," he said. "We think there is interest.”

--Editing by Christie Smythe and Andrew Park.

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