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Tough Economy Squeezes Role of Tax-Equity Investors

As political debate swirls over the future of federal incentives for US renewable energy, the role of investors has been somewhat overshadowed. The remaining programs, dominated by tax credits, only work if a developer has enough taxable income to benefit from them, but many renewables-focused companies generate little or no taxable income early on. That hurdle can be overcome with a tax-equity investor — an entity with lots of income that takes an ownership stake in a project and, through complex financial structures, uses the credits to defray its own sizable tax bill. But relatively few investors are willing to do such a deal — and the amount of capital available is tight, insiders say.

The main federal incentives are based on reductions of tax liability, including investment tax credits (ITCs) equivalent to 30% of a project's construction costs, and production tax credits (PTCs) worth 2.2¢ per kilowatt hour over 10 years (NE Jun.14'12). Enter tax-equity investors, who won't usually fund an entire project, but will provide enough capital to ensure it can secure debt financing and deliver an acceptable rate of return (NE Jun.7'12). Because of the size of the tax burden required, it is "essentially a market that is dominated by the major financial investors," says Mohammed Alam, president of consultancy Alyra Renewable Energy Finance. Around 20 players are active, including GE Capital, Bank of America Merrill Lynch, JPMorgan Chase and Credit Suisse, with a smaller presence by insurance companies like MetLife.

While efforts by the renewables industry and Obama administration to enlist nonfinancial players have borne some fruit — Google entered the market in 2011 and oil major Chevron pledged funding this year — the complexity of the transactions, lack of familiarity with the sector and a low appetite for risk have deterred most. Michael Zimmer, a project finance attorney at law firm Thompson Hine, says seven new companies have internally authorized tax-equity investments over the past year, but none has made a move yet.

The amount of tax-equity capital available in a given year is also limited by corporate profitability, making the market vulnerable to broader economic ups and downs. The financial crisis from 2007 took a heavy toll, particularly on banks. To spur investment in renewables, the Obama administration in 2008 introduced one-time cash grants as an alternative to tax credits, but these expired at the end of 2011. Demand for tax equity is expected to grow again, yet the banks are still struggling; between the European debt crisis and the sluggish American recovery, they are unable to predict how much tax equity they'll be able to afford. "Tax credit investments are not feasible right now for many financial investors," Alam says, adding that they really need "a good sense of taxable income not just this year or next year, but four, five, six, seven years down the road." Even existing tax-equity investments may be cut back if quarterly profits come in lower than expected, says attorney Zimmer. The American Council on Renewable Energy sees demand for tax equity reaching nearly $10 billion this year, but estimates only $3.2 billion will be available. Others put the funding figure higher, with $4.8 billion invested so far and $6 billion expected by year-end, but still short of demand. As a result there has been a scramble to lock down capital before it dries up.

With uncertainty looming — wind power's tax credits expire at the end of this year — the industry is looking for other models to raise capital, including master limited partnerships (MLPs) and real estate investment trusts (REITs). MLPs have significant tax benefits, but are restricted to certain sectors, including fossil fuels. A bipartisan bill in the Senate aims to extend eligibility to renewable electricity generation and alternative fuels, although its fate is far from certain. REITs are similar but used for real estate portfolios. Both forms of investment allow the involvement of smaller investors, and can be publicly traded.

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