Renewable Energy Tax Credit Finance Series: Unpacking Sponsor Benefits

There are many economic benefits generated by renewable energy facilities. Chief among them are tax credits, tax losses and distributable cash flow from operations and from sale or refinance. These benefits are shared between the investor and developer sponsor, typically outlined in a multi-year benefit schedule. However, there are other significant economic benefits for a sponsor, the two most notable being developer fees and annual asset management fees. In today's podcast, Michael Novogradac, CPA, and Novogradac partner Tony Grappone, CPA, will review the main economic benefits for a sponsor and how the ownership structure affects the sharing of those benefits.

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Transcript

Introduction

[00:00:15] **Michael Novogradac, CPA**: Hello. I'm Michael Novogradac and this is Tax Credit Tuesday. This is the Dec. 12th, 2023, podcast. Today's episode is a continuation of our Renewable Energy Tax Credit Finance Series. This series is designed to help listeners better understand the many tax credit funding resources and ownership structures that are used to finance renewable energy tax credit facilities.

In our most recent episode of this project finance series, we outlined the central economic benefits of renewable energy cash flow transactions for investors. Today, we're going to take a look at the other side of the partnership, sponsor or developer economic benefits.

Now there are many economic benefits generated by renewable energy facilities. Chief among them are tax credits, tax losses and distributable cash flow from operations and from sale or refinance. Now these benefits are shared between the investor and developer sponsor, typically outlined in a multi-year benefit schedule. However, there are other significant economic benefits for a sponsor, the two most notable being developer fees and annual asset management fees. If you're a renewable energy developer/sponsor, it's very important to fully understand each economic benefit available to you, as well as the derivative effects of various ownership structures. And if you're a renewable energy investor or syndicator, this episode is going to help you better understand the developer/sponsor side of the partnership equation.

Now in today's podcast, we will review those main economic benefits for a sponsor, and we're going to talk about, as you can tell by what I've already said, how the ownership structure affects the sharing of those benefits. Now, my guest today on the podcast is my partner, Tony Grappone. He's one of the country's leading experts on renewable energy tax credit financing.

You may know him as the chair of our annual Novogradac Renewable Energy Tax Credit Fall Conference. And also, he is a frequent guest on Tax Credit Tuesday. We do have a lot of ground to cover today. So if you're ready, let's get started.

Tony, welcome back to Tax Credit Tuesday.

[00:02:31] **Tony Grappone, CPA**: Thanks, Mike. It's great to be back.

[00:02:33] **Michael Novogradac, CPA**: Now, before we dive into the topic today, I wanted you to take a moment to describe for our listeners some of the many services you provide to Novogradac clients.

[00:02:43] **Tony Grappone, CPA**: Thanks, Mike. So I specialize in providing financial forecasting and related consulting services to renewable energy transaction participants, and we also provide financial statement audit services and tax return services.

Tax Credits

[00:02:57] **Michael Novogradac, CPA**: Great. Thank you there, Tony. And for our listeners, Tony also provides services in other tax credit areas. But he emphasized renewable energy services, and so that's what we're talking about today. So thank you for that, Tony. Now in my introduction, I described six major categories of sponsor benefits in a renewable energy transaction.

I didn't lay them out one through six, so let me do that now. And this isn't an exhaustive list, but they are the primary benefits.

1. Tax credits

2. Tax losses

3. Distributable cash flow from operations

4. Cash flow from sale or refinancing

5. Developer fees

6. Asset management fees

Now let's take a closer look at each one of these for our listeners. And I will start from the top and just march through. Talk about tax credits, then tax losses, then distributable cash from operations. Then cash flow from sale or refinancing, then developer fees, then annual asset management fees. So let's start with tax credits. Tony, what percentage of tax credits can sponsors generally expect in a typical transaction?

[00:04:06] **Tony Grappone, CPA**: Great. Thanks, Mike. So, you know, I'm going to talk in the context of a partnership flip transaction. And in a partnership flip transaction, the sponsor usually has a 1% pre flip ownership interest. And as a result, they could expect to get 1% of the total partnership's tax credits.

[00:04:26] **Michael Novogradac, CPA**: Great. Thank you for that. And maybe for our listeners, when you mention a flip transaction, what the flip references to.

[00:04:36] **Tony Grappone, CPA**: Great. So thanks. So the flip references the partners' ownership percentages, that's the percentage that they agree to share tax credits, losses, cashflow, and residual proceeds. And so the, yeah, and the most common, right?

The most common sort of partnership flip arrangement you see in renewable energy involves a two-partner partnership where the sponsor typically has a 1% pre-flip share of credits, losses and cash flow. And then a 95% post-flip share in profits, losses and credits and cash flow. The tax equity investor has the opposite. They've got a 99% share pre-flipped interest, and then a 5% post-flip interest.

Tax Losses

[00:05:18] **Michael Novogradac, CPA**: Great. Thank you for that, Tony. And as we'll discuss later, the flip will generally happen after Year 5 and different structures have it happen in different circumstances. So we've talked about tax credits. Now let's move to tax losses. Now, tax losses in renewable energy transactions can be fairly substantial because of the ability to expense a large portion of personal property. These losses can be so substantial that they'll often exceed the cash capital contributions made by the tax credit investor. And this often means that the allocation of tax losses shifts from the investor to the sponsor during the five-year recapture term, which is also during the pre-flip term. Now, Tony, what I just said is a bit dense. I think it's accurate, but maybe you could help unpack that for our listeners and further comment on my observation.

[00:06:16] **Tony Grappone, CPA**: Excellent. Yeah, thanks. So, as you said, renewable energy transactions, most, substantially all of the assets, can be depreciated over a very short timeframe, typically using five-year maker's depreciation methodology. And so, you know, if you think of a classic tax equity transaction, the investor usually puts in somewhere between, let's say, 30% and 40% of the total capital stack is what your classic sort of tax equity investor is putting in. But they're getting allocated 99% of the tax losses.

So, you know, you can imagine that their tax capital account is probably going to get reduced to zero before the end of the five-year recapture period. And, you know, if the partner's capital account is zero, if they don't have, if the partnership doesn't have minimum gain or the investor hasn't agreed to a deficit restoration obligation, then once their capital account reaches zero, then the remaining partnership tax losses need to get reallocated to the partner that can withstand those loss allocations.

And in this case, that would be the sponsor. I think this is really important to note because I think oftentimes, sponsors, when they're looking to participate in a partnership flip transaction, I think they just assume that because their stated ownership percentages are one and 99%, 1% of themselves and 99% of the tax equity investor, I think they sort of assume that the tax equity investor is going to get 99% of all partnership tax losses for all five years of the recapture period, but that's typically not what you see.

You see the tax equity investor get allocated 99% of the tax losses in the first year, oftentimes the second year, maybe even the third year, but at some point prior to the end of that fifth year, prior to the end of the five-year recapture period, losses eventually are going to start getting reallocated over to the sponsor.

Those losses can be significant. And we're not talking about economic losses here. We're talking about tax losses created by tax depreciation deductions. And so those tax depreciation deductions have value. You know, you take the tax deduction, you multiply it by their effective tax rate.

And that equals what the benefit is to the sponsor. And so again, because the tax equity investor usually can't get allocated 99% of the losses for all five years of the recapture period, the sponsor can count on, you know, getting a decent amount of benefits from those tax losses.

[00:08:45] **Michael Novogradac, CPA**: Great. Thank you for that, Tony. And I often think of them as debt-financed tax losses, and obviously it's a timing question, but it can create a significant benefit through those timing benefits.

[00:09:00] **Tony Grappone, CPA**: So I love that you mentioned the debt financing piece, right? So a lender, if the lender isn't a partner in the partnership, right? Well, tax losses can only get allocated to the partners, the owners. You can't allocate losses to the lender if they're not an owner, right? And so, one of the things I love about debt financing is you have to find a way to allocate losses, deductions that are funded by a non-owner. And so those debt-funded deductions are just powerful in terms of accelerating an IRR to the partners.

[00:09:33] **Michael Novogradac, CPA**: Yes, indeed. And you hinted at some of the various techniques in terms of minimum gain or not, but that, we'll save that for another episode.

[00:09:44] **Tony Grappone, CPA**: Exactly.

Distributable Cash Flow

[00:09:45] **Michael Novogradac, CPA**: So, we've talked about tax credits and tax losses. Next on the list of benefits that renewable energy sponsors often value most, which also involves a sharing with the investor, and that's distributable cash flow from operations, as well as cash flow from sale or refinance.

Now, preparing for the podcast, you and I did discuss how different partnership structures affect how cash flow distributions are shared. So if you could describe for our listeners some of the common partnership structures and how they affect cash flow distributions.

[00:10:17] **Tony Grappone, CPA**: Great. So, with the partnership flip arrangement, you know, you can have the, there are a couple of different types of flips you see in the marketplace.

One is referred to as a yield-based flip and the others referred to as a time-based flip. With a yield-based flip, the tax equity investor's interest doesn't flip until they have reached a minimum yield requirement. And so the way that typically works is the partners will agree on a point in time where they will calculate the investor's yield.

They usually don't agree to do that calculation until, say, the end of the five-year recapture period. But once you get to the end of the five-year recapture period, then the partnership agreement will stipulate that they're supposed to determine what the tax equity investor's yield is up until that point in time.

If the tax equity investor's yield up until that point in time isn't at that minimum agreed-upon level, well then the partnership terms usually dictate that the partnership has to increase the amount of distributable cash flow that goes to the tax equity investor, OK? And so obviously that reduces the amount of cash flow that would go to the sponsor.

All right, so that's your yield-based flip, and so with that yield-based structure, it creates some greater risk around how much operating, distributable cash flow, net operating distributable cash flow will actually go to the sponsor, OK? Now, with a time-based flip, under that structure, the partners just agree, look at the, at this point, at a very specific point in time, we agree our interests will flip regardless of what the investors yield is up until that time.

And so oftentimes sponsors prefer the time-based flip because it provides more certainty around how much net operating cash flow they're apt to get distributed.

[00:12:14] **Michael Novogradac, CPA**: Right. Thank you for that. That makes perfect logical sense.

[00:12:19] **Tony Grappone, CPA**: Can I add to that just a bit, Mike?

[00:12:21] **Michael Novogradac, CPA**: Yeah.

[00:12:21] **Tony Grappone, CPA**: Thanks. So another thing I just want to point out about net operating cashflow that gets distributed from these renewable energy partnership flip transactions is when sponsors, if they're doing this for the first time, and they're just learning about the structure and they hear the concept of sharing, having a 1% ownership sharing ratio versus 99% to the investor, one of their initial fears is, wait a minute, does that mean that the tax equity investor is going to get distributed 99% of the net operating income?

OK, and, and the answer to that is no, usually not. They get distributed 99% of the net operating cash flow, OK? But that's different than net operating income. And so you'll determine your net operating income, which is, you know, PPA revenue minus your core operating expenses. That gets you to net operating income.

But then in the partnership agreement cash distribution waterfall section, then it'll dictate how net operating cash flow should be distributed, OK? And there are usually steps along the way that lead up to your final net operating cashflow distributions. And one of the things that is usually inserted into one of these partnership agreements is called a return of capital provision to the sponsor. And what that does is it allows the sponsor to get a return of their capital invested ahead of the final step in the waterfall, which is where you distribute your final net operating cashflow. And I point that out because sponsors

want, they want some peace of mind to know that the net operating income, which can be very significant, isn't going to necessarily get shared in 99-1.

[00:14:08] **Michael Novogradac, CPA**: Right. Thank you for that. It's obviously a pretty important share. And when you talk about yield-based versus time-based flips, I always think of the yield-based flip as a way of making the investor whole with respect to how many tax credits they expected to receive versus the actual amount of tax credits they received, which go into the yield calculation.

And then when I can't help but think of that in the context of an investment tax credit transaction versus production tax credits. With investment tax credits claiming the credits when you place the property in service, production tax credits be claiming the credits over a 10-year period. In both transactions, the equity, generally speaking, needs to come in during the development phase and shortly thereafter.

So when you have an investment tax credit structure, the investor can often reduce future capital contributions if the tax credits expected aren't realized. And as such, you don't really need a time-based yield flip. You could do a, or a yield-based flip. You could do a time-based flip because the capital contribution to the tax credits is sort of trued up at that phase.

And I should note that if the investment tax credits are more, oftentimes the investor has to contribute more because there's upward adjusters as well as lower. However, with a production tax credit, given the capital contributions needed to build the facility, if in some later years the tax credits aren't generating the amount or the property isn't performing at a level to generate the tax credits expected, the investor can't reduce their capital contributions as much.

In that situation, they need to get more of the operating cash flow, so I would generally expect to see in a production tax credit transaction, it be more likely to have a yield-based flip. Your thoughts on all of that?

[00:15:55] **Tony Grappone, CPA**: Well, yeah, I mean, I really like that you brought up the production tax credit scenario because I think comparing PTC to ITC helps better sort of, relate to or visualize sort of the importance of the yield-based flip versus a time-based flip.

Like you said, the time-based flip works oftentimes better with an ITC transaction for the reasons you noted. And you can see how with a production tax credit transaction, you just don't know what the production tax credits are going to be on the front end. And so it's harder to just kind of get your final tax equity commitment spot-on accurate in year one.

You sort of need to kind of wait and see how things go throughout the operating cycle to know exactly what the PTCs are going to be. And that ultimately determines what your final cash contributions are

going to be, which were the yield-based transaction, that yield-based feature and a PTC transaction works really well to sort of get that investor hole, if you will.

Developer Fees

[00:16:52] **Michael Novogradac, CPA**: So we've talked about tax credits, tax losses, and just several cash flow. Now they're shared between sponsor and investor. And obviously, we've grossly simplified a lot of issues, and you even took time to unpack one gross simplification on operating income versus cash flow. But let's now move on to the economic benefits that a sponsor can generate that's I think of it as outside the partnership sharing structure, and that's developer fees, as well as annual asset management fees.

So, let's start with developer fees. There's a lot investors need to know about developer fees. Maybe you could share a few things. Clients can reach out to you and prospective clients later for more specificity.

[00:17:40] **Tony Grappone, CPA**: Yeah, indeed. So, developer fee, that's the profit the developer makes for building and completing the project and bringing it to a state of operations, right? And the receipt of that developer fee is usually not included in the sponsored benefit schedule because if you look at one of these tax equity models, the sponsored benefit schedule usually features the partners' share of distributions or returns of capital. And, and the developer fee isn't paid out as a distribution, right? It's paid out as a fee. That's received separately by the developer. And so if you were to analyze the sponsor benefit schedule without those developer fees included, the return would appear much lower, and so to get a sort of a better indication of what the sponsors true profit on the transaction and their overall return, you really want to factor in that developer fee.

In terms of how you size that developer fee, I mean, that's just, that's always a hot topic in renewable energy, and so there's a few different ways that you're seeing developers sort of make their profit for developing projects these days. You can see a scenario where the developer uses an affiliate that is in charge of developing the project, and then that affiliate, that development affiliate brings the project to what we call mechanical completion.

Mechanical completion is essentially the point in time, just before it's placed in service, and then a mechanical completion, that development affiliate agrees to sell the mechanically complete facility to the tax partnership, the tax partnership being the partnership flip vehicle that's going to be used to own and operate the facility.

And so under this scenario, the development affiliate, again, they bring the project to mechanical completion, they sell it to the tax partnership at some agreed-upon amount, oftentimes pegged to an appraised fair market value, OK? And that developer fee is paid on the date that the facility is essentially placed in service.

And so in that scenario, the developer is getting their fee or their profit all in Year 1. Another arrangement, which is sort of a classic tax credit structuring arrangement for developer fees, is where the partnership enters into a development fee services agreement with the developer and developer fee is charged pursuant to that agreement.

And then that fee is paid to the developer from available cash flow over a period of time. And that's a fee arrangement we're all very used to seeing in these types of tax credit transactions.

Asset Management Fees

[00:20:05] **Michael Novogradac, CPA**: I have a lot of additional questions on developer fees, but I'm going to move on. All right. Let's talk about annual asset management fees. What do you think listeners should be most mindful with respect to annual asset management fees?

[00:20:19] **Tony Grappone, CPA**: Right. So, oftentimes developers, they want to try to size them as high as they possibly can, obviously, right? And so one thing you just have to be careful about there is the IRS has certain views on what they think appropriate asset management fees are.

And so you just have to be mindful that your development fee doesn't start to take the appearance of a disguised kind of profit distribution, OK? And so the fees, so you try to size it to be commensurate for the facility and the complexity of the project, etc. OK?. But that asset management fee, it's a recurring fee. It's usually an annual fee. It's an expense of the partnership. It gets accrued and it gets paid out through available cashflow usually. And, you know, it's, it's oftentimes a very negotiated amount between the sponsor and the investor.

Exit

[00:21:10] **Michael Novogradac, CPA**: So thank you for that, Tony. So I do think in the course of this podcast, we've provided a pretty good overview of sponsor economic benefits, which makes it a nice bookend to our overview of investor economic benefits.

Thank you for that. And there's obviously much more to discuss that we don't have time for today, time for any single podcast episode. So to my listeners, I do encourage you to reach out to Tony with any specific questions you have. I will include Tony's contact information in today's show notes, which will be available at www. novoco.com/podcast. And also to our audience, please take a moment to subscribe to Tax Credit Tuesday on your favorite podcast platforms. That way you'll ensure you don't miss a future episode. And as I say every week, if you have any questions or ideas or suggestions for future episodes, please email us at cpas@novoco.com.

Off-Mike

So now we've reached our Off-Mike section, and this is the time where I get to ask my guests some non-tax credit related questions and generate some fun off-topic advice and words of wisdom. So Tony,

you're a frequent guest. So you run through a lot of my traditional questions. So the first question which, you know, many, many will say that a first impression is a lasting impression. So I'm curious what you think is a good way to make a good first impression?

[00:22:49] **Tony Grappone, CPA**: Top of my list. Be on time and dress, you know, dress appropriately, professional. OK? I think being on time and dressing professionally, the way that helps with your first impression is it sends a message that you respect the person that you're meeting with and you respect yourself in the way that you sort of present yourself.

[00:23:12] **Michael Novogradac, CPA**: Thank you for that. I can't, when you say be on time, I can't help but think about when I was in grad school, someone said, you have always got to be on time. And if you're not five minutes early, you're late.

[00:23:22] **Tony Grappone, CPA**: Yeah, that's right. One of my best friends says, if you're on time, you're late.

[00:23:29] **Michael Novogradac, CPA**: So my second question, and many listeners know that you are a composer. So what music album as a composer or as a non-composer do you think everyone should listen to at least once?

[00:23:45] **Tony Grappone, CPA**: Great. Love this question. So I will tell you last night we had our office holiday party. I hosted it at my house. And which meant I was in charge of the playlist, OK, or my wife was in charge of the playlist, and at some point during our party, my wife, she, I didn't realize this, but she has all the songs that I've written on a playlist, and so she, at some point started playing, the stuff that I've written, which was fun to listen to, but, if I was recommending an album, if, if somebody could only listen to one album, what album would I recommend?

I love James Brown's "Live at the Apollo." I love the raw energy, it not only does it, it's got groove, it's got, it rocks, it's got just a lot of different sort of elements to it and energy is just, it's a fun album and I highly recommend it.

[00:24:36] **Michael Novogradac, CPA**: Well, thank you for that. I'm going to have to add that to my Spotify playlist. James Brown Live at the Apollo. Have you been to the Apollo?

[00:24:46] **Tony Grappone, CPA**: I have not. It's on my bucket list though. Have you?

[00:24:49] **Michael Novogradac, CPA**: I have. I have. And, and talk about energy. I enjoyed myself immensely and I need to get back. So let you and I plan to make it.

[00:24:59] **Tony Grappone, CPA**: Awesome. All right. I'm there.

[00:25:02] **Michael Novogradac, CPA**: Thank you, Tony. And to our listeners, I'm Mike Novogradac. Thanks for listening.

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