ARRA Drives Need to Protect Partnership Earnings

by Dennis Moritz and Rajiv Advani

Although the 2009 American Recovery and Reinvestment Act ("ARRA") provides significant economic incentives for investing in renewable energy projects, GAAP earnings patterns may negatively impact investors should they choose to ignore liquidation provisions in tax equity partnership structures. The authors of this article propose investors negotiate Partnership Earnings Protection ("PEP") to address potential issues with GAAP earnings patterns. For example, in a representative $100M project using the cash grant the tax investor realizes an erratic earnings pattern and significant pre-tax losses (Earnings before Tax or "EBT") in the early years of the project. With PEP, this same investment example produces a smoother earnings pattern with no losses in any period. PEP smoothes earning patterns by structuring the partnership liquidation terms, better reflecting a partners' economic interest in the investment.

Cash Grant Impacts GAAP Earnings

When the market elected to use the ITC Cash Grant instead of Production Tax Credits ("PTCs"), the interaction between the financing structure and the accounting methodology caused earnings calculations to change dramatically. U.S. based corporations participating in flipping partnerships typically use the HLBV accounting method to allocate project earnings between partners. This method uses a *hypothetical* liquidation of the partnership's business at the end of each financial reporting period to determine each partner's share of book earnings from the business. Prior to the ITC Cash Grant, the after-tax earnings pattern was generally consistent with the economics of the investment. Although EBT typically reflected a small loss for the tax investor seeking PTCs, these were relatively insignificant compared to the after-tax earnings. Unlike the PTC incentive, the ITC Cash Grant flows through the HLBV earnings calculation and dramatically affects EBT. Although liquidation provisions were never something to ignore, the introduction of the ITC Cash Grant increased the importance of structuring and understanding the implications of liquidation terms. This situation is true for both solar and wind projects utilizing a flipping partnership and the Cash Grant.

Structure Partnerships to Protect Earnings ("PEP")

Partnership Earnings Protection ("PEP") is an approach to analyze and structure the liquidation waterfall to produce earnings more consistent with the base economics and a partner's interest in the deal. However, PEP only adjusts the pattern of earnings, not the aggregated total allocated to each partner.

To illustrate the point, take an example of a $100M project. Financing for the project uses a capital structure comprised of cash grant (28%), project debt (40%), tax equity (22%) and sponsor equity (10%). Figure #1 shows the tax equity's share of pre-tax earnings resulting from a liquidation waterfall that mirrors the base case rules - complete the cash sweep and achieve the tax equity's flip yield. In some periods, the other partner realizes significant earnings while the tax equity has large losses. Note the total of the partners' earnings is a zero-sum game as it totals to the earnings at the business level.

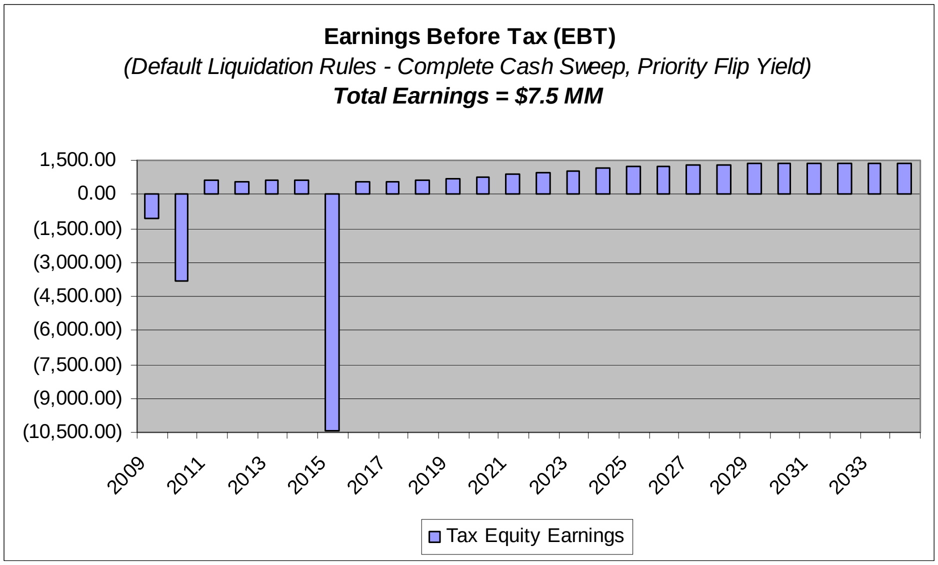

Figure #1: EBT using Default Liquidation Rules

Figure #2 shows the HLBV results of a liquidation waterfall modified with PEP to address (1) post-flip deferred tax liabilities (minimum gain), as well as (2) losses in the early years. The total earnings are still the same in both graphs; however, there is a much improved sharing of the earnings between the partners with the PEP case, though some smaller losses have now been pushed to later years.

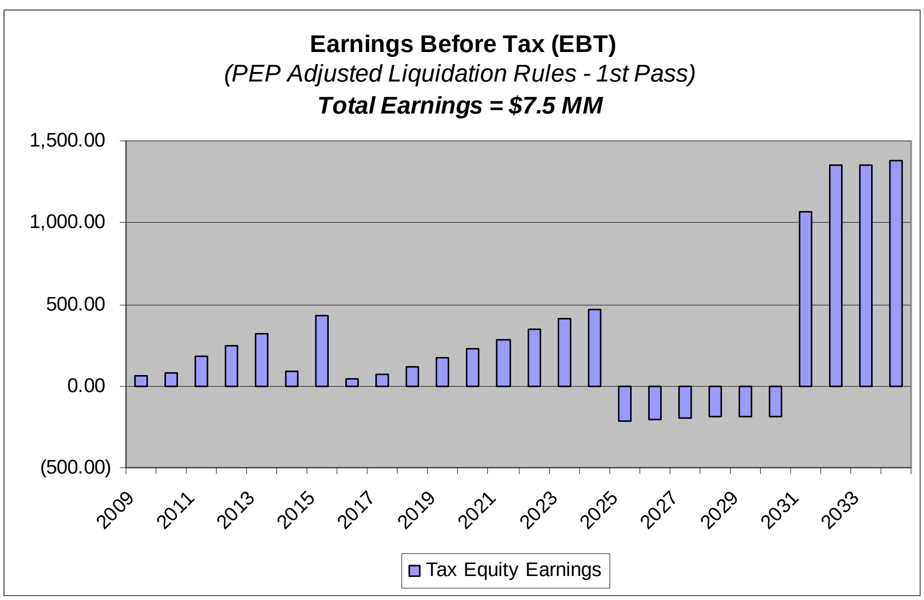

Figure #2: EBT with PEP, 1st Pass

Figure #3 shows the impact of further PEP structuring to address the remaining losses and pattern of earnings. As is evident, the losses have been eliminated and the pattern is now consistent with what an investor would expect for an investment that declines over time. This example highlights the importance of structuring liquidation waterfall rules similarly to the base case economics in order to achieve partner financial objectives.

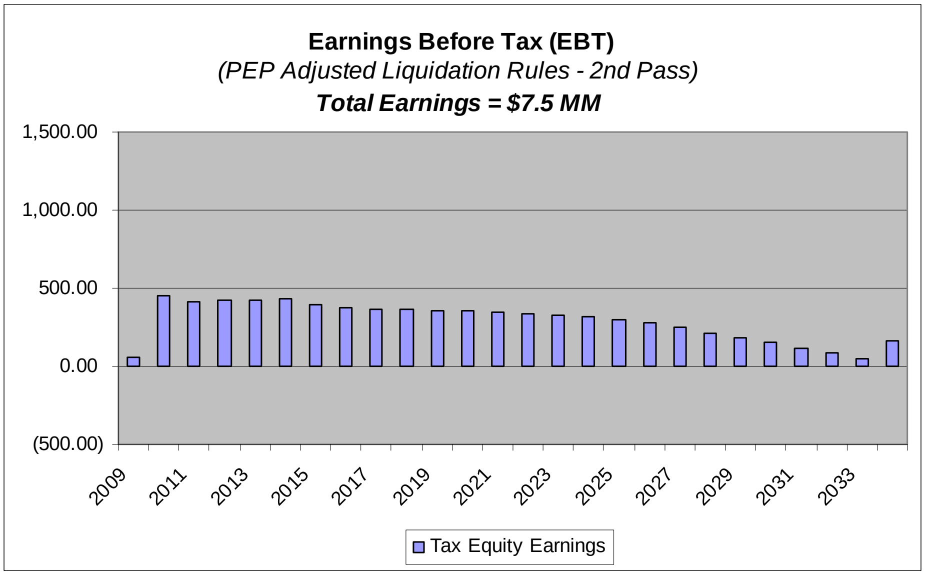

Figure #3: EBT with PEP, 2nd Pass

Though PEP does not change the total earnings of any partner, it will change the sharing of cash in a real liquidation scenario. However, since the original earnings patterns could be viewed as an unintended consequence of the business, making the PEP adjustments are likely justifiable and reasonable during deal negotiations.

A Structuring Solution to Earnings Exists

ARRA offers the industry new opportunities for growth, but also brings additional complexity to deal structuring and negotiation. For partners that report GAAP earnings, it would be an oversight to use a default waterfall structure in liquidation without first examining the impact on earnings. PEP (Partnership Earnings Protection) combines methodology and structuring analytics to mitigate HLBV earnings challenges. Project sponsors and tax investors need to consider PEP before deciding on their next renewable energy project investments.

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