Everything that's wrong with tax equity

Project finance | The importance of the investment tax credit in stimulating solar development has become an article of faith in the US, and its extension at the end of 2015 was welcomed as a vital lifeline. But as Danielle Ola hears, complexity, tightening supply and inefficiencies mean tax equity has a growing number of critics

When the investment tax credit (ITC) was first extended, it was hailed as the saviour of US solar. But whilst tax equity has undoubtedly been a key factor behind the extended period of solar capacity growth seen in the US in recent years, it has not been without its critics.

Despite being the most popular financing mechanism for solar in the US, tax equity is also one of the most complex out there when compared with its debt and sponsor equity counterparts. Greg Jenner, the former acting assistant secretary of the US Treasury for tax policy describes tax equity as "not optimal by any means".

"Right now I would describe it as necessary – and maybe not a necessary evil; but it's not optimal by any means," Jenner says. "The problem is that Congress has chosen to provide incentives [for solar] in the form of tax benefits. The only way that many developers can use these benefits is to use tax equity because they don't have their own tax liability. The lost value to developers is because tax equity doesn't invest dollar for dollar, it invests with a substantial discount. It's a high-priced cost, but it's cheaper than anything else – it's cheaper than debt, it's cheaper than equity. They've got to use it, but nevertheless it's an inefficient system. The transaction costs are high. From a policy standpoint it's incredibly inefficient. It would be much better if there were some alternate incentives."

Complexity

To those in the know, the various processes do not pose a problem. But for new market entrants or for the inexperienced, it can pose a significant barrier even to the point of being off-putting, according to Akamai Technologies' senior director of environmental sustainability, Nicola Peill-Moelter.

"The ITC, while I think it's great and some companies are doing really well with it, for the companies that don't really understand the renewable energy market and what advantages they could have, it's a very complicated model for procuring renewable energy. It might look good financially, but a lot of companies don't have the financial or accounting expertise or they are not experts in the power market. For those that do not have in-house expertise, it's a very complicated way to procure renewable energy. Most companies just see it as too complicated and too risky.

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Tax equity has been crucially important for solar in the US, but some believe alternatives are now needed

"For the companies that do understand the benefits and have in-house expertise, it's great that they can take advantage of it. But I do think those companies are few and far between."

John Berger, CEO of rooftop solar provider, Sunnova, expresses a similar concern: "At some point you've got to call the ball, and ask of that complexity associated with tax equity that a lot of these institutional investors have to get their head around: is that going to change? It doesn't look to me like that is going to change. That doesn't mean that some won't get into it and do some of it, but as the market becomes bigger we really need that investor base to come into it.

"It just seems hard for me to get my head around, that you're going to have a material impact or influx of capital as long as that tax equity structure is in the way. It just seems to be holding back the industry. Tax equity is the biggest hold back for the market by far."

'The benefit of the few'

Further to its being a difficult mechanism to grapple with, the effort may not even be worth it as the net benefit that filters down to the end user is significantly diluted. As the ITC is effectively divided between all parts of the supply chain, it could be questioned how material the end saving is that a solar customer would receive.

"The subsidy has to be shared by the developer and the consumer in order for the pricing mechanism to work," says Jenner. "The developer is going to want a piece of that subsidy because it is intended to help them develop an asset which doesn't necessarily have market parity yet.

"At the same time, you need to create an incentive for the ultimate consumer to use solar. So there's got to be a split. If you throw tax equity into it, developers are going to get their split first – so tax equity dilutes the benefit to the developer and the developer dilutes the benefit to the consumer; but that's just the system we have."

Not only does the average solar customer have a significant benefit from the ITC sliced in the process, but the overall pool that benefits from tax equity is limited, says Greenwood Energy CEO Camilo Patrignani.

"Aside from not resulting in a material cost saving to the end user, the other very important issue with the ITC is that it really is for the benefit of the few. Only really large solar companies can do this and a lot of local installers as a result are basically in a position of weakness," he says.

Much like the point about complexity, the exclusionary nature of tax equity means that it likely causes a barrier to market competition. According to Roundrock Capital Partners managing partner Matt James, the market has traditionally been dominated by banks and other financiers. The inclusion of corporate bodies and other entrants would help to diversify the marketplace and increase competition. "What the market could use is a much more diverse corporate base of tax investors," he adds.

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"There are only really 10-15 serious tax equity providers for larger projects and that is very little," agrees Patrignani. "It is mainly for those few that have the benefit of a strong balance sheet that can provide the right set of indemnities and can provide at least 10MW on an installation. It really sets a lot of barriers to entry that otherwise would enable the market to be more competitive and perhaps grow faster."

Limited supply

Not only is the number of individual tax equity providers arguably lower than would perhaps be desirable, the actual amount of capital available too is limited. If the government is providing a subsidy in the form of tax benefits, the only way that subsidy can be tapped into is through the market and market providers. If there is a limited supply of investment capital in the tax equity market, the consequences are evident. "Particularly as new entrants try to get into the field, if tax equity providers already have claims on the amount of money they are willing to invest, it becomes brutal for new entrants," says Jenner. Indeed, new market entrants from Europe, or even small and medium-sized domestic developers, still have problems accessing the vast amount of tax equity financing needed to complete their new-build projects, according to Scott Reising, managing director of Baker Martin Capital.

In addition, the lack of providers is preventing a lot of secondary liquidity from flowing through the industry, according to Berger. "We've got to have more players. It's a little difficult to have a lot of liquidity when you have six firms, maybe 10 at the most, existing in all the US."

"There is still a lack of capital in tax equity," agrees Reising. "Those who have it can kind of play a little bit and be more efficient with their projects. Those that don't, don't have to worry as much because they can hold on to that project for several years and just wait it out a little bit until they actually get the financing put together.

"You're going to see a lot more M&A […] so people think, let's see who survives the next four to five years with the tax credit and maybe there are going to be some mergers going on with only a few big players. And then after that, the world is their oyster; the big players who have survived will now have to survive on their own with no tax equity investment, no tax incentives (at least the major federal ones) and you'll potentially see a lot of major state ones go away as well because they'll follow suit of the federal players, and they may not see a need to have any sort of state or local tax credit."

A slow-down

The limited supply results in increased demand, which in turn causes an increase in cost. But stretching a limited supply among a disproportionate amount of partakers also has other downsides, namely in a prolonged delay in projects being executed.

As is well-known, the ITC extension at the end of 2015 meant many developers would delay projects so they could source better tax equity. "While it was good to have the extension, it did slow things down a little bit because the extension took the pressure off everything being done by Q4 of this year," says Reising.

A further impact has been on the

development of a secondary PV market in the US, as the widespread sale of operating assets can only really happen once the tax equity period is over. But according to Stacey Hughes, partner at solar development and finance specialist, SunLight General Capital, the barriers that tax equity is causing in regards to slowing down progress in solar should be looked at in context, as it may not be creating any more of a barrier than other factors.

"It definitely varies by segment," Hughes says. "With regards to utility, [the tax equity period] will reduce the number of utility plants that come online, but just as big of a constraint would be the availability of land. In the C&I space, tax equity doesn't tend to be really utilised so it probably doesn't make a huge difference. I think other forces will be ultimately more relevant than the decline in tax equity."

The future of tax equity

Due to the issue of demand caused by the ITC being extended at the end of 2015, this year has been a rough one for most developers, particularly the second half, as most tax equity providers had insufficient capital to last the entire year. The silver lining is that some of that volume should shift to 2017. Next year, the landscape should become easier to navigate. "There is a possibility that tax equity supply could ratchet up a little bit," says Santosh Raikar, managing director of renewable energy investments at State Street Bank. "We have seen a number of players entering the market over the last couple of years and there are a number of institutional investors stepping in. If there is an opportunity for this, there won't be as much constraint on capital."

Whilst it still has its road bumps, tax equity is no longer a wholly unknown entity and applicability is a lot easier than it was two or three years ago. However, Patrignani highlights the need for "smarter alternatives" to tax equity that are better able to cope with the fast-changing dynamics of the solar market.

The difficulty lies in finding an alternate mechanism that is simpler but still provides that same access to equity for solar developers. One alternative that has been suggested is some form of cash grant that is better geared towards a rapidly growingly market like solar that attracts many new entrants. Until such a mechanism is found, the industry will just have to sit tight and wait and see what happens once the ITC extension eventually expires for residential projects and drops to 10% for commercial and utility projects after 2023.

An optimistic view comes from Altus Power CEO Tom Athan: "Once the ITC runs out, solar will just exist in the same way it does now, if not better. It'll be a simpler investment for people to make without having to deal with tax equity. It'll 100% be easier; nobody questions that – it is just a question of whether or not the yields that you can get will be enough for investors. If you took the ITC away today, people probably wouldn't be comfortable with the yields. But if you lower the cost of the solar panels and the installation, and you got investors more comfortable in the next five years with solar as an asset class, then you will probably see when the ITC goes away that people are comfortable investing even in those yields." ■