USING THE PRODUCTION TAX CREDIT

James F. Duffy, Esquire
Nixon Peabody
100 Summer Street
Boston, MA 02110-2131
(617) 345-1129
(866) 947-1697 (fax)
jduffy@nixonpeabody.com

Community Wind Energy 2006
Expanding the Know-How –
Expanding the Market

Windustry
March 7-8, 2006
Des Moines, Iowa

NIXON PEABODY LLP

Using the Production Tax Credit

- Dollar-for-Dollar reduction in Federal income tax liability
- Section 45 of the Internal Revenue Code
- Under current law, the wind facility must have been placed in service prior to January 1, 2008 in order to be eligible for Production Tax Credits

Using the Production Tax Credit
(continued)

- The Production Tax Credit is currently (for 2005) 1.9 cents per kilowatt hour of electricity produced by the taxpayer and sold to an unrelated person for a 10-year period beginning on the date the facility was originally placed in service
- "Produced by the Taxpayer" means that the owner of the wind facility receives the Production Tax Credits

Using the Production Tax Credit
(continued)

- So, you can’t just sell Production Tax Credits; you have to make the purchaser of the Production Tax Credits an owner of the wind facility
- Most developers of wind facilities either: (i) do not anticipate having Federal income tax liability for the next 10 years such that they will be able to take advantage of the Production Tax Credits themselves, or (ii) need to monetize the Production Credits up front in order to help pay for the costs of developing the wind facility

Using the Production Tax Credit
(continued)

- One option is that at or just before the date when a wind facility is placed in service, the developer will sell the entire wind facility to a purchaser who will own the facility and receive the Production Tax Credits
- The original developer may or may not remain under contract with the purchaser to manage the facility

Using the Production Tax Credit
(continued)

- Under this scenario, it is often difficult to determine the value of the Production Tax Credits as a component of the total purchase price, and the original developer may not be maximizing the value of selling the Production Tax Credits
- Also, under this typical structure, the original developer generally gives up control of the wind facility

Using the Production Tax Credit
(continued)

- In a community wind project, the original developer may not want to give up control of the facility, as the original developer may have become invested in the local community (or may have already been a part of the local community)
- Also, the original developer may have made promises in connection with developing the facility which the original developer may feel an obligation to personally see through

Syndicating the Production Tax Credits

- Section 45(e)(3) of the Internal Revenue Code anticipates that the owner of a wind facility may have more than one owner
- Section 45(e)(3) provides that if a facility has more than one owner, the Production Tax Credits will generally be shared by the owners in proportion to their respective ownership interests in the gross sales from the facility

Syndicating the Production Tax Credits
(continued)

- The way to structure a transaction so that there is more than one owner for tax purposes is generally to use a limited partnership or a limited liability company
- For tax purposes, a partnership (which includes a limited liability company) is not recognized as an entity, so that the partners are treated as owners as to their allocable interests in the partnership

Syndicating the Production Tax Credits
(continued)

- Limited partnership and LLC structures are also commonly used for investments relating to other tax credits (such as Section 29 tax credits for fuel from nonconventional sources, Section 42 tax credits for low-income housing, and Section 47 tax credits for the rehabilitation of historic properties)

Syndicating the Production Tax Credits (continued)

- The original developer can structure the legal owner of the wind facility as a limited partnership or an LLC, and the investor who is interested in the Production Tax Credits can be a limited partner or member thereof and thus an owner for tax purposes
- The owner can then allocate all or almost all (99% or even 99.99%) of the Production Tax Credits to the investor

Syndicating the Production Tax Credits
(continued)

- The original developer can remain in control of the wind facility by being the general partner of the partnership (or the managing member of an LLC)
- But, remember that the Production Tax Credits are shared between the owners in proportion to their shares of gross sales
- So, in my example the investor would have to have a 99% (or 99.99%) interest in the gross sales of the facility

Syndicating the Production Tax Credits
(continued)

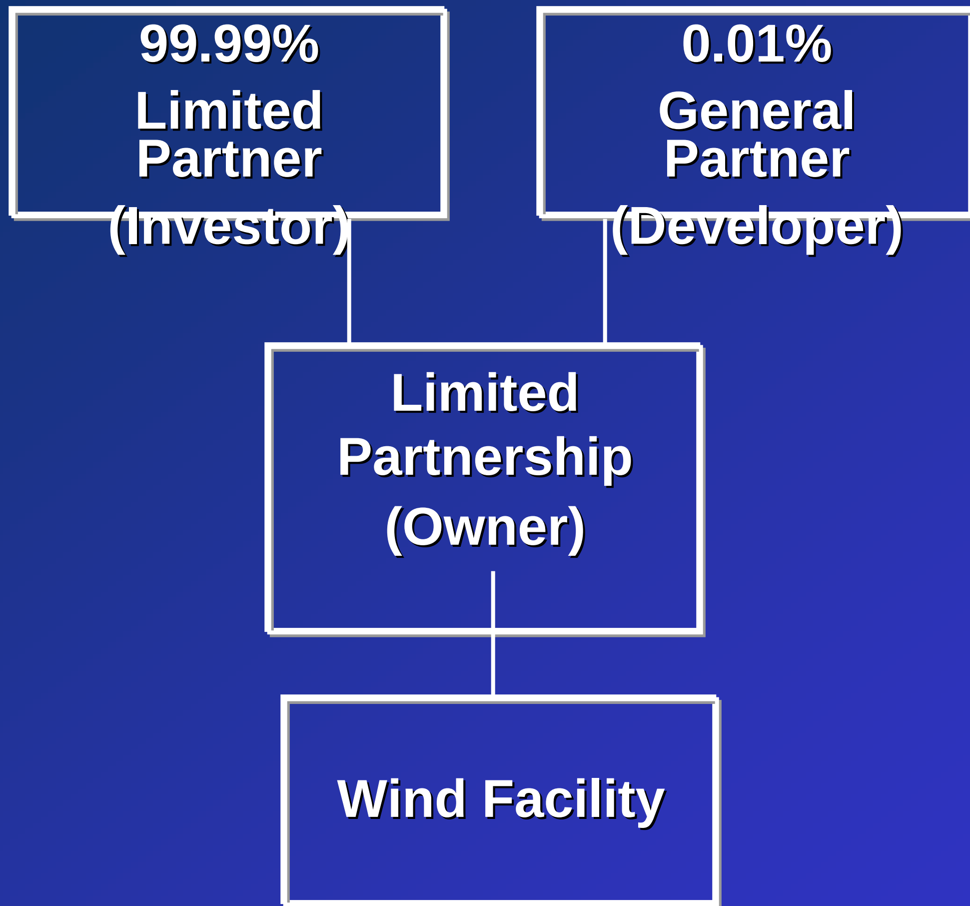
- However, the original developer, as the general partner of the limited partnership, can receive a reasonable fee for managing the facility
- The original developer could also receive a reasonable development fee for developing the facility, and to the extent that there were insufficient sources of initial debt and equity to pay that fee up front, some of it could be deferred and paid out of operating revenues

Syndicating the Production Tax Credits
(continued)

- Debt on the facility could be paid prior to reaching the 99-to-1 sharing ratio
- Transactions have been structured where the developer puts capital into the limited partnership to fund the gap between the total development costs and the amount of the investor's capital contribution, and the developer's capital contribution is then returned as a priority cash flow item prior to the 99-to-1 sharing ratio

Syndicating the Production Tax Credits
(continued)

- The developer could borrow outside the partnership to obtain this capital, possibly pledging its interest in the partnership as collateral


99.99%
Limited Partner
(Investor)
0.01%
General Partner
(Developer)
Limited Partnership
(Owner)
Wind Facility

Syndicating the Production Tax Credits (continued)

- Also, at some point after the end of the 10-year Production Tax Credit period, there could be a ”flip” to give the general partner (the developer) a greater percentage interest in the facility’s cash flow
- And at some point after the 10-year Production Tax Credit period, the general partner/developer could have an option to buy out the limited partner/investor’s interest at its fair market value

Syndicating the Production Tax Credits (continued)

- There could also be a "put" where the investor has the right to cause the developer to buy back the investor's interest, and the "put" price could be below fair market value

- The investor's payment can be made up-front, so that it can be used as owner's equity in the development process, or to pay off development period financing

Syndicating the Production Tax Credits
(continued)

- However, in order to protect the investor against the possibility that the Production Tax Credits might not be delivered as anticipated at the time of the investment, there would have to be financial guarantees from substantial guarantors if the investor were to be willing to put most of its money early in the process
- The investor could pay its funds on a 10-year pay-in schedule, as Production Tax Credits are delivered (a "pay-as-you-go" plan)

Syndicating the Production Tax Credits
(continued)

- The amount of the investor's payment depends in large part upon the Internal Rate of Return to be received by the investor, so the later in the process the investor puts up its money, the larger the dollar amount of the investment

Syndicating the Production Tax Credits
(continued)

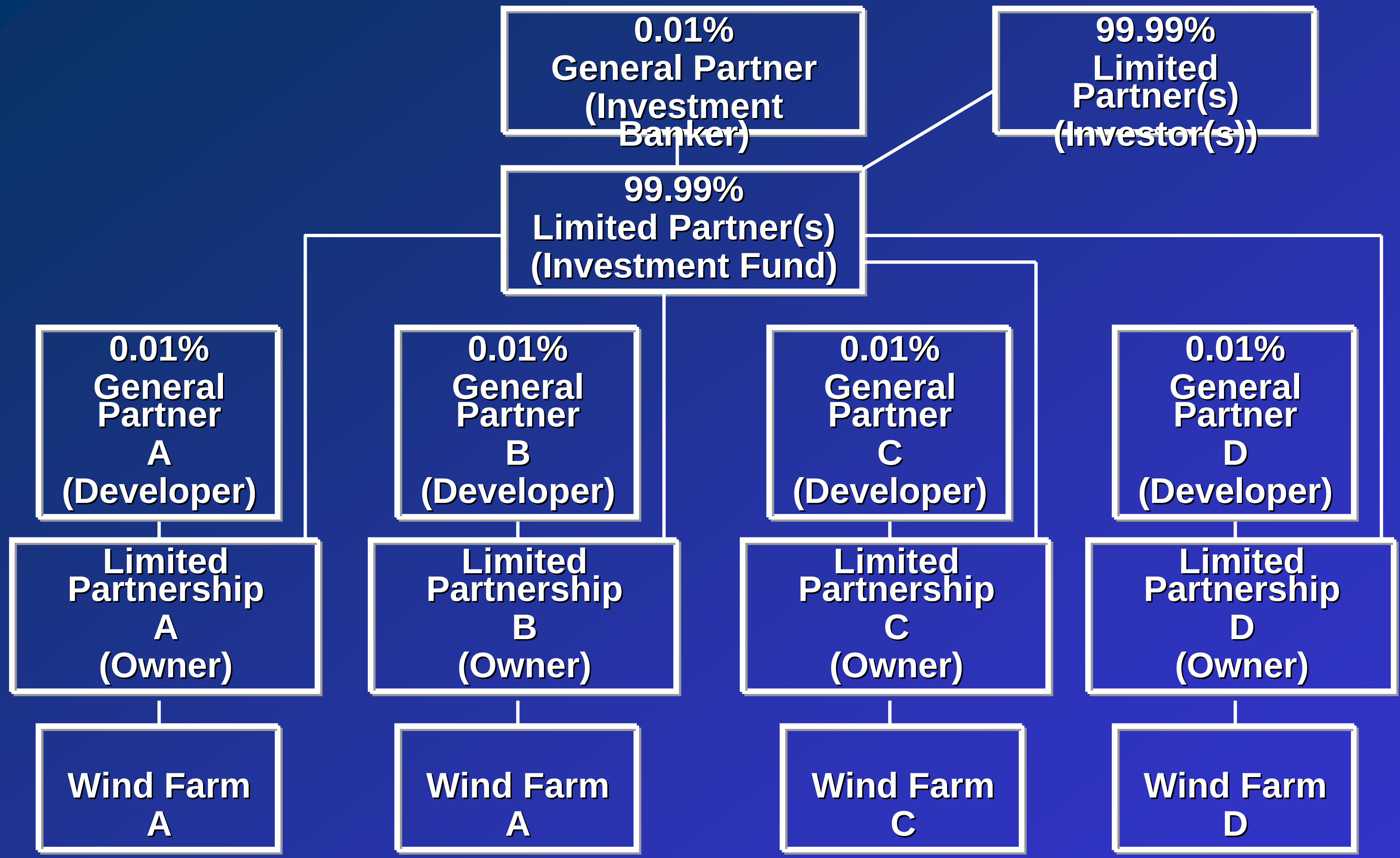
- In order to protect its investment, an investor will want a voice in how the facility is operated (such as, regular financial statements, probably audited by a CPA, approval rights on development and operating budgets; the right to take over day-to-day management if the developer is not doing its job; etc.)
- If the investor doesn't receive the anticipated Production Tax Credits as and when anticipated, it will want an adjustment in its payment obligation

Syndicating the Production Tax Credits (continued)

- On a pay-as-you-go plan, assuming a credit-worthy investor, the developer/general partner could cause the investor to pledge its payment obligations to a bridge lender to obtain bridge financing for the facility so that there would be more funds available up-front to be used in the development process
- These are just general concepts. The terms of the syndication of the Production Tax Credits from each wind facility will vary, based in part upon the economics of the particular transaction

Syndicating the Production Tax Credits (continued)

- Because of the sophisticated tax structuring involved, there will be not insignificant legal and accounting costs in each of these transactions, so it may not be as cost-efficient to syndicate the Production Tax Credits in this manner for smaller community wind facilities, unless either (i) the investor is a community-oriented company willing to make a relatively small investment or (ii) a community wind facility can be pooled with other similar community wind facilities to provide a larger investment to cover the transaction costs


0.01% General Partner (Investment Banker)
99.99% Limited Partner(s) (Investor(s))
99.99% Limited Partner(s) (Investment Fund)
0.01% General Partner A (Developer)
0.01% General Partner B (Developer)
0.01% General Partner C (Developer)
0.01% General Partner D (Developer)
Limited Partnership A (Owner)
Limited Partnership B (Owner)
Limited Partnership C (Owner)
Limited Partnership D (Owner)
Wind Farm A
Wind Farm A
Wind Farm C
Wind Farm D