

Capitalizing on Renewable Energy Investments Under the Biden Administration

By Lauren Anderson and Jim Cole

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It is still speculative as to what President Biden will put forward for promoting increased investment in renewable energy. Latham & Watkins attorneys explain how investment funds with a firm grasp of key structural considerations for investment choices in the renewables space will be well positioned to capitalize on any new opportunities.

If one topic was on the lips of energy investors in 2020, it was “transition.”

Against an evolving policy backdrop, investment funds are playing an increasing critical role in financing the next phase of energy investing. There is an increasingly deliberate push by both investors and consumers to shift the way both private equity and strategic investors approach the energy industry.

President Joe Biden has made clear that addressing climate change will be a focus of his administration, as further evidenced by his appointment of a number of climate experts and advisers to key roles in the administration. As a result, the new administration’s focus on infrastructure and climate change may well deliver a boost to these asset classes through increased subsidies and more accelerated governmental review processes.

Well positioned funds that anticipate the structural considerations that make these projects unique will prove to be both compatible capital partners and business partners for developers and strategic investors as the energy transition accelerates in the coming years.

The number of committed renewables and sustainable energy focused funds has grown substantially over the last few years, and other funds have announced specific climate change initiatives that will impact future investing and fund allocations. Funds investing in renewable energy projects have historically functioned as a tool for developers to monetize the cash flows associated with developed projects.

Involvement in Development Process

However, funds are increasingly moving directly into the development business, either through direct investment in power projects or through investments in or alongside developers with an existing project pipeline. In many instances, this creates a captive source of growth opportunities to support fund returns.

This trend is driven by what many view as compressed yields for fully developed generating assets with stable offtake contracts as a result of increasingly strong competition for these assets. This has pushed funds to look for better returns by investing earlier in the development cycle.

Many firms are approaching the energy transition through one of two lenses:

- a shift into “traditional” renewable technologies, such as wind farms or solar farms and their ancillary technologies; or
- a refocus to technologies that can be viewed as adjacent to the oil and gas industry, such as carbon capture and sequestration (CCUS), turquoise hydrogen (i.e., the production of hydrogen coupled with carbon capture), and green hydrogen (i.e., the production of hydrogen through electrolysis powered by a renewable energy asset).

Tax Issues

Each of these technologies is heavily subsidized by the U.S. tax code, though the form of the subsidy depends on the specific technology. However, limitations in the tax code often make these subsidies difficult to use, particularly for investors in funds, so funds frequently look to monetize these benefits in order to achieve attractive returns by selling them in the tax equity market.

The nature of each subsidy, either as investment based or production based, drives the terms of the tax equity financing. Absent changes to the tax code, funds looking to invest in this space need a firm grasp of the traditional development and permanent capital structures used for renewable projects in order to evaluate the tax benefits and project cash flows associated with a project or developer’s pipeline.

Renewable energy projects have historically been project financed using a construction loan that is ultimately paid off by the proceeds of a tax equity investment, which is typically made by a large bank, insurance company, or other strategic investor with a tax appetite. The exact amount of tax equity funding will be based on the value of tax attributes expected to be allocated to the investor, together with the negotiated cash distribution structure, which will change over the life of the project.

The interplay of construction debt at the project level, permanent debt at the sponsor investment level, and indemnities to tax equity can be complex as tax equity investors will typically require recourse guarantees from fund sponsors.

As fund sponsors typically resist providing such recourse guarantees as a general matter, this is a factor that private equity sponsors should be particularly cognizant of before making an investment dependent on a tax equity financing.

Further, in many instances, it will be critical for fund sponsors to negotiate the material terms of the ultimate tax equity investment, construction loan, and sponsor investment level debt in order to ensure that minimum fund return profiles are achievable.

Carbon Capture

As noted above, in addition to more “traditional” renewable technologies, investments in carbon capture facilities that are incremental to existing midstream infrastructure are also becoming increasingly popular. Both the technology and the contracting structure should feel familiar to funds that are experienced in oil and gas investing.

Additionally, financing structures for carbon capture projects that aim to monetize tax credits are so far following the template established in the renewable energy space, though these projects present unique challenges to obtaining tax equity. It is also likely that the sponsor of a carbon capture project is in some way related to the emitter, the sequesterer, or both, which makes the sponsor’s credit rating a key feature in generation of the tax credits.

While there is much speculation in the market regarding what the Biden administration might put forward in terms of promoting increased renewables investment, it’s likely that the structural considerations that have, to date, been key in making an investment in the renewables space will continue to be critical.

As the energy transition accelerates, investment funds with a firm grasp of these structural considerations will be well positioned to be valuable business partners for both developers and strategic investors keen to capitalize on whatever opportunities the Biden administration creates.

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