AFTER THE IRA – A NEW FINANCING LANDSCAPE

AS WE PASS THE FIRST ANNIVERSARY OF THE INFLATION REDUCTION ACT, THE PROJECT FINANCE MARKETS ARE BEGINNING TO COALESCE AROUND NOVEL FINANCING STRUCTURES DESIGNED TO MAKE OPTIMAL USE OF THE NEW TAX CREDIT SUBSIDIES THAT THE US CONGRESS ENACTED. THIS ARTICLE EXAMINES SOME OF THE KEY STRUCTURAL CHANGES IMPLEMENTED UNDER THE IRA, WITH A FOCUS ON HOW THESE CHANGES ARE SHAPING THE WAY US RENEWABLE ENERGY AND ENERGY TRANSITION PROJECTS ARE CAPITALISED, AND THE WAY PROJECT FINANCING FOR THESE PROJECTS IS EVOLVING. BY **KELLY CATALDO**, PARTNER, AND **ELI KATZ**, PARTNER AND VICE-CHAIR, ENERGY & INFRASTRUCTURE INDUSTRY GROUP, **LATHAM & WATKINS LLP**.

Most US wind and solar projects qualify for either an investment tax credit (ITC), which is available when a project is completed, or a production tax credit (PTC), which is generated over a ten-year period starting when the project first becomes operational. The IRA introduced significant changes to accelerate the energy transition, including extending existing tax credits through the next decade, creating new tax credit bonuses for projects in fossil fuel communities and those that use domestic components, and creating new tax credits for emerging technologies, such as battery storage and hydrogen projects.

But by far the most fundamental of the changes that the IRA introduced is the right of project owners to sell their tax credits freely in the open market. Prior to the IRA, tax credits could not be bought and sold. Instead, they could be shared only by equity owners of projects through structured joint ventures known as tax equity partnerships. Now, most tax credits may be sold in the market under a tax credit transfer programme. This change and a detailed set of regulations that the Internal Revenue Service (IRS) released in June 2023 are shaping the renewable energy project finance market in the US.

Navigating the tax credit sale rules

Financing projects that will sell tax credits involves new considerations and opportunities. The first is how best to structure bridge financing against the future sale of a project's tax credits. A second consideration is how project owners can protect against the risk of ITC recapture, as described below, which could result from a lender foreclosure at any time in the five-year period after an ITC is claimed.

- *Payment limitations* – Buyers and sellers of tax credits must follow two specific payment rules. First, the payment must be made in cash. Second, the payment must be made in a window of time starting at the beginning of the year in which the credit is generated and ending on the date the tax return is filed for the credit. For example, if a filing is made to extend the tax return filing deadline, the buyer is able to pay from January of a given year up to midsummer (or later) of the following year.

  The inability of buyers to prepay for credits effectively means that tax credit buyers cannot provide bridge capital to developers that have not yet earned their tax credits. Project owners, therefore, turn to banks or other capital sources to bridge to a tax credit purchase commitment. In the case of a sale of PTCs, the purchase commitment will likely call for payment instalments to be made over a period that could be as long as ten years.
- *ITC recapture* – Although an ITC is claimed in full when a project is completed, the credit vests over a five-year period, in equal 20% instalments per year. If a project loses its tax credit qualification status at any point during this five-year period, the unvested part of the credit is recaptured and must be repaid to the IRS. This rule applies not only to ITCs claimed by project owners but also to ITCs purchased by tax credit buyers in the open market. Recapture is most commonly caused by a casualty event that destroys the project, a systemic design failure

FIGURE 1 - TAX EQUITY BRIDGE LOAN STRUCTURE

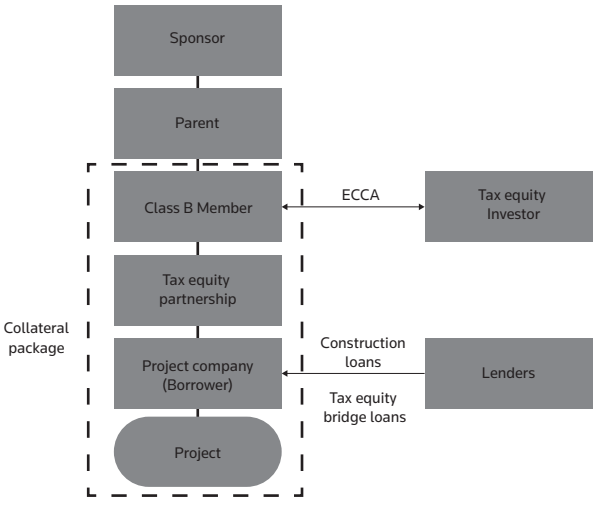
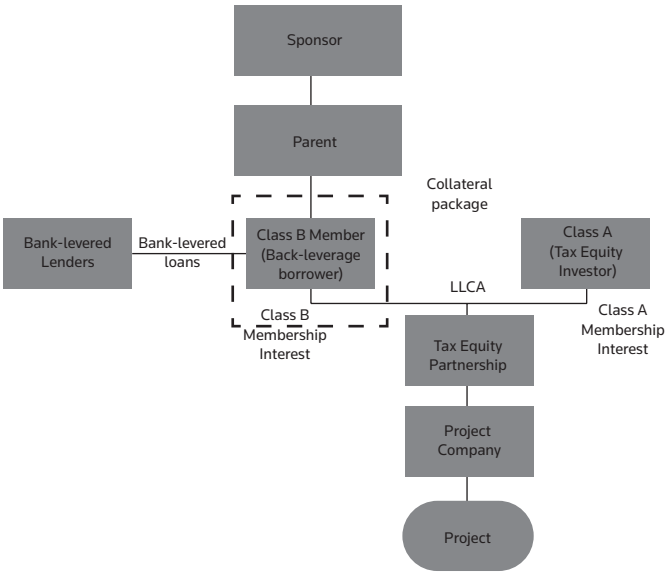


FIGURE 2 - BACKLEVERAGE LOAN STRUCTURE



that renders the project inoperable, or a sale of the project assets or equity during the five-year recapture period.

Historical structures

Historically, to raise capital for the construction of projects, sponsors have obtained loans from lenders and binding commitments from tax equity investors. Tax equity investors typically do not take construction risk and fund their commitments only once the project has achieved specified completion milestones. Tax equity bridge loan (TEBL) facilities have become a commonly used technique to raise capital against a future tax equity commitment. The structure of a typical TEBL facility is depicted in Figure 1.

Like a construction loan, a TEBL is drawn during construction, used to pay project costs as incurred and secured by all assets of and equity in the project company. The TEBL is sized off of, and repaid with the proceeds of, the tax equity investor's future funding commitment. As a result, lenders focus on the credit quality of the tax equity investor and any conditions to its funding obligations.

Generally, a tax equity investor memorialises its commitment in an equity capital contribution agreement, which is signed concurrently with or shortly after the closing of the loan facilities. Once the project is operational, the tax equity investor funds its commitment and repays the TEBL. Any remaining construction loans are then typically repaid with proceeds of a term loan, the "term conversion".

Tax equity investors generally do not permit the tax equity partnership to have secured debt. Accordingly, asset level liens are released at term conversion. The term loan is secured by assets of and equity in the term borrower, and the term lenders are structurally subordinated to the tax equity partnership. This structure is known as a back-leverage loan, and the associated collateral package is depicted in Figure 2.

Bridging to tax credit sales

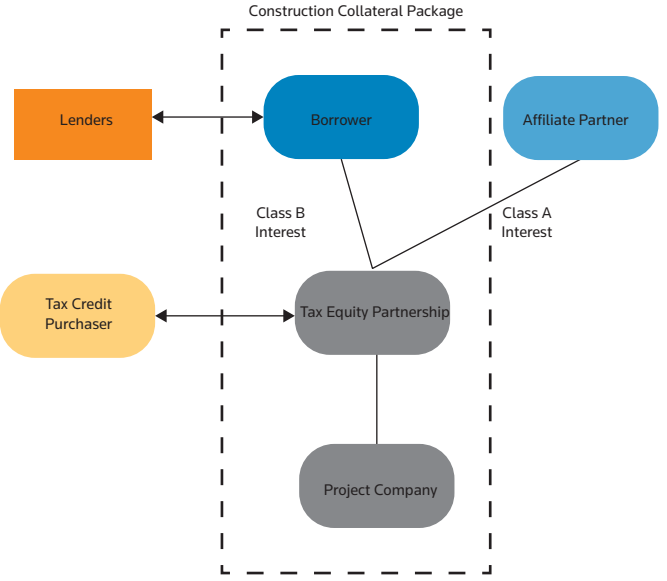
- *Bridge loans* – Bridge financing structures for tax credits sales borrow heavily from TEBL structures, but with significant differences and new considerations. Like the timing mismatch that created the need for a TEBL, project owners require significant capital for construction before tax credit buyers are permitted to pay for the credits. Tax credit transfer bridge loan (TRABL) facilities, which are sized based on the projected sale price of the tax credits, can be used to bridge this gap.

TRABL facilities for ITC transactions are structurally similar to TEBL facilities, with loans during the construction period repaid on a lump-sum basis with the proceeds of the sale of ITCs. Because the sale is not tied to construction completion milestones, the repayment of the TRABL, which depends on when the tax credit buyer agrees to pay for the credits, may be misaligned with when term conversion can otherwise be achieved.

In contrast, repayments under PTC TRABLs are likely to occur over a multi-year period as the PTCs are generated and sold. Loans will be sized against the projected aggregate payments from the sale of credits, and repaid on an amortisation schedule sculpted to the PTC instalment payments under the tax credit purchase agreement. Similar to ITC sales, there will be a mismatch between term conversion and repayment of the TRABL facility for PTCs.

The lenders in tax credit sale transactions will evaluate the creditworthiness of the buyer given that they are bridging to its commitment to buy the credits. The credit analysis for PTC sales will be even more important given the long tenor of the TRABL bridge. Lenders may insist on financial covenants and credit support to ensure their source of repayment will remain creditworthy over the purchase agreement term.

FIGURE 3 - PROJECT FINANCE VARIATION



While the mature TEBL market has settled around a 95% to 100% advance rate against a tax equity commitment, debt sizing in the nascent TRABL market continues to evolve. Debt sizing for PTC sales is further complicated by the longer-term repayment period, and the fact that PTCs – and therefore the corresponding payments from a tax credit buyer – fluctuate based on a project's generation profile.

Some near-term projects may not have arranged tax credit sale agreements at financial close, as the demand for construction financing is outpacing the ability of project developers to source tax credit buyers on attractive terms. Some lenders are advancing TRABL commitments against the value of uncommitted credits, at advance rates that range from 50% to 75% of expected credit value. Other lenders are requiring full or partial sponsor credit support during the period before a tax credit purchase commitment is executed.

Structure and recapture – There are at least two key variations on the conventional project financing structures discussed in the historical structures section. The first, depicted in Figure 3, is similar to a conventional tax equity partnership and is designed to avoid a recapture event if the lenders foreclose.

Lender foreclosure on the assets of or equity in the project company during the five-year period after a project is placed in service may result in a recapture of the unvested portion of the ITC. A recapture event would cause a tax credit buyer to lose its tax credit and would likely trigger an indemnity obligation from the project owner that sold the credits.

In a conventional tax equity partnership, after an ITC asset is placed in service, the term lenders do not have liens on the investor or on the investor's interests in the partnership. A foreclosure will be on the borrower or on the sponsor member's interests in the partnership, which will not result in a recapture of the tax credit allocated to the tax equity investor.

To achieve a similar result in a tax credit sale structure, the project owner may choose to hold the project in a joint venture between the term borrower and an affiliate and allocate the ITC to the affiliate. The affiliate's equity and assets are not part of the lenders' collateral, thereby avoiding recapture if the lenders foreclose on the term borrower.

This structure is easily adaptable for a tax equity partnership or tax credit transfer arrangement. It may, therefore, be attractive to both sponsors and lenders, because it provides the flexibility to toggle between a bridge loan repayment from a tax equity investor or a tax credit buyer.

For transactions in which this flexibility is desired, lenders and borrowers should determine the base case assumption of the value of the credits for debt sizing purposes, and provide flexibility for prepayments and incremental borrowings to toggle to the correct advance rate once the final take-out structure is known.

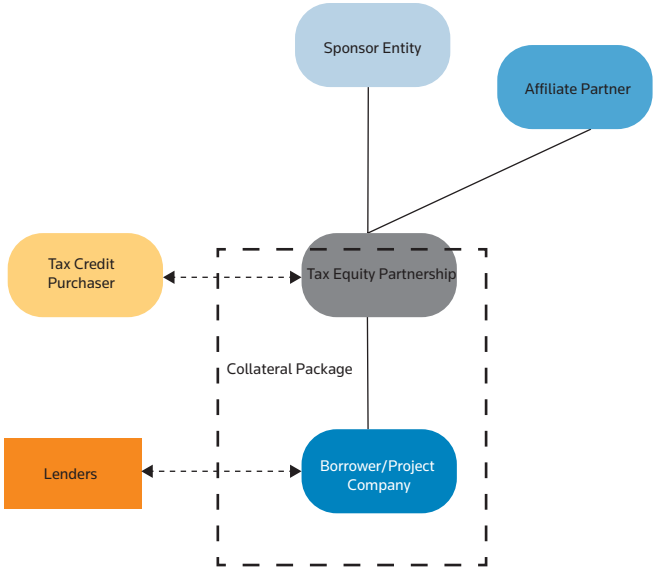
In a PTC sale transaction, in which tax credit recapture is not a concern, the term lender may negotiate to maintain asset-level collateral for the tenor of the loans. One variation of this structure is depicted in Figure 4.

This structure is more favourable for lenders than the conventional back-leverage structure, as it permits the lenders to maintain asset-level liens throughout the term of the financing, and to remain structurally senior to obligations under the tax credit transfer agreement. Lenders may also require a pledge of the tax credit transfer agreement and associated deposit account (for example, if they are bridging to payments under such agreement).

- *Intercreditor terms* – TRABL lenders will evaluate certain due diligence terms in the tax credit sale agreement, including remedies for under-performance, liquidated damages for credit shortfalls, and the scope of indemnities offered by sellers. Lenders will attempt to ensure that they are shielded from or have seniority over the project owner's obligations to a tax credit buyer.

Interparty agreements between the lenders and tax credit buyers may provide certain terms that apply prior to foreclosure (such as forbearance and cure rights), and specify the lenders' rights to enforce the tax credit buyer's commitment to purchase tax credits.

FIGURE 4 - PTC VARIATION



Conclusion

The IRA has heralded new opportunities to monetise tax credits and arrange project financing for renewable energy and energy transition projects in the US. The financing landscape will remain dynamic as market players adapt to new transaction structures that enable optimal use of the new subsidy regimes. ■