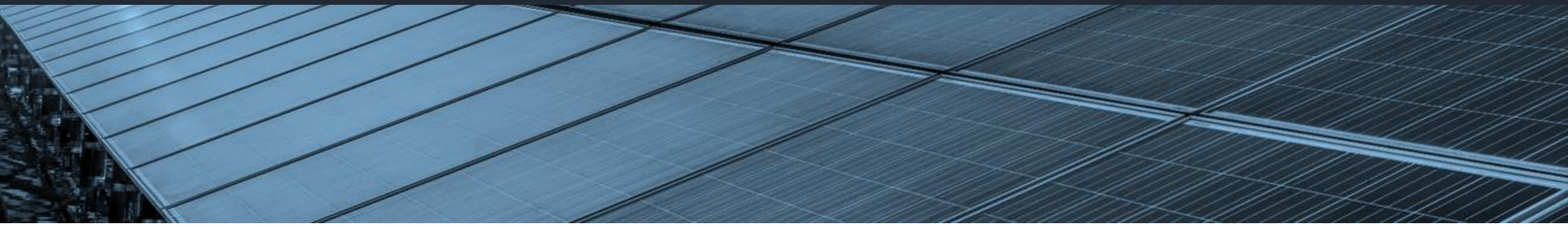
Facilitating Tax Equity Investments

Tax credits are an essential instrument in the government's toolbox to encourage a variety of environmental investments.



Introduction

Through the use of financial incentives such as grants and tax credits, the federal government encourages the development and use of alternative fuels. The recently passed Inflation Reduction Act ("IRA") will spend approximately $369 billion over the next decade promoting the ongoing shift from fossil fuels to more renewable forms of energy and encouraging developers and investors in the continued build-out of renewable energy initiatives.

For tax equity investors, a number of hurdles can stand in the way of these investments. One issue can be the credit quality of sponsors who typically provide various indemnities to the investor. Another potential constraint is the number of transactions an investor can enter into with a preferred partner sponsor due to limitations on the amount of concentrated counterparty risk arising from sponsor indemnities, that the investor is able to carry on its balance sheet. And yet another is the simple concern that arises from operating in an unfamiliar landscape, which carries risks that may not be backstopped by any indemnity.

Several years ago, tax indemnity insurers stepped in to address these hurdles and further promote the legislative goals of promoting clean energy globally. The amount of capacity that has been deployed to assist tax equity investments is in the billions and significant resources have been allocated to increase tax expertise within the tax insurance industry. Tax indemnity insurance facilitates tax equity investing by providing A-rated capital to support or replace transaction indemnities and insure non-indemnified risks.

While the vast majority of insurance transactions to date relate to solar ITC investments, the tax market is able to underwrite risks associated with other initiatives including wind and carbon capture/storage. Carbon capture projects continue to generate significant interest from developers and investors, despite the economics of these projects generally relying on the availability of a tax subsidy given the lack of revenue stream associated with the capture activity. As such, it is anticipated that tax equity will continue to play a large role in the financial construct of carbon related projects and underwriters are optimistic that they can play a role in these transactions.

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Tax insurance is a flexible tool that can be customized to each project. It can be underwritten directly to a tax equity investor or indirectly to benefit the tax equity investor by writing to a project company. Loss under the policy includes taxes owed, applicable interest, fines and penalties (if insurable under governing law), defense costs and gross up (taxation of insurance proceeds). The policy provides fulsome protection against successful challenges to the insured risks, allowing transacting parties to move forward with comfort while improving global climate concerns.

Insurable Risks

Tax credit policies typically cover the following risks:

1. **Structural Risks.** Insuring that the investment structure (sale leaseback, partnership flip, inverted lease) complies with governing law (partnership and partner status, ownership status, allocation of tax credits, validity of tax credit pass-throughs, etc., will all be respected).

2. **Inside Basis/Tax Benefit Qualification Risks.** Insuring that that the facilities qualify as "energy property" and that the "inside basis risk" which determines the amount of the ITC will be respected. Insurance can replace sponsor indemnities or backstop existing indemnities provided by the sponsor or developer.

3. **Recapture Risk.** Insuring that the tax credits will not be recaptured as a result of the property ceasing to be recognized as investment credit energy property with respect to the taxpayer.

4. **Begun Construction.** Insuring that the that onsite or offsite physical works are of a significant nature, (including related safe harbors).

Rates, Retention & Capacity

There is significant capacity in the tax indemnity market. Pricing for ITC placements typically ranges from 1.7% to 3% of the limits purchased, depending on the breadth of coverage sought. The one-time premium represents a multi-year policy that can range anywhere from 6 – 10 years depending on the risk. Additional costs include underwriting fees and applicable surplus lines and tax fees imposed on the polices.

With the passage of the IRA, there will undoubtedly be an increased interest in tax equity investing. Tax insurance is an established and knowledgeable segment of the property and casualty insurance market with significant capacity and a readiness to support tax equity investments.

For more information on how to integrate this coverage into your next transaction, please contact:

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