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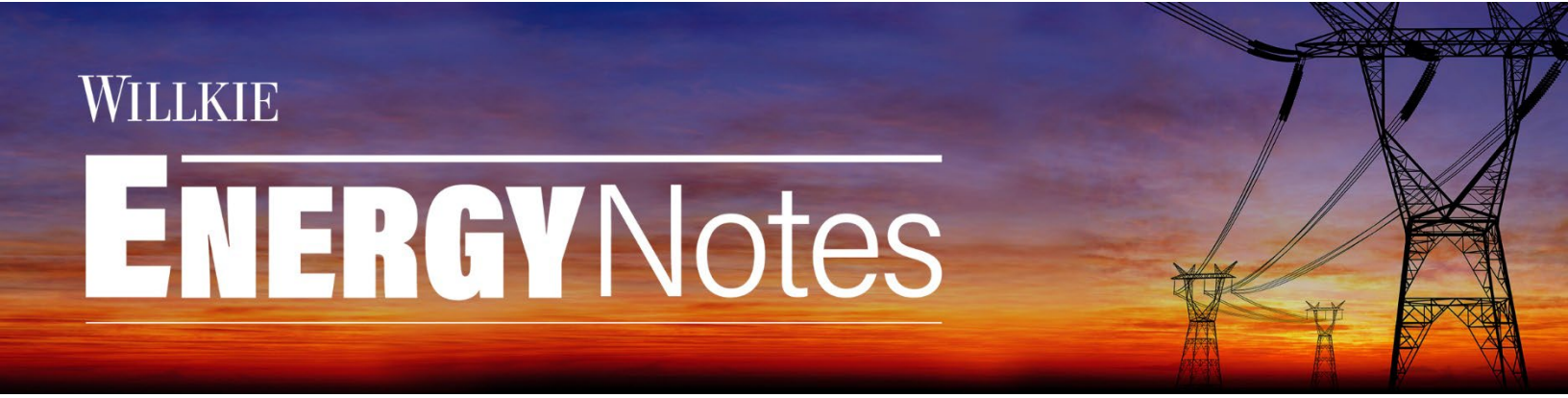

Preferred Equity Monetizations (PEMs) — Hybrid Capital meets Tax Equity

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The landscape for monetizing federal tax credits associated with energy projects continues to evolve rapidly. Since the enactment of the Inflation Reduction Act of 2022, project developers and owners (for purposes of this article, "project sponsors") have employed a range of capital structures to capture the value of federal energy tax credits and other tax benefits. An interesting development in this context is the emergence, and recent prevalence of, preferred equity monetization (or "PEM") transaction structures. PEM structures combine elements of third-party tax credit transfers *and* tax equity partnership-flip transactions with hybrid capital structures,[1] which are commonly utilized by energy and infrastructure participants to raise investment capital through private markets.

I. Background and Market Overview

A. Eligible Projects and Available Credits

Projects eligible for investment tax credits ("ITCs") under the Inflation Reduction Act (as modified by the One Big Beautiful Bill Act) include solar projects, energy storage systems, wind projects, fuel cells, geothermal projects, new nuclear projects and certain manufacturing projects. Production Tax Credits ("PTCs") also remain available for the foregoing types of projects along with a variety of energy transition projects (including carbon capture and

[1] As discussed below, hybrid capital (known by many terms in the market) broadly consists of structured solutions that have features of both debt and equity.

hydrogen), renewable natural gas, and certain critical minerals. Although a variety of hybrid capital structures have been employed in the PTC context, for the purposes of this discussion on PEMs, we primarily focus on ITC structures.[2]

B. Traditional Tax Equity Structures

Tax equity partnership-flip transactions (for purposes of this discussion, "tax equity") have served as the dominant mechanism for monetizing federal energy tax credits and other tax benefits for more than 15 years. In a typical tax equity transaction, a tax equity investor contributes capital to a newly formed partnership in exchange for an allocation of tax credits, other tax benefits (including depreciation) and a share of cash flows associated with the project(s) contributed or sold to the partnership by the project sponsor. The project sponsor uses this capital to re-pay development and construction costs and may recycle excess capital into future development. The tax equity investor, a member of the tax equity partnership, tracks its return (made up of a combination of cash and tax benefits — including ITCs and depreciation) and upon the investor receiving a target yield, a significant portion of the economic (cash and tax) rights, along with certain governance rights, "flip" back to the project sponsor. Tax equity is highly structured from a tax, accounting and commercial (including governance) perspective and a defined market has developed around transaction terms and documentation. In part due to that structuring complexity, the market of tax equity investors has been relatively limited to a handful of banks, insurance companies and other strategic corporates that possess both a significant "tax appetite" and interest in clean power investments (e.g., certain hyper-scalers and equipment manufacturers).

C. Tax Credit Transferability

The Inflation Reduction Act introduced a new, simpler option for monetizing tax credits: direct transfers or sales of tax credits to third parties. Under this structure, the project sponsor of an ITC eligible project may sell tax credits to unrelated purchasers solely for cash. Tax credit sales offer a streamlined alternative to tax equity, allowing project sponsors to monetize credits without forming partnership structures or otherwise sharing project economics or governance rights. However, as summarized in the below table, tax credit sales yield lower proceeds than tax equity transactions because the sale alone does not create a step-up of the ITC and does not create a mechanism to monetize other tax benefits (most notably depreciation) or project cash flows.

D. Hybrid Capital and Preferred Equity Monetizations (PEMs)

Hybrid capital (known by many terms in the market — including alternative finance, structured finance, structured private credit and quasi-equity) broadly consists of structured solutions that have features of both debt and equity. The primary purpose for these structures, simply put, is to raise significant capital. What makes hybrid capital unique is that the structure balances the ability to preserve upside equity returns to project sponsors (by prescribing investors' target returns) with mitigating potential adverse impacts that traditional debt products can have to sponsor

[2] As discussed below, this is because an economic driver for PEM structures is the fact that the transfer of project(s) to the PEM joint venture creates an opportunity for a step-up (i.e., to increase the taxable basis, and therefore the amount of ITCs and depreciation available, for a given project).

balance sheets and in turn sponsor share prices and credit ratings. Hybrid capital is used by a variety of entities seeking to raise capital (private and public companies — including utilities and hyper-scalers) and is industry agnostic (real estate, AI, healthcare, defense, etc.).

In the energy and infrastructure context generally, hybrid capital most frequently takes the form of project sponsors tapping into private capital markets in order to raise significant capital for new asset development (e.g., data centers and utility scale generation) by: (i) forming a joint venture with a private capital investor; (ii) the private capital investor funding its investment into the joint venture via a private capital, structured instrument; and (iii) the private capital investor recouping its investment and achieving its return via priority (or preferred) distributions from the joint venture.

Against this backdrop, an alternative to tax equity and third-party tax credit transfer transactions has emerged in the context of financing projects that are eligible for ITCs. Specifically, PEMs are transactions that are an amalgam of the hybrid capital model and traditional tax equity. In PEM transactions for ITC projects, project sponsors form a joint venture (partnership) with a private capital investor — wherein the investor funds an upfront investment and receives its return via preferred equity distributions from the partnership.

Like traditional tax equity, the PEM structure typically includes a sale from the project sponsor to a joint venture (i.e., a partnership between the project sponsor and the investor) that facilitates a step-up of the project's tax basis. In the PEM structure (unlike tax equity) the investor is not itself monetizing the tax benefits (ITCs or depreciation) but rather facilitating a step-up of the ITC basis and in turn the sale of the ITCs to a third party (via a transfer transaction). Accordingly, project sponsors utilizing a PEM structure enjoy a higher tax basis in ITC-qualifying assets and monetize those ITCs via a third-party transfer, but are not able to monetize other tax benefits associated with their project(s) (most notably depreciation). The trade-off for the project sponsor becomes balancing (A) the benefit of access to a larger (and different) pool of private capital investors for PEM transactions relative to traditional tax equity investors, which can in some cases also provide more flexibility in terms,[3] with (B) the drawback of not being able to monetize the other tax benefits / depreciation via the PEM structure.

Table: Summary of Economic Features

	Tax Credit Transfers*	Pref-Equity Monetizations**	Tax Equity (Partnership-Flip)
Is the ITC monetized?	**YES**	**YES**	**YES**
Does the structure facilitate an ITC step-up?	NO	**YES**	**YES**
Investor advances funds against a portion of project cash flows?	NO	**YES**	**YES**
Depreciation is monetized?	NO	NO	**YES**

* for this table, we are referring to tax credit transfers that are not coupled with a tax equity or PEM.

[3] For example, related to tax qualification, step-up percentages, flip term, etc.

** PEM structures in this table refer to a pref-equity investment coupled with a tax credit transfer.

II. Key Features of PEM Transactions

As a threshold matter, we note that a key feature of PEM transactions — and perhaps the most important feature — is the ability for project sponsors to tap into the broad private capital market of private equity, private credit and other investment funds, insurance and other institutional capital, and family offices. Our experience tells us that although "market terms" for PEM transactions have largely tracked those of tax equity transactions, a key reason for hybrid capital and in turn PEMs becoming commonplace is the flexibility available in structuring such transactions. Stated otherwise, there is a large variety in how PEM transactions can be structured and the below summary is just an overview of the most common characteristics that we have seen in recent transactions.

A. Structural Similarities to Tax Equity

PEM transactions share several foundational characteristics with tax equity transactions. In both structures, the investor contributes capital in exchange for a priority economic position in the project company. The investor receives distributions from project cash flows and the project sponsor typically retains residual upside after the investor achieves its target return. Both structures require detailed attention to partnership or limited liability company operating agreements, including provisions governing capital contributions, distribution waterfalls, and buyout mechanics. In our experience, the starting place for the papers in PEM transactions is typically tax equity papers (i.e., equity capital contribution agreements, membership interest purchase agreements and limited liability company agreements that are used in tax equity transactions).

At a more granular level, we have listed below some of the key features of PEM transactions that are shared with tax equity:

- 20/80 Funding Structure — Like tax equity, PEM transactions for ITCs typically track a funding structure tied to 20% of the capital being contributed at the project's mechanical completion and the remaining 80% at substantial completion of the project. This structure limits the investor's risk during development, while still becoming a member for tax purposes prior to the project being placed-in-service.

- Flip Architecture — PEM transactions typically track to a return. Preferred distributions go to the private capital investor (including make-whole payments to the extent prior priority payments are missed) and such distributions are tracked against a target return. After the return is achieved, like tax equity (and more general hybrid capital transactions in our experience) the economics largely revert to the project sponsor. Similarly, governance rights typically step-down and put (and/or call) options spring into place after the flip, which effectively create an exit path for the investor after five (5) years.

- Tax Features / Protections — Notwithstanding that the PEM investor is typically not monetizing the ITCs or other tax benefits, given a number of factors (e.g., the PEM investor may be receiving some of its return from the proceeds of the tax credit transfer, market practice and preferences around complying with tax safe harbors, etc.) in our experience PEM transactions largely include the tax features and protections of a tax equity

transaction. By way of example, PEM investors frequently require tax-based conditions precedent to funding including receipt of a tax opinion from its counsel and benefit from a suite of tax representations and indemnities from the project sponsor.

- Governance Rights — Governance rights in PEM transactions generally track the negative covenant package from tax equity transactions — major decisions (incurring project-level debt, changes in insurance programs or replacement of major project contracts, etc.) require investor consent.

B. Key Differences Relative to Tax Equity

Again, with the caveat that by definition PEM transactions are more bespoke and vary from transaction to transaction, some notable differences between PEMs and tax equity transactions include:

- Responsibility for Monetizing ITCs — Unlike tax equity, a key feature of PEM transactions is that the obligation for monetizing the ITCs rests with the project sponsor. In traditional tax equity the tax equity investor uses the credits (which count towards the tax equity investor's return)[4] — in PEM transactions the project sponsor, rather than investor, is responsible for sourcing a buyer of the credits. This tracks with the fees payable in connection with the tax credit purchaser (i.e., in a PEM transaction, unlike tax equity, the project sponsor is typically responsible for any fees — broker and legal — arising with respect to the tax credit sale).

- Economic Benefits re: Depreciation — As noted above, in a PEM transaction the investor often does not price-in the economic benefits associated with depreciation. That being said, in our experience some depreciation benefits nonetheless flow to the investor as a result of some portion (i.e., more than 1%) of the tax benefits, including depreciation, being allocated to the investor.[5]

- Tax and Cash Allocations — The tax and cash allocations in PEM transactions vary from transaction to transaction. With respect to tax allocations, which are generally 99/1 in tax equity transactions, in our experience these are bespoke / negotiated provisions in PEM transactions — notwithstanding the fact that PEM investors typically do not monetize ITCs or count depreciation benefits toward the flip calculation.

- Offtake Features — Although there is not a standard offtake structure associated with PEM transactions, in our experience the investors in PEM transactions are more flexible with respect to merchant exposure (as well as basis risk) than traditional tax equity investors.

- Step-Up Percentages — Similar to offtake structures, there is not a "market" step-up percentage in PEM transactions relative to tax equity. That being said, in our experience the investors in PEM transactions (who typically do not bear any tax risk associated with step-ups) are less restrictive on project sponsors with respect

[4] Note that the spectrum of transaction structures available to project sponsors also includes a structure (sometimes referred to as hybrid tax equity) pursuant to which a tax equity investor enters into a regular-way tax equity transaction and then facilitates the sale of some or all of the ITCs to a third party.

[5] The result being the investor receives certain depreciation benefits without making an upfront payment associated with the same (or taking the depreciation benefit into account when tracking its return via a flip calculation).

to step-up percentages assuming the sponsor member provides an indemnity and/or tax credit policy covering the taxable basis risk for the third party monetizing the tax credits.

- Tax Credit Insurance — In general, PEM transactions are more likely to require tax credit insurance to cover the tax credit purchaser's exposure to tax risks (i.e., to further insulate the joint venture, and in turn, PEM investor from any exposure to the tax credit purchaser for potential tax losses).

III. Conclusion

Just as hybrid capital has become an increasingly prevalent tool for raising capital in the energy and infrastructure space, PEM structures have become increasingly common in transactions involving ITCs. This structure — although not entirely unique from tax equity and not without its economic challenges — provides an interesting option to project sponsors to (i) access broad private capital markets and (ii) take advantage of additional structuring flexibility.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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