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The Role Of REITs In Wind Power Finance

Long associated with real estate finance, real estate investment trusts could become a worthy financing mechanism for wind projects, thanks to a recent addendum from the IRS.

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Over the last decade, one of the few constants in the wind industry has been policy change, each time bringing with it a temporary halt to the project financing market as the wind community determines the implications. Throughout the myriad of policy changes, there have been three sources of capital developers have been able use to finance a project: traditional equity, tax equity and senior debt. Numerous incentives have been introduced to stimulate these three sources of capital, including the Treasury Department's cash-grant program and the Department of Energy's loan-guarantee program.

To date, however, none of these mechanisms has been sufficient to incent other alternative sources of capital to the sector. There have been rumblings within the industry to lobby the Internal Revenue Service (IRS) to make wind assets eligible to master limited partnerships, thereby introducing a retail component to this asset class, but it does not appear that the necessary changes to the tax code are forthcoming. For developers, financing remains a source of anxiety. Today, bank financing is relatively abundant, and the tax-equity market seems to have recovered from its low in 2008.

However, the traditional equity market is challenged, as low natural-gas prices have depressed power purchase agreement (PPA) pricing and overall traditional equity returns. Furthermore, as the prospects for the extension of the cash-grant program look dim, there is a concern that the tax-equity market will once again become a bottleneck, because too much demand will be chasing too little supply. Traditional equity investor returns will also suffer if the cash-grant program is eliminated. An additional source of capital would be helpful to finance future projects.

One potential source of new financing could be real estate investment trust (REIT) capital. Currently, REITs are one of the largest sources of capital through which real property is financed. They are used to finance everything from apartment complexes and shopping malls to data centers and healthcare facilities.

REITs were created by Congress in 1960 to make large-scale, income-producing real estate accessible to all investors. REITs are afforded a tax deduction for dividends paid, which effectively creates one level of income taxation, because most REITs distribute 100% of their taxable income. (By law, they must distribute a minimum of 90%.)

As a result, REITs can raise equity capital at low costs – the implied capitalization rate for REITs is 6% to 7%. Structurally, REITs must be formed as a corporation, business trust or similar association. REITs must derive at least 75% of their gross income from rents on real property, be managed by a board of directors and have fully transferable shares with a minimum of 100 shareholders. There are currently 154 publicly traded REITs with an aggregate market capitalization of over $400 billion. In addition, there are approximately 1,000 privately held REITs. Historically, REITs have been restricted from investing in energy assets; however, recent private letter rulings appear to be changing the landscape.

In December 2010, Hunt Power, Marubeni Corp., John Hancock Life Insurance, TIAA-CREF and OPTrust Private Markets Group formed the Electric Infrastructure Alliance of America (EIAA) and the Gas Infrastructure Alliance of America.

These investors have committed up to $2.1 billion to develop and acquire electricity and gas transmission and distribution assets. These pioneering REITs will be the first of their kind, and their existence has been made possible by recent IRS private letter rulings. The Federal Energy Regulatory Commission has also approved this concept.

The EIAA does not include wind assets as targets to be developed or acquired for its REIT, but other market participants have been developing structures through which REITs could be used to provide an alternative source of financing for wind projects. There are, however, challenges to this strategy.

The primary challenge is that even with the recent private letter rulings, power-generation equipment does not qualify for REIT capital. While this would appear to be a fatal flaw for the REIT model as it pertains to wind assets, there are mechanisms to structure around the issue by including only real property assets and not power-generation technology in a REIT.

This would require dividing the wind project into two pieces. The power-generating portion (GENco) would contain the nacelle, generator and blades, while the REIT portion (REITco) would execute a sale leaseback on the remainder of the project. On a percentage basis, REITco would contain approximately 60% of the project. In this structure, an additional private letter ruling should not be required.

A second challenge is that REITs cannot be the operator of any of its assets; a separate entity must be responsible for all operations and maintenance (O&M). To address this issue, the existing developer could retain O&M responsibilities for the entire project.

Economically, placing wind assets in a REIT could create significant benefits for a developer. A REIT would size its investment by looking at a stream of P75 cashflows and applying a coverage ratio on the order of 1.25 times. The value of these cashflows would be discounted at a market rate of return to determine a lease size. GENco would then make quarterly rent payments to REITco and retain upside above the P75/1.25 times coverage ratios.

The developer could elect to receive REIT proceeds in either cash or stock. If the developer were to receive cash, this cash could be used to develop other projects in its pipeline. If the developer elected to receive stock, it would participate in any upside that could occur when the assets are placed in the REIT. The potential for upside would exist because the REIT would be acquiring the assets at a market rate of return that would be higher than the 6% to 7% capitalization rate, when the REIT should trade on the public market. In theory, transactions structured in this way would be accretive to the REIT and cause share price appreciation. In this scenario, the developer would also receive dividends from its shares, because REITs are required to pay out a minimum of 90% of their net income in dividends.

In addition, a REIT structure would be complementary to existing forms of capital. There would still be a role for cash equity at GENCo, which would capture the upside of the project above the P75/1.25 times coverage ratios. REITs are not able to efficiently monetize tax benefits, so there would also be a role for tax equity at the GENCo level to monetize depreciation and either production tax credits or investment tax credits.

Finally, while it is unlikely that there would be senior debt at GENco, most REITs typically operate with leverage at the REITco level. This debt would be similar to back leverage, could be sized based on traditional P99 1.0 debt-service-coverage-ratio metrics and paid from lease payments.

The role that infrastructure REITs will play in the financing of wind energy projects remains to be seen. It is unlikely that REITs represent a universal solution for all future wind projects; however, they may provide an additional tool that can be used to fill up the capital stack. Ultimately, the benefit of REIT capital may be to allow upside and liquidity for traditional equity investors and smaller developers. Even so, in an industry known for frequent policy and legislative challenges, any new sources of capital would be welcome. NWP

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