Accounting for Investments in Alternative Energy Projects

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Partnership “Flip” Structure

Developer

Tax Equity Investor

Cash distributions
Period 1: 100%
Period 2: 0%
Period 3: 95%

Gross income (loss)
Period 1: 1%
Period 2: 1%
Period 3: 95%

Project Entity

Power Purchase Agreement

Utility

Cash distributions
Period 1: 0%
Period 2: 100%
Period 3: 5%

Gross income (loss)
Period 1: 99%
Period 2: 99%
Period 3: 5%
Developer:
Sale of Investment in Project Entity

Do real estate accounting rules apply?

If developer sells an investment in a project entity that is in substance real estate:

real estate accounting rules apply to sale of investment (EITF 98-8)
Real Estate Rules Apply…

… for example, if substantially all of the assets of the entity are:

- land
- land and buildings
- power plants
- manufacturing facilities
- refineries
Real Estate Rules Apply…

… to all sales of real estate (and investments in entities that are in substance real estate) including real estate with property improvements or integral equipment on leased land

**Integral Equipment:** Any physical structure or equipment attached to real estate that cannot be removed and used separately without incurring significant cost (FIN 43; EITF 00-13)

Significant cost: 10 percent threshold
Example: Sale of Real Estate

Project Entity leases land and installs wind turbines on the land under lease.

Wind turbines are substantially all of project entity’s assets.

Fair value of turbines (installed): $10 million

Cost to remove turbines and decrease in fair value of turbines: $2 million

Do real estate rules apply to sale of equity interests in project entity?

Yes
If developer sells an investment in a project entity that is in substance real estate:

real estate accounting rules apply to sale of investment (EITF 98-8)

What is frequently the consequence?
As a result of continuing involvement (e.g., repurchase option), transaction is not accounted for as a sale, but as a financing, leasing or profit-sharing arrangement.
Accounting for Investments in Project Entities

Developer and Tax Equity Investor

- Consolidation
- Equity Method
- Cost Method
- Fair Value

FIN 46(R)
ARB 51
In Consolidation...

- Financial position and results of operations of parent company and project entity are reported as if they were a single entity.
- Assets, liabilities, revenues and expenses of project entity are combined with parent.
- Intercompany items are eliminated.
- Other investor’s equity interest is presented as minority interest.

For FY beginning on/after 12/15/2008, minority interest is presented as part of equity section (FASB Statement 160).
Consolidation – Relevant Guidance

• ARB 51, Consolidated Financial Statements
• FIN 46(R), Consolidation of Variable Interest Entities
• SOP 78-9, Accounting for Investments in Real Estate Ventures
• EITF 96-16, Investor’s Accounting for an Investee When the Investor has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights
• EITF 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights
Selecting the Consolidation Model

FIN 46(R)  ARB 51
Risks & Rewards  Control

Determinant for Consolidation

Which model to apply? If entity is not scoped out of FIN 46(R) and meets definition of variable interest entity: apply FIN 46(R)
FIN 46(R) – Variable Interest Entity (VIE)

Insufficient equity investment at risk
or
Investors do not have rights/obligations of “owners”

→ Right to receive expected residual returns
→ **Obligation to absorb expected losses**
→ Right to make decisions
→ Substantially all of activities on behalf of ONE investor
  and disproportionate voting rights
Identifying Variable Interests (VIs)

VIs: equity, loans

Developer

Tax Equity Investor

Project Entity

Utility

Potential VIs:
management agreement
service agreement
guarantees
supply arrangements
derivatives
PPAs

Important: Evaluate ALL Arrangements
FIN 46(R) – Who Consolidates?

The variable interest holder that absorbs more than half of the entity’s expected losses or receives more than half of the entity’s expected residual returns (when no party absorbs a majority of expected losses) consolidates.

There is no requirement that every VIE be consolidated by one of its variable interest holders.

Watch out for related party relationships!

Restrictions on transfer of equity interests can make investors related parties under FIN 46(R)
Proposed Amendment to FIN 46(R)

FASB’s new consolidation model …

**Step 1:** Qualitatively determine if a variable interest holder has:

1. The power to direct matters that significantly impact the activities of and success of a VIE; **and**

2. The right to receive *potentially significant benefits* from the VIE and/or the obligation to absorb *potentially significant losses* of the VIE

If **both** conditions above are met, consolidate. If Step 1 is inconclusive, proceed to Step 2.
Step 2: Quantitatively determine if a variable interest holder has:

1. An obligation to absorb a majority of the *expected losses* of the VIE; or

2. A right to receive a majority of the *expected residual returns* of the VIE

The variable interest holder that absorbs a majority of the expected losses (or receives a majority of the expected residual returns) consolidates.
Consolidation Under “Control Model”

• Investor consolidates if it has a controlling financial interest in project entity
  – Consider legal form of entity and rights and obligations of investors
Who Controls?

Corporate Venture
• Generally, investor with majority voting interest consolidates
• Participating rights of substantive minority shareholders overcome presumption of control (EITF 96-16)

Limited Partnership (LP)
• General partners are presumed to control
• The following rights overcome presumption of control (EITF 04-5):
  • Substantive ability to dissolve (liquidate) LP, or
  • Substantive kick-out rights, or
  • Substantive participating rights
Accounting for Investments in Project Entities

Developer and Investor

- Consolidation
- Equity Method
  - Income Allocation: APB 18, SOP 78-9, HLBV Method
- Cost Method
- Fair Value
Equity Method of Accounting

• If consolidation is not appropriate, most equity interests in project entities are accounted for under the equity method.

• Equity method is appropriate if investor exercises significant influence over operating or financial policies of investees.

Fair value option may be available for investments that qualify for the equity method of accounting.
Equity Method – Relevant Guidance

- APB 18, The Equity Method of Accounting for Investments in Common Stock
- SOP 78-9, Accounting for Investments in Real Estate Ventures
- EITF 94-1, Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects
- EITF 98-13, Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee
- EITF 99-10, Percentage Used to Determine the Amount of Equity Method Losses
- Proposed SOP, Accounting for Investors’ Interests in Unconsolidated Real Estate Investments
Application of the Equity Method

- Record investment in project entity at cost
- Adjust carrying amount of investment to recognize investor’s share of earnings or losses
- **Conventional Application:**
  Use “percentage ownership interest” approach to investee’s U.S. GAAP net income to determine investor’s share of investee’s earnings or losses for the period

- **Challenges to Conventional Application:**
  Investee’s capital structure provides different rights and priorities to its owners or ownership percentages are not specified
Example – Equity Method (Conventional Application)

On 1/1/2007, InvestCo (I) has acquired a 40 percent equity interest in Wind One Corp. (WIND) for a purchase price of $400 million. I shares in profits and losses of WIND commensurate with its ownership interests. I applies the equity method of accounting. WIND reports $10 million profits in 2007 under U.S. GAAP, and distributes $50 million to I.

1. What is I’s share of WIND’s earnings?
   ✓ $4 million

2. What is the balance in I’s investment as of 12/31/2007?
   ✓ $354 million
     (calculated as: 400 + 4 – 50)
SOP 78-9, Accounting for Investments in Real Estate Ventures

- Issued to provide accounting guidance for investments in real estate entities
- Often used by analogy for entities in other industries
- Paragraph 25 of SOP 78-9 states:
  “… in order to determine the investor’s share of venture net income or loss, such agreements or arrangements should be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with generally accepted accounting principles) will affect cash payments to the investor over the life of the venture and on its liquidation…”
Equity Method: Allocation of Profits

On 1/1/2007, InvestCo (I) has purchased a 40% membership Interest in Wind One LLC (WIND) for a purchase price of $40 million.

The terms of the LLC Agreement specify that I is entitled to a preferred return of 5% on its capital. I will not participate in any profits above 5%. In 2007, WIND has profits of $10 million. I applies the equity method of accounting.

How much profit should be allocated to I?

✓ $2 million
Losses of Project Entity

• General Rule:
  – Investor should not recognize losses in excess of the amount of its equity method investment (including loans and advances) in the project entity

• Exception:
  – Investor has guaranteed obligations of the investee or is otherwise committed (legally or otherwise) to provide further financial support to the project entity (e.g., general partner)

• Amount of Losses to Recognize (EITF 99-10):
  – Based on ownership level or loan/advance to which equity method losses are being applied; or
  – Based on change in investor’s claim on investee’s book value
Hypothetical Liquidation at Book Value (HLBV) Method

The HBLV Method is an income allocation method that overcomes challenges with the conventional application of the equity method

- Determines how better (or worse) off the investor is at the end of the period than it was at the beginning of the period (taking into consideration only those transactions and other events recognized by the investee under U.S. GAAP)
- Balance sheet-oriented approach

Note: Generally, the HLBV Method is not considered appropriate where the conventional method can be applied
HLBV Method: The Concept

- Company liquidates assets at book value
- How much is each investor entitled to?
- Change in amount each investor is entitled to during the period is income allocated to each investor (adjusted for distributions/contributions)
Example - Priority Return

**Company A**
Limited partnership interests: 100%
General partnership interests: 50%

**Company B**
General partnership interests: 50%

A’s limited partnership interests are entitled, on a priority basis, to return of their capital investment ($4,000) and an annual return of 10% thereon ($400). Thereafter, all remaining amounts go to the general partnership interests.

During 2007, Investee has net income of $1,000. No distributions were made during 2007, but the priority distribution of $400 had been made in all previous years.
Example - Priority Return (cont.)

At 1/1/2007 Investee's balance sheet is as follows:

<table>
<thead>
<tr>
<th></th>
<th>December 31, 2006</th>
<th>December 31, 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Real Estate, net</td>
<td>10,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Debt</td>
<td>(6,000)</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Equity</td>
<td>$5,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

What is A’s share of Investee’s earnings for 2007?
### Example - Priority Return (cont.)

**A’s Claim to Net Assets:**

<table>
<thead>
<tr>
<th></th>
<th>December 31, 2006</th>
<th>December 31, 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book value of assets</td>
<td>$11,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Debt</td>
<td>(6,000)</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Available for owners</td>
<td>5,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Return of A’s capital</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>10% return to A</td>
<td></td>
<td>400</td>
</tr>
<tr>
<td>50% of remainder</td>
<td>500</td>
<td>800</td>
</tr>
<tr>
<td>A’s total claim</td>
<td>$4,500</td>
<td>$5,200</td>
</tr>
<tr>
<td>FY 07’ equity pick-up</td>
<td></td>
<td>$700</td>
</tr>
</tbody>
</table>
Applying the HLBV Method to Partnership “Flip” Structures

Consider Tax Attributes
What’s Special About “Flip” Structures?

Returns to investors through...

- PTCs
- Project Entity
- MACRs
- Cash Flows

Not reflected in project entity’s accounts
Some Tax Considerations

- **PTCs:** Project entities are flow-through entities, and PTCs which are part of tax equity investor’s return, are not reflected in investee’s books and must be separately considered.

- **Tax make-whole provisions:** If investors agree on after-tax IRR: Tax implications from liquidation must be considered (convert post-tax to pre-tax amounts).

- **Tax depreciation (MACRS):** Consider that advantage to tax equity investor is only timing difference, i.e., tax will be due at later point in time.
Example Waterfall Provision in a Partnership “Flip” Structure

Distribute proceeds from the realization of the net assets upon dissolution of the project entity to...
- Members with a deficit capital account to bring their capital account to zero
- Developer: distribute amounts up to their original capital contribution
- Tax equity investor: distribute amounts until the “flip point”
- All remaining proceeds are distributed 95 percent to developer and 5% to tax equity investor

Flip point is determined on after-tax basis: post-tax amounts needed to achieve flip point need to be converted to pre-tax amounts

MACRS Recapture?
Accounting for Investments in Project Entities

Developer and Investor

- Consolidation
- Equity Method
- **Cost Method**
- Fair Value

Expected to be rare in partnership “flip” structures; only if investor’s interest is minor (no more than 3-5 percent)
Under the Cost Method...

- Investor records the investment at cost
- Income is recognized only when the investor receives distributions from earnings that have been accumulated by the entity → subsequent to the acquisition of the interest by the investor, or upon sale of the equity interest
- Any distributions that exceed the investor’s share of earnings since acquisition of the interest reduce carrying amount of investment

Fair value option may be available for investments that qualify for the cost method of accounting.
Cost Method – Relevant Guidance

APB 18, The Equity Method of Accounting for Investments in Common Stock
Accounting for Investments in Project Entities

Developer and Investor

- Consolidation
- Equity Method
- Cost Method
- Fair Value
The Fair Value Option

- Option to account for nonconsolidated interests in entities at fair value
- Changes in fair value are reported in earnings
- If applied to investment that would otherwise be accounted for under the equity method: must be applied to all of investor’s interests in the entity

Not appropriate, if investment includes significant component for future services.
Example – The Fair Value Option

- General partner A manages partnership’s assets
- A is entitled to return on its GP-interest that is disproportionately greater than return on B’s GP-interest
- A is not entitled to fees for asset management services
- A accounts for GP-interest under equity method.

Could A elect the fair value option?

Probably not, because fair value of A’s GP-interest could include value of services.
Questions?