Legal Issues for Tribal Energy Projects

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Overview of Presentation

- Key drivers to energy investment in Indian Country
- Understanding the investors
- Issues in leasing, joint ventures and tax credit investment (flip and other models)
- Considerations for tribes to improve the conditions for successful energy deals

Key Drivers for Energy Investment

- Tax benefits: Accelerated depreciation and Production Tax Credits (renewables)
- Serve local energy demands (small projects) or economic development with utility scale projects with revenues to tribe
- Cash flow to equity investors
- Affiliate contracts
- Policy
  - State/federal incentives
  - Environmental/social benefits

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Understanding the Investors

- Strategic investors
  - Capacity to develop investment in the sector
  - Capacity to accept project risks because of knowledge and active management
  - Historically balance sheet financed development and acquisition

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Institutional Equity Investors

- Mainly passive investors, motivated by tax benefits and overall return
- Experienced in other energy tax credit regimes
- Will not accept significant development risk
- Requirements similar to lender requirements

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Other Types of Equity Investors

- Utilities
- Oil/energy companies
- Other tribes
- European developers/markets (e.g., AIM)
- Other tax credit investors
- Other financial & development companies
- Nonprofits (Citizens Energy)
- Private equity funds/investors
- Venture capital investors

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Early Stage Development Equity

- Substantial development costs required to reach a financeable project
- Sponsor and developer may lack adequate capital, development expertise and ability to arrange additional financing
- Alternatively, sponsor finds developer with capital, expertise and financing ability

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Late Stage/Construction Stage Equity

- **Made through purchase or joint venture/limited liability company**
- **Required to support power purchase agreements (PPA) or interconnection agreement security, turbine purchase order and construction loans**

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The Formation of the Deal – Traditional Model

- Sponsor (including the tribe and/or a tribal entity such as an enterprise, tribal corporation or Section 17 corporation)
- Developer (could be tribe or non-tribal entity)
- Project company formed to carry out:
  - Development
  - Construction
  - Operation

Joint Venture Process

- Usually begins with a non-binding Letter of Intent coupled with a Confidentiality and Nondisclosure Agreement
  - Sets the basic tone for discussions between the tribal sponsor and developer
  - Allows both parties to share information without fear of disclosure to competitors
- Most non-tribal third parties will accept dispute resolution at this stage pursuant to tribal law

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Joint Venture/Joint Development Agreement

- **Guides the parties through the pre-construction development process**
- **Sets the tone and the “template” for future agreements between the tribal sponsor and the developer**
- **Establishes the business relationship, and the allocation of project development risk between the tribe and non-tribal project entities**

Major Issues in Joint Venture Structure

- Preconstruction development budget
- Project schedule and milestones
- Delineation of development activities and responsibilities between tribal sponsor and developer
- Rights of compensation before and after financial closing
- Allocation of development costs
- Property rights

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Critical Issues for Tribal Parties in Joint Ventures

- Shareholder rights, especially minimum proposed minority shareholder protections (e.g., anti-dilution, rights to acquire interests in the project and project company, management issues)
- Tribal employment and contracting preference
- Compensation for use of tribal lands, taxation

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Key Sticking Points

- Dispute resolution, governing law, choice of forum
  - Waiver of defense and right of sovereign immunity
  - Exhaustion of remedies in tribal courts
  - Arbitration vs. litigation
- Indemnification, limitation of liability, remedies on default and termination

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Negotiating the Sticking Points

- Limited waiver of immunity to suit essential - limit to specific assets, protect tribal officials and individuals, tie to dispute resolution
- Binding arbitration to avoid state court jurisdiction
- Authority to compel arbitration, enforce awards, protect parties during arbitration in any court of competent jurisdiction
- Insist on clear terms preserving tribal jurisdiction (covenant not to contest tribal jurisdiction on tribal status as Indian nation)

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Leasing Issues

- Critical early issue due to importance of site control in permitting, negotiations for PPA’s, transmission interconnection
- Joint venture or development agreement should guide sponsor and developer with general goals of project site lease to avoid surprises during the development process

Lease Basics

- **Most likely vehicle for siting energy facilities on trust lands**
- **Federal law and regulation governing leases on trust lands (.e.g., 25 USC §415; *see also* 25 CFR pt 162 and 25 USC §81).**
- **Allows tribe to collateralize trust land. The tribe may then assign the lease to a project company or third party lender**

Suggestions to Improve the Leasing Process

- **Evaluate tribal code provisions, if any, and consider adopting business site leasing regulations under BIA authority**
- **Consider creation of tribal energy authority (e.g., Dine Power Authority of the Navajo Nation) with leasing powers**
- **Talk with the local BIA officials *early* about the approval process, timelines, federal appraisal requirements, etc.**

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Select Features of Lease Structure

- Permitted uses
- Compensation, alternative tax structure
- Term (primary and renewal)
- Assignment and transfer
- Rights on termination, default
- Removal of improvements; reserve account
- Approved encumbrances
- Liability allocation
- Dispute resolution

Structures for the Tax Motivated Equity Investor

- **Recap:**
  - **Joint venture or joint development agreement provides rights of equity investment for tribal sponsor and third party equity investors, including tax credit investors**
  - **Joint venture and lease provide for rights of third party investors as approved encumbrances**

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Significance of Structuring Tax Equity Investment

- Typically, 60 to 65% of the economic benefits in US wind projects (on or off tribal lands) are tax benefits; also applies to other energy projects
- Two primary benefits
  - Depreciation
  - Production Tax Credits
- Tribe not subject to federal income tax, not eligible for tax credits. Deal needs to structure tax credit investment opportunities

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Accelerated Depreciation

- Most components of renewable energy projects may be depreciated using five year MACRS, 200% declining balance
- Placed in Service date will determine the use of the mid-year or quarter-year convention for the first year of depreciation
- Accelerated depreciation for qualifying projects in Indian Country even shorter if Congress renews law

Production Tax Credit (IRC Section 45)

- Applies to qualifying renewable energy facilities placed in service by specific deadlines
- The Production Tax Credit would provide a tax credit of 1.8 cents per kWh produced over ten (10) years
- For example, a 40 MW project operating at 30% capacity would be expected to spin off ~ $2,000,000 per year in tax credits

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Institutional Tax Credit Investors

- Established market of institutional tax credit investors – e.g. insurance companies, investment funds, oil companies -- to invest in the equity side of renewable energy projects, particularly for the tax credits.
- These investors are primarily interested in the tax benefits, not long-term ownership.
- For up-front capital-intensive energy projects, a project’s cost of capital and financial structure has a significant impact on the financial performance of the project.

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Why the Flip Structure Exists

- In order to claim the PTC, the taxpayer must own the facility and produce the electricity
- The party claiming the credit must receive the same proportion of gross revenues and PTCs from the project
- PTCs cannot be stripped and sold separately
- Other limitations (reduced by federal, state and local credits and grants related to construction of the facility, offsets limits to other taxes, subject to passive loss rules)

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The Flip Structure Basics

- LLC agreement provides for percentage interests among investors, usually 90% or more to tax equity investor and remainder to sponsor equity/developer
- After 10 year period, or longer period for PTC investor to meet agreed-upon internal rate of return, percentage interests “flip” such that sponsor/developer holds 90+% and PTC investor holds 10%
- Usually combined with a purchase option for the PTC investor’s interest after the flip

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Variety of Structures for Tax Equity

- **Not all structures work or are appropriate in all transactions. Transaction specific tax advice is critical and must be obtained at an early stage**
- **If flip is used, tribe should negotiate position to acquire PTC share after flip**
- **Majority position usually negotiable after 20-25 year life of project**

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Citizens and DPA Joint Venture

- MOU with Dine Power Authority entered July 2006
- DPA Citizens and DPA working together through wind development process:
    - Site selection and Leasing
    - Wind assessment
    - Environmental & Permitting
    - Transmission & Interconnection
    - Power marketing

- DPA has ownership interest in Dev. Co. and rights to increase stake up to majority stake over time
- All development funding provided by Citizens

For More Information

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