'Yieldcos' Present a New Growth Model for Renewable Energy Companies

Skadden

January 2015

This article is from Skadden's *2015 Insights* and is available at skadden.com/insights.

Contributing Partner

Andrea L. Nicolas
New York

Contributing Associate

Michael J. Hong
New York

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

In the past few years, many energy companies with investments in renewable energy projects have considered forming "yieldcos," with five formations in 2013 and 2014. A yieldco is a growth-focused public company, typically formed by a public sponsor to hold long-term operating assets that generate low-risk cash flows in the form of dividends for stakeholders, and a cost-effective financing option for the owners of the renewable energy assets. Yieldcos also provide an investment opportunity similar to master limited partnerships (MLPs), combining predictable and growth-oriented cash flows with favorable tax treatment for investors.

A Pure-Play Public Investment Vehicle

Assets are typically only put into the yieldco at a point in their lifecycle when their development presents limited risk. This allows investors to make a pure-play investment in operating energy assets through a highly liquid security. In addition, yieldcos generally are designed to provide an ongoing inflow of additional assets from the sponsor via a right of first offer or call rights on projects in the sponsor's development pipeline, which can result in further dividend growth potential over time.

Adopting a Hybrid Approach That Parallels MLPs

As the popularity of yieldcos has grown, the transaction structures have become more complex. The first yieldcos utilized relatively simple two-tier corporate structures that passed to investors distributable cash received by a yieldco from its operating subsidiaries. Over time, companies began to seek an incentive compensation structure that would provide upside potential to the sponsor, similar to the incentive distribution rights that historically were specific to MLPs.

Incentive rights are one of the more prominent features of MLPs, providing for an increasing percentage of distributions to be paid to the sponsor as the total distributions achieve specified thresholds. As the total distributions increase, the percentage paid to the sponsor increases, up to a ceiling of a 50-50 split between public holders and the sponsor. In exchange for this benefit, MLPs typically have a subordination mechanism, which provides that, for a specified period of time, public holders receive distributions on the public units before the sponsor receives payment on its units. As a result, to the extent quarterly distributions do not meet minimum quarterly distribution thresholds, the subordinated units held by the sponsor will not receive distributions.

Incorporating these structures into the yieldco model creates complexities because of both the differing tax treatment afforded to yieldcos, in that yieldcos do not benefit from the specific tax exemption afforded to MLPs, and the unique attributes of the projects in renewable energy portfolios, which often can make it difficult to fully adopt the MLP construct. These attributes differ from company to company and can include, among other things, consent requirements under power purchase agreements or from regulatory authorities, change-of-control provisions in certain agreements at the projects, and limitations on distributions and other restrictions in project financing arrangements, all of which can restrict a yieldco's

ability to replicate the capital structure of traditional MLPs as well as the securitization of incentive distribution rights. In addition, introducing public holders into a historically sponsor-driven structure presents several other challenges, particularly with respect to the grandfathering of historical management and operational services provided by the sponsor, and credit support provided by the sponsor to project entities, which requires a balance between maintaining efficiency and functionality while accommodating the interests of a broad group of public investors.

The First Yieldco to Successfully Incorporate the MLP Incentive Structure

The first public offering to successfully incorporate the MLP incentive structure within the existing yieldco model was the initial public offering of NextEra Energy Partners in July 2014. This transaction was an example of the need for a customized approach to balance commercial aspirations against the reality of an existing and sometimes inflexible operational structure. Using a two-tier limited partnership framework, NextEra formed a structure that achieved the incentive and subordination economics of MLPs via intricate and interdependent contractual arrangements among various sponsor entities. Importantly, the structure also followed the operational construct of other yieldco vehicles, including a right of first offer for the sponsor's developmental pipeline with ongoing management, as well as operational and credit support provided by the sponsor. Several subsequent transactions have followed a similar hybrid approach, and we expect that yieldcos will continue to be a point of interest for established players within the energy space. Ultimately, yieldcos may make a substantial contribution to the development of the U.S. renewable energy infrastructure.