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Accounting and Reporting Considerations for Renewable Energy Projects — Consolidation

Background

We are pleased to present the second installment in our *Renewables Spotlight* series, which focuses on emerging accounting and reporting topics that apply to the renewables industry.

U.S. renewable energy growth continues to accelerate, powered by factors such as clean-energy incentives under the Inflation Reduction Act of 2022, concerns about climate change, and support for environmental and sustainability initiatives. Investors in renewable projects have also been attracted to the strong cash flows and investment and production tax credits that are expected to be realized.

This *Renewables Spotlight* examines consolidation matters related to investments in renewable ventures. Such ventures often involve complex accounting considerations related to determining which entity (if any) should consolidate the venture.

Consolidation Considerations

A reporting entity that operates or invests in a renewable energy project often finds it necessary to evaluate whether, as a result of its interests in the project, it is required to consolidate another legal entity in accordance with ASC 810.[1] The reporting entity should perform this evaluation when it first becomes involved with a renewable energy project that is

[1] FASB Accounting Standards Codification (ASC) Topic 810, *Consolidation*.

a legal entity and to which none of the scope exceptions in ASC 810 apply. Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest* (the "Consolidation Roadmap") is a comprehensive guide to applying the guidance in ASC 810 and navigating the frequently complex consolidation accounting models. The discussion below summarizes several key aspects of the guidance that apply most directly to reporting entities involved with renewable energy projects.

Identifying a Variable Interest

One of the first steps in assessing whether a reporting entity is required to consolidate another legal entity is to determine whether the reporting entity holds a variable interest in the legal entity being evaluated for consolidation. As further described in Section 4.2 of the Consolidation Roadmap, a reporting entity should use the by-design approach to determine whether an interest is a variable interest. Under this approach, the reporting entity first analyzes the nature of the risks in the legal entity being evaluated for consolidation. It then determines the purpose(s) for which the legal entity was created and determines the variability (created by the risks whose nature the reporting entity has analyzed) that the legal entity is designed to create and pass along to its interest holders. Interests that absorb such variability are variable interests.

Common forms of potential variable interests in renewable energy companies include (but are not limited to) the following:

- Power purchase agreements (PPAs), tolling agreements, or similar arrangements.
- Other derivative instruments.
- Fees paid to a decision maker or service provider.
- Equity of the legal entity.

PPAs, Tolling Agreements, or Similar Arrangements

Renewable energy companies often enter into PPAs, tolling agreements, or similar arrangements that may, depending on their terms, create rather than absorb variability. For instance, a fixed-price forward contract to purchase electricity may not create a variable interest for the purchaser if the legal entity is designed to be subject to operating risk, credit risk of the purchaser, and fuel price risk. In this scenario, the role of the fixed-price forward contract is not to transfer any portion of those risks from the equity and debt investors to the purchaser since the price paid under the forward contract does not change as a result of changes in operating costs, fuel prices, or default by the purchaser (i.e., those risks are designed to be borne by the equity and debt investors).

In a scenario in which there is a variable-price forward contract to purchase electricity that reimburses the legal entity for costs of fuel and for operations and management (O&M) expenses, the contract may create a variable interest for the purchaser if the legal entity is designed to be subject to operating risk, credit risk of the purchaser, and fuel price risk. The role of the variable-price forward contract in such a case is to transfer the fuel price risk and some portion of operating risk from the equity and debt investors to the purchaser (i.e., changes in the fuel prices and O&M costs will be borne by the purchaser). Performing the variable interest assessment for these contracts can be particularly challenging. Before evaluating whether the arrangement is a variable interest, a reporting entity must determine whether it is:

- An operating lease that qualifies for the scope exception in ASC 810-10-55-39.
- A derivative under ASC 815[2] that creates (rather than absorbs) variability in accordance with ASC 810-10-25-35 and 25-36.

[2] FASB Accounting Standards Codification Topic 815, *Derivatives and Hedging*.

Section E.5.2.1 of the Consolidation Roadmap provides detailed guidance on how to evaluate these types of contracts.

Other Derivative Instruments

Renewable energy companies may enter into other types of derivative instrument agreements that they must evaluate to determine whether the counterparty holds a variable interest. During the development of the by-design approach, the FASB debated whether certain derivative instruments, such as interest rate swaps and foreign currency swaps, should be considered a variable interest in a legal entity by the counterparty to the derivative. From an economic standpoint, these types of derivatives could be viewed as both creating and absorbing variability in a legal entity. For example, in an interest rate swap in which the legal entity pays a fixed rate and receives a variable rate, the counterparty is absorbing fair value variability and creating cash flow variability for the legal entity. Although it would be atypical for such an instrument to give the counterparty power over the legal entity, the principles in ASC 810-10- 25-35 and 25-36 provide a framework under which the counterparty can conclude that many of these instruments are not variable interests in the legal entity. Thus, the counterparty would avoid further analysis of whether the legal entity is a variable interest entity (VIE) as well as the disclosures required by variable interest holders in a VIE.

See Sections 4.3.3 and E.5.2.3 of the Consolidation Roadmap for additional guidance.

Fees Paid to a Decision Maker or Service Provider

Renewable energy companies are often operated by a decision maker or service provider. ASC 810-10 contains specific guidance for assessing whether fees paid to the decision maker or service provider represent a variable interest in the legal entity. The determination of whether a decision maker's fee arrangement is a variable interest has a significant impact on the consolidation conclusion because if the decision maker's fee arrangement is not a variable interest, the decision maker would be acting as a fiduciary for the legal entity. This determination could affect whether the legal entity is a VIE and whether the decision maker is required to consolidate it.

If all of the following conditions are met, the fees paid to a decision maker or service provider do not represent a variable interest:

- The fees are "commensurate" under ASC 810-10-55-37(a).
- The arrangement is consistent with the guidance in ASC 810-10-55-37(d) (i.e., at market).
- The decision maker or service provider does not have any other interests (direct interests, indirect interests through its related parties, or certain interests held by its related parties under common control) in the legal entity that absorb "more than an insignificant amount" of the potential VIE's variability (ASC 810-10-55-37(c)).

However, if the fee arrangement is designed to expose a decision maker or service provider to risk of loss in the potential VIE (e.g., a guarantee embedded in the fee arrangement), the fees paid to the decision maker or service provider will be considered a variable interest even if all three conditions above are met.

Determining whether the conditions are met can be complex. See Section 4.4 of the Consolidation Roadmap for additional guidance.

Equity of the Legal Entity

Equity is almost always a variable interest because it typically represents the most subordinated interest in the legal entity's capital structure. Therefore, equity will typically absorb the variability in the returns of the legal entity. In addition, equity investments may be variable interests even if it is determined that they are not at risk as long as they absorb or receive some of the legal entity's variability.

However, if a legal entity has a contract with one of its equity investors (e.g., the legal entity has a financial instrument such as a loan receivable from the equity investor), the reporting entity would consider whether that contract causes the equity investor's investment not to be at risk. For example, if the contract with the equity investor (loan receivable) represents the only asset of the legal entity, that equity investment is not at risk and would not be considered a variable interest. A reporting entity should carefully consider any conclusion that its equity interest does not represent a variable interest because of an offsetting contract. Section 4.3.1 of the Consolidation Roadmap provides further illustrative guidance.

Determining Whether a Legal Entity Is a VIE

Once an entity identifies a variable interest in a legal entity, it must next evaluate whether it is required to consolidate the legal entity. ASC 810-10 establishes two primary consolidation models: (1) the voting interest entity model and (2) the VIE model. To decide which one to apply, the reporting entity must determine whether the legal entity is a VIE. The reporting entity makes this determination upon its initial involvement with a legal entity and reassesses it upon the occurrence of a "reconsideration event" (see Chapter 9 of the Consolidation Roadmap for a discussion of VIE reconsideration events).

If the legal entity is a VIE, the reporting entity with a variable interest in that legal entity applies the VIE provisions of ASC 810-10 to determine whether it must consolidate the legal entity. If the legal entity is not a VIE, it is considered a voting interest entity, and the reporting entity applies the voting interest entity model to determine whether it must consolidate the legal entity.

ASC 810 provides the following characteristics for a reporting entity to consider in determining whether a legal entity is a VIE; if any one of these characteristics is met, the reporting entity would conclude that the legal entity is a VIE:

- The legal entity does not have sufficient equity investment at risk to finance its activities.
- The equity investors at risk, as a group, lack the characteristics of a controlling financial interest.
- The legal entity is structured with disproportionate voting rights, and substantially all the activities are conducted on behalf of an investor (and its related parties) with disproportionately few voting rights (nonsubstantive voting rights) relative to the investor's economic interest.

Sufficiency of Equity

Determining the sufficiency of equity investment at risk often requires the use of significant judgment. This applies particularly to renewable energy companies that are in the development stage because equity funding may occur in phases, or the company's development may be primarily financed with temporary construction lending arrangements that are expected to be repaid with equity upon the achievement of certain operational milestones.

A legal entity is considered a VIE if it does not have sufficient equity investment at risk to permit it to finance its activities without additional subordinated financial support. A reporting

entity would determine the sufficiency of this equity investment by performing the following steps:

- *Step 1* — Identify whether the interest in the legal entity is considered GAAP equity.
- *Step 2* — Determine whether the equity investment is "at risk" on the basis of the equity investment population.
- *Step 3* — Determine whether the identified equity investment at risk is sufficient to finance the legal entity's operations without additional subordinated financial support.

When performing step 3, reporting entities must consider the design of a development-stage entity to determine whether its equity investment at risk is sufficient. That is, it may be appropriate in certain circumstances for the reporting entity to consider only the legal entity's current stage of development. Specifically, if a legal entity is in the development stage and there is substantial uncertainty about whether it will proceed to the next stage, it may be appropriate for the reporting entity to consider only the current stage in the sufficiency assessment. This approach is consistent with the assessment of power for a multiple-stage entity (i.e., the power to direct the most significant activities of the legal entity). For additional discussion of (1) the sufficiency of equity at risk and (2) whether a substantive contingency exists related to proceeding to the next stage of development, see Sections 5.2.4 and 7.2.9.2, respectively, of the Consolidation Roadmap.

A reporting entity should, on the date on which it first becomes involved with a legal entity, initially assess whether the legal entity is a VIE. It should then reconsider this assessment upon the occurrence of any of the events described in ASC 810-10-35-4. For a development-stage entity, these events would include but not be limited to:

- The funding of additional equity.
- The commencement of additional activities (e.g., entering a subsequent "phase" of development).

Example 1

Sufficiency of Equity

Company C maintains an investment in Entity B, a legal entity that is a tax equity partnership. Entity B consists of and consolidates Project Company P, which owns and operates assets under construction. Entity B has admitted to the partnership a third-party tax equity investor. Further, B is capitalized with a combination of equity and commercial debt that is noninvestment grade, which suggests that the lenders may not view B as having sufficient capitalization. In addition, B will need additional funding for its operations, including construction. The purpose and design of B is to construct and operate the assets for P.

In this example, there is not substantial uncertainty related to the completion of development; therefore, B is not a phased entity. The equity is not sufficient to finance B's current operations (which include construction) in the absence of subordinated financial support. Accordingly, B exhibits the characteristics of a VIE under the criterion in ASC 810-10-15-14(a) because of insufficient equity at risk.

Note that B's status as a VIE would need to be reconsidered upon each additional equity funding in accordance with the guidance in ASC 810-10-35-4(d). See Section 9.1.4 of the Consolidation Roadmap for additional information.

For additional discussion of sufficiency of equity, see Section 5.2 of the Consolidation Roadmap.

Equity Investors at Risk, as a Group, Lack the Characteristics of a Controlling Financial Interest

A legal entity is considered a VIE if the at-risk equity holders as a group, through their equity investment at risk, lack any of the following three qualities, which are the "typical" characteristics of an equity investment:

- The power to direct the most significant activities of the legal entity.
- The obligation to absorb the expected losses of the legal entity.
- The right to receive the expected residual returns of the legal entity.

For many renewable energy companies that are VIEs, the determination of whether the at-risk equity holders lack the characteristics of a controlling financial interest is based on the first characteristic above (i.e., the power to direct the most significant activities of the legal entity). Many renewable energy companies, particularly those structured as tax equity partnerships, are legally established as limited liability companies but have governance structures that are similar to limited partnerships. Generally, these entities have a managing member, which is the functional equivalent of a general partner, and a nonmanaging member or members, which are the functional equivalent of a limited partner or partners. ASC 810-10 contains specific criteria for limited partnerships and similar entities.

A limited partnership (or an entity that is considered to be similar to a limited partnership) would be a VIE regardless of whether it otherwise qualifies as a voting interest entity unless either of the following apply:

- A simple majority or lower threshold (including a single limited partner) of the "unrelated" limited partners (i.e., parties other than the general partner, entities under common control with the general partner, and other parties acting on behalf of the general partner) with equity at risk have substantive kick-out rights, including liquidation rights. (For additional discussion, see Section 5.3.1.2.2 of the Consolidation Roadmap.)
- The limited partners with equity at risk have substantive participating rights. (For additional discussion, see Section 5.3.1.2.7 of the Consolidation Roadmap.)

Accordingly, a limited partnership (or an entity that is considered to be similar to a limited partnership) would be a VIE unless the limited partners hold substantive kick-out or participating rights. The general partner and limited partners in a limited partnership must therefore use the voting interest entity framework to evaluate rights that are granted by law or by contract that are provided to limited partners to assess whether such rights have an impact on the determination of whether the reporting entity has a controlling financial interest in a legal entity. Noncontrolling rights can be broadly categorized as either (1) protective rights or (2) participating rights. Thus, an evaluation of protective rights and participating rights is critical to the VIE assessment and consolidation analysis. For additional discussion, see Section 5.3.1.2.2 and Appendix D of the Consolidation Roadmap.

Example 2

Equity Investors at Risk, as a Group, Lack the Characteristics of a Controlling Financial Interest

Company D maintains an investment in Entity E, a legal entity that is a tax equity partnership. Company D is E's general partner and has a 70 percent direct ownership interest in E. Entity E consists of Project Company P, which owns and operates assets under construction. Entity E has admitted to the partnership a third-party tax equity investor that has a 30 percent direct ownership interest. The tax equity investor is a limited partner with no voting rights over significant financial and operating activities that are necessary to direct and carry out E's current business activities. Further, the tax equity investor does not have kick-out rights over D as the general partner or liquidating rights over E. Significant financial and operating decisions of E's include (1) installing, operating, and maintaining facilities at PPA customer sites and (2) PPA customer acceptance and negotiations. Since the tax equity investor does not have kick-out rights over D as the general partner or liquidating rights over E or participating rights, E exhibits the characteristics of a VIE under the criterion in ASC 810-10-15-14(b)(ii).

It is critical for a reporting entity to determine whether the at-risk equity holders lack the characteristics of a controlling financial interest. This determination can be complex depending on the number of different parties involved that have the ability to make decisions related to the legal entity (e.g., the equity holders or the holders of interests other than equity such as debt) and the legal entity's governance structure. Section 5.3 of the Consolidation Roadmap provides a comprehensive discussion of factors to consider.

Nonsubstantive Voting Rights

The final condition in the VIE analysis is often referred to as the "anti-abuse provision" since it aims to prevent legal entities from being structured in a manner in which a party does not have voting control but in substance should be consolidated by a reporting entity that meets the "substantially all" criterion described in step 2 below. Although intended to address abuse, this provision may apply to many legal entities established with valid business purposes that qualify as VIEs. Further, a reporting entity that has been determined to have met the "substantially all" criterion does not automatically consolidate the VIE.

In assessing whether a legal entity is a VIE under the anti-abuse provision, a reporting entity must perform the following steps:

- *Step 1* — Determine whether one investor has disproportionately few voting rights relative to that investor's economic exposure to a legal entity.
- *Step 2* — Assess whether substantially all of the activities of a legal entity either involve or are conducted on behalf of the investor identified in step 1, including that investor's related parties and some de facto agents.

If a legal entity satisfies the criteria in **both** steps 1 and 2, its voting rights are considered nonsubstantive and it is therefore a VIE. A reporting entity would then evaluate the legal entity for consolidation under the VIE model. See Section 5.4 of the Consolidation Roadmap for additional guidance on identifying nonsubstantive voting rights.

Identifying the Primary Beneficiary of a VIE

The primary beneficiary of a VIE (i.e., the party with a controlling financial interest in the VIE) is the party that must consolidate the VIE. The analysis for identifying the primary beneficiary is consistent for all VIEs. Specifically, ASC 810-10-25-38A requires the reporting entity to perform a qualitative assessment that focuses on whether the reporting entity has both of the following characteristics of a controlling financial interest in a VIE:

- *Power* — The power to direct the activities that most significantly affect the VIE's economic performance (see Section 7.2 of the Consolidation Roadmap).

- *Economics* — The obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE (see Section 7.3 of the Consolidation Roadmap).

Example 3

Primary Beneficiary of a VIE

Assume the same facts as in Example 2 above, except that Entity E is a VIE in accordance with ASC 810-10-15-14(a). Profits and losses are allocated and distributed among the equity holders on the basis of each equity holder's respective ownership interest. Because (1) the tax equity investor does not have substantive kick-out rights or substantive participating rights over all of the most significant activities that affect E's economic performance and (2) Company D maintains an interest in E that could be potentially significant to E's profits and losses, D should consolidate E.

Applying the Voting Interest Entity Model of Consolidation

If a reporting entity has determined that a legal entity is not a VIE, it should apply the "general" guidance in ASC 810-10 or its guidance on the consolidation of entities controlled by contract. Under the voting interest entity model, a reporting entity consolidates a legal entity when it has a controlling financial interest in the legal entity.

A reporting entity should continually determine whether it should consolidate a voting interest entity. That is, the reporting entity should monitor specific transactions or events that affect whether it holds a controlling financial interest.

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