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Ruminations

WIND Investment Tax Credit vs. Production Tax Credit Options

Last week on May 7, 2009 we reviewed the 30% Investment Tax Credit Option under TARP for Wind Generation. Tables 5 and 6 on pages 5 and 6 contain our forecast of income statements, cash flows, profitability and credit measurements based on the Investment Tax Credit option and the Production Tax Credit option. (These comments are preliminary since we've not had an industry accountant detail the entries.) FPL Group (FPL-\$57-Hold) provided by far the most detail at its first-quarter earnings call. Both approaches rely on the goodness of "Uncle Sam."

The Investment Tax Credit option provides up to 30% of the cost of the investment and a one-time benefit to earnings from the flow thru of tax savings derived from the difference in the cost basis between book and tax reporting. The absence of the flow thru item in year 2 causes a sharp drop in earnings and profits rise modestly through year 15. Under the Investment Tax Credit approach earnings rise as long as qualifying investments exceed the prior years'. As investments decline, so too will earnings.

Production Tax Credits are applied to each megawatt hour sale (beginning at 2-cents) for 10 years. Earnings and cash flow in years 2 to 10 are greater than under the Investment Tax Credit option. Wind earnings decline sharply in year 11 with expiration of Production Tax Credits.

TARP

Under the American Recovery and Reinvestment Act of 2009, wind generation projects have the option of 1) taking a 30% Investment Tax Credit (convertible or straight) on qualifying investments, or 2) continue to book Production Tax Credits. Accountants have been reluctant to detail specifics of accounting under TARP, although FPL Group seems to have gone the furthest during its first-quarter earnings call. This piece is our best guess and subject to change.

Investment Tax Credit: The typical 100 megawatt plant investment (as per FPL Group analysis) would cost \$205 million and produce qualifying investment of about \$192 million and investment tax credits of \$57.6 million. According to the legislation (FPL management) cash is due from the US Treasury the later of 60 days after the COD date or 60 days after the application is filed.

Earnings Benefit: Under TARP, the cost basis per book is reduced by the full \$57.6 million (\$205 million less \$57.6 million) to \$147.4 million. The cost basis per IRS is reduced by half the ITC (\$205 million less \$28.8 million) to \$176.2 million. Over the 25-year investment life, IRS depreciation exceeds book depreciation by \$28.8 million. The \$28.8 million reduces taxes payable by \$11.5 million (assuming an overall tax rate of 40% including state taxes). FPL Group will flow thru the earnings benefit from the different tax basis in year 1.

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Table 2
Flow Thru
Tax Basis Earnings Benefit

Depreciation	\$-Mil.
IRS	176.2
Books	147.4
Excess IRS	28.8
Tax Benefit @40%	11.5

Accounting: For book reporting, the \$57.6 million Investment Tax Credit is normalized over the 25-year life. The initial journal entry is cash (Debit) of \$57.6 million offset by accumulated deferred investment tax credit (Credit) of \$57.6 million. In year 1, depreciation is recorded (Debited) at \$8.2 million (\$205 million divided by 25 years). Taxes per books are reduced (Credited) by amortization of \$2.3 million of Investment Tax Credits (\$57.6 million divided by 25 years).

Table 3
Journal Entries
Per Books

	Debit	Credit
Initial Entry	\$-Mil	\$-Mil
ITC Proceeds (BS)	57.6	
Accumulated Deferred ITC Credit (BS)		57.6
Depreciation & Amortization		
Depreciation (IS)	8.2	
Amortization ITC (IS)		2.3

(BS) Balance Sheet; (IS) Income Statement

PRODUCTION TAX CREDITS

TARP also extended the option of applying Production Tax Credits in lieu of Investment Tax Credits through 2012. Production Tax Credits have 10 year life, begin at 2-cents a megawatt hour (mwh) and escalate with inflation. (In an FPL Group report dated October 20, 2008, we provided 10-year income statements, cash flows, capitalization, and profitability for a hypothetical 100 megawatt wind unit for an 11 year period.)

In Tables 5 and 6 we present 11 years of income statements, cash flows, earnings, profitability and credit measurements for a 100 megawatt wind project on the basis of 1) investment tax credit availability (Table 5), and 2) production tax credits (Table 6).

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Table 4
Input for Income & Other in Tables 5 & 6

Column	(1)	(2)
	ITC	PTC
Input		
Capacity Factor	35%	35%
Capital Costs	2,100	2,100
Investment	205.0	205.0
ITC @30%	57.6	0.0
Book net of ITC	147.4	205
Debt	111	103
Equity	37	103
Total	147	205
Debt Initial	75%	50%
Equity Initial	25%	50%
Book Depreciation	8.2	8.2
ITC Amortization	2.3	0
Tax Dep 5yr Accelerated	35.2	41.0
Debt ret 15 years	7.4	6.8
Interest Rate	7.0%	7.0%
PTC mwh		2.0
Operating Exp per mwh	10	10
Purchase Pwr mwh	58	58
Tax Rate	40%	40%

In a rapidly growing business, the obvious choice is the upfront cash and initial earnings boost provided under the Investment Tax Credit option. Of course, once expansions slow or decline, earnings decrease.

The following Table 7 compares differences between the Production Tax Credit approach and the Investment Tax Credit method. Column 1 shows results for year 1; column 2 – years 2 to 5; column 3 – years 6 to 10; and column 4, years 11 to 15. The Investment Tax Credit option provides cash up front, an immediate boost to earnings with deferred tax credits flowed thru in year 1. Production Tax Credits provide higher earnings and cash flows years 2 through 10. ITC option produces higher earnings years 11 to 15, primarily from amortization credits.

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Table 7
PTC vs. ITC Methods

Column	(1)	(2)	(3)	(4)
Years	1	2 to 5	6 to 10	11 to 15*
Earnings – Mil				
PTC Method	6.4	30.1	50.4	24
ITC Method	12.4	8.0	20.2	32
Cash Flow Net Debt Ret. – Mil				
PTC Method	20.9	88.0	40.9	15
ITC Method	67.8	45.4	(3.8)	8
Cash Flow Coverage Interest				
PTC Method	4.99	5.82	4.92	7.84
ITC Method	3.35	4.02	2.72	7.96
Average Common				
PTC Method	95	59	35	44
ITC Method	24	11	1	1

*Years 11 to 15 not shown in Tables 5&6

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Table 5 Investment Tax Credit Option

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Year	1		2	3	4	5	6	7	8	9	10	11
Income	No Tax Benefits	AD ITC	AD	AD	AD	AD						
Load Factor 35% MWH	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil
	307	307	307	307	307	307	307	307	307	307	307	307
Revenues	17.8	17.8	18.0	18.3	18.6	18.9	19.2	19.4	19.7	20.0	20.3	20.6
Oper Exp	2.9	2.9	3.0	3.0	3.0	3.1	3.1	3.2	3.2	3.3	3.3	3.4
Depreciation	5.9	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2
Amortization ITC		(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)
Oper Exp	8.8	8.8	8.9	8.9	8.9	9.0	9.0	9.1	9.1	9.2	9.2	9.3
Operating Inc.	9.0	9.0	9.2	9.4	9.7	9.9	10.1	10.4	10.6	10.9	11.1	11.4
Interest	7.7	7.5	7.0	6.4	5.9	5.4	4.9	4.4	3.9	3.4	2.8	2.3
Pre Tax	1.1	1.5	2.2	3.0	3.7	4.5	5.2	6.0	6.7	7.5	8.3	9.0
Tax Rate	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%
Taxes 5 yr Amort		10.8	10.8	10.8	10.8	10.8	(3.3)	(3.3)	(3.3)	(3.3)	(3.3)	(3.3)
Taxes Pble	0.4	(10.2)	(9.9)	(9.6)	(9.3)	(9.0)	5.4	5.7	6.0	6.3	6.6	6.9
Net Taxes	0.4	0.6	0.9	1.2	1.5	1.8	2.1	2.4	2.7	3.0	3.3	3.6
Net Before ITC		0.9	1.3	1.8	2.2	2.7	3.1	3.6	4.0	4.5	5.0	5.4
Def Txs Flow thru		11.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Income		12.4	1.3	1.8	2.2	2.7	3.1	3.6	4.0	4.5	5.0	5.4
Cash Generation												
Net Income		12.4	1.3	1.8	2.2	2.7	3.1	3.6	4.0	4.5	5.0	5.4
Tax Dfd (pble)		(0.7)	10.8	10.8	10.8	10.8	(3.3)	(3.3)	(3.3)	(3.3)	(3.3)	(3.3)
Amort Itc		(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)	(2.3)
Depreciation		8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2
Total		17.6	18.1	18.5	18.9	19.4	5.7	6.2	6.7	7.1	7.6	8.0
% Change			3%	2%	2%	2%	-70%	8%	7%	7%	6%	6%
Cash to Parent		10.2	10.7	11.1	11.6	12.0	(1.6)	(1.2)	(0.7)	(0.3)	0.2	0.7
Debt Retirement		7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
Investment												
Debt	110.6	103.2	95.8	88.4	81.1	73.7	66.3	59.0	51.6	44.2	36.9	29.5
Common	36.9	10.2	10.7	11.1	11.6	12.0	(1.6)	(1.2)	(0.7)	(0.3)	0.2	0.7
Total	147.4	113.4	106.5	99.6	92.6	85.7	64.7	57.8	50.9	44.0	37.1	30.1
Structure												
Debt	75%	91%	90%	89%	88%	86%	103%	102%	101%	101%	99%	98%
Common	25%	9%	10%	11%	12%	14%	-3%	-2%	-1%	-1%	1%	2%
Profitability												
Ret Avg. Comon		52.7%	12.8%	16.4%	19.7%	22.7%	60.2%	**	**	**	**	**
Return Operations		1.1%	2.0%	2.9%	3.9%	5.0%	6.9%	9.8%	12.4%	15.8%	20.4%	26.9%
Return incl. Taxes		25.4%	15.7%	16.5%	17.5%	20.3%	24.5%	27.1%	30.5%	35.1%	41.5%	
CF % com.		43.5%	102.1%	102.0%	102.0%	101.9%	31.2%	83.7%	75.7%	52.5%	**	152.7%
Credit												
Cash Gen		25.1	25.0	24.9	24.9	24.8	10.7	10.6	10.5	10.5	10.4	10.4
Interest		7.5	7.0	6.4	5.9	5.4	4.9	4.4	3.9	3.4	2.8	2.3
Coverage		3.4	3.6	3.9	4.2	4.6	2.2	2.4	2.7	3.1	3.7	4.5
CF % Debt		23.5%	25.1%	27.1%	29.4%	32.1%	15.2%	16.9%	19.0%	21.9%	25.7%	31.2%
EPS		0.03	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Shares		406	406	406	406	406	406	406	406	406	406	406

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Table 6 Production Tax Credit Option

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Year	1	2	2	3	4	5	6	7	8	9	10	11
Income	No Tax Benefits	AD PTC	AD PTC	AD PTC	AD PTC	AD PTC	PTC	PTC	PTC	PTC	PTC	No PTC
Load Factor 35%	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil	\$-Mil
MWH Revenues	307	307	307	307	307	307	307	307	307	307	307	307
Oper. Exp	17.8	17.8	18.0	18.3	18.6	18.9	19.2	19.4	19.7	20.0	20.3	20.6
Depreciation	2.9	2.9	3.0	3.0	3.0	3.1	3.1	3.2	3.2	3.3	3.3	3.4
Oper. Exp	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2
Oper. Exp	11.1	11.1	11.2	11.2	11.2	11.3	11.3	11.4	11.4	11.5	11.5	11.6
Oper Inc.	6.7	6.7	6.9	7.1	7.3	7.6	7.8	8.1	8.3	8.6	8.8	9.1
Interest	7.2	6.9	6.7	6.2	5.7	5.3	4.8	4.3	3.8	3.3	2.9	2.4
Pre Tax	(0.5)	(0.3)	0.2	0.9	1.6	2.3	3.0	3.8	4.5	5.2	5.9	6.7
Tax Rate	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%
Deferred Taxes		13.1	13.1	13.1	13.1	13.1	(3.3)	(3.3)	(3.3)	(3.3)	(3.3)	(3.3)
Taxes Pble		(13.3)	(13.0)	(12.8)	(12.5)	(12.2)	4.5	4.8	5.1	5.4	5.7	5.9
Net Taxes	(0.2)	(0.2)	0.1	0.4	0.6	0.9	1.2	1.5	1.8	2.1	2.4	2.7
Inc Pre PTCs	(0.3)	(0.1)	0.1	0.5	1.0	1.4	1.8	2.3	2.7	3.1	3.6	4.0
PTC		6.4	6.6	6.7	6.8	7.0	7.1	7.3	7.4	7.5	7.7	0.0
Earnings		6.4	6.7	7.2	7.8	8.4	8.9	9.5	10.1	10.7	11.3	4.0
% Change			4.9%	8.3%	7.7%	7.2%	6.8%	6.4%	6.1%	5.8%	5.5%	-64.5%
Cash Gen												
Net Income		6.4	6.7	7.2	7.8	8.4	8.9	9.5	10.1	10.7	11.3	4.0
Tax Dfe (Pble)		13.1	13.1	13.1	13.1	13.1	(3.3)	(3.3)	(3.3)	(3.3)	(3.3)	(3.3)
Depreciation		8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2
Total		27.7	28.0	28.6	29.1	29.7	13.9	14.4	15.0	15.6	16.2	8.9
Cash to parent		20.9	21.2	21.7	22.3	22.8	7.0	7.6	8.2	8.8	9.3	2.1
Debt Ret.		6.8	6.8	6.8	6.8	6.8	6.8	6.8	6.8	6.8	6.8	6.8
Investment												
Debt	103	96	89	82	75	68	62	55	48	41	34	27
Common	103	88	74	59	45	30	32	34	36	38	40	42
Total	205	184	162	141	120	98	93	89	84	79	74	69
Structure												
Debt	50.0%	52.1%	54.7%	58.1%	62.8%	69.4%	65.8%	61.7%	57.2%	52.1%	46.3%	39.7%
Common	50.0%	47.9%	45.3%	41.9%	37.2%	30.6%	34.2%	38.3%	42.8%	47.9%	53.7%	60.3%
Profitability												
Return Com		3.3%	3.9%	4.8%	6.0%	7.7%	9.3%	10.4%	11.7%	13.1%	14.8%	5.6%
Ret Investment		3.5%	3.9%	4.5%	5.1%	6.1%	6.9%	7.2%	7.6%	8.0%	8.4%	9.0%
CF % Com.		21.9%	26.2%	32.8%	43.0%	61.2%	22.6%	23.0%	23.4%	23.8%	24.2%	5.1%
Credit												
Cash Inst.		34.6	34.7	34.8	34.9	34.9	18.6	18.7	18.8	18.9	19.0	11.3
Interest		6.9	6.7	6.2	5.7	5.3	4.8	4.3	3.8	3.3	2.9	2.4
Coverage		4.99	5.18	5.59	6.07	6.64	3.90	4.35	4.92	5.65	6.64	4.73
CF % Debt		21.9%	26.2%	32.8%	43.0%	61.2%	22.6%	23.0%	23.4%	23.8%	50.7%	36.8%
Per Share												
Shares		406	406	406	406	406	406	406	406	406	406	406
EPS		0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.03	0.03	0.01
PTC Per Share		0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.00
PTC % EPS		101%	98%	93%	88%	83%	80%	76%	73%	71%	68%	0%

Analyst's Certification

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Buy	15%	0%
Hold	85%	0%
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