

Financing Renewable Energy Projects After the Stimulus

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The economic stimulus bill that became law on February 17 will give wind, solar, geothermal, biomass, landfill gas, fuel cell and marine energy companies as many as three broad options for how to convert tax subsidies on their projects into cash.

The additional options are available only on equipment that is put into service in 2009 or 2010 or on which construction commences in 2009 or 2010 and is completed by a deadline that may be as early as 2012 or as late as 2016, depending on the type of project.

Two of the options may require that any tax equity investors fund before projects are placed in service or — at the outside — no more than three months after the in-service date. Therefore, developers who placed projects in service in early 2009 may have to hurry to close tax equity transactions by April.

PTCs

The bill extends the deadline to place wind farms in service through 2012 to qualify for production tax credits and through 2013 for geothermal, biomass and marine energy projects. The credits run for 10 years after a project is placed in service.

Developers whose projects qualify for such credits will still have the option to raise tax equity as before through partnership flip transactions. In such transactions, one or more tax equity investors are brought in as partners to own a project with the developer. As much as 99% of the tax benefits and other economic returns, except possibly cash, are allocated to the tax equity investors until they reach a target return, after which their interest drops usually to 5% and the developer has an option to buy out the remaining 5% interest of the investors for the fair market value determined when the option is exercised. Cash may be distributed 100% to the developer for the first few years until it gets back its equity in the project. After that, cash follows other economic returns and is distributed largely to the tax equity investors.

The tax equity market has been weak. Eighteen large institutions invested tax equity in renewable energy projects in the last two years. Only four or five appear still active. There was a shortfall in 2008 of \$2 to \$3 billion in supply of tax equity compared to demand. The shortfall has translated into escalating yields, which are a sign that the market is offering developers a diminishing percentage of the value of the tax benefits on their projects.

The stimulus bill does nothing to bring back any tax equity investors who exited the partnership flip market.

The Senate tax-writing committee originally proposed giving companies that cannot use tax credits the option to carry back credits arising during 2008 and 2009 for up to five years and receive a check from the US Treasury for taxes paid in the past. The Senate abandoned the proposal after being told by tax equity investors that five years would not be long enough to make any appreciable difference in the market. Investors wanted a 10-year carryback. This was not possible politically.

Both the House and Senate voted to allow depreciation and other net operating losses that a company cannot use during 2008 and 2009 to be carried back up to five years. However, both had proposed denying the extended carryback to banks, investment banks and insurance companies that have received TARP money from the federal government. Losses can be carried back two years currently. The final bill limits the five-year carryback to 2008 losses of small businesses with gross revenues of up to \$15 million a year.

Election to Claim ITC

The bill gives wind, geothermal, biomass, landfill gas and marine energy developers the option to forego production tax credits and claim a 30% investment tax credit instead.

The investment credit is taken entirely in the year a project is placed in service. It is 30% of the cost of the part of the project that is considered equipment as opposed to buildings. It cannot be claimed on any equipment that is used to transmit electricity.

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The option will be available only on wind farms placed in service during 2009 through 2012. It can be exercised on geothermal, biomass, landfill gas and marine energy projects placed in service during 2009 through 2013.

Solar and fuel cell developers already qualify for a 30% investment credit on projects placed in service by 2016.

Investment credits can be claimed on construction progress payments in cases where a project is expected to take at least two years to build.

Early modeling suggests that an investment credit makes more sense than production tax credits on wind farms that are expected to operate at less than a 31% to 34% capacity factor, depending on the cost per megawatt of installed capacity.

Choosing an investment credit will open the door to two forms of lease transactions that cannot be used in projects on which production tax credits are claimed. They are sale-leasebacks and inverted passthrough leases.

In a sale-leaseback, the developer sells the project to a tax equity investor and leases it back. The developer shares in the tax benefits in the form of a reduced rent to use the project. The lease cannot run longer than 80% of the expected life and value of the project. If the developer wants to continue using the project after the lease ends, then it must either negotiate an extension at then current market rent or buy the project. It can have an option to buy back the project for a fixed price negotiated in advance, but the price will be the expected value of the entire project — unlike in a partnership flip where the developer gets back 95% of the project automatically and has to pay the market value of only a 5% interest to recover the balance of the project.

In an inverted passthrough lease, the developer leases the project to a tax equity investor. The tax equity investor sells the electricity and pays most of the electricity revenue to the developer in the form of rent for use of the project. The developer elects to pass through the investment credit to the tax equity investor as lessee. The tax equity investor claims the investment credit and deductions for rent that may come close to mirroring the depreciation the investor would have had had it owned the project. The developer keeps the depreciation and uses it to shelter the rents from taxes.

There has been a lot of interest among solar developers in inverted leases. The lease term in such transactions runs anywhere from six to 15 years. At the end of the lease, the

developer takes back the project without having to pay anything for it. The market has already pushed the structure to an aggressive form that presents significant tax risk. There are other forms that are more conservative.

Projects on which investment credits are claimed face strict deadlines for when a tax equity transaction must be put in place.

An investment credit can be transferred in a partnership flip transaction or a sale-leaseback or inverted lease. If it is transferred in a partnership flip or inverted lease, then the tax equity must be in the partnership before the project is placed in service. A sale-leaseback must be put in place within three months after the project is placed in service.

There is no similar deadline for partnership flip transactions involving production tax credits. They can close whenever a tax equity investor is found. The investor cannot share in production tax credits that run before closing on the flip partnership, but it can pick up with credits for the remainder of the 10 years.

The option to claim an investment credit may allow wind, geothermal, biomass, landfill gas and marine energy companies the ability to tap a few additional tax equity investors who will invest in lease structures but not partnership flips. Some bank leasing companies fall into that category. Solar and fuel cell companies already had access to them. From their standpoint, this will introduce more competition for what were already scarce dollars in the market for lease equity.

The main advantage of a sale-leaseback is it provides 100% financing. The tax equity investor must pay the full market value for the project. Another advantage is that all of the tax benefits are transferred in the structure. Complicated tax accounting rules make it difficult in many partnership flip transactions to transfer even 99% of the tax benefits. Virtually all flip deals done in the past year have faced “absorption” issues with tax benefits.

The downside of doing a sale-leaseback versus a partnership flip is it costs more for the developer to get the project back. After the lease ends, the developer can only continue using the project by purchasing it from the investor. There is also a different risk allocation in leases compared to partnership flips. The developer may be required to give the investor a broader indemnity against loss of tax benefits in a lease.

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There may be room for argument about the basis on which the 30% investment credit should be calculated in wind farms and biomass, landfill gas and marine energy projects. The stimulus bill allows the 30% credit to be calculated on the cost the “facility” as defined in the production tax credit statute. Not all equipment at such a project is considered part of the “facility.”

For example, each turbine, pad and tower at a wind farm is considered a separate “facility.” The “statement of the managers” that accompanied the final stimulus bill suggested that Congress intended wind companies will be able to claim the credit on the same property that qualifies for depreciation over five years. That would include the SCADA system for controlling operation of the turbines and the collection system for collecting the electricity before it is fed through the bus bar on its way to the grid.

One downside with claiming an investment credit is it will make any tax equity investment in the project more illiquid. The investment credit will be recaptured in part if a project, or the interest an investor holds in a project, is sold within five years. Investment credits “vest” at the rate of 20% a year. Thus, if an investor sells his entire interest 15 months after a project is put in service, then 80% of the credit the investor claimed will be recaptured. An investor in a partnership can reduce his interest by up to a third without suffering recapture, but no more than that.

The stimulus bill drops a rule that until now has barred the investment credit from being claimed on a project to the extent the project benefited from tax-exempt financing or subsidized energy financing. The rule is eliminated for projects placed in service after 2008. This may give some developers a reason to choose investment credits over production tax credits. Production tax credits will continue to suffer a haircut of up to 50% to the extent a project benefits from any grant, tax-exempt financing, subsidized energy financing or other federal tax credits.

Cash Grants

Finally, developers will have the option to forego tax credits and receive a check from the US Treasury for 30% of the project cost.

This option will be available for projects placed in service in 2009 or 2010 or that start construction during 2009 or 2010 and are completed by a deadline. The deadline is 2012

for wind farms. It is 2013 for biomass, landfill gas and marine energy projects. It is 2016 for solar, geothermal and fuel cell projects. (The 2016 deadline for geothermal projects was probably an error. Geothermal developers should assume their deadline is 2013 at least until the customary technical corrections bill passes that seems to follow each large tax bill like the crew that follows the elephants at the circus cleaning up deposits.)

The 30% will be calculated on the same “tax basis” that would have been used to calculate any investment tax credit. Grants on fuel cell projects are capped at \$3,000 a watt. There are no caps on wind, solar, geothermal, biomass and marine energy projects.

A developer can apply for a cash grant at any time, but the Treasury has up to 60 days after the later of when the application goes in or the project is placed in service to pay the grant.

One concern about the grant program had been that it could take months for the Treasury Department to issue regulations implementing the program. Developers would be left in the meantime without answers to even the most basic questions like who is entitled to the grant when a project is owned by a partnership or when a project is owned by a lessor and leased to a developer. Congress said in the statement of the managers that was released with the final bill that it intends the grants to “mimic the operation” of the investment tax credit. Thus, until the Treasury says otherwise, developers should assume that the same rules will apply to grants that would have applied to the investment credit.

Thus, the grants will be paid to the same person who would have claimed an investment tax credit on the project. For example, if the project is owned by a partnership, the partnership is the entity entitled to the grant. If the project is sold and leased back, then the lessor is entitled unless it makes an election to leave the grant with the lessee.

The grants will be subject to recapture for the first five years after a project is placed in service in the same manner that an investment credit would be recaptured if the project is sold during that period, although the Treasury has been left some discretion by Congress to work out rules.

Any developer choosing a grant will be left with “stranded” depreciation that it probably cannot use efficiently. The depreciation can be

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carried forward for up to 20 years and used when the developer has income against which to offset it. Alternatively, a developer might enter into a tax equity transaction to try to convert the depreciation into cash.

Any such transaction using a partnership flip or inverted lease structure must fund before the project is placed in service. Any sale-leaseback of the project — including a sale-leaseback where the lessor chooses to leave the grant with the developer-lessee — must be done within three months after the project is placed in service. The problem with waiting longer is a grant paid to the developer will be recaptured. Except for a short window around when the project is placed in service, a developer must hold any project on which a grant is paid for at least five years after it goes into service.

The grants do not have to be reported as income by the recipients.

Only 85% of the cost of any project on which a grant is paid can be depreciated. However, in cases where a project is leased and the parties choose to leave the grant with the lessee, the lessor can depreciate 100% of the project cost, but the lessee must report half the grant as income. The income would have to be reported ratably over the period the project is depreciated.

Developers of large solar thermal, geothermal and biomass projects that take more than a year to construct may need a commitment letter from the Treasury in order to secure construction financing.

No grants will be paid on projects that are owned wholly or partly by government agencies, municipal utilities, electric cooperatives or other tax-exempt entities.

Buy American Clause

The bill bars stimulus monies from being used in connection with any “public building or public work” project unless all of the iron, steel and manufactured goods used in the project are made in the United States. However, this only applies to projects that benefit from the spending or federal loan guarantees in the bill and not from the Treasury cash grants or other tax benefits.

Privately-owned renewable energy projects should not be affected. The provision will affect government facilities that are put to public use.

It can be waived where use of US iron, steel or manufac-

tured products would increase the overall cost of the project by more than 25%.

The provision creates a risk of retaliatory measures by US trading partners. The European Union and Canada complained in strong terms to the Obama administration about it. Congress added a qualifier that it expects the provision to be applied in a manner consistent with US trade agreements.

Depreciation Bonus

The bill extends a 50% “depreciation bonus,” or the ability to deduct half the cost of a project immediately, to projects completed during 2009 and on some equipment installed in 2010.

The bonus is a limited-time offer to encourage companies to invest in new plant and equipment. It was also available during 2008. Half the cost of the project is deducted immediately when the project is placed in service. The remaining cost is depreciated normally. (In projects that claim an investment credit or cash grant, only 42.5% of the project cost can be deducted immediately.)

A company cannot claim a bonus on any project to which it was committed before January 1, 2008. It is usually not considered committed until turbine assembly starts at the factory or work starts at the construction site. Even then, up to 10% of the project costs can be incurred before work is considered to have started.

A bonus can also be claimed on a project completed in 2010 that has a “recovery period” of at least 10 years, but only if the project is expected to take at least a year to construct and will cost more than \$1 million. Wind, solar, fuel cell and geothermal projects have recovery periods of five years. However, a bonus might be claimed on the transmission equipment at such a project if the project has a long enough construction period and is completed in 2010. The power train at a biomass or waste-to-energy project might also qualify for a bonus in 2010 even though the rest of the project does not.

Manufacturer Credit

The stimulus creates a new 30% investment tax credit that can be claimed on the cost re-equipping, expanding or building a factory to make products for the green economy. Examples are factories to make blades / *continued page 5*

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for wind turbines, pumps for geothermal projects, solar panels, fuel cells and large batteries. However, only \$2.3 billion in such credits can be claimed nationwide. Anyone wanting to claim the credits will have to apply to the Internal Revenue Service for an allocation.

Tax Credit Bonds

The bill authorizes a series of new tax credit bonds on which borrowers have to pay little or no interest. The lenders will get tax credits instead. In the case of bonds issued in 2009 and 2010 for projects that will be owned by a municipal utility or government agency, the federal government will provide refundable tax credits to the government agency that is the borrower for 35% to 45% of the interest payable on the bonds.

The bill also authorizes tax-exempt bonds to be used to finance power projects on Indian reservations.

Anyone using such tax credit bonds will suffer up to a 50% “haircut” in the production tax credits that he can claim. However, there would be no haircut if an investment credit or cash grant were elected. There would be a loss in some cases in time value of the depreciation that could be claimed on the project.

Debt Restructuring

The stimulus bill reduces the tax cost of restructuring debt during 2009 and 2010.

Companies that renegotiate debt risk having to report “cancellation of debt” income. Such income might be triggered in various situations. One example is where a company (or its affiliate) buys back its own debt that is trading at a discount in the public market. Other examples are where a lender agrees to convert a loan into an equity interest in a project or where the debt terms are renegotiated, but in a manner that is considered a “significant modification” of the original loan. In the last case, the parties are treated as if they swapped the old debt for a new one. Cancellation of debt income might have to be reported if the new debt is considered an obligation to repay less money than before because the original debt instrument has lost market value.

The bill will let any income triggered by restructuring debt during 2009 and 2010 be reported ratably over the period 2014 through 2019.

Federal Loan Guarantees

The bill authorizes the US Department of Energy to guarantee loans made to renewable energy and transmission projects in an effort to jump start the stalled debt market. The guarantees will also be available to support loans to pay for construction or expansion of US factories that produce equipment for renewable energy projects. Any projects helped by the new loan guarantees must be in a position to commence construction by September 30, 2011.

Projects that benefit from the guarantees will have to pay contractors and subcontractors at least the “prevailing wages” for the local area as determined by the US Department of Labor. These are the same hourly wage rates that the federal government pays under the Davis-Bacon Act for union labor on federal construction jobs.

Any project that benefits from a federal loan guarantee will also become subject to the National Environmental Policy Act and require an environmental assessment and possibly even a full environmental impact statement before it can start construction.

The bill appropriates \$6 billion to avoid or reduce credit subsidy charges on the guarantees issued. Credit subsidy charges are charges that a borrower must pay under the existing DOE loan guarantee program to ensure the government will not have a loss on the program; they are like the premiums paid when buying an insurance policy. They vary from borrower to borrower depending on the perceived riskiness of his project. The \$6 billion would be enough to support roughly \$80 to \$110 billion in federal loan guarantees.

The Department of Energy already has authority to issue loan guarantees to promote innovative technologies that have not been commercially-proven. The stimulus bill expands the program on a temporary basis to cover all renewable energy and transmission projects and wind turbine, solar and similar manufacturing facilities. ☺

February 2009