

Washington and Deal Update

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Projects must be under construction by the end of this year to qualify for Treasury cash grants. The deadline is not expected to be extended. There are two ways to start construction, but banks and tax equity investors have a clear preference for the 5% test. At least 5% of the eligible project cost must be "incurred" by December 2011. Costs are not usually "incurred" until equipment or services are delivered. It is not enough simply to pay money.

3 1/2 month rule

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Many companies plan to stockpile components and then feed them out in small increments across a large number projects after this year so that the grandfathered components account for more than 5% of the cost of each project. This works, provided it is done by a real developer. Many questions come from finance companies or funds that see an opportunity for profit by trading later in grandfathered components. The Treasury will not allow trafficking after this year in grandfathered assets.

The Treasury has said a fair amount recently about whether projects that start construction in 2011 will remain grandfathered if transferred to a new owner after this year. In general, a sale of a project while it is still under construction after this year must be a sale of the project company. Eligibility for a grant will be lost if assets are sold. This will affect how tax equity transactions are structured and how lenders foreclose after this year.

Contributing a project to an LLC after this year will not cause loss of grandfather rights as long as the LLC is wholly owned. The Treasury is still thinking about what happens if solar rooftop systems are contributed after this year to an existing partnership with a tax equity investor. Many developers finance projects in a way that allows them to claim grants on the fair market value of the project rather than the cost. The Treasury is still thinking about whether the 5% test in such cases means more than 5% of the project cost or the fair market value on which a grant is claimed.

derivative

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Many developers are using developer fees to step up basis for the Treasury cash grant. That works provided the fee is not simply circled cash, is not more than 10% to 15%, and does not push the basis above the market value of the project. However, more aggressive schemes where the fee is paid over an extended period by having the project company give the developer a note are starting to attract attention from Treasury.

contingent payments?

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Some banks making cash grant bridge loans are getting more skittish about basis risk and are requiring a letter of credit to cover any shortfall in the grant above 30% of project cost. Advance rates vary from 65% to 100%, with most banks still at 95%.

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The Treasury has received several draft reports and two final reports from the inspector general after auditing grants that were paid. The final reports recommended that companies pay back relatively small amounts of money -- \$30,000 in one case and \$7,000 in the other. The draft reports question amounts in the several hundred dollar range up to about \$2 million. The inspector general staff does not appear to be doing any additional field work.

Any company that has to pay back part of a grant must report the overpayment as taxable income in the year the grant was received, the IRS is preparing to tell IRS agents in the field.

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Improvements to existing solar projects qualify for cash grants, even if one grant has already been paid on the project. This applies to improvements made during 2009 through 2011 or that start construction by the end of 2011. NREL confirmed in late August that the improvements do not have to increase the electricity output.

The IRS said in June that more equipment at substations qualifies for grants than was thought previously. People drew the line earlier at equipment through the step-up transformer. The IRS said that downstream circuit breakers, switches and surge arrestors that insulate the transformer from damage also qualify. The Treasury said it will not revisit this equipment at projects on which grants have already been paid.

The IRS is working on general guidance about what equipment at a solar project qualifies for an investment tax credit. Its current position is that the cost of solar tiles and solar curtain walls may qualify only partly for an investment credit. Part of the cost may have to be allocated to use as a roof or window.

**contrary ruling
panels**

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The IRS ruled privately in July that a large battery installed at a wind farm qualifies for an investment credit. Only generating equipment -- not transmission equipment -- qualifies. It helped that the battery was treated for regulatory purposes as generating equipment and only 3% of the charge was expected to come from the grid. The battery must be owned by the same legal entity that owns the power project or at least leased to it. Another ruling request was filed two weeks ago with slightly more difficult facts.

molten salt

compressed air storage

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The IRS ruled privately in June that a solar project in Puerto Rico qualifies for an investment credit and, by extension, a Treasury cash grant. The project is owned by a Puerto Rican company, but the company is "disregarded" for US tax purposes, and its owners for US tax purposes are all US corporations. It is unclear whether the IRS would have reached the same conclusion if the project company had a Puerto Rican investor as a part owner.

It is not clear how an across-the-board reduction in federal spending would affect the Treasury cash grants if the 12-person "super committee" in Congress that is supposed to find \$1.2 to \$1.5 trillion in deficit reductions by November 23 fails in its task. The cash grant program has an open-ended appropriation. The betting in Washington is split on whether the committee will be able to reach agreement.

The American Jobs Act that the Obama administration sent Congress on Monday would extend the 100% "depreciation bonus" for another year for projects completed in 2012 and delay until 2014 when municipal utilities and government agencies that buy electricity from independent power producers must start withholding 3% of the electricity payments in taxes. The bill hit Capitol Hill with a thud. Any thought that the jobs bill might provide a vehicle for helpful action on renewables is receding.

oil subsidies

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A House investigations subcommittee is holding a hearing Wednesday on the Solyndra bankruptcy and DOE loan guarantee. DOE appears to be behind a private equity fund in the capital structure.

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The renewable energy trade associations are lobbying to allow renewable energy companies to turn themselves into "master limited partnerships" so that they can raise equity more cheaply. REITs are also attracting more attention, particularly among wind and solar companies, as a path to the same end. However, Senate tax writers are looking at a proposal to tax partnerships with at least \$50 million a year in income as corporations.

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Tax equity yields are currently around 8.25% unleveraged in the benchmark wind market. They are all over the map for solar PV. There are 18 active tax equity investors, with several others on the verge of entering the market. Deal volume this year is expected to equal deal volume in 2007. The market will need to grow by 50% or more in capacity to cover the same volume of transactions after the cash grant expires. New structures are seeing greater use, including fixed-flip and modified pay-go partnerships, flips based on pre-tax yields, new markets tax credit structures, prepaid service contracts and inverted leases.

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DOE is racing to conclude loan guarantee negotiations by September 30 on 14 remaining projects with conditional commitments. A pool of another \$3.5 billion in loan guarantee authority will remain after the deadline, but it is unclear who will get it. Access to roughly half of it will require paying credit subsidy costs. A USDA loan guarantee program remains an alternative for projects in rural areas.

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