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The American Recovery and Reinvestment Act of 2009

Will the renewable energy engine be re-started?

By Ed Feo | Milbank Tweed Hadley & Mc Cloy LLP

In my last column, I discussed the status of the discussion in the transition period on energy legislation and, of increasing importance, getting the economy moving again. The slow, downward spiral of the economy in 2008 turned into a sickening dive after the Lehman bankruptcy in September 2008, and the debate on restructuring our energy infrastructure was overwhelmed by the need to stimulate the economy. After the new administration took office, the drumbeat of bad economic news continued. With impressive alacrity, Congress debated and passed, and the President signed, the American Recovery and Reinvestment Act of 2009 (the "Act"), a \$789 billion package of appropriations and tax benefits intended to get the economy back on its feet.

Renewable energy fares extremely well under the Act in terms of grants, loan guarantees, and tax breaks. Among the notable provisions are the following:

PTC Extensions

The Act extends the section 45 production tax credits ("PTC") for certain renewable energy generating facilities. Under the Act, to qualify for PTCs, wind energy facilities must be placed in service by year-end 2012. Qualifying closed- and open-loop biomass, geothermal, landfill gas, municipal solid waste, hydropower, and marine and hydrokinetic facilities (together with wind, the "eligible facilities") must be placed in service by year-end 2013. No PTC extension is provided for small irrigation power, refined coal, and Indian coal production facilities.

ITC Election

In lieu of claiming PTCs, the Act allows qualifying wind, closed- and open-loop biomass, geothermal, landfill gas, municipal solid waste, hydropower, and marine and hydrokinetic facilities placed in service after December 31st, 2008, and before the relevant PTC expiration date (year-end 2012 in the case of wind, and year-end 2013 for all others) to elect an investment tax credit ("ITC") for 30% of the costs of new equipment. Prior to the Act, only solar facilities were eligible for the up-front 30% ITC. Geothermal facilities had been permitted a 10% ITC, but this is increased to 30% by the Act.

Bonus depreciation, permitting an additional depreciation deduction equal to 50% of the adjusted basis of property, is extended to eligible property placed in service in 2009. Section 45 has also been amended to permit a lessor of an eligible facility to qualify for the PTC (or ITC). Previously, this financing device was only available for certain biomass facilities.

Renewable Energy Grants

The ability to claim a cash grant in lieu of a tax credit is, perhaps, the most remarkable option afforded by the Act. Under the innovative new program, the monetization of tax credits is provided directly by the government: the Act directs the Department of Treasury to issue grants equal to 30% of the cost of facilities that would otherwise qualify for the ITC.

The grant program is available for 30% of the cost of eligible facilities, 30% of the cost of fuel cell, solar, and small-wind energy properties that qualify for the ITC under Section 48, and 10% of the cost of qualified microturbine, combined heat and power, and geothermal heat pump property. No PTC or ITC may be claimed for facilities for which a grant was made.

The program is designed to spur development in the near-term. As such, to be eligible for a grant, a project must either: 1) be placed in service in 2009 or 2010, or 2) initiate construction in 2009 or 2010 and be complete by the "credit termination date," defined as 2013 for wind; 2014 for closed- and open-loop biomass, geothermal, landfill gas, municipal solid waste, hydropower, and marine and hydrokinetic facilities; and, 2017 for fuel cell, solar, small-wind energy, and other properties that qualify for the ITC under Section 48.

The Act requires that grants be paid by the Treasury Department expeditiously, within a period of not more than 60 days after the later of: 1) the date of application, or 2) the placement in service date. However, because of the post-completion funding of the grants, the program will not directly provide construction financing. The Treasury Department is expected to provide guidance in defining what constitutes an application and how "begins construction" is defined. Finally, grants under the program are not taxable income: the Act specifically provides that the grant is not to be included in the recipient taxpayer's calculation of gross income.

Enhanced Loan Guarantee Program

The Recovery Act expands the current federal loan guarantee programs under Title XVII of the Energy Policy Act of 2005 to permit loan guarantees for proven renewable energy, transmission, and biofuels projects. The new program makes loan guarantees formerly available only to "new or innovative technologies," now available for: 1) "renewable energy systems, including incremental hydropower, that generate electricity or thermal energy, and facilities that manufacture related components," 2) "electric power transmission systems, including upgrading and reconditioning projects," and 3) "leading edge biofuel projects." Loan guarantees under the new program are available for projects that commence construction no later than September 30th, 2011.

In addition, the Act appropriates \$6.0 billion to pay for the costs of loan guarantees under the new program. This appropriation to subsidize the cost of loan guarantees is expected to support \$60 billion in loan guarantees. Furthermore, Secretary of Energy Steven Chu has committed the DOE to begin offering loan guarantees under the augmented program by early summer 2009, and to disperse 70% of the Recovery Act investment by December 2010. Secretary Chu has indicated that he will streamline and simplify the loan application process, defer the payments of fees to closing, permit accelerated underwriting by outside partners, and allow rolling appraisals of applications.

What are the Consequences for Financing?

A few of these provisions merit further discussion...

The extension of the PTC for three years, the option to elect an ITC in lieu of the PTC, and the availability of a grant in lieu of claiming the ITC on a tax return are all good news for renewables relying on the federal tax incentive scheme. Tax incentives are fine if there are taxpayers able to use them. But the combination of restrictive tax rules, plus the financial services sector meltdown has meant that there have been only a handful of investors actually able to monetize these benefits. The grant in lieu of credit scheme means the federal government is replacing the tax equity investor in monetizing the ITC—and at a rate in excess of the value that a private investor would offer.

The next challenge involves what to do with accelerated depreciation, the other federal tax benefit available to these projects. With the ability to engage in a financing lease for any renewable project, the optimal structure would appear to be a lease of the project, with the tax equity investor being the lessor and using the depreciation. We believe that these transactions can be structured such that either the lessee or the lessor may receive the ITC grant (and there may be better reasons in terms of tax efficiency for the lessee to take it). This lease could then be leveraged with debt. Although this approach seems the most efficient scheme, there is one problem: there are not enough tax equity investors in the current market willing to absorb the early year losses incurred with accelerated depreciation.

So, what's the solution? It may be that for many projects, the capital structure will be the ITC grant (think of this, essentially, as a buy down equal to 30% of the installed capital cost of the project) with the remaining portion of the capital structure covered by senior debt and any remaining gap filled with pre-tax equity or mezzanine debt. In this structure, the project sponsor, as the continuing owner, will absorb the deprecia-

tion, booking losses in the years of accelerated depreciation, and carry those losses forward to later years when the project generates taxable income. Though this is not as efficient as a front-end monetization of the depreciation (if for no other reason than the time value of money to the sponsor), it may be the easier deal to do in the market of 2009.

So, who isn't excited about the ITC grant? Any project that qualifies for PTC and has a high capacity factor. There are a number of e-mailed tables circulating in the project finance world showing the crossover where the project capacity factor makes the PTC preferred to the ITC. The math can be simply stated as: 2.2 cents/kwh times high output has a higher net present value than 30% of the capital cost. Geothermal projects, in particular, are disadvantaged because they have very high capacity factors. What's the upshot? There is a market of projects where private investors can provide a better deal than the federal government, and we expect that the tax equity world (as small as it currently is) will be focused on these projects.

What about debt? The debt market actually seems to have hit bottom. There are a number of lenders still in business, although this number is reduced and their hold positions may be lower. The lenders include some of the companies formerly active as tax equity investors. The consequence is that deals currently are looking at \$200 to \$300 million as the maximum amount of debt. Although this level should rise as the financial sector recovers, for the time being the effect is that portfolio transactions (grouping together a number of projects into one transaction) are less likely, and mid-sized single asset deals are in the sweet spot of the market. Rates, of course, also reflect the financial times. Margins on senior debt are in the 300-plus basis point range compared to less than 200 a year or more ago. Mezzanine debt, a slice of current focus from private equity firms, carries a pre-tax rate in the mid-teens.

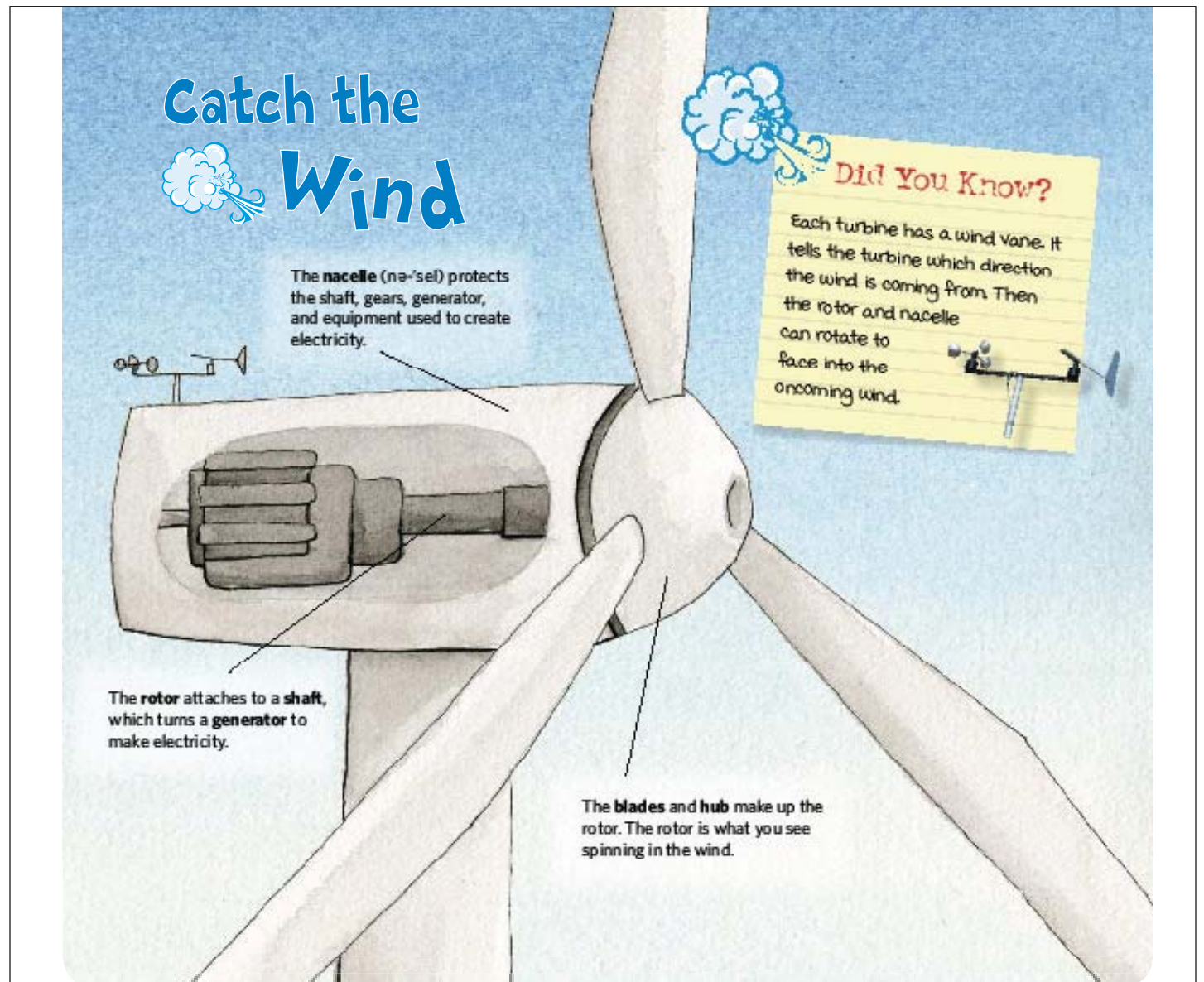
Unless, of course, we consider the effect of the federal loan guarantee program. The existing federal loan guarantee program did not advance much of anything, as no guaranties were granted, mainly as a result of underfunding and understaffing of the Department of Energy Loan Guarantee Office. But the current administration has made it clear that the guaranties and grants contemplated by the Act will move out the door briskly. The principle benefits of the federal loan guarantee will be to permit larger-scale financings, for a longer term and at lower rates on debt, than the current market will be able to offer without a guarantee cover. For larger projects, especially with newer technology, we expect the federal loan guarantee program to be the way to financial close in 2009. The interesting issues, among

others, will be how the Department of Energy decides to prioritize among very different competing technologies (commercialized large-scale wind versus less commercialized large-scale solar thermal, or for that matter even less developed technologies), and how the federal loan guarantee program will fare in terms of default risk given the current push to get money out the door.

What's next? The Administration is moving forward with additional energy legislation to address other challenges to the conversion to a flexible, green electric system. We should expect the federal renewable portfolio standard to receive much attention. Transmission siting will be on the agenda. Bills are already circulating on both topics. And, of course, at some point in the next two years, climate

change legislation. How the politics of these portions of the energy agenda play out is not yet clear, in light of the extraordinary priority of economic recovery. Stay tuned!

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