

Rush is on for 2010 US Wind Energy Cash Grants

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The clock is ticking towards the deadline for new US wind energy projects to start construction in order to qualify for the federal cash grant in lieu of the 30 per cent investment tax credit (ITC). Industry advocates continue to seek a legislative extension of the deadline beyond the stated date of December 31, 2010, on or by which planned projects must commence construction this year in order to qualify.

Given that projects receiving grants or other direct federal payments including loan guarantees must reach development milestones, (including site control, procurement arrangements, locking in funding, and environmental reviews) before breaking ground, and developers and lenders have heightened focus on what it means precisely, to start construction for purposes of beating the federal deadline, time is running out.

By any measure, the ITC grants have been a success. The programme makes up-front cash available to qualifying projects in a streamlined, straightforward manner. This supplemental funding has enabled projects to bridge the gap between available debt and cash equity. By March 2010, according to the US Treasury Department, about 400 projects had already received over \$2.6 billion in cash grants.

In contrast, the Department of Energy's loan guarantee programs have been much slower to ramp up funding for renewable energy projects and entail significantly more administrative and substantive complexity. The cash grants have helped to keep wind energy investment relatively strong through a recessionary period when both bank debt and tax equity were substantially scarcer than in earlier boom times.

The section 1603 cash grant, enacted as part of the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"), is available only for projects completed in 2009 or 2010, projects wherein construction begins in 2009 or 2010 and those that are completed before specified outside dates (i.e. January 1, 2013 in case of large wind facilities including wind facilities using turbines with nameplate capacities greater than 100 kilowatts). As year-end 2010 approaches, developers are already focusing on whether they will be able to satisfy the year-end commencement of construction requirement and, if not, what financing options will be available to them.

Plan A: Cash Grant Unavailable

Let's start with the down-side case, i.e. if project construction doesn't start before December 31, 2010 and Congress does nothing to renew the section 1603 grant or offer other incentives. In that case, many developers will need to tap the tax equity investor market. That market, although recovering, is still thin and brings with it other costs and complexities. But, we've been there before and know what, other than pricing, to expect. Owners of eligible wind farms will be able to claim production tax credits (PTCs).

That credit, in 2010 equal to \$22.00 per megawatt hour, is available for all electricity produced and sold during the 10 years following the date the facility is first placed in service and escalates each year with the implicit price deflator for the gross domestic product published each year by the Department of Commerce. Because the PTC for wind energy is not available to lessees of facilities, developers and tax equity investors will most likely use so-called partnership flip structures to monetize the anticipated PTCs. The PTCs will be of greater assistance to wind projects with higher capacity factors.

Alternatively, owners and lessees of large wind energy facilities placed in service in 2011 and 2012 will be eligible for the ITC in an amount equal to 30 per cent of the cost of eligible wind energy property. The 30 per cent ITC, like the cash grant, is available to the owner or lessee in the tax year the facility is first placed in service. Because the ITC is available to owner-operators, lessors and lessees of eligible facilities, there are more structuring options available to monetize the ITC, including leveraged and unleveraged flip-partnerships and leveraged and single-investor leases. The value of the ITC depends on eligible project costs. Unlike the PTC, the ITC is not dependent on the amount of output or availability of the wind project during operations.

Plan B: Commence Construction This Year

What will it take to be treated as having commenced construction as of December 31, 2010? Developers have been struggling with this question, which has prompted numerous inquiries of the Treasury Department. In fact, it was the sole reason for Treasury recently revising their published guidance on the cash grant program. The revised guidance, released in March, as a general matter provides that construction begins when "physical work of a significant nature" begins or, pursuant to what is described as a "safe harbor", when 5 per cent of the total cost of the project has been paid or incurred in accordance with the principles described below.

Physical work of a significant nature includes on-site construction activities such as digging foundations and pouring concrete equipment footings as well as off-site activities such as the manufacture of components for on-site delivery and assembly. The revised guidance specifically refers to the example of a wind facility to further explain this standard, providing

that on-site work of a physical nature begins with excavation for the foundation of the facility, setting anchor bolts into the ground, or pouring concrete pads for the foundation.

Where a wind facility's turbines and tower units are assembled on-site from components manufactured off-site, physical work of a significant nature begins when manufacture of the components begins off-site. Developers should note in this regard that Treasury views each separate wind tower as a separate facility for these purposes so that, subject to the ability to elect to treat the separate wind towers as a single unit of property, the commencement of construction of one wind turbine will not cause all the turbines in a project to be treated as having commenced.

Where the applicant seeks to rely on physical work carried out by a third party in manufacturing, constructing or producing eligible property (or components), on its behalf, rather than on-site physical construction, the work performed must be performed pursuant to a binding written contract entered into before the property (or component) has been manufactured, constructed or produced.

The Treasury guidance also provides that construction of eligible property will be treated as having begun when more than 5% of the total cost of the property has been paid or incurred. Note that because this safe harbour is measured by reference to the actual total cost of the eligible facility and not the anticipated cost of the entire project, care should be taken to make sure cost overruns and other contingencies and amounts spent on ineligible portions of the project are taken into account in estimating whether 5 per cent of the total cost of the eligible facility has been incurred.

The original Treasury guidance, published in July 2009, explicitly invoked the application of the economic performance standards of Internal Revenue Code section 461(h). Although the revised guidance removed any express reference to that Code section, Treasury officials have publicly explained that they intend to continue to apply those standards in reviewing grant applications and evaluating what costs have been paid or incurred as of December 31, 2010. Consequently, except as noted below, developers should assume that costs may be treated as paid or incurred only when "economic performance" under the principles of section 461(h) of the Code has occurred.

Under those principles, "economic performance" does not occur in respect of purchased goods until those goods have been delivered or accepted and title has passed or, in the case of services, until the services are rendered. Entering into contracts to buy goods or services or making payments under those contracts will not satisfy these standards.

One exception is that "economic performance" can be treated as occurring at the time of payment for goods or services if the applicant reasonably expects that those goods or services will be provided within 3 ½ months of the date of payment. Another caution to developers, if you are trying to rely on this 3 ½ month-exception to the economic performance requirements, the underlying contract should specifically identify the payment

that has been made with the goods or services to be provided within the next 3 ½ months. For example, long-term EPC contracts should be structured to require progress payments for specified work to be done during the initial 3 ½ month period (rather than undifferentiated payments).

For grant applicants who construct their own property, these standards are applied to the costs paid or incurred by the applicant. But, where property (including a component of the property) is manufactured, constructed or produced by a third party for the applicant under a binding written contract, the revised guidance relaxes the Code section 461(h) "economic performance" rules described above.

In that case, the applicant can treat as costs paid or incurred by it the costs paid or incurred by the third party (applying the Code section 461(h) economic performance rules described above) in manufacturing, constructing or producing the property. Note that because the Treasury guidance refers to the actual costs of the third party, the applicant cannot include as a cost paid or incurred by it any profit margin on the services or property provided by the third party.

Another point made clear by the revised guidance is that costs paid or incurred for engineering and design work and other preparatory activities count towards the 5% safe harbour threshold to the extent those costs will be capitalised as part of the cost of the eligible facility for federal income tax purposes.

Plan C: Legislative Proposals to Extend/Restrict the Cash Grant

Ideally, from the wind industry's perspective, the cash grant option will be extended. The reasons for the stimulus - to promote investment in green energy and to create jobs - persist. Similarly, although the debt markets and tax equity availability are recovering, credit remains constrained. Most financeable projects still require more leverage, with shorter loan tenors and wider margins, than was the case a few years ago.

As such, the cash grants, if extended, could build on the success to date of this key piece of the recovery legislation. Currently, there is a great deal of speculation as to whether Congress and the Administration will extend the cash grant program. Amidst this speculation, as of this writing, one proposal has emerged as the most likely option to replace the existing grant program, while another proposal would severely limit the existing programme.

S. 2899 - The "Feinstein Proposal": In December, Senators Dianne Feinstein (Democrat-California) and Jeff Merkley (Democrat-Oregon), introduced S. 2899, the Renewable Energy Incentives Act. The Act would extend the existing Treasury grant program two years, to eligible projects that are placed in service or that begin construction before January 1, 2013.

The Feinstein proposal would also make Treasury grants available to public power utilities. Under the existing Treasury grant rules, public power utilities are not eligible applicants

because they are government-owned. Aside from these two modifications, the Feinstein proposal does not alter the existing Treasury grant regime. The Feinstein proposal has been referred to the Senate Committee on Finance, but no further action has been taken to date.

HR. 4599 - The "Blumenauer Proposal": Congressman Earl Blumenauer (Democrat-Oregon) Vice Chairman of the Select Committee on Energy Independence and Global Warming and a member of the House Climate Change Caucus, in February introduced HR. 4599, the Renewable Energy Expansion Act of 2010. That Act would provide owners of eligible projects that commence construction before January 1, 2013 and which are placed in service after the date of enactment with the option of claiming, in lieu of a cash grant, a 30 per cent refundable investment tax credit.

The Blumenauer proposal uses the framework of the Treasury cash grant with some modifications. Most notably, unlike the cash grant which must be paid within 60 days after the later of the date the facility is placed in service and the date of the application, the refundable credit would only be paid after the applicant's income tax return for the year in which the property is placed in service has been filed.

This might be six months after the end of the tax year in which the facility was completed. Thoughtfully, the Blumenauer proposal includes provisions that would allow partnerships, which are generally not usually thought of as tax payers, to claim the credit and thereby eliminate the risk to financing parties that the anticipated refund may be offset against other tax obligations of the applicant.

The Blumenauer proposal relaxes some of the other restrictions applicable to Treasury cash grants. For example, one problem encountered with the cash grant program has been that the grant is 100% eliminated if any direct or indirect interest in the project is owned by a tax exempt or government entity. The Blumenauer proposal provides a proportionate disallowance mechanism to permit investment by these entities, reducing the credit amount proportionately according to the percentage of tax exempt or government ownership (i.e. if 10 per cent of the investors are tax exempt or government entities, the credit amount will be reduced by 10 per cent).

S. 3069 - The "Schumer Proposal": In March, Senator Charles Schumer (Democrat-NY) and a group of Democratic Senators introduced S. 3069, the American Renewable Energy Jobs Act. The Act would amend the existing Treasury grant rules to make the award of grants discretionary, to make grants subject to "buy American" requirements, and to make the award of grants contingent on the applicant's creation and or preservation of American jobs.

The Schumer Proposal was introduced in the wake of press reports highlighting a Texas wind project, which was a grant recipient, using Chinese-manufactured wind turbines. To address concerns about stimulus funds supporting foreign manufacturing and production, the Schumer proposal imposes stringent requirements to ensure grant funds are used for

domestically sourced materials and on US manufacturing and production. The Schumer Proposal would apply to any grants paid after the date of enactment.

Needless to say, by making the award of grants discretionary, the Schumer Proposal raises serious concerns for potential financing parties and developers. As a result, there has been a strong lobbying effort against the Schumer proposal.

What's next?

For now, developers and lenders are rushing to get construction of their projects started to meet the existing December 31, 2010 deadline for cash grants. Some projects will have to be more creative or bolder than others in meeting the applicable requirements if on-site construction is not already on track. Although hope remains that the cash grant programme will be extended or that the alternative Blumenauer proposal will be adopted, time is running out. If it does, there will be a clear need for tax-paying investors to close the financing gap that many wind energy projects will face in the future.

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