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# Client Alert

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## RENEWABLE ENERGY PROVISIONS IN THE AMERICAN RECOVERY AND REINVESTMENT ACT

President Obama has advanced a vision of a “clean energy economy” that reduces American dependence on foreign oil, combats climate change and grows the domestic labor market. As a significant first step towards achieving these ambitious policy objectives, President Obama signed the *American Recovery and Reinvestment Act of 2009* (the “Recovery Act” or the “Act”) into law on Tuesday, February 17.

The Act includes a number of new incentives designed to encourage investment in renewable energy projects and modifies many of the incentives available under prior federal law. This Memo describes and analyzes the Recovery Act’s myriad programs, incentives, and appropriations designed to encourage investment in renewable energy.

### ***Extension of the Section 45 Production Tax Credit***

The Recovery Act extends the section 45 “production tax credit” (PTC) for otherwise qualified facilities that are placed in service before January 1, 2013 in the case of wind facilities and January 1, 2014 in the case of closed and open-loop biomass, geothermal, solar, landfill gas, municipal solid waste, hydroelectric and marine renewable energy facilities. The Recovery Act does not extend the date by which refined coal and Indian coal production facilities must be placed in service to qualify for PTCs.

The federal PTC has been crucial to the recent expansion of wind power in the

United States. In the seventeen years since its adoption in 1992, cumulative wind power generating capacity has increased tenfold from just under 2,000 MW to over 20,000 MW today. The long-term extension of the PTC should create a stronger, more stable market for products and services tied to renewable energy.

### ***Ability to Elect Energy Investment Tax Credits (ITC) in Lieu of the PTC***

The Recovery Act permits any facility for which the PTC expiration date is extended that is placed in service after December 31, 2008 and prior to the relevant PTC expiration date to make an irrevocable election to claim an ITC in the year the facility is placed in service, in lieu claiming any PTCs. The amount of the ITC is 30 percent of the adjusted tax basis of those components of a facility that are used to generate electricity (which, in a wind farm is typically 90 to 95 percent of project cost). Before the Recovery Act, solar facilities were the principal beneficiaries of the 30 percent ITC.

In the case of a facility owned by a partnership, it appears that the election to claim an ITC instead of PTCs must be made by the partnership and will apply to all of the partners of the partnership. The rules currently applicable to lessees and lessors of energy credit property would also apply, i.e., lessors could elect to pass through the credit to lessees and the “3-month sale leaseback rule” would apply in determining whether a lessor originally placed the property in service.

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The ITC, in contrast to the PTC, decouples the tax-subsidy from the production of renewable energy. With the ITC, a project developer can receive an upfront tax credit based upon the overall capital cost of the project. This permits investors to take greater risk on technology and encourages the development of emerging technologies.

The ITC, however, is less “fungible” than the PTC because the ITC is tied more closely to a specific taxpayer. Any person with an ownership interest in a project eligible for PTCs may earn the PTCs during the period it owns the project. However, the ITC may only be claimed by the taxpayer that owns the project *when the facility is placed in service*. This leads to a tension between the business desire to not acquire a project until it is clear that the project is functioning properly and the need to be the owner of the project for federal income tax purposes on the placed in service date.

### **Renewable Energy Grants**

The Recovery Act requires the Treasury Department to provide cash grants to applicants who place in service renewable energy facilities that would otherwise qualify for the ITC (including those PTC-eligible facilities for which taxpayers are able to elect and claim the ITC).

In general, the grant amount is equal to the ITC, i.e., 30 percent of the basis of the qualifying property. For qualified microturbines, combined heat and power system property, and geothermal heat pump property, the amount is 10 percent of the basis of the property. To be eligible, the facility must (1) be placed in service in 2009 or 2010, or (2) construction of the facility must begin in 2009 or 2010 and the facility must be placed in service before the relevant PTC expiration date or in the case of solar energy property,

qualified fuel cell property and other property eligible for ITCs under pre-Recovery Act law, before January 1, 2017.

No PTCs or ITC can be claimed for facilities for which a grant was made. The Treasury Department grants will not be taxable income to the taxpayer, but the depreciable basis of the property for which grants are received will need to be reduced in the same manner as if the ITC had been claimed, i.e., by 50 percent of the grant.

Charitable organizations, federal, state and local government instrumentalities and agencies, and qualified issuers of clean energy renewable bonds (which includes certain cooperative electric companies and certain lenders to such companies) are not eligible for the renewable energy grant program. Also ineligible are any partnerships whose partners include any of the foregoing ineligible persons.

The Act directs the Secretary of the Treasury to make grant payments expeditiously. Specifically, the Act requires that the Secretary make grant payment within 60 days after the latter of (1) the date of the application for such grant, or (2) the date the specified energy property for which the grant is being made is placed in service. Applications for grants must be received before October 1, 2011.

Federal guidance on how the grant program will operate is pending and not expected until June 2009. We expect the Department of the Treasury to issue guidance establishing the procedure for grant applications and interpreting the “in construction” requirement. It is also expected that some sort of certification will be required.

In opting for a cash grant, a developer may increase the pool

of possible sources of financing. Projects that elect to receive a treasury grant are not dependent upon finding a tax equity investor, but instead can adopt a more traditional capital structure using debt and non tax equity. This may help reduce the “all-in” cost of financing. Ultimately, the ability to tap additional sources of capital should enable more projects to become viable with lower costs of financing. This, in turn, could result in lower costs of energy for ratepayers.

At the same time, special purpose project companies that opt for the grant program may not be able to as effectively utilize the depreciation benefits afforded by accelerated depreciation under MACRS due to a project company’s lack of “tax appetite.” Lease structures may provide a way for renewable energy projects to receive a federal renewable energy grant without forgoing valuable depreciation tax benefits.

Nonetheless, depending upon project specifics, the PTC partnership “flip” structure may yet remain the optimal investment vehicle. Indeed, projects with higher-capacity factors (greater production per capital cost) may prefer the PTC because of the higher value of the PTC in a high capacity factor project (compared to the ITC based on the capital cost of the project). On the other hand, projects with higher capital cost and lower capacity factors are likely to favor the treasury grant or ITC election.

Notably, the issue of lost efficiencies related to project companies’ not being able to use the full amount of accelerated depreciation does not apply to utilities, who continue to have “tax appetite” despite the economic situation. This suggests that utilities may increase the number of their renewable energy generating facilities in order to take advantage of the new

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incentive options available. Indeed, the next wave of renewable energy investment may be driven by utilities who face increasingly stringent renewable portfolio standards.

In sum, the Recovery Act affords an array of options for renewable energy projects. The optimal project structures will depend upon deal specifics, and the number of choices may be constrained by the current economic climate. However, in light of current market conditions and today's dearth of tax equity investors, developers may opt for traditional, non-tax equity financing. This, though, will require project financiers to seek new sources of equity capital in today's credit constrained environment.

### ***Repeal of the Subsidized Energy Financing Limitation***

The Recovery Act repeals the requirement that the amount of the allowable ITC be reduced in the case of facilities financed in whole or in part with the proceeds of tax-exempt bonds or federal, state or local financing programs designed to conserve or produce energy. Note that the comparable provision relating to the amount of allowable PTCs will continue in effect, but not with respect to facilities in respect of which taxpayers have elected to claim the ITC in lieu of PTCs.

The repeal of the subsidized financing limitation may open a new financing avenue for renewable energy projects. Proceeds from the sale of tax-exempt bonds may lower the cost of capital for renewable energy developers. However, because of the severe limitations on the ability to use tax exempt financing for renewable energy projects (including federally mandated state volume caps applicable for most privately owned projects), it remains to be seen how quickly—and to what extent—states and municipalities will allocate their

limited ability to tap bond markets for such projects. This is especially true in these times of constrained credit markets in light of the many competing demands that will be made on states and municipalities for the limited allocations that are available.

### ***Increased Amount of CREBs and QECBs***

The Act increases the national limits on the amount of New Clean Renewable Energy Bonds (CREBs) and Qualified Energy Conservation Bonds (QECBs) that can be issued pursuant to sections 54C and 54D of the Internal Revenue Code to \$1.6 billion in the case of CREBs and \$3.2 billion in the case of QECBs. CREBs funds are to be used to finance facilities that generate electric power from renewable energy sources. Funds from QECBs can be used to reduce energy consumption in publicly-owned buildings, develop renewable energy electricity systems, and support projects designed to reduce peak electricity use and energy efficiency. Together with the repeal of the subsidized energy financing limitation, the increased amount of CREBs and QECBs should provide financing for additional renewable energy projects.

### ***Extends Bonus Depreciation***

The Recovery Act extends the ability to claim an additional depreciation deduction equal to 50 percent of the adjusted basis of property to eligible property that is placed in service in calendar year 2009 (or, in the case of certain property with longer production periods that is placed in service after 2009, but before January 1, 2011, to the adjusted basis of such property attributable to manufacture, production or construction before January 1, 2010). Thus, for an asset with a five-year life under MACRS, such as most wind energy property, a taxpayer may depreciate 60 percent

of the asset cost in the first year (determined without regard to the basis adjustment that a taxpayer must make if it elects to claim the ITC or to receive a grant.

### ***Section 179 Election to Expense***

The Act extends the ability to elect to expense up to \$250,000 of capital expenditures for depreciable property through taxable years beginning in 2009. This provision is phased out if a taxpayer places more than \$800,000 of property in service, so it is likely to be of limited interest.

### ***Deferred Recognition of CODI***

An issuer that repurchases its debt at a discount or exchanges its debt for property with a value that is less than the adjusted issue price of the debt generally recognizes cancellation of indebtedness income (CODI) on the repurchase or exchange. Similar rules apply where an issuer's debt is purchased at a discount by a party related to the issuer. The Recovery Act allows borrowers to defer taxes on CODI for 5 years following the date of recognition for the amount of debt cancelled in 2009 and 4 years following the date of recognition for the amount of debt cancelled in 2010. The CODI would then be included ratably over the 5-year period following the deferral period. The change will be effective for debt that is repurchased, exchanged for a new instrument or deemed exchanged for a new instrument after December 31, 2008 and prior to January 1, 2011. This provision will facilitate general debt restructuring. It does not change the law as to foreclosures and it is likely to have a small impact on alternative energy projects.

### ***Smart Grid Investments***

The Recovery Act provides \$4.5 billion in funding for the "Smart Grid" programs set

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forth in Title XIII of the Energy Independence and Security Act of 2007 (EISA), including funding for DOE research, development and demonstration programs under Section 1304 of EISA and federal matching funds for Smart Grid investments by electric utilities, grid operators and others under Section 1306 of EISA. The Secretary of Energy's authority with respect to matching funds is expanded to provide for up to 50 percent of the cost qualifying advanced grid technology investments, in lieu of the original provision, which afforded reimbursement of 20 percent. In addition, the Act provides funds for the purpose of facilitating the development of regional transmission plans.

### ***Transmission Investment***

The Act expands the Loan Programs for Federal Power Marketing Administrations within DOE, including \$3.25 billion for loans from the Treasury to the Western Area Power Administration (WAPA) for transmission that delivers and facilitates renewable power resources and \$3.25 billion for loans from the Treasury to the Bonneville Power Administration (BPA). The geographic region covered by WAPA contains a number of renewable resource rich states, including the windy upper-Midwest and the sunny Southwest. The transmission of electric power from these regions, especially power from renewables, is currently constrained by inadequate transmission capacity. Federal effort to help finance transmission to these regions will be crucial to meeting the President's ambitious renewable energy goals.

### ***Renewable Energy Transmission Study***

The Act provides that the Secretary of Energy shall provide an analysis of "significant potential

sources of renewable energy that are constrained in accessing appropriate market areas by lack of adequate transmission capacity" and provide "recommendations for achieving adequate transmission capacity." Notably, the Bill does not expand federal authority with respect to siting of high-voltage electric transmission lines. This DOE study may be part of a renewed effort with respect to expanding the authority of the Federal Energy Regulatory Commission in future legislation.

### ***Expansion of Renewable Energy Loan Guarantees***

The Act expands the current federal loan guarantee programs under Title XVII of the Energy Policy Act of 2005 (EPAct 2005) by adding a new program that permits loan guarantees for proven renewable energy, transmission, and biofuels projects. This new Section 1705 program makes loan guarantees formerly available only to "new or innovative technologies" 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 that will use technologies performing at the pilot or demonstration scale... that are likely to become commercial technologies and will production transportation fuels that substantially reduce life-cycle greenhouse gas emissions." Loan guarantees under the new program must be entered into no later than September 30, 2011. No more than \$500 million is to be used for loan guarantees for biofuel projects.

In addition, the Act appropriates \$6.0 billion to pay for the costs of loan guarantees under the new Section 1705. This appropriation to

subsidize the cost of loan guarantees should support many billions more in loans for qualified projects. Estimates of the value of the projects the new Section 1705 could support vary, reflecting variances in the risk profiles of the potential mix of loan guaranteed projects. The Conference Report that accompanied the Conference Bill indicated the appropriation is expected to support \$60 billion in loan guarantees.

### ***Research and Development***

The Recovery Act Appropriates an additional \$3.4 billion for Fossil Energy Research and Development, \$1.6 billion for "Science," and \$400 million for the Advanced Research Projects Agency.

### ***Local Government Energy Efficiency Block Grants***

The Act provides an additional \$6.3 billion for implementation of state and local government energy efficiency and conservation projects. These appropriations expand programs under the EISA and the Energy Policy and Conversation Act and include \$3.2 billion of Energy Efficiency and Conservation Block Grants to states, local governments and Indian tribes and \$3.1 billion for the State Energy Program (SEP) for state energy offices to promote adoption of renewable energy and energy efficiency technologies.

Notably, the Act requires decoupling and an updated energy-efficient building code prior to States' receipt of SEP grants. Specifically, the Act requires, as a condition to receipt of appropriated funds, that the Governor of the state seeking funds certify that the applicable state regulatory authority will seek to implement "a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and that provide[s] timely

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cost recovery and timely earnings opportunity” and will implement an updated energy-efficient building code.

### ***Renewable Energy on Federal Property***

The Recovery Act appropriates \$5.5 billion for expenditures to construct, repair and make alterations on federal buildings, with \$4.5 billion these funds to be available for measures necessary to convert federal buildings to high-performance green buildings. In addition, the Act provides \$1 billion for Veterans Affairs facilities, including energy projects. These significant appropriations for improvements to federal buildings underscore a number of business opportunities for energy service companies (ESCOs) as well as providers, manufacturers and installers of distributed generation systems.

### ***Renewable Energy for the Military***

The Act appropriates significant sums for renewable energy projects within the Department of Defense (DOD). Notably, the Act provides the DOD \$300 million for research, development, testing and evaluation of projects to improve energy generation, transmission and energy efficiency. In addition, the Act appropriates \$100 million for Navy and Marine Corps facilities, with funds marked for energy efficiency and alternative energy projects. Again, appropriations for energy-related improvements should create additional opportunities for ESCOs and distributed generation providers, manufacturers and installers.

### ***Advanced Batteries***

The Act provides \$2.0 billion for grants for the manufacturing of advanced batteries and components.

### ***Advanced Energy Project Credit for Manufacturing Facilities***

The Recovery Act establishes an advanced energy project credit for manufacturing facilities that produce renewable energy equipment. Taxpayers who qualify are entitled to a 30 percent tax credit for investments in qualifying advanced energy manufacturing projects. Up to \$2.3 billion may be awarded under this program.

The credit is available for projects that reequip, expand or establish manufacturing facilities for the production of (i) property designed to produce energy from the sun, wind, geothermal deposits, or other renewable resources; (ii) fuel cells, microturbines, or energy storage systems for use with electric or hybrid-electric motor vehicles; (iii) electric grids to support the transmission of intermittent renewable energy, including storage; (iv) property designed to capture and sequester carbon dioxide emissions; (v) property designed to refine or blend renewable fuels or to produce energy conservation technologies; (vi) qualified electric vehicles and components thereof; and (vii) other advanced energy property designed to reduce greenhouse gas emissions, as determined by the Treasury Secretary. Only projects constructed after February 17, 2009 are eligible.

The advanced energy project credit program, which statutorily must be established by August 26, 2009, will be administered by the Treasury Secretary in consultation with the Secretary of Energy. The Treasury Secretary is directed to award certifications based on an applicant project's (1) commercial viability, (2) domestic job creation, (3) impact in reducing air pollutants and greenhouse gases, (4) potential for innovation and commercial

deployment, (5) levelized cost of energy generated or stored or measured reduction in energy consumption or greenhouse gas emissions, and (6) shortest project time from certification to completion. Projects that are awarded certifications have three years from the date of issuance of the certification to place the project in service.

The detailed statutory criteria for awarding the credit suggest that the Treasury Department may take some time to establish the program's rules and regulations, and ultimately to award certifications and to issue credits. The presence of a \$2.3 billion cap on the amount of credits available suggests that it would be advisable to apply as soon as possible.

### ***Other Energy Incentives***

The Recovery Act makes a number of other changes to existing law, including increases in the credits available to individuals for amounts spent for energy efficiency and renewable energy for non-business property and increases in the credit for alternative fuel vehicle refueling property.

		PTC	ITC	Grant Election	2009 Bonus Depreciation	EP Act Loan Guarantee*	Payor of Guarantee Cost**
<b>Renewable Technology</b>	Wind Facilities	If PIS before 1/1/2013	If PIS before 1/1/2013	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Closed-Loop Biomass	If PIS before 1/1/2014	If PIS before 1/1/2014	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Open-Loop Biomass	If PIS before 1/1/2014	If PIS before 1/1/2014	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Geothermal (Electricity)	If PIS before 1/1/2014	If PIS before 1/1/2014	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Geothermal (Heat/Cool)	None	If PIS before 1/1/2017	10% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Solar	None	If PIS before 1/1/2017	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Landfill Gas	If PIS before 1/1/2014	If PIS before 1/1/2014	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Trash Facilities	If PIS before 1/1/2014	If PIS before 1/1/2014	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Refined Coal Production	If PIS before 1/1/2010	None	None	50% of Cptl Cost	§ 1705	Govt.
	Qualified Hydropower	If PIS before 1/1/2014	If PIS before 1/1/2014	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Indian Coal Production	If PIS before 1/1/2009	None	None	50% of Cptl Cost	§ 1705	Govt.
	Marine & Hydrokinetic Renewable Energy Facilities	If PIS before 1/1/2014	If PIS before 1/1/2014	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Qualified Fuel Cell	None	If PIS before 1/1/2017	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
	Microturbine	None	If PIS before 1/1/2017	10% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.
Combined Heat and Power	None	If PIS before 1/1/2017	10% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.	
Small Wind	None	If PIS before 1/1/2017	30% of Adj. Basis	50% of Cptl Cost	§ 1705	Govt.	

\* To the extent that these technologies also qualify as “new or significantly improved,” they may also be eligible for loan guarantees under EPAct 05 § 1703. Though the DOE is not currently accepting applications for § 1703 projects, recently enacted legislation increased funding for the § 1703 program. The DOE has not yet announced the application procedure for § 1705 projects.

\*\* The cost of the guarantee will be paid by the government only for projects that receive guarantees under § 1705

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