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Government Support for Financing Renewables: A win and a draw

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The American Recovery and Reinvestment Act of 2009 (“ARRA”) was enacted into law in February of this year with two significant incentives for financing of renewable energy projects: The Department of Treasury (“Treasury”) cash grant in lieu of investment tax credit under Section 1603 of ARRA, and the expanded Department of Energy (“DoE”) loan guarantee program for commercialized technologies under Section 1705 of Title VII of the Energy Policy Act of 2005. These programs were intended to deal principally with the lack of liquidity in the tax equity markets (in the case of the Treasury grant program), and the debt markets (in the case of the loan guarantee program) resulting from the broader financial crisis. Since the enactment of ARRA, each agency has been working on the applicable program rules. In July, Treasury issued its guidance regarding the grant program, and DoE issued its first solicitations under the Section 1705 program (For more detailed analysis of these programs, read the “Client Alerts” at www.milbank.com/en/News-Events/ClientAlerts.)

The Section 1603 program addresses the clearest liquidity need in the renewable energy finance market—the absence of tax equity. The effect of the financial crisis was to wipe out the taxable income of many of the financial institutions, which were the historic providers of tax equity. While a number of players remain in the space, the volume of available tax equity has been greatly diminished.

The guidance issued by Treasury on the Section 1603 program reflects a well thought out approach to issues raised by market participants about the program. The program will provide a grant in lieu of the investment tax credit for most renewable energy projects. The application itself is simple. The submittals with the application are more detailed including a certification from a licensed engineer and, for larger projects, a certification of an accountant as to the eligible costs. The grant can be recaptured during the five-year period after the grant, where either the project ownership is transferred to a governmental or charitable entity, or the project fails to continue to operate on a permanent

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basis as a renewable energy facility. The recapture claim by the Treasury will be an unsecured debt claim against the applicant, subordinate to the project's secured lenders. The guidance also provides rules for determining when a project has commenced construction—a key element as ARRA requires construction on qualifying projects to commence by the end of 2010.

The reception to the Section 1603 program in the renewable energy finance market has generally been positive. A number of construction financings have closed with the grant being part of the capital structure. Project lenders are now satisfied the grant will be treated as a form of equity in the transaction. Prior to the issuance of the Treasury guidance, transactions closed with the sponsor guaranteeing the funding of the cash grant. With the clarifications provided in the Treasury guidance, the finance market has quickly adapted to provide non-recourse funding against the cash grant itself, without sponsor guarantees. The financing is based on the expected size of the grant, and there are detailed requirements for the borrower to apply for the grant.

The Treasury grant has effectively replaced private tax equity to the extent of the equivalent tax credit. Under ARRA, projects qualifying for the production tax credit can elect to take the tax credit and the cash grant in lieu of the investment tax credit. Initial views after ARRA suggested project sponsors would analyze whether it made sense to take the grant in light of the tradeoffs of capital cost, project capacity factors, and applicable discount rate of future tax credit streams. Instead, we see a nearly universal election to take the grant in lieu of any tax credit, mainly given the certainty of the grant over the more complex and expensive tax equity deals. A number of sponsors are closing transactions with no tax equity, electing to take the cash grant and to use the accelerated depreciation within the project or their broader tax group. Although this structure is not as efficient as monetizing the depreciation in a transaction, these sponsors have concluded that obtaining debt and the cash grant is an easier and more certain transaction to close than doing a tax equity deal in the current market.

Even active tax equity participants are recognizing that the Treasury grant is an attractive alternative and are structuring their transactions to accommodate the grant with the tax equity investor, then monetizing depreciation and cash flow in the project. This approach permits those institutions with tax appetite to stretch their tax capacity to more projects by combining the grant with tax equity. In addition, there are also new entrants in the tax equity market with corporates, including Japanese trading companies, with some taxable income buying into projects to monetize project depreciation and cash.

The conclusion is the Treasury grant program is having the intended effect of providing more liquidity to the tax equity market. As the economy recovers, more companies should have both taxable income and an interest in providing tax equity. The issue will be how additional tax equity will be accommodated along with

the cash grant program—which will continue through the date of completion of projects commencing construction by the end of 2010. There is also speculation that the renewable energy industry may push for a continuation of the grant program for a longer period. The effect of the cash grant program, designed to provide liquidity in lieu of unavailable tax equity, may be a displacement of tax equity even as the economy recovers.

The DoE loan guaranty program has had a rougher road than the Treasury cash grant program. The DoE has had a loan guarantee program under Section 1703 of Title VII since 2005, with the first solicitation being in 2006. The 1703 program is available for innovative renewable technologies. Section 1703 loan guarantees may be made up to 80% of project costs and up to 100% of the project debt. Section 1703 program was hamstrung during the Bush administration by a lack of funding and staff—both of which have increased dramatically with the new administration.

Section 1705 loan guarantee program is oriented toward commercialized technologies, and so may have broader application than Section 1703. In addition, Section 1705 provides for appropriation of the credit subsidy (in effect, the premium for the loan guarantee), whereas under Section 1703 the applicant must fund the credit subsidy out of its own pocket. However, Section 1705 requires construction on a guaranteed project to commence by the end of September 2011, and further requires compliance with NEPA and Davis Bacon prevailing wage requirements.

DoE initially worked on a proposed set of rules for the Section 1705 program, but later decided to proceed with solicitations using the existing rules of the Section 1703 program, with waivers as necessary to accommodate the purposes of the Section 1705 program.

The DoE will bifurcate loan guarantee projects into two broad classes: those that involve a technology risk or of a type such as large transmission projects that will benefit from loan guarantees of 100% of the project debt, and those projects with established technology and/or of a smaller size where a lower loan guarantee level makes sense. For the first category, the DoE will be performing its own diligence and the lender will likely be the Federal Financing Bank. For the latter category, the DoE proposes that financial institutions will take the lead in evaluating the projects and will be the lenders of both the guaranteed portion of the loan and the uncovered portion of the loan.

DoE has undertaken an extended dialogue with market participants and, at this point, the intercreditor terms between these two loan tranches has been challenging to settle. Section 1703 rules contemplate that the DoE loan guarantee must be secured by the assets of the project, but may accommodate a *pari passu* interest of an unguaranteed lender. Those same rules contemplate that the uncovered loan is entitled to a *pari passu* lien, but does not have rights to accelerate the loan or to exercise remedies (which are reserved to DoE). These points, among others, are of concern to the private finance market. In an attempt to advance the discussion on

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the intercreditor issues, the DoE published a proposed rulemaking that would leave to the Secretary of Energy the ability to negotiate intercreditor terms on a transaction by transaction basis.

The DoE issued two solicitations in late July. One is for major transmission projects, with applications due September 14th, 2009, with an available credit subsidy level of \$750 million. The other is for renewable energy projects, with a series of seven application dates commencing September 14th, 2009. This solicitation is divided between projects, which would qualify under Section 1703, as well as renewable energy projects which meet the “innovative” requirement and would otherwise meet Section 1705 requirements. In effect, the Section 1703 program requirement is married to the Section 1705 requirements, presumably to better access the credit subsidy appropriation for innovative technology projects. The renewable energy solicitation also falls into the first category of projects outlined above, thereby avoiding the issues of the bifurcated transactions.

It is expected that the DoE will be issuing many more loan guarantees over the coming months. These will initially be under the Section 1703 solicitations, which are currently outstanding, including the innovative renewables solicitation from February 2009. These will be followed by awards under the Section 1705 solicitations described above. Additional solicitations are expected for later this summer.

The loan guarantee program will clearly have the greatest impact on financing of projects with non-commercialized technology, which cannot access the private project finance markets currently for any amount of capital, as well as large transmission projects which may have difficulty accessing enough capital in the private finance markets. Less certain is how the loan guarantee program for commercialized technologies will work. The burden of loan guarantee program requirements (such as NEPA and Davis Bacon prevailing wage compliance, as well as the intercreditor issues) must be weighed against the improving availability of unguaranteed private project finance market debt. Project finance debt is available for well-structured projects using commercialized technology.

Currently, sponsors are heading to the private project finance market rather than waiting for the DoE commercialized technology program to be implemented. Over the coming months, it will become apparent whether sponsors will choose the loan guarantee program instead—our suspicion is that the loan guarantee program will continue to be first choice for projects with new technology, but may be a second (or lower) choice for projects with commercialized technologies—unless the project is so huge as to outstrip the capabilities of the private finance market.

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