Educate and Innovate Around IRA Project Finance

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A bit of a history lesson:

Back in 1984 I was young, single, and had the world by the tail. I was syndicating Reg–D partnerships and really thought I was a Master of the Universe, at least of my universe. Life was grand.

The typical structure was an investor purchased a partnership interest for $50,000: The investor would put up $10,000 and pay in an additional $10,000 in each of the next four years. The magic sauce was the investor could take the tax write-off and depreciation immediately, as if they had paid in full at the start.

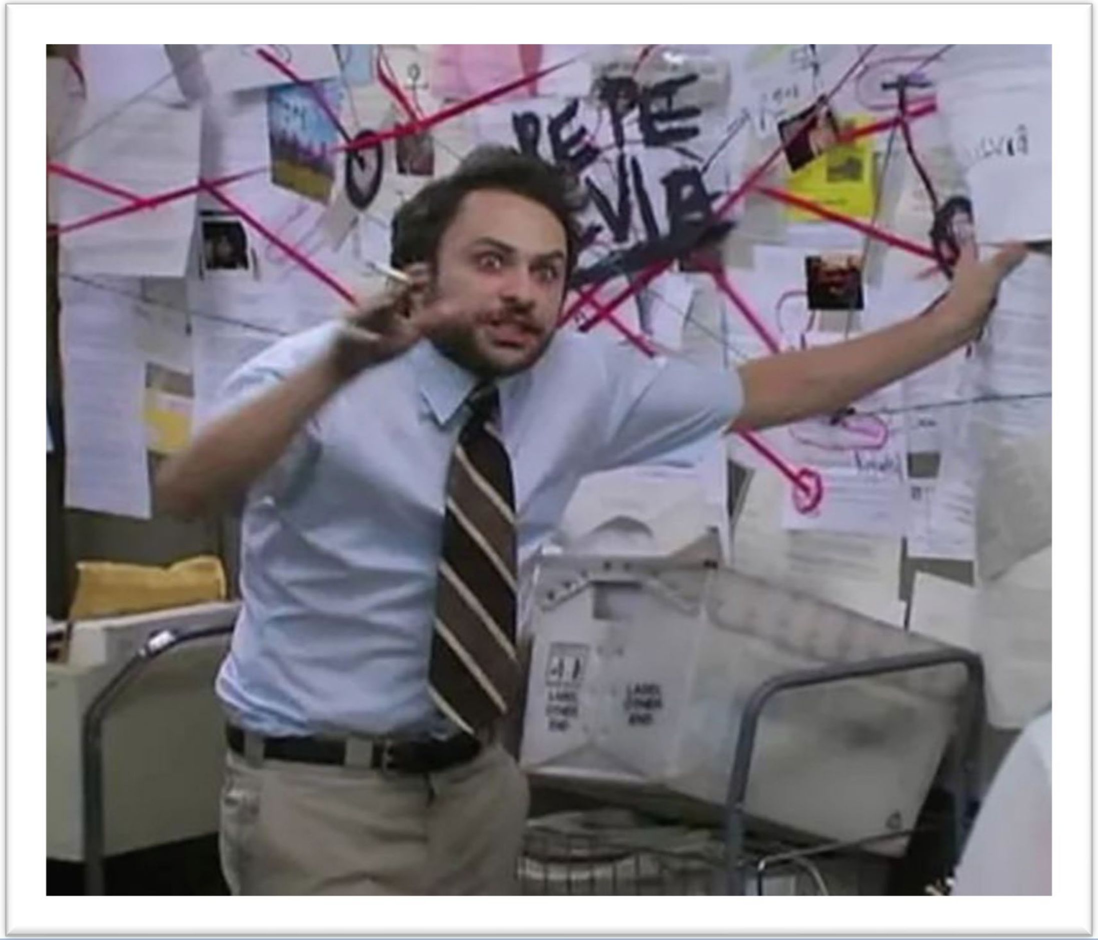
Then, the Tax Reform Act of 1986

In 1986 the Tax Reform Act became law and it changed the Federal Tax Code to the core. It was not until 1988 that we actually acknowledged the economics of what we were doing were gone and, but for the tax benefits, which were no longer available, there were no economics. We were out of business.

The analogy

The IRA is similar to the Tax Reform Act of 1986: Unlike a stimulus program, it is a rewrite of major components of the Federal tax code. It is not a “one and done”. Unlike the Bush Booster Shot for our Economy, the Cash for Clunkers, the American Recovery and Reinvestment Act, Payroll Protection Program, ARPA, the CARES Act, ESSER funding, etc. it is a rewrite of a code that exceeds 71,000 pages.

The planning process for this presentation.



Overview:

- Prior to the Inflation Reduction Act (”IRA”), only taxpaying entities, like private developers/companies, benefitted from federal tax credits for renewable energy and other qualifying GHG projects
  - **Project owners earned tax credits, which benefitted <u>private</u> project ownership**
- The IRA now provides for a **direct payment (rather than a tax credit) that can benefit governmental tax-exempt entities or 501(c)(3) organizations if the entity owns the project**. Qualifying projects can also now be financed on a tax-exempt basis to directly reduce project net costs.
  - Lower cost of capital to finance the project + direct payment project subsidy = **much enhanced project affordability**
  - **The direct payment is now at least 30% of the project costs** as compared to a 26% base tax credit previously
    - (However, if also using tax-exempt financing, then subsidy reduced by 15% to **25.5%.)**
  - Bonus direct payments might also be received **up to a total of 50% of project costs**

Direct Pay Election

- Certain “applicable entities” eligible for cash payment of tax credit
- Limited to certain credits
- Partnerships and S Corporations
  - Election made at partnership / S corporation level
- Starting in 2024, facilities electing direct pay for the ITC and PTC must meet domestic content requirement or be subject to phaseout
  - Exception expected if U.S. steel, iron or components are not available or too expensive
  - Does not apply to facilities smaller than 1 MW

Direct Pay Election – Applicable Entities

- Available for “applicable entities”
  - Tax-exempt organizations
  - Any State or political subdivision thereof
  - The Tennessee Valley Authority
  - Indian tribal governments
  - Any Alaska Native Corporation
  - Cooperatives furnishing electricity in rural areas
- Direct pay for the following tax credits not limited to applicable entities:
  - Clean Hydrogen Production Credit (Section 45V)
  - Carbon Oxide Sequestration Credit (Section 45Q)
  - Advanced Manufacturing Production Credit (Section 45X)

Direct Pay Election – Applicable Credits

- Alternative Fuel Refueling Property Credit (Section 30C)
- Production Tax Credit (Section 45)
- Carbon Oxide Sequestration Credit (Section 45Q)
- Zero-Emission Nuclear Power Production Credit (Section 45U)
- Clean Hydrogen Production Credit (Section 45V)
- Commercial EV Credit (Section 45W) – limited to certain entities
- Advanced Manufacturing Production Credit (Section 45X)
- Clean Electricity Production Credit (Section 45Y)
- Clean Fuel Production Credit (Section 45Z)
- Investment Tax Credit (Section 48)
- Qualifying Advanced Energy Project Credit (Section 48C)
- Clean Electricity Investment Credit (Section 48E)

Transferability

- Taxpayers other than “applicable entities” are eligible
  - Payment must be made in cash
  - Payment is not income for transferor and not deductible for transferee
- Transferee cannot be related to transferor
- Transferee must use credit in year of transfer or following year
- Credit can only be transferred once
- Special rules for partnerships and S corporations
  - Election made at partnership / S corporation level

Transferability – Eligible Credits

- Alternative Fuel Refueling Property Credit (Section 30C)
- Production Tax Credit (Section 45)
- Carbon Oxide Sequestration Credit (Section 45Q)
- Zero-Emission Nuclear Power Production Credit (Section 45U)
- Clean Hydrogen Production Credit (Section 45V)
- ~~Commercial EV Credit (Section 45W) – limited to certain entities~~*
- Advanced Manufacturing Production Credit (Section 45X)
- Clean Electricity Production Credit (Section 45Y)
- Clean Fuel Production Credit (Section 45Z)
- Investment Tax Credit (Section 48)
- Qualifying Advanced Energy Project Credit (Section 48C)
- Clean Electricity Investment Credit (Section 48E)

* Main difference from credits eligible for direct pay

4 Big Policy Goals of New Tax Credit Rules

- Create jobs
  - Prevailing wage and apprenticeship requirements
- Increase domestic manufacturing
  - Domestic content requirements
- Help communities that depended on fossil fuels
  - Bonus for energy communities
- Environmental justice
  - Bonus for low income communities

New Structure for Tax Credits

- Base Rate (6% / 2% for ITC and per-KWh amount for PTC)
- Multiplied by 5 if prevailing wage and apprenticeship requirement met
- Increased for bonuses / adders
- Subject to maximum 15% haircut for tax-exempt bonds

Prevailing Wage Requirement

- Wages of mechanics and laborers must be at least equal to DOL's prevailing wages for type of work and locality
- Requirement must be met during construction and after project placed into service
- Corrections available if requirement not met
  - Catch-up payment to worker + $5,000 penalty to IRS per worker
  - Higher penalties for case of "intentional disregard"
- Piggybacks off Department of Labor's Davis-Bacon rules
- https://sam.gov/content/wage-determinations

Apprenticeship Requirement

- Specified percentage of total labor hours must be performed by "qualified apprentices"
    - 10% for 2022
    - 12.5% for 2023
    - 15% for 2024 and beyond
- Facility must satisfy apprentice to journeyworker ratios
- Contractors and subcontractors with more than 4 employees must employ at least one qualified apprentice
- Failure is excused if good faith effort to request qualified apprentice from registered program
- Correction if penalty paid to IRS
- Relies on Department of Labor and State Apprenticeship Agencies

Domestic Content Bonus

- Bonus is 10%
  - Reduced to 2% if capacity is 1 MW or more and prevailing wage / apprenticeship requirements not met
- Steel and iron used in facility must be produced in U.S.
- Specified percentage of manufactured products must be produced in U.S.
  - Generally, percentage is 40%
  - For offshore wind facilities, percentage is 20%
  - Both increase to 55% by 2028
- Taxpayer must certify compliance
- Direct pay subject to phaseout

Energy Communities Bonus

- Bonus is 10%
  - Reduced to 2% if capacity is 1 MW or more and prevailing wage / apprenticeship requirements not met)
- Energy communities are:
  - Brownfield sites
  - Statistical areas with historical connection (since 2009) to coal, oil and natural gas industries and high unemployment
  - Census tracts where coal mine has closed (since 1999) or coal-fired electric generating unit has been retired (since 2009), and directly adjacent census tracts
- DOE Map
  - https://arcgis.netl.doe.gov/portal/apps/experiencebuilder/experience/?id=a2ce47d4721a477a8701bd0e08495e1d

Low-Income Communities Bonus

- Bonus is 10% or 20%
- Facility must obtain an allocation of “environmental justice solar and wind capacity limitation” from Treasury Department and DOE
  - Total allocation is 1.8 gigawatts for each of 2023 and 2024
- Available for solar and wind projects with capacity of less than 5 MW
- Bonus is available for facilities:
  - In a “low-income community” as defined in Section 45D(e) (10%)
  - On Indian land (10%)
  - Part of a “qualified low-income residential building project” (20%)
  - Part of a “qualified low-income economic benefit project” (20%)
- Only available for ITC

ITC: Energy Property

- Qualified fuel cell or microturbine property
- Qualified small wind energy property
- Waste energy recovery property
- Energy storage technology
- Qualified biogas property
- Microgrid controllers
- Solar equipment (thermal, electric, illumination)
- Geothermal equipment
- Combined heat and power system property
- Ground / ground water heating equipment
- Qualified interconnection property

PTC: Qualified Energy Resources

- Wind
- Closed-loop biomass
- Open-loop biomass
- Geothermal energy
- Solar energy
- Small irrigation power
- Municipal solid waste
- Qualified hydropower production
- Marine and hydrokinetic renewable energy

Technology Neutral Tax Credits - 2025

- In 2025, ITC and PTC will switch to Sections 48C and 45Y
- Instead of having a list of qualified technologies, credit will be based on “greenhouse gas emissions rate”
  - Rate will be expressed a grams of CO_2e per KWh
  - IRS will publish tables showing rate for different types of facilities
- Facility is eligible if emissions rate is net zero and facility placed into service in 2025 or later

Guidance Issued to Date

- **Proposed Regulations under Section 30D (REG-120080-22)** (Apr. 17, 2023) - Detailed rules on evaluating critical minerals requirement (3-step process based on 50% of value added) and battery component requirement (4-step process).

- **Notice 2023-29** (Apr. 4, 2023) - Rules on what constitutes an "energy community." For production credits, project must qualify each year (unless special beginning-of-construction rule applies). For ITCs, project must qualify on placed-in-service date.

- **Notice 2023-18** (Feb. 13, 2023) - Guidance on procedures for taxpayers to apply for an allocation of tax credit for "qualifying advanced energy projects." Program is to be administered jointly by the Department of Energy and Department of Treasury.

- **Notice 2023-17** (Feb. 13, 2023) - Details on 10% / 20% bonus ITC for projects in "low-income communities." Provides for a total of 1.8 gigawatts of "environmental justice solar and wind capacity limitation" available for 4 categories of low-income community for each of 2023 and 2024, and provides some guidance on procedures for taxpayers to apply for an allocation of capacity limitation.

- **Notice 2023-9** (Dec. 29, 2022) - Safe harbor regarding incremental cost of EVs less than 14,000 pounds placed into service in 2023.

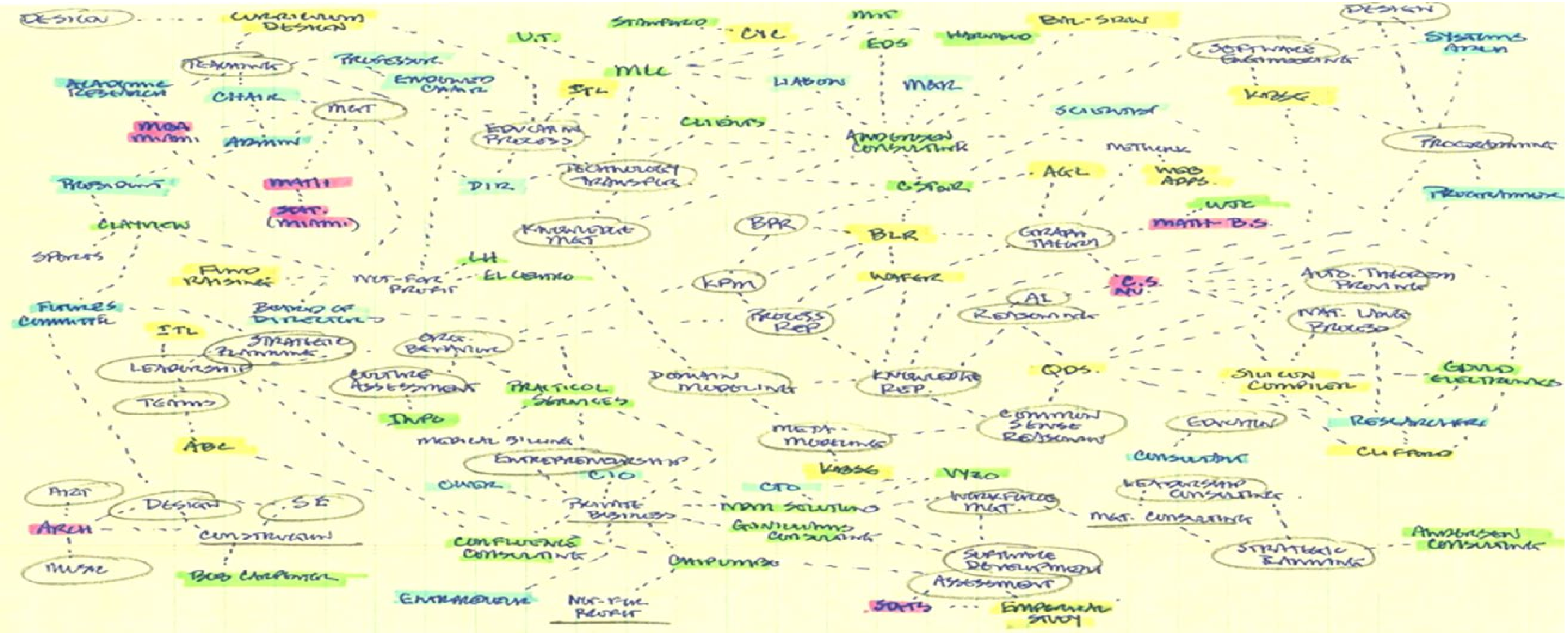
- **Rev. Proc. 2022-42** (Dec. 12, 2022) - Details on how a vehicle manufacturer can enter into an agreement with the IRS to become a "qualified manufacturer." Also provides guidance on reporting requirements for sellers of new and used clean vehicles.

- **Notice 2022-61** (Nov. 30, 2022) - Started 60-day grace period for prevailing wage and apprenticeship requirements to kick in.

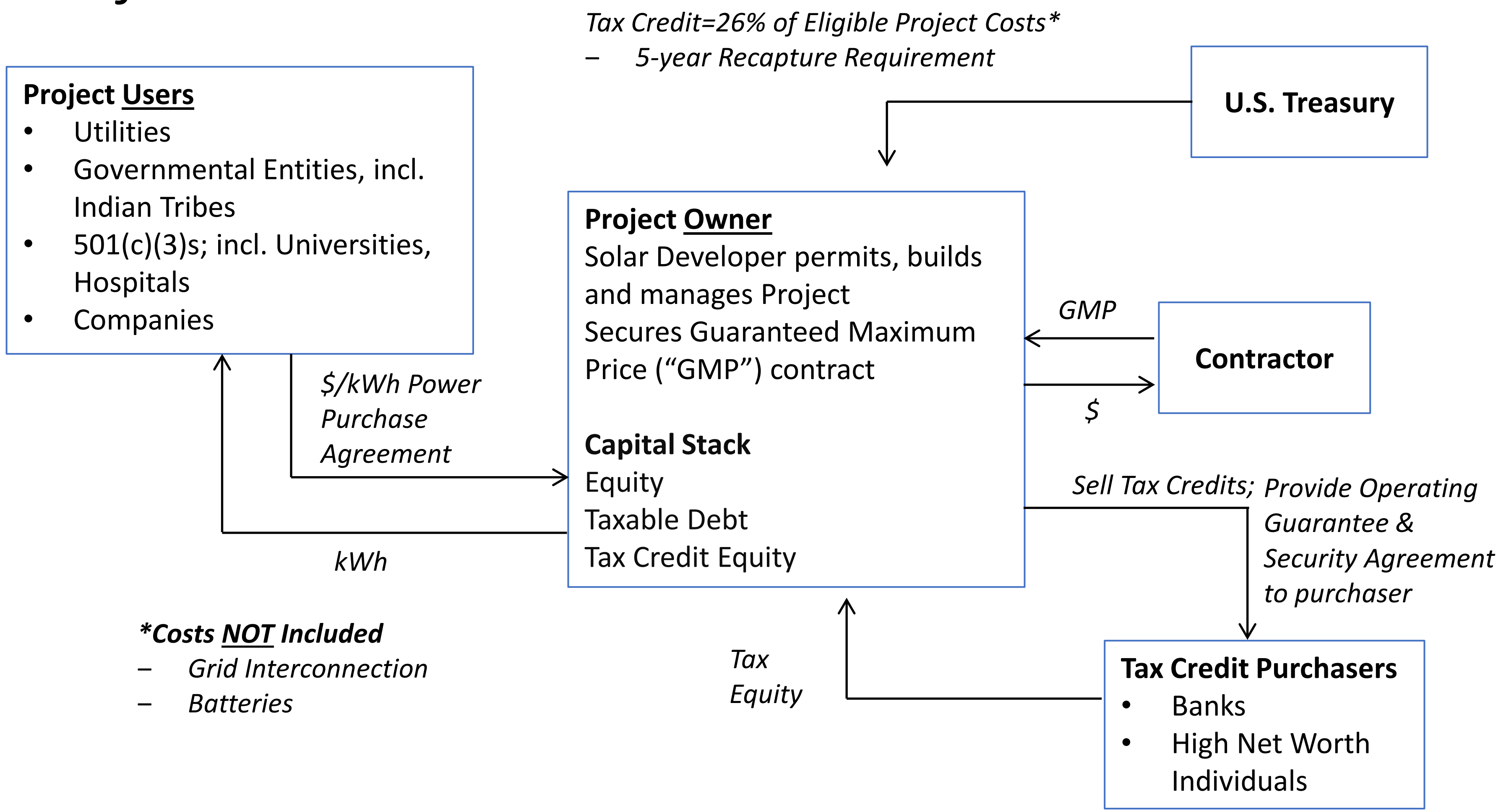
Guidance Still Needed

- Direct Pay and Transferability - IRS shooting for “before end of spring”
  - Application of partnership / S corporation provisions
  - Procedural requirements
- Domestic Content Bonus
- Second Notice on Qualifying Advanced Energy Projects (Section 48C)
- Prevailing Wage and Apprenticeship Requirement
- Low Income Communities Bonus

Scattergraph of the traditional project finance model with tax credit incentives.



Prior Project Finance Model *with Tax Credit Incentives*



New IRA Project Finance Model *with Tax Incentives*

*Direct Payment of tax credit @ 30% base rate of Eligible Project Costs**
- *5-year Recapture TBD*

U.S. Treasury

***Expanded** Scope (see slide 3)*

Project Owners
- Utilities
- Governmental Entities, incl. Indian Tribes & Alaska Native Corporations
- 501(c)(3)s; incl. Universities, Hospitals

Capital Stack
- Tax-exempt debt if cost effective for balance of project cost
- Investment Tax Credit Direct Payment
- Cash or Reserves

GMP

$

Developer-Contractor

Project Manager

- **Bridge financing** will be needed by some governmental/non-profit owned projects until direct payment is received after the placed-in-service date.

IRA Timeline

- Direct Payment eligibility began for new projects as of January 1, 2023
- Direct Payments will be viewed by IRS as a tax refund upon the Project being placed in service
- U.S. Treasury currently preparing rules…expected mid-year 2023
- Phase-out of tax credits or direct payments in 2032

20-year PPA with Tax-Exempt Takeout after Year 5

PPA Financing Through Year 5

Project Cost:	$	10,000,000
Energy Investment Tax Credit (30%)	$	3,000,000
Other tax benefits	$	750,000
467 Loan*	$	1,200,000
Lender Residual	$	2,000,000
Total PPA Payments (60 months)	$	1,990,000
Net Developer EBO – Month 63	$	3,900,000
Breakage Fee (PV of remaining PPA Payments):	$	3,000,000
Muni Purchase Price	$	6,900,000

EBO Exercised & Tax-Exempt TELP Conversion

TELP PPA Purchase Price (at EBO)	$	6,900,000
Estimated COI	$	138,000
TELP Financed Amount	$	6,762,000
10 Year Bloomberg Muni Bond Rate		2.36%
Spread		2.50%
Tax-Exempt Interest Rate		4.86%
Tax-Exempt Annual Payments	$	432,883
Total Payments	$	6,493,244
Assumed Financing Term (years)		15

Total Combined PPA and TELP Payments = $8,429,244, $1,570,756 Less than Project Cost

*467 Loan is borrower equity returned to borrower over time

Direct Pay or PPA?

What are the options?

- Muni-owned utility? Many alternatives…
- PPA? Only 28 states currently allow for 3rd party power sales, so a utility-direct PPA may be only PPA option
- Design/Build/Own/Maintain through Direct Pay? Still waiting on the details….

PPA Pros and Cons

Pros

- Relatively Simple - sign it and forget it
- Only obligation is to pay for power delivered
- Zero maintenance
- Insulation from system performance

Cons

- Lack of ownership
- Locked in, only exit (assuming system performance) is to pay in full
- Providing long term site lease may be required
- Little/no control over system modification

Direct Pay Pros and Cons

Pros

- Long term ownership of 30-40 year asset
- System control for add-ons, expansion, relocation, etc.
- Traditional approach – borrow>build>own> maintain

Cons

- Diminished monetization of all potential benefits
- Long term debt issuance
- Capex vs Opex
- Ongoing maintenance costs
- IRS reimbursement timing
- Ongoing IRS filings

IRA Direct-Pay Cash Subsidy
Taxable vs. Tax-Exempt Financing
(Assumes 15 Year Municipal Lease-Purchase)

Taxable Financing

IRA-Eligible Project Cost	$	10,000,000
Taxable Cash Subsidy (30%)	$	3,000,000
Net Taxable Financed Amount	$	7,000,000
10 Year US Treasury Rate		3.43%
Spread		1.50%
Taxable Interest Rate		4.93%
Taxable Annual Payments	$	558,369
Total Payments	$	11,167,382

Tax-Exempt Financing

IRA-Eligible Project Cost	$	10,000,000
Tax-Exempt Cash Subsidy	$	2,550,000
Net Tax-Exempt Financed Amount	$	7,450,000
10 Year Bloomberg Muni Bond Rate		2.36%
Spread		1.50%
Tax-Exempt Interest Rate		3.86%
Tax-Exempt Annual Payments	$	541,410
Total Payments	$	10,828,197

Breakeven Spread is 114bps Taxable vs. 150bps Tax-Exempt, 36 bps Difference

Renewable Energy Project Lifecycle
IRA Direct-Pay Cash Subsidy

Exploring Options (Timing TBD)
- Research Solutions & Potential Funding Solutions

Initial Project Development (Timing TBD)
- Stakeholder Education
- Consensus Building

Contractor Selection Process, Financing & Board Approvals
(6 – 12 Mos.)
- Procurement & Contracting
- IRA Bonus Applications

Installation, Construction
(6 - 12 Mos.)
- Utility Interconnection
- IRA Cash Subsidy Filing upon Placed In Service Date

Project Operation
(20 - 30 Yrs.)
- ESCO Savings or Performance Guarantee
- Manufacturer's Warranty
- Ongoing O&M

The IRA was signed into law in August of 2022. Treasury, and to a greater extent, Revenue, have made it clear their guidance and regulations will be thoughtful and slow as opposed to rapid and incorrect. That said, the IRA may well be as big of a game changer as the TRA of 1986. For those that can be patient and can pivot the opportunities are nearly endless.

Questions From Customers and ESCOs/Developers About the IRA Direct-Pay Cash Subsidy

- Municipal Government Host Customers/Project Owners are Unfamiliar and Skeptical (remember, we are dealing here with elected officials!)
- Will the IRS actually cut us a check if we place a project into service and when will we receive the cash?
- How do we explain all this technical tax stuff to stakeholders?
- Our Business Office has never filed IRS tax returns. Will there be someone there to help us process the forms and ongoing returns?
- How do we access the “bonus” cash subsidies and should we proceed with a project not knowing whether it will qualify?
- How can ESCOs and lenders get involved in the IRA process and avoid MA violations?
- How do we blend TELP and other types of municipal financing products into our project cashflows? Optional partial prepayments? Will lenders place a lien on our cash subsidy and what types of opinions will be required?
- Can someone provide us with interim funding prior to receipt of the cash subsidy?

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