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Strategies for Starting Construction

by Keith Martin and John Marciano in Washington, and Eli Katz in New York

The race is on to get renewable energy projects in the United States under construction by year end to qualify for cash grants from the US Treasury.

Developers are pursuing different strategies.

It is not enough merely to have made a large down payment toward turbines, modules or other equipment for the project by year end. A senior Treasury source said the government is looking for economic activity during 2010. A developer must show work at the site or at the factory on equipment for the project during 2010.

The grants are 30% of the project cost and are paid on new wind, solar, geothermal, biomass, landfill gas, waste-to-energy, ocean energy and fuel cell projects that are completed in 2009 or 2010 or that start construction in 2009 or 2010.

Grants of up to 10% of project cost are also paid on small cogeneration facilities of up to 50 megawatts in size.

Projects that merely start construction in 2010 must be completed by a deadline. The deadline is 2012 for wind farms, 2016 for solar, small cogeneration and fuel cell projects and 2013 for other types of projects.

Congress may ultimately give companies more time. A bill in the House would give developers another two years through December 2012 to start / continued page 2

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UNCERTAIN TAX POSITIONS will have to be flagged on US tax returns starting this year using a new form the Internal Revenue Service released in mid-April.

The form — called a Schedule UPC — will have to be attached to corporate tax returns filed for 2010.

The IRS hopes that forcing corporations to disclose tax positions about which they are uncertain will save the government time in tax audits. Critics speculate that IRS agents will be able to save even more time by simply disallowing all the positions a company identified.

The forms will have to be filed for now only by / continued page 3

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Germany Cuts Solar Subsidy

by Dr. Till Vogel, with Schiedermair Rechtsanwälte in Frankfurt

The German federal cabinet decided in early March to reduce feed-in tariffs for newly-built solar photovoltaic projects in Germany by an average of 15% starting July 1, 2010. Another 9% is already scheduled to take place on January 1, 2011.

The plan must still be approved by the Bundestag, or the German parliament. Some changes are possible before the bill implementing the plan is approved

The lower tariffs will apply to projects that go into service on or after the dates set for tariff reductions.

The tariffs were already cut by 9% at the start of 2010. They currently run from 37.14¢ to 28.43¢ a kilowatt hour depending on the size of the project and its location. The feed-in tariff is the amount that utilities in Germany are required by law to pay for electricity offered to them — in this case from photovoltaic facilities. Total installed generating capacity from solar in Germany is 8,877 megawatts from photovoltaic installations. There are currently no concentrating solar power projects (also known as solar thermal). The tariff is the same for both types of solar.

The feed-in tariffs have been declining over time, but they normally decline only once every year. When Germany first instituted them in 2000, they were 62.4¢ per kWh.

The latest plan would lead to a total reduction in the feed-in tariff for PV energy of almost 30% within a 13-month period. As the feed-in tariff is guaranteed by law for the year of the connection to the grid plus the following 20 calendar years, the amount is important for financing PV projects. The latest measures mean a significant loss of revenue over 20 years if a project starts too late.

Reductions Vary

The feed-in tariffs for electricity generated in roof-mounted solar systems will be reduced by 16% if the system is connected to the grid after June 2010. The relevant date for the calculation of the feed-in tariff for a German PV project under the regime of subsidies is the day of the first power supply into the grid. Thus, commencing power sales on July 1 rather than June 30 can cost a developer a lot of money.

The reduction of the feed-in tariffs for / continued page 6

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signed a bill to waive the taxes in early April.

The bill is not effective until January 1, 2011, but will be retroactive to 2009 and 2010 once it takes effect. The Franchise Tax Board said in the meantime that it does not plan to collect taxes on grants paid in 2009 and 2010.

WYOMING will start collecting an excise tax of $1 a megawatt hour from wind generators in the state. The tax will apply to electricity generated after 2011. It will apply on a turbine-by-turbine basis, but will not be collected until the turbine has been in use for at least three years.

The state legislature debated setting the tax at anywhere from a penny to $5 a mWh before settling on $1. It delayed the effective date to allow time to study the potential effect on the wind industry.

INDIA reaffirmed in late March that companies based in Mauritius do not have to pay capital gains taxes when they sell shares they own in Indian companies.

An E*Trade subsidiary in Mauritius sold shares in an Indian company to an HSBC investment vehicle also in Mauritius. The sale generated a long-term capital gain for E*Trade. The Indian authorities challenged E*Trade on its position that it was entitled to an exemption from capital gains taxes in India under article 13(4) of the India-Mauritius tax treaty, which says that a Mauritius resident can only be taxed in Mauritius on its gains, arguing that the E*Trade subsidiary in Mauritius was merely a shell company and the real owner of the shares in the Indian company was the E*Trade parent company in the United States. The Indian authorities directed HSBC to withhold 21.11% of the sales price for the capital gains taxes. E*Trade appealed.

The Authority for Advance Rulings held that India had to honor the treaty exemption, ruling essentially that there is no prohibition against treaty shopping. It also / continued page 7

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electricity from ground-mounted PV systems installed on so-called redeveloped areas — for example, former military sites or former landfills — is not as painful as for roof-mounted systems. The reason for this is purely political. The intention is to promote the use of such real estate for PV systems as they are of limited use for other purposes. Furthermore, the investors run the risk of having to deal with environmental pollution on such sites. Thus, the reduction of the feed-in tariffs for projects in such locations is only 11%.

For other areas, the tariff will be reduced by 15%.

Feed-in tariffs will be eliminated for ground-mounted PV systems installed in areas that are defined as "farm land." This has been a subject of intensive discussion. Opponents argue that it is unethical to produce electricity on land that could feed humans while people starve and prices for food rise. From July 1, 2010 on, there will no longer be an obligation for grid operators to buy and remunerate solar companies using "farm land" to generate electricity. Since there are a lot of projects already in the pipeline, there needs to be a transition arrangement for these projects. The bill provides "grandfather" relief. The current tariff would continue to apply to projects that are already in an advanced stage of development, were approved by the local authorities by an official development plan before the end of 2009 (although this date is currently under discussion) and will be built and connected to the grid by the end of 2010.

In order to compensate for the loss of "farm land" for solar development, the cabinet suggested that trade and industrial areas as well as areas along motorways and railways (the latter in 100- to 200-meter-wide strips) should be included on the list of areas on which PV systems can claim special promotion under German law. Systems in such areas will be eligible for the feed-in tariff in the future.

Although such changes in the guaranteed feed-in tariffs have been foreseeable since the current black-yellow government formed its coalition in Berlin, the amount of the reduction is surprising.

Also the complete ban of ground-mounted PV systems on "farm land" was unexpected.

The German PV industry now claims that it is being strangled and that the number and size of new PV projects in Germany will drop significantly with a cost of thousands of jobs in the national PV industry. The government responds that since the price of solar power equipment (especially solar modules) dropped significantly during the last 18 months, solar projects have become more profitable leading to an "over-promotion" of new projects by the current tariffs.

Under the German law, the local grid operator has to connect every PV plant to its grid and to purchase all electricity generated as well as to pay the feed-in tariffs provided for by law. German law guarantees a constant feed-in tariff for the year in which the plant starts to supply electricity into the grid and the following 20 calendar years. The details are in an "Act on Granting Priority to Renewable Energy Sources." The grid operator can pass through all these amounts to its customers as an add-on fee to the regular electricity invoices. Thus, the subsidies are paid ultimately by all electricity consumers in Germany. To the extent electricity from solar costs more than from other sources, this becomes a burden on the German economy. The current German government wants to slow the rate at which Germany is adding to this burden by cutting tariffs which, in turn, will mean fewer new projects.

Lobbyists from the solar industry have mobilized and are working on the politicians from both partners of the black-yellow coalition in Berlin. These efforts have already met with some success: only two weeks after the declaration by the federal cabinet, the prime minister of Bavaria — which is one of the southern states and thus hosts more solar projects than any other state in Germany — demanded changes in the federal plan. Perhaps surprisingly, it appears that the coalition is willing to follow this demand and will provide for a longer transition period to allow projects that are currently under development to be completed under the existing tariff. More changes are possible before any plan is adopted by the Bundestag.

Significance?

So what does all this mean for investors and banks who are engaged in the PV business in Germany?

For those who have German PV projects in the pipeline, the best advice is to watch the legislative process closely and try to qualify for grandfather relief under whatever transition rule is adopted. Currently the bill states that PV plants already operating are not affected at all by the changes. It should be safe to assume that this will not change. Any retroactive reduction in tariffs would be declared unconstitutional by the federal constitutional court.

Also, PV plants that start to feed energy into the grid before the key dates (July 1, 2010 or possibly October 1, 2010) will not be affected by the changes for the same reasons.

Only plants that start to feed electricity on or after July 1, 2010 (or whatever date is chosen ultimately) are affected by the new tariffs. As the construction period for a PV project is in some cases longer than the three months remaining until July, this means that some projects that were planned, calculated, funded and developed under the old feed-in regime could be hit hard. Developers in such a position will have to decide whether to start construction or cancel their projects.

To soften the hardship, the bill grants a grace period for very large countryside projects that are already under development. Such projects can be built and connected to the grid until the end of this year and still receive the existing feed-in tariff until 2030 if the competent local parliament had already agreed to the project by December 31, 2009 and has granted the permission to build the plant. However, for all other types of PV projects, especially the very popular roof-mounted systems, this transition rule will not apply. Therefore, there is now tremendous time pressure to finish construction of these projects before July 1, 2010. In case of some large projects, this will not be possible.

Upside

The bill is not only a one-way street. It increases some subsidies.

Under the current German regime, there is a financial incentive for owners of smaller PV plants (such as private households) not to feed the electricity into the grid but to use the energy for themselves on site. If an owner does so, he receives an incentive payment from his grid operator. The owner receives this money and also avoids having to buy electricity from the grid. Thus, householders are better off than if they sold to the grid. The bill increases this incentive from 3.6¢ to 8¢ per kWh. The incentive will also be extended to larger PV systems with outputs of up to 800 kilowatts. However, the incentive payments to owners of such larger systems are reduced to the extent the price the homeowner would be charged to buy electricity from the grid is less than 20¢ a kWh. This is the benchmark price in the bill.

Further reductions in the feed-in tariff will occur at the rate of 9% a year. However, the rate could increase to 11% a year if additionally installed PV capacity reaches 3,500 megawatts a year. The national target for / *continued page 8*

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questioned the continuing viability of the treaty.

The Mauritius treaty used to confer two benefits. One was a reduced withholding tax on dividends received from Indian companies. The other is an exemption from capital gains taxes. India cut off the withholding tax benefit by converting its withholding tax to a tax on the Indian company paying the dividend. It has periodically fought exemption claims on capital gains taxes.

In 2000, the Central Board of Direct Taxes said in Circular 789 that Indian tax collectors must honor certificates of tax residency from the Mauritius authorities. The circular was temporarily set aside by the Delhi high court before being reinstated by the Supreme Court in 2003.

The Indian government is moving to replace its existing income tax code with a new "direct" tax code. The proposed new tax code would give the government additional tools to ignore the form of transactions and focus on the substance, for example by declaring transactions as "impermissible avoidance arrangements." This may be used to attack treaty transactions.

In a related case, an income tax appellate tribunal in Mumbai held in March that a service company in Dubai could take advantage of the India-United Arab Emirates tax treaty to avoid withholding taxes on fees that the Dubai service company, Caltex, received from an oil refinery in India.

Caltex could only benefit from the treaty if it was "liable to tax" in Dubai. It did not pay any taxes in fact. The tribunal cited a Canadian court decision for the proposition that actual current taxation is not required; it is enough that Caltex could be taxed in Dubai should the government choose to tax it. The case is *Hindustan Petroleum Corporation, Ltd. v. ACIT.*

BUILD AMERICA BONDS now constitute more than 20% of the municipal bond market, the US Treasury Department said in April.

The bonds are taxable / *continued page 9*

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the growth of PV capacity in Germany is being raised from 1,700 megawatts to 3,500 megawatts per year. Once the growth of installed PV capacity exceeds 3.500 megawatts, then the feed-in tariffs will be reduced automatically by an additional 2% a year on top of the 9% annual reduction. On top of the scheduled reduction of 9%, tariffs will be reduced at the end of 2011 by another 3% for every 1,000 megawatts of additional growth in PV capacity above the national target. On the other hand, the bill provides that if the market growth in production capacity leaves Germany below a minimum limit of 2,500 megawatts per year, then the feed-in tariffs decrease more slowly. The 9% normal rate of reduction would be shaved by 2.5% for every 500 megawatts that installed capacity is below the minimum limit.

Update: Tax Equity Market

Most renewable energy projects in the United States have been financed in the past largely with tax equity. The US government pays as much as 65% of the capital cost of such projects through tax incentives. Few developers can use the incentives directly, so they barter them in tax equity transactions to raise capital for their projects.

The tax equity market largely collapsed after Lehman went bankrupt in September 2008. Congress reacted by directing the US Treasury in an economic stimulus bill in February 2009 to pay owners of new renewable projects completed in 2009 or 2010, or that start construction in 2009 or 2010, 30% of the project cost in cash in place of part of the tax incentives. The tax equity market started to revive after the Treasury issued rules implementing the 30% cash grant program in July 2009. There were at least 15 active tax equity investors by April 2010, down somewhat from the number before the market collapsed.

The following is an edited transcript of a discussion among six of the largest tax equity investors about the state of the market at an Infocast wind finance summit in late February in San Diego. The panelists are John Eber, managing director of energy investments for JPMorgan Capital Corporation, Jeetu Balchandani, director of private securities, structured leasing and tax investments at MetLife, Jack Cargas, managing director of energy and power finance at Bank of America, Lance Markowitz, senior vice president of the equipment leasing division at Union Bank of California, Marshal Salant, a managing director at Citigroup, and Jerry Smith, a managing director at Credit Suisse. The moderator is Keith Martin with Chadbourne.

MR. MARTIN: What do you see in the year ahead for the tax equity market?

MR. MARKOWITZ: It will be a much stronger year than 2009. We should see a large number of deals. There will be more variety in deal structures. There are more tax equity investors in the market.

MR. BALCHANDANI: The pipeline of deals expected to come to market this year suggests a demand for tax equity that will far outstrip the supply. Anyone looking for tax equity in 2010 should keep in mind there will be limited capacity. Start talking to potential tax equity investors as early in the year as possible.

MR. SALANT: I agree with the point that was just made. Demand for tax equity could easily reach $10 billion a year in 2010 and 2011. If JPMorgan takes $1 billion, we take $1 billion and each other person at this table takes $750 million, you are still $5 billion short, and it is not a simple matter for any of us to close on that volume of transactions this year. The days of casual dating are over in tax equity investing. Tax base is a precious commodity. Investors will want to preserve it for use with their most important relationship clients.

MR. EBER: More deals were done last year in the tax equity market than I think most people realize. We counted 19 wind tax equity deals that reached funding last year for total tax equity of $1.8 billion. That is about half of the tax equity invested in wind in 2008, but it is still a lot more than most people expected given how weak the economy was in 2009.

The most interesting thing about 2009 — and it will continue into 2010 — is that wind developers have options. The US Treasury is paying the cash value of the tax credits on wind farms. Wind companies no longer need to use tax equity, and a lot of companies did not last year. There was a lot of debt raised. Over $5 billion in debt went into wind farms in 2009, more than double the amount of debt the year before.

I agree that tax equity remains scarce. We will see the gap between demand for and supply of tax equity filled with debt.

MR. MARTIN: You said 19 deals last year. How many involved cash grants? How many were legacy deals where tax equity investors committed in 2008 but did not fund until 2009?

MR. EBER: Eight of the 19, or about half, were carryover,