

Energy Insights

An Update from the Third Quarter of 2014



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In this edition of Seyfarth Shaw's Energy Insights Newsletter our *Energy and Clean Technologies* team covers important developments in Q3 2014 for the energy industry, including: 1) securitization of solar lease receivables 2) additional clarification from the IRS regarding eligibility requirements for the PTC and ITC and 3) creation by the EPA of a Voluntary Quality Assurance Program for Renewable Identification Numbers.

Securitized Sizzle for Solar Companies as Lower Cost Alternative Financing

In July, SolarCity completed its third securitization of solar assets and issued over \$200 million in bonds, at an average-weighted coupon of 4.3%, backed by customer payments under solar lease contracts, generally a highly predictable contract. "Securitization" is the process of pooling various types of contractual debt and selling such pool of assets as tranches of bonds, securities and/or collateralized obligations to investors. Although this is SolarCity's third securitization of solar assets, the company may have solved one of the key impediments to its earlier, smaller issuances by eliminating the tax credit repayment issue should there be a default on the underlying credit obligation. This result is accomplished by having the securitization vehicle lease the solar project assets back rather than buy them, meaning the securitization vehicle does not need to repay the tax credits should a project or customer default on its underlying lease obligation and/or go bankrupt and thereby lowering the risk and cost of capital to SolarCity. Many are aware of the term "mortgage backed securities" and the crash of that market back in 2008 when the housing "bubble" burst, causing defaults on the underlying obligations, namely the mortgages themselves. Should this trend continue, not only in the solar asset class, but in other alternative assets classes, additional doors may open to lower cost access to financing to fuel growth in the renewable energy space.

IRS Clarifies Eligibility Requirements for the PTC and ITC for Projects Beginning Construction in 2013

The American Taxpayer Relief Act of 2012 modified the Internal Revenue Code to allow certain renewable energy facilities to qualify for renewable electricity production tax credits (PTCs) or energy investment tax credits (ITCs) if construction of such facilities began before January 1, 2014. Prior to such modification, facilities needed to be placed in service before January 1, 2014 in order to be eligible for PTCs or ITCs. On August 8, 2014 the IRS issued additional guidance (the "[IRS Notice](http://www.irs.gov/pub/irs-drop/n-14-46.pdf)") to clarify when construction has begun on a qualified facility (see <http://www.irs.gov/pub/irs-drop/n-14-46.pdf>). As outlined in the IRS Notice, there are two methods to determine when construction has begun on a qualified facility: (i) a "physical work test" and (ii) a five percent "safe harbor". Both methods require that continuous progress towards completion be made once construction has begun. "The Physical Work Test requires that a taxpayer begin physical work of a significant nature prior to January 1, 2014. This test focuses on the nature of the work performed, not the amount or cost." To allay certain industry concerns generated by the examples of significant work provided by the IRS in previous guidance, the IRS made clear that it takes a qualitative approach to the "physical work test". "Assuming the work performed is of a significant nature, there is no fixed minimum amount of work or monetary percentage threshold required to satisfy the Physical Work Test." With respect to the five percent "safe harbor," the IRS indicated that, with respect to a single project comprised of multiple facilities, if a taxpayer has paid or incurred at least three percent of the total cost of such project before January 1, 2014, PTCs or ITCs

may be claimed with respect to a portion of the individual facilities comprising the project. A project consisting of a single facility remains subject to the five percent “safe harbor” and at least five percent of the total cost of the facility at the time the facility is placed in service must have been paid or incurred prior to January 1, 2014. The PTC and ITC remain a critical component to the development and viability of renewable energy projects and the latest IRS guidance offers some greater clarity for projects that begin construction in 2013. A longer-term policy, however, around the availability of PTCs and ITCs will depend on Congressional action.

EPA Establishes A Voluntary Quality Assurance Program for Renewable Identification Numbers (“RINs”)

In late 2011 and early 2012, the EPA discovered that a significant amount of fraud had taken place within the RIN market. Specifically, three separate biofuels producers allegedly registered and sold RINs without having produced any of the underlying renewable fuel. As a result, obligated parties purchased and tendered upwards of 140 million invalid RINs in connection with the 2010 and 2011 compliance years (see <http://www.seyfarth.com/publications/100312b>). In response to such fraud, the EPA held the obligated parties strictly liable, requiring such parties to (1) replace the invalid RINs and (2) pay a penalty. The EPA’s “buyer beware” approach engendered much controversy and opposition within the biofuels industry which has led the EPA to modify its stance. In June of this year, the EPA established a program for verifying the validity of RINs. According to the EPA’s release (see <http://www.epa.gov/otaq/fuels/renewablefuels/documents/420f14042.pdf>), “the program provides a means for ensuring that RINs are properly generated through audits of renewable fuel production conducted by independent third-parties using quality assurance plans (“QAPs”), provides an affirmative defense for the transfer or use of invalid RINs that had been verified under an approved QAP, defines the conditions when RINs must be replaced, and a process for determining who will replace the RINs.” Following an interim period, in which a number of QAP options will be available, beginning January 1, 2015 the EPA program will consist of a single QAP option. The single QAP option remains under development by the EPA but will include:

- minimum requirements for a QAP, including such things as verification of feedstocks, verification that volumes produced are consistent with amount of feedstocks processed, and verification that RINs generated are appropriately categorized and match the volumes produced;
- qualifications for independent third-party auditors; and
- requirements for audits of renewable fuel production facilities, including minimum frequency, site visits, review of records, and reporting.

The 2011/2012 fraud and initial EPA response disrupted the RIN market. The biofuels industry is hopeful that the EPA’s latest policy revisions will restore the confidence of market participant in and increase liquidity and enhance the overall functioning of the RIN market.

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