Concord Specialty Risk

David S. De Berry, CEO
212.784.5678
daviddeberry@concordspecialtyrisk.com

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Energy Projects – Tax Equity Investors and Other Parties Confronting Tax Risks

Tax benefits, including federal or state investment tax credits and depreciation deductions, and other government subsidized cash benefits such as the grants (the "1603 Grants") under Section 1603 of the American Recovery and Reinvestment Tax Act of 2009 (the "1603 Program") can help finance renewable energy projects. In 2011, the total tax equity investment, apart from the 1603 Program, in wind and solar projects was $6 billion**.** 2012 figures, though not yet available, appear to be similarly sized. As of September 2012, 1603 Grants to more than 44,000 domestic solar projects alone leveraged over $7.17 billion in private sector investment in projects across all 50 states.

There are billions of dollars at risk for expected tax benefits that may not be realized, and the trend is continuing for 2013 (although not for the 1603 Program, which is now expired to new applicants). This document summarizes the risks associated with such financing, and how insurance can provide a possible solution to such risks.

A. Relevant Parties to an Energy Project and Information Needed for a Robust Submission

The key players in a typical energy project are described below. A "robust" insurance submission will provide the identity and relevant background/financial strength of, and amount of contribution/loan by, each of these key parties.

1. Sponsor: the entity that creates the investment vehicle(s) and gets the project funded. The Sponsor may also be an affiliate of the Developer, discussed below

2. Developer: the entity that performs the design, engineering, construction, installation, and/or operational management of the energy property. The identity and description of the component manufacturers (whether Tier 1) for the system and a description or copy of any draft a EPC (Engineering, Procurement and Construction) agreement and any O&M (Operations and Maintenance) Agreement will ultimately be needed.

3. Federal Tax Equity Investor: the entity that will invest in an investment vehicle created by the Sponsor in exchange for the federal tax benefits and cash flow expected to be derived from such investment.

4. (N.C). State Tax Equity Investor: the entity that will invest in an investment vehicle created by the Sponsor in exchange for N.C. state tax credits expected to be derived from such investment.

5. Law Firms and Advisors: e.g., solar industry leaders who have experience in closing transactions for the Sponsor using a structure identical to the structure that will be used in this submission (the so-called "capital lease" structure, a/k/a as the "inverted lease" structure).

6. Purchaser of Solar Generated Electricity:the entity that will enter into long-term power purchase agreements (PPAs) .

7. Project Lender: –the entity that will lend a certain amount of debt to the project, which will have a certain amount of development cost (a portion of which will be equity). The lender may enter into a forbearance agreement.

8. Other Insurance: – as a condition to any coverage we provide, the projects must be fully insured by an all-risk property policy that provides that recaptured (or forfeited) tax credits resulting from a named-peril is additional loss under the policy and/or that an acceleration of rent will be triggered that will offset lost tax credits.

B. Various Sources of Financing an Energy Project

Capital for renewable energy projects is generally raised through the following means, set forth in order of the least to most expensive cost:

1. Government grant through the 1603 Program
2. Government-guaranteed debt through the Department of Energy Loan Guaranty Program
3. Commercial Debt
4. Tax Equity
5. Subordinated Debt
6. True Equity

The 1603 Program was a major part of the American Recovery and Reinvestment Act of 2009, designed to stimulate the U.S. economy and encourage investment in renewable energy projects. It offers cash grants, in lieu of an investment tax credit, to eligible applicants who satisfy the requirements. The deadline for applications for a 1603 Grant expired October 1, 2012. However, applicants who have not placed their energy property in service are at risk of not complying with the "begun construction" requirement or "completed construction"

requirement. All pending applicants for, and all recipients of a 1603 Grant are at risk for "recapture." These concepts are detailed in Section D below.

"Tax equity" is a term that is used to describe a passive ownership interest in an asset or a project, where an investor receives a return based not only on cash flow from the asset or project, but also on federal and state income tax benefits. Tax equity benefits arise from two broad categories: tax deductions and tax credits. The most common tax deductions are depreciation and interest deductions which are only available in transactions with leverage at the asset or project level. The most common federal tax credits in renewable energy projects are the investment tax credit (the "ITC") and the production tax credit (the "PTC"). ITC has been available in recent years to investors in solar and fuel cell assetsin an amount equal to 30% of the cost of the energy property (35% for state tax credits in North Carolina). The ITC is available in the year the project is placed in service. There is a cap of $3 per watt for fuel cell ITC. For microturbines, there is a cap of $2 per watt. Microturbines and qualifying combined heat and power qualify for 10% ITC. The PTC is paid based upon the output produced by the renewable energy facility. The PTC and the ITC are mutually exclusive. Generally, as the cost of energy property (wind turbines, for example) is reduced and the energy capacity is increased, a sponsor/investor may consider a PTC paid over time is a better yield than the ITC. **Tax insurance is available for both the ITC and the PTC, however, there are more tax risks with the ITC and generally the insurance is purchased in connection with the ITC, rather than the PTC.**

A 1603 Grant and capital raised via tax equity stand out as instances in which tax related issues pose significant risk. However, even in the absence of such financing, both debt and equity may desire that the tax related issues are mitigated or transferred.

In most cases, the construction of a project is financed by initial funding commitments from the developer (or construction lender) and once the property is placed in service, the alternative financing sources pay out the construction loan or repay (in whole or in part) the developer.

C. Major Investment Structures and Key Risks

Although the investment structure will be tailored, depending upon the type of financing being obtained, the type of energy project, use of debt, etc., there are only three main structures:

1. The Partnership Flip. A partnership, or limited liability company taxed as a partnership, owns the energy property. A tax equity partner invests in the partnership alongside the sponsor and/or developer. In exchange for its investment/contribution, the tax equity partner is allocated tax credits and bonus depreciation at a set percentage until a certain time period and/or yield is achieved at which time the allocations are "flipped" so that the

sponsor and/or developer obtain a higher percentage of profits, cash-flow and tax attributes. Often at the time of the "flip", the investor has the right to exit the investment.

The primary reason why this structure is preferred is that the IRS issued guidance for such a structure, albeit with respect to financing wind projects, in Rev. Proc. 2007-65. Notwithstanding, there are common issues with the partnership flip structure that are both financial (e.g., whether any deferred developer fees will be supported by project cash flow) and tax/legal (e.g., whether the tax investor will have enough upside and downside to be a "partner" and whether the investment will have economic substance).

2. The Sale-Leaseback. The developer/sponsor constructs the project, and sells the project to an investor or investment vehicle housing investors' contributions of debt and equity, who then leases the project back to the developer/sponsor under a net lease (sometimes referred to as either a "triple net lease" or a "hell-or-high water" lease). The sale allows the investor to be the owner and obtain the tax benefits as well as the lease payments. The developer/sponsor obtains cash at closing and then, via the lease, the right to operate the facility and obtain profit to the extent it exceeds the rent payment.

   The key issue in this structure is whether the lease will be respected as a "true" (or operating) lease as opposed to a synthetic or capital lease. A capital lease would be treated as a loan for tax purposes. The IRS provided a safe harbor for such structures in IRS Notice 2001-28. However, even under the safe harbor rigors (e.g., the lease term is not longer than 80% of the expected life and the rent payments are not more than 80% of the fair market value of the project), there are subjective "facts and circumstances" that can be highly relevant to the ultimate legal determination of the arrangement.

3. The Inverted Lease (a/k/a the Capital Lease Structure). The owner of the project, which may be the developer/sponsor or an investor interested in only state tax credits, leases the project to a second entity that is entitled to the federal income tax benefits (sometimes, limited to the federal investment tax credit via an operating lease with a pass-through election under Section 50(d)(5)). Often the second entity uses a partnership flip structure, as well as the first entity, if a state tax equity partner has invested in the project, because the partnership flip structure facilitates exit from the investment.

   The issues noted above regarding the partnership flip structure are present in this structure, since it typically builds on a partnership flip structure. In addition, a number of nuanced tax issues can emerge regarding either the state or federal tax attributes allocated by this structure.

D. Key Tax Risks and the Potential Coverage for Energy Projects

The table below identifies the risks that may be covered and the policy features offered by such insurance. The risks in bold and underlined are risks that are most commonly insured, but unless otherwise noted, all risks are potential candidates. The insurance may cover one, several or all (at least theoretically and subject to underwriting) risks. The recapture risk is the most frequently sought coverage.

Risk Description	**Instances Where Risk May Be More Prominent**	**Features**
The Partnership/Partner Risk. The risk that the entity will not be respected as a partnership and/or an investor will not be respected as a partner for tax purposes.	The recent *Historic Boardwalk Hall* case challenges typical structures where a "partner" has no meaningful risk in the downside of an investment. The codification of the *"economic substance" doctrine* is a potential issue, especially where a federal tax equity investor expects (bonus) depreciation in a leveraged investment or facility.	By having the investor purchase the policy, rather than having the sponsor guarantee the tax benefits, the risk of challenge to the partnership/partner characterizations is both mitigated and transferred. A sponsor-guaranty imperils the structure!
The Allocation Risk. The risk that the allocation (or special allocation) of tax benefits will not be respected.	If partner is receiving tax credits in a disproportionate amount to its profits interest or if non-recourse financing exists.	There is no safe harbor for allocation of tax credits. Insurance provides the needed certainty.
The Investment Structure Risk. The risk that the sale leaseback, inverted lease or capital lease structure will not be respected for tax purposes.	When a sale leaseback or inverted lease or capital lease structure is implemented.	The insurance can cover the owner, or the lessor, of an indemnitor of either.

Risk Description	Instances Where Risk May Be More Prominent	Features
Recapture Risk. The risk that federal investment tax credits (or a 1603 Grant) allocated to an investor (or, in the case of a grant, used to pay down debt, etc.) must be returned or effectively returned (with interest) and/or that any remaining installments of state investment tax credits are expired.	**This risk is always present**. Generally, if during the five year period after energy property is placed in service, the energy property is disposed of, destroyed, ceased to be used as such, relocated out of state (as to state tax credits), or its owner experiences a change in ownership, the tax credits may be subject to recapture.	**Insurance is available** for the "recapture" risk (however nominated) with respect to a 1603 Grant, federal investment tax credit, or state tax credit. Concord Specialty Risk provides loss mitigation service by reviewing and/or making indirectly available all risk property cover that includes lost and/or repaid ITC as part of loss payable from an insured property peril.
Change in Law Risk. The risk that a state tax credit installment will be discontinued.	Whenever a state tax credit is significant to an investor.	Insurance is not predicated upon receipt of a private letter ruling from the state tax authority.
Capital Loss Deduction Risk. The risk that a state tax credit investor is disallowed a capital loss (incurred upon exiting the investment) for federal tax purposes.	Whenever a state tax credit is significant to an investor who is not obtaining federal tax benefits from the investment.	Insurance is available whenever a state tax credit investor has a positive capital account balance that is written down upon exiting the investment.
The Eligible/Qualified Property Risk. The risk that the some components of the project will not be considered "energy property" for the investment tax credit, or as "qualified property" for a treasury grant, or as "separate facilities" for state investment tax credits.	When cost components of the facility serve dual purposes or have value independent of their use as energy property.	Concord Specialty Risk provides a loss mitigation service in reviewing the accountant's certification and related work papers as part of its underwriting.

Risk Description	Instances Where Risk May Be More Prominent	Features
The Eligible Basis Risk (a/k/a the "Inside Basis" Risk). This risk overlaps with the Eligible/Qualified Property Risk but focuses on the risk that the cost of the qualified, energy property will not be respected for tax purposes.	When the energy property is being sold between related parties (e.g., developer to Owner Partnership). If developer has a direct or indirect interest in the buyer in a sale-leaseback transaction.	If a sponsor/developer has an indemnity obligation for the Inside Basis Risk, the sponsor/developer can be the insured or loss payee. Coverage can be extended to risk that IRS asserts that a 1603 Grant was paid in excess of eligible basis.
Placed in Service Risk. This risk generally relates to inability to complete construction of the project within the time frame needed to satisfy the "Credit Termination Date" for a 1603 Grant. Although less frequent, the timing risk may also relate to when an investor may claim an investment tax credit or begin taking depreciation. This risk is generally available through a surety company, if at all, and is not available through Concord Specialty Risk at this time.	Section 1603 Grant.	N/A
Commenced Construction Risk. This risk relates to the 1603 Grant program – intended for "shovel ready" projects. This risk is generally available through a surety company, if at all, and is not available through Concord Specialty Risk at this time.	Section 1603 Grant.	N/A
Other Political Risk	Approved application not paid due to lack of appropriations or change of law following	Coverage for these (and each category shown above) is optional.

Risk Description	Instances Where Risk May Be More Prominent	Features
	approval	
Eligible Applicant for 1603 Grant	1. Applicant is a pass-through entity with one or more pass-through entity investors. 2. If applicant is a lessee. 3. If there is a question regarding when property was originally placed in service or if used parts become components. 4. Applicant has non-US investors.	If (perhaps at Concord Specialty Risk's suggestion) a blocker corporation is used, Concord Specialty Risk will insure that the indirect interest in the applicant through the blocker corporation does not disqualify the applicant.

Amount of Insurance Proceeds

The amount of limits is generally the amount of expected tax benefits at risk. The calculation can become slightly nuanced. For example, a credit is a dollar for dollar reduction of taxes. But state tax credits, which reduce state taxes, result in an increased federal tax, because state taxes are deductible against federal taxes. So, the loss of state tax credits results in a lower federal tax, which may be used to discount the limits of insurance.

Insurance proceeds can also be increased to include gross-up costs (approximate amount of tax on receipt of insurance proceeds), and, if IRS audit coverage sought – (3) contest costs, plus (4) interest and (5) penalties.

Concord Specialty Risk will work with an applicant and its broker in developing an appropriate "loss calculation" and setting appropriate limits.

Submissions

To forward a submission, please provide the following information to David.DeBerry@concordspecialtyrisk.com:

1. Name of applicant
2. Specify scope of coverage sought based upon above
3. Specify amount of limits sought
4. Provide copy of confidential information memo, term sheet or other description of the investment
5. For a more robust submission, include the background information on each party described in Part A and a loss calculation. (Optional)