

Using Tradable Renewable Energy Credits in California

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A decision by the California Public Utilities Commission in January lets California utilities satisfy part of their 20%-by-2010 renewable procurement requirements by buying “unbundled” credits from renewable generators in other states.

Credits are “unbundled” if they are purchased separately without also buying electricity.

Before this decision, a utility could not use unbundled credits—called tradable renewable energy credits or TRECs—to fulfill renewable procurement requirements. A controversial March 2010 decision and a subsequent stay on the decision had left the ability to rely on renewable energy credits purchased out of state in doubt. Even with the January decision, the issue remains highly contentious and may not have been settled.

After nine years, the extent to which TRECs can be used in California and even what qualifies as a TREC remain under debate. The ultimate answers may differ for the 20%-by-2010 renewable portfolio standard or “RPS” and the 33%-by-2020 renewable electricity standard or “RES.”

Background

Investor-owned utilities and retail energy service providers in California are required to provide 20% of their electricity from renewable energy sources beginning in 2010, although flexible compliance rules in the RPS program effectively extend the compliance deadline to 2013. (A retail service provider is an entity that competes with investor-owned utilities to sell electricity to retail customers directly.)

The California Public Utilities Commission administers this 20%-by-2010 RPS program. The program has been underway since 2002 and is mostly well defined. The ability of utilities to use TRECs to meet their compliance obligations is among the few remaining aspects of the program that have not yet been finalized.

All California utilities, including retail service providers and public and municipal utilities not under CPUC jurisdiction, will be required to procure 33% of their electricity from renewable energy sources beginning in 2020. This / continued page 26

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payments may be treated as compensation to the seller rather than additional purchase price if the remaining payments are tied to additional work that must be done. This can affect the tax treatment to both the buyer and seller. Compensation must be reported as ordinary income rather than capital gain. The buyer can deduct compensation while a payment of purchase price would go into basis and be used to calculate Treasury cash grants, investment credits and depreciation on the projects.

One way to avoid confusion is to make sure employees are paid separately at market rates for ongoing services or offered retention bonuses. True earn out payments should be paid in proportion to the ownership interest of each seller, whether or not he performs additional services. The amount should be fixed at sale. It can be subject to future events, like project completion, but not whether the seller remains with the company.

IRAN SANCTIONS will get more attention in Congress.

The House Foreign Affairs Committee is working on a bill to tighten US sanctions further in the wake of charges by critics that a 2010 law imposing additional sanctions still has too many loopholes that allow companies to continue doing business with Iran. The 2010 law was a compromise between sanctions hawks in Congress and the Obama administration, which wanted flexibility to impose sanctions in individual cases, particularly against businesses in allied countries.

The administration has used the 2010 law to sanction just one company—Naftiran, a Swiss-based subsidiary of the Iranian national oil company that has entered into joint ventures with a number of European oil companies to import oil into Iran. The company had \$21.9 billion in revenues in 2008.

The House may replace the word “should” take certain actions with “shall immediately” do so.

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TRECs

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33%-by-2020 RES was approved by the California Air Resources Board in September 2010 and in many respects remains a work in progress. Notably, the authority for this program currently stems from an executive order issued by then-Governor Schwarzenegger; however, legislative efforts to enact a bill establishing a 33%-by-2020 renewable energy obligation continue. If a bill is passed, then the bill and its legislative requirements will supersede the executive order and the CARB regulatory framework.

A Tortured History

Parties have been asking the CPUC to authorize the use of TRECs for RPS compliance from the very earliest days of the RPS program, but the path toward establishing rules regarding use of TRECs has been tortured.

The CPUC initially considered the use of TRECs for RPS compliance as the parties were seeking, but fearing the issue

A California Public Utilities Commission decision lets utilities purchase renewable energy credits from generators in other states to satisfy California renewable energy targets, but it may not be the last word.

would delay implementation of the RPS program, the CPUC decided to table the matter.

The CPUC subsequently revisited the issue in several proceedings and began focusing seriously on the TREC issue in 2006, when legislative activity on the matter also heated up. But once again the CPUC put off a decision to authorize the use of TRECs for RPS compliance, committing only to revisit the matter at a later date. Since that time, parties have held numerous workshops, filed briefs, and waited for the CPUC to act.

Finally, in March 2010, the CPUC issued a decision authorizing the use of TRECs for RPS compliance. However, rather than closing the issue, the March 2010 decision simply ignited more controversy.

TRECs Under the RPS

Before the March 2010 decision authorizing the use of TRECs, utilities and retail service providers could comply with their RPS requirements only through “bundled” contracts, in which physical energy and renewable energy credits were purchased in the same transaction.

The March 2010 decision expanded compliance options by allowing the use of unbundled TRECs for RPS compliance. It also allowed TRECs to be banked and used for RPS compliance for up to three years following the physical delivery of renewable energy to the grid. However, for the state’s three large IOUs for the years 2010 and 2011, the decision limited the use of TRECs to 25% of the utility’s annual RPS obligation. The CPUC also capped the price during these years at \$50 per megawatt-hour for TRECs used for RPS compliance. (A subsequent decision extended these limitations to retail service providers.)

The March 2010 decision sparked controversy among both utilities and renewable energy project developers primarily on account of the 25% TRECs limit combined with the expansive definition of a TREC transaction, which redefined some already approved bundled contracts as TREC contracts.

Under the decision, all transactions are defined as TREC transactions unless they include either (1) physical energy deliveries from a generator that has its first point of interconnection with a California balancing authority such as the California Independent System Operator

or (2) energy deliveries that are dynamically transferred to a California balancing authority area.

Under this sweeping definition, contracts with out-of-state generators are nearly always considered TREC contracts, even if they include physical energy deliveries.

However, the CPUC left open the possibility that out-of-state transactions that include firm transmission arrangements, but not dynamic transfers to a California balancing authority, could be reclassified as bundled contracts since, prior to the March 2010 decision, such transactions had been considered bundled transactions.

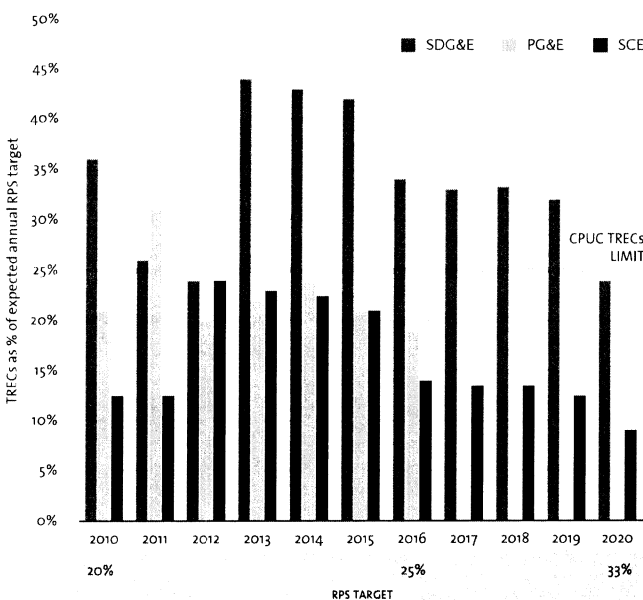
The narrow definition of bundled contracts imposed by the March 2010 decision and the application of the definition to already-approved contracts limit additional out-of-state procurement.

The chart below, which was created by The Utility Reform Network, a consumer advocacy group, shows the utilities' annual TREC procurement under the CPUC's adopted definition. As shown, San Diego Gas & Electric has already exceeded the 25% TREC usage limit in nearly each year through 2020 under this definition. This means that SDG&E would be able to enter into new RPS contracts with out-of-state generators only under very narrow circumstances. (SDG&E would be allowed to use deliveries from contracts exceeding the TREC usage cap for RPS compliance as long as the contracts were approved before March 11, 2010.)

The other two utilities approach the 25% limit for much of the first half of the decade and would have the opportunity for significant new out-of-state procurement beginning only around 2016. The utilities objected to being hamstrung by these limitations since they restricted procurement options, and developers of out-of-state renewable projects objected to being pushed out of the California market.

IOU Renewable Procurement

Approved/Submitted TREC contracts as a fraction of expected RPS procurement targets



Prepared by Matt Freedman (TURN) using public data provided by the IOUs

As a result of this controversy, the CPUC stayed the March 2010 decision in May 2010 and placed a moratorium on approving contracts that would be classified / continued page 28

It could also require public companies to report any potentially sanctionable investments in Iran in quarterly and annual reports to the US Securities and Exchange Commission.

Any bill would also have to pass the Senate, which has been less critical of the administration's efforts.

NEW JERSEY confirmed that Treasury cash grants paid on renewable energy projects in the state are not subject to state corporate income taxes. The announcement is in a "technical advisory memorandum" issued on February 11 by the New Jersey Division of Taxation.

GRANTS that low-income housing developers received from state housing agencies out of federal stimulus dollars under a so-called TCAP program—tax credit assistance program—had to be reported as income.

Congress gave the Department of Housing and Urban Development \$2.25 billion in the economic stimulus bill in February 2009 to allocate among state housing agencies. The states then made awards to certain privately-owned low-income housing projects that still needed money to finish construction.

The IRS national office told its agents in the field in an internal legal memorandum made public in February that the grants must be reported as income. The memorandum is ILM 201106008.

The memo also addresses the timing of the income.

Grants received by developers who determine their incomes on a cash basis must report income once they have access to the funds in a state account from which to pay project costs. Larger developers that use accrual accounting must report income upon signing an agreement with the state housing agency fixing the amount of the grant the developer will receive.

These positions have no effect on Treasury cash grants paid on renewable energy projects under section 1603 of / continued page 29

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according to that decision as TREC contracts. The CPUC and interested parties then spent an additional eight months debating the issue, resulting in no less than six revisions to the administrative law judge's initial proposed decision as well as a competing proposed decision from a commissioner (which was also revised). Finally, the commission adopted a "final" decision in January 2011, reinstating the March 2010 decision in nearly all respects, except for extending the TREC usage and cost limitations until 2013. This decision also lifted the moratorium on approving TREC contracts.

Given the similarity between this decision and the highly unpopular March 2010 decision, it is not surprising that the controversy continues. In February, several parties submitted applications to rehear the January decision. Once again, their arguments primarily revolve around the very restrictive definition of bundled transactions.

Further revisions to the January 2011 decision are still possible. Only three sitting commissioners approved the January decision. (Two commissioner seats were vacant at that time.) The term of one of the three commissioners has since expired. Incoming Governor Jerry Brown appointed new commissioners to two of the three vacant seats. Thus, any future decisions on the TREC issue will be taken up by a commission that currently has four members, two of whom did not vote on the January decision. (A fifth appointment is still pending.)

TRECs Under the RES

The controversy at the CPUC over TRECs relates specifically to the 20%-by-2010 RPS, but the controversy could easily spill over to the 33%-by-2020 RES. This is because CARB has decided to defer to the CPUC on the TRECs matter. The CARB resolution approving the 33%-by-2020 RES requires CARB to initiate a rulemaking within 30 days of adoption of the CPUC decision "to ensure continued harmonization of the two programs, specifically incorporating provisions related to Tradable Renewable Energy Credits for all regulated parties under the RES regulation." This 30-day period ended on February 13, 2011, but CARB has not yet initiated the required rulemaking.

On the other hand, the discussion at the CPUC could also be substantially moot if the legislature passes 33%-by-2020 RPS legislation. A new 33% RPS bill currently moving through the California legislature identifies three categories of renewable energy resources rather than trying to define what is or is not a

bundled transaction. One category is resources with a first point of interconnection with a California balancing authority or that would be dynamically transferred to a California balancing authority (*i.e.*, the CPUC's restrictive definition of bundled resources). Another category is firmed and shaped resources that are scheduled into a California balancing authority (*i.e.*, transactions that were redefined in the CPUC decision from bundled to TREC-only). The third category is all other resources (TREC transactions under all definitions).

The legislation sets separate procurement requirements or limits for each of these categories in three different time periods. For example, beginning in 2017, at least 75% of renewable resources must come from the first category, which is the equivalent of the CPUC requirement that no more than 25% come from TREC-only transactions. However, the legislation further specifies that of the remaining transactions, only 10% can come from the third category. These restrictions are outlined in Table 1 below.

Table 1: Comparison of TREC Usage Limits in California Programs

	First-point of interconnection with or dynamically transferred into California balancing authority	Firmed and shaped and scheduled into California balancing authority	All other out-of-state, REC only contracts
20%-by-2010 (CPUC January 2011 decision)			
2010-2013	At least 75%	No more than 25%	No more than 25%
2014+	No limit	No cap	No cap
33%-by-2020 (CARB, September 2010 decision)			
To be "harmonized" with CPUC rules			
33%-by-2020 (SBX1 2, active bill in legislature)			
Prior to 2013	At least 50%	No more than 50%	No more than 25%
2014-2016	At least 65%	No more than 35%	No more than 15%
2017+	At least 75%	No more than 25%	No more than 10%

The bottom line is that the recent decision by the CPUC to allow RPS-obligated entities to use TRECs to meet part of their RPS compliance obligations is an important first step to finally

realizing a tradable REC market in California. But the CPUC framework applies only to the 20%-by-2010 RPS, creating uncertainty as to what the TREC rules might be under a 33%-by-2020 RES. The framework may also not be final, as it remains highly controversial.

This uncertainty will linger while the CPUC continues to grapple with TRECs rules for the 20% RPS and the legislature continues to debate 33% RPS legislation.

Even once these debates are completed, the two RPS (or RES) programs will need to be harmonized, which could provide another opportunity for modifications to the TRECs program and more uncertainty for out-of-state developers interested in selling renewable power into California. ©

China Wind Power Update

by Christopher Flood, in Beijing

Despite a recent tide of positive news generated by the Chinese wind power industry, a deeper look reveals a large number of challenges facing both equipment manufacturers and project developers as the domestic industry continues to mature.

Days after the January announcement that China had surpassed the United States in 2010 as the world leader in installed wind power capacity, Sinovel, its largest wind turbine manufacturer, raised US\$1.4 billion in an initial public offering on the Shanghai Stock Exchange, pricing the offering at the top of the range. Just weeks earlier, Datang Renewable Power, China's second largest wind power generator by capacity, raised US\$643 million in its own Hong Kong IPO. The second half of 2010 also saw public offerings in Hong Kong by Shenzhen-listed wind turbine manufacturer Xingjiang Goldwind Science & Technology and on the New York Stock Exchange by China Ming Yang Wind Power Group, the country's largest non-state-owned turbine firm.

Away from the public markets, the news from the China Renewable Energy Industries Association that China had installed 16,800 megawatts of new wind generating capacity in 2010, for a total of 41,800 megawatts, was met with a mixture of surprise and resignation from those outside of the Chinese industry, as many observers predict China will dominate the world market for many years to come. / continued page 30

the stimulus. Congress made clear when it authorized the renewable energy grants that they do not have to be reported as income.

Many renewable energy projects are owned by limited liability companies treated as partnerships. Even though section 1603 payments are exempted from taxes, their receipt still has an effect on partner capital accounts that determine, among other things, how much depreciation a partner can absorb from a project. A partnership receiving a grant treats it as tax-exempt income. Tax-exempt income increases the partner capital accounts. This gives partners more capacity to absorb depreciation from a project.

The timing of when this income bumps up capital accounts is unclear. Because of the uncertainty, tax equity investors would be wise still to invest in partnerships that own projects on which section 1603 payments will be made before the projects are placed in service to ensure they are partners before the bump up in capital accounts occurs.

CALIFORNIA said out-of-state corporations must file franchise tax returns if they own "disregarded" subsidiaries that do business in the state. It does not matter if the corporation has no other ties to the state.

The Franchise Tax Board took the position in Legal Ruling 2011-01 in mid-January.

THE DISTRICT OF COLUMBIA reneged on a promise to reimburse 51 residents who installed solar panels for roughly a third of the cost.

The city said it will try to find money in next year's budget.

The city set up an incentive program in 2009 that is funded by a dedicated tax on electricity and gas bills. The tax was supposed to raise \$2 million a year through 2012. However, \$700,000 from the fund that was supposed to be used to make incentive payments to the 51 residents who had been approved for the payments before they installed panels has been diverted to help close a citywide budget gap. / continued page 31

Environmental Update

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facilities at the time the draft guidance was first released” should coordinate with the Fish and Wildlife Service if they are interested in obtaining a programmatic eagle take permit. The first set of guidelines—the draft land guidance—also recommends that existing projects and projects already far down the development path implement those portions of the draft land guidance that apply to the remaining phases of those projects. The Fish and Wildlife Service said it will view compliance with the new guidelines as evidence of good faith when deciding whether to impose fines or other penalties for violations of the environmental statutes the new guidelines address.

Boilers

The Environmental Protection Agency released final rules to regulate emissions of hazardous air pollutants from boilers and process heaters at large power plants and factories—so-called major sources of hazardous pollutants—in February as well as a separate set of rules regulating such emissions from boilers and process heaters at smaller sources, sewage sludge incinerators and commercial and industrial solid waste incinerators. It then announced that it would begin a process to reconsider certain provisions of these rules.

It also proposed a new definition for the term “solid waste.”

The new definition of “solid waste” is important because any incinerator burning “solid waste” is subject to more stringent air emissions requirements. Under the new definition, materials that are considered discarded would continue to be considered solid waste unless reprocessed in a manner that turns the material into a legitimate

fuel. Traditional fuels like coal, oil and natural gas are not considered solid waste under the proposed definition.

“Major sources” of hazardous air pollutants are those that emit or have the potential to emit 10 or more tons per year of a single hazardous air pollutant or 25 or more tons per year of any combination of hazardous air pollutants. Boilers at such facilities considered major sources burn fuels like coal, natural gas and biomass to produce steam or heat. Process heaters are used to heat certain materials as part of an industrial process.

New and existing sources with heat capacities of less than 10 million British thermal units per hour (MMBtu/hr) or that are fueled by natural, refinery or equivalent gas are not subject to numeric emissions standards. Instead, such sources must comply with certain work practice standards, like periodic scheduled tune-ups of units. The new rules also impose work practice standards for new and existing boilers that are operated less than 10% of the year as emergency or back-up boilers. The new boiler rules provide numeric emissions standards for all other existing and new boilers that are located at major sources of hazardous air pollutants. Compliance with these standards will require the use of the “maximum achievable control technology” or “MACT” to control emissions of mercury, dioxin/furan, particulate matter (used as a surrogate for certain metals), hydrogen chloride and carbon monoxide.

The boiler rules are not expected to take effect for existing units covered by the numeric emissions standards until 2014, unless implementation is delayed. They are attracting a lot of criticism from industry and Congress.

— *contributed by Sue Cowell in Washington.*

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