
This webinar will begin shortly.
FIA

Energy Transition: Trends in Derivatives Transactions

June 8, 2023

Reminders

- The webinar will be recorded and posted to the FIA website within 24 hours of the live webinar.
- Please use the “question” function on your webinar control panel to ask a question to the moderator or speakers.

Presenters

Host:

Michael Sorrell, Deputy General Counsel, FIA

Panelists:

Dickson Chin, Partner, Financial Markets, Jones Day

Kelly Rubin, Partner, Tax, Jones Day

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AGENDA

I. Overview of Energy Tax Credits

ENERGY TAX CREDITS BEFORE THE INFLATION REDUCTION ACT (IRA)

- Tax credits available for certain technologies – primarily **wind and solar**
- Tax credit monetization strategies generally took the form of "**tax equity**" – an investor funds a project and claims the project's available tax credits
- Disadvantages of tax equity:
    - Transaction costs are high relative to tax benefit
    - Partnership tax rules increase complexity
    - Investors must commit to multi-year projects
    - Accounting treatment results in above the line hit to earnings

"IRA tax credits expected to be worth hundreds of billions"

- Catherine Clifford, *Startup aims to help climate companies unlock billions in Inflation Reduction Act tax credits*, CNBC (Apr. 13, 2023), https://www.cnbc.com/2023/04/13/crux-climate-to-provide-a-marketplace-for-ira-tax-credits.html

"EU Struggles To Match Renewable Energy Incentives In Inflation Reduction Act"

- Steve Hanley, *EU Struggles To Match Renewable Energy Incentives In Inflation Reduction Act*, CLEANTECHNICA (Jan. 25, 2023), https://cleantechnica.com/2023/01/25/eu-struggles-to-match-renewable-energy-incentives-in-inflation-reduction-act/.

"The majority of the [IRA's] $394 billion in energy and climate funding is in the form of tax credits."

The Inflation Reduction Act: Here's what's in it, MCKINSEY & CO. (Oct. 24, 2023), https://www.mckinsey.com/industries/public-and-social-sector/our-insights/the-inflation-reduction-act-heres-whats-in-it

"[S]ubsidies and tax breaks enshrined in the Inflation Reduction Act will spur a decade of heavy investment in renewable technologies."

- Jason Kaminsky, *How Lenders Are Gearing Up For A Green Boom Spurred By The Inflation Reduction Act*, FORBES (Feb. 22, 2023), https://www.forbes.com/sites/richardmatsui/2023/02/22/lending-for-a-greener-tomorrow-lenders-tackle-the-state-of-renewable-energy-financing-key-ira-impacts-and-market-expectations-for-2023/?sh=62a297fb4f4d.

"The New Climate Law Is Working. Clean Energy Investments Are Soaring."

- Brian Deese, *The New Climate Law Is Working. Clean Energy Investments Are Soaring.*, THE N.Y. TIMES (May 30, 2023), https://www.nytimes.com/2023/05/30/opinion/climate-clean-energy-investment.html

TRANSFERABLE CREDITS UNDER THE INFLATION REDUCTION ACT

investment tax credit

production tax credit

carbon oxide sequestration credit*

alternative fuel vehicle refueling property credit

qualifying advanced energy project credit

new clean electricity investment credit

new clean electricity production credit

new zero-emission nuclear power production credit

new clean hydrogen production credit*

new advanced manufacturing production credit*

new clean fuel production credit

* Eligible for direct pay to non-tax exempts for five years.

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PRODUCTION-TYPE TAX CREDITS

Clean electricity production credit (Sections 45 and 45Y)

- Generally calculated on a per-kWh basis.
- Applies to wind <u>and</u> solar. Other eligible technologies include biomass, geothermal, waste and hydropower.
- Starting in 2025, applies to any zero-emissions technology.

Credit for manufacturing of green energy components (Section 45X)

- Calculated on a per-component basis or, in some cases, as a percentage of costs incurred.
- Applies to components used in solar, wind and battery technologies.
- Also applies to production of critical minerals, including aluminum, graphite, lithium, manganese, nickel, tin and tungsten.

Other production-type tax credits

- Credit of up to $1.75 per gallon of sustainable aviation fuel (Section 40B)
- Credit of up to $85 per metric ton of carbon oxide and other carbon oxides that are captured and sequestered (and $180 per metric ton for carbon dioxide captured using direct air capture technology) (Section 45Q)
- Credit of up to $1.50 per kWh produced at certain existing nuclear facilities (Section 45U)
- Credit of up to $3.00 per kilogram of clean hydrogen, indexed for inflation (Section 45V)
- Credit of up to $7,500 for each qualifying EV placed in service (Section 45W)

INVESTMENT-TYPE TAX CREDITS

Clean electricity investment credit (Sections 48 and 48E)

- 30% credit for qualifying energy properties include solar equipment, fuel cell power plants, waste energy recovery facilities, combined heat and power facilities, small wind energy facilities, geothermal heat pumps, certain energy storage technology, biogas property, electrochromic glass, microgrid controllers, electromechanical fuel cells, linear generator assemblies and certain interconnection property.

Advanced energy project credit (Section 48C)

- 30% credit for re-equipping, expanding or establishing an industrial or manufacturing facility for the production or recycling of property designed to produce energy conservation technology, including facilities to manufacture solar, wind, hydro and geothermal equipment, fuel cells, electric grid modernization equipment, CCS equipment, fuel refining and blending equipment, and EV vehicles or components
- Also available for re-equipping an industrial or manufacturing facility with equipment designed to reduce greenhouse gas emissions by at least 20%
- Total credits capped at $10 billion; must apply to IRS for an allocation of credits.

Refueling Property Credit (Section 30C)

- 30% credit for EV charging stations and fueling equipment for natural gas, propane, hydrogen, E85 and 20% biodiesel blends, not to exceed $100,000 per charging station / fueling equipment for commercial taxpayers.
- Starting in 2023, equipment must be installed in low-income census tracts

RULES FOR “SELLING” TAX CREDITS

- **Taxpayers may elect to transfer certain energy credits (all or a portion) to unrelated parties for cash**
    - Can only be “transferred” (i.e., election to transfer made) once
    - Must be transferred “for cash”
    - Payments received are excluded from seller’s taxable income
    - Amounts paid may not be deducted by buyer
- **Transfer election made on year-by-year basis, but buyer may carry back or forward purchased credits**

Widely held corporations

with past, present or future income tax liability

who are unrelated to seller

BENEFITS OF “BUYING” TAX CREDITS

- “Buying” tax credits offers several advantages over tax equity
  - Eliminates need to comply with complex partnership tax rules
  - Investors can “buy” tax credits only as needed
  - Unlike tax equity transactions, accounting treatment does NOT result in above the line hit to earnings
- Although the IRA does not allow the transfer of accelerated depreciation, the bigger picture supports the development of a transferable tax credits market
  - Depreciation is only a timing benefit
  - Increasing number of operating companies with net zero goals who are developing their own projects will have sufficient tax capacity to utilize depreciation and sell tax credits

II. Treatment of Transferable Tax Credits Under Commodity Exchange Act

KEY CONTOURS OF THE COMMODITY EXCHANGE ACT (CEA)

commodity

(a) specified agricultural commodities and (b) “all other goods and articles . . . and all services, rights and interests . . . in which contracts for future delivery are presently or in the future dealt in”

commodity swaps and future contracts

subject to a comprehensive framework of regulation under the CEA

commodity forward contracts

transactions that qualify for the forward contract exclusions from the “swap” and “future delivery, but are still subject to CFTC jurisdiction

forward contract

transaction for any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled

THINKING ABOUT TAX CREDIT TRANSACTIONS UNDER THE CEA

Principal issues to resolve under the CEA :

1.	Do tax credits under the Inflation Reduction Act constitute **commodities**?
2.	Do tax credit sale transactions constitute **swaps** or **off-exchange futures contracts**?
3.	Do tax credit sale transactions constitute **forward contracts**?

III. Potential Transaction Structures – Forward Contracts

DIRECT FORWARD CONTRACT

Legend
Seller
Buyer

- **STEP 2:** When each such vintage of tax credits is generated, ***Buyer pays the preset amount of cash to Seller in exchange for the tax credits***

Tax Credits

- **STEP 1**: ***Seller enters into a contract with Buyer*** in which Buyer will purchase each vintage of tax credits generated in the future at an agreed-upon price (the "Forward Contract")

Forward Contract

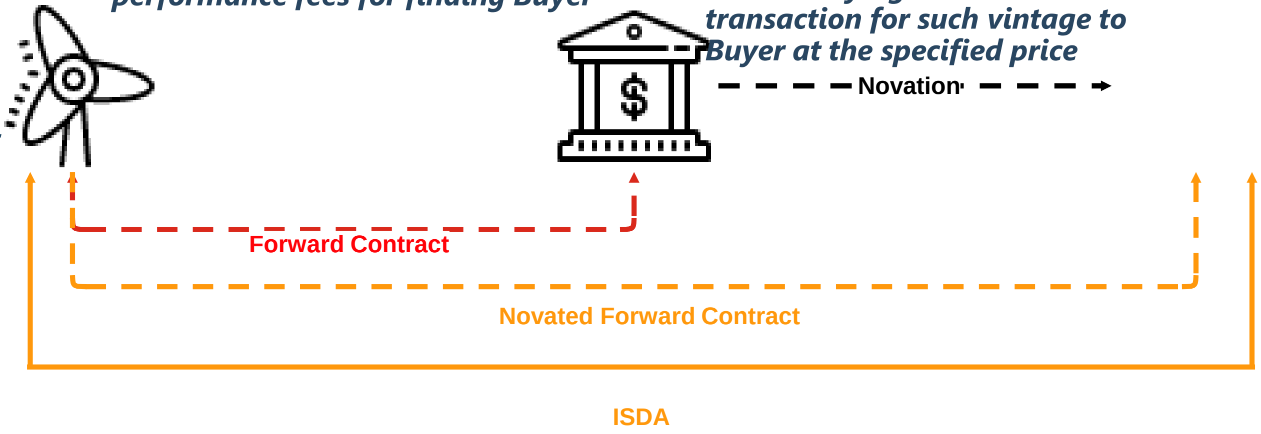
INTERMEDIATED FORWARD CONTRACT – SELLER PAYS FEE

Legend
Seller
Intermediary
Buyer

- **STEP 1: *Seller and Intermediary enter into a contract in which Seller pays Intermediary a noncontingent upfront fee*** and Intermediary agrees to (1) purchase each vintage of tax credits generated in the future by Seller at a backstop price or (2) find another buyer willing to purchase the tax credits from Seller at a specified price higher than the backstop price, whereupon the Intermediary would receive additional performance fees from Seller (the "Forward Contract")

- **STEP 2(b): *Seller will pay Intermediary the appropriate performance fees for finding Buyer***

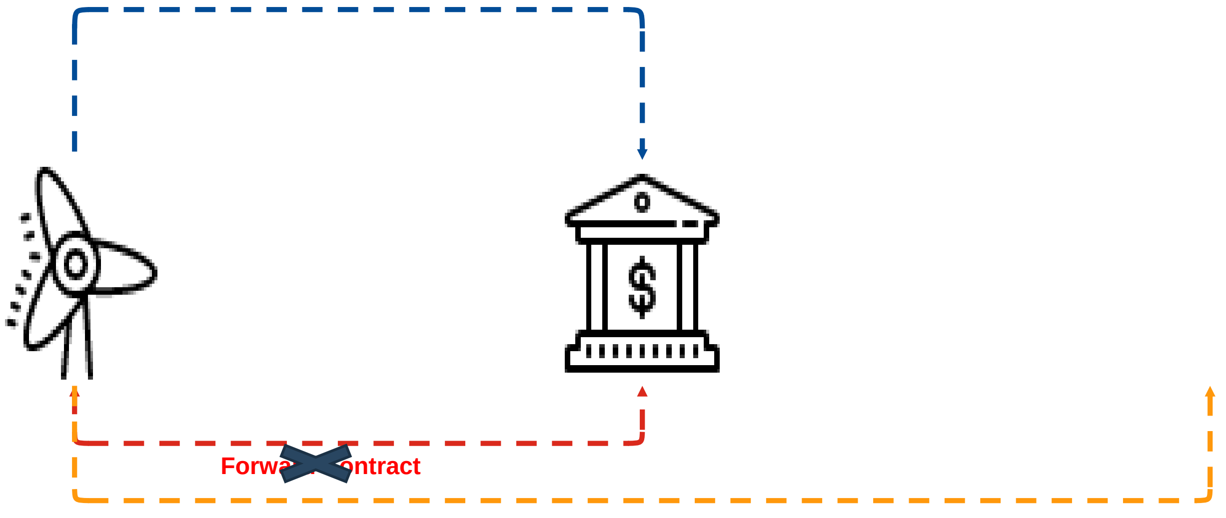
- **STEP 2(a):** Where Intermediary finds a buyer for a vintage at a specified price higher than the backstop price and there is an ISDA between Buyer and Seller, ***Intermediary will novate the underlying tax credit transaction for such vintage to Buyer at the specified price***



Intermediated Forward Contract – Seller Pays Fee (cont'd) (alternative without novation)

Legend
Seller
Intermediary
Buyer

- **ALT. STEP 2(a):** Where Intermediary finds a buyer for a vintage at a specified price higher than the backstop price and ***there is no ISDA between Buyer and Seller, Buyer and Seller will execute a non-ISDA purchase and sale agreement at the specified price***, whereupon the underlying rights to such vintage in the Forward Contract between Seller and Intermediary will automatically terminate

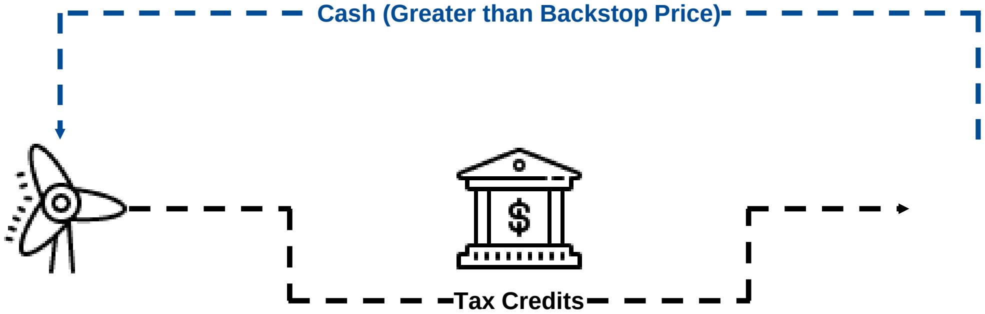


INTERMEDIATED FORWARD CONTRACT – SELLER PAYS FEE (CONT

Legend
Seller
Intermediary
Buyer

- **STEP 3: *Buyer purchases the specific vintage of tax credits from Seller*** at the specified price, in cash, which will be greater than the backstop price Seller would have received from Intermediary

- ***If Intermediary is unable to find a buyer*** for a vintage, the underlying tax credit transaction will proceed and ***Intermediary will purchase, in cash, such vintage of tax credits from Seller at the backstop price***

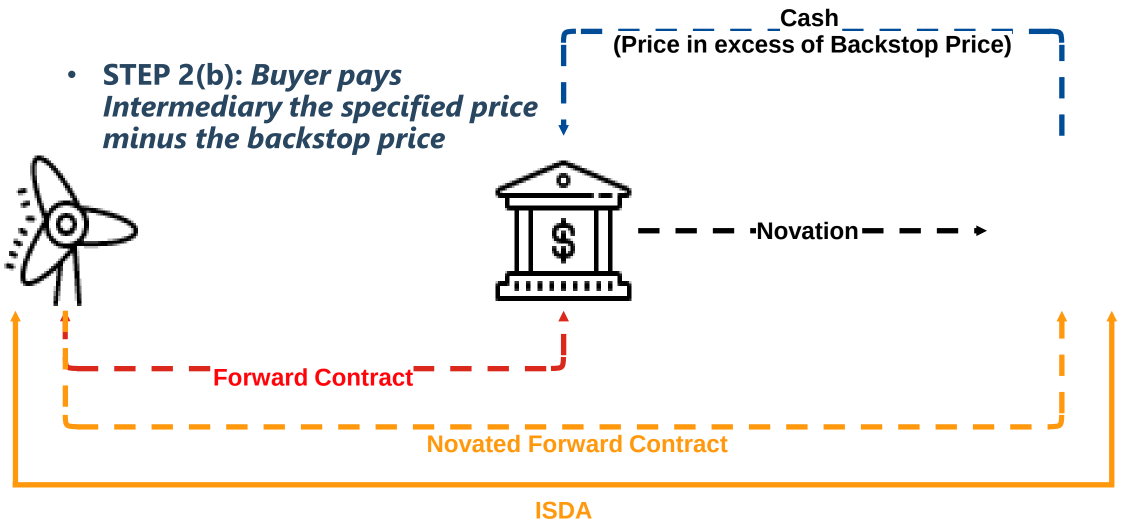


INTERMEDIATED FORWARD CONTRACT – BUYER PAYS FEE

Legend
Seller
Intermediary
Buyer

- **STEP 1: *Seller and Intermediary enter into a contract in which I***ntermediary agrees to (1) purchase each vintage of tax credits generated in the future by Seller at a backstop price or (2) find another buyer willing to purchase such vintage at a specified price higher than the backstop price. If Intermediary finds such buyer, ***the Buyer will purchase the tax credits from Seller at the backstop price and pay Intermediary the higher specified price minus the backstop price*** (the "Forward Contract")

- **STEP 2(b): *Buyer pays Intermediary the specified price minus the backstop price***

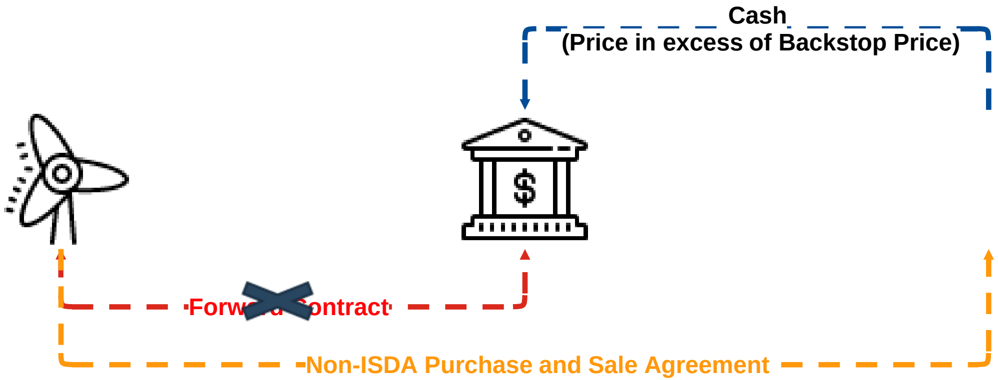


- **STEP 2(a):** Where Intermediary finds a buyer for a vintage at a specified price higher than the backstop price and there is an ISDA between Buyer and Seller, for such vintage to Buyer at the backstop price, ***Intermediary will novate the underlying tax credit transaction***

INTERMEDIATED FORWARD CONTRACT – BUYER PAYS FEE (CONT’D) *(ALTERNATIVE WITHOUT NOVATION)*

Legend
Seller
Intermediary
Buyer

- **ALT. STEP 2(a):** Where Intermediary finds a buyer for a vintage at a specified price higher than the backstop price and ***there is no ISDA between Buyer and Seller, Buyer and Seller will execute a non-ISDA purchase and sale agreement at the backstop price***, whereupon the underlying rights to such vintage in the Forward Contract between Seller and Intermediary will automatically terminate

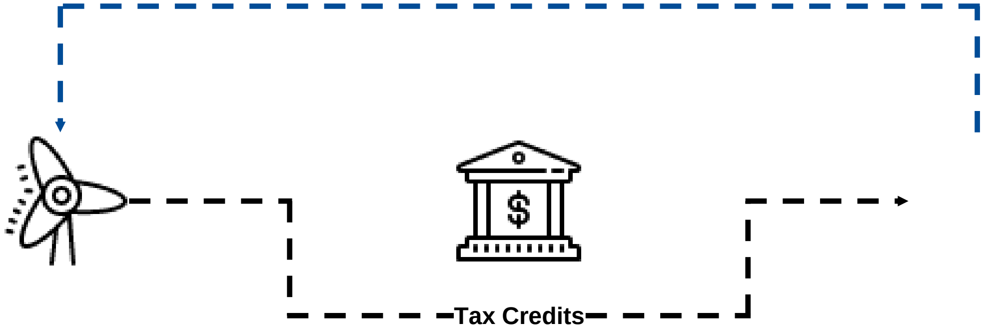


Intermediated Forward Contract – Buyer Pays Fee (cont'd)

Legend
Seller
Intermediary
Buyer

- **STEP 3:** ***Buyer purchases the tax credits, in cash, from Seller for the backstop price***

- ***If Intermediary is unable to find a buyer*** for a vintage, the underlying tax credit transaction will proceed and ***Intermediary will purchase, in cash, such vintage of tax credits from Seller at the backstop price***



POTENTIAL DRAWBACKS WITH STRUCTURING THESE DEALS AS FORWARD CONTRACTS

Regulatory and enforcement risk that CFTC reviews these transaction structures and decides that any of them must be treated as a swap:

- ***Direct tax credits purchase and sale transaction*** → Potential regulatory and enforcement risk is relatively lower
- ***Intermediated tax credit transaction in which Seller pays a fee to the Intermediary*** → While each leg is consistent with forward sales treatment, the overall structure may raise questions and carry increased regulatory and enforcement risk; noncontingent upfront fee may mitigate risk
- ***Intermediated tax credit transaction in which Buyer pays a fee to the Intermediary*** → While each leg is consistent with forward sales treatment, the overall structure may raise questions and carry increased regulatory and enforcement risk; potential gain by Intermediary of the difference between the specified price and the backstop price may increase such risk

IV. Potential Transaction Structures – Swaps

STRUCTURING THESE DEALS PRIMARILY AS SWAPS

- **How to Do It:**
  - Structure the deal as ***an intermediated tax credit transaction in which Buyer pays a fee to the Counterparty*** as described above

- **Why Make This Choice:**
  - Transaction between Seller and the Counterparty is treated as a swap, ***mitigating regulatory and enforcement risk of relying on forward contract exclusion***
  - ***Transaction between Seller and Buyer is treated as a forward contract*** (if the Counterparty finds a buyer)

POTENTIAL DRAWBACKS WITH STRUCTURING THESE DEALS PRIMARILY AS SWAPS

- Regulatory and enforcement risk if the CFTC views the transaction between the Seller and the Buyer as a swap
- Complications, costs and regulatory burdens of swap transactions generally
- Unique swap structure increases complexity, costs and risk in developing, implementing and marketing new product

MITIGATING RISK WHEN STRUCTURING DEALS AS SWAPS

- Rely upon internal determination of reasonableness of treatment of transaction between Seller and Buyer as forward contract
- Request a no-action letter from the CFTC
- Engage with ISDA for potential industry-wide approach

V. Further Issues to Address

ADDITIONAL STRUCTURING ISSUES TO ADDRESS

- As structuring of these tax credit transactions progress, there will also be additional issues to address such as:
  - **tax credit disallowance risks**
  - **financing of tax credit sale transactions**
  - **security interests in tax credits**
  - **intermediary authority** to transact in tax credits that are transferable (which potentially is possible if intermediary is a bank, based on preliminary analysis)
  - **tax credit sale contract provisions** (e.g., indemnity and insurance, availability / volume guarantees, etc.)

VI. Contacts

CONTACTS

DICKSON CHIN (Derivatives)

- Engaged by ISDA to prepare (i) ISDA U.S. Renewable Energy Certificate Annex and (ii) updated Dodd-Frank Commodities Derivatives Disclosure Annex
- Lead counsel on working group for ISDA Verified Carbon Credit Definitions and Confirmation templates
- Currently advising market participants on developing new products and new trading platforms, including coordination of overall strategy and preparation of contract templates
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JOSHUA STERLING (Derivatives)

- Former Director, CFTC Market Participants Division. In that capacity, he and his team worked on product / transaction categorization issues with registered firms
- Currently assisting clients with the development of new trading platforms and strategies that focus on environmental commodities
- Actively engaged in several strategic initiatives and enforcement matters before the CFTC for bank clients
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KELLY RUBIN (Tax)

- Provides tax structuring advice with respect to traditional tax equity deals for major energy players
- Has advised with respect to monetization strategies other than traditional tax equity, such as assignments to banks of the railroad maintenance tax credit for short-line railroads
- Advises leading banks and other financial institutions with respect to the tax implications of their most complex loans and other financial instruments
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