Federal Performance Contacting Coalition Response to DOE Request for Comment Issued by the Federal Energy Management Program concerning:

Tax Treatment of an Energy Savings Performance Contract Energy Sales Agreement

Due Date: September 3, 2016

The Federal Performance Contracting Coalition (FPCC) appreciates the opportunity to comment on the potential for an ESPC Energy Sales Agreement (ESPC ESA) to qualify for the investment tax credit under 26. U.S.C. Section 48. Our coalition is comprised of many of the world's leading Energy Service Companies (ESCOs), including twelve of the sixteen DOE Super-ESPC IDIQ Contract holders, and several Energy Service Companies (ESCOs) that are approved by the Army Corps of Engineers IDIQ contract for implementing Energy Savings Performance Contracts (ESPCs) within the Federal government. As a coalition, we are solely focused on ensuring that the Federal use of performance-based contracting for energy savings grows. We thank you for the opportunity to provide our comments today.

Overall Comments

The FPCC continues to see a large market opportunity for renewables and other ITC-eligible technologies within ESPCs and, like agencies, our ESCOs have been challenged by the mandatory title transfer requirement under OMB Memorandum M-12--21 when considering tax ownership requirements to be eligible for the investment tax credit. The ability to monetize the investment tax credit for on-site ITC-eligible energy under an ESPC ESA would enhance the cost-effectiveness of applicable project opportunities and increase their project scope. Since the issuance of the 2012 OMB Memo, our members, have had limited success in structuring a readily-financeable ESPC ESA contract that includes the use of the investment tax credit (ITC) due to the mandatory title transfer requirement in the OMB Memo and the safe harbor requirements under26 U.S.C. § 7701(e).The uncertainty around this conflictual language has resulted in an inability to attract project financing for an ESPC ESA and a reluctance among industry to further develop these projects.

Thus, we are very pleased that the U.S. DOE has issued this subsequent Request for Comment and is proposing IRS and Treasury Department language to provide the ESCOs and their financial partners' clarification on this important issue. We believe this is the best and most expeditious solution for all parties

Comments on the ESPC ESA Fact Case (Question 1)

The FPCC believes that the ESPC ESA Fact Case generally reflects how our members would structure an ESPC ESA project and its components. However, we are recommending that DOE make some changes pertaining to the suggested periodic re-appraisals to determine the Fair Market Value (FMV) purchase of the system, as well as requirements for the agency's consumption of the electricity being generated by the system.

The FPPC is supportive of the ESCO establishing a reserve account to fund the Fair Market Value (FMV) purchase of the system by the Government at the end of the ESPC ESA contract term. We are familiar with the basis of this structure and the additional project components described in the ESPC Fact Case.

We are pleased the Fact Case addresses termination policy and the need for the ESPC ESA to include terms and conditions allowing for agreement termination, such as Termination for Convenience (FAR Part 52.249-2) or Cancellation (FAR Part 52.217-2). As DOE has described in the Fact Case, the ESPC ESA will need to include a cancellation ceiling schedule for each year which establishes the maximum termination liability of government. The termination liability in years 1 through 7 may be higher, corresponding to ITC and Modified Accelerated Cost Recovery System (MACRS) values that have not yet fully vested.

We support the use of a reserve account estimating in the TO schedules the Fair Market Value (FMV) of the system at the end of the contract term and amortizing the cost as a Performance Period line item in the task order. The ESPC ESA Fact Case suggests that there will be a cap on the damages the government will have to pay at any given time if it terminates the contract for convenience. The ESCO would need a termination value schedule that fixes the amount to be paid, and the amount would have to be enough not only to cover any recapture of unvested investment tax credits claimed on the equipment, but also to repay any outstanding project-level or back-levered debt and to get the tax equity investor to its target yield. Under this legal defeasance scenario, the ESPC ESA should reflect termination liability appropriately for the ITC and MACRS.

As the Fact Case lays out the pattern for how an ESPC ESA contract will be structured, we expect project stakeholders will use the Fact Case as a structural guide. As such, the FPCC is concerned by its language which suggests a federal agency will have to "use all of the electricity" generated by the PV system on Page 6.

We are recommending DOE strike the below *"and use"* language (which we have bolded and stricken through) from the following paragraph on Page 6:

> "Overview: The ESPC ESA project contemplates that an ESCO will install, maintain ownership (until the end of the contract – see purchase details below), and provide operation and maintenance of a renewable energy generation asset at a federal site. The federal agency will purchase **~~and use~~** all of the electricity generated onsite at a rate that is less than the agency's current and forecasted electricity rate."

Removing this language will acknowledge that under the ESPC ESA, the government is required to purchase the electricity generated on a take-or-pay basis. Take-or-pay is an important principal of any ESA or PPA: the host is required to “take-or-pay” for all the generation asset it produces, or could have produced, rather than what the host consumes.

Under the ESPC ESA, and also under ESPC contracts in general, the Energy Service Company (ESCO) does not bear risk for changing electric loads at the federal agency site which may be associated with an increase or decrease of site activities and personnel. Thus, if a federal customer’s load were to be reduced to the point that an ESPC ESA system is generating more than the site needs at that time, the Government is still required to pay for the electricity generated by the system (or could have been generated if the ESCO had to curtail production in this case) under a take-or-pay basis.

Striking the language will also acknowledge that the federal agency may participate in Net Metering, whereby surplus electricity from the ITC eligible system may be transferred onto the electric grid to offset the cost of electricity provided by the utility to the federal agency.

Secondly, the FPCC recommends DOE consider a different approach to the periodic re-appraisals discussed on Page 6. DOE proposes a re-appraisal to determine FMV at least once every 5 years during the term of the contract.

The FPCC believes a periodic re-appraisal every 5 years is excessive and, when combined with language referring to “contract modifications”, could create a perception of increased financial risk. We believe this approach would provide the Government little value for the potential disruptions it could cause, especially in the earlier years of the contract.

We recommend a re-appraisal of the system occur during the years closer to the conclusion of the contract, thereby allowing for any necessary true-up of the reserve account to still occur prior to the FMV purchase of the system, if necessary. Under this approach, a re-appraisal could occur in the more immediate preceding years of the conclusion of the contract, providing the ESCO sufficient time to adjust the reserve account, if necessary, based on a more precise estimation of the FMV.

Feedback on Draft Language (Question 3)

To address the tax ownership concerns of the mandatory title transfer requirement, the DOE has proposed adding the following statement in forthcoming IRS or Treasury guidance:

> “The mandatory title transfer required by the 2012 OMB Memo, will not disqualify an ESPC ESA project from being a service contract, so long as the transfer takes place at fair market value pursuant to 26 U.S.C. § 7701(e)(4)(A)(iv).”

This language, while helpful, does not address all of the uncertainties raised by the 2012 OMB Memo. The FPCC supports the language submitted to DOE by the Solar Energy Industries Association (SEIA) as we understand it is representative of recommendations made by legal counsel highly-experienced in working with tax equity lenders. We concur with the following SEIA-recommended additional clarifications to the DOE suggested language:

Clarification #1: We suggest additional clarity on ownership for federal income tax purposes. First, to address the uncertainty raised by the Title Requirement, we would propose including the following statement in the IRS guidance:

> "**The mandatory title transfer required by the 2012 OMB Memo will not adversely affect the eligibility of the service provider to claim the federal income tax benefits associated with its ownership of the ESPC ESA project**, so long as the transfer takes place at fair market value."

The clear implication of qualifying as a service contract under the safe harbor is that the service provider owns the underlying asset and is providing services to the government agency. Adding a statement to this effect is consistent with this clear implication. It is also consistent with long-standing tax authorities that hold that a future transfer of an asset at fair market value does not, in and of itself, shift ownership for federal income tax purposes from the seller to the buyer before the option is exercisable.

Clarification #2: To address the uncertainty raised by the potential 25-year term of an ESPC ESA, we would also propose including the following in the IRS guidance:

> "**The contract period of an ESPC ESA will not adversely affect the eligibility of the service provider to claim the federal income tax benefits associated with its ownership of the project**, assuming the term does not exceed 25 years as in 42 U.S.C. § 8287."

This statement is needed to confirm that the economic useful life of an ESPC ESA project sufficiently exceeds the maximum 25-year contract term so as not to transfer ownership to the federal agency for federal income tax purposes.

In addition to these comments, we would like to cite our agreement with more extensive comments offered by Ameresco, one of our FPCC members. Again, thank you for the opportunity to comment on an issue that is very important to the FPCC membership. If you have any questions about our comments, please feel free to contact me at 202-554-5828 or jasca@cascadeassociates.net.

Sincerely,

Jennifer A. Schafer
Executive Director, FPCC
202-554-5828