

AUGUST 16, 2005

ENERGY POLICY ACT OF 2005

The recently enacted Energy Policy Act of 2005 (the "Act") includes a provision granting state and local governments and cooperatives the ability to issue clean renewable energy bonds ("CREBs"). CREBs are a tax credit bond designed to provide the borrower with an interest free loan and the holder of the bonds with a tax credit (rather than interest) in an amount intended to provide an after-tax return equal to that of a comparable taxable investment. CREBs may be issued in 2006 and 2007 to finance expenditures paid after August 8, 2005. CREBs are modeled on the qualified zone academy bond ("QZAB") program, under which tax credit bonds may be issued for certain educational facilities. Unlike QZABs, which can only be purchased by banks, CREBS may be purchased by anyone.

Qualified Projects

CREBs may be issued only if at least 95 percent of the proceeds are to be used for capital expenditures of a qualified project. "Qualified projects" are defined as the following types of facilities: wind-energy, closed-loop biomass, open-loop biomass, (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, landfill gas, hydropower, and trash combustion. These qualified projects are the same types of facilities as those that qualify for the federal tax credit for renewable energy projects. Expenditures for these projects must be paid after August 8, 2005. The new rules permit the reimbursement of costs paid after this date and prior to the issuance of the CREBs if a declaration of intent is made by the borrower prior to the payment of the qualified costs. CREBs may also be issued to refinance debt incurred after August 8, 2005.

Volume Cap

Only \$800 million of CREBs may be issued in the aggregate and at least \$300 million of this authority is reserved for cooperatives. The Secretary of the Treasury is responsible for allocating this volume cap among projects but the Act provides no guidance on how this is to be done.



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Maturity Limitations and Credit Rate

Treasury will set the maturity limitation and credit rate on CREBs. CREBs must be structured to pay principal in level annual installments. In addition, the final maturity of a CREB is limited to the number of years that will result in that final principal payment having a present value equal to 50 percent of its face amount (rounded up the next full year). The interest rate used for this purpose is to be determined at least monthly by the Treasury using the average annual interest rate on tax-exempt bonds having a term of 10 years or more that are issued during that month. For example, on August 5, 2005 the maximum bond term under the QZAB program was 16 years.

The Treasury is to set the tax credit rate daily for CREBs as the rate that will permit the issuance of CREBs without interest and without original issue discount. For QZABs, the Treasury sets the rate daily based on the yield on outstanding AA rated corporate bonds of a similar maturity (using rates from the previous day). It is likely that a similar process will be used to establish separate rates for CREBs.

Expenditure Requirements

In order to meet the requirements for CREBs, 95 percent of the proceeds must be spent within 5 years of the issuance of the CREBs. This period may be extended by the IRS if the failure is due to reasonable cause. If this requirement is not satisfied, a portion of the CREBs must be redeemed within 90 days of the applicable expenditure deadline. This redemption requirement is likely to necessitate the inclusion of “excess proceeds” redemption provisions in each CREB issuance.

Other Requirements

CREBs are subject to the arbitrage requirements, including arbitrage rebate rules. If a project ceases to be used for a qualifying purpose, the borrower must take a remedial action, which presumably will include redemption or defeasance of the CREBs within 90 days of the change of use.

Conclusion

CREBs are designed to provide a zero percent loan for renewable energy projects for 2006 and 2007. How well this subsidy will work is a significant question. The \$800 million volume cap and an uncertain allocation method present significant limitations, as does an uncertain market for these bonds. The Act requires that the IRS publish regulations to implement CREBs within 120 days of August 8, 2005.

For further information, please contact Travis Gibbs, John McQueen, Jeff Piemont, Mitch Rapaport, Bruce Serchuk, or any member of the Nixon Peabody Power Group.

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