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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Recovery Act Grant Ruling: An Uncertain Precedent

Daniel Sinaiko

Law360, New York (November 9, 2016, 2:43 PM EST) -- On Oct. 31, 2016, the U.S. Court of Federal Claims ruled that the U.S. Department of the Treasury underpaid American Recovery and Reinvestment Act (ARRA) Section 1603 cash grant applications made in respect of the Alta Wind Energy Center by approximately $206 million.

The much-awaited decision in a 2013 case filed by the owners of the 1,500-megawatt wind project may be a harbinger of good news for similarly situated cash grant applicants who did not receive full awards on their Section 1603 applications, and for investment tax credit players, though there are mitigating circumstances surrounding the case that leave some questions as to whether other stakeholders will have similar success.

The 11-phase Alta Wind Energy Center was developed by Terra-Gen Power LLC following its acquisition of the project development rights for the plant in 2008. The first five phases of the project were sold into trust vehicles designed to facilitate sale/leaseback financing transactions with Union Bank of California and Citibank.

The sixth phase was sold outright to EverPower Wind Holdings Inc. Each transaction was designed, in part, to ensure that the project would qualify for ARRA Section 1603 cash grants, and each transaction required Terra-Gen to indemnify the purchaser against the risk that the 1603 grant would be short-paid.

Each cash grant application was supported by a cost segregation analysis from KPMG that validated the portion of the project basis that was eligible for a 1603 grant and the portion that was not. These portions were applied to the purchase price for the facilities to arrive at the fair market value eligible basis of the wind energy facility and, in turn, the amount of 1603 grants for the project (30 percent of the fair market value eligible basis).

The government challenged the purchase prices of each phase as the fair market value (and thus the cost basis), arguing that the eligible basis needed to be adjusted to account for ineligible goodwill associated with the purchase price, that the purchase price was not established through an arm’s-length negotiation and that the purchase price was influenced by an economic incentive to increase the purchase price.

The Court of Claims discarded each of these arguments in turn, specifically finding that:

- No goodwill or going-concern value could have been attached to the purchase prices because the projects had not begun operations at the time of the sale, the projects had an exclusive customer through a long-term Power Purchase Agreement (PPA), and the location of the project could not be considered goodwill.
- The turnkey nature of the facilities justified a premium over the cost to construct the facility, since all of the development risk had been removed from the project.
- The sale transactions were all concluded at arm's length, and there was no evidence that the parties had "highly inflated" the purchase prices.
- Side agreements related to the sale (including wake impact agreements, Section 1603 indemnities, fee land transfers and land lease agreements) did not "highly inflate" the purchase price.
- The pro rata allocation of eligible and ineligible costs to the purchase price was reasonable.

Of particular interest in the court's decision was a finding that value ascribed to the project PPAs should not be treated as an ineligible "customer-based intangible" because the PPAs related to only the applicable wind farm facilities. In recent years, the concern about ineligible PPA value has given financial professionals and sponsors headaches in producing cost segregation reports.

While the case remains subject to appeal, the immediate repercussions of the Alta decision should be favorable. The Section 1603 cash grant regulations are closely aligned with the rules for renewable energy investment tax credits.

At a minimum, sponsors that pursue investment tax credits and follow the methodologies used in the Alta projects should have comfort that the government has an uphill fight in challenging the eligible basis of the projects. Moreover, financial professionals may have a higher degree of comfort that the conclusions in appraisals and cost segregation reports will be respected by the Internal Revenue Service.

Finally, investment tax credit investors could take a commercial view that basis risk has become attenuated, if not commercially insignificant.

While this is a resounding win for the Alta project owners and a clearly important precedent for Section 1603 grant applicants and investment tax credit players, it may not signal complete victory for developers. A few postural elements of the case may need to be overcome by subsequent claimants.

First, the Alta decision relied significantly on the presence of 11 nearly identical transactions that carried similar valuations. This "Alta liquidity" is likely unique among utility-scale applicants, though commercial-and-residential scale project developers may benefit from a high volume of similarly repeatable transactions.

Second, the government struggled in the prosecution of its case, since its expert witness was disqualified from the trial, leaving the government unable to present contravening valuation evidence.

Additionally, the court's opinion does not foreclose every possible attack by the government on basis grounds, to the extent that the basis in the asset in question has been "highly inflated" by peculiar circumstances.

—By Daniel Phillip Sinaiko, Akin Gump Strauss Hauer & Feld LLP

Daniel P. Sinaiko is a partner at Akin Gump Strauss Hauer & Feld LLP, and a member of the firm's global project finance group, focusing his practice on project development and finance, with particular emphasis on infrastructure project financings, debt financings, and mergers and acquisitions.

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