Inflation Reduction Act Opportunities and Considerations

FOR ELECTRIC COOPERATIVES

National Rural Utilities Cooperative Finance Corporation

NRCO® NATIONAL RENEWABLES COOPERATIVE ORGANIZATION

The Inflation Reduction Act (IRA) has created unprecedented opportunities for electric cooperatives to use federal assistance to deploy clean energy technologies and grid infrastructure.

This paper provides an overview of the new programs and a set of considerations that cooperatives can take into account when evaluating project financing and ownership structures.

Project Ownership vs. Power Purchase Agreement

Until the IRA, electric cooperatives were largely limited to accessing clean energy technologies such as solar and wind through Power Purchase Agreements (PPAs) with third-party developers. Tax credits, such as the Investment Tax Credit (ITC) and Production Tax Credit (PTC), and the tax attributes associated with accelerated depreciation, were utilized by the developer and some of the benefits were passed through to the cooperative via the PPA rate. With the direct-pay incentive, the IRA has opened up direct access to the ITC and PTC, creating new and substantial incentives for electric cooperative ownership. Direct pay is a cash refund equal to the ITC or PTC paid to the cooperative in the year after the project reaches commercial operation.

The choice between a PPA or ownership involves evaluating risks and rewards. Cooperatives should analyze several factors in deciding which option is best suited to their needs.

These include:

Economics: By owning a project, a cooperative can be assured it is maximizing all of the available tax credits. Total project costs may be lower because the cooperative can avoid paying a premium to a developer. However, developers can take advantage of accelerated depreciation and the "stepped-up basis" that cooperatives cannot.[1] Alternatively, cooperatives generally have access to more attractive financing terms and lower interest rates. Direct pay also requires domestic content on projects beginning construction starting in 2026, which may increase equipment costs if a robust domestic supply chain does not materialize. Cooperatives should compare the net cost of a PPA with the net cost of ownership when considering project economics.

Control: By owning a project and, more importantly, owning the interconnection point, the cooperative has autonomy to make future improvements and technology upgrades. For instance, battery storage can be easily added to an existing solar or wind facility, or surplus interconnection service can be utilized at a future date. The cooperative can also decide to insource or outsource operations and maintenance at any time.

Long-Term Value: The long-term value of the land, the asset and the interconnection rights cannot be understated in the rapidly changing clean energy transition. ISO queue backlogs have led to scarcity pricing for near-term clean energy facilities. Renewable developers often factor into their models a merchant tail under the expectation that prices will steadily rise and the asset value in the marketplace will be greater the farther into the future it goes. Interconnection rights are incredibly valuable in a constrained transmission environment.

Staff Development: Clean energy technologies are growing in importance and create a need for new skill sets among cooperative staff. Exposure to these technologies can improve cooperative workforce talent and morale. Transitioning to operating and maintaining cooperative-owned clean energy facilities provides retention opportunities as fossil fuel-based plants are retired.

Local Community Impact: Owning a project can provide direct benefits to the local community, such as creating jobs, stimulating the local economy and demonstrating the cooperative's commitment to sustainability.

Public Relations: Owning a clean energy project can serve as an educational tool for cooperative members and the community. It allows the cooperative to showcase the benefits of new technologies and engage in public outreach activities. Developers tend to be from out of state and may lack sensitivity to local issues during the project development and permitting process. In some parts of the country, rural resistance to utility-scale renewables has increased, and cooperatives are in the best position to understand local concerns.

Operations and Maintenance: Plant operations and maintenance is outsourced to the developer under a PPA, along with the risk of equipment failure and damage—all ultimately paid by the cooperative as a premium included in the PPA rate. But for cooperatives that choose not to operate and maintain the facility themselves, there are several large, national firms and smaller regional and local firms that provide O&M services for solar, wind and battery storage facilities. Additionally, cooperative-owned organizations, like ACES, can transact in wholesale markets on behalf of the member (e.g., scheduling and dispatch).

[1] Stepped-up basis is the ability of a developer to mark up the cost of a project to its fair market value, which in turn increases the amount of the tax credit the developer is eligible for.

Direct-Pay Incentive

Direct pay (called "Elective Payment" in the Treasury regulations) gives electric cooperatives more tax credit parity with taxable entities when deploying clean energy technologies.[2] Cooperatives are able to receive a direct payment instead of a tax credit for various clean energy tax credits such as the ITC and PTC. One stipulation to keep in mind for cooperatives also receiving grant funding is that the combined total of the grant and the direct-pay incentive cannot exceed the total cost of the project (called the "basis" in the regulations).

ITC vs. PTC

The ITC and PTC are the two primary incentives that cooperatives can utilize for clean energy projects. Given their differences, cooperatives should analyze which incentive is most beneficial for their specific project. The PTC is an annual credit based on the amount of energy production over a 10-year period. It provides a base credit of 2.6 cents per kilowatt-hour. The ITC is a credit that is based on a percentage of the qualifying costs of a project. Generally speaking, lower capital-intensive projects with higher capacity factors will favor the PTC, while the inverse will favor the ITC. The discount rate cooperatives apply to the PTC payment streams also has a material impact on the choice.

Prevailing Wage and Apprenticeship Requirements

Both with and without direct pay, recipients of the ITC or PTC must comply with prevailing wage and apprenticeship requirements during construction and, in some cases, for the maintenance and repairs of a facility. Apprenticeship provisions will vary based on when the project begins construction. Generally speaking, for cooperatives with a unionized workforce or those that operate in states with union labor, these requirements are less likely to increase construction costs than those where union labor is less prevalent.

[2] Due to accelerated depreciation, total tax parity is not achieved as cooperatives still do not qualify for accelerated depreciation.

Under a rule proposed on August 30, 2023, an entity will need to adhere to prevailing wage requirements and apprenticeship requirements to claim the full 30% clean energy tax incentives that were created by the IRA. Without this adherence, the credit would be capped at 6%. The prevailing wage requirements are the same as Davis-Bacon. To meet the apprenticeship requirements, at least one apprentice must be included if a crew consists of four or more workers, and apprentices must make up 10-15% of hours worked. The apprenticeship requirements apply to construction, alteration, and repairs, and would not be required for ongoing maintenance of facilities whose construction was funded by the IRA. Any project under one-megawatt is exempt from these requirements.

Bonus ITCs/PTCs

Electric cooperatives can obtain an additional 10% in tax credits (either ITC or PTC) for each of the bonuses listed below.

Domestic Content: The domestic content requirements apply to any steel, iron and "manufactured product" that is a component of an energy project. The minimum percentage of domestic content required to qualify for the bonus credits varies depending on when construction starts. There are separate requirements for steel and iron (100% American iron and steel) and a slid ing scale for manufactured products—a minimum 40% if construction begins before 2025, 45% if construction begins in 2025, 50% in 2026 and 55% after 2026. If either test fails, the project is not eligible for the domestic content bonus. As mentioned earlier, domestic content is also a requirement for direct pay. Projects that begin construction in 2024 without domestic content will lose 10% of their tax credit. In 2025, that increases to 15%. Projects that begin construction in 2026 without meeting the domestic content requirements are not eligible for direct pay.

It is important to note that the Department of Treasury has not yet finalized domestic content rules, so these stipulations may be changed. It is possible that a waiver process will be created, but that is not guaranteed. Waivers have historically been based on factors such as costs increasing by more than 25% and/or materials not produced in sufficient quantities or of satisfactory quality in the U.S.

Energy Community: An "Energy Community" refers to areas where coal mining or coal power generation has historically occurred. This may be a brownfields site contaminated by mine tailings, a census tract or adjoining census tract where a mine or power plant closed, or certain statistical areas where historic employment or tax revenue is tied to coal mining or power generation. To qualify for a safe harbor under this bonus category, a cooperative can check several lists maintained by the U.S. Environmental Protection Agency and the U.S. Energy Information Administration.

Low-Income Communities: The low-income bonus is only available to projects using the ITC and is subject to a 1.8 GW-dc program cap per year. This bonus provides projects that are under 5 MW an additional 10% ITC for being located in a low-income community as defined by the New Markets Tax Credit or on Indian land.

Federal Grant and Loan Programs

Electric cooperatives have several options to reduce total project costs through federal grant and loan programs. The following is a select list of programs that may be useful to cooperatives:

Empowering Rural America—IRA Section 22004

This program provides $9.7 billion in Rural Utilities Service (RUS) funding for loans, grants, loan modifications and other financing methods to support the purchase of renewable energy systems, zero-emission systems, carbon capture systems and related infrastructure. Allowable funding requests include:

- Loans to finance new clean energy projects.
- Loans to refinance existing non-RUS debt or to modify RUS debt for stranded assets.
- Grants up to 25% of total project cost.
- Grants and loans to finance PPAs for clean energy.

An eligible entity is defined as an electric cooperative that is, or has been, an RUS electric loan borrower, serves a largely rural area or is a subsidiary of such an electric cooperative. Grant funding can cover a maximum of 25% of total project costs, and a cooperative can receive no more than 10% of the total funding. The window to submit Letters of Interest is currently closed.

New ERA funding is available for PPAs. To be eligible, PPAs must add to an electric cooperative's clean energy using 2022 as the baseline. PPAs must also either be executed after the date of the IRA's enactment (8/16/2022) or construction commenced after that date for PPAs executed prior to enactment. Additionally, NEPA and Buy America provisions are not applicable to PPAs. Cooperatives can apply for only a New ERA grant to cover 25% of the PPAs cost.

Powering Affordable Clean Energy—IRA Section 22001

The Powering Affordable Clean Energy (PACE) program provides $1 billion for partially forgivable loans (up to 50%) for renewable energy and energy storage projects. Electric cooperatives and any entity eligible for RUS funding are eligible for the program. PACE applications are accepted and awarded on a first-come, first-served basis. The deadline for submitting letters of Interest has now passed.

Rural Energy for America Program—IRA Section 22002

The Rural Energy for America Program (REAP) offers $1.7 billion in guaranteed loans and grant funding for rural small businesses such as electric cooperatives and can be used for renewable energy systems and making energy efficiency improvements. This program offers another $300 million to provide guaranteed loan financing and grant funding to electric cooperatives for underutilized renewable energy technologies. REAP applications are accepted on a rolling basis throughout the year.

Buy America Provisions

Recent Guidance from RUS indicates that new construction for generation projects by cooperatives will not be subject to the more stringent Build America, Buy America Act (BABAA) provisions. Traditional Buy America Act (BAA) provisions will apply which allows for materials from US trade partners. If the country of origin is not a trade partner, a cost waiver is available. Under BAA a use of domestic materials must increase the project cost 6% or more to be eligible for a waiver. Under BABAA, use of domestic materials must increase the project cost 25% or more to be eligible for a waiver.

Project Development Steps

Whether for a grant application or direct pay, cooperatives considering project development should follow a process that minimizes cost and reduces risk as much as possible. This is especially true during the initial steps prior to construction.

A successful development process includes:

1. ***Conducting a Feasibility Study:*** The cooperative begins the development process by assessing the viability of the project and the overall effect it will have on the system, including evaluating resource requirements and availability, land suitability, regulatory requirements and economic/financial analysis.
2. ***Developing a Project Plan:*** Based on the feasibility study, the cooperative develops a project plan that determines key roles and responsibilities, defines project goals, establishes a project budget and pro-forma financials, determines the facility size and location, identifies infrastructure and equipment requirements, and creates a project development timeline.
3. ***Securing Financing and Funding:*** The cooperative explores grants and loans, including new federal incentives as well as long-term financing.
4. ***Permitting and Regulatory Compliance***: The cooperative obtains all necessary approvals and permits and complies with local, state and federal regulations. Environmental assessments, land use permits, interconnection agreements and other requirements should be addressed.
5. ***Construction and Installation:*** Once financing and necessary permitting and approvals are obtained, the cooperative can begin equipment acquisition and construction. This includes hiring contractors, overseeing construction and ensuring compliance with safety standards and regulations.
6. ***Commissioning, Operations and Maintenance:*** Once the project is brought online, the cooperative will operate and maintain the project, or hire a third party. This includes monitoring energy production and alarms, conducting regular maintenance activities and addressing any technical issues.

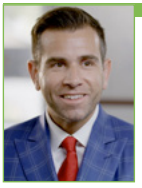
The specific details of the project development process may vary depending on the type and location of the project. Cooperatives may want to seek guidance from industry experts, such as NRCO, for project evaluation and development, and from CFC for financing options.

Cooperative Project Example

XYZ Electric Cooperative wants to own and operate a community solar project that will cost $1.2 million. The cooperative decides to use the direct-pay option of the ITC and also applies for, and wins, an Empowering Rural America (New ERA) grant worth 25% of the total project cost. The ITC incentive is worth 30% of the total project cost (in other words, no bonuses). The project's basis is $1.2 million for purposes of direct pay. Therefore, XYZ Electric is eligible for a $360,000 ITC. The New ERA grant will provide the organization with $300,000 in additional funding. This leaves the cooperative's remaining share of the project cost at $540,000, less than half of the original cost.

Keep in mind, the funding is only available upon completion of the project. XYZ Electric uses a line of credit or construction loan from CFC during the construction period, which is paid back after receipt of the direct-pay incentive and New ERA grant funding. XYZ Electric also uses a long-term loan from CFC for its remaining share of the project.

For more information contact:



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