Battery & Storage Podcast: Analyzing the Impact of the IRA on Energy Storage
Host: Bill Derasmo
Guests: Anne Loomis and John Leonti
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Bill Derasmo:

Hello, and welcome back to the Troutman Pepper *Battery + Storage Podcast*. I'm your host, Bill Derasmo. And today, I am very excited to have two of my partners, Anne Loomis and John Leonti. Welcome, Anne and John.

Anne Loomis:

Thanks, Bill. It's great to be here.

John Leonti:

Thank you, Bill.

Bill Derasmo:

Absolutely. Well, you guys are experts in all things transactional and energy tax and provisions under the Inflation Reduction Act, so why don't we just dive right in. This is a podcast dedicated to storage, so we'll start there. Anne and John, if you could speak a little bit about the standalone storage ITC, how has that been a game changer for the storage sector?

Anne Loomis:

I'm happy to talk about the really exciting changes that the Inflation Reduction Act gave us when it comes to standalone storage. It is one of the biggest changes that we got in the IRA. Prior to the IRA, storage could only receive a federal tax credit if it was a generation project that was eligible for ITC, so that would be a solar or a wind project. Otherwise, utilizing the investment tax credit or the ITC. In order to be treated as part of that solar or wind facility, there were some restrictions that applied about how the battery could be charged. Only a certain amount of grid charging was allowed, and that grid charging would result in a haircut to the investment tax credit.

So now as a result of the IRA, we have a new standalone storage ITC where storage is qualifying for the ITC by itself, not as part of a generation project. That means that it's no longer bound by those restrictions on grid charging that we had in the past. And in fact, recent proposed regulations that came out just in the last couple of weeks from the IRS have clarified that, when we're talking about storage that's co-located with generation, that storage can qualify for the standalone storage ITC, even if the generation facility that it's co-located with is taking advantage of the production tax credit and if there's some shared integral property being used by both the generation facility and the storage facility.

John Leonti:

Just to unpack that a little bit, that means that if I have a wind facility co-located with a battery facility, I could do a traditional production tax credit deal on the wind facility as well as take the ITC on the battery, notwithstanding that they may have a shared facilities agreement in place sharing certain assets of that shared facility.

Anne Loomis:

That's right. That was something that the market thought was the correct answer after the Inflation Reduction Act came out. There was some positive legislative history that supported that, but still a little bit of nervousness. And the recent clarification from the IRS has been very helpful making it clear that both of those things can apply.

John Leonti:

And that opens up the world for batteries in ways that we just hadn't seen previous to that. Standalone financing, it doesn't have to be financed with the solar or with the wind. We could just literally do a wind financing or solar financing and standalone battery financing. You don't have to worry about the development cycle of one plant with the other. What we had in the past, particularly with solar, was that it was solar plus storage. And getting those projects done on the same pace sometimes delayed one or the other. But now, having the separate tax credits does really give sponsors flexibility to build on the progress that they deem the right approach for those particular projects. Obviously, having the tax credit health, but then just this added flexibility on development and construction cycles shouldn't be underestimated. It's really a game changer for batteries.

Bill Derasmo:

I really appreciate those comments about flexibility and kind of building on that theme of flexibility. The law creates a lot of options in terms of who can use the investment tax credit and the production tax credit. Maybe you guys could walk through at a high level the particulars of that additional optionality, and how has that affected the market for tax equity?

Anne Loomis:

I think there are two big changes there as a result of the IRA in terms of who can utilize the ITC and the PTC. The first big change there is that the IRA has brought tax-exempt owners into the mix by giving them a way to participate in the tax credits. Traditionally, tax-exempt owners couldn't be owners of renewables and take advantage of the tax credit because they didn't have any tax liability. And then there weren't really structuring options there either because of rules associated with tax-exempt partners in partnerships or tax-exempt parties in leasing structures that would make it not possible to monetize the credit through tax equity structures that had both a taxable and a tax-exempt party.

So the IRA has now created a new option for tax-exempt parties to own renewables and receive a direct payment from the US government of the tax credit. That is a whole new way of bringing a group of investors into the mix that have the ability now to own or operate or invest in renewables. And then the other big change from the IRA is having transferability as a way to invest in projects. That's brought in some new investors who were not pursuing equity interests in the past. They can now purchase the tax credit without needing to be an owner of the project itself or a partner in a partnership that owns a project. So that's bringing in some new investors into the market who don't want the risk of long-term ownership.

John Leonti:

And that's really interesting for batteries because the traditional tax equity market was really built off of assets that have contracted revenues, and in particular, long-term contracted revenues. So power purchase agreements with utilities for 20 years, these corporate VPPAs that go anywhere from 12 to 20 years, and these really just long-term contracts. When you speak with folks in the battery industry that are looking to develop, construct, and own batteries, long-term revenue contracts may not be the appropriate off-take structure. These batteries are flexible. They want exposure to merchant prices. And as a result, the traditional tax equity market might not be the right market for some of these batteries.

Some of them have partial off-takes. And in those situations, a traditional tax equity deal with a third party might make sense. But the transferability market, and this goes beyond batteries, this could be for solar, wind, and other technologies, really just opens up, again, the flexibility of the types of financing products that are out there that can help these projects be developed, constructed, and put on the grid. So the transferability market really does give another tool to the industry to allow folks to build and operate these assets as they see fit. It's been great. We're really starting to see that, once the proposed regs came out, we saw this market take off. I think this is going to be an important way for the battery industry to monetize their tax credits.

Bill Derasmo:

Great to hear that. And in general, what trends are you seeing, John, in the market right now for renewable energy finance, storage finance? And in particular, how do transferability deals compare to traditional tax equity deals?

John Leonti:

What we're seeing is it could be very straightforward where a battery is built and then the tax credits are just transferred and there's no real financial product there. It's just a straight asset sale. Some transactions are more complex where there's a use of a basis step up and they're bringing in other partners in order to help monetize the credits further. And so there is a litany of just basic purchase and sales to more technical partnerships. And again, it's given the market the flexibility to really go out there and build the project as they see fit and take the economic risks that they're comfortable with. Some have long-term off-take contracts, some have no contracts. And the financing markets have been responding and kind. We've seen debt deals close with both portfolios and batteries that have had 100% merchant exposure, as well as a hybrid where there's some merchant exposure. So really, at the end of the day, what we're seeing is flexibility.

Bill Derasmo:

Flexibility seems to be the theme for today's talk, but probably one of the major purposes behind the Inflation Reduction Act in general was trying to get beyond the years that we had of how you had to do deals to take advantage of the ITC and the PTC, so it opens up a lot more possibilities. I wanted to shift gears for a second and talk about battery factories. There were some important provisions in the law that pertain particularly to that sector as well. And maybe you could speak to those provisions, tell our audience about some of the things that are going on in that space.

Anne Loomis:

There are a lot of exciting things for battery factories as a result of the IRA. First of all, two new tax credits for manufacturing components of renewables projects that can potentially apply to manufacturing batteries. First, we have the 48C Advanced Energy Project credit. That was an existing tax credit, but it has now been expanded to cover several new types of projects, and that includes manufacturing facilities that produce equipment related to the clean energy transition. This is a program where Congress has allocated $10 billion through this legislation. 4 billion of that 10 billion will have to be allocated to projects that are located in certain energy communities. Those are communities that are related to coal closures, so closures of mines or coal generation facilities. This program, because it has a set dollar amount tied to it, there is an application process. That application is reviewed by DOE and by the IRS.

There's a process of preparing a concept paper, getting some feedback from DOE, and then ultimately, if the project goes through all the stages of the application process and is approved by the IRS, then there's a certain period of time that the owner would have to get the facility placed in service and utilize this credit. It's in the nature of an investment tax credit, so it's based on a portion of the cost to build or to expand the manufacturing facility. Then there's also the 45X Advanced Manufacturing Production tax credit, which is available for producing and selling components that are going to be used in renewable energy projects. So when we think about batteries, that includes the electrode active materials, the battery cells, the battery modules, and critical minerals.

And for this tax credit, which is based on a dollar amount per item produced over a period of time, there's no set amount that Congress set aside for this. There's no application process. It's just available for performing the activity that it's intended to be incentivizing. It's available from now until the end of 2032 with a phase out that starts at the beginning of 2030. And the dollar amount of the credit here varies based on what component is being produced. There's a list in the Internal Revenue Code of what all of those dollar amounts are. And then interestingly, for this credit, one of the very special aspects of this is that it is eligible for direct pay for five years. So not for the full credit period, but for the first five years of qualifying for the credit, you can actually get direct payment of the credit from the federal government, even if you have no taxable income that you would use your credit to offset.

Bill Derasmo:

A lot of important provisions that you ran through. And let me add one more question there. What about the domestic content bonus?

Anne Loomis:

That's another very exciting aspect from the IRA that has the potential to bring some more value to the manufacturing side of the whole renewable energy supply chain. The bonus that you're talking about there, the domestic content bonus, is available for placing in service a facility that would include an energy storage technology facility that meets certain requirements. The requirements are a little complicated, but basically, 100% of the steel or iron used in a project has to be domestic, and then there's a calculation of how much of the cost of the manufactured products in the facility is domestic. As long as 40% or more is domestic, then the whole project can qualify for this extra 10% bonus that makes the whole project more valuable. And that value we are seeing is likely to be shared throughout the whole supply chain. So for manufacturers, that has made the products they're producing more valuable.

John Leonti:

And Anne, these credits, they're stackable, correct?

Anne Loomis:

That's right. Domestic content is one of these bonuses that can apply. Another one that has been very popular since the IRA passed is the energy community bonus, having a facility that's located in an energy community, which could be related to coal closure, in this context, it actually can be broader. There are also qualifying areas based on unemployment with a combination of past fossil fuel employment, and in certain brownfield areas as well. For location in those communities, there's another 10% bonus. And if you were able to utilize both the energy community bonus, for example, and the domestic content bonus, you could be looking at an ITC of 50%.

John Leonti:

And just to circle back real quick as we were talking about the manufacturing credits and direct pay, maybe just to delineate that cutoff, I think the direct pay was really towards the manufacturing credit. And then when we started talking about domestic content and these adders, those are more traditional, potentially direct pay to tax-exempt entities, but otherwise, you need taxable income.

Anne Loomis:

That's right. The direct pay option for the first five years of a credit is only available to a small number of credits, one of which happens to be that 45X Advanced Manufacturing PTC. It makes that credit even more important to pursue. But when we're talking about just the traditional ITC and PTC, which are the things that the domestic content bonus would be layered onto, those are not available for direct pay for a taxpayer. Direct pay there only applies to tax-exempt entities.

Bill Derasmo:

Shifting gears again, we've talked a lot about some of the particulars of the IRA, we've talked a lot about just now the particulars related to manufacturing. What about some broader trends? I mean, right now, we're in a very high interest rate environment compared to recent history. What are some options that different companies might be looking at in lieu of traditional bank lenders?

John Leonti:

In addition to high interest rates, the industry's also struggling with higher costs generally. It just costs more now than it did yesterday to build power plants. As a result, we're seeing quite a few industry participants looking to renegotiate off-taker contracts, supply agreements, and other types of contracts to make these projects economical and pencil for the developers and the other market participants. I think that's going to be a continued trend. There's no real panacea for higher rates other than rates coming down. And so whether you're in the traditional bank market or we're in a private lending market, we're just seeing higher cost of capital throughout the industry. And it's something that the industry is going to have to adjust to and then move forward. I think that is a big concern and will ultimately result in project delays in 2024 and beyond.

Bill Derasmo:

We've seen it wreak havoc on the offshore wind project, so we'll have to keep an eye on that. Hopefully, that doesn't spread more broadly. It's just an important trend for us to be on top of. I think the discussion has been great today, and hopefully our clients and listeners will find the discussion useful. I really appreciate John and Anne being on the program today. Hopefully, we'll have you guys on again soon to discuss whatever the trends are maybe a few months from now. Take care, everyone.