DEPARTMENT OF ENERGY
FEDERAL ENERGY MANAGEMENT PROGRAM

Request for Comment on the Tax Treatment of an Energy Savings Performance Contract Energy Sales Agreement

August 4, 2016

The purpose of this request for comment (RFC) is to gather information on the potential for an Energy Savings Performance Contract Energy Sales Agreement (ESPC ESA) to qualify as a service contract under 26 U.S.C. § 7701(e) and thus allow for an otherwise eligible renewable energy project to claim the investment tax credit (ITC) under 26 U.S.C. § 48. It would be helpful for commenters to identify any specific language included in 26 U.S.C. § 7701(e)(4)(A)(i)-(iv) that could benefit from clarification in the form of guidance from Internal Revenue Service (IRS) and the U.S. Department of Treasury (Treasury). This RFC is a continuation of the issues presented in the Federal Energy Management Program's (FEMP) Request for Comments on Including Onsite Renewable Energy Generation under Energy Savings Performance Contracts, issued on February 2, 2016, *available at* http://energy.gov/eere/femp/downloads/request-comments-including-onsite-renewable-energy-generation-under-energy.

DUE DATE: Comments and information are requested electronically on or before **September 3, 2016**.

COMMENT SUBMISSION INSTRUCTIONS: Interested parties are to submit comments electronically:

E-mail: tracy.niro@ee.doe.gov. Include "August 2016 ESPC Request for Comments" in the subject of the message.

FOR FURTHER INFORMATION CONTACT: Tracy Niro, U.S. Department of Energy, Federal Energy Management Program, e-mail:tracy.niro@ee.doe.gov.

SUPPLEMENTARY INFORMATION: The ESPC ESA project structure is intended to facilitate onsite renewable energy generation projects in compliance with the ESPC authority and Office of Management and Budget (OMB) requirements while maintaining project eligibility for the 26 U.S.C. § 48 solar investment tax credit (ITC). Please refer to the attached Energy Savings Performance Contract Energy Sales Agreement Fact Case (ESPC ESA Fact Case) for an overview of the ESPC ESA project structure.

FEMP has observed that certain federal agencies, ESCOs, and investors have been reluctant to pursue privately-owned onsite renewable energy generation projects under the ESPC ESA structure. As such, on February 2, 2016, FEMP issued a request for comment (the February RFC) to obtain information on potential obstacles to this approach, including potential issues with project ITC eligibility. FEMP learned through the comments received in response to the February RFC that there was uncertainty as to the tax treatment of ESPC ESA projects, which served as a deterrent to the widespread use of the contract mechanism. In this regard, commenters sought clarification on whether a renewable energy project structured with an ESPC could meet the requirements for ITC eligibility, which in this context necessitates that the ESPC ESA is a "service contract" under 26 U.S.C. § 7701(e). Here, the service contract analysis under 26 U.S.C. § 7701(e) must consider certain OMB requirements that a federal agency "must retain title to the installed capital goods at the conclusion of the contract" for an ESPC with an onsite energy source to be scored on an annual basis. *See* OMB Memorandum M-12-21, "Addendum to OMB Memorandum M-98-13 on Federal Use of Energy Savings Performance Contracts (ESPCs) and Utility Energy Service Contracts (UESCs)" (Sept. 28, 2012) (2012 OMB Memorandum), *available at* https://www.whitehouse.gov/sites/default/files/omb/memoranda/2012/m-12-21.pdf.

FEMP currently is working with Treasury and IRS to provide clarity on this issue and welcomes suggestions and feedback, particularly in the form of sample language that may be incorporated into FEMP guidance or IRS guidance, on the following issues:

1. Feedback on the attached ESPC ESA Fact Case: Does the Fact Case accurately represent how your organization would structure an ESPC ESA project? If not, please describe how your organization's ESPC ESA would differ.
2. Sample language for potential inclusion in IRS or Treasury guidance that would resolve concerns about an ESCO or financing partner's ability to retain the ITC in recognition of the requirements set forth in 26 U.S.C. § 7701(e) and the 2012 OMB Memorandum.
3. Feedback on whether the following statement if addressed in IRS or Treasury guidance would resolve concerns regarding an ESCO or financing partner's ability to retain the ITC:
    a. 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).
4. Suggestions and specific language that could assist Treasury and IRS in addressing other

tax issues directly related to the ESPC ESA, 26 U.S.C. § 7701(e)(4)(A)(i) – (iv), and the availability of the 26 U.S.C. §48 ITC.

FEMP invites all interested parties to submit by e-mail by **September 3, 2016** comments and information on matters addressed in this announcement, and would especially welcome feedback from parties with tax advisory experience. FEMP intends to use the comments received as information only. Commenters are advised that FEMP is under no obligation to acknowledge receipt or provide feedback with respect to any comments received under this announcement. Comments received in connection with this announcement do not bind FEMP to any further actions related to this topic. After the close of the comment period, FEMP together with Treasury and IRS will consider information received and may issue guidance on this topic, if warranted. FEMP, Treasury and IRS also may elect not to issue such guidance.

CONFIDENTIAL AND PRIVILEGED INFORMATION: FEMP advises commenters to avoid including any information in their responses that might be considered business sensitive, proprietary, or otherwise confidential. If, however, a commenter chooses to submit business sensitive, proprietary, or otherwise confidential information, it must be clearly and conspicuously marked as such in the response. In addition, (1) the header and footer of every page that contains confidential, proprietary, or privileged information must be marked as follows: "Contains Confidential, Proprietary, or Privileged Information Exempt from Public Disclosure" and (2) every line and paragraph containing proprietary, privileged, or trade secret information must be clearly marked with double brackets or highlighting. Failure to comply with these marking requirements may result in the disclosure of the unmarked information under the Freedom of Information Act or otherwise. The U.S. Federal Government is not liable for the disclosure or use of unmarked information and may use or disclose such information for any purpose. If a comment contains confidential, proprietary, or privileged information, the commenter must include a cover sheet identifying the specific pages containing confidential, proprietary, or privileged information.

Issued in Washington, DC, on August 4, 2016.

Timothy D. Unruh
Program Director
Federal Energy Management Program

ATTACHMENT

Energy Savings Performance Contract Energy Sales Agreement Fact Case

An Energy Savings Performance Contract Energy Sales Agreement **(**ESPC ESA) is a contract between an energy service company (ESCO) and a federal agency that utilizes the 25-year ESPC contracting authority. This document outlines important components of an example ESPC ESA project and summarizes the OMB and ESPC requirements.

Authorities

- Federal agencies may enter into an energy saving performance contract (ESPC) pursuant to the authority under 42 U.S.C. § 8287, et seq.
- For an ESPC or UESC that includes *onsite energy generation* to be scored on an annual basis, the Federal government must retain title to the installed capital goods at the conclusion of the contract.[1]

ESPC ESA Project Components

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.

Term: The total contract term can be up to 25 years in length. The contract term will depend upon the scope and scale of the renewable project. The term will include construction, commissioning, an acceptance period, and a defined performance period.

Price: The contract price, including operation and maintenance costs, is based on a fixed per-kWh basis and must be paid for by the federal agency from the energy savings generated under the project.

- The ESCO bears all financial risk for non-performance, consistent with the requirement that an ESPC must provide for a contractor performance guarantee.

- The contract price does not vary if the operating costs are lower than expected. In this case the private party net income may increase.

Equipment Purchase: The federal agency will purchase the renewable energy generation asset at the fair market value (FMV) appraised at the time of the sale by the end of the contract term, consistent with the OMB title retention requirement.

- The ESCO will transfer a portion of the payments it receives from the federal agency into a reserve account held by the ESCO for the federal agency's future purchase of the onsite renewable energy generation asset.

- The ESCO's deposit into the reserve account will be based on the estimated future FMV. Periodic re-appraisals (at least every 5 years) and contract modifications (as necessary), will ensure that

[1] Section III

the reserve account has sufficient funds for the FMV purchase of the renewable energy generation asset by the government. Any excess reserve account funds after the equipment purchase may be used to offset the final ESPC payment(s).

- The FMV shall be determined by selecting a mutually agreed upon, nationally recognized independent appraiser with experience and expertise in the applicable renewable industry. Such appraiser shall act reasonably and in good faith to determine FMV and shall set forth such determination in a written opinion delivered to the Parties. The valuation made by the appraiser shall be binding upon the Parties in the absence of fraud or manifest error.

Termination Policy: The ESPC ESA will 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). The ESPC ESA will 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.