



Audit Report



OIG-15-045

RECOVERY ACT: Audit of Penascal Wind Power LLC Payment
Under 1603 Program

September 3, 2015

Office of
Inspector General

Department of the Treasury

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Abbreviations and Acronyms

IRS	Internal Revenue Service
JAMES	Joint Audit Management Enterprise System
kV	kilovolts
NREL	National Renewable Energy Laboratory
OIG	Office of Inspector General
TD	Treasury Decision
Treas. Reg.	Treasury Regulation

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*The Department of the Treasury
Office of Inspector General*

September 3, 2015

David A. Lebryk
Fiscal Assistant Secretary

As part of our ongoing oversight of the Department of the Treasury's (Treasury) 1603 Program – Payments for Specified Energy Property in Lieu of Tax Credits (1603 Program)¹ authorized by the American Recovery and Reinvestment Act of 2009 (Recovery Act),² we conducted audits of selected award recipients. In this regard, we have audited the award made to Penascal Wind Power LLC (Penascal I), for a wind energy property in Sarita, Texas. Penascal I submitted its claim for payment in lieu of tax credit in the amount of \$114,071,646 and was awarded that amount by Treasury on September 1, 2009. Our audit objectives were to assess the eligibility and accuracy of that award by determining whether (1) the property existed, (2) the property was placed into service during the eligible timeframe, and (3) the award amount was appropriate. Appendix 1 provides a detailed description of our audit objectives, scope, and methodology.

Results in Brief

We verified that the subject property described by Penascal I in its 1603 Program application existed and was placed in service on April 22, 2009, which was within the eligible timeframe. However, we concluded that Penascal I included \$3,068,194 in its reported

¹ Treasury's Office of the Fiscal Assistant Secretary administers this program.

² Pub. L. No. 111-5, 123 Stat. 364-366 (Feb. 17, 2009). Under section 1603 of the Recovery Act, Treasury makes grants (payments) to eligible persons who place in service specified energy property and apply for such payments. The purpose of the payment is to reimburse eligible applicants for a portion of the expense of such property and is made in lieu of tax credits that could have been potentially claimed by the awardees.

cost basis of \$380,238,820 that did not comply with Treasury's 1603 Program Guidance³ based on clarification provided by Iberdrola Renewables, LLC (Iberdrola), the parent company of Penascal I, in its response to a draft of this report.

In the draft report provided to Iberdrola management, we originally questioned \$1,538,095 of its 1603 Program award (30 percent of \$5,126,984) related to high-voltage substation costs, a transmission engineering study, technical advisory fees, and overstatement of intangible costs. We questioned these costs because at the time Penascal I was awarded its 1603 Program funds in September 2009, Treasury did not allow applicants to claim high-voltage substation and other high-voltage related costs for reimbursement. It was not until September 2010, subsequent to Penascal I's award, that Treasury clarified its position to allow high-voltage substation and related costs in applicants' cost bases based on advice received from the Internal Revenue Service's (IRS) Chief Counsel.

Although the amount awarded to Penascal I was deemed unreasonable at the time of award, we no longer question the eligibility of the high-voltage substation and other high-voltage related costs. However, we continue to question \$3,068,194 of Penascal I's reported cost basis for costs that we found did not comply with Treasury's 1603 Program Guidance and Treasury Decision (TD) 8147.⁴ Ineligible costs are as follows:

- \$3,067,161 for technical advisory fees; and
- \$1,033 for overstatement of intangible costs.

As a result, we are questioning \$920,458 of Treasury's 1603 Program award (30 percent of \$3,068,194). See appendix 2 for the definition of questioned costs.

Additionally, subsequent to our visit to Iberdrola headquarters, we reviewed Penascal I's annual performance reports which were submitted to Treasury for reporting periods 2010 through 2014. In

³ "Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009 Program Guidance" (July 2009/Revised March 2010/Revised April 2011)

⁴ Treasury Decision 8147, 26 CFR 1.48-9: *Definition of energy property*.

its reports, Penascal I certified that the subject property was not sold, transferred or disposed of, and that it continued to qualify as a specified energy property. As of April 2014, Penascal I completed its 5 year reporting requirement.

We are recommending that your office ensure that Penascal I reimburse Treasury \$920,458 for the excessive 1603 Program payment received. We are also recommending that your office ensure that inappropriate or otherwise ineligible costs were not included in the cost basis of other Iberdrola affiliates that have received 1603 Program payments.

In a written response, Treasury management concurred with our recommendation to seek partial reimbursement of Penascal's award in the amount of \$920,458. The response also noted that Treasury management will re-review the cost information previously submitted by other Iberdrola affiliates to determine if any ineligible costs were included in those awards. Management's response is provided in appendix 5.

Background

Eligibility under the 1603 Program

Applicants were eligible for a 1603 Program award if a specified energy property was placed in service in 2009, 2010, or 2011, and the amount awarded was in accordance with applicable provisions of the Internal Revenue Code for determining the appropriate cost basis. Applicants may be eligible for an award after 2011, but only if (1) construction of the energy property began during 2009, 2010, or 2011, (2) the credit termination date of the property has not expired⁵, and (3) an application was submitted to Treasury by September 30, 2012.⁶

⁵ Credit termination dates range between 2013 and 2017 for energy properties eligible for a 1603 Program award.

⁶ Section 707 of the "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010," (Pub. L. 111-312, 124 Stat. 3312, Dec. 17, 2010) extended Treasury's 1603 Program for 1 year.

Under the 1603 Program, applicants submitted an application to Treasury that reported the total eligible cost basis of the specified energy property placed in service.⁷ If approved, award amounts were based on a percent of that eligible cost basis. For the type of property claimed by Penascal I, the percentage of cost basis eligible for award was 30 percent. According to Treasury's 1603 program guidance, the cost basis of the subject property is ascertained in accordance with the general rules for determining the cost basis of property for federal income tax purposes. Specifically, for this type of property, applicants follow the capitalization procedures found in Treasury Regulation (Treas. Reg.) §1.263A-1, "Uniform Capitalization of Costs."⁸

Treasury requires applicants to certify annually for a period of 5 years following the property's in-service date that the claimed property (1) has not been sold, transferred, or disposed of to a disqualified person and (2) continues to qualify as a specified energy property. Otherwise, the 1603 Program payment will be subject to full or prorated recapture.

Penascal I

Iberdrola developed the Penascal I wind energy facility located in Sarita, Texas. The subject property is a 201.6 megawatt wind farm which utilizes 84 Mitsubishi wind turbines capable of generating approximately 683 gigawatt hours of electrical output annually. Penascal I's generated power is sold to two Texas utilities and the Electric Reliability Council of Texas⁹ power market.

As of the end of our fieldwork, Iberdrola affiliates received \$1.9 billion in 1603 Program awards for 28 specified energy properties.

⁷ Treasury 1603 Program applications are reviewed by the National Renewable Energy Laboratory (NREL) which is a national laboratory of the Department of Energy. Under an interagency agreement between Treasury and the Department of Energy, NREL performs the technical review of 1603 Program applications and advises Treasury on award decisions.

⁸ Treas. Reg. §1.263A-1(a)(3)(ii), Property produced: "Taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(i) and (3) of this section), regardless of whether the property is sold or used in the taxpayer's trade or business."

⁹ Electric Reliability Council of Texas is an independent system operator that manages the flow of electric power for approximately 75 percent of the state.

Appendix 3 provides a detailed list of awards made to Iberdrola affiliates.

Audit Results

We verified that the subject property described by Penascal I in its 1603 Program application existed and was placed in service on April 22, 2009, which was within the eligible timeframe. However, we concluded that Penascal I included \$3,068,194 in its reported cost basis of \$380,238,820 that did not comply with Treasury's 1603 Program Guidance. We reached this conclusion after obtaining clarification on the eligibility of certain costs from Iberdrola management, the parent company of Penascal I, in a written response to a draft of this report (see appendix 4 for that written response in its entirety).

In our draft report, we originally questioned the appropriateness of Penascal I's claimed costs of \$5,126,984 for high-voltage substation costs, a transmission engineering study, technical advisory fees, and overstatement of intangible costs. We questioned these costs because at the time Penascal I was awarded its 1603 Program funds in September 2009, Treasury did not allow applicants to claim high-voltage substation and other high-voltage related costs for reimbursement in accordance with Treasury's 1603 Program Guidance¹⁰ and TD 8147.¹¹

It was not until September 2010, subsequent to Penascal I's award, that Treasury clarified its position to allow high-voltage substation and related costs in applicants' cost bases based on

¹⁰ "Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009 Program Guidance" (July 2009/Revised March 2010/ Revised April 2011), "For qualified property that generates electricity, qualified property includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items but does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines."

¹¹ Treasury Decision 8147, *Business Energy Investment Credit for Solar, Wind, and Geothermal Energy Property (e) Wind energy property* – "(1)... In general, wind energy property consists of a windmill, wind-driven generator, storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. Wind energy property does not include equipment that transmits or uses electricity derived from wind energy..."

advice received from the Internal Revenue Service's Chief Counsel. As a result, we modified our questioned cost accordingly.

High-Voltage Substation Costs

Initially, it was our understanding that in accordance with Treasury's 1603 Program Guidance and TD 8147, qualified energy property was not to include any electrical transmission equipment – equipment used to transmit electricity to the utility company for sale. The substation collects the electricity at the low voltage of 34.5 kilovolts (kV), which is transmitted for sale at the high-voltage of 345kV as required by the utility company. We concluded that once the electricity was stepped-up to 345kV, all energy property costs beyond the step-up transformer were ineligible since the property was being used for electricity transmission purposes. At the time Penascal I submitted its 1603 Program application, it claimed \$1,694,210 for transmission equipment that was embedded in its substation costs. Also at that time, Treasury did not allow applicants to claim construction and equipment costs for transmitting electricity on the high-voltage side of the substation.

In a written response to our draft report, Iberdrola management did not agree with our assessment of high-voltage substation costs. The response noted that in May of 2011, the IRS released additional guidance affirming Iberdrola's original interpretation of the IRS' qualified-property guidelines. Upon further inquiry with NREL, we learned that in September 2010 Treasury clarified its position regarding the eligibility of high-voltage substation and related costs based on advice of IRS Chief Counsel.

After confirming the applicability of guidance provided subsequent to Penascal I's award, we no longer question the eligibility of high-voltage substation and other related costs under the 1603 Program.

Transmission Engineering Study Costs

As noted above, it was our understanding that according to Treasury's 1603 Program Guidance and TD 8147, qualified energy property was not to include any electrical transmission equipment used to transmit electricity to the utility company for sale.

Therefore, we concluded that the transmission engineering study was an intangible cost that should have been allocated to the transmission equipment only. At the time Penascal I submitted its 1603 Program application, it claimed \$43,396 of transmission engineering costs in the subject property's cost basis.

After reviewing our draft report, Iberdrola management disagreed with our conclusion on the eligibility of the transmission engineering study costs. That is, the engineering study costs were related to the high-voltage substation equipment, and therefore, also eligible under the 1603 Program.

Since high-voltage substation costs were deemed eligible under the 1603 Program, we no longer question the related transmission engineering study.

Technical Advisory Fees

We found that the subject property's claim of \$7,687,161 in technical advisory fees was overstated by \$3,067,161. A dispute arose between Penascal I and Mitsubishi, the wind turbine manufacturer, over the calculation of technical advisory fees that Mitsubishi was charging. Subsequent to Penascal I submitting its 1603 Program application in July 2009, a settlement was reached whereby the parties agreed on fees of \$4,620,000. Therefore, we conclude that the excess cost of \$3,067,161 should not be included in the subject property's cost basis.

In its written response to the draft report, Iberdrola management disagreed with our determination that the technical advisory fees were ineligible. The response noted that management incurred additional capital costs after submitting its 1603 Program application for the Penascal I facility that would have resulted in a higher cost basis for the subject property had they been included in the application or an amendment. Management further noted that as it became clear in its review of eligible costs after the application was submitted, it understated some eligible costs for the facility which would have offset the reduction in fees resulting from the Mitsubishi settlement.

In accordance with Treasury's 1603 Program Guidance, "Applicants must submit with their application for a Section 1603 payment documentation to support the cost basis claimed for the property. Supporting documentation includes a detailed breakdown of all costs included in the basis. Other supporting documentation, such as contracts, copies of invoices, and proof of payment must be retained by the applicant and made available to Treasury upon request. For properties that have a cost basis in excess of \$500,000, applicants must submit an independent accountant's certification attesting to the accuracy of all costs claimed as part of the basis of the property."

The additional costs for the Penascal I facility discussed in Iberdrola management's response were neither included in its application for payment nor supported in its documentation as required by Treasury. Furthermore, the attestation provided by the independent public accountant certifying the accuracy of the costs claimed did not include the additional costs discussed by Iberdrola management in its response. We also noted that management reflected a lower cost basis, rather than a higher one, in its *Penascal Wind Power Updated Cost Sheet*, included as an attachment to its response. Appendix 4 provides Iberdrola's response in its entirety.

Therefore, we continue to question the eligibility of \$3,067,161 in technical advisory fees.

Overstatement of Intangible Costs

We determined that the subject property's claim of \$23,940,384 in intangible costs was overstated by \$1,033 as a result of the questioned costs discussed in this report. That is, we recalculated the indirect cost allocation rate and determined 99.5 percent as the appropriate rate. Using this allocation rate, we calculated \$23,939,351 as the eligible intangible costs.

Therefore, we conclude that \$1,033 of intangible cost should not be included in the subject property's cost basis.

Annual Reporting

As part of the terms and conditions of the award, Penascal I was required to certify for 5 years that the property had not been sold, transferred, or disposed of to a disqualified person and the property continued to qualify as a specified energy property. Subsequent to our visit to Iberdrola headquarters, we reviewed Penascal I's "Annual Performance Report and Certification" for reporting periods 2010 through 2014 to ensure compliance with Treasury's reporting requirements contained in the applicant's terms and conditions of award. As required for continued eligibility, Penascal I certified that the subject property had not been sold, transferred, or disposed of to a disqualified person and that the property continued to qualify as a specified energy property. Additionally, Penascal I has completed Treasury's 5 year annual reporting requirement.

Recommendations

We recommend that the Fiscal Assistant Secretary do the following:

1. Ensure that Penascal I reimburse Treasury \$920,458 for the excessive 1603 Program payment received for the subject property.

Management Response

Management concurred with our recommendation. Management noted that under the Section 1603 Program's Terms and Conditions, applicants have an ongoing obligation to inform Treasury of events that may result in a fee reduction and to return funds that are in excess of the amount which the applicant was entitled to. Additionally, management disagreed with the views expressed by Iberdrola that any excess funds should be offset against amounts it claims it could have, but did not, include in its claim. Management emphasized that applicants are advised not to submit Section 1603 applications until all costs are known and the amount of the claim is final.

OIG Comment

Management's response meets the intent of our recommendation.

2. Ensure that inappropriate or otherwise ineligible costs were not included in the cost basis of other Iberdrola affiliates that have received 1603 Program payments.

Management Response

Management generally concurred with our recommendation. Management noted that it will re-review the cost information previously submitted by other Iberdrola affiliates in an effort to determine if any ineligible costs were included in those awards.

OIG Comment

Management's response meets the intent of our recommendation.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during this audit. If you wish to discuss this report, you may contact me at (202) 927-6236 or James Hodge, Audit Manager, at (202) 927-0009. Major contributors to this report are provided in appendix 6.

/s/

Lisa Carter
Audit Director

We initiated an audit of Penascal Wind Power LLC (Penascal I) wind energy property as part of our ongoing oversight of the Department of the Treasury's (Treasury) 1603 Program – Payments for Specified Energy Property in Lieu of Tax Credits (1603 Program). The objectives of the audit were to assess the eligibility and accuracy of the award made to Penascal I under the 1603 Program by determining whether (1) the property existed, (2) the property was placed into service during the eligible timeframe, and (3) the award amount was appropriate.

Penascal I was selected as part of a risk-based sample representing large dollar awards made to 1603 Program applicants through 2009. At that time, our sample represented \$951million (i.e. 55 percent) of the \$1.7 billion funded applications. Penascal I was also part of a series of funded applications submitted by the same parent company, Iberdrola Renewables, LLC (Iberdrola).

In performing our work, we visited Penascal I's parent company, Iberdrola, in Portland, Oregon, where we interviewed key personnel of Iberdrola and key personnel associated with its independent public accounting firm. We also reviewed Penascal I's 1603 Program application and related documents reviewed by the Department of Energy's National Renewable Energy Laboratory, as well as documentation used to support the property's existence, its placed in service date, and the costs claimed by Penascal I. Subsequent to our site visit, we reviewed Penascal I's required annual performance reporting and certification to Treasury for reporting periods 2010 through 2014. We conducted our work between February 2010 and March 2015.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

A questioned cost is a cost that is questioned by the auditor because of an audit finding: (1) which resulted from an alleged violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds; (2) where the cost, at the time of the audit, is not supported by adequate documentation; or (3) where the cost incurred appears unreasonable and does not reflect the actions a prudent person would take in the circumstances. Questioned costs are to be recorded in the Joint Audit Management Enterprise System (JAMES). The questioned costs will also be included in the next Office of Inspector General Semiannual Report to the Congress.

<u>Recommendation Number</u>	<u>Questioned Costs</u>
Recommendation 1	\$920,458

The questioned costs relate to excess funds that Treasury awarded to Penascal I under the 1603 Program. The amount questioned is 30 percent of the excess costs included in Penascal I's cost basis. As discussed in the audit report, the questioned costs in the cost basis consist of two components: (1) \$3,067,161 of overstated technical advisory fees and (2) \$1,033 of overstated intangible costs associated with ineligible costs identified.

Appendix 3
Iberdrola Renewables, LLC Affiliates

Iberdrola Affiliate	Award Amount
Blue Creek Wind Farm LLC	\$172,688,076
Streator-Cayuga Ridge Wind Power LLC	170,115,870
Manzana Wind LLC	130,111,169
Penascal Wind Power LLC	114,071,646
Leaning Juniper Wind Power II, LLC	110,997,989
Penascal II Wind Project LLC	108,789,503
Buffalo Ridge II LLC	108,005,692
Elm Creek Wind II, LLC	95,564,386
Barton Windpower LLC	93,419,883
Juniper Canyon Wind Power LLC	92,851,679
Farmers City Wind, LLC	84,959,857
Rugby Wind LLC	73,094,236
Barton Chapel Wind, LLC	72,573,627
Locust Ridge II, LLC	59,162,064
Hardscrabble Wind Power LLC	54,199,724
Hay Canyon Wind LLC	47,092,555
Pebble Springs Wind LLC	46,543,219
Star Point Wind Project LLC	46,454,062
New Harvest Wind Project LLC	45,291,452
San Luis Solar Statutory Trust I, II, & III	35,177,507
Dry Lake Wind Power II LLC	32,159,397
Dry Lake Wind Power LLC	31,345,799
Groton Wind, LLC	29,241,749
South Chestnut LLC	28,873,226
Big Horn II Wind Project LLC	28,186,721
Moraine Wind II LLC ¹²	28,019,520
Copper Crossing Solar LLC	25,150,031
New England Wind, LLC	23,006,018
Total Funding to Iberdrola Affiliates	\$1,987,146,657

¹² *RECOVERY ACT: Audit of Moraine Wind II LLC Payment Under 1603 Program* (OIG-12-069; issued Aug. 23, 2012).

Appendix 4
Iberdrola Renewables, LLC Response



Amni Samson, 740-510
US Department of the Treasury
Office of the Inspector General
Building 410/Door 123
250 Murray Lane SW
Washington, D.C. 20220

Dear Mr. Samson:

Iberdrola Renewables appreciates the opportunity to provide comments on the draft audit report on the award made to Penascal Wind Power LLC, under the Department of the Treasury's 1603 Program – *Payments for Specified Energy Property in Lieu of Tax Credits*.

The Office of Inspector General (OIG) draft audit report verified the existence of the Penascal wind generating facility and determined the property was placed into service during the eligible timeframe. Iberdrola Renewables agrees with the determination of the OIG in this regard. The draft audit report also recognizes the project remained operational with no change in ownership for the requisite five-year window after commencing operation, and that Iberdrola Renewables successfully completed its five-year reporting requirements. Iberdrola Renewables also agrees with these determinations.

The draft report suggests that Iberdrola Renewables should not have included \$5,126,984 of its reported costs basis for the Penascal award and recommends that the company reimburse Treasury for \$1,538,095 of the 1603 Program award for Penascal. The costs in question are as follows:

- \$1,694,210 for high-voltage substation costs;
- \$43,396 for transmission engineering study costs;
- \$3,067,161 for technical advisory fees; and
- \$322,217 for overstatement of intangible costs.

Iberdrola Renewables disagrees with the OIG's determination of the ineligibility of these costs for the reasons stated below.

High-Voltage Substation Costs

Iberdrola Renewables prepared the Penascal Wind Power application based on Treasury Guidance titled *Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009*, issued in July of 2009. This document provides program guidance including information related to the eligible basis of qualifying property. This guidance states the basis of property is determined in accordance with the general rules for determining the basis of property for federal income tax purposes per Internal Revenue Code section 1012. Qualified electricity generating property includes storage devices, power conditioning equipment, transfer equipment, and parts

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Appendix 4

Iberdrola Renewables, LLC Response

related to the functioning of those items but does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines. Consistent with IRC section 1012 and the program guidance documentation, Iberdrola Renewables excluded all equipment properly related to transmission in the Penascal Wind Power application.

During the February 2010 audit, the OIG expressed a different interpretation of the program guidelines and asserted all property costs beyond the step-up transformer were ineligible for 1603 Program payment. Iberdrola Renewables reiterated its reasoning for the inclusion of the property questioned by the OIG staff and stood behind its documentation of eligible costs. In May 2011, the Internal Revenue Service (IRS) issued further guidance related to qualified wind property in an electric substation which clarified the guidelines and affirmed Iberdrola Renewables' original interpretation of the IRS qualified-property guidelines. This document, *Internal Revenue Service Guidance – Chief Counsel Advice CCA 201122018 - Section 1603 - Qualified Wind Property in an Electric Substation Located at a Wind Farm*, is included here as Attachment A. This 2011 Guidance was not available to the OIG when it conducted the audit of the Penascal Wind Power LLC award under the Treasury's 1603 Program. The 2011 Guidance removes any doubt that equipment beyond the step-up transformer is qualified property if that property is related to the functioning of the transformer or of transfer equipment. This determination directly contradicts the conclusion in the draft audit report which states "once the electricity was stepped-up to 345 kV, all energy property costs beyond the step-up transformer were ineligible since the property was being used for electricity transmission purposes." Based on the analysis and conclusions in the 2011 IRS Guidance, items such as dead end structures, grounding transformers, switch gear buildings, switches, and step-up transformers clearly meet the criteria for qualified equipment. The 2011 Guidance further clarifies that arresters, high voltage switches, metering CTs, high voltage circuit breakers, and high voltage switches are also eligible equipment under the 1603 Program if that equipment relates to the function of the transformer or transfer equipment.

Iberdrola Renewables included three categories of high-voltage substation related costs in its Penascal Wind Power cost basis. Reviewing the function of this equipment against the criteria established in the 2011 IRS Guidance demonstrates the eligibility of this equipment under the Treasury's 1603 program.

- 345 kV Disc Switches – required to isolate the transformer that produces the high voltage necessary to sell the electricity produced (2011 Guidance Item 7).
- 345 kV Transformers – power conditioning equipment required to increase the voltage of the electricity generated in the wind farm (2011 Guidance Item 5).
- 345 kV Breakers – automatically operated electrical switch designed to protect the substation from damage caused by overload. This type of protection is a necessary part of the power conditioning and transfer circuit (2011 Guidance Item 9).

Transmission Engineering Study Costs

Per the OIG draft audit report, costs that lacked sufficient detail to be assigned to high voltage or low voltage were assigned a 19% allocation to high voltage equipment and were determined to be

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Appendix 4

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ineligible. The OIG further determined transmission engineering study costs were similarly ineligible. The particular engineering study costs singled out in the draft audit report are related to the high voltage equipment detailed above. Based on IRC Section 1012 and the 2009 and 2011 Guidance documents, all of the substation costs included in Penascal Wind Power's cost basis are eligible property under the 1603 Program. Therefore, the related transmission engineering costs are also eligible property under the Program.

Technical Advisory Fees

In early 2010, responding to the initial document request from the OIG auditors for the Penascal Wind Power facility Treasury payment, Iberdrola Renewables noted a dispute between Penascal and Mitsubishi, the wind turbine generator manufacturer, was resolved in favor of Penascal resulting in a reduction of eligible technical advisory fee costs of \$3,067,161. This settlement was reached *after* Iberdrola Renewables submitted the 1603 Program application for the Penascal wind facility.

Iberdrola Renewables again apprised the OIG auditors of this settlement and the reduction in the cost basis relative to the 1603 Program application submittal during the auditors' field visit to the Iberdrola Renewables main offices in 2010. At that time, Iberdrola Renewables also noted that additional capital costs were incurred for the Penascal Wind Power facility after the 1603 application had been submitted. These additional costs would have resulted in a higher cost basis for the project and thus a higher 1603 payment, had they been included in the application or an application amendment.

The 1603 program was established through legislation and fleshed out through Treasury Department Guidance to provide an alternative to traditional tax credits and the market-driven mechanisms many renewable energy developers rely on to monetize those credits. The Department guidance allows a payment based on costs that may be documented at a point in time; i.e., at the point a facility application is submitted. The law does not allow a rolling, iterative series of applications to recover costs, but instead uses a "snapshot" methodology for compiling eligible facility costs.

In preparing the Penascal Wind Power application Iberdrola Renewables took a conservative approach to ensure all costs included in the cost basis met the eligibility requirements of the 1603 Program and, as became clear with a review of eligible costs after the payment application was submitted, understated some eligible costs of the facility in the grant application submittal. The updated cost basis for the Penascal facility with the adjusted technical advisory fees has been included as Attachment B and demonstrates the incremental eligible costs of the facility effectively offset the reduction in fees that resulted from the Mitsubishi settlement. In the case of Penascal, the "snapshot" methodology compares well with the "iterative" methodology.

Intangible Costs

The OIG's draft report determined that Penascal Wind Power's cost basis for intangible costs was overstated as a result of the costs questioned in its report. These costs are directly related to the three cost adjustments previously addressed. With the additional clarity provided by the IRS Guidance and the information outlined above, the overstatement of intangible costs is not valid.

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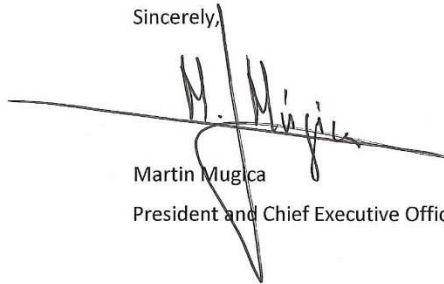
Appendix 4
Iberdrola Renewables, LLC Response

Conclusion

Iberdrola Renewables appreciates the efforts of the OIG to oversee implementation of the Treasury's 1603 Program by conducting a review of the eligibility and accuracy of the Penascal Wind Power award. For the reasons stated above, Iberdrola Renewables believes the Treasury appropriately implemented Section 1603 in its approval of the Penascal Wind Power award.

If you have questions or require additional information, please contact Laura Beane at (503) 478-6306.

Sincerely,

A handwritten signature in black ink, appearing to read "M. Mugica", is written over a horizontal line. The signature is stylized with a large, sweeping flourish that extends below the line.

Martin Mugica
President and Chief Executive Officer

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Attachment A

*Internal Revenue Service Guidance – Chief Counsel Advice CCA 201122018 - Section 1603 - Qualified Wind
Property in an Electric Substation Located at a Wind Farm*

Appendix 4
Iberdrola Renewables, LLC Response

ID: CCA_2011050409385248

Number: 201122018

Office:

Release Date: 6/3/2011

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From:

Sent: Wednesday, May 04, 2011 9:38:53 AM

To:

Cc:

Subject: Qualified Wind Property 1603 (2).doc

Below is the memo that I sent to

Qualified Wind Property in an Electric Substation Located at a Wind Farm

You have asked for our interpretation of how to determine which property associated with a wind energy property qualifies for the grant under §1603 of ARRTA. Sometimes this question is described as finding a separation point between the low side and the high side of wind energy generation.

You provided me with a diagram showing equipment in an electric substation located at a particular wind farm. Below is a list of items from that diagram. The wind farm produces electricity for sale into a high voltage transmission line. The listing starts at the point that electricity enters the substation from the wind farm and ends at the point at point of connection to the high voltage transmission line.

1. Dead end structure
2. Grounding XFMR
3. Switch gear building
4. Switch 34.5 KV
5. Transformer 34.5 KV to 345 KV
6. (Lightning or surge) Arrester
7. 345 KV switch
8. Metering CT
9. 345 KV Circuit breaker
10. 345 KV switch
11. Dead end surge arrester

The information submitted does not indicate whether the listing represents one of two or more parallel circuits within the electric substation. Parallel circuits were used in the one other instance in which the operations of such a substation was described to me. The existence of parallel circuits would emphasize the need for the various switches used to isolate items of equipment within a circuit for repair and maintenance. The wind farm can continue to operate (possibly, at a reduced capacity) when equipment in one circuit is isolated for repair and maintenance.

The Program Guidance for § 1603 ARRTA that was issued by Treasury describes qualified property generally in part IV. I. (page 11) as follows:

Qualified property includes only tangible property that is both used as an integral part of the activity performed by qualified facility and located at the site of the qualified facility. ... Property is an integral part of a qualified facility if the property is used directly in the qualified facility, is essential to the completeness of the activity performed in that facility, and is located at the site of the qualified facility.

The Guidance provides more specifically for property generating electricity (page 12) as follows:

For qualified property that generates electricity, qualified property includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items but does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines.

The terms used in § 1603 are based, in large part, on § 48 of the Internal Revenue Code. The above language from the guidance is based on §1.48-1(d)(4) of the income tax regulations, which defines “integral part,” and on §1.48-9(d)(3) and §1.48-9(e)(1), which define solar and wind energy property. TD 8147 and TD 7765 issued the portions of § 1.48-9 of the regulations that are relevant here. Section 1.48-9(e) provides:

(e) Wind energy property--(1) In general. Energy property includes wind energy property. Wind energy property is equipment (and parts related to the functioning of that equipment) that performs a function described in paragraph (e)(2) of this section. In general, wind energy property consists of a windmill, wind-driven generator, storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. Wind energy property does not include equipment that transmits or uses electricity derived from wind energy. ...

(2) Eligible functions. Wind energy property is limited to equipment (and parts related to the functioning of that equipment) that--

...

(ii) Uses wind energy to generate electricity ... *.(emphasis added)*

The issue^[1] whether a particular item of property is qualified property turns on the following two questions:

1. Is the equipment used an integral part of the activity of generating electricity from wind?
2. Does the equipment constitute power conditioning equipment, transfer equipment, or parts relating to the functioning of those items?

My research found over one-hundred revenue rulings published by the Service that discuss whether property is an integral part of an activity. None seem directly on point. Rev. Rul. 84-40, 1984-1 C.B. 11 (copy attached), is a good summary and concludes that in each situation, the test is whether the property is used directly in the activity and is essential to the manufacturing (here, the electricity generation) process. I found nothing that discusses what constitutes power conditioning equipment, transfer equipment, or parts relating to the functioning of those items.

¹Phrasing the issue in terms of determining the separation point between the low-side and the high-side probably confuses the analysis because the break point is so clearly at the transformer.

Most of the equipment listed above is essential to the manufacturing process because the equipment is necessary to deliver the generated electricity. The guidance and the regulations under § 1.48-9, however, make clear that transmission equipment is not qualified property. We read “power conditioning” equipment to include the step-up transformer that increases the voltage of the electricity generated in the wind farm to the voltage of the high voltage transmission line. Equipment beyond the step-up transformer is qualified property if that property is related to the functioning of the transformer or of transfer equipment. Items 1-5 in the list above clearly are qualified equipment under the above analysis. For purpose of simplicity, I have not discussed the wires or support structures within the substation—generally, these items are clearly related to specific equipment and are qualified property, or not, depending on whether the equipment to which they relate is qualified property.

Item 6. The lightning or surge arrestor protects the transformer and clearly relates to the functioning of the transformer. Circuit breakers cannot operate fast enough to protect circuits from the effects of lightning and some transient electrical surges—the equipment used to protect circuits from lightning and these surges is called an arrestor.

Item 7. The 345 KV switch is necessary to isolate the transformer that produces the the high voltage necessary to sell the electricity produced. (Generally, a switch is used to manually isolate equipment and a circuit breaker automatically isolates a circuit or equipment.) The transformer will have to be removed from service from time to time for inspection, repair, and maintenance. Therefore, the switch directly relates to the functioning of the transformer.

Item 8. The metering CT measures the amount of electricity that the wind farm produces for sale. Possibly, it is also used to control operations of the wind farm. In either case, it is a necessary part of the transfer equipment.

Item 9. The 345 KV circuit breaker is an automatically operated electrical switch designed to protect the substation from damage caused by overload. Again, this type of protection is a necessary part of the power conditioning and transfer circuit.

Item 10. Even if the surge arrestor, as discussed below, is considered part of the transmission function rather than part of the qualified facility, a strong argument can be made that the 345 KV switch is the last item of transfer equipment because the 345 KV switch serves to isolate the transmission line from the power conditioning and transfer equipment in the substation. If the dead end surge arrestor is qualified property then, because the switch allows that two items of qualified property to be isolated for maintenance and repair, this switch is qualified property.

Items 11. The term “dead-end” usually refers to the last tower in a transmission line. Thus, it appears that the dead-end surge arrestor should be considered part of the transmission activity, because it appears that the purpose of the dead-end surge arrestor is to protect the transmission line. In such a case the surge arrestor is not qualified property. However, if your investigations develop a good reason for treating this surge arrestor as part of the substation (for example, you are convinced that the primary purpose of this surge arrestor is to protect the substation, rather than the transmission lines), then this surge arrestor is equipment related to the functioning of power conditioning and transfer equipment and the equipment should be qualified property.

Attachment B

Penascal Wind Power Updated Cost Sheet

Appendix 4
Iberdrola Renewables, LLC Response

Penascal						
Total costs to be used in the calculation for the ITC Grant Application						
Task	Task Name	Actual Project Costs (Updated)		Post ITC filing	Meals @ 50%	Total
1.01	Turbines	\$	235,102,283	\$	13,481,308	\$ 248,583,591
1.02	Shipping	\$	17,740,752	\$	-	\$ 17,740,752
1.03	Start Up	\$	3,542,238	\$	1,095,449	\$ 4,637,688
1.04	Install - Turbines	\$	1,050,410	\$	-	\$ 1,050,410
2.01	Engineering	\$	380,608	\$	-	\$ 380,608
2.02	Construction	\$	37,852,129	\$	2,370,375	\$ 40,222,504
3.01	Engineering	\$	40,436	\$	51,851	\$ 92,244
3.02	Procurement	\$	3,556,573	\$	83,786	\$ 3,640,359
3.03	Construction	\$	4,730,035	\$	3,051	\$ 4,733,886
4.01	Engrg - Subst	\$	702,582	\$	(77,679)	\$ 624,903
4.02	Procure - Subst	\$	7,191,405	\$	12,250	\$ 7,203,654
4.03	Constr - Subst	\$	3,909,383	\$	219,050	\$ 4,128,732
2.03.02	Met Tower - Perm	\$	274,514	\$	-	\$ 274,514
2.03.03	Avian Monitng Equip	\$	409,425	\$	6,739	\$ 416,164
3.04.01	Engrg - OH Collect	\$	72,200	\$	-	\$ 72,200
3.04.03	Constr - OH Collect	\$	2,937,600	\$	18,914	\$ 2,956,513
Turbines and associated electrical work		\$	336,562,719	\$	-	\$ 336,562,719
2.02	Construction - Roads	\$	17,306,710	\$	-	\$ 17,306,710
Roads for turbine construction and maintenance		\$	17,306,710	\$	-	\$ 17,306,710
2.02	Construction - O&M Bldg	\$	554,492	\$	-	\$ 554,492
2.03.01	O&M Building	\$	204,028	\$	21,810	\$ 225,838
O&M Building - Structure and Facilities		\$	780,331	\$	-	\$ 780,331
9.04	Furniture & Computer	\$	135,805	\$	18,517	\$ 154,220
9.05	O & M Other	\$	211,759	\$	2,754	\$ 214,269
O&M Building - Furnishings		\$	368,489	\$	-	\$ 368,489
6.01	Engg	\$	16,913	\$	-	\$ 16,913
6.03	Construction	\$	592,403	\$	309	\$ 592,660
Transmission Line		\$	611,573	\$	-	\$ 611,573
5.02	Utility Upgrades	\$	62,500	\$	-	\$ 62,500
Interconnection - Network Upgrades (reimbursed)		\$	62,500	\$	-	\$ 62,500
7.02	Trans/Interconnect	\$	45,236	\$	(83,786)	\$ (38,572)
7.03	Prelim Engg	\$	538,169	\$	-	\$ 538,169
7.05	Wind Analysis	\$	32,182	\$	-	\$ 32,182
7.06	Met Towers	\$	135,274	\$	2,578	\$ 137,852
7.07	Legal - Proj Dev	\$	2,566,510	\$	401,833	\$ 2,968,143
7.1	Legal (King Ranch)	\$	7,129	\$	-	\$ 7,129
7.12	PPM Internal Costs	\$	412,457	\$	3,959	\$ 416,416
7.14	PR/Lobbying	\$	14,279	\$	-	\$ 14,279
7.99	Conversion	\$	1,019,162	\$	-	\$ 1,019,162
8.01	Project Mgmt	\$	523,008	\$	27,021	\$ 550,029
8.02	Construction Mgmt	\$	808,570	\$	6,818	\$ 815,388
8.03	Contract Lbr/Consult	\$	61,739	\$	1,900	\$ 63,639
8.04	Constructn Facilities	\$	16,604	\$	-	\$ 16,604
9.03	Safety Equip & Unif	\$	5,516	\$	-	\$ 5,516
10.01	LndOwnr Install Pymt	\$	6,048,000	\$	-	\$ 6,048,000
10.05	Land Other	\$	647,214	\$	-	\$ 647,214
11.03	IDC	\$	7,528,591	\$	-	\$ 7,528,591
11.04	Sales & Use Tax	\$	29,934	\$	46,445	\$ 76,379
11.05	ARRR Insurance	\$	1,167,377	\$	774,566	\$ 1,941,943
7.01.01	Land Agents	\$	100	\$	-	\$ 100
7.01.03	Lease Fees	\$	582,272	\$	100	\$ 582,372
7.01.04	Filing Fees	\$	37,491	\$	-	\$ 37,491
7.01.05	Surveys	\$	311,215	\$	6,035	\$ 317,250
7.04.01	Filing Fees	\$	325	\$	-	\$ 325
7.04.02	Permit	\$	2,551	\$	-	\$ 2,551
7.04.03	Env. Studies	\$	676,035	\$	758	\$ 676,793
7.04.04	Others	\$	121,934	\$	-	\$ 121,934
7.01.05	Title Work	\$	-	\$	-	\$ -
Intangible and Development Costs		\$	24,503,987	\$	-	\$ 24,503,987
Grand Total		\$	361,821,288	\$	18,494,519	\$ 380,296,310

Tax Depreciation Schedule	Cost	Intangible Allocation	Initial %	Tax Basis	Final %
Turbines and associated electrical work	\$ 336,562,719	\$ 23,186,501	88.53%	\$ 359,849,220	94.62%
Roads for turbine construction and maintenance	\$ 17,306,710	\$ 1,191,641	4.55%	\$ 18,498,651	4.89%
O&M Building - Structure and Facilities	\$ 780,331	\$ 53,743	0.21%	\$ 834,073	0.22%
O&M Building - Furnishings	\$ 368,489	\$ 25,378	0.10%	\$ 393,868	0.10%
Transmission Line	\$ 611,573	\$ 42,120	0.16%	\$ 653,693	0.17%
Interconnection - Direct Assigned (non-reimbursed)	\$ -	\$ -	0.00%	\$ -	0.00%
Interconnection - Network Upgrades (reimbursed)	\$ 62,500	\$ 4,304	0.02%	\$ 66,804	0.02%
Intangible and Development Costs	\$ 24,503,987	\$ -	0.00%	\$ -	0.00%
Spare Equipment and Land Purchases	\$ -	\$ -	0.00%	\$ -	0.00%
	\$ 380,296,310	\$ 24,503,987	100.00%	\$ 380,296,310	100.00%

ITC Qualifying Cost =	\$ 378,347,871
30% ITC Grant Application Value =	\$ 113,504,361
ITC Non-Qualifying Cost =	\$ 1,948,439

Appendix 5
Management Response



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

AUG 21 2015

Marla Freedman
Assistant Inspector General for Audit
Department of the Treasury
Office of Inspector General
740 15th Street, N.W., Suite 600
Washington, D.C. 20220

Dear Ms. Freedman:

Thank you for the opportunity to review and comment on the draft audit report of the Section 1603 award made to Penascal Wind Power LLC (Penascal). On September 1, 2009, the Treasury Department (Treasury) awarded Penascal a Section 1603 payment in the amount of \$114,071,646.

The draft report contains two recommendations. The first recommendation calls for Treasury to seek partial reimbursement of Penascal's award, in the amount of \$920,458. We concur. This amount represents a portion of costs Penascal incurred for fees to a third party for technical advisory services. Such fees are generally properly included in Section 1603 claims, and they were properly included at the time Penascal submitted its application. However, subsequent to receiving its Section 1603 award, Penascal settled a dispute with the service provider over the amount of these fees, resulting in a fee reduction. Under the Section 1603 program's Terms and Conditions, applicants have an ongoing obligation to inform Treasury of such events and to return funds to Treasury in circumstances where Treasury determines that the funds received were in excess of the amount to which the applicant was entitled. Penascal did not meet its reporting obligation to Treasury with regard to its fee reduction. In addition, we disagree with the view expressed by Ibedrola Renewables, LLC (Penascal's parent company), on behalf of Penascal, that any excess funds should be offset against amounts it claims it could have, but did not, include in its claim. Applicants are advised not to submit Section 1603 applications until all costs are known and the amount of the claim is final.

We also generally concur with the draft report's second recommendation, which pertains to Section 1603 awards made to other Ibedrola affiliates. We will re-review the cost information previously submitted with such applications in an effort to determine if any ineligible costs were included in those awards.

Sincerely,

David A. Lebryk
Fiscal Assistant Secretary

Appendix 6
Major Contributors to This Report

Lisa Carter, Audit Director
James Hodge, Audit Manager
Rufus Etienne, Referencer

Department of the Treasury

Assistant Secretary for Management of the Treasury
Fiscal Assistant Secretary
Deputy Assistant Secretary, Fiscal Operations and Policy
Office of Strategic Planning and Performance Management
Office of the Deputy Chief Financial Officer, Risk and Control
Group
Program Manager, Office of Fiscal Assistant Secretary

Office of Management and Budget

OIG Budget Examiner

Iberdrola Renewables, LLC

President and Chief Executive Officer

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