

**Alternative Energy:
Third Party Financing and Development**

Final Report

Submitted by:

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All errors, omissions, and desultory prose are solely the responsibility of the author.

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Disclaimer

The information in this report should **not** be relied upon as legal, accounting, or financial advice. It is general in nature and refers to rules and regulations which are subject to change over time. Moreover, the results shown reflect hypothetical scenarios for specific third party financed alternative energy installations – these results most certainly could not be duplicated. **The author and Focus on Energy are providing this information as a public service and are not responsible for the success or failure of alternative energy developers that utilize the information contained herein.**

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Executive Summary

The Energy Policy Act of 2005 raised the Federal Tax Credit from 10% to 30% on alternative energy property. Combined with soaring natural gas prices and electricity rates in the Fall of 2005, the change in law created new demand for commercial installations of solar electric and solar thermal equipment. Ongoing state grant programs (In Wisconsin, sponsored by Focus on Energy) provided additional subsidization benefits.

The primary goal of this project was to determine whether established financial engineering principals used successfully in the real estate development world could be applied to alternative energy development – in particular, whether a third party ownership model could be the basis for a new alternative energy development business. The following topics were explored:

- **Financial model:** Would third party owners extract sufficient subsidization benefits to provide customers savings on their power bills? Would this occur despite mid-teen returns required to attract risk capital from limited partners / investors?

The financial returns are not sufficient *on their own* to motivate potential customers looking for savings on their power bills. Financial feasibility is doubtful for solar electric in the near-term, but solar thermal may begin to make sense if natural gas / propane prices continue to rise and economies of scale can be realized in larger-sized commercial installations.

- **Accounting and Tax:** Would third party owners be able to completely exploit all possible tax and accounting rules to simultaneously maximize savings for the customer while providing enough benefits to the tax-credit investor? How does the timing of receipt of: credits, deductions, and state grants affect the savings to the customer and returns to the investor?

Third party ownership enables the energy developer to get the “best fit” – the right equipment to match customer needs and specific tax benefits to tax-motivated investors. But the cost for such tailoring is significant – professional fees take a big bite out of returns.

- **Legal Review:** How does tax law impede or assist the third party structure? How do state rules governing energy production and distribution affect outcomes?

Complex rules determine the apportionment of income/loss, cash flow, and liquidation proceeds within a third party ownership structure. The developer (in concert with tax and legal counsel) must ensure the structure passes legal and regulatory muster on behalf of the customer, lender, and investor.

We saw inquiry from potential non-profit solar energy customers looking to work with third party for-profit owners able to utilize tax credits – a combination that should be mutually beneficial. Unfortunately, federal tax code provisions deny these non-profits (often, the most frequent users of PV arrays) from the opportunity to exploit the new 30% credit.

- **Tax Credit Investors:** Who can invest? What rate of return is required? What is their likely investment horizon?

As a new and relatively unproven business model, investment returns between 13% and 18% are likely required to motivate institutional-only involvement (individuals are almost always **unable** to utilize energy property tax credits). Early adopters and socially conscious investors may be willing to invest at considerably lower return rates, possibly as low as 7%-9%. As the tax credit recapture period is 5 years for energy property and the accelerated depreciation schedule is also 5 years, deal lengths from 5 to 6 years are to be expected. Socially conscious investors may permit longer deal lengths.

- **Customers:** Who are they? What is their motivation to purchase alternative energy equipment? Is the third party structure acceptable?

In most cases, non-profit and/or socially conscious customers remain the most interested users of alternative energy. This is to be expected given the long payoff periods for the equipment (the length of which is discussed herein). It does not appear that 3rd party ownership discourages customers from getting involved – after all, ownership of the equipment typically reverts to the customer after about 5 to 6 years.

- **Lenders:** Who are they? What risk will they take? What rate will they charge?

Banks familiar with real estate Section 42 tax-credit investments are comfortable with third party ownership structures and thus, showed interest in this potential business. Importantly, it is possible to structure deals so that lenders “face” the customer (who would be required to meet the lender’s credit standards). In some cases, local utilities have lending programs that 3rd party developers could utilize. In either case, terms will likely include: 10-15 year amortizations, 5-10 year maturities, and rates at approximately LIBOR + 3-4%. (LIBOR = London Inter-bank Offered Rate)

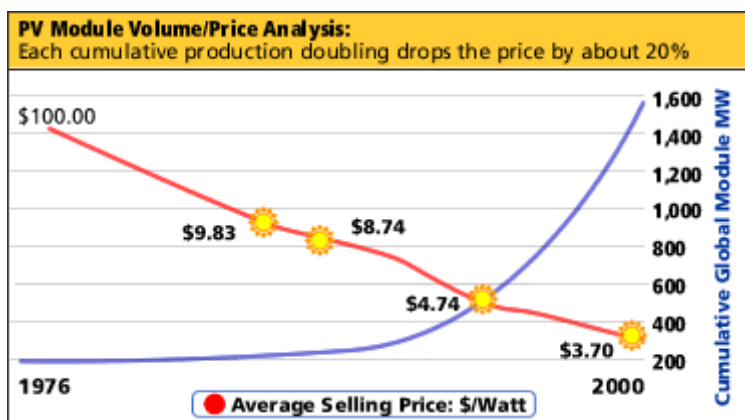
Introduction

The 2005 Energy Policy Act raised the credit for “energy property” -- primarily alternative energy equipment including solar thermal (heated liquid or air) and solar electric (photovoltaic - PV) – from 10% to 30%. This legislation was passed at a time when rising energy prices for electricity and natural gas motivated us to begin exploring whether finance and development principles regularly used in the real estate world could be applied to alternative energy development. Indeed, a variety of financial benefits were available to the equipment owner – tax credits, federal accelerated depreciation deductions, and state grants (in Wisconsin, distributed by Focus on Energy). We wanted to determine whether a development model that completely utilized all subsidies would provide the basis for a start-up business, possibly helping to reinvigorate the alternative energy sector here in Wisconsin.

Further inspiration for getting started was provided by the success of SunEdison -- a Baltimore, MD based company that was beginning to pursue similarly structured alternative energy development primarily in California. It was clear they were using a third party ownership model similar to the type we wished to explore for use in Wisconsin.

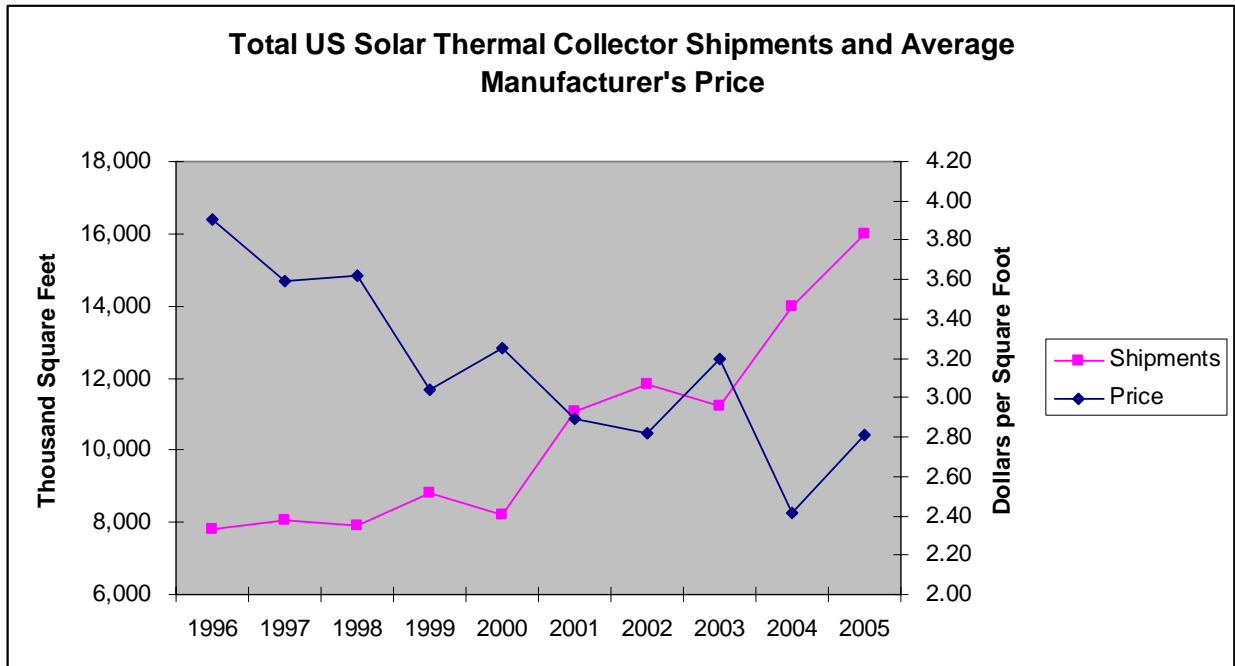
Pent-up demand for socially responsible energy consumption was also apparent. In particular, numerous non-profit entities were interested in having solar energy (usually, PV) equipment placed on top of their facilities. These businesses were usually realistic – accepting that long-term commitments were required to achieve payback. Moreover, they were motivated as much by concerns regarding global warming, natural resource depletion, and reliance on foreign supplies of energy as they were by savings on their energy bills.

It seemed a “perfect storm” was brewing – higher energy prices, a new 30% credit, and attractive state grant programs, all pointed to a potential boom in the alternative energy business. In addition, (and as shown in Figures (1) and (2) below), industry efficiency gains were driving down costs for both solar electric (PV) and solar thermal equipment. Could a third party ownership business model be just the tool to jump-start the industry?



Source: Solar Energy Industry Association website: SEIA.org.

Figure 1. PV Module Volume / Price Analysis



Source: Mark Daugherty, MSB Energy Associates, Middleton, WI
US EIA, Solar Thermal and Photovoltaic Collector Manufacturing Activities
<http://www.eia.doe.gov/cneaf/solar.renewables/page/solarreport/solar.html>
Energy Information Administration, Form EIA-63A, "Annual Solar Thermal Collector Manufacturers Survey."

Figure 2. Solar Thermal Collector Volume / Collector Price Analysis

Methods

We began work by reviewing the development model popular in the real estate industry and used commonly in conjunction with the federal Section 42 Low-Income Housing Tax Credit. This model places the real estate (for example, a large apartment building to be occupied in part by income-qualified individuals) inside a single purpose vehicle -- a limited liability company (LLC) ownership entity. The member/owners of the LLC are: 1) a developer who receives a fee for developing the property (and who acts as managing partner for the LLC ownership entity); and, 2) investor(s) who commit capital and are limited partners able to fully utilize both depreciation deductions and tax credits. Two sources were particularly useful in providing the foundation of understanding for this structure (also shown in the References section of this report):

- 1) Novogradac & Company LLP, CPAs, *Low-Income Housing Tax Credit Handbook, 2000 Edition*; and,
- 2) Stevens, et. Al., *A Developer's Guide to the Low Income Housing Tax Credit*.

We created a financial spreadsheet model using the principals of the real estate development model, creatively re-worked and then applied to a new asset – alternative energy equipment. Mark Daugherty (MSB Energy Associates) confirmed that a version of this structure was also being used to finance certain wind power installations in the US. Although in their infancy in the solar thermal and solar electric world, we also determined that third party ownership structures were being successfully employed in California and a few other states – in particular, by SunEdison.

We met with professionals to review the accounting and legal principles underlying the model and their applicability to solar thermal and solar electric installations. These meetings provided crucial insights that shaped the results shown herein.

We met with potential investors, customers, and lenders to determine their financial goals, an acceptable time horizon, and the necessary set of contractual agreements required to move forward in a niche market using a relatively untested business approach.

Finally, we ran a series of scenarios in our spreadsheet model to determine overall viability of the third party model. Although general results are referenced throughout this report, detailed results (for one sample PV installation) can be seen in Appendix A.

Results

Task 1 – Financial Model

Assumptions

An example third party ownership deal diagram is shown below in Figure 3.

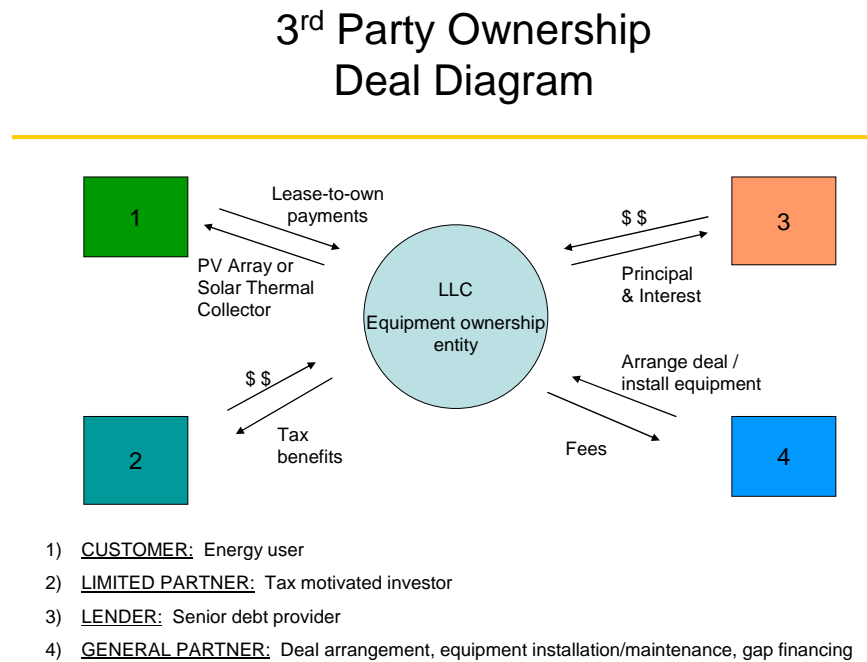


Figure 3. Third Party Ownership Deal Diagram

The ownership structure shown above is assumed to remain in place for at least 6 years. Additional assumptions are as follows:

Customer:

- Non-profit (or other) entity unable to fully utilize tax benefits
- Agrees to enter into 6 year unconditional lease (payments to occur irrespective of system performance)
- Agrees to enter into agreement to purchase equipment ownership entity after 6 years
- Agrees (if necessary) to refinance equipment with lender at end of initial 6 year term

Limited Partner / Tax-Credit Investor:

- Minimum return requirement = 13% IRR
- Can fully utilize all depreciation deductions and tax credits when first available
- Distributed cash flow = 1.0%
- Equity contributed = approximately 40-60% of total invested proceeds

Lender:

- Loan rate requirement = approximately LIBOR + 3.0%
- Will lend for initial 6 year term with renewals with customer to 10-15 year final term
- 10-15 year amortization schedule
- Minimum 1.20 debt service coverage ratio
- Loan amount = approximately 40-60% of total invested proceeds

General Partner / Energy Developer:

- Will locate, install, and service equipment for 6 years
- Will arrange deal, obtain financing, and identify limited partner / tax-credit investor
- Will ensure proper accounting and legal oversight
- Fees earned (paid out of available cash flow for 6 years) total approximately 5-9% of equipment cost

Regarding equipment:

Two different types may be installed – photovoltaic arrays (PV) used to generate electric power and/or solar thermal collectors used to produce hot water for domestic consumption or space heating. In either case, the equipment is fully depreciated in approximately 5 years using the federal modified accelerated cost recovery system (MACRS). The equipment is owned for the first 6 years by the LLC entity as shown above, and thereafter by the customer. Our analysis assumed commercial system sizes of: a. 20 kilowatts (20 KW) for solar electric (PV) systems (producing 25,000 kilowatt hours per year – KWh/yr); and, b. 2500 square feet of collectors for solar thermal systems (producing 5,000 therms/year). Total installed costs for solar electric and solar thermal in the results shown here are: \$160,000.00 and \$150,000.00 respectively. These production and cost assumptions may prove conservative in practice. See also Appendix A for additional assumptive data concerning the federal tax credit, depreciation schedules, state incentives, tax rates, system finance, upfront legal and accounting charges, residual value assumptions, cost and benefit growth rates, and system operating costs.

Solar Electric

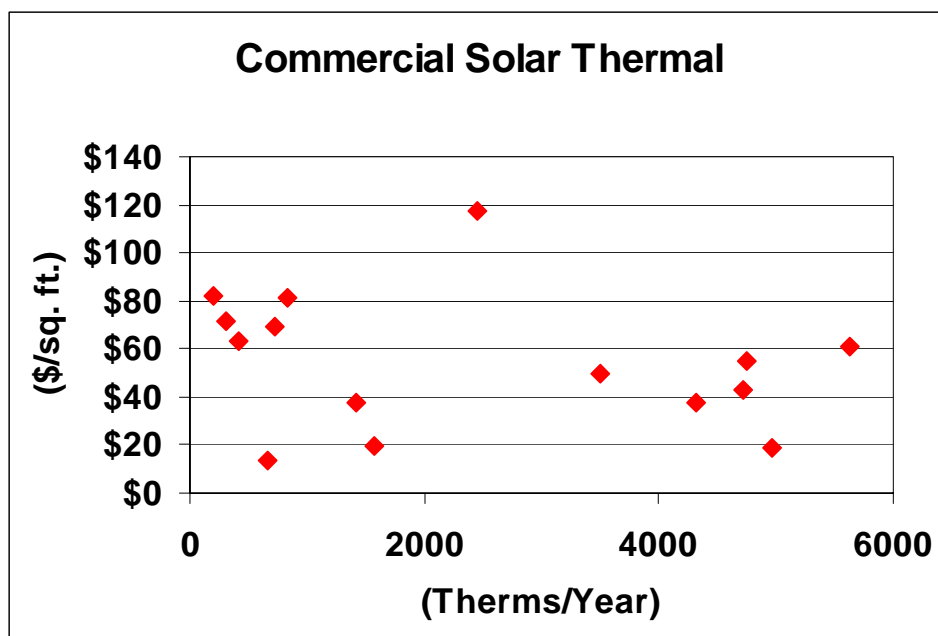
Despite steady advances in PV manufacturing technology and increasing numbers of skilled installers in the state of Wisconsin, there remains little financial-only justification for installing solar electric equipment in the hopes of lowering energy bills. Over a 20-year investment horizon, a potential customer would not see annual cash flow turn positive until year 16, while cumulative cash flow remains disappointingly negative throughout the analysis period. However, this assumes a year one starting price for electric energy at 10 cents per kilowatt hour (KWh) – a rate level generally prevailing in today’s markets in Wisconsin. If rates were assumed to be 19 cents per KWh or higher, the model shows a positive cumulative cash flow in year 20 (or earlier for higher rate levels). The October 2005 We Energies’ announcement introducing an *Energy for Tomorrow* Power Partner Program Solar Buy-Back rate at 22.5 cents per KWh successfully targets potential PV customer/generators looking for a sub-20 year payback on their investment. See Appendix B for more details on this attractive program.

Potential non-profit or environmentally-conscious customers may look not to their utility bills for energy cost comparisons, but instead may prefer to compare third-party ownership to outright purchase. These customers have already made the decision to purchase solar electric, and are looking for the least expensive way to proceed. In a discounted cash flow cost comparison (over a 20-year investment horizon) the third party model does indeed outperform simple outright purchase. (See also Tables 3 and 4 in the “Customers” section below.) The amount of possible savings depend most directly on the size of the system, but for the 20 KW system described herein, customers entering into third party ownership agreements would cut costs by 10-12%. (Moreover, for the first 6 years the burden of servicing the equipment would rest in the hands of the third party operator.) Encouraged by these results, we hoped a market would develop and our model could be the basis for a new alternative energy development business.

Solar Thermal

Financial-only results for solar thermal equipment are more encouraging than for PV. Over a 20-year investment horizon, a potential commercial customer would see annual cash flow turn positive in year 10, while cumulative cash flow (payback) turns positive in year 18. Results are very sensitive to assumptions regarding equipment costs and natural gas price levels. Interestingly, as shown in Figures 4 & 5 below, these variables have been highly volatile during the past three years. If one were to assume costs at the lower end of the chart shown and prices at the upper end, payback time could shorten by up to 10 years.

As with solar electric, the third party model outperforms a simple outright purchase with savings results similar to those seen with PV.



Source: Mark Daugherty, MSB Energy Associates and Focus on Energy

Figure 4. Wisconsin Solar Thermal Collector Costs (2004-2006)



Source: Futuresource.com website

Figure 5. Recent Natural Gas Prices

Task 2 – Accounting and Tax

Issue Review

There is little doubt that the third party ownership model depends upon federal tax credits and depreciation deductions for it to be feasible. Indeed, the tax-credit investor derives practically no real cash benefit – the investor puts up cash and gets federal forms in return! The developer (in conjunction with legal and accounting counsel) must ensure that the investor is truly able to fully utilize all tax benefits and thus realize an acceptable effective return from the investment.

The intricacies surrounding the proper allocation of income and loss, cash flow, credits, and liquidation proceeds are beyond the scope of this report. In the Section 42 tax credit real estate world and in any application of Energy Credits via the third party model considered here, experienced accounting advice is a must. However, certain tax and accounting issues strongly affect financial outcomes, and these are considered as follows:

- 1) Timing of the receipt of the credit: The sooner the investor is able to reduce payments to the internal revenue service, the higher the realized return. As soon as the equipment is placed in service, the third party owner is eligible to receive the credit. This could mean a corresponding reduction in the investor’s next corporate quarterly estimated payment.
- 2) Depreciation schedule: The following table describes the rate at which the equipment will be depreciated – resulting in tax losses that can offset corporate income.

Year	Deduction Amount
1	20.00%
2	32.00%
3	19.20%
4	11.52%
5	11.52%
6	5.76%

Source: Dept of Treasury, Internal Revenue Service, Pub. 946

Table 1. Accelerated Depreciation Schedule (half-year convention)

- 3) Recapture Period: Although the tax credit investor can reap the benefit of the tax credit as soon as one quarter into the deal, the IRS mandates that eligible energy property must remain in service for a minimum of five years. If not, the credit will be “recaptured” and the investor will receive a tax bill at least as large as the amount of the credit. This, combined with the approximately 5 ½ year depreciation schedule (MACRS, 5 year property with half-year placed-in-service convention), is the reason for our 6-year deal length assumption.
- 4) Federal Credit in Conjunction with State Grants: A number of issues are involved here, including: a. when to apply the federal energy tax credit – before or after a state grant (such as those available through Wisconsin Focus on Energy) is received, b. whether the state grant should reduce taxable basis, and; c. whether the state grant is taxable at the federal level. We reviewed forms and publications available on the IRS website. We consulted with national organizations such as the Clean Energy States Alliance (CESA) and the Solar Energy Industries Association (SEIA). We met with Tim Sherry of Suby, Von Haden & Associates, a Madison, WI – based accountant familiar with third party financing strategies. It was determined that: a. the federal tax credit is applied on the pre-state grant installed cost of the system, (and the federal tax credit reduces taxable basis by ½ the federal tax credit amount); b. the state grant does not reduce taxable basis; and, c. the state grant is counted as income, and thus is taxable at the federal level (in the case of commercial installations).
- 5) Other issues: 1) At the termination of third party ownership (at the end of year 6), the LLC structure must be liquidated and dissolved and the equipment properly transferred to the customer. 2) Capital gains tax may be due upon sale of equipment. 3) Correct calculations of internal rates of return will be critical for the tax-credit investor. 4) State tax issues (although having relatively small effect) need to be investigated. (They were ignored for purposes of this report.)

Solar Electric and Solar Thermal

Regardless of the type of installation, the tax and accounting issues are the same. PV arrays and solar thermal collectors both qualify as energy property, eligible for tax credits. (Also, ancillary systems for both also usually qualify -- for example: supports and trackers for solar electric and pipes and storage tanks for solar thermal.) Finding customer/owners who **both** want energy produced by the sun **and** are able to fully utilize the federal tax benefits is likely to prove difficult. Third party ownership enables the energy developer to tailor specific tax benefits to qualified (usually corporate) investors while separately recruiting alternative energy users. But the cost is high -- professional fees are significant in relation to overall project size. Total fees for accounting and legal advice can exceed 10% of total equipment cost.

Task 3 – Legal Review

Federal Rules Regarding Non-Profits

The impact of federal tax law as it relates to non-profit customers cannot be understated. It remains the primary reason we have postponed the creation of a new energy development business. This section will be devoted to a description of the issues.

Internal Revenue Code Section 50b3 turns out to be critical to our analysis. It states (in part): “No credit shall be determined under this subpart with respect to any property used by an organization which is exempt from... tax.” Although the legislative intent behind this sentence was not to restrict non-profit access to alternative energy, as will be shown below, certainly that is the result. As can be seen above in Figure 3, the property is indeed “used” by the non-profit customer via an equipment lease. But, the Code prevents third party owners from receiving tax credits – “no credit shall be determined” -- if the equipment lease is with a non-profit customer.

We looked for ways around this prohibition and considered the possibility of a service contract where the customer pays the third party owner for the delivery of electrical and thermal energy. Indeed, service contracts are anticipated by the Code (see Section 7701e3A) to be used as replacements for equipment leases, specifying “...any contract or arrangement between a service provider and a service recipient with respect to the sale to the service recipient of electrical or thermal energy produced at a cogeneration or alternative energy facility, which *purports to be a service contract*, shall be treated as a service contract.” [Emphasis added.] At first, this seemed to be the solution.

In Wisconsin, the State Administrative Code grants the Public Service Commission powers to regulate utilities. In return, utilities are granted oligopoly powers with regards to electricity generation. That is, **only** regulated utilities (and cooperatives not subject to PSC regulations) are permitted to sell **electrical** energy to retail customers. Unfortunately, there is no carve-out for alternative energy producers. Residential and commercial customers may produce electrical energy *for themselves* or even sell such energy to a utility, but they cannot sell it to another customer. (Only electrical energy production is so regulated; there is no such restriction on the sale of thermal energy.) Thus, a service contract crafted to garner federal tax credits (meeting the requirements of 7701e3A) would be deemed illegal in the State of Wisconsin. Most notable alternative energy development success stories are confined to deregulated states such as California, New York, and New Jersey where such restrictions on the sale of electric power do not exist. It is in these states that companies such as SunEdison are successfully pursuing third party ownership structures.

Three experienced attorneys assisted us in our research in this area, and although they disappointed us with their confirmation of the above regulatory environment (!), they were nonetheless generous with their time. They were: Wayman Lawrence of Foley and Lardner (who first identified the issue), Joseph Boucher, of Neider & Boucher, and Michael Allen.

Two silver linings exist in this otherwise gloomy legal review and may be worth pursuing by interested market participants: 1) given recent public enthusiasm for all things solar, now is the

time to encourage appropriate State of Wisconsin legislation permitting an alternative energy carve-out; 2) solar thermal does not suffer from such State regulation and if economies of scale can be realized in medium to large commercial applications (and are accompanied by high natural gas prices) third party structures can make economic sense.

Task 4 – Tax Credit Investors

Risk and Rate of Return

As with Section 42 tax credits, energy credits are typically only available to large corporate entities. From Stevens, et. Al., *A Developer’s Guide to the Low Income Housing Tax Credit*:

“All taxpayers can use the Tax Credits to offset taxes from passive income. However, the passive loss rules can restrict the ability of certain types of taxpayers to use the Credit to offset tax from other income. Therefore, it is important to determine whether an investor is an individual, S-Corporation, personal service corporation, closely held C-Corporation, or widely held C-Corporation.”

“The alternative minimum tax is a method of determining tax liability that is imposed on wealthy taxpayers to limit the use of various tax shelters and preferences. Although the Tax Credits are not a preference item for purposes of the alternative minimum tax, the Credits cannot be used to offset that tax... For some taxpayers, the alternative minimum tax will be a more limiting factor than the passive loss rules...”

As widely held C-Corporations are not subject to the passive loss rules and are typically not subject to the alternative minimum tax, they are potential purchasers of the credits. Although the analysis above was written in the context of real estate development, the principles can be also applied to alternative energy development.

Given that it is usually large corporations that will be participating in a third party business deal, and since tax credit structures for solar thermal and solar electric equipment are quite new, it comes as no surprise that investment returns in the middle teens will be required to motivate such institutional involvement. Although we use a 13% annualized rate of return target in the analysis shown here, it is probable that higher returns will be demanded by some investors.

Given insufficient customer interest in solar thermal energy installations (that suffer from lengthy payback periods) and regulatory hurdles facing PV, we only managed to have discussions with one potential tax-credit investor. In addition to the deal diagram shown in Figure 3 above, Table 2 below was used during our presentation:

SUMMARY INFORMATION FOR SAMPLE 6 YEAR TAX CREDIT DEAL

LEGAL FORM	Limited Liability Company owned 99.99% by Tax Credit Investor, .01% by Development Company	
TERM	6 Years	Example 1
INVESTMENT AMOUNT	\$60,000 to \$90,000 Depending on Customer Installation	\$ 75,000
TAX CREDIT AMOUNT (when "placed-in-service")	69% - 77% of Investment Amount	\$ 55,200
AVERAGE ANNUAL LOSS (6 year average)	17% - 25% of Investment Amount (Tax benefit at 35% rate = 5.95% - 8.75% of Investment Amount)	\$ 13,100
PERCENTAGE OF TAX BENEFIT / TOTAL BENEFIT	87% - 95% (The rest comes from distributed cash flow at 2%/year)	90%
IMPLIED TAX CREDIT "PRICE" (cents on the dollar)	1.25 - 1.45	1.36
IMPLIED TAX BENEFITS "PRICE" (cents on the dollar)	0.87 - 0.93	0.91

	Example 1	Example 2	Example 3	Example 4
Investment Amount	\$ (75,000)	\$ (75,000)	\$ (75,000)	\$(75,000)
Year 1	\$ 53,200	\$ 25,500	\$ 16,400	\$ 7,200
Year 2	\$ 17,100	\$ 45,200	\$ 36,000	\$ 27,000
Year 3	\$ 10,000	\$ 10,000	\$ 28,400	\$ 19,200
Year 4	\$ 5,400	\$ 5,400	\$ 5,400	\$ 14,500
Year 5	\$ 5,200	\$ 5,200	\$ 5,200	\$ 14,400
Year 6	\$ 725	\$ 725	\$ 725	\$ 9,900
IRR	12.0%	10.3%	8.9%	6.5%

Example 1 = Tax Credit Utilized in Year 1

Example 2 = Tax Credit Utilized 1/2 in Year 1, 1/2 in Year 2

Example 3 = Tax Credit Utilized 1/3 in Year 1, 1/3 in Year 2, 1/3 in Year 3

Example 4 = Tax Credit Utilized Equally in All 6 Years

Table 2. Investor Financial Analysis

Note the following:

- 1) As this is a copy of a presentation from an actual potential deal, some assumptions are slightly different from those used elsewhere in this report. (For example, generally we have assumed 1% per year in distributed cash flow; in the analysis directly above 2% is used.)
- 2) Four different return scenarios are shown because this particular investor was concerned they would be unable to fully utilize the tax credit in year 1. It is readily apparent that IRR's drop quickly when such suboptimal conditions exist.

Finally, note that we previously discussed tax and accounting rules that result in minimum deal lengths of 6 years. Certain socially conscious or environmentally motivated investors may be willing to commit to longer involvement. Our third party model is essentially a lease-to-own arrangement that insulates the customer from future energy rate increases. The greater the assumed rise in future energy prices, the greater the savings that accrue to the solar electric or solar thermal customer. Giving an investor some participation in these savings via longer deal

lengths (that is, increasing the time during which the third party owns the equipment, and thus, delaying the moment in time when the customer takes possession of the equipment) might encourage environmentally-conscious institutional money to get involved.

Task 5 – Customers

Presentation Materials

Tables 3 and 4 were commonly used during our meetings with prospective customers. (The numbers reflect our hypothetical deal with assumptions as described in “Results: Task 1 – Financial Model” above):

	SYSTEM FINANCIAL ANALYSIS					#DIV/0! <10yr IRR	#DIV/0! <15yr IRR	#DIV/0! <20yr IRR	VS. Purchase			
	7.0% Income PV	Lease Pmts	Loan Pmts	3.0% Equip Expns	Princ Bal	Cash Flow	Cum Cash Flow	Discntd Cash Flow	Cost> Grant>	(160,000) 35,000 Income (125,000)	Equip Expns	Discntd Cash Flow (125,000)
1	2,500	(15,552)	-	-		(13,052)	(13,052)	(12,140)	2,500	(525)	1,837	
2	2,675	(15,552)	-	-		(12,877)	(25,929)	(11,173)	2,675	(541)	1,852	
3	2,862	(15,552)	-	-		(12,690)	(38,619)	(10,274)	2,862	(557)	1,866	
4	3,063	(15,552)	-	-		(12,489)	(51,108)	(9,429)	3,063	(574)	1,879	
5	3,277	(15,552)	-	-		(12,275)	(63,383)	(8,637)	3,277	(591)	1,890	
6	3,506	(15,552)	-	-		(12,046)	(75,429)	(7,894)	3,506	(609)	1,899	
7	3,752	-	(8,665)	(627)	50,854	(5,540)	(80,969)	(3,380)	3,752	(627)	1,906	
8	4,014	-	(8,665)	(646)	46,148	(5,297)	(86,266)	(3,007)	4,014	(646)	1,912	
9	4,295	-	(8,665)	(665)	41,044	(5,035)	(91,300)	(2,658)	4,295	(665)	1,917	
10	4,596	-	(8,665)	(685)	35,510	(4,754)	(96,055)	(2,332)	4,596	(685)	1,919	
11	4,918	-	(8,665)	(706)	29,509	(4,453)	(100,508)	(2,035)	4,918	(706)	1,925	
12	5,262	-	(8,665)	(727)	23,002	(4,130)	(104,638)	(1,758)	5,262	(727)	1,931	
13	5,630	-	(8,665)	(749)	15,946	(3,783)	(108,421)	(1,500)	5,631	(749)	1,936	
14	6,025	-	(8,665)	(771)	8,296	(3,412)	(111,833)	(1,260)	6,025	(771)	1,941	
15	6,446	-	(8,665)	(794)	0	(3,013)	(114,846)	(1,037)	6,446	(794)	1,945	
16	6,898	-	-	(818)		6,080	(108,766)	1,949	6,898	(818)	1,949	
17	7,380	-	-	(842)		6,538	(102,228)	1,952	7,380	(842)	1,952	
18	7,897	-	-	(868)		7,029	(95,199)	1,955	7,897	(868)	1,955	
19	8,450	-	-	(894)		7,556	(87,643)	1,957	8,450	(894)	1,957	
20	9,041	-	-	(921)		8,121	(79,522)	1,960	9,041	(921)	1,960	
	102,489	(93,312)	(77,988)	(10,711)		(79,522)		(68,743)	102,489	(14,107)	(86,672)	
Savings of 3rd party deal vs. outright purchase >								17,930	11.2%			

Table 3. Customer Financial Analysis – Solar Electric

SYSTEM FINANCIAL ANALYSIS										#NUM! <10yr IRR	VS. Purchase			
										#DIV/0! <15yr IRR	Cost>	(150,000)		
										4% <20yr IRR	Grant>	25,000	Equip	Discntd
7.0%	Lease	Loan	Equip	Princ	Cash	Cum	Discntd	Grant>	Income	Equip	Discntd			
Savings	Pmts	Pmts	Expns	Bal	Flow	Cash Flow	Cash Flow		(125,000)	Expns	Cash Flow			
SoTherm									(25,000)		(125,000)			
1	5,556	(15,825)	-	-	(10,269)	(10,269)	(9,552)		5,556	(653)	4,560			
2	5,944	(15,825)	-	-	(9,881)	(20,150)	(8,573)		5,944	(672)	4,575			
3	6,361	(15,825)	-	-	(9,464)	(29,614)	(7,663)		6,361	(693)	4,589			
4	6,806	(15,825)	-	-	(9,019)	(38,634)	(6,809)		6,806	(713)	4,600			
5	7,282	(15,825)	-	-	(8,543)	(47,176)	(6,011)		7,282	(735)	4,607			
6	7,792	(15,825)	-	-	(8,033)	(55,209)	(5,264)		7,792	(757)	4,610			
7	8,337	-	(8,904)	(779)	52,253	(1,346)	(821)		8,337	(779)	4,611			
8	8,921	-	(8,904)	(803)	47,417	(785)	(446)		8,921	(803)	4,609			
9	9,545	-	(8,904)	(827)	42,173	(185)	(98)		9,545	(827)	4,603			
10	10,214	-	(8,904)	(852)	36,486	458	225		10,214	(852)	4,593			
11	10,929	-	(8,904)	(877)	30,320	1,148	525		10,929	(877)	4,593			
12	11,694	-	(8,904)	(904)	23,635	1,886	803		11,694	(904)	4,593			
13	12,512	-	(8,904)	(931)	16,385	2,678	1,062		12,512	(931)	4,593			
14	13,388	-	(8,904)	(959)	8,524	3,526	1,302		13,388	(959)	4,591			
15	14,325	-	(8,904)	(987)	0	4,434	1,526		14,325	(987)	4,589			
16	15,328	-	-	(1,017)		14,311	4,587		15,328	(1,017)	4,587			
17	16,401	-	-	(1,048)		15,353	4,584		16,401	(1,048)	4,584			
18	17,549	-	-	(1,079)		16,470	4,580		17,549	(1,079)	4,580			
19	18,777	-	-	(1,111)		17,666	4,576		18,777	(1,111)	4,576			
20	20,092	-	-	(1,145)		18,947	4,572		20,092	(1,145)	4,572			
	227,753	(94,950)	(80,133)	(13,318)		39,352	(16,894)		227,753	(17,540)	(33,183)			
Savings of 3rd party deal vs. outright purchase >							16,289	10.9%						

Table 4. Customer Financial Analysis – Solar Thermal

Results & Recommendations

In the vast majority of cases, non-profit and/or socially conscious customers remain the most interested users of alternative energy. As can be seen from the tables above, the financial-only returns are not impressive. However, the third party structure does produce superior financial returns **relative** to a simple outright purchase strategy. And, since ownership of the equipment typically reverts to the customer after year 6, it has been our experience that customers are interested in the concept. We met numerous potential PV users that were ready to pursue our strategy, but were hamstrung by Wisconsin’s regulatory environment. Regrettably, we did not pursue potential solar thermal customers – in part, because (although paybacks were slightly better than for PV) we felt it was a tougher sell. In particular, casual conversations indicated there are still customer acceptance issues with liquid-filled roof-mounted solar thermal collectors and the potential for long-term service concerns. (Solar thermal collectors generally have shorter warranties than do photovoltaic panels.) There are also significant uncertainties surrounding the solar thermal market. Can cost savings be realized at large commercial installations? Will dramatic swings in natural gas prices continue? But given the potential for dramatically shorter paybacks, it certainly would be our recommendation to further explore these issues.

Task 6 – Lenders

We met with Dennis Haefler of the Town Bank of Madison and discussed our concept in general terms with certain M&I Bank representatives. Both banks agreed that only lending institutions (and experienced personnel therein) familiar with tax credit structures would have an interest in pursuing deals. The lenders stressed the importance of credit quality. In order to meet underwriting guidelines, the third party structure must (among other things) include an agreement whereby the customer enters into an unconditional lease (where payments occur irrespective of system performance). This allows the lender to “face” the customer (who would, therefore, be required to meet the lender’s credit standards) and **not** the third party owner. (The third party owner is a single purpose LLC with no operating history and zero credit quality.) This raises an important question for future research – can the credit concerns of lenders be satisfied when non-profit customers are required to enter into service contracts (and not leases) with third party owners?

Towards the end of our research, we learned that MGE offers business customers the opportunity to participate in a “Shared Savings Program” which can apply in the case of alternative energy equipment. From the MGE website:

- A shared savings loan from MGE can finance energy and money-saving improvements to businesses.
- The money saved from these improvements hopefully offsets the cost of repaying the money to MGE.
- Out of pocket expenses are avoided.
- After the loan is repaid, the customer receives the entire savings benefit generated by the energy improvements.
- Interest rates are fixed for one year then adjusted with the prime rate annually. Terms up to 10 years.
- No down-payment, transaction charges, closing or filing fees.

It was confirmed by various Focus on Energy representatives, including Niels Wolter, that “money-saving improvements” include the installation of new solar thermal or solar electric equipment.

The terms of this program (including rate information not shown above) match closely the assumptions in our model. They include: 10-15 year amortizations, 5-10 year maturities, and rates at about LIBOR + 3-4%.

Conclusions

Widespread implementation of the third party development / financing model in the alternative energy industry here in Wisconsin depends most crucially on a more favorable regulatory environment. Giving non-utilities the right to sell renewable electric power to retail customers is the single most needed change. As third party models gain traction in the alternative energy industry, economies of scale will result. Repeated use of the model will encourage the standardization of contracts -- reducing currently punitive upfront project costs. Increases in equipment efficiency will help adoption and, (although not generally desired) so will higher natural gas and electric rates. The ability of the model to fully extract a variety of economic benefits is clear. Whether its time has come is yet to be determined.

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Appendices

Appendix A – Spreadsheet Model

PROFORMA FOR 6 YEAR ENERGY TAX CREDIT DEAL																														
INPUTS TO MODEL -- INFORMATION REGARDING INVESTOR, CUSTOMER, LENDER, EQUIPMENT, DEVELOPER, ETC.																														
			6 Ownership period = years			9.72% Lease rate in % of Total Installed Cost																								
			7.27% Discounting in summary performed at %			\$ 1.00 Amount paid at end of yr 6 to purchase equipment ownership entity (LLC)																								
			45.26% Equity contributed = % of total invested proceeds			\$160,000.00 Total Installed Cost																								
			35.00% Tax rate for investor			MACRS = Years 1 through 6:																								
			8.12% Loan rate in summary = %			20.00% 32.00% 19.20% 11.52% 11.52% 5.76%																								
			6 Term in years			\$ 1,525.00 Annual operating and admin expense in \$																								
			15 Amortization in years			\$ 35,000.00 State Grant (counted as income when rcvd but put on deposit thru year 6)																								
			54.74% Loan amount = % of total invested proceeds			\$ 55,267.33 Residual value set EQUAL to loan balance at end of year 6 + \$1.00																								
			Variable incentive management fee schedule as shown			30.00% Tax Credit, % of Total Installed Cost																								
			\$ 12,000 Upfront fees			50.00% Basis Reduction, % of Tax Credit * Total Installed Cost																								
			3.00% Growth rate, costs			1.00% Distributed cash flow																								
Year	Gross Oper Inc	State Grant Inc	Oper Expenses	Net Inc	Interest Income	Incentive Mgmt Fee	Mty Service	Cash Avail	Deprec.	Rough Mty Int	Rough Loan Balance	Tot Exps	Taxable Inc/Loss																	
0	3/16/2006																													
1	Mar-07	15,552	35,000	1,525	49,027	-	1,867	8,665	3,495	29,600	6,004	72,339	37,471	11,556																
2	Mar-08	15,552		1,571	13,981	-	1,867	8,665	3,449	47,360	5,780	69,454	55,007	(41,025)																
3	Mar-09	15,552		1,618	13,934	-	1,867	8,665	3,402	28,416	5,537	66,326	35,819	(21,885)																
4	Mar-10	15,552		1,666	13,886	-	1,867	8,665	3,354	17,050	5,273	62,933	24,189	(10,304)																
5	Mar-11	15,552		1,716	13,836	-	1,867	8,665	3,304	17,050	4,987	59,255	23,903	(10,067)																
6	Mar-12	15,552		1,768	13,784	3,341	1,867	8,665	6,593	8,525	4,677	55,266	15,068	2,057																
													IRR >>> 13.0%		1.292		<<< Price paid for credit													
													Net Inc. / Tax Save/ (Loss) (Expense)		Distributed Cash Flow		On Deposit		After-Tax Benefit		incl. Sale Benefit		IRR		Proceeds		Tax/Gain		Capital Acct Check	
1	Mar-07	11,556	(4,045)	48,000	620	2,875	44,575	44,575	(62,000)	55,267	148,000	148,000	62,000	55,267	62,000															
2	Mar-08	(41,025)	14,359	-	620	2,829	14,979	44,575	14,979	148,000	148,000	69,669	(24,000)	148,000																
3	Mar-09	(21,885)	7,660	-	620	2,782	8,280	44,575	8,280	148,000	148,000	(23,598)	(21,885)	69,669																
4	Mar-10	(10,304)	3,606	-	620	2,734	4,226	44,575	4,226	148,000	148,000	55,267	(10,304)	23,598																
5	Mar-11	(10,067)	3,524	-	620	2,684	4,144	44,575	4,144	148,000	148,000	55,266	(10,067)	23,598																
6	Mar-12	2,057	(720)	-	620	5,973	19,778	44,575	4,35	124,5	55,266	55,266	(1)	23,598																
													(69,669)		3,720		19,878		19,778		4,35		124,5		55,266		SumTo 0?			
													24,384		3,720		19,878		19,778		4,35		124,5		55,266		SumTo 0?			
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													24,384		3,720		19,878		19,778		4,35		124,5		55,266		SumTo 0?			
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													24,384		3,720		19,878		19,778		4,35		124,5		55,266		SumTo 0?			
													24,384		3,720		19,878		19,778		4,35		124,5		55,266		SumTo 0?			
													24,384		3,720		19,878		19,778		4,35		124,5		55,266		SumTo 0?			
													24,384		3,720		19,878		19,778		4,35		124,5		55					

Appendix B – We Energies Solar Buy-Back Rate Program

Energy for Tomorrow Power Partner Program Solar Buy-Back Rate:

“The Public Service Commission of Wisconsin (PSC) has approved a new solar buy-back rate, and the option is available to qualifying Energy for Tomorrow customers now through September 2008. The rate allows customers who install qualifying PV systems to sell their solar energy output back to us. We will buy the energy output of the PV systems for up to 10 years at a rate of 22.5 cents per kilowatt-hour. This solar buy-back rate is available to Energy for Tomorrow customers whose program participations level is at least as great as the anticipated annual PV output. Eligible equipment must be rated for an aggregate generation capacity of not less than 1.5 kilowatts DC and not more than 100 kilowatts DC. The customer must comply with the various applicable national, state and local electrical codes, rules and regulations, as well as the electric service rules and regulations of We Energies, the requirements of Wisconsin Administrative Code Chapter PSC 119, the Distributed Generation Interconnection Agreement, and the Energy for Tomorrow Power Partner Program Agreement. Eligible customers can sign up for this rate option any time between October 2005 and September 2008. Customers participating in the solar buy-back rate program must enter into a 10-year contract with We Energies. This rate option is limited to the first 500 kilowatts of total generation capacity enrolled in the program.”