SPECIAL UPDATE

CHADBOURNE & PARKE LLP

Strategies for Starting Construction

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The race is on to get renewable energy projects in the United States under construction by year end to qualify for Section 1603 payments from the US Treasury.

Developers are pursuing different strategies.

It is not enough merely to have made a large down payment toward turbines, modules or other equipment for the project by year end. A senior Treasury source said the government is looking for economic activity during 2010. A developer must show work at the site or at the factory on equipment for the project during 2010.

The grants are 30% of the project cost and are paid on new wind, solar, geothermal, biomass, landfill gas, waste-to-energy, ocean energy and fuel cell projects that are completed in 2009 or 2010 or that start construction in 2009 or 2010.

Grants of up to 10% of project cost are also paid on small cogeneration facilities of up to 50 megawatts in size.

Projects that merely start construction in 2010 must be completed by a deadline. The deadline is 2012 for wind farms, 2016 for solar, small cogeneration and fuel cell projects and 2013 for other types of projects.

Congress may ultimately give companies more time. A bill in the House would give developers another two years through December 2012 to start construction without changing the deadlines to complete projects. However, the odds of such an extension at this point are probably a little better than 50%. Most developers are taking steps to start construction in case there is no extension.

Two Ways

The Treasury Department explained what it means to start construction in written guidance on March 15. The guidance left many unanswered questions. The Treasury answered some of the questions since then in private meetings and in public statements at industry conferences.

There are two ways to show construction started.

One is to show there was "physical work of a significant nature" on the project during 2010.

The Treasury said that "the beginning of excavation of the foundation, the setting of anchor bolts into the ground or the pouring of concrete pads of the foundation" at the site count as such work. It also counts if physical assembly of major components starts off site at a factory. However, the developer must have a "binding" contract in place before such work starts in order to count work done by an equipment supplier or other contractor.

To be "binding," the contract must be more than an option to choose equipment later. The Treasury said "the amount and design specification of the property to be purchased" must be clear from the contract. The contract should not limit damages if the developer walks away to less than 5% of the contract price. Any conditions to performance by a party must be outside the control of the parties. Thus, for example, if the developer must give a notice to proceed before the contractor will start work, the notice should be given before year end.

It is not clear whether a contract between related parties can be "binding." It is best to assume not.

There is a risk that amending the contract after work starts could lead to loss of grandfather rights. The guidance suggests that it does, but the Treasury may still be thinking about this issue. The guidance said that any amendment must be "insubstantial." Minor modifications in design are not a problem; an example is the later addition of a "cold weather package for wind turbines." The IRS used a similar standard in 1986 after the investment tax credit was repealed. Projects that were under binding contract before the repeal to be built still qualified for an investment credit provided there was no "substantial modification" of the contract later. An amendment that increased the contract cost by more than 10% was considered substantial.

Ellen Neubauer, the cash grant program manager, said at a wind industry finance conference in New York in early April that it is the start of physical work of a significant nature to construct roads on the project site. The roads must be used to transport equipment rather than solely to provide access for people working at the site.

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She said it is also the start of physical work for the developer to lay three concrete pads for a wind farm that will consist of 65 turbines or for the turbine vendor to commence physical assembly of at least one turbine for the project at the factory under a binding turbine supply agreement signed before physical assembly starts.

It is not clear whether it matters if work starts in 2010 but then nothing is done for another year at the site or at the factory on the turbine order. Some senior Treasury staff are not bothered by such a delay; they stress that the Treasury guidance said all that is required in 2010 is the "beginning" of construction or else they view the deadline to complete the project as a check on how long a delay is possible. However, there may be a risk if the facts show with hindsight that construction did not truly get underway.

Developers who plan to rely on physical work to start construction plan to work steadily once construction starts, although possibly at a slower pace than normal. For example, a wind farm that might normally take six months to construct might take 12 to 18 months under an elongated construction schedule.

There is an assumption in each of these cases that the developer will choose to treat all the turbines or solar arrays as a single "property" so that the work done in 2010 counts as the start of work on the entire project. The Treasury treats each turbine or solar array that can operate independently as a separate property. Therefore, work must start independently on each. However, a developer can choose to treat multiple turbines or solar arrays that are owned by the same company and are on the same site as a single project.

5% Test

The other way to show that construction started is to "incur" more than 5% of the total project cost by December 2010.

A developer does not have to satisfy both the physical work test and the 5% test; either is enough.

Costs are considered "incurred" when the developer pays them, but only if he expects the equipment or services for which payment was made to be delivered within 3 1/2 months after payment. Otherwise, he must wait until delivery to count the costs. Thus, for example, a payment made on December 31, 2010 counts in 2010 as long as the equipment is reasonably expected to be delivered by April 15, 2011. Otherwise, the payment is treated as spending in 2011 after delivery in 2011. Delivery may include transfer of title to equipment that has been manufactured, but that the manufacturer is holding in storage at the site.

The developer can look through any "binding" contracts with equipment suppliers or other contractors that are signed before manufacture of the equipment or other work starts and count spending by the contractor using the same principles. Thus, for example, the developer can count spending by a turbine vendor on components or services, but the spending counts at time of payment only if it is reasonable to expect delivery of the components or services to the turbine vendor within 3 1/2 months of payment. Otherwise, costs are incurred only as equipment or services are delivered to the vendor. This will require getting equipment suppliers to certify how much they spent toward manufacture by year end this year.

To show how this works, suppose a developer signs a binding turbine supply agreement in mid-2010 for turbines to be delivered in late 2011 and makes a 20% down payment. The turbine vendor then spend 15% on components for the turbines. The developer cannot count the 20% down payment in 2010, but can count the 15% spent by the turbine manufacturer provided the manufacturer expects delivery of the components within 3 1/2 months of payment.

The manufacturer would also have to link the components to the turbines ordered under the contract.

Two large wind turbine manufacturers told the Treasury at a meeting in early April that it is impossible to certify that components ordered this year are for particular turbines that will be manufactured next year or the year after. One said that components are ordered well in advance of use based on expected orders. Ninety-five percent of the components in a turbine are interchangeable across turbine types. The manufacturer said components are not assigned to a particular turbine until roughly a week before manufacture starts. Actual manufacture of the turbine takes five days.

This has caused wind developers to take a harder look at starting physical work at the site or else requiring manufacturers to manufacture at least one turbine for each project in 2010 in order to commence construction under the physical work test.

The developer must incur more than 5% of the actual project cost, not the expected cost in 2010. A developer would be wise to incur more to leave a margin for error. However, it may be possible if project costs spiral to fix the problem by choosing not to include one or */ continued page 3*

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more turbines or solar arrays as part of the project on which a cash grant is taken. For example, the developer has the option in a 65-turbine wind farm of treating 63 turbines as one project and two turbines as a separate project.

Other Issues

The Treasury is still thinking about several issues. They may be addressed in questions and answered posted to the Treasury website. Any such answers are unlikely to be posted before June.

The Treasury has not sorted out how to deal with frame or master agreements that larger wind companies use to buy turbines for multiple projects. The agreement is usually signed by a parent company. Closer to the time turbines are manufactured, "daughter" contracts are signed with project companies essentially designating turbines for use in particular projects and copying over the terms from the master agreement into each standalone contract. Among the issues are whether spending by the parent company carries over to the subsidiary and by when turbines must be designated for use in particular projects.

The Treasury is looking for a way that it can confirm to developers that they started construction. A developer can apply for a grant after starting construction, but before the project is completed. The Treasury said last year that it planned to respond in such cases whether it agrees the project is under construction. However, it has not sent any such confirmations to date despite receiving more than 100 applications. In all the cases to date, the agency concluded that the projects would be completed by December 2010 so it was a moot issue when construction started. Whether it is able to send such confirmations in the future is a resource issue. It is looking into what is possible.

Developers should ask equipment suppliers to certify to spending or the start of physical assembly as soon after the threshold for starting construction is reached in 2010, and then the developer should apply to Treasury for a grant. This may leave time to fix any problems before year end if the Treasury responds promptly. Even if the response is not received until early 2011, at least the issue whether construction started in time can be taken off the table.

Geothermal companies that started drilling before 2009 for power plants that will not be completed until after 2010 received some relief in March. The Treasury said that it is not the start of physical work on a project to do "test drilling of a geothermal project." It also said that a developer "may treat physical work of a significant nature as not having begun until more than 5 percent of the total cost of the property has been paid or incurred."

Senior Treasury staff told Chadbourne at the same time that it is the start of physical work on a geothermal power plant to drill a fully-functioning production well whose output will be dedicated to the power plant. An example of such a well is one drilled to production depth and diameter and for which permanent casing, a tree or other above-ground equipment and flow controls have been installed and tested.

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