

Internal Revenue Service

Department of the Treasury

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Date:

October 10, 2001

LEGEND

Taxpayer =

State A =

Date B =

City C =

Department D =

County E =

Commission F =

Organization G =

Company H =

Organization I =

State J =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

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p =

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x =

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Dear :

This letter is in response to Taxpayer's authorized representative's letter of June 4, 2001, and subsequent correspondence concerning your request for a private letter ruling pertaining to § 45 of the Internal Revenue Code. Taxpayer has provided the following representations:

FACTS:

Taxpayer is a limited liability company organized under the laws of State A. Taxpayer maintains its books and records on the accrual method and ends its accounting year on Date B.

Taxpayer will construct, own, and operate a wind-powered, electric generation project. The project will be located in City C and it will have a total generating capacity of a. It will be comprised of b turbines generating facilities, each having a maximum c megawatt generating capacity.

Each turbine is mounted on a tubular steel tower. The towers will range between d to e meters in height. Each tower is secured to a concrete pad or foundation. The size and weight of the concrete foundation pad will match the requirements of the tower, turbine, rotors, and soil conditions. The blades which attach to the turbine's rotor hub will have a circular sweep of d to e meters.

The turbines with their towers will be arranged in rows along a ridge line. Each turbine will be placed so as to secure optimal wind conditions to power the blades. The turbines will also be spaced to minimize air turbulence and interference for the entire array. The exact spacing depends on topography and wind conditions at the site.

Each facility is activated to generate electricity when the control anemometer on the turbine senses sufficient wind speed. The turbine control and yaw drive then turn the turbine towards the direction of the wind. As the wind passes through the blades, it creates a lifting force. This lift moves the blades which in turn rotate the rotor assembly. Gear boxes transfer the power of the spinning rotor to induction generators. The resulting electric power is fed into a transformer located at the base of the turbine to step up the current. The electricity is subsequently fed into a central transformer and from there the power is transmitted to a substation for delivery to the electric purchaser.

Since the wind is not constant throughout the turbine array, the turbines will be generating power at different levels. Therefore, each turbine must operate independently of its neighbors and each has its own control mechanism. A central computer tracks and records the operation and production of all the turbines in the

project.

In f, Taxpayer's corporate affiliates completed the advance wind data collection proving the technical feasibility of the project's site and secured long-term use easements from the underlying land owners for the construction of the project. The corporate affiliates also completed the required environmental assessment studies. In addition, they are in the process of obtaining the necessary permits from Department D, County E, and the townships. Construction is anticipated to be completed in g and all b generating facilities will be placed in service prior to i.

Based on the estimation of annual mean windspeed at the site, utilizing anemometer data, the application of the mean windspeed distribution to the power characteristics of the wind turbine, and standard industry calculations, Taxpayer estimated that the generating facilities in the Project will produce approximately j kilowatt hours of electricity annually. Taxpayer executed a contract on k to sell this electricity to a company unrelated to the Taxpayer or to Taxpayer's affiliates.

In l, Commission F, an agency of the state government, authorized the creation of Organization G, pursuant to an order approving the restructuring plan for Company H, a privately-owned utility company. Under the terms of the approval, Company H will fund Organization G's activities with regular payments based on an assessment in the transmission and distribution tariff for each kilowatt hour of electricity which Company H delivers during a specified period. Organization G will use these payments to "promote the development and use of renewable energy technologies, energy conservation and efficiency, and economic development projects which promote clean energy."

A h-member board of directors oversees Organization G's energy activities. The parties to the utility's restructuring case nominate the directors. The commission approves the nominees, who take office after such approval. The Organization G board of directors operates under by-laws which are approved by Commission F. Any change to the by-laws must also be approved by Commission F.

Although a board of directors oversees Organization G, Commission F placed Organization G under the administration of a publicly supported, nonprofit corporation called Organization I. Among its administrative responsibilities for Organization G, Organization I drafts programs and annual budgets, implements and monitors approved programs, and maintains financial records. Organization I has wide latitude in administering the programs and committing program funds. If Organization G's board of directors determine that Organization I has breached its fiduciary duties to Organization G, Organization G's board with Commission F's approval, may remove Organization I as administrator.

After Commission F had approved Company H's initial restructuring plan in l and after the creation of Organization G, Company H applied for permission to create a holding company which would merge with another corporation. To obtain the

Commission F's approval of this merger, Company H agreed, among other things, to provide additional financial support to Organization G. This support had to be borne by the company shareholders; the cost could not be passed through to the ratepayers. This additional support was specifically designated for the development of new wind powered generation facilities within State J.

On n, Organization G's board of directors adopted a motion allocating a part of Company H's payment for the first phase of a wind development program. Under this phase, Organization G would assist the development of new wind generation facilities through production incentive payments. As stated by the Organization G board of directors, this program:

will provide wind energy production incentives of up to t cents per kilowatt-hour for the electrical output of eligible and approved new wind projects located in State J for the first v years of project operation. These incentive payments shall be based on actual wind energy production during this v-year period. Payments will be made on a quarterly basis upon receipt by Organization G of proof of the project's actual electrical production for the previous calendar quarter.

Organization G invited interested parties to submit applications describing their proposed generation facilities, technical expertise, and level of incentive payment desired. The applications had to include the estimated operational budget, cash flow, and balance sheet for the proposed facilities. Organization G would favorably view applications requesting an incentive payment lower than t cents per kilowatt-hour. If the total incentive payments requested by approved projects exceed available funds, Organization G retained "the right to negotiate the terms of the incentives."

On o, Taxpayer's corporate parent successfully applied for support under this program. Taxpayer's parent signed Organization G's "Wind Energy Production Incentive Agreement" on p, which sets out the terms and conditions of the award. Taxpayer's corporate parent is in the process of transferring the award agreement to Taxpayer with Organization G's approval.

This application had requested Organization G to provide a u cent incentive payment for each kilowatt-hour produced at the project in the first v years of operation. Based on the project's estimated g kilowatts hours of yearly production, the request would have amounted to production incentive payments totaling more than r over the program's v years. Organization G's production incentive payments would supplement the sale price which Taxpayer will receive for electricity. In effect, the incentive payment would enhance the project's revenues and profit to insure the project's economic feasibility.

Seven other applicants applied for Organization G's production incentive payments. Total requests exceeded Organization G's funding for the program. Consequently in its award to Taxpayer's parent, Organization G provided a production

incentive award of only s rather than the r sought by Taxpayer. To compensate for the smaller award, Organization G set the incentive payment rate at a higher rate of c cents per kilowatt hour rather than the u cent Taxpayer requested. The c cent award rate covers about w kilowatt hours of production equal to the saleable output of two-and-a-quarter years; whereas the u cent requested rate would have covered about x kilowatt hours, the saleable output for approximately y years.

The higher rate, however, allows the incentive payment to be earned more quickly. Organization G will also pay the award in advance. Rather than making quarterly incentive payments as the electricity is produced, Organization G will provide the total of \$ s production incentive payment to Taxpayer upon proof that the project construction is completed and upon proof that sale of wind generated electricity has commenced. The advance payment confers the present value of the full award rather than a discounted value for payment over an extended period of time.

This advance payment is conditional one which must be repaid to the extent that the project fails to produce and sell the required electricity. The right to the advance payment becomes unconditional, that is the obligation to repay the s to Organization G is released, as the required power is generated and sold.

Before Organization G makes the advance production support payment, it requires two unrelated parties to provide documentation that the project actually is producing electricity to qualify for the payment. First, Organization G requires that a professional engineer, independent of the Taxpayer and registered to practice in State J, physically inspect the project and its operations. The engineer is to certify in the form specified by Organization G that the project "has begun generating and selling electricity, that it is reasonably good operating condition and generating at or near (within 15%) of the designated capacity...and that it should continue producing at or near this designed electrical capacity for at least y years."

Second, Organization G requires that the company which buys the project's electricity certify that it is actually buying the production generated by the project. Under penalty of perjury, the company is to declare to Organization G that it is purchasing electricity from the project. The buyer is also to specify the date on which it began to receive and purchase the project's electricity.

Furthermore, to guarantee that the project actually produces all the electricity covered by the advance production incentive payment, the Taxpayer must deposit a s letter of credit with Organization G. The letter of credit serves as security to reimburse Organization G in the event the project fails to generate sufficient wind energy to have earned the production incentive.

Taxpayer's letter of credit is reduced quarterly by the amount of electricity which the project has generated and sold multiplied by the c cent kilowatt hour incentive payment rate. To that end, within y days of the end of each calendar quarter, Taxpayer must report to Organization G the number of kilowatt-hours of electricity produced and

sold during that quarter. The report must be in the form specified by Organization G and the declarations in the report are to be made under penalty of perjury. Upon receipt of this report, Organization G will notify the issuer to reduce the letter of credit by an amount equal to the c cent per kilowatt hour production incentive rate times the number of kilowatt-hour electricity reported for that quarter. In this way, the Taxpayer will gradually reduce the security it posts in the letter of credit. The letter of credit, with Taxpayer's obligation to repay, terminates when Taxpayer's project generates and sells the total kilowatt hours of electricity covered by the s production incentive payment.

The Organization G price incentive agreement sets deadlines for Taxpayer to achieve six, so-called performance milestones: 1) obtains all necessary permits for the proposed project, 2) secure full project financing, 3) contract for the project's major equipment, 4) start construction, 5) execute an interconnection agreement to secure transmission access to a utility grid, and 6) start electricity generation. To enforce these performance milestones, Organization G required Taxpayer to post a \$ z performance bond. Organization G would reduce the total bond by one-third after milestones (1) and (2) are attained, by another third after milestones (3) and (4) are met, and by the final third after sixth milestones (5) and (6) are reached.

The price incentive agreement allows Organization G to collect on the performance bond outstanding, if Taxpayer fails to achieve the performance milestones. Organization G can also collect under certain other conditions such as the commencement of involuntary bankruptcy proceedings against Taxpayer. If Taxpayer were to misstate the quarterly production report in a purposeful and materially inaccurate manner, this would also allow Organization G to immediately collect on the bond.

RULING REQUESTED

Taxpayer's § 45 renewable electricity production credit for this project will not be offset by the wind energy incentive payments received from Organization G.

LAW AND ANALYSIS:

Section 45(a) provides that the renewable electricity production credit for any taxable year is an amount equal to the product of 1.5 cents multiplied by the kilowatt-hours of specified electricity produced by the taxpayer and sold to an unrelated person during the taxable year. This electricity must be produced from qualified energy resources and at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service.

Section 45(b)(1) provides that the amount of the credit determined under § 45(a) is reduced by an amount that bears the same ratio to the amount of the credit as (A) the amount by which the reference price for the calendar year in which the sale occurs exceeds 8 cents bears to (B) 3 cents. Under § 45(b)(2), the 1.5 cents in § 45(a) and the 8 cents in § 45(b)(1) are each adjusted by multiplying the amount by the inflation

adjustment factor for the calendar year in which the sale occurs.

Section 45(b)(3) provides that the amount of determined under § 45(a) with respect to any project for any taxable year (determined after the application of § 45(b)(1) and 45(b)(2) shall be reduced by the amount which is the product of the amount so determined for such year and a fraction— (A) the numerator of which is the sum, for the taxable year and all prior taxable years, of-

(i) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the project, (ii) proceeds of an issue of State or local government obligations used to provide financing for the project the interest on which is exempt from tax under § 103, (iii) the aggregate amount of subsidized energy financing provided (directly or indirectly) under a Federal, State, or local program provided in connection with the project, and (iv) the amount of any other credit allowable with respect to any property which is part of the project, and

(B) the denominator of which is the aggregate amount of additions to the capital account for the project for the taxable year and all prior taxable years. The amounts under the preceding sentence for any taxable year shall be determined as of the close of the taxable year.

Section 45(c)(1) defines qualified energy resources as wind, closed-loop biomass, and poultry waste. Section 45(c)(3) defines a qualified facility as any facility owned by the taxpayer that originally is placed in service after December 31, 1993 (in the case of a facility using wind to produce electricity), December 31, 1992 (in the case of a facility using closed-loop biomass to produce electricity), or December 31, 1999 (in the case of a facility using poultry waste to produce electricity), and before January 1, 2002. See § 45(d)(7) for rules relating to the inapplicability of the credit to electricity sold to utilities under certain contracts.

Concerning the issue of whether any renewable electricity credit allowed by reason of Taxpayer's project should be offset by the wind energy incentive payment received from Organization G, we note that § 45(b)(3) requires a reduction in credit in proportion to a facility's capital cost which is financed by government grants, proceeds of government issued tax-exempt obligations, subsidized energy financing under a government program, and any other credits.

In the present case, we conclude that Organization G's wind energy incentive payment is not pursuant to a governmental program and thus not subject to offset under § 45(b)(3). Specifically, Organization G is a non-governmental body that derives its funding from a private, investor owned utility company, Company H. We believe Commission F's approval of the settlement agreements based on funding from Company H does not transform Organization G's wind energy development program into a state governmental function or program.

No opinion is expressed or implied regarding the application of any other provision of the Code or regulations. Specifically, we express no opinion on whether Taxpayer's project qualifies for the renewable electricity production credit under § 45.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in this ruling. See section 12.04 of Rev. Proc. 2001-1, I.R.B. 1, 46. However, when the criteria in section 12.05 of Rev. Proc. 2001-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

In accordance with Taxpayer's power of attorney, we are sending a copy of this letter ruling to the Taxpayer's authorized representative.

Sincerely,
Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Attachments:

- Copy of this letter
- Copy for section 6110 purposes