

THE LAW OF WIND
—Community Wind—

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Although the majority of wind development projects in the United States are spearheaded by larger development companies, “community wind” has emerged as a method by which local landowners and the community can be involved in every stage of development and have a more substantial ownership stake in the project. Community wind has aspects of entity formation, ownership structure, and financing that are unique and that require a close look at the goals of the project and the opportunities that such projects provide.

I. What Is “Community Wind”? A community wind project is a wind project developed by local farmers, ranchers, and investors, or local governments or educational institutions, rather than national developers. A community wind project will yield a return on equity for investors from the local community, not just wind lease payments or local tax revenue. Community wind projects have historically been small in size, but second-generation projects are around 100 MW and third-generation projects are expected to be 350 MW and larger. Publicly owned projects are usually quite smaller and may provide lower-cost energy for local governments or community institutions. The Midwest has been a leader in the successful development of community wind projects, but such projects are attracting greater interest throughout the United States. These projects have features similar to the development of ethanol and biodiesel projects, which are often owned and operated by cooperatives or other local business interests.

II. Structuring and Developing Your Community Wind Project. Before raising any capital, entering into contracts, or applying for grants, the project team should organize a legal entity to shield the individual team members from liability. A community wind project will most likely consider two entity forms in structuring its business: a limited liability company (“LLC”) or a cooperative. The project team must decide early in the process which entity best meets the needs of the project. If the project decides on the LLC, it will likely be organized under Delaware law unless the project decides to organize in its “home” state to be eligible for certain state incentives or if it is planning to rely on an “intrastate” exemption in its equity offering. If the project decides to organize as a cooperative, it will typically file in its “home” state. Each project should carefully consider the advantages and disadvantages of each structure, as well as other organizational structures, to determine which form of entity will best help the project achieve its objectives.

An *LLC* is a business entity formed by one or more persons who may actively participate in management of the business while retaining limited liability for its obligations. The owners of an LLC are referred to as its “members.” Members can manage the business themselves or elect managers, who may be members or nonmembers, to operate the business in accordance with an operating agreement among the members. The typical community wind project is “manager-managed” with a board of managers. Members’ voting rights are usually based, in some variation, on their respective investment. The LLC is generally a pass-through entity for federal income tax purposes, with no tax at the entity level and a pass through of gains, losses, and tax credits to the members.

A *cooperative* is a corporate business entity organized for the collective marketing or purchasing of products and the joint benefit of all members. Similar to an LLC, the owners of a cooperative are referred to as its “members.” Different from an LLC, the cooperative is governed by a board of directors and, with few exceptions, each member has only one vote regardless of his or her investment. Corporate cooperatives must be structured and operate on a “cooperative basis” as determined by Subchapter T of the Internal Revenue Code. By operating on a cooperative basis, a cooperative is allowed to deduct patronage-sourced income that is allocated on a patronage basis, therefore avoiding taxation at the entity level. This is discussed in greater detail below.

A. Capitalization and Securities Considerations.

LLC. The capitalization of a project requires strict compliance with federal and state securities laws. A community wind project organized as an LLC will likely have two offering rounds for seed capital. The first round offering will be made only to the “founders”—those who have been involved with the development of the project to date and who are currently serving as officers or managers of the LLC. This round of capitalization can be completed quickly and inexpensively via a short-form subscription/investment agreement relying on an exemption pursuant to the federal safe harbor provided by Rule 506 of Regulation D of the Securities Act of 1933 (“Rule 506 exemption”) for transactions not involving a public offering. In general, sales can be made to an unlimited number of accredited investors (as defined in Regulation D) and up to 35 nonaccredited investors, there can be no general solicitation or general advertising, and the securities cannot be resold unless otherwise registered or otherwise exempt. States can require notice filings be made for any offers or sales made in accordance with Rule 506.

Community wind projects will generally raise \$250,000 to \$500,000 in the founders’ round. This money will be used to evaluate the feasibility of the wind project on a preliminary basis. Standard feasibility analysis will include research of the wind resource, interconnection and transmission issues, property requirements and potential landlords, initial analysis of permitting requirements, preliminary project design and turbines, preliminary discussions with utilities or other potential power purchasers, and preliminary analysis of financial feasibility.

A positive feasibility study will move the project into the second round of seed capital financing to fund initial project development efforts. These development efforts include continued assessment of the wind resource (a minimum of one year of data will be required by prospective power purchasers, lenders, or tax equity investors); obtaining site control through wind leases and easements; filing of the interconnection, transmission, and permit applications; conducting avian, archaeological, threatened and endangered species, wetlands, and other studies; and continued discussions with potential power purchasers. A typical project will need \$2 million to \$4 million to cover these preliminary development costs.

Although the LLC may raise additional capital from its founders, it will also seek investment from other landowners and investors. The Rule 506 exemption will likely be used again for this capital raise. Because of the need to seek investors outside the founder group and the restriction on general solicitation, this equity round could take up to six months.

For the community wind project, the obtaining of site control by the LLC will focus on entering into wind leases or wind easements with its member landowners, as discussed further in Section IV. With capital in place to fund initial project development, the LLC must decide whether to attempt to fund the project with a primary equity round from numerous investors or secure an investment from a larger developer with access to financing and wind turbines, as well as construction and operations and maintenance expertise. A significant hurdle to raising capital from numerous investors is the amount of capital that is needed to fund a project. For example, the cost of a 100 MW project may exceed \$200 million. To raise this amount of capital, the project would most likely need to make general solicitations to hundreds of investors. This would require a federal registration of the securities, which is costly and time-consuming. Even then, there is no guarantee that the project would be able to raise the necessary capital. Another obstacle is the utilization of the production tax credit (“PTC”), as discussed in Section III.

Cooperative. The capitalization of a community wind project organized as a cooperative is driven by how returns may ultimately be returned to the member-investors on a patronage basis to avoid entity-level taxation. The key is determining the “patronage transaction” for a community wind project.

For biofuels projects organized as a cooperative, the equity investment by a member is typically tied to that member’s obligation to deliver a specified commodity, *i.e.*, the “patronage transaction.” For example, an ethanol project organized as a cooperative may require each member, under the terms of the bylaws and marketing agreement, to annually deliver one bushel of corn for each unit owned, and each member’s allocated income would be based on patronage. Note that because the delivery obligation is tied to investment, each member’s allocation, although based on patronage, is proportional to his or her investment in the cooperative.

It is not so easy to define the patronage transaction for a community wind project. Wind is not a tangible commodity that can be consistently delivered. That being said, one could define the patronage transaction as the acreage a member provides to the cooperative for wind development, regardless of whether turbine(s) are located on the member’s property. (Note: This requirement alone severely limits the equity capitalization of the cooperative because it narrowly defines the patronage class to landowners.) For example, 20 landowners who, in the aggregate, were willing to commit an aggregate of 8,000 acres, could organize as a cooperative association. To cover estimated preliminary project development costs of \$4 million, the cooperative could require that each landowner invest \$500 for each acre the member was committing to the cooperative. However, this would require an average investment by each landowner of \$200,000. Although the cooperative could seek investment from nonlandowners, this would be difficult because state and federal statutes have legislated that outside investment should not receive more than an 8 to 10 percent dividend on equity. These restricted cooperative dividend rates on equity are not likely to attract investors to a start-up business.

If a project wishes to operate as a cooperative and also seek outside investment, it should examine the new cooperative statutes that have been adopted by Iowa, Minnesota, Tennessee, Utah, Wisconsin, and Wyoming. For example, cooperatives organized under Minnesota Statutes chapter 308B permits producers (landowners) and nonproducers to be members so long as certain protections are in place for the benefit of the producer members. The 308B cooperative can elect to be taxed as either a cooperative or a partnership, and the securities implications of raising capital for a 308B cooperative would be similar to an LLC. This type of cooperative is discussed in greater detail in chapter 3, “Renewable Energy: Trends in Finance and Business Structures” in *The Law of Cooperatives* (Stoel Rives 2007 ed).

A community wind project that moved forward under a cooperative structure would face similar securities laws issues as an LLC. The cooperative would likely rely on the Rule 506 exemption for seed capital financing and would need to register the securities should it seek significant outside investment from numerous investors.

Once operational, the cooperative would likely make lease payments to those members who have turbines located on their property. All members, regardless of turbine locations, would then participate in the allocation of income based on patronage. Patronage under this scenario would be based on the proportionate number of acres each member commits to the cooperative. For example, if a member commits 400 of the 8,000 total acres, that member would receive 5 percent of the allocable income.

Although a traditional cooperative or a 308B cooperative may be used for community wind development, the structuring and capitalization will likely prove more difficult than an LLC. First, the cooperative structure is new to the wind industry and will demand a learning process that may take longer than outside equity investors are accustomed to. Second, the tax issues associated with the cooperative model and the project’s ability to utilize the PTC and other tax incentives as a cooperative may prove too complicated and time-consuming. Regardless, the

cooperative model should be considered as an alternative as it may be a better option than an LLC for a community wind project in certain circumstances.

Electric cooperatives, sometimes referred to as RECs or rural electric cooperatives, are a form of member- or user-owned utility. In cases in which electric power users desire to form a project, the unique form of an electric cooperative may be considered. Financial assistance may be available through programs of the Rural Electric Association. Although financing assistance may be beneficial to start a project, investor objectives may not be realized through this user model.

B. Revenue Participation or Royalty Model. Taking the above challenges into account, a community wind developer may choose to develop the wind project to a certain point and then seek investment, partnership, or buyout from a larger developer. For example, the community wind developer may develop a project that has significant value in the form of a secure and exclusive land position, a year's worth of wind and other valuable data, a place in the interconnection queue, and a power purchase agreement with a creditworthy offtaker. The developer may then discover that obtaining financing or wind turbines for the project is more challenging than expected. A large wind developer, which likely will have better access to turbines and financing than the community wind developer, may be willing to acquire the rights to build, own, and operate the proposed wind project, sometimes using a "revenue participation" or "royalty" model.

In this scenario, the large wind developer might purchase the right to build, own, and operate the project by paying the community wind developer (1) an initial payment in the nature of a development fee, (2) subsequent payments tied to the achievement of project milestones (such as commercial operation), (3) a negotiated royalty share of project revenues tied in some manner to the project's performance, or (4) a combination of such payments. From the community wind developer's perspective, the disadvantage of this approach is that it requires the community to cede control of the project to a developer from outside the community, which will of course be seeking to make a profit of its own. Nevertheless, in this scenario, the revenues received by the community wind developer (which will ultimately be distributed to its members) would be in addition to local taxes and payments received by landowners under wind leases and easements on which property turbines and associated facilities are placed. The community wind developer would also be more likely to retain a role in project development and operation than a landowner-lessor would.

III. Tax Equity Needs, Incentives, and Options.

A. Production Tax Credit. As discussed in greater detail in [Chapter 7](#), the PTC provides a credit against federal income tax for electricity produced from certain renewable resources, including wind. However, utilizing the PTC in community wind projects may be challenging because of the associated regulatory requirements, such as the requirement that the PTC can only be offset against passive income. Further, even if a local investor has passive income or "materially participates" in the project, the project will likely generate more PTCs than the member can use. If the LLC were to scale back the project in an attempt to make the success of the equity offering and the full utilization of the PTCs by the local investors more feasible, it is less likely to command the attention of power purchasers and turbine suppliers.

B. Equity "Flip" Structure. Under the "Minnesota Flip" structure, a tax equity investor that is brought in to finance a project gets 99 percent of the cash and tax benefits before the "flip" occurs, at the end of the 10-year PTC period, or when the tax investor achieves a negotiated target rate of return on its investment. The tax equity investor, however, may control 99 percent of the governance rights as well as the financial rights. After the 10-year period is up, the allocation reverses and the majority of cash and tax benefits are allocated to the project developer, in this case an LLC or a cooperative ("Flip"). At the point when the Flip

occurs, the project developer has the right to buy out the tax investor at fair market value of the tax investor's expected cash flow. The project developer receives a development fee at financial closing and a management fee annually. The pros to the Flip structure include the lower amount of capital required by the LLC or cooperative up front, and the higher potential return for the project entity. The cons include the complexity of the structure, the different commercial interests of the project sponsor and the tax investor, and the higher tax risk. The IRS's Revenue Procedure 2007-65, which was published in fall 2007, now provides detailed guidance concerning the requirements of the Flip structure.

C. Community-Based Energy Development (C-BED). In Minnesota, community wind projects may be able to take advantage of a program that provides a C-BED tariff with public utilities. Under this state statute, qualifying projects will have a tariff that has a rate schedule that allows for a net present value rate over the 20-year life of the Power Purchase Agreement ("PPA"). The tariff provides for a rate that is higher in the first 10 years of the PPA than in the last 10 years. To qualify as a C-BED project, the project must have no single qualifying owner owning more than 15 percent of the project (unless the project consists of only one or two turbines or is owned by a public entity that is not a municipal utility), must demonstrate that at least 51 percent of the gross revenues from the PPA over the life of the project will flow to qualifying owners and other local entities, and must have a resolution of support from the county board of each county in which the project will be located. A "qualifying owner" includes a Minnesota resident; a Minnesota LLC, cooperative, or nonprofit; a Minnesota political subdivision; or a tribal council. Despite being required to publish a C-BED tariff, public utilities are not required to enter into C-BED contracts. They are, however, strongly encouraged to do so. Other states, including South Dakota, are currently evaluating enactment of statutory provisions similar to Minnesota's C-BED law.

IV. Landowner Involvement and Financial Return. As discussed above, depending on the business structure of the project, member landowners may or may not receive lease payments. Member landowners, will, however, receive a share of project revenue as investors in the LLC or cooperative even if turbines are not located on their property.

Land control options for community wind projects are similar to traditional wind projects. One option is for the community wind developer to enter into an easement with a landowner with an exclusive option to lease. As discussed in [Chapter 1](#), this provides an opportunity to determine each property's wind resource and to begin designing the actual layout of the project. Those landowners on whose property meteorological towers and ultimately wind turbines are located will receive payments for the placement of the towers and turbines, as with traditional developments. However, because all members will receive a share of project revenue, local investors who are not landowners or who own land unsuitable for wind turbines will still have a stake in the success of the project.

V. Advantages and Disadvantages of Community Wind. Community wind projects have significant advantages. Local investment in these projects may enhance community support for the project and reduce potential project opposition. Smaller projects may also avoid interconnection or transmission constraints faced by larger projects. Further, profits from community wind projects stay in the community. Local issues are addressed by local involvement and sensitivity to community concerns. Permitting may also be easier in smaller projects. From the utility perspective, community wind projects might disperse wind generation in a manner that takes advantage of differing wind conditions in a given control area, thus potentially reducing the costs of wind integration.

However, community wind projects require member cooperation, sometimes with more than 100 members, and a level of sophistication to raise sufficient capital. Further, the PTC can only offset against *passive* income, so a tax

equity investor is usually needed to monetize the PTC. Even if a local member has passive income or “materially participates” in the project, the project will likely generate more PTCs than the member can use. Publicly owned projects cannot utilize the PTC. Additionally, larger projects are also more apt to command the attention of power purchasers and turbine suppliers.