

IMPACT OF PROPOSED IRS “NETTING RULE” ON OPEN-LOOP BIOMASS

The section 45 production tax credit (PTC) for wind and closed-loop biomass has been in existence since 1992 as an incentive to build and operate renewable power facilities. In the 2004 JOBS bill, this credit was extended to open-loop biomass and other renewable technologies, though at half the rate and for half the length of time. The 2005 Energy Policy Act equalized the length of the credit for all new technologies but left open-loop biomass and some other technologies at one-half the rate.

In late 2006, IRS issued Interim Guidance Notice 2006-88 on the open-loop biomass tax credit. As part of this publication, IRS proposed a “netting rule” (Section 3.03), requiring open-loop biomass plants sited at an industrial facility to net the electrical load of any adjacent industrial facility (if owned by the same taxpayer) from the open-loop plant’s electricity generation, before claiming the PTC on the remainder, if there is one, regardless of whether the open-loop plant was actually serving the electrical load of the industrial facility.

This interpretation was neither required by any language in the statute nor by any references in the legislative history of the provision.

The impact of the guidance is to effectively eliminate the vast majority of growth opportunities for the open-loop biomass industry. Aside from restart efforts of a few shut down facilities, the predominant business model for growth in the industry involves co-locating a biomass plant with an industrial facility that provides on-site fuel and takes steam thus creating a second revenue stream. The margins, especially with only half the PTC, are thin and require the synergies that the industrial plant brings in the form of fuel; transportation savings; existing land; utilities; zoning and permits; shared rolling stock; an existing electrical infrastructure; and shared personnel for operations, maintenance and management. This situation is unique to open-loop biomass among renewable electricity technologies, with the host facility usually a forest products facility under common ownership.

It is not reasonable to net the electrical load of the host facility against the power plant. Importantly, the power plant has no intentions of selling its output to the adjacent facility, for the following reasons:

1. The industrial facility operates only on a single or double shift basis, only on weekdays, and only during the utilities peak load periods, leading to an underutilization of the generation assets.
2. Any excess power made available to the utilities is much lower value as it only comes during off-peak periods and is not firm.
3. The generation assets are sized to serve the peak industrial facility steam load and to utilize all available low valued residuals, and is not matched to the industrial facility’s electrical load.
4. The industrial facility would only avoid about 2/3 to 3/4 of its current electrical charges as utility backup and demand charges would still be 1/4 to 1/3 of current bills.

One “work around” to the proposed “netting rule” is for the power plant to be owned by a different party than the industrial facility. This is not a logical expectation, however, as the proposed facilities are highly integrated with the host industrial facility. The number 1 priority of the power project is to provide steam for processing of the industrial facility’s primary product (lumber, veneer, pulp/paper) and the control of that power plant should not be turned over to others. In addition, the power plants are typically very small, with the transaction costs of separating the two entities eating up any potential advantage. Independent developers will not typically focus on projects this small.

A final reason for eliminating the proposed “netting rule” is that it runs counter to every other federal policy and program concerning renewable energy, energy efficiency and wise use of resources. These combined heat and power (CHP) installations are much more efficient than standalone facilities, often 2 to 3 times more fuel efficient. They are encouraged by various federal programs and in fact, the Environmental Protection Agency (EPA) has a formal CHP program to encourage such installations.

The IRS interim guidance has the potential to destroy the growth prospects for the entire open-loop biomass power industry. Congress should clarify that the tax credit for electricity produced by qualified open-loop facilities is not to be reduced by calculations involving the electrical loads of co-located host facilities.