

Client Alert

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Court of Federal Claims Limits Section 1603 Grant for Biomass Cogeneration Facility

As a number of cases involving Section 1603 renewable energy grants are making their way through the US Court of Federal Claims, the court issued its first opinion regarding Treasury's newly minted position on the downstream use of steam from a cogeneration facility.

On January 12, 2015, the US Court of Federal Claims issued an opinion in favor of the federal government with respect to the proper grant amount for an open-loop biomass cogeneration facility. *W.E. Partners II, LLC v. United States*, No. 13-54. The court held that "Section 1603 requires only reimbursement for the portion of the cost that is fairly allocable to the production of electricity." The court concluded that only one of the facility's three steam boilers was reasonably allocated to the qualifying activity of generating electricity and the other two boilers were allocated to the nonqualifying activity of generating steam for industrial processes. Accordingly, the court sustained Treasury's allowance of the grant for the costs of the turbine and one-third of all other costs in the facility but not for any of the remaining costs associated with the two additional steam boilers. A copy of the *W.E. Partners* opinion is available [here](#). A link to our prior coverage of the Section 1603 litigation is available [here](#).

Background

The facility was located next to a Perdue chicken rendering plant and was designed and operated to meet Perdue's steam needs for its chicken rendering processes. The facility included a 495 kilowatt (kW) steam-turbine generator to produce electricity from steam. All the steam produced in the facility passed through the turbine, which lowered the pressure of the steam, and the steam then was used in the chicken rendering plant.

Although the facility produced electricity, the primary purpose of the facility was to produce steam for use in the Perdue processes. The facility used three steam boilers, each with a heat input of 29.4 million Btu (mmBtu), a steam flow of 20,700 pounds per hour (pph) and a pressure of 325 pounds per square inch (psi). In total, 2.2 percent of the useful energy that the facility produces is electrical energy and 97.8 percent is thermal energy.

After the facility was placed in service, W.E. Partners filed an application requesting a grant (\$2,711,331) for the total cost of the facility (\$9,037,769), which included the costs associated with all three of the facility's steam boilers. According to the National Renewable Energy Laboratory ("NREL"), which reviewed W.E. Partners' application for the Treasury Department, a biomass boiler with a heat input of 8.4 to 11.2 mmBtu would be sufficient to power a 495 kW turbine. Thus, NREL determined that one of W.E. Partner's three steam boilers would be more than sufficient to power the facility's 495 kW turbine.

Accordingly, NREL determined that one-third of the facility's costs could be attributed to electrical production and it recommended an eligible cost basis that included all costs associated with the turbine and one third of all other costs. This resulted in a revised cost basis of \$3,145,847 and a reduction of the grant amount to \$943,754. W.E. Partners filed a complaint in the Court of Federal Claims challenging this determination, eventually filing for summary judgment, which the government answered with its own cross-motion for summary judgment.

Court's Holdings

The Court of Federal Claims stated that the question presented was whether the phrase “a facility using open-loop biomass to produce electricity” in I.R.C. § 45, as applied in Section 1603, “necessarily includes the entire cost basis of facilities that use open-loop biomass and produced electricity, regardless of other purposes and capabilities, or whether the phrase implicitly contains limitations to the eligible cost basis of the grant.” The court answered this question in the affirmative – “the Court finds that Section 1603 grants are properly restrained by the limitations on eligible cost basis found in the Treasury Guidance [issued in connection with the Section 1603 grant program].”

The court focused on a particular section of the Treasury Guidance relating to eligible cost basis, which segregates costs between eligible costs for “qualifying activities” and ineligible costs for “non-qualifying activities”:

The eligible basis of a qualified facility does not include the portion of the cost of the facility that is attributable to a nonqualifying activity. For example, for a biomass facility that burns fuel other than open-loop biomass or closed-loop biomass, the eligible cost basis is the percentage of the total eligible costs that is equal to the percentage of the electricity produced at the facility that is attributable to the open-loop biomass and closed-loop biomass. In the case of costs that relate to both a nonqualifying activity and a qualifying activity, the costs must be reasonably allocated between the nonqualifying and qualifying activities. For example, if combustion equipment burns both qualifying biomass and other fuel, the equipment's eligible cost basis is limited to the percentage of its otherwise eligible cost corresponding to the percentage of the equipment's electricity production that is attributable to the qualifying biomass.

Although this provision is oriented toward the cofiring of open-loop biomass and nonbiomass fuels (a situation that is specifically addressed in I.R.C. § 45), the court found that the provision was broader in its application: “Although the Treasury Guidance illustrates the eligible cost basis of a facility using qualifying and nonqualifying fuel as an example, there is no indication that the guidance applied exclusively to fuel type.” Rather, the court concluded that the use of the phrase “for example” indicates that “there are other, different scenarios where costs must be allocated between nonqualifying and qualifying activities.” Thus, the Court of Federal Claims concluded:

In this case, the eligible cost basis of qualifying property must be reasonably allocated between the nonqualifying chicken rendering processes and the qualifying electricity generation.

The court agreed with NREL's determination that only the costs associated with the turbine and the one steam boiler were reasonably allocated to qualifying electricity generation:

Pursuant to the Treasury Guidance, the Treasury Department determined that 8.4 and 11.2 mmBtu of steam would be sufficient to generate 495 kW, the amount produced by WEP II's turbine. Thus, one of WEP II's three 29.4 mmBtu boilers reasonably could be allocated to the qualifying activity of generating electricity. Based on these calculations, the Treasury Department awarded WEP II a 30 percent reimbursement for the full cost of the turbine and one-third of all other costs. In light of the WEP II facility's substantial thermal energy production and comparatively small electrical generation, the Court concludes that the Treasury Department's determination of the WEP II facility's eligible cost basis is a reasonable allocation of the costs between the generation of qualifying electrical energy and nonqualifying thermal energy.

The court therefore granted the government's motion for summary judgment and denied W.E. Partners' motion for summary judgment.

Analysis and Takeaways

Although the court held in favor of the government, the court rejected many of the principal arguments made by the government. First, the court concluded that the W.E. Partners facility was a “qualifying facility” (i.e., an “open-loop biomass facility”) under I.R.C. § 45(d)(3). The court put not stock in the government’s argument that Section 1603 does not apply to cogeneration facilities that do not qualify as combined heat and power facilities under Section 1603(d)(7) (see I.R.C. § 48(c)(3)). Second, the court concluded that all the components in the W.E. Partners facility, including all three steam boilers and the turbine, represented “qualified property” under Section 1603 and the investment tax credit rules (I.R.C. § 48(a)(5)(D)). The court rejected the government’s arguments that the primary purpose of the facility must be electricity production in order to be qualified or that *de minimis* electricity production by the facility was somehow fatal to qualification. The court concluded that all that was necessary for qualified property under Section 1603 is that the property be “actually involved in making electricity, and without which the electrical production would be reduced.”

In the normal course, the court’s conclusion that the turbine and each of the three boilers represent qualified property that is part of a qualifying facility would be determinative. To be sure, neither Section 1603 nor the open-loop biomass facility definition in I.R.C. § 45 nor the investment tax credit rules in I.R.C. § 48 require anything more. The court readily admitted this but nonetheless concluded that limitations beyond the statutory language were appropriate under Section 1603. In order to take this leap, the court went into its judicial toolbox and pulled out the regulatory deference principles — even though the government did not argue for deference — concluding that the Treasury Department’s interpretation of Section 1603 in the Treasury Guidance was entitled to “considerable weight as a reasonable interpretation of the statute and reasonable limitation consistent with the intent of Congress.” Despite these affirmations, the court did not provide any analysis of Congress’ intent or, indeed, any contextual support for the particular limitations that it referenced. Treasury did not provide any explanation in the Treasury Guidance beyond the limited text provided above.

The court assumed, without providing any analysis, that “thermal energy production” for purposes of the chicken rendering processes represented a “non-qualifying activity” for purposes of the Treasury Guidance. Although the court cloaked this critical assumption with regulatory deference, the Treasury Guidance does not go that far and, indeed, says nothing about concurrent thermal energy production. IRS Notice 2008-60, which the court likewise held was entitled to deference, says that “[a] facility using open-loop biomass to produce both electric energy and useful thermal energy, such as heat or steam, through the sequential use of energy (cogeneration) may be a qualified open-loop biomass facility.” Although this point was argued by W.E. Partners, the court never addressed it.

Even though the Court of Federal Claims accepted the notion that a facility may be engaged in both qualifying and nonqualifying activities, the court did not define the parameters of what is a “non-qualifying activity” beyond the specific use of thermal energy production by W.E. Partners. The court did not embrace a broader holding that would require an allocation of cost basis in all cases that involve the downstream use of steam. While the court concluded that it was reasonable to exclude the costs associated with the additional two steam boilers, the court allowed all the costs associated with the turbine and with the one steam boiler that was necessary for the production of electricity. In other cases, Treasury has applied a percentage allocation method by reducing cost basis based on the ratio of electrical energy production to thermal energy production from a facility. The court did not follow that approach in *W.E. Partners*.

The Court of Federal Claims confirmed that its standard of review is *de novo* and is not limited to agency action/administrative record review. The court determined that this standard of review followed from the procedures applicable to the court’s review of tax refund claims. The court explained that taxpayers are entitled to *de novo* review when they have received an unfavorable determination by the Treasury Department regarding property that otherwise qualifies for the I.R.C. § 45 production tax credit or I.R.C. § 48 investment tax credit. “There is no indication in Section 1603 that Congress intended a

different standard of review based on Section 1603's provision of direct reimbursement in lieu of tax credits." This holding may have significance in the context of the scope of discovery, the introduction of evidence and the burden of proof in the broader group of Section 1603 cases in the Court of Federal Claims.

The tax controversy team at Hunton & Williams LLP consists of a cross-practice group with significant experience in energy tax credits and Section 1603 Treasury grants, tax controversy and litigation. Hunton & Williams LLP is well positioned to assist Treasury grant applicants resolve disputes with Treasury. Please contact us if you require assistance with Treasury's denial or reduction of Section 1603 grant amounts.

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