RNG Investment Tax Credit: Start of Construction Physical Work Test

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ITC for RNG Projects

- The recent Inflation Reduction Act of 2022 has expanded the Investment Tax Credits (ITC) to include qualified biogas projects.
- Investment Tax Credit (ITC) – Section 48(a) of the Internal Revenue Code provides an investment tax credit for renewable natural gas (RNG), solar and other renewable energy property. The amount of ITC available depends on when construction begins.

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Qualifying RNG Projects for ITC

- The biogas ITC includes a base investment tax credit (6%) and two bonus credits of 2% each that can be added to the base tax credit. These bonus credits are:
  - Domestic Content (>40%) – adds 2% to base ITC of 6%
  - Energy Community – adds 2% to base ITC of 6%
- Thus, depending on the conditions above, your base ITC would be either 6%, 8% or 10%.
- IRA 2022 also provides an additional incentive, by way of a multiplier of 5 on the base ITC, if the project uses prevailing wages (or union wages) for all construction activities.
- Thus, a project with a base(+bonus) of say 8% that uses prevailing wages (or union wages) for all construction activities, the total ITC would be 40% (8% x 5).

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Qualifying RNG Projects for ITC

- Also, the ITC amount is based on the date the construction of an RNG project begins and when it is placed in service. In the following example, we will assume that the project qualifies for a 40% ITC (base + domestic content satisfied):

If construction begins:	and is completed:	The ITC percentage is:
Prior to/during 2022	Before 12/31/2022	0%
Prior to/during 2022	After 1/1/2023	40%
During 2023	Before 2027	40%
During 2024	Before 2028	40%
After 2024	No end date	0%

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Start of Construction

- The IRS will be providing further Guidance for the Biogas ITC soon (section 48) that will provide guidance on the Start of Construction rules.
- It is anticipated that the Biogas ITC guidance will be like the guidance previously issued for solar projects (IRS Notice 2018-59).
- The new IRA 2022 law also states that any project that has begun construction within 60 days after the Secretary publishes the new Guidance, shall be assumed to be compliant with the prevailing wage rule, and thereby would be grandfathered and would not need to use prevailing wages on all construction activities, but would still qualify for the 5 x multiplier on the base ITC (as long as the project is completed in 2023 or within 4 years from start of construction).

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Start of Construction

- The IRA 2022 requires project owners, contractors, or subcontractors to pay laborers "prevailing wages" during construction and for repairs or alterations performed during the tax credit period. For this purpose, "prevailing wages" refers to wages paid for similar work in the locality of the project site, as determined by the U.S. Secretary of Labor.
- If a project owner, contractor, or subcontractor does not pay its laborers "prevailing wages" as required, it can remedy this failure by paying each worker the difference between the prevailing wage and wage actually paid, plus $5,000 per worker and interest. If the project owner intentionally fails to satisfy the wage requirement, additional costs will be imposed.

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Start of Construction Apprenticeship Requirements

- Additionally, the new IRA 2022 law requires a percentage of labor hours based on the minimum number of hours for construction, alteration, or repair work to be performed by qualified apprentices. The labor hours percentage requirement varies depending on the year in which construction begins, as follows:

Project Construction Period	Percentage of Apprentice Labor Hours
Construction beginning before Jan. 1, 2023	10%
Construction beginning on or after Jan. 1, 2023, and before Jan. 1, 2024	12.5%
Construction beginning on or after Jan. 1, 2024	15%

- Under relevant transition rules, the IRA 2022 law provides exemptions from the wage and apprenticeship requirements and automatic qualification for the ITC multiplier for RNG projects as follows:
  - Projects that start construction before the date that is 60 days after the U.S. Treasury Department issues guidance regarding the wage and apprenticeship requirements.

Start of Construction
IRS Notice 2018-59 & Best Guess

- Many in the industry expect that the Secretary will issue the IRS Guidance on Biogas Start of Construction rules in 4^{th} QTR 2022 (October?)
- Many also believe they will be similar to IRS Notice 2018-59 (Section 48 solar energy projects).
- What does previous IRS Guidance tell us about Begun Construction?
  - Two methods available to establish beginning of construction:

  – Physical Work Test

  – 5% Safe Harbor

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Start of Construction
IRS Notice 2018-59 & Best Guess

- Physical Work Test
  - Construction begins in the year when physical work of a significant nature begins
  - Nature of work important, not amount of work (or cost)
  - On-site work or off-site work
- 5% Safe Harbor
  - Construction begins in the year in which the taxpayer “pays or incurs” 5% or more of the total cost of ITC eligible property
  - Tangible “ITC eligible” property;
  - Land is not eligible

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Start of Construction
IRS Notice 2018-59 & Best Guess

Preliminary Project Work

- Previous Guidance provides non-exclusive list of items that don't count as significant physical work
  - Planning or designing or engineering
  - Securing financing
  - Exploring
  - Researching
  - Conducting mapping and modeling
  - Conducting geophysical and engineering studies
  - Clearing a site
  - Conducting test drilling
  - Removing existing foundations, et

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Continuity Requirement
IRS Notice 2018-59 & Best Guess

- Both the Physical Work Test and the 5% Safe Harbor require continuous progress towards completion once construction has begun.
- Under the Physical Work Test, construction must continue once commenced – meaning continuing physical work of a significant nature.

Note that this is a subjective test that has been based on facts and circumstances, and assumes that the new Guidance will be similar to IRS Notice 2018-59

Excusable Delays
IRS Notice 2018-59 & Best Guess

- Previous Guidance provides examples of excusable disruptions under the Continuity Requirement, including:

  - Delays due to sever weather conditions
  - Delays due to natural disasters
  - Delays due to labor stoppages
  - Delays in obtaining permits or licenses from federal, state, local, or Indian tribal governments
  - Delays at the written request of a federal, state, local, or Indian tribal government regarding matters of public safety, security, or similar concerns.
  - Interconnection-related delays
  - Delays in the manufacture of custom components
  - Delays due to the inability to obtain specialized equipment of limited availability
  - Delays due to the presence of endangered species
  - Financing delays
  - Delays due to supply chain shortages.

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Safe Harbor

New law provides for safe harbor:

- If energy property is placed in service by the end of a calendar year that is no more than four years after the year during which construction began, the continuity requirement will be satisfied.
  - For example, if construction begins in 2023, the continuity requirement will be satisfied if the energy property is placed in service by December 31, 2027.
- Construction will be deemed to have begun on the first date when either the Physical Work Test or 5% Safe Harbor is satisfied.

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Navigating the Prevailing Wage Requirement

- Developers should consider “beginning construction” on as many pipeline projects in 2022 as possible (within 60 days of when the Secretary publishes the Guidance, presumed to be in October 2022), to be grandfathered and therefore not be required to use prevailing wages or union wages for all on-site construction.
- Depending on where the project is located, this may or may not have a significant impact on cost.
- However, for many projects located in rural areas, the local wages are often not at prevailing wages or better.
- This could add between 15% and 25% to the on-site labor cost.

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Navigating the Prevailing Wage Requirement What can we do?

Based on previous IRS Guidance:

- If you have site control – perform on-site work
  - Construction of roads
  - Pile driving
  - Installation of racks
- No site Control – Perform off-site work
  - Either by taxpayer or by relying on a third party through a binding written contract (the look-through rule)
  - To be a binding written contract, it must:
    - Be in writing
    - Be executed prior to the start of manufacturing, construction or production
    - Be enforceable under local law against buyer
    - Identify the item(s) purchased and the purchase price of such items
    - Not limit damages to an amount that is less than 5% of the total contract price

Navigating the Prevailing Wage Requirement What can we do?

Based on previous IRS Guidance:

Equipment Procurement:

- In the case of manufactured equipment, such equipment must not be in existing inventory or normally held in inventory by vendors
- Cannot contract for “off the shelf” components
- Examples of qualified components:
  - Heat exchangers
  - Chillers
  - Vessels
  - Skid based components (compressors, H2S removal systems, etc.)
  - Membranes, absorber columns, PSA vessels
  - Transformers
  - Boilers
- Developer should consider long lead items

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Navigating the Prevailing Wage Requirement Transferring Equipment and/or "Projects"

Based on previous IRS Guidance:

After Construction has begun:

Action	
Move ITC eligible equipment intended for Project A to Project B	Allowed
Transfer of ITC eligible equipment to Affiliate	Allowed
Sale of project which includes the ITC eligible equipment to a third party	Allowed
Sale of ITC eligible equipment to a third party [1]	Not Allowed

[1] Sale to third party may be allowed if seller receives some ownership in third party company as part of the transaction

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Navigating the Prevailing Wage Requirement Tax Equity Interpretation

Based on previous IRS Guidance:

IRS Rule	Tax Equity "Interpretation"
As long as the work is of a significant nature, no minimum amount is required	Must begin work on at least 10% of roads/pilings Must spend roughly 1% of ITC eligible costs
Components manufactured under binding written contracts must not be held in inventory or regularly held in inventory	Must be custom equipment with a strong preference that such components are customized for a site Must be a transformer
Work performed by others must be pursuant to a binding written contact that is entered into prior to the manufacture, construction or production of any components	The binding written contract cannot be modified at a later date (no material changes to contract executed)

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Navigating the Biogas ITC Phaseout

Based on previous IRS Guidance:

- Developers should plan for the phaseout of the biogas ITC and grandfathering of 2024-2028 projects at the current 30%, 40% or 50% ITC level (assuming prevailing wage/apprenticeship and domestic content is met).
- Follow the Navigating the Prevailing Wage Requirement slides presented previously, but in this case, developer is looking to begin construction not to avoid prevailing wage requirement, but to prolong the applicable ITC for up to 4 years.
- Projects that begin construction after 12/31/2024, the ITC is eliminated and only the New Clean Fuel Product Credit (45Z) can apply.
- HOWEVER, Projects that begin construction (following the ITC guidance herein), can also stack the ITC and the New Clean Fuel Production Credit!
- Beginning in 2025, biogas to renewable natural gas that qualifies as (law doesn't say has to be sold as) a transportation fuel would be eligible for the **New Clean Fuel Production Credit (45Z).**
- **45Z** Creates a new technology neutral 2-year tax credit for low-carbon transportation fuel.
  - Maximum credit is $1 per gallon (or $1.75 per gallon for sustainable aviation fuel) multiplied by an emissions factor. If certain prevailing wage and apprenticeship requirements are not met, the base credit amounts will apply equal to $0.20 or $0.35 per gallon, respectively.
  - Emission factor is calculated proportional to a maximum emission rate standard of 50 kilograms of CO_2e per 1 million British thermal units (mmBTU).
  - Emission rate is calculated with GREET model.

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Hypothetical Example

To Avoid Prevailing Wages, and/or Extend ITC through 2028

- Developer has 8 similar sized RNG projects in early-stage development:
- Recommendation:
  - Developer should set up a wholly-owned subsidiary (SPE) to enter a binding written contract to obtain custom designed equipment
  - Then, the Developer should plan to assign these custom fabricated components to the SPEs later.
- Recommend that Developer consider long-lead equipment components
  - Will shorten project schedule from Full NTP through Commissioned Complete
  - Will eliminate current inflationary pricing
- If begun construction before 12/31/24, ITC applies and the 45Z production credit also applies!

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Hypothetical Example
$110MM Biomass to RNG Project

- Developer is close to a full financial close in September 2022
- Has not yet met the begun construction rule
- Project is not in an energy community, but will meet domestic content
- Should Begin construction within 60 days of Secretary ruling to avoid prevailing wages on construction activities, and eligible for the 5 x multiplier
- ITC will be 40% of qualified expenses, or ~$44MM (assuming EPC cost is 100% eligible)

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Hypothetical Example
Multiple Biomass to RNG Projects

- Developer has 10 projects in pipeline that are likely to close in 2025 or 2026
- It is December 2024
- Projects are not in an energy community, but will meet domestic content
- Should Begin construction in December 2024 to be eligible for the 5 x multiplier and extend ITC to all 10 projects and complete them within 4 years from Begun Construction.
- ITC will be 40% of qualified expenses, and
- 45Z production credit can be stacked on top of the ITC, which could be another 20% to 40% credit (depending on fuel type).
  - Note: currently the 45Z PTC is only a two-year credit for transportation eligible fuels

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How can Venture Help?

- We are a full-service EPC company with 12+ RNG projects in last 6 years
- We can help strategize on what types of qualified components to buy (that can fit multiple projects).
- We can quickly reach contract terms to begin manufacturing qualified components.
- We have capability to fully document the progress of the manufactured components to satisfy IRS scrutiny.
- We have long history of working with all major equipment vendors, with T&Cs in place with all such major vendors:
  - DVO, Emerson (Vilter), Ariel, ANGI, Air Liquide, PlanET, HOST, Wartsila, DMT, Biogest, KOCH Industries, Biorem, Paques, Suez, Quadrogen, Steel tank vendors, Digested Organics, Daritech, US Farms, GE, ABB, Westinghouse, and many others…

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