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Guest Column
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The Importance Of Decommissioning Security

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A landowner who is approached by a developer interested in leasing land in connection with a renewable energy project should consider negotiating for decommissioning security in its ground lease or other contractual arrangements with the developer.

Every project has a lifetime after which it is no longer cost effective to continue operations. At that time, it is said that the project is "decommissioned."

The goal of decommissioning is to remove the installed power generation equipment and to return the site to a condition as close to a pre-construction state as possible. Although decommissioning typically occurs at the very last phase of an energy project, it is something every landowner should think about and plan for before signing a lease agreement.

Why Should a Decommissioning Plan be Made Part of a Ground Lease?

First and foremost, after the energy project has run its useful life, the leased land will be returned to the landowner. Unless the lease contains provisions requiring the lessee to remove the energy project and restore the land to its original condition, the land may very well be returned to the owner with the non-operating energy facility and all related structures left on it.

This will not only leave the owner with limited use of its land, but will also result in removal costs and expenses, unless reimbursement of the same have been addressed at the outset of the lease. Obsolete equipment left on the land may also represent an eyesore and detract from the value of the land.

However, "decommissioning" involves more than simply removing the physical assets comprising the energy project.

For instance, there will be certain environmental factors to consider when a project is decommissioned, including noise, dust, public safety, water quality and impact on local wildlife and livestock. A landowner may also be held responsible for the disposition of any hazardous materials left on the project site.

By including a decommissioning provision in its ground lease, the landowner can ensure that the developer, who is most likely better suited to address these concerns because of its experience and familiarity with the project, is the one ultimately responsible for attending to these concerns.

Why Should a Landowner Require Decommissioning Security?

Complete decommissioning of a renewables project is a major task in and of itself, and can be a costly endeavor. By way of illustration, public landowners, such as several counties throughout the United States, have recognized the issues involved in decommissioning an energy project and have developed regulations concerning the removal and restoration requirements for energy projects.

For example, below are some of the requirements set forth in local wind energy ordinances from various counties throughout the country[1]:

- Removal of all foundations, pads and underground electrical wires[2] to a depth of four feet below ground surface

- Removal of all hazardous materials from the property and disposition of hazardous material in accordance with federal and state law

- Restoration of the site to its original condition prior to location of the generating facility, subject to reasonable wear and tear

- Restoration of site vegetation

- Removal of all structures (including transmission equipment and fending) and debris to a dept of four feet, restoration of the soil, and restoration of vegetation within six months[3] of the end of project life or facility abandonment

- Removal of all access roads (unless the landowner desires to keep the access roads)

- Implementation of a post-decommissioning storm run-off plan

Some regulations explicitly require compliance by the owner of the facility (i.e., the developer/lessee).[4] Others, however, set forth decommissioning requirements without specifying whether the developer or the landowner is responsible for compliance.[5]

In these cases, a landowner subject to such regulations should ascertain whether it or the lessee is legally responsible for decommissioning the project. If the regulation holds the landowner accountable, these responsibilities could be passed to the lessee through the ground lease.

Because decommissioning costs are typically incurred at the end of the lease term when the project is no longer generating revenue, securing funds ahead of time to cover these expenses is a prudent measure. Absent a local regulation requiring the lessee to decommission the site, and unless the lease states otherwise, responsibility for these activities (and the costs associated therewith) will fall to the landowner.

Even if local regulations place the burden of decommissioning on the lessee, the landowner will want to assure itself that the lessee will be financially capable of complying with such legal requirements.

When Should Decommissioning Security be Provided, and What Form Should it Take?

Many renewables leases provide for a diligence period prior to the construction of the project, during which the developer will survey the land, determine where to place its facilities, identify and address any issues with title, and conduct other diligence.

Typically, the developer is not permitted to make any permanent improvements to the land during this period, and developers are ordinarily not required to provide decommissioning security unless they have determined to lease the site and proceed with construction of their project.

Once the developer has completed its diligence and has committed to move forward with construction of the facilities (typically, on the lease commencement date), the landowner should consider requiring decommissioning security.

Decommissioning security may take several different forms. Some of the most common types are letters of credit, bonds, a decommissioning fund or a guaranty.[6] There are certain factors to consider depending on which type of security is required.

For example, if security is in the form of a letter of credit, the letter of credit should be from a financial institution that is creditworthy or that is otherwise subject to the landowner's approval, and the form of the letter of credit should similarly require landowner approval.

If the security is a guaranty, similar considerations apply: The landowner will want to analyze the credit-worthiness of the entity providing the guaranty and perhaps set forth minimum requirements in the lease agreement as to who may act as a guarantor and what form the guaranty should take.[7]

Another possibility is to establish a cash account, held by the landowner, to which the developer makes periodic contributions until the fund reaches a denominated dollar amount which equals the parties' reasonable estimate (or the estimate of a neutral third-party consultant) of the costs required to decommission the project.

Failure by the lessee to contribute such funds would be an event of default under the lease.[8] By way of illustration, Annex I (below) contains sample decommissioning security provisions.

Some lessees ask for the right to utilize decommissioning security during the lease term (for example, to cure other payment defaults of the lessee). If the landowner agrees to allow the developer to have access to decommissioning funds during the lease term, then the landowner should consider requiring a replenishment obligation.

However, a developer who has obtained third-party financing to develop and construct the project may find it difficult to come up with the required replenishment funds, especially if those funds were utilized to pay rent (indicating that the project may be in financial difficulty).

Landlord's Rights to Utilize Decommissioning Security

Once the decommissioning security has been provided, the next question is when the landowner should be permitted to exercises its rights with respect to such security.

As a general matter, decommissioning funds should be available once the project ceases commercial operations — regardless of whether this occurs at the expected end of the lease term or at some earlier point during the lease term. For instance, landowners should consider requiring that decommissioning security be made available upon the expiration or early termination of the lease, or upon abandonment of the project.

"Abandonment" should be carefully defined in the lease so that this does not become a point of dispute in the future. The point is that once the lessee's obligation to restore the site matures — whether that occurs at the end of the lease term or at some earlier point — then the security should be available to the landowener, should the lessee fail to perform.[9]

Conclusion

The best time to address the issue of decommissioning security is at the beginning of ground lease negotiations, when both parties are presumably motivated to establish a meaningful contractual relationship.

Both landlord and developer should be sure to include, in the negotiation of their ground lease, provisions describing the amount of decommissioning security, the form it must take, and the time at which it must be contributed. Such clarity will go a long way toward minimizing future disputes when a project ceases to operate and it becomes time for someone to "clean up the site."

Annex I

Sample Decommissioning Security Provisions[10]

The sample language below is for illustrative purposes only; potential parties should, of course, consult with their own legal advisers to ensure that their contractual provisions meet their needs and reflect the intent of the parties.

Example 1: Sinking Fund

Commencing with the [INSERT THE FIRST DATE SECURITY SHALL BE REQUIRED], Lessee shall deposit on the first day of each month the amounts listed on Schedule A attached hereto (collectively, the "Sinking Fund Payments") into the account listed on Schedule B attached hereto (the "Sinking Fund Account"), securing Lessee's obligation to remove the Facilities located on the Property, whether upon a termination pursuant to Section [___] or otherwise.

Landowner shall be permitted to draw from the Sinking Fund Account in the event that Lessee fails to remove the Facilities and restore the Property as required pursuant to the terms of this Agreement. The interest paid by the banking organization where the Sinking Fund Account is held shall remain in such account and be credited against subsequent deposits.

Upon termination of this Agreement in its entirety and satisfaction by Lessee of its removal and restoration obligations set forth in Section [___] hereof, any amount remaining in the Sinking Fund Account shall be returned to Lessee.

Example 2: Performance Bond

Lessee shall provide security sufficient for decommissioning costs in the form of a performance bond to ensure the availability of funds for such costs (the "Decommissioning Security") to Landlord.

The performance bond shall be issued by a surety registered with [_____] and which is, at the time of delivery of the bond, on the authorized insurance provider list published by the Insurance Commissioner. The performance bond shall be in an amount equal to the decommissioning costs.

The performance bond shall be for a term of 1 year, shall be continuously renewed, extended, or replaced so that it remains in effect for the remaining term of this Agreement or until the secured decommissioning obligations are satisfied, whichever occurs sooner. In order to ensure continuous renewal of the performance bond with no lapse, each performance bond shall be required to be extended or replaced at least one month in advance of its expiration date.

Decommissioning costs shall be revaluated annually during construction of the Project and once every five (5) years thereafter from [INSERT DATE (EX. DATE OF SUBSTANTIAL COMPLETION OF THE PROJECT)] to ensure sufficient funds for decommissioning and, if the parties agree at that time that the decommissioning costs need to be modified, the amount of the Decommissioning Security shall be adjusted accordingly. Failure to secure such renewal or extension shall constitute a default of Lessee under this Agreement.

Example 3: Letter of Credit

Lessee shall provide security sufficient for decommissioning costs in the form of a letter of credit to ensure the availability of funds for such costs (the "Decommissioning Security") to Landlord.

The letter of credit shall be issued by a bank whose long-term debt is rated "A" or better by a Rating Service. The letter of credit shall be in an amount equal to the decommissioning costs. The letter of credit shall be for a term of 1 year and shall be continuously renewed, extended or replaced so that it remains in effect for the remaining term of this Agreement or until the secured decommissioning obligations are satisfied, whichever occurs sooner.

Landlord shall be authorized under the letter of credit to make on or more sight drawings thereon upon certification to the issuing bank of Lessee's failure to perform its decommissioning obligations when due. Decommissioning costs shall be revaluated annually during construction of the Project and once every five (5) years thereafter from [INSERT DATE (EX. DATE OF SUBSTANTIAL COMPLETION OF THE PROJECT)] to ensure sufficient funds for decommissioning and, if the parties agree at that time that the decommissioning costs need to be modified, the amount of the Decommissioning Security shall be adjusted accordingly. Failure to secure such renewal or extension shall constitute a default of Lessee under this Agreement.

Example 4: Guaranty

Lessee shall provide security sufficient for decommissioning costs in the form of guaranty to ensure the availability of funds for such costs (the "Decommissioning Security") to Landlord.

The guaranty shall be from an entity having (i) at the time of delivery of such guaranty, a senior unsecured long term debt rating ("Credit Rating") of BBB- or better from Standard and Poor's and Baa3 or better from Moody's or (ii) audited financial statements, prepared by a nationally-recognized firm of independent auditors and indicating a financial net worth of at least $[_____].

Decommissioning costs shall be revaluated annually during construction of the Project and once every five (5) years thereafter from [INSERT DATE (EX. DATE OF SUBSTANTIAL COMPLETION OF THE PROJECT)] to ensure sufficient funds for decommissioning and, if the parties agree at that time that the decommissioning costs need to be modified, the amount of the Decommissioning Security shall be adjusted accordingly. Failure to secure such renewal or extension shall constitute a default of Lessee under this Agreement.[11]

--By Sosi N. Biricik (pictured) and Noreen A. Haroun (pictured), Latham & Watkins LLP

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[1] See Oteri, F. (2008) An overview of existing wind energy ordinances. Golden, Colo., National Renewable Energy Laboratory. www.nrel.gov/docs/fy09osti/44439.pdf.

[2] Ordinances vary in the required depth at which these structures must be removed, generally ranging from three to eight feet.

[3] Note that ordinances often vary in the amount of time allowed for decommissioning following the termination or abandonment of a project; such timeframes often range from 90 days to over a year.

[4] For example, the Town of Morrison, Wisconsin, adopted an ordinance for wind energy projects in 2008. The removal provisions in the ordinance require that the owner (i) remove all generators and appurtenances from the site, (ii) stabilize, grade, and clear the site of any debris, (iii) remove any foundation to a minimum depth of eight feet below grade, and (iv) remove, clear and grade any access roads. The "owner" is defined as the entity that develops, operates or owns the wind system and the entity who has applied for a permit to operate the energy facility. Therefore, in a ground lease situation, the lessee/developer would be responsible for the decommissioning. See Town of Morrison Zoning Ordinance, Article XXIV – Large and Small Wind Energy Facility Ordinance.

[5] In Swift County, Minn., for example, a local ordinance requires that a decommissioning plan be submitted to the county and that, at a minimum, all facilities be removed to four feet below ground level, without stating who is responsible for the removal. See Swift County Wind Energy Ordinance.

[6] For example, the Bureau of Land Management (the "BLM") requires a minimum bond in the amount of $10,000 per wind turbine for all wind energy development projects on public lands. All bonds are periodically reviewed (at least every five years) to ensure the adequacy of the bond. The BLM does not accept a letter of credit as security.

[7] Of course, the question arises as to why a mere covenant by the lessee to perform the requisite decommissioning is not sufficient. Typically, developers of renewables projects are single-purposes entities whose projects are project-financed, meaning that such entities have no meaningful credit outside the assets of their project. At the end of a project's life (which is the point in time when decommissioning typically takes place), the lessee may have no real creditworthiness backstopping its lease obligation to perform the decommissioning.

[8] Regardless of the form of decommissioning security, the landowner should consider periodic reassessments of the security amount, to ensure that the amount remains sufficient over time to cover decommissioning costs, particularly if the scope of the project changes. In addition, the security amount could be escalated each year by the reference to an index or other formula. In the case of a reserve fund, the parties may also negotiate that interest on the security amount remain in the fund and also comprise a portion of the security. In all cases, that after the site has been fully restored, any remaining security should be returned to lessee, unless the lease provides otherwise.

[9] Landowners may also negotiate the ability to utilize the security in the event of any payment default of the lessee.

[10] Note that all capitalized terms should be revised to match the defined terms in the lease agreement.

[11] Examples 2, 3 and 4 are based on language from a draft Development Agreement between Kittitas County, Washington and Sagebrush Power Partners LLC. See Draft Development Agreement Between Kittitas County, Washington and Sagerbrush Power Partners, LLC: Kittitas Valley Wind Power Project (Apr. 28, 2008), www.efsec.wa.gov/kittitaswind/preemption/Exhibits%205/KV%20Amended%20Development%20Agreement%205.01.06.pdf.