



Farm Income: From Above and Below the Farm

By: John W. Flora

Year in, year out, farming is a challenge, particularly when you look at the net cash return on farm assets. Farmers in the east should take a lesson from farmers in the west on several methods developed out west to increase cash flow.

The purpose of this article is to encourage you to be alert for opportunities to increase revenues from assets below the dirt and above the dirt. Specifically, wind farms, which are cropping up all over this country; natural gas leases, which again are in vogue; geothermal energy; water, which is becoming a scarce commodity even in the east; and finally, sunlight for solar energy.

Fortunately, right now gas prices are lower and we are all thankful for \$2 gas, instead of \$4 gas. However, to increase cash flow, one of the goals for farmers is to reduce energy costs by having more fuel efficient tractors and “homemade” electricity or “homemade” biofuels.

Visionaries in the energy sector of the economy believe that you may actually plug in your tractor or truck at night when battery technology has improved so that you will be operating with electric power in your tractor and truck. They also suggest that within the next five to twenty years you will have no electric bill. Most residences and small busi-

ness owners, including farmers, will be “off the grid” in many areas of this country. The concept is that between wind and solar energy you will produce enough electricity for your own personal and small business use.

There are innumerable resources for you to track the developments in the energy sector of the economy, and I encourage all of you to check the American Wind Energy Association website (www.awea.org) from time to time, as well as the Solar Energy website (www.seia.org). Renewable energy continues to receive significant support from both political parties in this country. Internationally, the Europeans are way ahead of the

United States in wind technology and most other developed countries are way ahead in solar technology, in part due to energy policies in other countries that encourage renewables.

However, the primary focus of this article is to talk about more immediate opportunities to improve cash flow on farms.

Commercial Wind

For some of you, mostly in the mountains of Virginia and West Virginia, there are current opportunities to lease high elevation property to large wind development companies. This market has matured rapidly over the past several years and most of the developers are now European utilities, some American utilities and a few turbine manufacturers. Wind farms will never be as plentiful in the Virginias as they are in the Midwest because the wind resource is better and more consistent in the Midwest. However, the advantage and the reason developers focus in the eastern mountains is the proximity to the population base in the East Coast. The comparison is much like the poultry and pork industry production analysis. Poultry plants in the east are at a disadvantage because of the added cost of moving the grain from the Midwest. However, they make up for that disadvantage by proximity to markets. The same is true right now for wind energy.

Unfortunately, most of you will not have developable commercial wind sites on your farm. For those of you that have a good wind resource, keep in mind you also need a transmission line on your property or nearby to make the project viable.

There are many legal and business issues related to the negotiation of an appropriate wind farm lease and set forth below is a list of some of those issues and concerns:

- a. **Term.** These are long leases: Most last thirty to fifty years when you include the requested renewal periods.
- b. **Option Period.** Many leases start out as nothing more than an option to lease. Although improving, the annual payment for the option, which eliminates your ability to negotiate with another developer, is a modest sum, which should (i) be negotiated upwards if you need the money or (ii) only accepted after you have exhausted your search for the best deal. As I often say to clients, "Why would you sell your farm to the first person who knocks on the door without checking the marketplace first to see if the price offered is the best available price?"

Most wind leases today pay a percentage of gross revenue. In the east, I have seen leases as high as 5% of the gross revenue and in Texas and the Midwest; there are leases as high as 7%. In addition, many leases now also pay a fixed amount for real estate taken or used by the developer. If your property has a substation, access roads or some other ancillary improvements related to a wind farm you should obtain additional rent.

The percentage of gross revenue provides an automatic inflation adjustment for you, but to the extent you negotiate fixed fees for roads, substations and other types of rent, you need to be sure to include some sort of CPI adjustment. Again, the time period of



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- c. **Study Period.** Once a wind farm lease is in place, there is often a second stage, which is the development and construction phase, during which time you are not generating significant revenue. There are some developers who want to build their inventory and will pay modest lease payments to hold property until they decide to build. Again, you want to understand and negotiate this time period and possibly incentivize the developer to build by increasing every year, the lease payments during the development stage to keep them on task.
- d. **Payment.** Lease payments themselves continue to change. When the industry in this country first developed, flat fees were paid per turbine or per megawatt.

the lease is very lengthy and you need inflation protection.

- e. **Relationships.** Many farmers like to work with people they know and respect. Wind leases are generally assignable without your consent and in most cases; the person who knocks on your door will never be seen again once the lease is signed. You need to understand this process and consider whether you want to restrict the assignment. This industry has matured dramatically over the past several years and many of the developers are now employees of the ultimate builders and owners. Large utilities are now fully integrated in the wind business and you may be able to restrict

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CONTINUED FROM PAGE 5

assignments, but simply know that big companies can merge and consolidate.

In a similar vein, most of these projects are leveraged, some highly-leveraged, which means you may want to also inquire as to who the lender is so you know who else you might be dealing with, other than the developer.

f. **Development Process.** Ask questions about the development process itself. If you sign a lease with a developer new to the area, you may be “riding the wrong horse” because they will not get the development permitted. Wind farms in Texas and the Dakotas are not particularly controversial and permits are attained fairly easily. However, in the east, there are many individuals who protect and cherish all mountain ranges and forests and who do not want any development of any nature in the mountains. In the press and during the permitting process, these same individuals will raise a myriad of challenges and questions unrelated to view shed, to slow down and stop wind farms. Therefore, you will want to deal with a sophisticated development company if you ever expect to see a return on your lease.

g. **Real Estate Description.** What exactly are you leasing? You need to be as precise and exact as possible. A wind farm does not need much acreage for the final product. As mentioned earlier, you may have a small substation located on your property, which is approximately a quarter of an acre. There will be a wide road built to deliver the turbines and to provide access for any required maintenance. You need to see the wind farm site plan to determine how much land you will lose to the road and where exactly that road will be. The road will travel along the wind turbine

sites. You also want to know where the wind turbine sites are, which occupy approximately a quarter of an acre in terms of the concrete pad upon which the turbine rests. Depending on your farm, you need to look at the plan and make sure the lease allows you to utilize all of your remaining property as you always have and that once built the lease does not cover excess acreage.

Initially, many wind farm developers will not know exactly how many turbines will be located on your property. However, you should negotiate to restrict the leased space to the property that they actually utilize when they are finished so that there is no dispute over what you can do with the rest of your property. As to the leased property, in most cases, you can reserve full and complete access for grazing, cropping, hunting, timbering and other activities, provided the road remains available to access the turbines. If you have visions of natural gas leases or other commercial enterprises at the same time as a wind farm lease, then make sure that is provided for in the lease.

The construction process will require additional acreage and much like utility easements, there should be a temporary construction easement negotiated and then when the project is completed, the leased land can be reduced to the permanent easement.

h. **Studies and Reports.** If there is a development or feasibility period after which the developer can terminate the arrangement, be sure to negotiate your right to all of the studies and work performed by the developer related to your property, including the wind data. The first step in the development of a wind farm is the erection of an anemometer (met tower) to measure the wind re-

source to generate required documentation for the developer and any lender, proving that the wind resource makes the project feasible. Negotiating a met tower lease is much like negotiating a cell tower lease, except for the temporary nature of the met tower, which may only be in place for one to three years. However, in some cases, developers actually keep the met tower in place for the balance of the project life—another final lease payment opportunity.



i. **Termination.** You need to negotiate, although most local officials require, that the developer properly decommission the project. This means that you want the concrete pad taken out at least down to plow depth level when the project is decommissioned. Different jurisdictions have developed different methods of securing decommissioning funds. The issue is if the developer goes bankrupt, who will pay to decommission the project? In the present economy, the value of the turbines or even the scrap material exceeds the cost of

decommissioning and therefore, if you negotiate the return of the equipment to you, if a bankruptcy occurs, that concern may be covered. There are also surety bonds being developed to cover decommissioning costs.

- j. **“Standard” Provisions.** Toward the end of any contract are what some lawyers call “boiler plate language” that is sometimes listed as “Miscellaneous” on the last page of the fine print. Remember this is a very, very long term lease



and each and every one of these “standard” provisions should be read, considered and discussed. For example, dispute resolution can be extremely important. What law applies? Where do you litigate? Where do you arbitrate? Where do you mediate? These are all extremely important when you have a farmer negotiating with a European utility company. If you prevail in the dispute, you should probably have your professional fees reimbursed, which is not the standard American law, but is more typical in other countries. So,

choice of law, venue and type of dispute resolution are all very important items.

- k. **Definitions.** Make sure terms are defined. For example, the percentage of the gross revenue concept is probably the best type of rent to negotiate, but you need to be sure you define gross revenue. Is it actual cash flow exclusive of various state, local and federal tax incentives? Some tax incentives can be monetized more easily than others. For example, a traditional wind lease in computing gross revenue includes the proceeds from the sale of the electric power, usually to a utility. The second source of revenue is the sale of the “green tags” or renewable energy certificates or whatever the market wants to call the intangible value of electricity from a renewable source. If a “cap and trade” system is part of the new political landscape and energy independence, then that likewise needs to be part of the revenue definition.

- l. **Miscellaneous.** Confidentiality and non-disclosure are common provisions. The developer certainly does not want you to brag about the revenue you are receiving and you may not want that well known either. Long term leases need to be recorded in the public records, but the lengthy lease being described herein is not recorded, instead a summary of the lease or “Memorandum of Lease” is recorded, and it does not contain details as to the rent payments. Also included in the “Miscellaneous” section would be liability for property taxes. Generally the farmer pays the real property tax, but not any tax whether it is personal property tax, a utility tax or a real estate improvement tax assessed on the income or the value of the wind farm improvements. Similarly, insurance and liability provi-

sions need to be included, which would be similar to most lease provisions. Rights to place Deeds of Trust on the property are important for both parties to negotiate. Subordination provisions can be very important as to who has the right to pledge the property and requiring a developer to subordinate to your lender. Be sure to ask your Farm Credit banker about what they prefer in the lease to protect their interest and to keep them comfortable with your banking arrangements.

Natural Gas Production

We just went through a short period of rapidly rising natural gas prices, which has just collapsed again. However, there was a flurry of activity, particularly in the mountainous regions of Virginia and West Virginia from natural gas leasing companies. Most of what I summarized above for a wind lease is applicable to a natural gas lease.

Unfortunately, the natural gas business is much older and by practice, the forms used in West Virginia and Virginia have not changed much in many, many years. When confronted by a two or three page, fine print, front and back lease that looks the same as the ones I looked at twenty five years ago when I first started to practice, I simply hand it back to the developer and tell them that my client is interested in a lease, but only a fair and modern lease. I have actually handed them a copy of leases you can find on the Internet from Texas that are approved and provided by the Texas regulatory authorities. Those leases are not perfect, but they certainly include provisions and protections for farmers that are seldom seen in the old forms still utilized too often in our region.

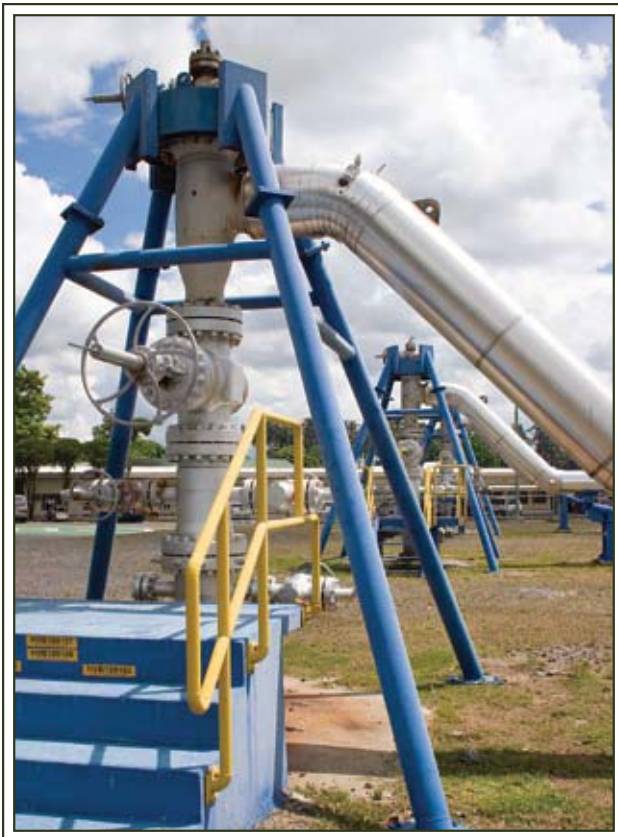
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Farm Wind, Solar and Geothermal

We just had an election and “change” is in the air. It is important to note that both candidates strongly supported energy independence and included that as one of their top priorities. It is also important to note that in the recent “bailout bill” or “TARP” that was passed, spending seven hundred billion dollars of our money to correct our finance markets, many renewable energy tax provisions were included. Of particular interest to you is the 30% federal tax credit available for the installation of small wind facilities and a 10% credit for geothermal systems. Tax credits have been in place for several years for solar installations, but were not available to wind and geothermal installations.

Generally speaking, wind, properly cited has become competitive with the more customary energy producers such as coal,



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nuclear and natural gas, depending on how you compute the cost of production. Without arguing about which type of energy is more cost effective, almost all energy experts will admit that solar is still more expensive to produce than any of the other alternatives. Wind, if it is not already equal to the traditional energy sources, is certainly much closer than solar. Therefore, with this new tax credit just recently adopted, you are going to see a tremendous jump in the development of small wind.

Because of the lack of an energy policy for decades in this country, you have to look to Europe and other countries for guidance and experience. With an emphasis on energy independence in this country, you are going to see tremendous opportunities to place wind / solar combined products on your farms to “get off the grid” and save on your energy bill, if not eliminate it.

In the wind business, there have been tremendous advancements in the efficiency of the large, commercial wind turbines. The same size turbine can provide double, if

not triple, the energy of the turbines manufactured ten years ago. Unfortunately, the research and development dollars have in large part focused on the commercial wind turbine space up until now. With the 30% tax credit for small wind, the energy independence focus and possible adoption of an energy policy in this country, you need to pay attention to developments and decide when the time is right for you to defer your next tractor purchase and instead purchase some type of wind turbine, potentially combined with some solar installations.

There is not enough space in this article to delve into all of the tax incentives and programs available for small wind in Virginia and West Virginia. I suggest that you go to the AWEA website (www.awea.org), click on “small wind” and then go to the relevant state to check on what is available in terms of incentives. Currently, Virginia and West Virginia are very similar in providing some assistance, but nothing compared to what the farmers in the Midwest enjoy in states like Iowa and Minnesota. You need to continue to lobby your legislators so you can be, and remain, competitive with your brethren in the Midwest, who are going to be energy independent much sooner than you are.

In addition to the various tax incentives, which I suspect will be changing over the next two years; you need to watch how you get paid when you connect your project to the grid. You will find on those websites referred to, a summary of net metering. For farmers in Virginia, the 500 kilowatt net me-

tering cap is very favorable, provided your electric utility is cooperative in assisting you with the connection. There are ongoing efforts to make sure that the interconnection process is and remains efficient. In the progressive jurisdictions in this country, state feed-in tariffs have been legislated. This is a concept developed in Europe that establishes a premium price at which the utility must buy the extra energy produced on your farm. I encourage you to educate yourself on this concept so that you can lobby and encourage your state representatives to improve net metering rules and regulations and to adopt feed-in tariffs. Again, I suggest you take a look at the AWEA small wind turbine global market study released earlier this year, which is a very helpful overview of the marketplace.

My belief is that within the next five years, many farmers will generate their own electricity that will minimize, if not eliminate, their electric bill. For those that have good wind resources, I believe you will generate more electricity than you can utilize and you can work toward sharing that with neighbors in a community wind system or you may start to convert some of your motor vehicles powered by diesel and gasoline to electric fueled vehicles and plug in at night. Finally, if you have a really good wind resource, you may sell the extra electricity, hopefully at a high price, utilizing a feed-in tariff.

Water

Finally, looking toward the future, you need to monitor and protect your water. Most of you use wells, which means there is water underneath your farm and some of you have springs, rivers or streams that are located above ground.

As most of you know, water is a scarce commodity west of the Mississippi and has been the subject of many farm fights and liti-

gation. You have just started to see that type of legal issue arise in the east between the states of Alabama, Georgia and Florida this past summer as the drought intensified. Water law is not well developed in the Virginias, but it will be in the coming years.

You need to protect your water resources and monitor what you use to make sure you use what you need. If you have any growth plans, the sooner you plan to use more water for your farm operation, probably the better. At some point there will be more and more restrictions on what each land owner who has access to underground and above ground water resources is permitted to use, which is the law of "West." This wonderful resource, which we take for granted, is going to become an issue, but maybe only for the next generation of farmers.

Conclusion

1. In the long term, you should be able to increase cash flow by reducing, if not eliminating, energy costs; solar and wind comes from above the farm.
2. If you are approached by a wind farm developer—educate yourself and get experienced help—the leases are negotiable.
3. If you are approached by a gas developer—maximize your below the farm income, educate yourself and get experienced help—the leases are negotiable.
4. If you have a good wind resource, you need to utilize it now. If you do not have a good wind resource, you need to monitor progress in the geothermal and solar industry over the next decade.
5. Protect and Monitor Your Water. ∞

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