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Details And Accuracy Help Insure The Wind Farm

What a developer building a single site or series of mid-sized wind farms needs to know.

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Celebration for the passing of the federal production tax credit (PTC) in September 2004 will soon turn into scrambling as developers strive to compete for and complete wind projects before the December 2005 deadline. As this industry goes back to work, now is a good time to brush up on the liability insurance needs and regulatory climate that affect wind farm developers.

Trying to stay ahead of the changing wind energy regulations and insurance requirements can be as frustrating as running into the wind – uphill. Recently, the bidding process on a large wind farm contract halted because the developer was unaware of the new Federal Energy Regulatory Commission (FERC) requirement regarding the large generator interconnection agreement (LGIA) and its particular insurance provisions. The developer had to show proof of general liability insurance with very high limits before the LGIA negotiations could continue. The necessary insurance coverage had to be arranged before the developer had even been awarded the wind project. This scenario is not uncommon in the wind energy industry.

The insurance process

Before an insurer can begin to assess risk, they need to know who it is they are dealing with – accurately and in detail. It is imperative that you address the insurance process early. Why address it early? Price, price, price! When an underwriter receives your submission, he is going to assess whether your account is a good risk to even quote. Your application and how accurate and complete it is give an indication to the underwriter of what the risk will be like. A good insurance agent/broker knows that a complete and well-thought-out submission will get the preferred pricing consideration.

How and when your submission is presented to the insurance underwriter is almost as important as the data itself. Your submission needs to provide underwriters the information they need quickly, clearly and completely. Otherwise, they may just decline the submission or red flag it for items that are missing or incomplete, which could mean delays or higher premiums.

The five primary types of information an underwriter considers are:

- exposure base,
- underwriting history,
- risk management program,
- experience of the development team with wind farms, and
- company financial position.

Failing to include any of these pieces of information jeopardizes the opportunity for receiving the best quote possible.

Financial liability considerations

All of the developer's financial considerations need to be evaluated by the underwriter. Typically, a business plan is created that includes a feasibility study and pro forma financial projections. These are heavily based on projections of what should be – but is not always – fact. Variation can cause plans to fluctuate wildly from original plans, resulting in cost overruns and cash flow shortages. Liability insurance is normally not invalidated by bankruptcy, so underwriters are careful not to get involved in financially risky projects.

This exposure is heightened when a developer is selling the project to a new equity owner. At this point, the equity owners and their sources of capital will certainly audit and question the status of all facets of the construction and permitting phase. The transition will likely be subject to Securities and Exchange Commission or Blue Sky regulations, and the new equity partners may look for representations and warranties from the developer. Both the developer and the equity partnership should seek directors and officers liability insurance (D&O).

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Contractual questions

Another financial consideration the underwriters assess is the liquidated damages and other penalty clauses in contracts and agreements. These clauses can have an onerous effect on the developer's financial position as well as require remedial work to be done at an additional cost. Similarly, contracts between manufacturers, developers and contractors often include various forms of indemnity or hold-harmless clauses.

These can range from each party assuming liability for its own work to one party assuming liability for the entire work of another party. Underwriters usually are more comfortable with the former and less with clauses that invoke one party holding the other one harmless, even for the sole negligence of the second party.

Larger companies have been known to force such types of contractual wording or hold harmless clauses on smaller companies who are more dependent on gaining the contracts to provide cash flow for their business. Special care is recommended for those who are faced with a party requiring onerous clauses, as this may make procuring adequate insurance more difficult and costly.

Special liability issues

The wind energy PTC has been reinstated through 2005, providing a 1.8 cent-per-kWh tax credit for electricity generated with wind turbines. Wind farms will now have until Dec. 31, 2005, to produce commercial power and transmit it to a utility grid. If the turbine is not up and running before the deadline, wind farm projects could potentially lose millions of dollars. What could prevent a wind farm from meeting the 2005 deadline? Delay in shipment of turbines, equipment breakdown, back order of replacement parts or failure to secure necessary permits, just to name a few.

As indicated, the PTC can dramatically impact the financials. The PTC can enhance the financial picture for profitable equity owners by nearly 60%. Typically, the power may generate 3 cents per kWh produced, while the PTC may provide tax credits of an additional 1.8 cents per kWh, substantially lessening the tax burden of the owners. This is a key component of the pro forma financials and can be greatly colored by cost and overruns, delays, damage clauses, and other contractual or regulatory issues. Great care in protecting the PTC is advised, as lack of the PTC can challenge the viability of the project.

Regulatory climate

Federal, state and local regulations exist to make a wind project acceptable to the community and still allow the wind farm to be economically viable. From environmental concerns, including land use, avian studies, soil erosion and water quality, to aesthetic matters, such as visual and noise impact to public health and airport safety – numerous regulations and permits need to be addressed very early in the wind farm development project. Not all permits are applicable to every wind project.

And the permitting process varies from one state to another. The developer must deal with local, state and federal permitting authorities and know which authority to contact first and when. Some of the authorities may include local planning commissions, zoning boards, state agencies with siting or review responsibilities, and federal authorities such as the Bureau of Land Management (BLM). The projects also may be subject to local environmental laws or require involvement of the Federal Aviation Administration (FAA).

This environment of regulations and permits represents a precarious landscape for the developer. If the developer stumbles in this process, he will be exposed to a host of liabilities that he may or may not have insurance coverage for. There is also a chance that the developer could face a lawsuit for a concern not covered in his project's permitting process.

The developer needs to understand what insurance covers and what risks remain exposed. There are many types of liability insurance needed. Insurance coverage is available for just about any risk as long as price is not an issue. Your general liability policy should cover your liability for bodily injury and property damage from your premises, operations and the operations you perform for others that are completed; your products; advertising injury and contractual liability.

However, it does not address liability arising from a regulatory or permitting violation. In order to protect against these risks, you must purchase separate specialty coverages, such as environmental liability insurance, that a knowledgeable insurance agent can help you select.

FERC regulations

Not all developers are aware of the new Federal Energy Regulatory Commission (FERC) requirement regarding the large generator interconnection agreement (LGIA) and its particular insurance provisions. This regulation requires "public utilities that own, control or operate facilities for transmitting electric energy in interstate commerce to file revised open access transmission tariffs containing standard generator interconnection procedures and a standard agreement that the Commission is adopting in this order, and to provide interconnection service to devices used for the production of electricity having a capacity of more than 20 MW, under them. Any non-public utility that seeks voluntary compliance with the reciprocity condition of an open access transmission tariff may satisfy this condition by adopting these procedures and this agreement."

Simply stated, developers subject to LGIA must have a $20 million excess or umbrella liability limit on top of their general liability policy to comply.

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The developer trying to access public lands for a wind project needs to work with the Bureau of Land Management (BLM) in order to gain approval for his project. The BLM tries to protect the land and balance the interests of the developer, who is offering a positive economic opportunity to the local area, with the wishes of the community and the agency's charge to protect the environment.

In selecting a site, you need to plan ahead and consider the impact your project will have on the area and investigate what potential obstacles exist. The developer needs to have a strategy to deal with the property owners, local authorities and the BLM. Be aware of the environmental concerns of that particular region, develop some strategic local partnerships and have a plan on how you can help to improve the region.

Possibly, your project will bring much-needed jobs to the area, or perhaps you will be asked to provide funding to help with matters such as botanical resources, law enforcement and other management issues. The local authorities may be concerned about the need for an expanded road network, an increase in littering or vandalism. You may see this wind project as a great business opportunity, but you must be prepared to make concessions to a community/agency that is less optimistic.

In general, gaining the necessary permitting will not be easy or swift. Doing the prep work well in advance will improve the odds for a positive outcome and will likely reduce the number of appeals, protests and lawsuits filed. However, there are no guarantees that the process will yield the end results you are expecting. And even if you secure the required permits, you may still face lawsuits and lengthy delays.

Power purchase agreement

Typically, the power purchase agreement (PPA) is the document that brings together the developer and the equity partners with the utility purchasing the power. It is under the PPA that the generator produces power and the utility must buy the power. A renewable portfolio standard (RPS) has been passed in 14 or more states whereby the utilities are governed by regulations which generally state that the utilities must buy an increasing amount of renewable energy and by a certain time period.

The fact that these regulations exist does not always mean that the utilities will jump to enter into them. In fact, there are quite a few ways that the utilities can and will frustrate the process with delays in contracting, delivery of transmission lines and meeting compliance standards.

A PPA, it should be noted, is not really the developer's document, but a document that will be signed by the equity partners and the local utility. Its importance, therefore, is magnified because the developer must foster the conditions that will allow this document to reach fruition. Without this document, it is unlikely the project will ever sell. In addition, the financial stability of the utility becomes a factor as well. If the utility is small and not creditworthy, the project's financing could be adversely affected.

Another potential barrier is the delivery of transmission lines. A utility will undertake the costly construction of transmission lines only if they are confident of a profitable return. Assuming that everything falls into place, the equity partners, likely a new LLC, will own the PPA, have rights to or have acquired the land and have completed the wind studies, and the transmission and distribution lines will be in position. At this point, the developer can exit the process and turn the project over, in most cases, to the new LLC (the equity owners).

Additional liability issues

In any discussion of wind farm liability issues, it is useful to examine the sensitive liability issues facing businesses in general. High on that list are punitive, exemplary and multiplied damages. Through the efforts of trial attorneys, certain types of claims have garnered monetary awards far in excess of a plaintiff's actual loss – sometimes to a factor of many times whatever the damages themselves were. Consequently, some insurance companies are no longer providing coverage for punitive damages. Any policy that the developer purchases should be carefully reviewed to understand the coverage, if any, for these damages. Also note that these punitive, exemplary, multiplied damages are not insurable in certain states.

"Construction defects" is an emerging liability issue that the developer needs to be aware of. It has developed from litigation spurned by the Northridge earthquake in the 1990s in California. Essentially, under construction defects, anyone who works on a project in virtually any capacity can be found to be at least partially responsible for a defect in construction of the project as a whole.

Typically, construction defects have revolved around residential real estate issues. However, attorneys have attempted to apply the same logic to commercial ventures. As such, a mechanical contractor working in the construction phase of a wind energy project might be held liable for a claimed defect (for example, a defect in the foundation), even though the defect might have nothing to do with the contractor's work on the site.

The effect of construction defect litigation has been to override longstanding triggers and limitations to the insurance company's liability on a single policy, and to allow the stacking of limits from multiple policy periods (when it is impossible to track the actual defect/loss date). If the developer is working in a "construction defect state," a state that accepts the theory in the courtroom, insurance

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companies may be reluctant to offer coverage. And the cost of any coverage that they do write will be higher, while the policy may contain new and limiting exclusions.

Class actions

The subject of mass torts, or class action suits, is unlikely to affect a developer, but is still worthy to be aware of. These suits are generally brought by a single plaintiff's attorney, who gathers large numbers of individual plaintiffs into one suit against a single defendant. While the wind farm developer may scoff at the improbability of such litigation, it is not impossible to imagine a loss-provoking incident outside of his control. Consider the following scenario: a commercial airplane strikes a wind turbine whose warning lights had a history of malfunctioning, and lives were lost. Such a liability could certainly arise and present enormous difficulties.

A final area to note for new issues in liability is the emergence of intellectual property litigation. Inadvertent failure to acknowledge the ownership and protection of patents, trademarks, copyrights and, importantly, computer software is more often being litigated. Intellectual property issues need to be checked and vetted carefully by the developer's attorneys. When in doubt, it is highly recommended that appropriate licenses be sought and paid for.

Against this background of liability trends, the developer needs to understand what can and cannot be insured in today's marketplace. There are some basic types of liability insurance and some new ones that a developer might want to consider. At the forefront is general liability insurance (GL). GL is triggered by a bodily injury or property damage liability loss. It covers an insured company's (the developer's) premises, operations, contractual liabilities, liability for completed operations and products.

General liability insurance has exclusions, one of the most notable pertaining to environmental liabilities. The GL policy can also have additions, or endorsements, which can add valuable cover for the developer. One such endorsement adds hired and non-owned automobile liability. This is useful when the developer actually has no automobiles, yet requires coverage, for example, for airport rental cars. Please note that this coverage, hired and non-owned automobile liability, is not appropriate to all use of rental vehicles. For example, rental trucks used to service a facility belong on an automobile liability policy.

Another coverage which developers typically purchase and, with the LGIA, are required to buy more of is excess or umbrella liability. These are specific policies purchased to expand the limit of liability purchased by the developer. They sit on top of the GL policy and add higher limits.

Other or newer coverages that a developer might wish to consider are environmental liability policies, which plug a big part of the exclusions referenced above, and professional liability policies, which cover the professional errors or omissions liability of the developer. As professionals, developers are expected to provide true and complete services. Professional errors can often be characterized from a loss perspective by something as simple as clerical errors, which can cause economic damages.

Directors and officers liability

Another insurance policy or cover which the developer might be interested in pursuing is directors and officers liability. Even with a brand new LLC, this cover provides liability for directors and officers for wrongful acts committed by the organization and the management or oversight of the organization. It is important to note that most directors and officers wish to see this coverage purchased because they can be held personally liable (yes, their personal assets) for this exposure.

Now, all of the pieces have come together, with descriptions of the wind farm, who is the insured, how the project comes together, the regulatory hurdles, the contractual issues and the types of insurance coverage which the developer might wish to consider.

At this point, it is appropriate to review how much money the developer can actually afford to spend on insurance against potential liability. A good insurance agent will help a developer understand risk management and the "ART" of risk transfer. ART is an acronym standing for avoidance, retention or transfer of liability.

Let's start with transfer. Transfer of liability can occur in two ways: the risk can be transferred contractually, putting the biggest parts of the liability burden on someone else, or the risk can be transferred with the purchase of insurance, in which case the liability is then assumed by the insurance company for cost. Insurance agents are generally very good at this aspect of risk management.

There are, however, two other areas of risk management where risks are either too expensive to insure or are better handled by another technique. The avoidance section of the risk management formula might include steps taken to stay out of certain jurisdictions where the environment is not friendly. It might involve not using certain contractors, who, although they are cheaper, might have a checkered past or poor financials. It might involve not agreeing to certain clauses in contracts that are executed. All of these used together are a very effective and economical way of avoiding liability.

When it's no longer possible to avoid liability and the cost of transfer is prohibitive, the remaining option is retention. Many companies retain significant loss exposure. A good rule of thumb on retention, however, is "don't risk a lot for a little."

Use of transfer and avoidance is

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recommended in almost all cases, except where known certainty of loss exists and trading dollars with insurance companies is involved. There are various methodologies for retaining loss exposure, but typically a company can accrue for expected liabilities over a period of time. Typically, they cannot be deducted as a business expense until such time as payment is made against them.

A usual area in which retention might come into play could be large workers compensation exposures where there is a known certainty of loss. This type of approach has also been used with large fleet exposures where there is also a large certainty of loss. In both cases, it might not be economically feasible to trade dollars with insurance companies for known loss amounts. So funds are set aside, TPAs or claims adjusters are set up to manage those exposures (they are not ignored), and as the losses are paid, they are then expensed within a certain finite financial area. For example, sometimes that area might be a large deductible or self-insured retention. So which of these exposures should the developer transfer, avoid or retain? Well, that is the art.

Together with a knowledgeable insurance agent, an "insurance-savvy" developer can better understand what his exposures might be and how they might be handled. Obviously, each and every developer faces a different set of circumstances. Consequently, it would be impossible without looking at those developers' individual circumstances to make any type of generalization as to how the project might be insured. But rest assured there are many very qualified people in the insurance industry that would be more than happy to work with a developer in trying to find the best combination to suit the developer's individual needs. NWP

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