
Marketplace: Project Finance

Wind Power Financing In Canada And The U.S.

The tax code in both countries plays a crucial role in project development.

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The financing of wind farms in North America is heavily dependent upon the tax incentives available to investors in each local jurisdiction. The tax benefits available in Canada, in the form of favorable tax deductions, have resulted in several recent tax-based public offerings of limited partnerships that invest in flow-through shares issued by wind developers.

By contrast, the “on-again, off-again” production tax credit in the U.S. has stimulated investment on a sporadic basis in privately financed wind farm developments.

The Canadian experience

In Canada, renewable energy production is a priority. Nowhere is this more obvious than in the realm of wind energy production. All levels of

Canadian government (both federal and provincial) have provided several incentives to promote investment in Canadian wind energy projects.

These incentives are potentially available at each stage of a particular wind energy project’s lifecycle – from research and development, to capital funding, to production. A well-known example of the latter is Natural Resources Canada’s wind power production incentive

(WPPI) program, which is designed to subsidize about half of the cost premium of producing wind energy over conventional energy sources.

The Canadian Income Tax Act also provides a number of incentives. For example, certain wind power production equipment may be eligible for accelerated and enhanced depreciation expense claims.

In the 2005 federal budget, the

Canadian government announced that certain renewable energy generation equipment (including wind turbines) acquired after February 22, 2005, will be eligible for depreciation (for tax purposes) at a rate of 50%. Investment tax credits may also be available for “scientific research and experimental development” costs incurred in connection with the development of new energy-saving technologies.

In addition, the Tax Act allows for a 100% deduction of Canadian renewable and conservation expenses (CRCEs). CRCEs include certain project development costs that would otherwise be capitalized or only partially deductible in the year they were incurred. The Tax Act contains rules that, under certain circumstances, permit a corporation incurring CRCEs to transfer the tax deduction benefits to its shareholders through a “flow-through share” structure.

Flow-through share structures have long been popular in the mining and oil and gas industries, and more recently have been used to finance the early phases of wind energy projects. With the exception of the number of

companies that the limited partnership invests in, the flow-through share structure for wind energy projects is practically identical to the structure for mining or oil and gas projects.

With mining and oil and gas structures, the limited partnership often invests in several companies (typically more than 10) with the hope that one or two are highly profitable, whereas the emerging trend with wind energy structures is that the limited partnership invests primarily in only one or two companies.

In a simple flow-through share structure, investors acquire shares of a company (either directly or indirectly through a limited partnership) that has or will incur CRCEs. Under the terms of the investment, the company will agree, for purposes of the Tax Act, to “renounce” the CRCEs and “flow-through” such expenses to its investor shareholders.

The flow through of CRCEs effectively reduces an investor’s money at risk (commonly by more than a third) and thus provides downside protection on the investment by lowering the investor’s break-even point.

As an additional incentive, the Tax Act allows an eligible company to renounce its projected CRCEs for a given year with retroactive effect to the previous year – this “time value of money” incentive permits the tax deduction for the CRCEs to be realized generally within a few months of the flow-through share investment, while any tax payable on income from the investment would not be due until at least a year later.

The Creststreet Power & Income Fund LP was the first Canadian public offering of limited partnership units to finance a wind energy project. In December 2003, the offering closed, reportedly with high demand, raising C \$42.5 million for the acquisition of two wind energy companies, one located in the province of Quebec and the other in Nova Scotia. Investors reportedly received tax deductions of 83% of the subscription amount in their 2003 taxation year.

Following Creststreet’s offering, the First Asset Renewable Power Flow-Through Limited Partnership closed in September 2004, raising C \$16,624,600.

Unlike the Creststreet offering, the First Asset offering was a “blind pool” setup whereby the stated intention of the partnership was to invest in flow-through shares of six or more “renewable energy issuers” (which could include issuers engaged in the production of wind energy).

It is a blind pool setup in that the offering materials disclose the parameters by which the partnership will invest the proceeds from the offering, but do not indicate what specific companies will be invested in. As of January 31, 2005, approximately 50% of the partnership’s investments were wind energy related. On February 8, 2005, preliminary materials were filed for a second offering, the First Asset Renewable Power Flow-Through Limited Partnership II.

The largest and most recently completed offering is the Airsource Power Fund I LP, which closed in November 2004 and raised C \$65 million to finance a Manitoba wind energy project.

With the tax benefits associated with the flow-through share structure,

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together with other tax – and non-taxed – based incentives provided by the Canadian federal and provincial governments for wind energy production, further flow-through limited partnerships forming to finance such production is expected.

The U.S. experience

Wind power offers an increasingly viable and technologically sound power source in the U.S. Yet, its wind energy industry still faces a struggle for long-term financial viability. Federal and state incentives help the wind farms compete for a space on the electrical grid as it becomes a reliable and unlimited natural resource to generate electric power.

The primary federal incentive to promote investment in U.S. wind energy projects is the production tax credit (PTC). The PTC for any tax year, prior to the expiry of the program (currently December 31, 2005), currently is an amount equal to the product of 1.9 cents multiplied by the kilowatt-hour of specified electricity produced by the taxpayer and sold to an unrelated person during the tax year.

The PTC is available for each taxable year in the 10-year period beginning on the date the facility is originally “placed in service” (put in a state of readiness and availability for its specifically assigned function). The PTC is subject to adjustment in accordance with the U.S. Internal

Minnesota.

The expiration of the PTC will likely push the wind industry into another boom-bust cycle – from boom this year as developers race to place in service new generation before the PTC expires December 31, to the potential bust in 2006 when the credit

the PTC being in effect.

Unfortunately, unless Congress acts in the next few months, the bust, or at least a slow-down in development of wind power, seems likely to occur early next year. Despite state initiatives to develop wind power, the economics do not compete well against other traditional oil and gas energy resources without the boost from the PTC. While Congress addresses other national issues, the wind power industry worries about the continuation of the PTC and the future development of wind power.

Consequently, since 2004, the American Wind Energy Association has been calling on Congress to pass a long-term extension of the PTC to provide a stable market environment and unleash the technology’s potential as an energy source.

Although the PTC plays a crucial role in the future viability of the wind energy section, U.S. tax incentives are not limited to the PTC. Wind energy companies will still be able to claim depreciation on the wind turbine assets under the Modified Accelerated Cost-Recovery System. The value of those tax benefits depends on the tax position of the sponsor that claims them, but the substantial acceleration of the write-off of the investment

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Revenue Code of 1986, as amended.

The PTC arguably makes the delivery of wind energy financially competitive with hydrocarbon fuel sources such as oil or gas. However, even with oil costs skyrocketing toward \$55 per barrel, Congress may allow the PTC to expire at the end of this year. Previously, it expired in 2003 and was reinstated in 2004. History has shown that the loss of the PTC damages the stable and continuous development of wind power. As a result, this situation will force many developers to accelerate construction of wind farms into 2005 in such states as Texas, Colorado, Pennsylvania, Kansas, Illinois, California and

may not be available.

This boom-bust cycle occurred previously when the PTC expired at the end of 2003, before it was reinstated on October 4, 2004, when President Bush signed into law a two-year extension of the PTC. Section 313 of the Working Families Tax Relief Act (2004) extended the then 1.8-cent-per-kWh tax credit for all facilities placed in service on and after January 1, 2004, and on or before December 31, 2005.

The problem this year is compounded by market reports that the turbine supply for 2005 has been sold, and that the turbine manufacturers do not yet have any reliable way to predict demand for 2006 and beyond without

helps lower the total after-tax cost of the wind power project.

On the state side of the wind industry, states continue to enact or propose legislation to encourage or require the development of energy production from renewable resources, including wind power. For example, Illinois Governor Rod Blagojevich plans for wind farms to generate 3,000 MW of power for the state by 2012, and 19 states have created incentives and/or requirements to build renewable energy resources. With the benefit of the PTC, the industry may have a solid year of growth in 2005, with about 2,500 MW of new generation to be installed this year.

Most wind farms use the incentives and structure their development and financing like most other power projects. Typically, a combination of limited partnerships will constitute a

project company group that designs, constructs and finances a wind farm. The project entity that owns the wind farm can use the PTC, federal tax benefits and state wind incentives.

For example, in Texas, one of the major U.S. states for wind power, wind farms can sell renewable resource credits to utilities that must meet mandated purchases of renewable resource power. Texas developed its Renewable Energy Credits Trading Program in 2000 for the purpose of ensuring that an additional 2,000 MW of generating capacity from renewable energy technologies is installed in Texas by 2009 pursuant to the Public Utility Regulatory Act (PURA) §39.904.

Texas also aims to ensure that the new renewable energy capacity is built in the most efficient and economical manner; to encourage the development, construction and operation of

new renewable energy re-sources at those sites in the state that have the greatest economic potential; and to protect and enhance the quality of the environment in Texas through increased use of renewable resources.

Texas has made real progress toward its goal of generating 2,880 MW of renewable energy resources by January 1, 2009, pursuant to the PURA §39.101(b)(3). Texas legislators, in Senate Bill 533, recently considered expanding, but did not enact, requirements in Texas to generate up to 10,000 MW of electrical energy from renewable resources by 2025.

With the help of the U.S. Congress, industry participants in the U.S. hope that wind energy will eventually “breeze” right into the mainstream of power development and generation. However, the industry has encountered a dilemma: What will it do in 2006 and

beyond if the extension of the PTC remains in doubt, despite the increasing interest in the wind power industry by states and the private sector.

The wind power industry will continue to move ahead, but a long-term renewal period for the PTC will surely put the wind at its back. *WVP*

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