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## **ORTECH Power Points™**

### **Double Whammy!**

by

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On Friday, May 5, 2006, Creststreet announced in its Q1 quarterly report that its Mt Copper wind facility had operated at 30 % below the expected average long-term estimated output and that, accordingly, the directors of the general partner determined that it was prudent to reduce the partnership's distributions by 13.6%. The partnership's unit value suffered immediately. The narrative accompanying the quarterly results attributed the shortfall in output as to 20 % to low winds and 10 % to equipment availability. The announcement noted that Creststreet was working with the turbine manufacturer to correct the equipment aspect of the problem which was gear box related.

The primary stated reason for the cut in distributions was the prudent management of lower than targeted cash reserves in light of the current variability of energy output caused by a low wind period combined with reduced equipment availability. In other words, the distribution cut addresses a temporary matter, but interestingly, it was not portrayed as a temporary measure, sending mixed signals as to management's expectations of long-term asset performance.

In a news release dated June 6, 2006, Creststreet provided an interim update for April and May. Despite low equipment availability at Mt Copper, the combined production of its two wind farms was close to the long-term forecast during the period. This would imply that wind conditions were above average during the period. The unit price has recovered slightly, but remains significantly below the initial issue price and the trading price prior to May 5<sup>th</sup>.

The reduced trading value of the units provides an indication that the market was either not prepared for significant variability in production or it perceives increased uncertainty in the sustainable long-term average energy output (i.e. the P50 estimate contained in the initial public offering) or both. We reviewed the available information to better understand the broader significance of this event.

As to the sustainable long-term energy output, the P50 annual energy production number represents an estimate of the projected average long-term output over 10 or 20 years given the wind resource at that location and the equipment type deployed. Creststreet disclosed both, monthly and annual output estimates. Significant variations from these estimates can be entirely consistent with the cyclical nature of wind resources. In order to determine if low wind performance during a quarter lies within the natural variability of the initial P50 estimate, one would have to carefully verify the wind farm performance in the context of the original P50 estimate. While such analysis is possible, the published information is inadequate to do so.

In the absence of further information, the under performance of the wind in Q1 and the better performance in April and May illustrate only the variability that is inherent in wind resources.

As to the equipment performance, the P50 estimate disclosed in the initial public offering appears to account for some equipment losses but not others. For example, the independent engineer estimated the turbine availability at 97% (i.e. outages 3% of the time). The published information stated that the first year warranty was for 90% availability and the actual first year availability was around 90% (but lower during Q1), with years 2, 3, 4 and 5 warranted at 95%. The difference between 90% actual output and 97% expected output is very significant to distributable cash flow in the short-term; however, the manufacturer's ability to deliver the availability level warranted during the first year, despite gear box problems provides some indication that 95% availability is being worked towards for the remaining warranty period. The remaining equipment uncertainty relates to the difference between the 95% and 97% availability, and the ability to address gear box issues before expiry of the five year warranty period.

Perhaps the market reaction to the Q1 results could have been mitigated somewhat if the 90% availability anticipated in the service agreement had been better communicated to unit holders at an earlier time. Although Creststreet's disclosure in the initial public offering prospectus was generally detailed and of a high standard, this issue was not covered. Warranties with reduced first-year availability numbers are typical in service agreements, as they reflect start-up complications that are common with newly commissioned equipment.

Unfortunately for Creststreet, the market reacted with a double whammy. The 13.6% cut in distributions has dropped the trading value of the units roughly 45% below the initial issue price. This indicates that the market has not only adjusted for the distribution cut, but has imposed a significant penalty for the perceived uncertainty regarding the wind asset performance. The latter should be of concern to the wind sector as a whole. It indicates that the market is looking for risk management information that is often lacking.

This event draws attention to P50 estimates, wind resource variability and equipment performance. In the short term, this uncertainty could affect the market appetite for new flow-through tax product and power income fund issues. The market value of publicly traded entities that have a significant wind component could also be affected.

Increased market uncertainty is likely to trigger higher hurdle rates for new equity and higher bid prices for upcoming power purchase agreements. To a limited degree, this indeed may be

prudent as ORTECH has argued for some time that returns on equity have been aggressively low, given the sensitivity of wind projects to small changes in revenue or operating costs. However, it is equally undesirable if return expectations swing to the opposite extreme and become unreasonably high.

Wind energy continues to be a relatively new area for the capital markets in Canada. While wind farms are excellent infrastructure investments, the market's understanding of the risks and uncertainties is still maturing. More detailed and insightful disclosure would reduce market uncertainty, reduce uncertainty penalties, improve market values, lower costs of capital and keep power prices competitive. Unfortunately, many wind farms are not even gathering the underlying technical and operational information to do so. We believe better reporting is possible; performance benchmarks are required to which long-term estimates and quarterly results can be compared on an on-going basis. Should you be interested in following up on this topic, please contact us.

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