

Locke Lord QuickStudy: Bridging the Gaps: Will the IRA Really Be a Game Changer for Offshore Wind??

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The excitement surrounding the passage of the Inflation Reduction Act (“IRA”) was perhaps felt nowhere as strongly as among proponents of the US offshore wind industry. From project developers to original equipment manufacturers to vessel owners, the fledgling industry welcomed the passage of the IRA as potentially the single largest tool available to reduce uncertainty around project development costs, surmount supply chain challenges, and put the industry on a fast track to viability. In the intervening months, while enthusiasm still abounds, a more detailed analysis of the IRA has revealed a number of significant gaps that could have meaningful implications for the US offshore wind industry.

Scope of “Qualified Energy Property”

Sections 45 and 48 of the IRA provide new incentives for developers of offshore wind projects in the form of revamped investment tax credits (“ITCs”) and production tax credits (“PTCs”) for “qualified energy property”; however, precisely what “energy property” is actually “qualified” remains murky. Take for example the case of subsea power cables. Every offshore wind project will require both inter-array cables (which carry power from individual turbines to the offshore power substation) and export cables (which transmit power from the offshore power substation to the shoreside power substation), yet neither type of cable was explicitly identified as “qualified energy property” under the statute. Given that subsea power cables (inter-array and export combined) constitute between 25-30% of an offshore wind project’s total CAPEX, the failure of the IRA to explicitly identify subsea power cables as “qualified energy property” elicited a strong reaction from interested parties in response to the IRS Request for Comments on Domestic Content Requirements under the Inflation Reduction Act of 2022. Among those submitting comments, trade associations and project developers alike underscored the importance of the inclusion of subsea cables as qualifying property under the IRA. As succinctly explained by one developer commenter:

“At an offshore wind facility, massive turbines are spread over a large area in the water. Subsea cables bring the electricity from each turbine to a 10-story offshore electrical services platform that collects the electricity and then steps up the voltage so that the electricity can be pushed to shore through an undersea export cable. The larger the project and the farther the distance offshore, generally the higher the voltage required. The export cable connects on land to the project substation, which has another transformer to adjust the voltage and condition the electricity for delivery through a gen-tie line to the utility grid.

The turbines, subsea cables, electrical services platform, and export cable offshore and the project substation and transformer on land are all wholly within the perimeter of the project. The project company owns them. They are a “single project” as used in the IRS construction-start notices. The current IRS regulations defined “qualified property” for ITC purposes as the parts of a project that are “tangible personal property” and “other tangible property (not including a building or its structural components) that is used as an integral part” of the wind farm. The subsea export cable and onshore project substation and transformer are tangible personal property or other tangible property that are integral to the operation of the project.”

Existing IRS regulations hold that “qualified wind energy property” includes “a windmill, wind-driven generator, storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items.” 26 CFR §1.48.9. Further, IRS guidance released by the Joint Committee on Taxation (JCS-1-22) on March 8, 2022 provides that qualified property “include[s] property owned by the taxpayer necessary to condition electricity for use on the grid such as subsea cables and voltage transformers.” This precedent should provide a sufficient foundation for subsea power cables to come within the ambit of the newly-expanded ITC and PTC under the IRA; however, if the IRS declines to follow suit, the benefits promised by the IRA to offshore wind developers will be appreciably circumscribed in scope.

Qualifying Wind Energy Components

Sticking with the theme of subsea power cables, another significant omission in the IRA arises in connection with the Section 45X Advanced Energy Manufacturing PTC. As with the Section 45 and 48 developer tax credits for “qualifying energy property,” the IRA similarly fails to identify subsea power cables as “wind energy components” eligible for the Section 45X PTC. As explained above, subsea power cables are integral to offshore wind development projects. Without them, any power generated would be captive at the turbines, rendering the project effectively useless. Nonetheless, subsea power cables are notably absent from the enumerated list of wind energy components, which are limited to “blades, nacelles, towers, offshore wind foundations and related offshore wind vessels.”

Commenters have been vocal in support of the inclusion of subsea cables under the developer direct benefit ITC and PTC provisions contained in Sections 45 and 48, but there has not been a corollary response to the absence of subsea cables as enumerated “qualifying wind energy components” under Section 45X. Given that the Section 45X credit targets the manufacture of qualifying components, developers do not stand to benefit directly from it, and further given that the US subsea power cable market is in its infancy and therefore without as strong of a lobby in the US to advance its concerns, there is a real risk that subsea cables – and other similarly-situated wind energy components – will be left on the sidelines as the IRA’s manufacturing tax credit benefits are realized.

Offshore Wind Vessels

Another missed opportunity under Section 45X of the IRA concerns the classification of offshore wind vessels as “qualified wind energy components.” As such, they qualify for a tax credit equal to 10% of the sales price of the vessel. This credit is of questionable value, however, as it inures to the manufacturer of the vessel; not the vessel owner. Unlike other “wind energy components,” shipyards do not mass produce vessels. Rather, vessels are individually commissioned by shipowners, at a significant cost of investment. Against the backdrop of uncertainty that permeates the US offshore wind market, it is the vessel owner – the party putting its capital at risk – who

should be incentivized to deploy that capital on a potentially risky and expensive new vessel build. Instead, the IRA paradigm only rewards the shipbuilder – e.g. the manufacturer. While market forces may ultimately reallocate the tax credits (through private party contracts) to reward the entity ultimately taking the risk – and therefore advancing the development of the offshore wind market – the legislation itself missed the chance to properly calibrate the tax credit to maximize its value as an incentive to US shipowners to build the new, expensive vessels that will be required to install offshore wind projects.

State v. Federal Incentives

Until recently, the development of the US offshore wind industry has largely been a state-driven initiative, which is reflected in the contracting schemes that govern the offtake of power from US offshore wind projects. Although most commercial scale projects will be sited in federal waters, the power generated from those wind farms will be transmitted through state-governed electricity offtake constructs. Consequently, power offtake agreements are governed primarily by the laws of the state in which the power will be received and transmitted to retail customers. This state-led procurement paradigm leads to another area where the IRA may create unintended consequences: the interplay between the IRA's federal incentives and conflicting governing-state laws and policies. In some states, offshore wind developers have been required to agree, as a condition to securing an offtake arrangement with the applicable state regulatory authority, to pass through to retail customers some or all of the incentives the developer can obtain through federal grants, rebates, tax credits, loan guarantees or similar benefits. Many of these state-administered offtake agreements were initially brokered during healthier economic times, which likely diluted developer focus on federal incentives. With the passage of the IRA, however, and the introduction of new federal incentives amidst the increasingly challenged economic environment facing developers, a growing number of developers are seeking to revisit those offtake agreements, under the auspices that the original terms now threaten the viability of the projects themselves.

Conclusion

The IRA is unquestionably a landmark piece of legislation with the potential to provide the federal support necessary to simultaneously catalyze and stabilize commercial offshore wind development in the US. That said, gaps in its interpretation, and challenges with respect to its interaction with conflicting state policies, threaten to reduce its beneficial impacts.

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