

PROJECT FINANCE

NewsWire

October 2001

Fallout From The Terrorist Attacks

by Keith Martin, in Washington

The terrorist attacks on the United States are expected to affect the project finance market in a number of ways.

Here are the main points that came out of a survey of chief financial officers and general counsels at project developers, top bankers and investment bankers, and others involved in the market.

Travel Bans

Travel bans are slowing down work on deals.

Many companies still had travel bans in place in late September as the *NewsWire* was going to press, forcing cancellation of meetings. The delays are affecting projects not just in the obvious places. Scheduling a meeting on a debt restructuring for a project in Latin America became difficult after several of the international banks in the syndicate reported that flying to and from the United States as well as most of the countries in North Africa and the Middle East was not allowed for bank employees until further notice. The head of an Africa investment fund said the fund canceled travel to Amsterdam for meetings because of concern about "US fighter planes in the air."

However, a project developer with a US power company in London / *continued page 2*

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THE TAX TREATMENT OF ELECTRIC INTERTIES will be settled by late November, officials at the US Treasury Department said. However, the World Trade Center disaster could delay things. At issue is whether utilities must report interconnection payments they receive from independent generators as income.

Meanwhile, the Internal Revenue Service released a private letter ruling in September that said a utility did not have to report interconnection payments from the owner of a cogeneration facility. The main focus of the cogeneration facility was to supply power to the owner's own factory. However, the owner planned to sell any / *continued page 3*

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said there were “some nervous travelers” at her company but no cancelled trips. “I don’t think financings will be delayed more than a couple of weeks, but we’ll see.”

Insurance

Insurance has become significantly more expensive and could have an effect on coverage ratios for debt service

The US government is expecting to have to fill in gaps in insurance coverage and in cases where jittery banks back away from financing commitments.

because it drives up operating costs.

Insurance companies served notice on international air carriers that they would cancel coverage for war liabilities as of midnight on September 24. Air carriers were given options to renew but at higher premiums and for drastically reduced per-occurrence policy limits. The cancellations appear not to have spread to power plants, but one US power company with projects in Moslem countries reported, “We are seeing terrific price hikes on insurance rates, particularly terrorist insurance.”

The US government is expecting to have to fill in gaps — not just in insurance coverage but also in cases where jittery banks back away from financing commitments. Any US government role would be through the Overseas Private Investment Corporation or The Export-Import Bank. One lawyer familiar with the thinking at both agencies — Ken Hansen in the Chadbourne Washington office — said, “OPIC and Ex-Im are already being called on to backfill for financial institutions who are becoming skittish and either want a government partner or want to quit the field and need OPIC or Ex-Im to take over their positions.”

OPIC expects be asked to provide credit guarantees for banks or insurance companies that are under market scrutiny.

The US Export-Import Bank expects to be called on to buttress trade arrangements that, absent Ex-Im involvement, could unravel for reasons unrelated to buyers and sellers of goods but rather because of failing confidence in relationships among banks, Hansen said. An example is where the Export-Import Bank guarantees letters of credit issued by emerging market banks that could have been confirmed two weeks ago by US banks but now are in question. “Ex-Im did a great deal of this following the onset of the Asian economic crisis supporting, for instance, letters of credit by Japanese banks that had not required such support for decades and today no longer do,” Hansen said. “Absent Ex-Im support for a period, innumerable trade transactions might at least have been delayed and possibly unwound.”

There should be a resurgence of interest in political risk insurance. However, it may

be difficult to buy such insurance for existing projects. According to Noam Ayali in the Chadbourne Washington office, “MIGA [the insurance arm of the World Bank] will not provide political risk coverage in ‘secondary’ situations. The same is true for OPIC. They will provide coverage in connection with additional, follow-on investments in existing projects, but not for existing projects where the investor is not putting in any new money.” Ayali suggests that “private insurance carriers — Sovereign Risk, Zurich Re, AIG to name a few — do not have the same ‘developmental’ constraints,” but he suspects that even they would be “loath to provide cover for someone who approaches them now for political risk insurance or else accept the underwriting at extremely high premiums.” (See related article on “Spotlight on Political Risk Insurance” starting on page 7.)

Force Majeure

At least two projects — one in the US and one abroad — received force majeure notices from contractors in the two weeks after the attack on the World Trade Center.

Chadbourne lawyers report fielding calls from clients about not only force majeure provisions but also whether the terrorist attacks, collapse in stock prices and the US declaration of war against terrorism are a “material adverse

change” that would allow cancellation of acquisition or merger agreements or loan commitments.

The typical force majeure provision in a construction or operating and maintenance contract allows the contractor to suspend performance — or extend deadlines — after “any act or event that adversely affects performance by the contractor of its obligations” but only if “such act or event is beyond the control of, and occurred without the fault or negligence of the contractor.” War and terrorism are usually given as examples of force majeure events. However, some contracts specifically exclude as an excuse for force majeure late delivery of equipment by subcontractors or vendors. If force majeure continues for more than a certain number of days — for example, more than 270 consecutive days or more than 365 cumulative days — then either party usually has a right to cancel the contract.

“Material adverse change” is not usually well defined in contracts. However, it is a common condition to continuing draws on construction loans and to closings in corporate acquisitions, loan agreements or other transactions that there have been no “material adverse change” in the financial condition of one of the parties.

A construction contractor for a US domestic project gave notice soon after the World Trade Center disaster that it had received a force majeure notice from one of its subcontractors, and it also warned of delays in getting equipment. An equity fund doing deals in Africa said that worldwide flows of cargo have been disrupted. “Anyone who is building a project and counting on shipment of equipment from Europe will have a hard time getting it, even in cases where the equipment is supposed to move by ship.”

Engineers at a project in Pakistan fled the country in the middle of a major turbine overhaul, leaving the turbines partly disassembled, after the US State Department issued a travel warning for Pakistan advising all US “non-vital personnel” to leave. The project company then claimed a “Pakistan political force majeure event” and notified its lenders and the government-owned utility to whom it supplies power. Under the concession agreement between the project company and the government, the government of Pakistan agreed to make capacity payments in place of the utility during a “Pakistan political force majeure event.” The government had not yet responded to the declaration when the *NewsWire* went to press. Travel warnings have been issued for a number of other countries in the region. / continued page 4

excess power both under a long-term contract to the local utility and also to power marketers. The ruling is interesting because the logic the IRS used to explain why the utility did not have to report the interconnection payments in this case as income suggests that interconnection payments utilities receive from merchant power plants also should not be reported as income.

A private ruling can only be relied on by the taxpayer who received it. The announcement later this year is expected to take the form of a “notice” on which all taxpayers can rely.

THE IRS TOLD OWNERS OF SYN FUEL PLANTS that make synthetic fuel from coal that they will have to agree to limit output to the “contract capacity” of a plant if they want a ruling that the plant qualifies for federal tax credits.

The federal government offers “section 29” tax credits of \$1.059 an mMBtu for making “synthetic fuel from coal.” The IRS stopped ruling in the late summer last year that coal agglomeration facilities that add chemical binders to coal particles and then press the mixture in a briquetter to make pellets qualify for the tax credits. The rulings window reopened in theory in late April this year. However, no real rulings are being issued in practice. The IRS wants to impose a limit on output from such plants as a trade-off for granting future rulings in the hope that this will stem the revenue loss to the government from the tax subsidies. Owners of the synfuel plants are still pressing for a higher limit on output. The “contract capacity” means the minimum output that the construction contract for the project said it would be capable of producing when built.

At least 73 coal agglomeration facilities claim to have been put into service in time to qualify for tax credits. Most were built by three developers: / continued page 5

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Projects in the New York area are also expected to be affected because contractors have had to shift employees to help with the cleanup in New York City.

An equity investor doing deals in Africa where transactions are sometimes governed by Dutch or French law said he is looking at whether he can postpone closings on grounds of material adverse change, but has been advised by

Debt coverage ratios for projects that are currently under development will probably have to be recalculated.

European lawyers that they have an estoppel concept that makes it harder than under US law to walk away from a transaction at the last moment. Estoppel is the notion that one party cannot back out of a deal when the other party has done things like spend a significant sum of money with the reasonable expectation that the first party will follow through on the transaction — even if he is not formally required by contract to proceed.

Recalculating Debt Coverages

More projects will be put on hold — not directly because of the terrorist attacks or US war effort — but because the economy is heading down. Many people surveyed said that this will be merely an acceleration of a trend that was already in evidence.

Developers tend to be optimists who believe in business cycles. Therefore, there is no reason to delay a project that will take three years to build just because the economy appears to be on the downside of a business cycle. However, lenders are more likely to be influenced by the headlines.

One banker — formerly with a European bank — said international banks have tended to abandon the US project market in times of economic downturn and that this trend might be more pronounced this time because a number of

banks had their offices in the World Trade Center.

Another head of project finance lending for a European bank said he is in the market now trying to syndicate loans for two US merchant plants and is “at least a little concerned” about whether he will be able to fill out his syndicates. However, he added, “From my institution’s perspective, our opinion of the US from an investment perspective has been quite stable for more than 30 years and these events, albeit incredibly depressing, are not likely to change this opinion.”

Several consulting firms have been predicting for at least the past year that the United States faces an “overbuild” situation in many parts of the country because of the number of project developers rushing into these areas to build merchant power plants. (See “US Heading for Merchant Plant Overdevelopment” in the

NewsWire for September 2000.) One head of project finance lending at a US bank said, “I have read the conflicting articles regarding overcapacity-undercapacity in the wholesale electricity markets. A drop in demand [brought about by a weakening economy] will most assuredly push the balance towards a surplus.”

However, the chief financial officer at a large US power developer said he thought recent events would push in the other direction — the overbuild situation would correct itself. “Power plant developers have to have a much longer range view of the markets than one season that may be hot or cold, or the beginning of an economic downturn. Therefore, I doubt you will see many public announcements of project cancellations. However, lenders and equity markets are driven more by short-term phenomena, and ‘headline risk’ for them is often something they make decisions on, rightly or wrongly. So the reality might be fewer projects getting financed and, therefore, more projects deferred. Companies who had planned to raise equity to keep their balance sheets in balance may be unable to do so in the near term and, therefore, may defer capital expenditures. The resultant slowdown in ‘new builds’ could self correct the ‘overbuild’ scenarios that people are predicting.”

If financing costs increase at the same time that higher

insurance premiums and falling electricity prices reduce project cash flow, some projects will not get financed simply because they can no longer pay debt service.

One can almost hear the whirr of computer models recalculating debt coverage ratios for projects that are currently under development.

The head of project finance advisory work at an international investment bank said, "I am getting somewhat concerned that the IPP stock prices will make it increasingly difficult to finance the plants to which IPPs have committed. Moreover, even if financed and built, will these new plants' returns exceed a rapidly increasing cost of capital? To get a sense of the size problem some companies face, think of how many turbines companies have ordered at \$35 million each. Next, multiply this number by five as the turbine is about 20% of the cost of a combined-cycle gas plant. The numbers are quite large."

The higher cost of capital will inevitably push more projects into the unfinanceable column.

Other Trends

Several other trends are foreseeable.

Falling stock prices mean that equity is now more expensive to raise. This will place a limit on the ability of companies to borrow and push project developers to look harder at synthetic and leveraged leasing and other off-balance sheet methods of finance.

It may also lead some companies to use the opportunity to buy back shares.

Some US utilities could become bigger takeover targets if prices for utility stocks were to decline significantly.

The reason falling stock prices make it more expensive to raise equity is a company must give away a larger ownership share to raise the same dollars as before. The trend in recent years had been to move away from project finance and use balance sheet corporate debt facilities. The general counsels at two large US power companies said they now foresee a move in the opposite direction back toward project and structured finance. As one of them explained, "To the extent the disruption prompts further interest rate cuts, debt financing becomes attractive. But regardless of how low interest rates go, public companies with the need to maintain investment grade ratings can only take on so much leverage on the balance sheet. The equity market was already unappealing to offerings. The

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Startec, Covol and Earthco. The IRS has tentatively set the contract capacities of the units at 50 tons an hour for Startec plants, 70 tons an hour for Covol, and 150 tons an hour for Earthco. The working assumption is that the plants operate for 8,000 hours a year. Startec owners are questioning whether 50 tons an hour is the right starting point for them.

Both the output limit and the contract capacity for Startec plants are expected to be settled soon.

A WINDFALL PROFITS TAX on electricity generators failed to pass the California legislature before the legislature adjourned in late September. The legislature is expected to come back into special session in October. This provides a platform in theory for another run at the issue, but the main sponsor of the tax in the state assembly said he doubted the agenda for the special session would be broad enough to allow any further debate on tax issues.

LOUISIANA clarified in late August that owners of new merchant power plants built in the state qualify for a 10-year holiday from parish and local property taxes.

Louisiana hopes to turn itself into a center for electricity generators. Developers have proposed building at least 23 new power plants in the state. The tax at the parish level ranges from 0.5% to 1.5% of assessed value of industrial property, excluding land value, and is paid annually. The holiday applied in the past to other types of "industrial" facilities. Some utilities claimed the holiday for their power plants. The Board of Commerce and Industry said it wanted to end any uncertainty about whether the tax holiday also applies to merchant power plants and also make clear that the application for an exemption can be submitted early in the development process.

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events in September only make it more so.”

The US Securities and Exchange Commission made it easier in the week after the attack on the World Trade Center for public companies to buy back their own shares. Public companies are limited in practice by “safe harbors” on both the volume and timing of share buybacks. The safe harbors are designed to protect the companies from charges of market manipulation.

Prospects for action by the US Congress on energy legislation appear to be dimming quickly.

The SEC announced on September 14 that the usual limits would not apply for the first five days of public trading beginning with the reopening of the markets. Instead, the timing restrictions were suspended and the volume limit was increased to an amount, excluding “block purchases,” not to exceed 100% of the average daily trading volume over the four weeks preceding September 10. The normal trading volume restriction was 25% of the average daily trading volume over the prior four weeks. The hope was this would help prop up share prices when the US stock exchanges reopened for business on the Monday after the disaster. On September 28, the SEC extended the exemptions until September 28.

There are no securities law limits on the number of shares that a private company can repurchase. However, all companies must make sure they comply with other limits in their organizing documents or financing agreements and in their local corporation law statutes.

Energy Legislation

Prospects for action by the US Congress on energy legislation appear to be dimming quickly.

The Bush administration declared in late May that the US is in the midst of an energy crisis, and it called on Congress to act this year. However, its plan began losing momentum

almost immediately after it was announced. Jonathan Weisgall, a lobbyist for Mid-American Energy Holdings, attributed this to the fact that Congress only acts when there is consensus or a crisis. There was never any consensus this year on what to do, and the sense of crisis passed in the summer as gasoline and electricity prices returned to more normal levels.

Congress is reportedly under pressure from the Bush administration to conclude its session for the year at the earliest possible time. “The administration wants to limit the possibility of partisan outbreaks, intelligence leaks and

debates that dilute the attention of the president and his senior staff,” Weisgall said. “Congressional leaders want to stay in town to show their constituents that they are playing a role in the response, but they will most likely try to comply with the wishes of the administration. They are also

facing major problems scheduling business because of travel difficulties.” Many congressmen try to go home to their districts on weekends. The House tends to schedule votes only from Tuesday to Thursday to allow travel back and forth.

Congress has a must-do list of only a few remaining items before it adjourns. These include completing appropriations for the year so that the federal government can continue operating, a short-term economic stimulus package, any legislation necessary to implement anti-terrorism programs, and an education reform bill that was largely done before the terrorist attacks on September 11. “Anything that is controversial has been pushed off the list to keep up the appearance of bipartisanship,” Weisgall said.

Many power company lobbyists are still hoping that at least some action can be taken this year on energy issues, perhaps under the rubric of energy security and economic stimulus. The House already passed a bill this summer. The focus is on the Senate. However, with Congress expected to adjourn around November 1, there is almost no time.

Report from the Gulf

Jack Greenwald, a US lawyer who has practiced law for many years in Dubai, reported in late September that many US companies were deferring plans and projects, and some have

pulled their US employees and families out of the Persian Gulf region to Europe until the US takes military action and they can better assess the situation. He had met with Benazir Bhutto in Dubai a few days earlier. He worried about a “real threat” of the violence spreading to Pakistan where “the US has lost the support of the middle class and the moderates.” He said work on the big infrastructure projects in the Gulf was continuing, at least as long as the international banks remain willing to extend finance, but that some large tourism projects are likely to be cancelled.

“If I want to be optimistic,” Greenwald said, “I would say that the World Trade Center bombing will result, first, in Israel and the Palestinians finally reaching a reasonable settlement, with heavy behind-the-scenes pressure from the US on Israel, and, second, in an opening between the US and Iran. Both steps will dramatically reduce the quiet but crucial support of the moderates for the extremists, and although terrorism will remain a threat, it will be marginalized.”

“And then I woke up!” ☉

Spotlight On Political Risk Insurance

by Kenneth W. Hansen, in Washington

Among the likely reverberations of the US declaration of war on terrorism may be a decline in the volume of foreign investment into emerging markets. Those investments that go forward are more likely than ever to welcome some mitigation of political risk. This article reviews the basic elements of what is available in the market for political risk insurance, and from whom, on what terms, and with what associated issues. Another article will follow in the next *NewsWire* on hidden or otherwise unexpected issues to watch out for in seeking and structuring political risk coverage and on new developments in the market.

What Does it Cover?

The classic coverages generally available in the market insure against losses because of expropriation, political violence or currency inconvertibility.

A claim payment for expropriation typ- / continued page 8

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The board also called on the state legislature to eliminate a 4% sales tax on fuel used in power plants.

WEST VIRGINIA increased a reclamation tax on coal mining from 3¢ to 14¢ a ton, effective next January 1. The measure passed the state legislature on September 15.

The new rate would remain in effect through March 2005, after which it would drop to 7¢ a ton. The tax applies to all surface mining of coal, including recovery of coal from gob piles and silt ponds. The money collected from the tax is used to clean up abandoned mines.

WINDPOWER PROJECTS will probably receive a break on property taxes from West Virginia.

The state is moving to classify wind turbines and the towers on which they are mounted as a type of pollution control equipment, which means that they would be assessed for property taxes at only their salvage value. The state tax department proposed a rule to that effect for comment in May this year. No comments were received. The tax department “refiled” the “agency approved” rule on July 23. The measure must still be approved by the state legislature. Approval is expected in time to take effect as early as May 2002.

VIETNAM imposed a 25% surtax on highly profitable companies.

The tax will be collected on top of the normal 32% corporate income tax and is retroactive to the start of the current income tax reporting year, which started in July. It will apply to any company that reports after-tax income of more than 20% of its capital base. Companies with special tax holidays or that operate in special manufacturing zones may be temporarily exempted.

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ically requires total expropriation of the insured investment. Total expropriation may be the result of a “creeping” process. Partial expropriation of a portion of the project will typically not support a claim absent specific terms fine tuning the policy. One test of whether an expropriation is “total” is whether the investor is willing to turn all of its interests over

Insurance against political violence typically covers losses caused by wars and terrorism.

to the insurer in exchange for the claim payment. Consequently, expropriation coverage is effective against complete seizure or other blockage of the operations of a project, but not against government measures that simply reduce the rate of return from an investment.

Political violence coverage is typically asset-based. That means it provides compensation adequate to repair or replace project assets damaged by politically-motivated violence.

Insurance against political violence typically covers losses whether caused by “official” wars — that is military actions by nations — or unofficial, private violence ranging from terrorism to revolution, riots, and, in some coverages, general civil unrest. There may be important carveouts. Insurance purchased from the US government through the Overseas Private Investment Corporation, or “OPIC,” excludes — for statutory reasons — losses from violence that is primarily motivated by student or labor objectives. Insurance purchased from the World Bank through the Multilateral Investment Guarantee Agency, or “MIGA,” — for non-statutory reasons — has the same carveout.

Coverage for currency inconvertibility offers investors hard currency offshore in exchange for local currency whose conversion and transfer has been blocked by foreign

exchange regulations imposed since the original investment was made.

This coverage lost a bit of luster during the Asian economic crisis. It was first conceived in connection with the Marshall Plan to protect US investors in war-torn Europe against the imposition of foreign exchange control regimes that might prevent the repatriation of dividends or return of the original investment. Although over the years currency inconvertibility has certainly proven to be a risk worth miti-

gating, in the past decade claims have been few and far between. The dominant international monetary risk for emerging market infrastructure projects has been instability in currency values, such as the devaluations that occurred in Thailand and Indonesia in 1997. Throughout the Asian economic crisis, and its reverberations in Latin America and

Eastern Europe, actual currency inconvertibility was a non-issue. This has given rise to great demand in the political risk insurance market for currency devaluation cover, but, at least until very recently, there was no supply of such cover.

Gaps in Coverage

Several variations on these core themes are available in the marketplace. For instance, coverage for losses due to business interruption as a result of political violence — as opposed to physical damage to assets — is available.

An area of current tension in the marketplace has been between the demand for effective cover against contract frustration by governments and limits on the scope of available policies. Most such coverage focuses on the government’s compliance with just one contractual provision — the arbitration clause. If a dispute arises, the investor must invoke the arbitration clause in order to trigger the coverage. If the government refuses to participate in the arbitration, or somehow frustrates the proceedings, or fails to pay an arbitral award, then the insurer will be obligated to pay a claim in the amount of the award. (A recent example is the efforts by the Indonesian government to frustrate the CalEnergy arbitration which resulted in, at \$237 million, the largest single claim payment in OPIC’s history.) Some versions of this coverage also

require that the government's breach giving rise to the arbitration constitute a violation of international law. This has introduced some uncertainty into the effectiveness of the coverage — the risk that a government breaches a contract and defaults on its arbitration obligations, but without clearly violating the often fuzzy parameters of international law. Some insurers have been willing to drop the requirement of a breach that violates international law. Project developers have eagerly sought coverage that also avoids the necessity of first prosecuting an arbitration. Although such coverage has not typically been available, some such coverage has recently appeared in the commercial market.

Who Offers It?

Political risk insurance is available from both private companies and public agencies.

Public sources of political risk insurance fall into two categories: the investment-promotion agencies — notably OPIC and MIGA — and the export credit agencies of which there are a multitude around the world, including the Export-Import Bank of the United States. Although each program has its own statutory constraints and policy goals — typically third world development in the case of the investment promotion agencies and export promotion in the case of the export credit agencies — there is substantial overlap among the terms and even the language of the coverages available from the various programs.

Given the insuperable challenges of undertaking useful statistical analysis of the probabilities of future adverse political events in particular host countries, newly arrived insurers, both public and private sector, have taken great comfort from trying to mirror the OPIC products to the extent possible in the hope of reproducing its profitable history. In particular, notwithstanding their different legal constraints, the project political risk coverages offered by both MIGA and Ex-Im Bank were substantially fashioned after the coverages provided by OPIC. For instance, MIGA excludes student and labor-based claims from its political violence coverage notwithstanding — unlike OPIC — any legal requirement to do so.

Private cover has been available from, and for generations dominated by, the venerable Lloyds of London. In the 1970's AIG arose as an important force in the market. However, the mid-1990's saw a minor eruption in the availability of political risk insurance from an assortment of / continued page 10

PERU adjusted its income tax rates.

Rates will be higher in 2002 than in 2001. The new base income tax rate for corporations and partnerships will be 27%. An additional tax of 4.1% must be paid on profits that are distributed in an effort to encourage companies to reinvest earnings rather than distribute them to shareholders. Branches of foreign companies doing business in Peru will be subject to income tax at a 30% rate.

At the same time, Peru will make it easier to carry forward losses. Companies have been able to carry forward losses for up to four years. This will not change, but the four years will be measured in the future from the first year in which the company has profits.

DEBT RESTRUCTURING: The owners of a distressed hydroelectric project tried — apparently without success — to avoid having to report taxable income after its lenders wrote off part of the project debt. The IRS suggested the scheme would have worked if the debt had been “recourse” debt.

The IRS analysis is in a memorandum — called a “field service advice” — that the IRS national office sent an agent who was questioning the scheme on audit.

A power company formed a special-purpose subsidiary to own a hydroelectric project. The subsidiary borrowed the money it needed to build the project on a “limited recourse” basis from a bank. The parent company pledged the shares in the subsidiary to the bank and guaranteed repayment of the loan.

The project lost money. The parent decided to sell the project. Its subsidiary, the lender and the company that planned to buy the project entered into a three-way agreement where the bank agreed to write down the debt to the purchase price the buyer was willing to pay, and the buyer took over the project and assumed this debt.

Ordinarily, when a / continued page 11

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private insurance companies. Today, roughly a half-dozen major companies compete to offer coverages that are substantially similar to those described above.

Advantages of the commercial insurers are that they purport to be faster in making coverage available. In Chadbourne's experience, many deliver on that claim. Pricing can be higher than that of the public agencies, especially in the riskiest countries (like Russia) and in high-demand countries where capacity constraints may be binding (like Brazil) and for inconvertibility coverage (in which public providers

Rates vary, but will probably be between 1.0% and 2.5% of the maximum amount insured.

have certain advantages in salvage arrangements that are reflected in lower pricing). On the other hand, in some countries, particularly those perceived to be less risky, the commercial insurers may be favorably competitive with the public agencies.

Another advantage is that the commercial insurers are not hampered by the network of statutory and policy constraints that are imposed on the availability and terms of the public sector programs. Thus, there is some truth to the claim by the commercial insurers that they can tailor the terms of coverage to the particular needs of a project or its investors. On the other hand, because of the absence of reliable statistical tables for political risks, commercial insurers take great comfort from the profitable history of OPIC and its predecessor programs going back to the Marshall Plan. Consequently, they hesitate to cover risks that are too far from those that have been subjected to OPIC's 50-year test run.

To date, some of the most innovative political risk insurance products to arrive on the market have come from the public agencies who appear to be maintaining their primacy as a proving ground. This has been the case for the develop-

ment of both capital market and devaluation risk products. However, in other areas marginal (but important) adjustments to mainstream political risk coverage terms have been available from commercial insurers well in advance of the public providers. Examples are waiving the requirement under contract frustration coverage of finding a violation of international law or the requirement, in filing an expropriation claim, that the related assignment of ownership interests be free and clear of any liens from project lenders.

At What Price?

Pricing depends on the country, the nature of the project, the nature of the investment, the insurer and the details of the coverage sought.

Consequently, it is impossible to provide specific guidance regarding what to expect. Very broadly, rates for a basket of the traditional coverages as described above (expropriation, political violence and currency inconvertibility) is very likely to come at a per annum rate between 1.0% and 2.5% of

the maximum amount insured.

Equity Versus Debt

Political risk insurance purchased to protect the equity investors in a project compensates for the loss in value of an investment as a result of a covered political event, but only to a limited extent.

Expropriation cover yields the book value of the insured investment. Political violence provides compensation adequate, if reinvested in the project company, to repair damaged assets. Currency inconvertibility coverage will support both dividend payments and the return of the original investment. However, coverage is effectively limited to out-of-pocket losses versus expectations. That is, for instance, expropriation cover reimburses out-of-pocket investment but will not typically cover lost profits, although commercial insurers have been known to provide this.

Political risk insurance purchased to protect project lenders covers defaults in scheduled payments of principal and interest as a result — typically a “direct and immediate” result — of a covered political event. Loans to a project that

is failing for commercial reasons are unlikely to be bailed out by political risk insurance. If a failing enterprise is expropriated, the insurers will see the commercial deterioration rather than the expropriation as the cause of the defaults.

Existing Projects

Public agencies offer insurance to promote something — either trade or investment. If a project already exists, their provision of new support of prior investment lacks “additionality.” In other words, it contributes nothing to their trade or investment promotion mission. Consequently, OPIC, MIGA and Ex-Im Bank insurance is available only in connection with new investment transactions. However, commercial insurers are typically open to offering coverage to existing projects as long as they are comfortable with the underwriting environment.

Nationality Issues

The availability of coverage from public agencies will depend critically in some fashion on the nationality of the investor or, in the case of the export credit agencies, the site where loan proceeds are to be expended. In the case of the only multilateral insurer, MIGA, the requirement is that the insured investment originate in a member country other than the prospective host country. So, well-to-do expatriates of an emerging market that would like to invest in the homeland will not be able to do so with MIGA support. Unless they have established US citizenship, they also will not qualify — unless they establish a joint venture majority-owned by friends with US passports — for OPIC insurance. OPIC insurance is, by law, only available to “eligible investors” which includes US citizens, US businesses majority-owned by US citizens, and foreign businesses at least 95%-owned by US citizens or such US businesses.

Export credit agencies will typically insure loans from lenders of any nationality, but only if the loan proceeds are expended on goods or services from the export credit agency’s home country. One relatively recent development has been the willingness of export credit agencies to develop joint underwriting arrangements in which they agree to provide joint coverage of loans the proceeds of which may be expended in any of their respective home countries, allocating their respective exposures according to the distribution of procurement that ultimately develops. Ex-Im Bank, constrained by US labor interests, has been / continued page 12

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lender cancels part of a debt from a borrower, the borrower must report the amount cancelled as income. However, this rule does not apply if the borrower is insolvent. The borrower in this case claimed it was insolvent. However, the IRS national office said that insolvency is a shield to having to report income only if the loan was a “recourse” loan. It said the loan in this case was “nonrecourse,” despite the fact that the parent had guaranteed repayment. It went on to say the rule for nonrecourse loans is that a project is always assumed to be worth the full amount of the outstanding nonrecourse debt to which the property is subject when it is sold. The IRS appears to have recast the transaction in this case as a sale by of the project by the borrower back to the bank for the full debt, and then a resale by the bank to the new buyer at a reduced price.

The bottom line was the taxpayer had to report a large capital gain measured by the full amount of the nonrecourse debt. The field service advice is FSA 200135002. It suggests a number of planning possibilities.

THE IRS PROVIDED A ROADMAP for how to draft a hybrid loan.

It is common for US power companies investing offshore to try to inject funds into the project company in a form that is considered equity for US tax purposes, but debt in the foreign country. This is done in an effort to “strip” earnings from the project country as interest so that they can be deducted against the local tax base, but still allow US taxes to be deferred. US taxes can only be deferred on certain equity returns.

The IRS national office released an internal memo in September analyzing “perpetual” instruments that a US manufacturing company had its offshore holding company use to reinvest cash in another offshore company. The instruments had no fixed maturity date. They were subordi- / continued page 13

Political Risk Insurance

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slow to cooperate with its fellow export credit agencies in this regard, but recently entered into such an arrangement with the Export Credit Guarantee Department, or “ECGD,” in the United Kingdom.

Holes in the Market

Not all political risks are insurable, at least not in today's market, at any price.

As an example drawn from today's headlines, if the prospect of political violence in a country were to force an evacuation of key personnel whose departure were to result in a suspension of the operation of a project thus interrupting its revenue flows, but without any physical damage to the property of the project, conventional political violence coverage would be of no assistance. Business interruption coverage is available in the market, but typically only for revenues lost as a consequence of actual physical damage to the project as a result of politically-motivated violence. A perception of danger in the region is unlikely to support a claim — though it is perhaps a far greater, and more widespread, risk than the physical destruction of any particular facility. ☉

California: Crisis Over?

by Dr. Robert B. Weisenmiller, Steven McClary, William Monsen, Mark Fulmer and Heather Vierbicher, with MRW & Associates, Inc. in Oakland, California

As summer turns to autumn, the electricity and gas markets in California are more or less back to “normal.”

By late September, electricity spot market prices were around \$30 a mWh, well below the federal price caps of \$90 a mWh. The last electric system emergency alert occurred on July 3. The state emerged from the summer without suffering a single additional rolling blackout. Daily reserve margins occasionally reached as high as 20%.

The independent system operator, or “ISO,” reports a peak load hovering around 35,000 megawatts while available generation is around 42,000 megawatts.

The state Department of Water Resources, or “DWR,” which is responsible for procuring power for the financially-

crippled electric utilities in California, has so much power locked up under high-priced short- and long-term bilateral contracts that — at times — it has had to dump power at prices as low as \$1 a mWh.

Gas prices at the California border have plummeted from their winter highs of more than \$10 an mmBtu to much less than \$3 an mmBtu. Gas storage levels are on target both to meet supply needs and to provide a hedge against supply shortages.

What happened? Have the electric and gas markets in fact returned to normal or is the current situation just a lull in the storm?

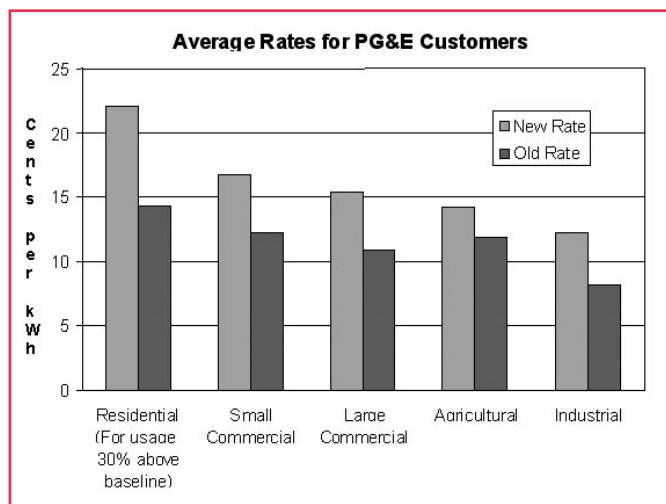
Why Did Prices Fall?

A combination of factors — often alluded to as the “perfect storm” — led to the California power crisis. (For background on the crisis, see “California at Sea: The Perfect Political Storm” in the *NewsWire* for December 2000.) The apparent return of the market to normalcy is the result of a similar convergence of factors.

Conservation Helped

The state recognized it could not rely solely on “building” out of the electricity shortage. Demand reduction measures helped bring supply and demand back into balance. First, the California Public Utilities Commission, or “CPUC,” authorized record rate increases for electric customers and these brought about price-induced conservation. Second, almost as an act of faith, the state initiated a set of very aggressive conservation programs at a cost of more than \$1 billion. These programs ran the gamut from a statewide public information blitz — including placemats in fast food restaurants with energy saving tips printed on them — to complex, market-driven peak demand reduction schemes. This two-pronged approach appears to have contributed measurably to lower peak demands for electricity.

The electricity rate increases this year were the first statewide since 1996. Retail rates for the heaviest residential users increased about 37%. Rates for small businesses increased an average of 38 to 45%, while industrial customers saw a nearly 50% increase. Agricultural customers flexed some of their political muscle and ended up with rate increases of only 15 to 20%. The new rates had an “inverted block” structure, meaning that rates increased as consumption increased. For example, residential customers who con-



sumed less than a pre-specified baseline level did not see any meaningful rate increase but customers who consumed more saw rate increases of between 13 and 100%. High prices cause consumers to consume less.

In addition, customers who managed to reduce monthly usage by 20% compared to the year before were paid a 20% rebate on their electricity bills by the state. This program was surprisingly successful. Three million customers qualified for the rebates in June and 4.3 million qualified in July, which was three to four times the expected participation rate. Total rebates during June and July were \$155 million.

Traditional utility demand-side management, or “DSM,” programs played a significant role as well. Over the past few years, California’s utility conservation programs were not aimed at immediate demand reductions but, instead, attempted to bring about long-term changes in customers’ energy usage habits as well as to develop markets for energy-efficient devices. As a result, the utilities would under-spend DSM budgets and achieve little in the way of near-term energy conservation or peak demand reductions. This all changed in 2001, when “savings now” became the mantra. Rebates and direct subsidies for the purchase and installation of energy-efficient appliances and equipment again became the norm. The CPUC set very high peak demand and energy conservation reduction targets for the utilities while giving the utilities a freer hand as to which DSM programs to pursue.

Customers swarmed to the utility rebate programs. Through the second quarter of 2001, the three major electric utilities spent or committed almost \$200 / continued page 14

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nated to all other creditors, but received payment ahead of the common shares. The holder was entitled to a cumulative fixed return, but it was only paid each year to the extent of the “distributable profits” that year and then could only be paid after formal approval by the board. Many other details are described in the internal memo. They make a good starting point for discussions with local counsel in other countries for anyone trying to structure a hybrid instrument. The US parent company treated the instruments as equity for financial purposes, but was inconsistent in its reporting for US tax purposes. The IRS national office said they were still equity. The memo is ILM 200134004.

THE IRS NIXED A SCHEME TO RELEASE FOREIGN TAX CREDITS for use in the US that were trapped in an offshore subsidiary.

The taxpayer tried to release the credits by having its offshore subsidiary make a “section 956 loan” back to the United States.

A US parent company owned two US subsidiaries, US1 and US2. US2 owned, in turn, a foreign subsidiary, FC1. FC1 owned FC2. US1 made a loan to FC1 which lent the cash to FC2. FC2 then immediately lent it to US2. FC2 had “earnings and profits” that had not been taxed yet in the United States. The loan by FC2 back to US2 is treated under section 956 of the tax code as “dividend” of the earnings back to the United States so that the earnings became subject immediately to tax. However, any credits for foreign taxes already paid by FC2 on the earnings became available for use at the same time in the US.

US companies often make section 956 loans as a way to release foreign tax credits. However, the IRS national office recast the transaction in this case as a loan from US1 to US2. The internal IRS memo discussing the transaction is ILM 200137005. The agency made it public in September. / continued page 15

California Update

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million of their annual budgets of \$259 million. The programs were so successful that all three utilities have had temporarily to shut them down due to lack of funds. This is all the more impressive considering the programs did not become available until late February 2001.

Conservation and higher electricity prices have reduced real electricity demand by 9%.

The three utilities have achieved combined annual savings of about 800 million kWh and a peak demand reduction of 200 megawatts. This is collectively about 80% of the savings targets set by the CPUC, which, at the time the targets were set in January, seemed ridiculously aggressive. All three utilities are on track to achieve their targets well before the end of the year. Southern California Edison has had the best results to date, achieving over 114% of its peak demand reduction target and over 90% of its energy savings target by July 1.

How did these conservation efforts affect electricity consumption and peak demand this summer? The results are startling.

Both peak demand and overall consumption were about 5.5% lower in 2001 than in 2000. Adjusting for weather and the downturn in the economy, the California Energy Commission estimated that conservation saved closer to 9%. It is difficult to determine exactly how much of the decline is attributable to what factors. However, it is clear that a concerted program of

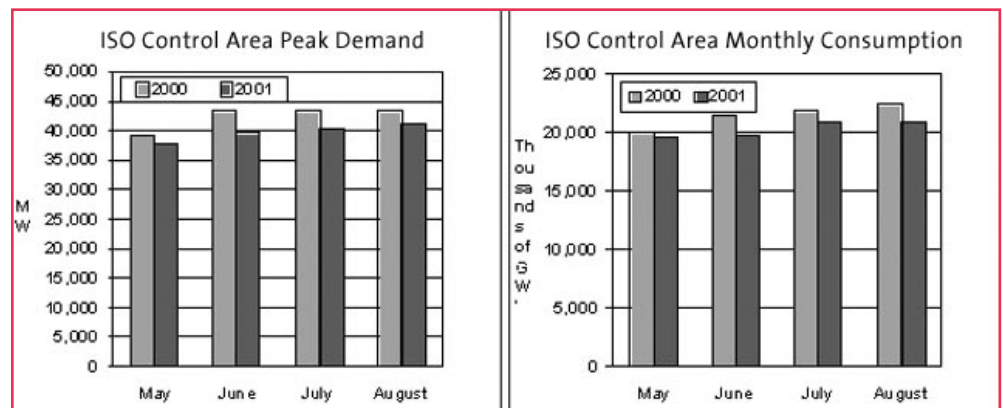
consumer education, carrots (rebates) and sticks (steeply increasing prices) can, in a very short time, have a substantial impact on electricity use.

Gas Prices Fell

The California power system relies on natural gas as its marginal fuel. Thus, soaring gas prices last year contributed to higher power prices. Conversely, the falling gas prices of the past few months have helped to bring down spot and forward power prices.

Several factors are responsible for the decline in gas prices. Mild weather, a slowing economy, and electricity conservation resulted in lower demand for natural gas and more opportunities to inject natural gas for storage than the previous summer. The other important factor was Pacific Gas & Electric's solution to the credit concerns of gas suppliers, which prevented any disruption to gas supplies to PG&E and the utility's customers. (See box on page 18 called "Overview of California Gas Infrastructure.")

The original run-up in gas prices was stunning. Demand for natural gas increased by 8% in 2000 as compared to 1999, largely due to increased in-state gas-fired electric generation. The demand for greater quantities of in-state gas-fired generation resulted from dry hydro conditions in the Pacific Northwest, low availability of power imports, and increased electricity demand in many sectors due to a thriving economy.



Injections of gas into storage effectively ceased in July 2000, with significant storage withdrawals occurring in August. Reduced levels of gas in storage led to less gas inventory available to serve winter peak demand and to provide protection against price spikes.

PG&E's credit problems also contributed to the gas price run-up last winter. Gas suppliers became concerned that PG&E would be unable to pay for gas and would only sell to the utility for cash, with reasonable assurance of payment, or under Presidential decree. PG&E was forced by its deteriorating financial condition to withdraw gas from storage to meet its winter core loads. PG&E warned that it was facing a situation where it would have to cut off customers. Last January, the CPUC granted a request by PG&E to allow the utility to pledge its gas customers' accounts receivable for the purpose of procuring gas supplies for its customers. Core gas in storage was pledged as collateral in case the core customers' receivables were insufficient for suppliers' concerns. Through this pledge and the nearing end of the winter season, PG&E was able to purchase sufficient gas supplies to serve all of its customer loads — despite filing for bankruptcy on April 6.

The California Public Utility Commission asked the federal government to investigate whether the consistently higher Topock price premiums were the result of market abuses by El Paso Natural Gas Company and El Paso Merchant Energy. The Federal Energy Regulatory Commission launched a formal hearing into these allegations in May.

In February 2000, El Paso Natural Gas Company awarded 1,220 mmcf a day of firm capacity to its affiliate, El Paso Merchant Energy. The CPUC and Southern California Edison claimed that El Paso Merchant Energy used market power to manipulate natural gas prices in California, which contributed in turn to higher electricity prices. Southern California Edison presented as evidence a report by The Brattle Group that El Paso Merchant Energy had manipulated natural gas prices by withholding 35% of the available capacity on the El Paso and Transwestern pipelines, resulting in \$3.6 to \$3.8 billion in higher natural gas costs for Californians. El Paso Merchant Energy countered with reports by Economists, Inc. and Lexecon, Inc. that said El Paso had neither the opportunity, means nor motive to control pipeline capacity in order to raise California's gas costs. In June 2001, El Paso Natural Gas split the disputed capacity among 30 different natural gas shippers / *continued page 16*

The company probably tried the scheme in an effort to avoid "pooling" problems if the foreign tax credits had had to follow the more normal path of moving up to US2 via FC1.

A SECOND SCHEME TO RELEASE FOREIGN TAX CREDITS also was shot down.

A US parent company owned an offshore subsidiary that had paid foreign taxes on its earnings. The subsidiary plowed the earnings back into its business so that it had no cash to pay a dividend to the US parent. A dividend would have released the foreign tax credits for use in the United States.

Therefore, the US parent made a capital contribution of cash to the subsidiary and received back more shares for its capital contribution. The subsidiary then used the cash a few days later to pay a dividend to the parent, thereby releasing the foreign tax credits. However, the parent described the capital contribution and quick dividend back in a footnote to its financial statements as "in substance . . . a transfer of retained earnings to paid-in capital."

The IRS refused to recognize the cash dividend on audit. It said that what the US parent company really received was a dividend of more stock in the subsidiary. Stock dividends do not release foreign tax credits. The IRS explained its position in a "field service advice" that the agency made public in late September. The number is FSA 200135020.

The case serves as a warning not to assume favorable tax consequences from circling cash.

A TAX PLANNING MEMO prepared by an accounting firm could not be withheld from disclosure to the IRS under the "attorney-client privilege," a federal court said.

Ernst & Young sent the owners of two closely-held companies a memo with advice on what values to report for the two companies in connection with / *continued page 17*

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when its affiliate's capacity contract expired. While this nullified future concerns about market manipulation, El Paso's past actions remain hotly debated. The FERC judge has yet to issue a decision.

California natural gas prices spiked to record levels in late 2000 and early 2001, but have now returned to pre-2000 levels. Bidweek prices at the California delivery points

Gas prices at California delivery points rose far above other regional markets, such as Chicago.

of Malin and Topock broke through the \$3 threshold in June 2000 and did not drop back below this threshold until July 2001. Prices at these delivery points rose far above other regional markets, such as Chicago.

At Topock, bidweek prices peaked at \$16.41 an mmBtu in January 2001. At Malin, bidweek prices peaked at \$14.42 in December 2000. The national average price of gas was \$6.88 an mmBtu.

Daily gas prices were even more volatile. For example, in response to a cold front, Topock daily prices peaked between \$54 and \$59 an mmBtu during December 9 to 11, 2000, while falling as low as \$13.20 an mmBtu during the same month.

Gas prices began to fall in January and February, bumped back up in May, and then resumed falling.

The expectation that the high summer 2000 gas demands would reappear in 2001 were reflected in the premiums paid for June bid-week prices in California as compared to the Henry Hub. The Topock-Henry Hub differential was \$7.99 an mmBtu and the Malin-Henry Hub differential was \$2.25 an mmBtu. However, bid-week prices at Topock dropped throughout the summer months: July, August and September bid-week prices fell to \$4.75, \$3.76 and \$2.65 an mmBtu, respectively. At Malin, July, August and September

bid-week prices dropped to \$3.24, \$3.14 and \$2.34 an mmBtu, respectively. By September, the differentials between Henry Hub and the California delivery points fell to \$.29 an mmBtu at Topock and \$.10 an mmBtu at Malin.

By mid-September 2001, the American Gas Association reported that US storage fields were 81% full as compared to 68% full last year. Storage fields in the western consuming region were 85% full in mid-September 2001 as compared to 72% full at that time last year.

Gas pipeline companies are working to address the longer-term gas transportation shortage that exists in California. Currently, interstate capacity to California exceeds intrastate receipt capacity by 345 mmcf per day. Approximately 6,480 million cubic feet per day of interstate natural gas pipeline capacity to California has been proposed, along with 645 mmcf per day of California intrastate

natural gas pipeline capacity. If all of these pipeline expansions were built, there would be a shortage of takeaway capacity at the California border — only 300 mmcf per day of the 6,480 mmcf per day of deliveries could be delivered to the local distribution companies. How many of these expansions are actually built will depend on responses from open seasons, utility plans and regulatory policies. With such a number of potential interstate pipeline expansions being proposed, it seems likely that the natural gas supply situation in California will change in the next few years, possibly to one of excess capacity.

New Power Plants Came On Line

California has among the most stringent air quality rules in the nation, and many power plants can only operate a limited number of hours per year as a result of emission caps in their air permits. In 2000, many power plants produced much more power than the plants had generated in the past decade. In fact, some plants generated 50% or more power compared to the plants' recent history. However, since emissions caps were often instituted based on historic emission (and generation) patterns, some plant operators either violated their emissions caps or had to buy emissions

credits to allow them to continue running during the power emergency. As a result of increased demand, the price of emissions credits soared to record levels, resulting in increased power costs.

Operators of gas-fired generating facilities with high capacity factors rushed to install pollution control measures, such as selective catalytic reduction, or “SCR,” to avoid the need either to buy emissions credits in the future or to violate emissions caps. SCR has now been installed in plants representing about 2,400 megawatts, with retrofits at 4,600 megawatts of additional generators planning or pending. These actions will reduce the demand for emissions credits. In addition, the South Coast air quality management district also reformed its emissions credit trading program for power plants to reduce the impact of offset trading on power prices throughout the rest of California.

Other actions have been taken to reduce the impact of air pollution regulations on generation from existing plants. Governor Davis used his emergency powers to direct air districts to issue variances to power plants in return for substantial mitigation payments. The governor issued another emergency order to allow the use of backup generators as a means of preventing blackouts, but this provision so far has not had to be activated. These measures are temporary: all of the governor’s emergency orders will expire on December 31, 2001.

California also took steps to increase the number of power plants. In the past three years, the California Electricity Commission has approved more power facilities than it had on a cumulative basis in the prior 20 years. Some of these approved projects are under construction and two Calpine projects are now operating. The governor issued an executive order to expedite CEC permitting and established a goal of having an additional 5,000 megawatts on line by the end of September. While not meeting this ambitious goal, approximately 2,279 megawatts of new generation capacity will become operational in California by the end of September, with another 1,000 megawatts expected to become operational by the end of the year.

Over the next few years, the new supply situation looks healthy. Another 3,500 megawatts is expected to come on line by next summer.

As of August 1, the DWR had executed about 40 contracts and reached an agreement in principle on another 18. Moreover, many of these contracts are / continued page 18

a merger and how to minimize gift taxes on gifts to their children. The taxpayers did not follow the advice and signed affidavits directly at odds with the valuations that Ernst & Young had recommended, thereby reducing their gifts taxes even further. The IRS began a fraud investigation and issued a summons to Ernst & Young for its files on the work it did. The taxpayers moved to quash the summons, arguing that the accounting firm was working for their lawyers, Hale & Dorr, and, therefore, was protected by attorney-client privilege.

A federal district court in Massachusetts said there was no evidence that the accountants were working for the law firm. The engagement letter ran from one of the merged companies directly to Ernst & Young. The files had to be turned over to the IRS.

FIVE PROMOTERS are being investigated by the IRS for failure to register transactions the government considers corporate tax shelters.

Investment bankers and others who try to persuade corporations to enter into transactions to reduce taxes must register the transactions with the IRS. Three things must be true about a transaction before it must be registered. First, it must have “avoidance or evasion” of federal income taxes as a “significant purpose.” Second, the transaction must be offered “under conditions of confidentiality.” Third, the investment bankers must expect fees of more than \$100,000. Registration is required for transactions offered to corporations after February 28, 2000. The forms must be filed with the IRS before any interests in the transaction are offered for sale.

The IRS said 1,268 transactions have been registered as corporate tax shelters in the past year.

— contributed by Keith Martin and Samuel R. Kwon in Washington.

Overview of California Gas Infrastructure

Gas service within California is generally provided by either PG&E, the Southern California Gas Company (SoCalGas) or San Diego Gas & Electric Company (SDG&E). SoCalGas and SDG&E are both affiliates of Sempra, which essentially provides gas service throughout southern California. PG&E serves the north.

California imports nearly 85% of its natural gas from producing basins outside the state. Four interstate pipelines currently bring gas from producing regions to California: Pacific Gas Transmission - Northwest (PGT), El Paso Natural Gas Company (El Paso), Transwestern Pipeline (Transwestern) and Kern River Gas Transmission (Kern River). El Paso and Transwestern bring gas in from the southwest and primarily serve southern California. PGT brings in Canadian gas at the Oregon border at Malin and generally serves northern California. Kern River brings in gas from the Rocky Mountain region and serves central and southern California. In addition, the Mojave gas pipeline originates at Topock, Arizona and connects to Kern River at Dagget. The Mojave pipeline receives gas from the El Paso pipeline and is not directly connected to a supply basin. Generally, Kern River and the expanded PGT system have operated at very high load factors, while the El Paso system serves as the swing pipeline for gas service to California.

There is currently up to 7 Bcf per day of available flowing interstate capacity to the state, but this same capacity can provide service to other states before reaching California. Thus, pipeline deliveries to California are affected by the natural gas demands of upstream customers.

At the beginning of 2001, the total receipt capacity in California was less than the sum of the interstate delivery capacities by 345 mmcf a day. In other words, California was unable to move the full amount of gas inside the state that could be delivered to its borders.

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the credit support for projects that are under construction or in planning or permitting. Also, the state legislature this year established the California Consumer Power and Conservation Financing Authority, which has adopted a goal of adding up to 3,000 megawatts of additional resources by next summer. This new agency wants to develop a portfolio that contains about 1,000 megawatts of renewables and an additional 2,000 megawatts of gas-fired peaking plants as insurance against price spikes in California. These peaking plants would be owned and operated by the state government.

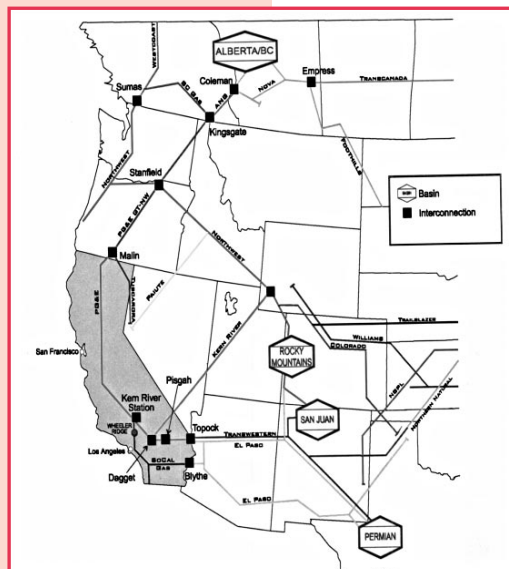
There has been less progress on transmission upgrades. The CPUC has approved and expedited the construction of at least 31 transmission upgrade projects at a cost of more than \$120 million. However, major transmission upgrade projects such as Path 15 between northern and southern California, Rainbow-Valley into San Diego, additional transmission capacity into the San Francisco area peninsula, and upgrades into the rapid load growth areas of San Jose and Tri Valley have been controversial and are proceeding much more slowly through the CPUC's certificate of public convenience and necessity and environmental review processes.

The reliability of new generation facilities will also require the expansion of gas pipeline capacity discussed earlier.

Regulatory Actions Helped

Two important federal regulatory actions provided much-needed price stability in western wholesale electricity markets. First, FERC directed California last December to shift from its reliance on the Power Exchange, a spot market, to long-term bilateral contracts. DWR's power purchase contracts accomplished this. Moreover, these contracts addressed credit issues for the suppliers, which has further stabilized the market.

Second, FERC imposed price caps in an 11-state area in the West. Although there have been a number of challenges to this sweeping order, and there are also numerous



implementation issues, the price caps have played a significant role in stabilizing western electricity markets. The unresolved implementation issues include the application of the must-offer requirement to “slow start” units, reliance on the price of California marginal units when the Pacific Northwest has its peak this winter, and the demise of ISO ancillary service markets for replacement reserves given the “free call option” required by the must-offer requirement.

Who Will Pay the Bill?

Even with the return to normalcy, there is still a very significant issue associated with recovery of past power costs.

PG&E and Southern California

Edison ran up bills of \$14 billion

before the DWR stepped

in to buy electricity for them.

The DWR has paid about another \$10 billion to buy electricity. Generators have unpaid claims for billions of dollars.

As the NewsWire goes to press, at least three generators are talking about forcing Southern California Edison into bankruptcy.

PG&E announced a reorganization plan in mid-September to emerge from bankruptcy. The plan claims to repay fully all creditors and, at the same time, not to increase electric rates for PG&E’s retail customers. The cornerstone of PG&E’s proposal is a shift of assets from the CPUC-regulated distribution company to three new FERC-regulated companies. One of the newly created entities would own and operate about 7,100 megawatts of nuclear and hydroelectric generating units and control some low-cost power contracts with northern California irrigation districts. Another entity would own and operate PG&E’s electric transmission system as part of a FERC-approved western regional transmission organization. A third entity would own and operate PG&E’s backbone gas system as an interstate pipeline. PG&E believes that this transfer of assets can occur as part of the bankruptcy reorganization plan without CPUC approval but with approval by the appropriate federal agencies. The new PG&E generating company would commit to sell all of its power to the distribution company for 12 years at long-term market-based rates. Generators and some other creditors would receive

60% of their receivables in cash and 40% in long-term notes from the three new companies. The distribution utility would not return to the procurement business unless it is guaranteed a passthrough of these expenses, and it would not be assigned any of DWR’s contracts.

Meanwhile, Governor Davis claims that California is owed \$8.9 billion for overcharges by power sellers. The governor hopes to use any refunds to cover some of the outstanding power procurement costs. FERC established a settlement conference to consider these claims, but the judge ultimately concluded that California would be unlikely to demonstrate that there were more than \$1 billion in overcharges, which is

Credit issues continue to cast a long shadow over the California electricity market.

far less than the amount of the unpaid bills. FERC then took the extraordinary step of expanding the amount of the potential refunds by including extra-jurisdictional entities. Hearings are set for this fall on these issues. Any and all FERC decisions on the issue of power refunds will be challenged in the courts by both California buyers and also power suppliers.

Aside from hoping for a big refund from power suppliers, California is preparing for “the mother of all bond issues” — a \$13.5 billion offering. Legal challenges are likely to delay this bond issuance at least until early next year. California’s state budget has gone from ever-expanding surpluses for the past several years to a spiraling deficit. All of these issues will provide a difficult backdrop for the 2002 state budget debate and also next year’s election for governor. The political blame game is likely to intensify as the state draws nearer the elections.

Is the Crisis Over?

At a minimum, there is an enormous amount of clean up to be done.

Credit issues continue to cast a long shadow over the electricity market. PG&E is in bankruptcy / *continued page 20*

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proceedings. Southern California Edison may soon also be. The California utilities were the credit support behind the Power Exchange and the ISO. The Power Exchange filed for bankruptcy on January 28.

Many market participants are concerned that the ISO market is beginning to unravel. The ISO operates a real time market to ensure balanced supply and demand for electricity. In April, the federal government ordered the ISO to find a creditworthy entity to stand behind its supply orders. The ISO had to turn to the DWR as such an entity. The DWR insisted in return on access to the ISO trading room floor, which is a violation of the ISO's tariffs. In response to bad

The long-term contracts California signed to buy electricity at peak prices have become a new lightning rod for political activists.

publicity, the ISO ended this practice in late August.

Power suppliers, the DWR, the ISO, PG&E and Southern California Edison are embroiled in a dispute over who is responsible for paying for the electricity sold through the ISO since last January. The utilities claim that the DWR has assumed this responsibility to the extent of the "net short" of the utilities last January. The DWR admits to being responsible for these costs, but only from an unspecified later date. However, the DWR claims either that it has never received an invoice for these costs from the ISO or that the ISO settlement process is too opaque to allow it to pay the bills. Before it will pay these invoices, the DWR wants access to confidential information from the ISO settlement records. In late September, the DWR and the ISO proposed a complex and cumbersome process to redo the settlement process at the ISO, to negotiate additional agreements between DWR and the California utilities, and potentially to get the CPUC or FERC approval. At this time, the ISO

owes more than \$1.2 billion to electricity suppliers, and the tab grows each month.

In reaction to the nonpayment of these invoices, suppliers are either netting their claims against preliminary invoices from the ISO or attempting to avoid providing services to the ISO. Such behavior is in violation of tariffs, but so are the actions of the ISO and DWR. Such netting is becoming so endemic that the ISO only paid about 8¢ on the dollar for its June 2001 invoices. The ISO has complained to FERC that generators are increasingly ignoring its dispatch requests. Generators charge that the ISO is implementing its tariffs in a manner that minimizes DWR costs.

Underlying these market issues is a conflict between the state and federal governments. In January, Governor Davis appointed a new board to run the ISO in violation of the

FERC-approved ISO bylaws. This new board is not only closely aligned to the governor, but is also prone to blame FERC and the generators for any and all problems.

Similar jurisdictional disputes and finger-pointing may paralyze efforts to upgrade California's gas delivery system.

There is substantial political instability in California. The governor's effort to help Southern California Edison avoid bankruptcy dissolved in a blaze of acrimony in the state legislature. Consumer groups are threatening some form of ballot initiative. DWR's power sales contracts have become a new lightning rod for political activists. The legislature passed a bill intended to force generators to renegotiate the contracts with DWR. Little political consensus has developed for solutions aside from a desire to rely more upon state government and less on markets.

In addition to these regulatory and political issues, there are other issues of concern for the coming year. The Pacific Northwest is low on water to run its hydroelectric plants. A return to expected or average hydro conditions in California and the Pacific Northwest could substantially depress power and gas loads next summer. On the other hand, a continuation of dry hydro conditions for another year could have adverse consequences on both reliability and prices. ☉

A Growing New Source Of Finance: Venture Capital

by Chris Groobey, in Washington

Venture capital investments in the energy sector are on a dramatic upswing.

Independent analysts recorded energy-related investments of \$218 million in 1999 and \$450 million in 2000, and they project that more than \$1 billion will flow into energy-related technologies by the end of 2001. This amounted to just 0.47% of the \$46 billion in total venture investments in 1999 and 0.52% of the \$87 billion in venture capital investments in 2000, but 2.5% of total venture capital investment of \$40 billion projected for this year.

Early and seed-stage investors — who, by definition, are always looking for the “new new thing” — are banking that deregulation, increased energy costs and uncertain fuel supplies will create expanding markets for everything from customer relationship management, or “CRM,” software to energy management systems to new power generation and energy storage technologies. Upheaval in the \$300 billion US utility industry will, these investors hope, generate opportunities and financial returns that will offset fading opportunities in the information technology and life sciences areas.

Investing in the energy sector — especially at the seed and early stages — will require a different skill set than most information technology-focused venture firms have currently. To profit from deregulation, investors must first understand the existing regulatory environment and then predict what will happen as it is dismantled. They must evaluate new power generation technologies against existing — and still formidable — technologies and with an experienced eye toward the future pricing and availability of fuels. For these and other reasons, energy venture investing is not dominated by Kleiner Perkins, New Enterprise Associates and the other household names of the new economy, but rather by a relatively small number of established and new partnerships led by energy veterans and often backed by larger energy firms.

The Venture Capitalists

One example of these newly prominent venture capital firms is Kinetic Ventures, which is currently raising a \$100+ million fund, its eighth, to invest in e-commerce, customer service and communications technologies useful to utilities competing in the new, deregulated environment. Kinetic has invested more than \$290 million from its previous seven funds over the past 15 years, with the majority of the funds' limited partners being domestic and international utility companies.

Todd Klein, managing director of Kinetic Ventures, believes that his firm's unique value proposition comes from the principals' utility-industry experience, the firm's utility investor base and — perhaps most important — the firm's semiannual gatherings of investors and portfolio companies, which have resulted in joint ventures, sales opportunities and direct equity investments. Kinetic summarizes this strategy as “maximizing investor relationships to provide unprecedented access to the utility industry.”

Klein reports that Kinetic's deal flow is at an all-time high. He believes this is the result of three key trends: 1) entrepreneurs adapting existing software and technologies to the relatively untapped energy market, 2) a resurgence in fuel cell, powerline carrier and superconductivity research and development and 3) an increasing focus among the utility companies on the value of customer relationships and the need to draw ever-increasing revenue from relatively mature markets. Kinetic's investments include APX (an internet exchange for the buying and selling of electricity), Peace Software (customer care and billing systems) and SmartSynch (wireless-enabled metering).

Toucan Capital is another, younger venture capital firm founded in 1998 by power-industry veterans Robert Hemphill — a former executive vice president and current board member of The AES Corporation — and Linda Powers — a former senior vice president for global finance of Enron Corporation. Toucan is currently investing its second, \$120 million fund in life sciences and information technology companies.

According to Hemphill, Toucan is especially interested in small-scale fuel cells and energy storage technologies, primarily for portable and vehicular applications. Toucan has declined to invest in other, large-scale generation technologies, partly due to an aversion to business plans that rely on significant capital expenditures or gov- / continued page 22

Venture Capital

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ernment subsidies to survive and also because, as Hemphill puts it, “nothing beats the GE Frame 7 turbine. It presents a very high barrier to entry” for new generation technologies due to its high efficiency and low cost of operation.

Other energy-oriented venture capital firms include Nth Power Technologies (\$200 million under management, 20 portfolio companies), EnerTech Capital Partners (\$285 million, 18 companies), Prospect Street Ventures (\$216 million, 30 companies), GFI Energy Ventures (\$454 million, 30 companies) and Altira Group (\$100 million, 10 companies). Later-stage investors include prominent private equity firms Thayer Capital Partners, The Carlyle Group and JPMorgan

Venture capital investors see opportunities in increased energy costs and uncertain fuel supplies.

Partners, each of which manages more than \$1 billion. Finally, many large energy firms are making direct strategic investments in promising companies, including Cinergy, Exelon, PG&E and Enron.

Investment Philosophy

Venture capital firms typically expect that between one and four of every 10 investments will achieve a “liquidity event,” be it an acquisition or an IPO. Therefore, to be worth investing in, a new technology must be capable of capturing a reasonable share of a large market and present a plausible exit strategy. In the utility sector, most investors are focusing on technologies that make energy more reliable and efficient — which translates into increased earnings from the same revenue — or that give one company a competitive edge over another in the fight for the most profitable customers — which translates into revenues at the expense of one’s competitors.

AES Intricity is one of the new breed of energy companies that believes proprietary, unique technologies will help it to acquire customers. According to Rob Morgan, AES Intricity’s general manager, direct investment in new energy technologies by established energy companies has often followed — and suffered from — the pattern of “if you build it, they will come.” Products were built first, marketed second — often at great expense — but actually sold to customers and used last, if at all. Morgan argues that the smarter path is to build products based on specific needs of existing customers, then market them beyond the initial group of users.

AES put this philosophy into practice through its July 1999 acquisition of New Energy Ventures — now called AES New Energy — and the subsequent spin-off of a new compa-

ny called AES Intricity. AES Intricity includes the information technology support, billing and back-office groups of AES New Energy and the people and technology of Energy Tracking Inc. and OhmTech Labs, which AES acquired in December 2000.

AES purchased Energy Tracking Inc. and OhmTech, and those companies’ tech-

nologies relating to the measurement of energy consumption and analysis of customer consumption patterns, in response to customer demands for real-time, internet-capable metering devices. In opting for the “buy” side of the build-versus-buy decision, AES purchased an already-mature product line that has since been rolled out to customers in 11 states, far faster than if AES had developed the technology itself.

The bottom line, according to Morgan, is that deregulation is offering customers choices for energy that correspond to actual consumption patterns, not statistical load profiles. With its newly acquired technology, AES Intricity is able to provide to its customers information that allows them to monitor usage across their own facilities, and then to compare that usage to usage by other companies in the same industry. AES believes that customers using this technology will be able to lower their costs and better manage their processes.

Conclusion

Venture capitalists and established companies alike hope that the energy sector will experience the same growth and create as much wealth as did the telecom sector in the first years following its deregulation. The venture capital community is currently holding approximately \$40 billion in uncommitted funds. A significant portion of these funds, and of the billions in funds yet to be raised, will be invested in energy-related technologies. The challenge will be for the players in the now-hot energy sector to avoid the losses and business failures that have recently befallen the telecom sector. ☉

Training Session: Letters Of Credit

Chadbourne runs internal training sessions for lawyers in the project finance group and interested clients. The following is an edited transcript of a session on letters of credit that took place by videoconference in mid-August among the Chadbourne offices in New York, Washington and London. The speaker is Denis Petkovic in London. Copies of the handouts — including slides used for the presentation and a detailed outline of the law in this area — can be obtained by sending an e-mail to dpetkovic@chadbourne.com.

The starting point for this topic is to look at the “Uniform Customs and Practice for Documentary Credits,” or “UCP 500.” This is a set of rules published by the International Chamber of Commerce that nearly all international banks follow when issuing international letters of credit. The rules have been revised five times since they were first issued in 1983. The most recent revision took effect in January 1994.

Standard Conditions

UCP 500 is a set of conditions that is routinely incorporated into letter-of-credit transactions by the parties. It pays to be familiar with the conditions because they are not usually spelled out — merely incorporated in letters of credit by reference.

These conditions govern all *international* letters of credit that expressly incorporate them. The United States has its own version of UCP 500. It is article 5 of the “Uniform Commercial Code.” This is meant to be consistent with UCP

but it is not identical and UCC article 5 is really only suitable for purely domestic letters of credit in the United States.

If a bank does not expressly incorporate UCP 500, can one argue the letter of credit should still be considered governed by these conditions on grounds of existing custom or usage? There is a school of thought headed by a leading English academic named Professor Goode that says these rules are now so widely used that they do constitute existing custom and usage, but I am not sure this is correct. The fact that one has a different set of conditions in the UCC in the United States calls into question whether Professor Goode is right and when dealing with issuers in civil law countries like France and Italy, local civil codes will invariably influence the legal position.

In cases where the set of standard conditions is incorporated by reference in a contract, it becomes part of the contract. However, the conditions can be varied as the parties see fit. English case law holds that the express terms of the letter of credit govern. If they are inconsistent with the UCP, the set of conditions in the UCP yields to the more express terms.

US practice is that only banks tend to issue letters of credit — possibly because of concerns about triggering breaches of banking laws. This is not the practice outside the US where non-banks frequently issue standby and other “non-trade finance” LCs.

Sample Transaction

On page 24 is a diagram of a fairly typical letter of credit transaction. The most important point to take away from the diagram is that a letter of credit transaction is not just one transaction. It is a series of transactions

The diagram shows a buyer in China who wants to purchase goods from a US seller. The first contract in the transaction is a contract to sell the goods. Obviously, the seller in the United States wants to be paid and the buyer is a long way away.

Therefore, we come to the second contract. The buyer approaches its local branch or local bank to arrange for the issuance of a letter of credit. The bank in the diagram is in Hong Kong. The letter of credit is nearly as good as cash to the US seller.

The issuance contract — contract two in the diagram — can be described as mandate or a reimbursement agreement or a counter-indemnity. In that contract, / *continued page 24*

Letters Of Credit

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the buyer will be obliged to put the bank in funds when the bank makes a payment under the letter of credit or when the bank's obligation matures to make such a payment because the US beneficiary of the letter of credit has presented the documents required to draw on the LC. The bank will allow the draw, but it then looks to its customer under an indemnity reimbursement or other obligation for payment.

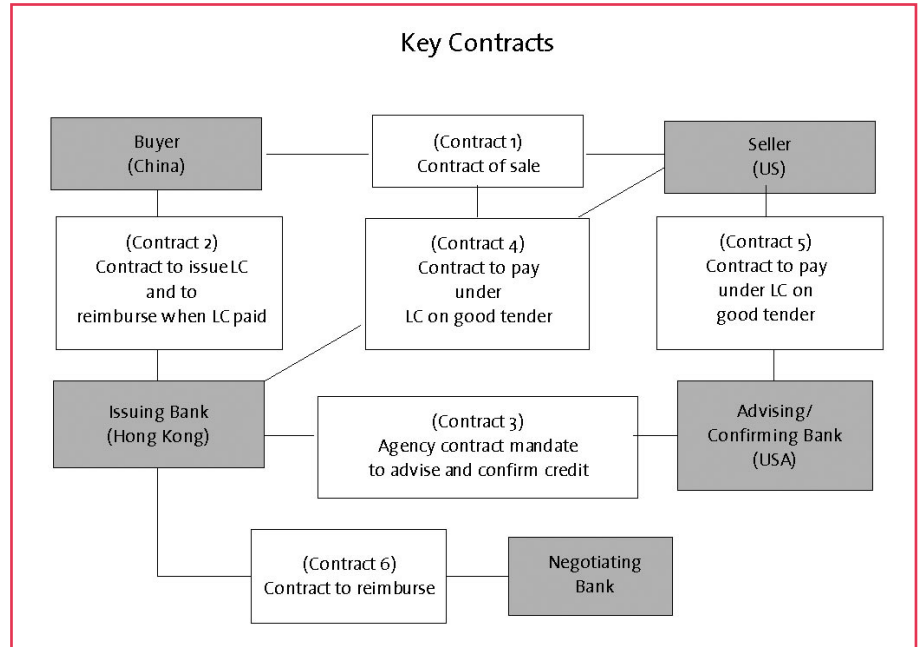
Contract three: the bank is in Hong Kong but the beneficiary of the letter of credit is in the United States. In contract three, the Hong Kong bank enters into an agency contract with a US bank that says — in effect — please tell the beneficiary what the nature of our obligation is under our letter of credit. This is called the “advising” of credit.

This still doesn't get the US seller where it wants. It will want someone whom it can sue locally if there is non-payment or non-performance of the Hong Kong bank's obligations. That gets us to contract five. Contract five occurs when a US bank — usually the advising bank — confirms the LC in favor of the US seller. This confirmation constitutes a separate and independent legal obligation of the confirming bank to the US seller. The wording typically goes something like, “We confirm the credit issued by Hong Kong bank in the following terms” The magic words “we confirm” create a separate and independent obligation by the US bank so that the US seller now has what it needs: someone in the United States who is prepared to pay. The US seller has a choice of suing the Hong Bank directly or going against the US bank.

Turning to the last contract, we have yet another bank called the negotiating bank. LCs may provide for payment in, say, 30 days after presentation of documents required for a draw. The negotiating bank will buy at a discount those documents from any party who is in possession of the documents and make a profit when the documents are finally

presented to the Hong Kong bank because the negotiating bank has “negotiated,” or given value for the documents. The negotiating bank obtains by law under the UCP an indemnity obligation from the issuing Hong Kong bank whereby it will be reimbursed by virtue of having given value for the documents stipulated in the credit.

Typical Letter of Credit Transaction



Which Country's Law Governs?

These are five separate contracts. Because they are written in different countries, the question increasingly comes up whose law governs? The answer is that they may not all be governed by the same country's law — even though they are related pieces of a trade finance LC.

Letters of credit in practice have not had a governing law clause inserted, and you may still find many trade finance LCs that lack such clauses. Be sure to insert such a clause. Left to its own devices, an English court — and I believe the approach is the same in the US — would look to the law of the country that has the closest and most real connection to the transaction. This is typically the place where the issuing bank — in the diagram, the bank of Hong Kong — has to perform its obligations under the letter of credit. When you have an advising or confirming bank involved, it will be where the beneficiary is located. The point is that where parties fail to specify what is the governing law, one gets into questions

about which country has the closest and most real connection. This becomes important because countries have, in the past, invoked remittance blocking orders or passed laws to prevent payment. For example, if a foreign law governs the letter of credit obligation or any applicable obligations in the chain, a bank in the chain will rightfully be entitled to withhold payment by virtue of an applicable block order. This is why it is so important for letters of credit and other related contracts to contain governing law clauses.

Autonomy Principle

There are other concepts that are fundamental to understanding how the letter-of-credit rules apply.

The main one is the “autonomy principle” in articles 3 and 4 of UCP 500. Article 3 says that LCs are separate transactions from the underlying sales contract. Banks are in no way concerned with or bound by the sales contract.

Article 4 says that parties to a letter of credit are concerned only to insure that documents presented to them conform on their face to the terms of the credit. The LC bank is not concerned with the correctness of statements in the documents. It will not examine the goods that are the subject of the contract of sale to see if they conform. Its business is only to deal in the documents. These are documentary credits.

There are strong policy reasons why courts observe these principles. The absolute nature of the payment obligation that one gets under a letter of credit would be threatened if banks looked beyond the documents presented to draw on the LC. There is, though, one major exception to this principle, and that is fraud. It is very hard to establish fraud. The bank must have had knowledge of the fraud before a court will issue an injunction to block payment.

Illegality is another exception to the autonomy principle. An example is where it is illegal under the applicable law for the Hong Kong bank in our scenario, to make payment.

What the Law Requires of Banks

What duties are imposed on banks in an LC transaction? The issuing bank — the Hong Kong bank in the diagram — has a

duty first to issue a credit in accordance with its instructions, second to receive and examine documents under the credit, and third to pay against conforming documents. A important corollary is to refuse to pay against documents that do not conform.

UCP 500 is largely silent on the issuance duty, but the payment duty and the examination duty are covered and are probably the most significant articles in UCP. Article 13 of UCP 500 requires banks to examine all documents stipulated in the credit with reasonable care, to ascertain if they appear on their face to be in compliance with the terms and conditions of the credit. Documents that are inconsistent with one another do not appear on their face to be in accordance with the terms and conditions of the credit. In addition, if additional documents are presented that are not stipulated in the credit, the bank is not required to examine them. So UCP 500 provides guidance for banks when trying to figure out what they must do to comply with the examination function.

Advising banks have a fairly limited role. They are an agent of the issuing bank, and the normal contractual rules of agency apply. Not much is written in UCP 500 about advising banks. They simply inform the beneficiary of the terms of the credit.

The confirming bank has a very interesting role that is addressed in article 9 of the UCP. It is clear to me on various

It is very hard to block draws on a letter of credit in the absence of clear fraud.

readings — and I have advised banks in the past — that the confirming bank’s obligation to make payment is a collateral obligation that is independent from that of the issuing bank. If the issuing bank goes bust, the beneficiary can look to the confirming bank for payment. The point about confirming banks is the same as for issuing banks: if they pay against nonconforming documents, they do so at their own peril and may not be entitled to recover the amount of their payment — even though they end up in fact with possession of the underlying transaction documents! ☹

Environmental Update

The environmental agenda is yet another casualty of the terrorist attacks on the United States on September 11.

Both Congress and the Bush administration are expected to set aside work on major environmental initiatives for at least the rest of this year. The Senate Environment and Public Works Committee will continue making inquiries and holding “stakeholder meetings” about how to write a

Both Congress and the Bush administration are expected to set aside work on major environmental initiatives for at least the rest of this year.

bill that will limit air emissions further from power plants. However, the bill is not expected to advance this year. The Environmental Protection Agency will continue working on a multipollutant legislative strategy for power plants, but any internal deadlines for formulating a plan will almost certainly be extended.

Air Permitting

The Senate Environment and Public Works Committee had scheduled “stakeholder meetings” with persons interested in air emissions from power plants for September 11 and 12. The meetings were abruptly cancelled when the Capitol was quickly evacuated after a United Airlines jet crashed into the Pentagon. The meetings have been rescheduled for October 4 and 5. The focus is to find common ground for a bill that would tighten existing limits on power plant emissions of nitrogen oxides, or NO_x, and sulfur dioxide, or SO₂, and impose new limits for mercury and carbon dioxide, or CO₂.

Multipollutant legislation is controversial. It is expected to impose huge new costs on power companies that would have to retrofit existing power plants. There is also serious disagreement about whether mandatory reductions in CO₂ emissions — a greenhouse gas — should be required, particularly since pollution control technologies

to reduce CO₂ are not yet proven and remain in the developmental phase.

Senator James Jeffords (I.-Vermont), chairman of the Senate committee, has already introduced a bill called the “Clean Power Act” that calls for significant reductions in all four pollutants — NO_x, SO₂, mercury, and CO₂. The Bush administration is working on a multipollutant proposal of

its own to present Congress that would leave out mandatory reductions for CO₂. The administration was also in the process of completing a cabinet-level review of measures to address global warming when the terrorists attacked on September 11. The results

of that review may now not be announced until next year.

A draft proposal circulated earlier within the Environmental Protection Agency had called for power plants to reduce NO_x emissions by approximately 75% by 2012, reduce SO₂ emissions by about 80% by 2010, and cap mercury emissions at 7.5 tons a year (approximately an 80% reduction from current levels). By comparison, the Jeffords bill would order approximately a 75% reduction in NO_x and SO₂ emissions and a 90% reduction in mercury emissions from power plants. The Edison Electric Institute — the trade association for regulated utilities — has warned that the EPA proposal would cost twice as much to implement as utility industry proposals seeking a 50% reduction in all three pollutants. The US Department of Energy has also criticized the internal EPA proposal as being too costly and lacking in scientific and human health data to support such steep cuts.

Twenty-four organizations have been invited to participate in the Senate stakeholder meetings, including 13 environmental and public interest groups, six industry groups and five state organizations. During the discussions, there will be approximately 29 seats at the table with the power sector having at least nine. Numerous other interested parties have been invited to observe the meetings, but will

not have an opportunity to participate in the discussions.

The prospects for the Senate Environment and Public Works Committee reaching an agreement on a multipollutant bill this year are dim. Given the controversy surrounding the issue and more pressing national priorities, it is questionable whether multipollutant legislation will advance beyond the discussion phase before the end of the 107th Congress at the end of next year.

Mercury and CO₂

The Conference of New England Governors and Eastern Canadian Premiers adopted resolutions at the end of August pledging to cut mercury emissions and greenhouse gas emissions, including CO₂, from sources in the region. The cross-border agreements to reduce mercury and greenhouse gas emissions are intended to build on past successes by the US and Canada in taking regional action to address the acid rain problem.

The new resolution calls for a 75% reduction in mercury emissions from all sources, including power plants, using a 1998 emissions baseline. It calls for the reductions to be achieved by 2010. The resolution does not have the force of law and allows each state and province to determine how the mercury reductions will be achieved. For example, Massachusetts enacted legislation earlier this year that will require the state's six oldest power plants to reduce mercury emissions to an as-yet undetermined limit by October 1, 2006.

The Conference of New England Governors and Eastern Canadian Premiers also adopted a "climate change action plan" that advocates reducing regional greenhouse gas emissions to 1990 levels by 2010. The conference also called for regional greenhouse gas emissions to be further reduced by 10% below 1990 levels by 2020. The climate change action plan also sets a goal of promoting a uniform and coordinated regional banking and trading system for greenhouse gas emissions.

The conference consists of the six New England governors and premiers from the provinces of Quebec, New

Brunswick, Nova Scotia, Prince Edward Island and Newfoundland.

Global Warming

The Edison Electric Institute and a number of utilities individually submitted recommendations to the Bush administration's climate change policy task force in August on how to address the problem of global warming. The utilities want voluntary reductions in greenhouse gas emissions and a package of tax incentives and research and development funding.

The utilities recommended creating a national registry with mandatory reporting of greenhouse gas emissions. Companies would have the option to enter into voluntary commitments to reduce greenhouse gas emissions and would be eligible, as a result, for greenhouse gas emissions offsets and credits. The utilities proposed two alternatives to structure a climate change technology research, development, and deployment program. The first option focuses on forming an industry-federal government partnership that would include additional federal funding of research and development projects and tax credits for certain industry research and development efforts. Alternatively, they proposed creation of a private, for-profit climate change efficiency corporation — called the "CEC" — that

The New England governors want a 75% reduction in mercury emissions from power plants by 2010.

would act as an investment vehicle for research and development into new climate change technologies. The CEC would be funded by industry contributions, and participating companies would share in any technology patents, profits and greenhouse gas emission credits generated.

The utility proposal appears to build on the administration's pledge earlier this year to devote additional federal funds for research into the causes of global warming and into technological innovations to

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Environmental Update

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reduce greenhouse gases. However, with agencies now being asked to give back unspent money so that the federal government can divert resources to the war against terrorism, research into global warming will probably take a back seat.

In light of the Bush administration's other pressing priorities, any new US climate change proposal is unlikely to be unveiled before the upcoming international meeting on climate change in Marrakesh, Morocco scheduled for October 29 to November 9 at the earliest and, even then, more likely not before next year.

NO_x Emissions

A federal appeals court for the DC circuit granted a utility request in late August to delay implementation of a "section 126 rule" by the US Environmental Protection Agency. This is a rule that requires reductions in NO_x from specific power plants and factories in 12 states in the eastern half of the United States. The court largely upheld key provisions of the rule earlier this year. The section 126 rule is an effort by the federal government to prevent migration of NO_x from power plants and factories in the 12 states to neighboring states.

The appeals court's decision essentially gives power plants and factories four years rather than three years to comply with the section 126 rule. The deadline had been May 1, 2003. The additional delay results from the court ordering the Environmental Protection Agency to clarify how it calculated the "growth factors" for electricity demand

that were used to develop the emission limits in the rule.

The delay will probably push back the start date for compliance from the 2003 ozone season (May to September) to the 2004 ozone season. It will also align the section 126 rule requirements with the so-called NO_x SIP call provisions. The same appeals court has already extended the NO_x SIP call compliance deadline to May 31, 2004. The NO_x SIP call requires similar NO_x reductions from a broader range of emissions sources, but also applies to power plants. The federal government is expected to try to coordinate implementation of the section 126 rule with the NO_x SIP call rule requirements.

In its decision in late August, the federal appeals court also remanded — or sent back — the section 126 rule provisions that apply to cogenerators to the agency for further rulemaking to determine how cogeneration plants will be classified under the rule. The court also set aside a portion of the rule that classified certain cogenerators for the first time as "electric generating units." The cogeneration facilities in question are not treated as electric generating units for purposes of other EPA rules, like the acid rain program.

The section 126 rule and the NO_x SIP call rule will eventually force owners of many existing power plants and factories to install costly new pollution control devices — like selective catalytic reduction systems — to reduce NO_x emissions. ☉

— contributed by Roy Belden in Washington.

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