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Opportunities and Risks

This has been a year of change for the US power industry. Many companies have put assets up for sale. State regulators are wondering whether to freeze any further deregulation. The federal government has investigations underway into "wash trades" in domestic electricity markets. California is trying to break long-term contracts that it signed just last year to buy electricity. A new national energy bill has passed both houses of Congress and could become law this fall.

The following are excerpts from a discussion about the significance of the latest regulatory and legislative developments in the United States that took place at a Chadbourne conference in Quebec in late June.

The speakers are Sheila M. McDevitt, senior vice president and general counsel of TECO Energy, Eugene Peters, vice president for legislative affairs of the Electric Power Supply Association, the national trade association for the US independent power industry, Vincent P. Duane, vice president and assistant general counsel of Mirant Corporation, Sanford L. Hartman, vice president and associate general counsel of PG&E National Energy Group, Christopher Seiple, director of North American electric power studies for Cambridge Energy Research Associates, Jeanne Connelly, vice president – federal relations for Calpine Corporation, Robert J. Munczinski, managing director of French bank BNP Paribas, Lynn N. Hargis, a former assistant general counsel of the Federal Energy Regulatory Commission for electric utility regulation and now a Chadbourne lawyer, Bruce Davis, assistant general counsel of Mirant Corporation, and Dr. Robert B. Weisenmiller, one of the leading experts on the California electricity / continued page 2

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GAS INTERTIE payments may not have to be reported as taxable income.

A power company must usually pay the cost of a gas lateral or tapline to connect its power plant to an interstate pipeline so that it can receive gas. The pipeline insists on owning the lateral. A corporation must usually report the value of property paid for by someone else as taxable income. Consequently, pipelines usually insist on a "tax grossup" in addition to reimbursement for the cost of the new line. The grossup makes it more costly for independent generators to tap into gas pipelines. / continued page 3

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market and a founder of MRW Associates, Inc. in Oakland, California. The moderator is Keith Martin.

MR. MARTIN: We had a call last week to discuss the most important regulatory developments of the last few months. Everyone had at the top of his or her list the possible slowdown in electricity deregulation. Sheila McDevitt, start us off: what is the issue?

In my 29 years as a banker, I have never seen so much talk given to a sector that provides so little value as electricity trading.

Nervousness About Competition

MS. McDEVITT: It is whether the experience in California and with Enron will lead states and the federal government either to put on hold plans to move forward with electricity deregulation or possibly even to retrench and reexamine those deregulation models that have already been put in place.

MR. MARTIN: Gene Peters, is the trade association following which states are backtracking or are considering shelving new plans to deregulate?

MR. PETERS: I never use the word "deregulation."

MS. McDEVITT: Restructuring.

MR. PETERS: A lot of my business is vocabulary and that's an important point.

MR. MARTIN: Why is it important?

MR. PETERS: First, we are not deregulated. We never were. We never will be. It is essentially a revolving regulatory context. Two, if you spend as much time as I do on Capitol Hill, you know that "deregulation" generally means hands off or *laissez faire*. It is not a good word. For example, if you talk to [Senator] Byron Dorgan [from North Dakota], he can't make a trip today to Fargo — thanks to airline deregulation — without paying less than $1,000, so he has a very clear vision of what deregulation is, and he doesn't like it.

MR. MARTIN: Are there some states that are backtracking and others that are just stopping any forward motion?

MR. PETERS: There are two issues here. One is retail restructuring and the other is the wholesale market. At a retail level, at last count 24 states had passed some form of restructuring legislation. It is safe to say the remaining states have put any similar plans on hold. Everyone is merely watching New York, Pennsylvania and Massachusetts now to see how they fare.

MR. MARTIN: Are there states that are backtracking?

MR. PETERS: One way to measure the potential for backsliding is to watch how many new rate-based facilities are being proposed. You have not seen that in general except in places where you would expect to see it anyway. When we start to see rate-based facilities proposed in Ohio, Pennsylvania and New York, we are in trouble. At the moment, you see them in Florida. You see them in TVA territory. No surprises there.

MR. MARTIN: Vince Duane, is there a danger of backtracking in the 24 states that have already restructured their electricity markets?

MR. DUANE: Maybe I am more skeptical than the others, but I think there has been backtracking already. The political climate at the moment favors those forces that have not traditionally supported change and innovation. Their tide is quite high and they are using it very effectively. You are even seeing a renaissance in public power and municipalization in some areas — places like New York — that we have not seen for some time. The behavior of the ISO in that market is currently so unaccommodating to merchant generation that I do not see anyone building new merchant generation in areas like eastern New York, where there is a critical need for power, unless it is by the New York Power Authority or a utility that can put the assets into rate base.

MR. MARTIN: So even if there is no backtracking in the legislature, there may be backtracking in how the rules are enforced?

MR. PETERS: Most states that passed these laws left the fine print to local regulators. What we are seeing is that the public utility commissions that are supposed to create and implement these rules are not doing it. They are all saying, "Look what happened to California. Let's just hunker down here."

MS. McDEVITT: I think it is growing pains. You have to take a more positive view — a longer-term view. This business is not a snapshot in time. We must have faith that the need for electricity is there and there are ways to create competitive markets that actually work. ISOs and RTOs are an essential part of the answer, but they are only a step.

MR. MARTIN: Sheila is our positive thinker.

MR. PETERS: The name of this panel is "Opportunities and Risks." The ground rules ought to be that we are not allowed to talk about risks unless we mention an opportunity.

MS. McDEVITT: That's right. Many speakers who preceded us talked about problems, but you can take problems and make them into opportunities.

MR. MARTIN: Sandy Hartman, what is the significance for generators? I can see that there might be fewer opportunities for independent generators. Are there broader consequences from what has been described here?

MR. HARTMAN: I tend to look at this differently. There is currently a real surplus of power so it is academic whether the industry has been hurt by backsliding on market access for independent generators. I don't mean to offend any regulators in the room, but regulators don't like to make decisions. They don't like to decide who pays and how much. If they don't need to do it, they don't. So this pattern of ebbing and flowing and going back and forth should be expected.

I am really interested to see the first state commission that actually approves a cost-based 1,000 megawatt combined-cycle plant without any competitive bidding, without any market tests, and says, "We think we are going to need it, and we are just going to pass through the cost to the ratepayers." Nobody has had to do it quite like that yet, and I think everyone has in many ways forgotten that we got to where we are for a reason. Things will work out.

MR. MARTIN: Chris Seiple, you have a comment.

MR. SEIPLE: Some of what was just described is occurring. Mid-American got PUC approval recently to build a coal-fired power plant in the midwest. There are utilities in the central United States that are having discussions with their regulators about their desire to grow and return to a rate-based strategy. These utilities are / continued page 4

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US policy is to collect taxes whenever a pipeline receives interconnection payments from one of its customers. However, at a recent meeting, Internal Revenue Service officials confirmed that there are some fact patterns where no tax would have to be paid. An example is where the gas supplier pays the cost of the lateral so that a power company can receive gas from the supplier.

THE NEW DEPRECIATION BONUS rules will probably be changed this fall through "technical corrections" to the statute. Some of the changes under discussion are unfavorable to taxpayers.

Key staff of the tax-writing committees in Congress and at the US Treasury hope to meet in August — while Congress is away on recess — to make decisions about what technical corrections to make. There is talk at the staff level that too much time may have passed since the depreciation bonus was enacted last March to tighten the rules retroactively. Technical corrections are usually retroactive in effect since they merely clarify what was intended. Therefore, staff are holding out the possibility that the chairmen of the tax-writing committees might introduce a bill in September with the technical corrections that are planned. Any changes that tighten the rules would take effect prospectively from the date the bill is introduced.

Meanwhile, the IRS is working on guidance. The business plan the agency released in July for the next 12 months said guidance would be issued "under section 168 . . . regarding special depreciation allowance." Charles Ramsey, the IRS branch chief for this area, said a revenue ruling or other guidance is possible as early as October. However, the guidance may not deal with "transition issues," or the question whether projects on which work straddled September 11, 2001 qualify for the bonus.

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telling the regulators, "We have an oversupply in our market area. There is an opportunity for us to acquire some of these IPP facilities and bring them back into rate base." My sense is they have gotten a favorable response from their state PUCs. We have also seen utilities, like Cinergy, trying to transfer some of their merchant facilities back into rate base. I think the signs are there.

Public Relations Battle

MR. MARTIN: Let me ask this. One of you made the comment earlier — I don't know whether it was Sandy Hartman or Vince Duane — that there is basically a public relations battle going on between which is the better model: the vertically-integrated utility or, say, the PJM model. Who is winning that battle?

MR. DUANE: I agree with Chris Seiple. I think there has been a reversal because we as independent generators have taken certain things for granted. One of them is we assumed consumers understood that, as a general proposition, deregulation, or liberalization of the markets, is a good thing. That question is now being reexamined. People are asking, "Do we want our energy markets served by public utilities with their public service notion of social responsibility?" They are very different companies than the Mirants and Dynegys and Williams of the world which are rather agnostic in that regard.

We have obligations to shareholders. We are ruthless in some senses, as someone characterized it, in seeking out market inefficiencies and making sure the markets correct around those inefficiencies. Public policymakers are asking, "Is that really what we want in our energy markets or is energy too important or too different to be left to free markets?"

MR. MARTIN: Sheila McDevitt, who is winning the public relations battle? You sit on both sides of the fence.

MS. McDEVITT: The average consumer doesn't even understand the issue nor does he or she want to have to shop among power producers, at least as of this moment. The public reads about the headline disasters, but doesn't understand that there is a distinction between companies engaged in speculative trading and the generators who sell power from their own power plants.

The public is not really the audience for generators. Their audience is their shareholders — who are reached through Wall Street analysts — and the banks who finance their projects. It is that audience to whom the generators need to get the message that the industry is fundamentally sound.

MR. DUANE: The question people have to ask is, "Do we need retail competition in order to support healthy, robust competitive wholesale markets in electricity?" If the answer to that question is yes, then I think we have a serious problem because I don't see us winning the retail battle. Consumers don't understand it. A lot of them don't want it. A lot of them are fearful of it. A lot of states are retrenching and politicians are saying, "Why should I stick my neck out on this after California?" It is not going to happen.

I myself don't think the two must go together. I think you can support a competitive wholesale market with an active role for state PUCs to force load-serving entities to purchase wisely, prudently and effectively in the wholesale market from merchant generators and power marketers. It doesn't have to mean opening up markets at the retail level.

California's attempt to cancel contracts is symptomatic of a much broader problem of asymmetrical re-regulation.

Government Investigations

MR. MARTIN: Let me move to the next regulatory development that is affecting us. It is the ongoing investigations by various federal agencies — the Federal Energy Regulatory Commission, the Securities and Exchange Commission, the Commodity Futures Trading Commission — into use of Enron-style trading practices and market manipulation in

California and into wash trades in US electricity markets. CMS said wash trades accounted for 78% of its total electricity trades in 2000 and 72% in 2001. FERC is threatening to revoke the authority for five generators to sell power at market rates. The grid operator in California asked FERC to revoke such authority for six generators that it accuses of having gamed the system in California. Vince Duane, your thoughts about the ongoing investigations?

MR. DUANE: Let me tell you how I think we viewed this as the year progressed. Initially, the strategy was to confine the Enron issues to ones of accounting disclosure, reporting, creative financial engineering — things of that sort, and the —

MR. MARTIN: That's a long list to be confined to.

MR. DUANE: But it is all confined to one area.

MR. MARTIN: Broad corporate management issues?

MR. DUANE: Exactly. These are issues that could have happened to anybody selling Girl Scout cookies or electricity or pharmaceuticals or anything. The troubles are showing up in the Tycos and WorldComs of the world. The point is it is not an indictment of the wholesale energy business. It is not an indictment of deregulated energy business.

Unfortunately, with the revelations around the Enron trading strategies in California, we now have a war on a second front that is much more focused on this industry and the behaviors in the wholesale trading and merchant energy market.

MR. MARTIN: Sandy Hartman, how do you see this playing out for the industry, over what time period and with what result?

MR. HARTMAN: I think it is going to take a fair amount of time, and it will proceed on two or three different levels. The first is the overall corporate governance issue must be fixed. That's a much broader issue than the power industry. Second, as long as we are awash in power, arguably it doesn't matter if decisions about electricity markets aren't made for the next couple of years. Third, eventually, even in California, decisions are going to have to be made about whether people will be paid for delivering services, whether it is the load-serving entity, the generator or the gas supplier. I think I successfully dodged your question. [Laughter]

MR. MARTIN: Okay. Jeanne Connelly, same question.

MS. CONNELLY: I was just going to say one of the problems with all of the recent revela- / continued page 6

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the depreciation bonus last March in the hope that it would help stimulate the economy. Any company purchasing new equipment during a window period from September 11 last year through 2004 or 2005 is allowed to claim 30% of the cost as a depreciation deduction in the first year. The remaining 70% of the equipment cost is depreciated normally. The length of the window period depends on the equipment. The deadline for most power plants is 2005. The bonus reduces the cost of a new coal-fired or combined-cycle gas-fired power plant by 5.39%.

Independent power companies submitted 25 fact patterns to the Treasury and IRS in May that they asked be addressed in guidance. A meeting is expected with senior Treasury and IRS officials about the fact patterns in August.

WRITTEN ADVICE from accounting firms is becoming harder to protect from disclosure to the IRS.

The IRS said in June that it will routinely demand any company that invested in a "listed transaction" to turn over all audit workpapers its accounting firm prepared in connection with deferred tax reserves and the footnotes in its financial statements about possible future tax liabilities. A "listed transaction" is a transaction that the US government has put the public on notice it believes does not work. There are currently 16 such transactions.

The new policy also applies to transactions that are "substantially similar" to listed transactions.

The IRS said that if the company disclosed the transaction — as required under US tax shelter registration rules — then the agency will limit its demand to the audit workpapers that discuss the particular transaction. However, if the company failed to disclose the transaction / continued page 7

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tions around energy trading is that it has undone the educating that we tried to do in the past year about what underlying structural problems exist in California, and we were beginning to make headway. Now they believe that it was simply manipulation of the market. So we have lost almost an entire year of educating public policymakers about what lessons should be drawn from the chaos last year in California.

Today, you have one utility — PG&E — trading at a share price in the low twenties while it is still in bankruptcy, while the Mirants and Dynegys and Williamses are trading at $8 a share.

The other problem is that it is diverting the attention of FERC. The current FERC chairman, Pat Wood, wants to move further toward competition. Instead, the agency is now bogged down in more investigations, more market monitoring. This inevitably slows down the process of moving toward competition.

MR. HARTMAN: Keith, if I could add one other point? We tend to focus on Congress and the state legislatures and regulators. There is a raft of private lawsuits right now winding through the courts — the creativity of which I find remarkable — that are the fallout from the chaos last year in California. These lawsuits are going to take a fair amount of time to work through the courts. They get into very complicated technical questions about federal preemption, about whether you are going to have independent causes of action under state laws, and many of us are struggling with what to say in securities disclosures about them. It is impossible for companies to quantify what their liability is because the cases raise novel and untested theories of liability. Imagine joint defense groups comprising 80% of the industry. The point is that once everything is cleared away on the political side, the industry will still have to contend with this litigation. At the end of the day, the lawsuits create risk, and it is a risk to capital and a risk to investing.

Power Marketers

MR. MARTIN: Vince Duane, another consequence of California, Enron and the revelations about wash trades is that many independent power companies with trading affiliates are finding it hard to continue in the trading business. They need to bring in partners. You believe those partners may eventually be banks or insurance companies. Why?

MR. DUANE: Yes, but I am not sure how much of the financial travails of the trading companies should be attributed to Enron or California as much as to a better understanding of what this industry is all about and an appreciation that it takes a tremendous amount of collateral to support the credit obligations of what is a high volume, very volatile business. A lot of the people in that business no longer have an investment grade profile and yet investment grade is critically important to minimizing the amount of collateral that is used to support that business. The question is what do you do?

The answer that many are coming to is to look for someone with a strong balance sheet as a partner. The banks have shown a renewed interest recently in this area. Banks have dipped in and out of the energy commodity trading business over the past 10 years. They have trading expertise. They have the balance sheets and the creditworthiness. The piece they may be missing on the power side is assets, and you have to ask the question whether some of these banks are going to end up owning some of these assets — whether they want to or not — through foreclosures.

MR. MARTIN: Bob Munczinski, a question?

MR. MUNCZINSKI: My bank, BNP Paribas, is a trader in gas but not electricity. I want to mention a study that Cambridge Energy Research Associates did. They tried to value the entire chain using 2000 data. I don't recall the exact number, but it was around $239 billion. Can anyone guess what value was ascribed to trading out of that $239 billion? One billion dollars in 2000.

My question — maybe a comment — is in my 29 years as a banker, I have never seen an industry where there has been so much talk given to a sector that provides so little value added. I frankly do not understand why capital would flow to support trading activities.

MR. HARTMAN: I have been in this business about 15 years. This is a very personal observation. I have never fully understood — maybe it's because I am not an economist — how all of this does integrate together unless you view a trading business as creating value separate and apart from providing liquidity, from addressing market inefficiencies and from managing the output of assets. That is one of the great debates about the structure of this industry. Maybe it is that you can get your picture on the front of *Fortune* magazine overlooking a trading floor. I don't know the answer to your question. It is exactly the question to be asked.

MR. MUNCZINSKI: In an efficient capital market, if this were a real business that can generate substantial returns, capital would flow. The real issue is that a lot of us don't believe that this is a sector that is going to generate sufficient return given the collateral and credit intensity that this business requires.

MR. MARTIN: Vince, you get the final word on this.

MR. DUANE: Thank you. First off, I have tremendous respect for Cambridge Energy Research Associates, but I don't think they understand trading at all. And they are not alone.

To respond to the question about why should capital flow into the business, one thing on which we can all agree is electricity is a volatile commodity. If it is going to be traded in the wholesale market, there is a tremendous need for risk management. The electricity market is necessarily not as liquid and efficient a market as the market in other commodities because of the physical dimensions to it.

Next point: compare a power company with a 10 price-to-earnings multiple historically to a trading house. Arguably, someone engaged in a much more volatile commodity with a lot of physical and operational inefficiencies — not to mention all these other regulatory issues — should deserve a higher multiple and should be attracting more capital than it is currently trading, and there should be a perceived greater need for the services that the trading house provides.

There is a lot of inherent efficiency in / continued page 8

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or invested in more than one such deal, then the government will demand all audit workpapers. The new policy applies to tax returns filed on or after July 1, 2002. It is found in Announcement 2002-63.

Meanwhile, B. John Williams, the IRS chief counsel, asserted in June that tax advice from accounting firms cannot be kept from the IRS if the advice is from the same firm that does the company's audit. Williams said the audit firm already has a duty to disclose to the public the propriety of the company's financial statements. These have embedded in them assumptions about the company's tax positions.

The US government has issued 148 summonses to eight accounting firms and three other entities seeking customer lists, opinion letters and other documents. It filed suit on July 9 in federal court against two accounting firms — KPMG and BDO Seidman — seeking information about tax schemes the two firms have marketed since 1998 and 1995, respectively.

US SUBSIDIARIES OF FOREIGN COMPANIES are starting to focus on a potential threat to their interest deductions.

A bill introduced by Rep. Bill Thomas (R.-California), the chairman of the House tax-writing committee, would tighten existing limits on the amount of the deduction that a US company can take for interest payments it makes to a related party. The bill closely tracks recommendations made by the Bush administration in June.

Under current law, a US subsidiary of a foreign company can deduct all interest paid to a foreign affiliate if the US subsidiary's debt-to-equity ratio is less than 1.5 to 1. If the subsidiary fails this test, then the amount of its deduction is capped at the dollar amount equal to 50% of its net taxable income. Any interest above this threshold may be carried forward indefinitely. / continued page 9

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how we trade natural gas and electricity currently. We may have a notional amount on our book that is out of the money by hundreds of millions of dollars, but the book is balanced and the amount at risk — even for a large trading company — is in the single digits. However, we are not posting collateral based on the net exposure. We are posting collateral on the full amount of the out-of-market position. If we can get to a point where we can net and clear the costs of collateral, we would go a long way to solving the trading companies' problem. I think the banks are an interim step.

Attacks on Contracts

MR. MARTIN: Moving on. This panel made a list before the conference of the most significant regulatory developments in terms of impact on the industry. Next on the list is the move by the California government and Sierra Pacific to void contracts. California has asked the Federal Energy Regulatory Commission for help getting out of 32 contracts it signed last year to buy electricity long-term from 22 power companies. Sierra Pacific charges that the prices it agreed to pay last year are "unjust and unreasonable." Sandy Hartman, explain the issue.

MR. HARTMAN: This is actually really easy to explain. It boils down to three words: "We won't pay."

Let me put this in a broader context. This is one prong in a series of activities that are being undertaken to put the maximum amount of pressure on generators either to give money back or reduce their prices. This is prong one. "You didn't have your rates properly filed." "There was a dysfunctional spot market that affected the long term market." At the end of the day, FERC will probably sit there like a big potted plant.

The second part of this, though, is don't underestimate the relationship between plaintiffs' attorneys and regulatory lawyers. It is no coincidence that, when you pick up these pleadings, you see the same allegations being made in state court that are being made at FERC.

Third, it is no coincidence that state rate commissions take very hawkish views on this. In a sense, PG&E National Energy group was lucky. We had our liquidity crisis a year ago when the CPUC said, "No, we are not passing through these rates." Well, why not? Three words, "We won't pay." They didn't give a reason why. The market didn't work.

Some people in our industry have said that volatility is good for the power business.

MR. MARTIN: California has asked FERC to let it get out of 32 contracts that were entered into last year when electricity prices were high. Does this cast doubt on the inviolability of long-term contracts? Such contracts are the basis on which many power plants are financed. Were long-term contracts inviolable in the first place?

MR. HARTMAN: A little historical perspective on that one. There is a book called *Cadillac Desert* about water in California. A farmer signed a contract in the 1920's or a little earlier when the big irrigation projects were just getting underway. He was asked, "Are you worried about signing these long-term contracts for all this water?" His exact words were, "No. Long-term contracts are meant to be broken."

Different people approach contracts differently and, in different parts of the country, frankly, there is a lot more sanctity of contract than in other parts of the country. The real debate is not whether contracts are going to be renegotiated or abrogated. It is what does the market need to do and what do the regulators need to do to attract the capital to build the infrastructure to supply the products that are needed. The California contracts are contracts that were signed quickly to solve a problem. It comes as no surprise that the state is now trying to renegotiate them.

MR. DUANE: I see it a little differently. I see it as symptomatic of a much broader problem of asymmetrical re-

regulation. We have plenty of long-term contracts at Mirant that we would love to jettison. We are losing money on them, but at Mirant, a deal is a deal and we stick with it. Unfortunately, when we have a contract that seems to make money, there is political pressure to modify it. God help us if this is the way we are going to conduct a business because it will come down to who has the strongest political constituency, and the independent generators and trading companies today have no political constituency — absolutely none whatsoever.

Just one more point: the irony is you have two utilities in California that were on the brink of insolvency just a year ago, one in bankruptcy and one teetering on the edge of bankruptcy, and you had a merchant generation business on the other end. Today, look at what has happened. You have one utility — PG&E — trading at a share price in the low twenties and reinstituting a dividend program while it is still in bankruptcy while the Mirants and Dynegys and Williamses are trading at $8 a share. The fact of the matter is the utilities are making a hell of a lot of money right now and nobody is paying attention to that and nobody is saying, "How come the consumers in the state of California aren't sharing in the benefits from that?"

MR. MUNCZINSKI: What is the difference between China and California? At least in China, they let you complete the projects before reneging on the contract.

A few months ago, our bank found it hard to imagine FERC ever allowing California to renege on its contracts, but since the "Get Shorty" disclosure and disclosures of other Enron trading strategies — this is more of a question than a comment — I wonder if the FERC experts in the room can now foresee FERC deciding to abrogate contracts on grounds that there was proven market manipulation?

MR. MARTIN: Lynn Hargis, you were the assistant general counsel at FERC for electric rates, what do you think?

MS. HARGIS: I can easily see FERC ordering refunds. The question is whether FERC will get away with it in the court of appeals, where the issue is sure to land eventually. The Federal Power Act is designed to respect contracts, but to allow FERC to change them when the public interest demands it. What the courts ultimately will do, we won't know for a few years.

MR. HARTMAN: I want to add two points to that. One is I think Lynn is absolutely right. As long as these bad facts keep coming out, the political pressure / *continued page 10*

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Interest paid to third parties is also caught if the debt is guaranteed by a foreign affiliate.

The Thomas bill would eliminate the debt-equity test, replacing it with a rule that would disallow all interest deductions to the extent that a corporate group's level of indebtedness in the US exceeds its world-wide level of indebtedness. The bill would also reduce the cap on deductible interest from 50% to 35% of the US company's net taxable income. The company's ability to carry forward any excess would be limited to five years.

Thomas's bill closely follows a list of recommendations on "corporate inversion" transactions that was presented to the House Ways and Means Committee by Pamela Olson, the assistant Treasury secretary for tax policy, in June. Inversions are transactions where a US company with foreign subsidiaries turns itself upside down. It becomes a subsidiary of a new parent company in Bermuda or another tax haven and the foreign subsidiaries of the US company are moved directly under the new Bermuda parent. The growing popularity of inverting to avoid US taxes has led to calls for reform of the US tax rules that encourage such transactions.

The section of the US tax code that would be affected by these changes is section 163(j).

The Thomas bill is controversial. A planned "mark up" of the bill by the House Ways and Means Committee in late July was put off until September.

A US APPEALS COURT dealt a blow to the Federal Energy Regulatory Commission.

The court cast doubt in mid-July on the federal government's ability to require utilities to enter into — and stay put in — transmission organizations like ISOs and RTOs. In an ISO or RTO, utilities cede operating control (or sometimes even / *continued page 11*

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increases for FERC to do something more than it would do normally.

The other is an historical point. I used to license nuclear power plants, and I remember when the Washington Public Power Supply System defaulted. I remember reading article after article saying, "This is the end as we know it of municipal bonds." Spreads were a little higher in the northwest for a couple of years, but at least as best as I can recall, when the dust settled at the end of the day, it really didn't matter and life went on.

MR. DAVIS: There is precedent for what we are seeing in California. It is no different than what New Jersey, New York and other states tried to do in the 1990's when power prices plummeted and the utilities were left with obligations under long-term contracts with QFs to buy power at prices that were by then significantly above market. Some power plant owners resisted and held out and, ultimately, I don't think the courts supported what the public service commissions were doing. There were other generators who felt the pressure and renegotiated their contracts. I think that's what California is trying to do now. I hope the outcome at the Federal Energy Regulatory Commission and in the courts will be the same as before.

MR. MARTIN: Time to shift gears. Let me ask Bob Weisenmiller, who has an excellent piece on the current situation in California in the June *NewsWire,* is the power crisis over in California or are we going to see a reprise?

Mess in California

DR. WEISENMILLER: At this stage, we have at least two or three phenomena going on. The first one is the California fiscal situation is enormously bad. For those of you who watched the California state government fumble with the energy crisis last year, be aware that the exact same thing is going on with the state budget, only the difficulties are compounded by the fact that this is an election year. No one is prepared to take decisive actions on the budget, certainly not in an election year. The budget shortfall next year could well be on the order of $40 billion. About $6.5 billion of that is accounted for by the DWR contracts.

MR. MARTIN: Have the underlying problems with the electricity market been fixed? Are we just in the phase where the politicians must work through the political fallout from how the crisis last year was handled?

The problem in a deregulated market is: "Who is going to build power plants to supply the reserve margin 'just in case'?"

DR. WEISENMILLER: The state is really struggling with what the vision is. Last year, the talk was about moving to public power. Governor Davis is running for reelection and may run next year for president. There is an enormous political currency this year in bashing generators and traders. Enron has given the politicians a lot of fuel for that. The point is there is the political momentum this year for a move to public power, but the state faces a dilemma. It must decide whether using public funds to build new power plants is the best use of scarce public funds.

MR. MARTIN: The number of megawatts that was expected to come on line this summer has not come on line on schedule. Is this a sign that California will be facing the same problems next year or the year after that it had in 2001 when there were rolling blackouts and high prices?

DR. WEISENMILLER: Possibly. There is a group of projects — about 8,000 megawatts or so — that is well under construction and moving forward. These new facilities will go a long way to make up the deficit that California worked its way into over the past decade.

Having said that, some people in our industry have said that volatility is good for the power business — certainly for traders. However, volatility is bad for the public. The question the government faces is how to dampen volatility. The theory used to be to have a sufficient reserve margin built so that even if it is a very dry year or a very hot year — even if there are lots of outages — there will not be price spikes. The idea was to have a 15 to 20% — even 25% — reserve margin just in case. The problem in a deregulated market is who is going to build power plants to supply the reserve margin "just in case."

MR. MARTIN: In your article in the June *NewsWire,* you made the statement, "There are some niche opportunities [in California today] where the balance of financial risks and returns is attractive." What are those niche opportunities?

DR. WEISENMILLER: Number one, a lot of the problems that owners of QF projects faced last year have been worked through. QF projects seem relatively straightforward at this point. There is a lot of emphasis in California now on self-generation projects. There remain questions about how the regulatory situation will play out and whether there will be an exit fee for self generators to exit the system and how that works, but there is a very strong push by large industrials to generate their own electricity and regain control over their own destinies.

I think the restructured DWR contracts that Calpine negotiated provide a model for others for how to dodge the regulatory bullet. The state now has sort of a Calpine model for baseload or a Calpine model for peakers. If that works for some of the other projects, then those projects will move forward and step out of the current firestorm.

Beyond that, it becomes more difficult. For generators thinking of putting assets into the ground, a couple of years from now those assets may be very valuable, but you have a lot of volatility and risk in the short term.

New Legislation

MR. MARTIN: Let's move in the remaining time to the national energy bill that is moving through Congress. It passed the House in July. It passed the Senate in April. It is now in "conference" between the two houses to iron out differences and could soon be on the president's desk. There are things in it to which the industry should be paying attention. Jeanne Connelly, what are the odds that it will become law this fall?

MS. CONNELLY: I'm an optimist on this subject. I think the odds are pretty high. The Bush administration wants an energy bill. The president has made it one of his top priorities for this year. Billy Tauzin, the congressman who was chosen to chair the conference committee, said recently: "Those of you who know me know better than to under- / continued page 12

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ownership) of their transmission lines to a central grid operator. The US appeals court for the DC circuit held that FERC has no authority to prevent utilities from withdrawing from such organizations. This comes at a time when the agency is having a hard enough time getting utilities to join such groupings in the first place.

Many independent generators have been encouraging the federal government to order utilities to join RTOs, or regional transmission organizations, in the hope that this will make for more uniform operating procedures for the national grid. To date, FERC has left participation in RTOs voluntary, but its Order No. 888 — which the courts have upheld — requires individual utilities to allow open access to their grids. FERC may now have to seek Congressional modification of its statutory authority if it wants to make participation in RTOs mandatory.

However, in potentially a favorable move for independent generators, the court also set aside, in the same decision, a FERC attempt to modify an entire class of contracts. The agency had made a generic finding that the contracts are against the public interest. The court said the agency had to look at individual cases. This part of the decision could tie the agency's hands in responding to a complaint by the California Public Utilities Commission that power purchase agreements California signed when electricity prices were high last year should be set aside en masse.

The case is Atlantic City Electric Co. v. FERC. *The court issued its decision on July 12.*

POWER PLANT REPAIRS get attention from the IRS.

The IRS said in mid-July that it will try to work out an agreement with the power industry about when money spent on maintenance at power plants can be deducted as a "repair" or must be recovered over / continued page 13

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estimate me. We will have a bill." Senator Bingaman, who will be the chief Senate conferee, is a very substantive, quiet kind of guy. He put a lot of time and effort into getting this bill through the Senate.

On the other side, there is always the possibility that party leaders will decide they would rather have a political issue for the election, but I think there are many more cards stacked in favor than against.

MR. MARTIN: Gene Peters, do you agree?

MR. PETERS: The first question is, "What bill are we talking about?" You have two very different bills that passed in the House and Senate. Notably, the Senate bill has an electricity title that the House bill doesn't. If the question is the odds of a bill passing with substantive electricity provisions in it, they are probably about 60%.

MR. MARTIN: EPSA is currently supporting the bill?

MR. PETERS: We are supporting the electricity provisions in the Senate bill — absolutely.

MR. MARTIN: Jeanne, what would you say are the three most important provisions in the bill about which people in this room should be aware?

MS. CONNELLY: I actually think the most important provisions are the tax incentives that relate to energy, whether they are for renewables or clean coal technology or cogeneration or plants on Indian land. When you come to the electricity title, probably the only part of it that is really important for the industry is what we call "FERC lite." It gives FERC authority over the transmission of electricity over the parts of the national grid that are owned by public power entities like [the Tennessee Valley Authority] and [the Bonneville Power Administration] plus municipals and co-ops. Then it is more important to —

MR. MARTIN: Stop there for a moment. "FERC lite" would give FERC the ability to order municipal utilities to wheel power for generators?

MS. CONNELLY: To have open access transmission. It is called FERC "lite" because it is not absolute authority over the pricing of that transmission.

MR. MARTIN: Okay. And third on your list?

MS. CONNELLY: Third is what is not there. What's important is that there were efforts on the Senate floor to move away from competition. They were defeated. The thing to watch in conference is whether some of these backtracking provisions make it into the final bill.

I just don't think anyone understands any longer what PUHCA does. Repealing it is like taking out a wall in a house that could turn out to be a load-bearing wall.

PURPA Repeal

MR. MARTIN: Lynn Hargis, I think you have a different view of what is significant. What is at the top of your list?

MS. HARGIS: The Senate bill would drop the current 50% limit on utility ownership of qualifying facilities under PURPA. [*Ed. The "Public Utility Regulatory Policies Act" is a 1978 law that requires regulated utilities to buy electricity from cogeneration facilities and certain power plants that burn waste fuels at the "avoided cost" the utility would spend to generate the electricity itself.*] Although there are not many new qualifying facilities being built, I think in terms of existing ones, when utilities get the green light to own them, they will. The 50% limit is one of the things that preserved a role for independent generators for a long time.

MR. MARTIN: Let me stop you there for a moment because the Senate bill repeals PURPA altogether, right?

MS. CONNELLY: No, it repeals the obligation of utilities to purchase on a prospective basis and then only if FERC makes a finding that there is true competition in the market.

MR. MARTIN: And do you think FERC will make that finding?

MS. HARGIS: No way.

MR. MARTIN: Perhaps in certain markets? What is the "market"? Is it the whole country or how large an area?

MS. HARGIS: It will go market by market, region by region, and I think that FERC will have a hard time finding true competition in a lot of places. For instance, in the southeast, either in the Southern Company or Entergy territory, FERC would have a hard time saying today that there is a competitive market. Since utilities in these areas will still be obligated to buy power from QFs, you will have an interesting situation. There is nothing to prevent the utilities in these areas from owning their own QFs.

MR. MARTIN: Okay. And then there is another provision in the bill —

PUHCA Repeal

MS. HARGIS: The biggest thing of all, I think, is that the bill would repeal PUHCA. [*Ed. The "Public Utility Holding Company Act" is a 1935 law that inhibits the formation of large utility conglomerates that cross state lines.*] As all of you know who have attended this conference over the years, this is the 13th year I have predicted we are on the verge of PUHCA repeal. [Laughter] I just don't think anyone understands any longer what PUHCA does. To me, it's like going into a house and saying, "Let's get a modern look and take out that wall." You take out that wall and it turns out it's a load-bearing wall, and the house falls in. This is my fear for what happens when the Public Utility Holding Company Act is repealed.

MR. MARTIN: You believe the utility industry is in for a major restructuring if PUHCA is repealed. Gene Peters and Jeanne Connelly, you are not particularly concerned about this. Why?

MR. PETERS: First of all, it is hard to imagine a much more uncertain future right now anyway with or without PUHCA repeal. Second, SEC enforcement of PUHCA has been non-existent for a long time. I think most members of the trade association think PUHCA is essentially an anachronism. Repeal could lead to a major consolidation, but we haven't heard from members that any of them is concerned.

MR. DUANE: As an EPSA member, I share that opinion and that has historically been the opinion of the merchant energy companies. PUHCA is an anachronism and you have to get rid of it. However, there has been an interesting evolution as we find ourselves in the predicaments that we are in today. A lot of people are predicting significant consolidation. You have a perverse incentive where, if you are a party who wants to be acquired, you almost prefer to see PUHCA remain in effect because it limits the pool of eligible companies that can be acquired */ continued page 14*

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time as an "improvement."

The issue comes up frequently on audit. The Edison Electric Institute had been asking the agency to negotiate a settlement with the industry as part of the IRS's "industry issue resolution" program. The IRS declined to devote resources to it last year. However, in July, it put the subject on the agenda for this fall or winter (along with issues affecting six other industries).

It is not clear yet what form the guidance will take. It could be a "revenue procedure" or notice. The principal focus is to resolve the issue for future years, but the IRS said resolution could also lead to a settlement of cases on audit. Meetings are expected between the power industry and government officials to come up with bright lines that are acceptable to both sides.

The IRS worked out a similar settlement with the airline industry in January 2001 after years of negotiation and litigation. The airlines typically deduct the cost of heavy maintenance of the kind that is done once every eight years and involves stripping down the airplane to inspect parts and replace ones that are worn. Large commercial airliners are expected to last 25 years.

The airline guidelines are in Rev. Rul. 2001-4. The IRS will probably use them as a starting point in discussions with the power industry.

"WASTE" may be defined more broadly for tax purposes.

Power plants that burn waste fuels qualify for more rapid tax depreciation and tax-exempt financing.

The IRS put on its business plan for the 12 months starting July 1 that it will take another look at how it defines "waste" for federal income tax purposes. The current definition is material that is useless, unwanted or discarded and for which no one would pay anything in */ continued page 15*

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without major hassles by foreign utilities or the large domestic utilities.

MR. MARTIN: Many people expect PUHCA repeal to be a great thing for investment bankers because it opens the door to lots more acquisitions and mergers.

MR. PETERS: But keep in mind the Senate bill also provides for increased merger review by the federal government. This is going to be a point of contention between the House and Senate in conference. The Republicans, who control the House, have pushed essentially to get rid of section 203 of the Federal Power Act, which is FERC's major review authority. The language that is in the Senate bill actually expands that merger authority in some potentially odd but significant ways. Just because PUHCA goes away doesn't mean that the rubber stamp comes out at FERC. I just don't see that happening.

MS. McDEVITT: PUHCA has not been a roadblock for any of the recent consolidations. People structure around it. The only thing the government has enforced — and I'm not sure it has been enforced lately — is a limit on investments in unrelated businesses. Keep in mind that you not only have the FERC review, whatever it turns out to be, but you also have [Federal Trade Commission] and [Department of Justice] review, whoever ends up getting the ball, and they do traditional, hard core, very detailed, antitrust evaluations. In 1935 when PUHCA was enacted, these reviews did not exist the way they do today.

Renewables Mandate

MR. MARTIN: One thing that none of you has mentioned about the bill is the renewables mandate. Jeanne Connelly, tell us about it.

MS. CONNELLY: They call it the renewable portfolio standard. It requires utilities over a set period of time to ramp up the percentage of renewables that make up their portfolio of energy. There is a penalty if they don't. They can pay 1.5¢ per kilowatt hour instead of purchasing the mandated percentage of renewables. It is the only thing in the legislation that environmental groups find positive.

MR. MARTIN: What percentage of power would have to come from renewable resources?

MS. CONNELLY: Ten percent by 2020.

MR. MARTIN: And what is the percentage today?

MS. CONNELLY: I think that renewables — if you don't count hydropower — account for between 2% and 3% of energy today. With hydropower, it may be between 7% and 8%. The bill does not define renewables to include hydropower, so the utilities must eventually close a significant gap.

> The Senate energy bill requires utilities to produce or buy at least 10% of their electricity from renewables by 2020.

MR. MARTIN: So another 7% to 8% of electricity distributed by utilities will have to come from renewables by 2020. Is that just in the Senate bill or also in the House?

MS. CONNELLY: It's only in the Senate bill, but it is the only thing the environmental groups think they are getting out of the legislation so they are fighting hard to keep it in.

MR. PETERS: This is clearly a provision that is going to be drafted in conference. What is in the Senate bill will not survive in its current form.

MR. MARTIN: Any closing thought by anyone in the room?

MR. PETERS: Yes. We haven't talked as much about opportunities. At the end of the day, let's not lose sight of the fact that the FERC agenda is still very positive toward wholesale competitive markets. FERC still has on its agenda this year standard market design, the [regional transmission organization, or] RTO initiatives, and standardized interconnection. At the end of the day, the federal regulators are not being swayed by the political hyperbole from the west coast.

Turning to the legislation, we feel very good about what happened in the Senate. It is no accident that the Senate bill gives FERC additional authority and regulatory powers over people the agency hasn't traditionally regulated and that the bill is silent on some of the initiatives that FERC has underway that help open markets. On the downside, one of the most depressing things about the Enron trading-strategy memo surfacing when it did is it happened immediately after we got the bill through the Senate and did very well there. But we remain positive about our prospects in conference.

Downward Ratings: Where Does It End?

The following are excerpts from a discussion at the Quebec conference about the pressure that US power companies are under from the rating agencies.

The speakers are William Chew, vice president of Standard & Poor's, Charles H. Wilson, director of business unit finance for Duke Energy Corporation, John Cooper, senior vice president-finance for PG&E National Energy Group, Eric McCartney, head of project finance lending in North and South America for KBC Bank, a Belgian lender, Bryan Urban, senior vice president-finance for Panda Energy International, and Robert J. Munczinski, managing director of BNP Paribas. The moderator is Robert Shapiro.

MR. SHAPIRO: The degradation of Enron has led the rating agencies to take a much closer look at the utility business. Most of the publicly-traded power companies have seen their credit ratings questioned or lowered in recent months, and the rating agencies have apparently decided that the utility business as it is commonly practiced is much riskier than they had originally thought. These downward movements in ratings have had a devastating impact on the industry and have contributed to the uncertainty that currently reigns in the business.

The rating agencies have become a pivotal player in the market. People are struggling to figure out what they must do to please them. Bill Chew, give us your view of the ratings landscape and how things have evolved over the last six months since Enron collapsed.

Deteriorating Credit

MR. CHEW: There are a couple of basic points that Standard & Poor's has been making for a while — even before Enron collapsed. We have felt for / continued page 16

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the place where the material is located. The Bush administration is under pressure from the recycling industry to treat as waste corrugated cardboard and other materials for which recyclers pay small amounts of money to buy in large bundles.

The lawyer assigned to the issue at the US Treasury Department said no decisions have been made about direction — or even whether to change the definition — but that the government will listen to the recyclers' arguments.

WIND CREDITS were 1.8¢ a kilowatt hour last year, the IRS said in late June.

The agency also said the average contract price at which electricity from wind projects was sold last year in the US was 5.54¢ a kilowatt hour. The tax credit would have phased out last year if the average electricity price had exceeded 8¢ a kilowatt hour.

Section 45 of the US tax code allows a tax credit for anyone generating electricity from wind, "closed-loop" biomass or poultry litter. The power plant must be in the United States. "Closed-loop" biomass means plants grown exclusively for use as fuel in power plants. Projects must be in service by the end of next year to qualify; however, Congress will probably extend the deadline through 2006 this fall. The credits run for 10 years after a project is in service. The credit amount is adjusted each year for inflation. The credit amount is announced each April for the prior year. This year the announcement was delayed until late June.

The IRS said it is not aware of any closed-loop biomass or poultry litter projects that were in operation last year. The IRS announcement is Notice 2002-39.

A GAS PIPELINE project to bring gas from Alaska to the lower 48 states is expected to receive special tax subsi- / continued page 17

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some time that there has been a misperception in the debt markets about the nature of credit in the electricity business. This applies to both corporate and project credits. I have had many conversations with lenders who would make a statement essentially along the following lines: "Wait a minute. At the end of the day, this is electric power, an essential service, and ultimately that should be" — the key phrase is "should be" — "the basis for a strong credit."

What was missed in deregulation is that electricity standing alone is not inherently a good credit story.

What Standard & Poor's has been arguing for some time is, yes indeed, that can be the basis for a strong credit and, since the 1930s, the combination of federal legislation and state commission legislation created a regulated utility base with rate-based credits that was one of the most attractive sectors in the corporate bond market.

Unfortunately, I think that aura continued even while the market pursued deregulation. What was missed in deregulation is that electricity standing alone is not inherently a good credit story. It is not like any other commodity business. It has a particular tension. It is important, and the danger of being important is that if its price increases, sooner or later the government intervenes. But the price is also volatile downward. Electricity companies also have greater capital needs than other types of commodity operations.

Without some type of bolstering in the form of franchise rate bases or contract supports, you are generally looking at something that carries a relatively higher risk than other commodity businesses. That's the reason why we were saying well before Enron collapsed: "Wait a minute. Deregulation in this industry raises business risk. It is not a good mix with rising leverage." That has been a theme.

It is the reason that we have been downgrading this industry really for the last four or five years.

Focusing on some of the key issues, what do you need to support credit? You essentially need to keep your eye on the recurring cash flow in relation to full fixed charges. That is the key ratio to which we think everyone needs to return.

What occurred recently is a radical change in the perception of the industry. There have been massive cuts in valuation, massive shifts from greed to fear in the market, and absolute terror breaking out in some cases.

MR. SHAPIRO: Has S&P changed its view on whether a company with a major trading business can sustain an investment grade rating?

MR. CHEW: People need to be aware of the capital requirements both in terms of capital adequacy and liquidity that are required to support trading companies. We have not changed our basic view, but we have updated our approach to address some of the current issues that are arising in the market.

The area where I think you are going to see expanded requirements for capital is to address the problem of compound risk — between the credit risk these firms face and the market risk. Companies sometimes assume incorrectly that they have more diversification in their credit profiles than they really do. The reality is their counterparty credit exposures are highly correlated with the markets in which they are trading. You cannot assume that collateral levels will support those credits. The collateral levels are being driven by the market and that is putting stress on the very credits that the trading companies are trying to collateralize. There is a tremendous correlation effect.

What needs to happen is you have to look at the credits separately. The stronger companies will separate the credit risk from the market risk just as every other trading operation in financial products has done.

The other point, if you are running a trading desk in a commodity such as electricity, is you must recognize that your ability ultimately to continue trading rests on the competence of your counterparties. It is not simply what you state your credit to be. It is what your credit is perceived to be.

It is interesting to note that when these trading operations began, we started with much sounder counterparties — double A, triple A counterparties — some of whom operated as separate entities precisely to break out the credit risk and keep it separate from the market risk. These entities were walled off from the banks and non-bank institutions were doing the trading.

That has yet to happen here. Here we began with low investment grade credits in most cases, leaving little headroom to deal with competence and sensitivity issues.

MR. SHAPIRO: Charlie Wilson, do you think that companies like Duke will end up being the only players in this market because they have such strong credit to begin with and the weaker players will be driven from the market?

The Merchant Model

MR. WILSON: When we first looked at merchant generation — merchant energy we call it — you had to be in the trading and marketing business in order to be successful. Much of the value that you get from being in the business is extracted through trading and marketing. By just owning plants, a company is taking a very long term, unhedged position or a long position. Pursuing that strategy alone cannot be successful in the long run. I won't name companies, but everyone knows companies that primarily had a generation-first strategy with trading and marketing as an afterthought. They scrambled to get into it too late.

Another conclusion we reached was in order to be successful in trading and marketing, you have to be very large. You need a large trading book in order to transact more efficiently. You can manage risk more efficiently.

The last point is trading is an inherently risky business even if it is large, and you need a strong balance sheet and a lot of liquidity. Many early traders did not understand this.

Bill Chew is exactly right. If you go back to the analysis papers that they have published as far back as two or three years ago, they brought this up, but people did not focus on it. Moody's position was a little harder to discern — that's just Moody's — but it hinted at the same things.

Because our management is inherently conservative — and very ratings-focused since Duke got into trouble in the early 1980s with nuclear plants whose cost overruns nearly brought the company down — the view was that we were not going to follow the pack despite pleadings and advice from the investment bankers that, "You / continued page 18

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dies from the US government.

The project would carry up to 4.5 billion cubic feet a day, or about 7% of US gas demand. It is expected to cost $15 to $20 billion.

The Bush administration appears committed to working out a package of tax incentives to help the project. Top energy and tax officials met with the Alaska Congressional delegation at the White House on July 18. They oppose tax subsidies that the Senate voted for the project in April, but discussed alternatives that would pose less risk of distorting gas prices.

The Senate voted in April for a special tax credit that would effectively guarantee gas producers who ship via the pipeline that they will receive at least $3.25 an mmBtu for their gas. The credit would be available for the first 15 years after the pipeline starts operating. Gas producers would be able to claim a credit for any shortfall in the average monthly price for Alaskan natural gas at the Alberta hub below $3.25 an mmBtu. If gas prices are higher than $4.88 an mmBtu, then the credits would begin to be recaptured. The Canadian government is up in arms about the proposal.

The Senate also voted to have the federal government guarantee repayment of up to $8 billion in debt to build the project.

WINDFALL PROFIT TAXES that US utilities paid in the United Kingdom cannot be used as an offset against US taxes, the IRS said in a "coordinated issues paper."

The agency made the paper public in late July. The utilities own shares in UK regional electric companies that the British government privatized in the early 1990s. The British government collected a one-time tax on the "windfall profits" that the owners of the privatized companies earned due to the initial bump up in share prices after privatization. The tax had to be / continued page 19

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shouldn't be hanging onto an A rating in a sector. The most efficient place to be is triple B flat or maybe even lower. In some cases the cost of capital is lower. It is a capital-intensive industry, blah, blah, blah."

I'm not sure we were really that smart. Maybe it was serendipity or maybe it was just the inherent nervousness and conservative instincts of our management. But I think the strategy our management pursued has proven itself as a wise approach.

You need those three things. We think the market is now recognizing that. You can't be a pure generator. You can't be a pure marketer. You must have a mixed strategy. The trading and marketing must move to the center of that strategy and the plants serve and feed that business. It's not a matter of "asset lite" or asset heavy or worrying about looking like Enron by being too focused on trading. It's really how do we work together, where do we extract the value, and how do we sustain things over the long run.

S&P is now repeating more loudly the things that it said more quietly or that people chose to ignore a few years ago: You must be big. This is not a game for the small player.

MR. SHAPIRO: John Cooper, do you agree with Charlie that only the big will survive?

MR. COOPER: Yes, I agree absolutely with everything he said and with the three prongs of the evaluation.

I want to go back to the initial point: can the merchant energy business be investment grade? If you turn that around and ask, "Can you have a merchant energy business without being investment grade," I think the answer is no.

Start with the integrated model of which trading is a necessary component. The trading business is driven on credit. You can't buy pipeline capacity, you can't buy gas, you can't sell your output to many other marketers unless you can provide counterparty credit. Unless you have an investment-grade credit — and whether a triple B- or a triple B is good enough time will tell, but it probably isn't because it is not good enough in any other commodity business — then the only way to do it is based on collateral, and nobody has enough cash or can afford enough credit facilities in a shrinking-margin business to collateralize all of your transactions unless we evolve to a system of multi-counterparty netting arrangements through some sort of a clearing process. With such a system, trading would require a smaller capital base. We are not there yet.

> Utilities will eventually conclude that a portion of their portfolios should be contracted for long-term — 20 years — and a portion at 15 years, and a portion at 10 years.

MR. SHAPIRO: Do you also agree with Charlie's point that trading is an essential component of a merchant energy business.

MR. COOPER: There are models where you build assets and enter into long-term contracts to sell all of your output, but I wouldn't call that merchant generation.

MR. SHAPIRO: Can that model sustain itself in the current environment?

MR. COOPER: Yes, I think so — as long as the counterparties to whom you are selling your power honor the long-term contracts. We used to think that business was very complicated to put together with lots of documents, but it was dirt simple. You build a power plant. You enter into long-term agreements, and all you had to do was make the power plant work and operate at levels of relative efficiency.

MR. CHEW: There is a counterparty dimension to that, though.

MR. COOPER: Yes. Twenty-year contracts at a fixed price eventually get out of market for one party or the other. That's not really the way the business is evolving, and there are very few counterparties today who are willing to enter into long-term contracts.

MR. WILSON: There will always be room for a niche player. I think you may see some revival in long-term contracts in regions that experienced a lot of price volatility. There will be a return of bilateral contracting and the old project finance model will be employed on a very small scale.

Duke has decided not to do that. First, it is really small. It can't meaningfully contribute to the bottom line of a company the size of Duke. We might invest in such projects through our finance affiliate, Duke Capital Partners — and smaller developers can probably earn a nice little return doing that one- and two-off projects — but the merchant energy business is a game for the "big boys." There is no other way to succeed in it.

MR. SHAPIRO: Eric McCartney, is the S&P analysis correct or is it overcompensating for Enron?

MR. McCARTNEY: No one likes to point the finger at anyone else because I think it is partly all of our faults, to be quite honest with you. S&P and Moody's have been accused of moving the goal posts. In fact, the goal posts never moved, but the play on the field kept moving closer and closer to the out-of-bounds lines as people took more and more liberties with the rules. Every time we did a new deal, we gave in to one more small point. This became the starting point for the next transaction. Before you knew it, we were out of bounds. Before you knew it, we were in a situation where we had not the same type of quality of credit that we had when this industry got started.

Long-Term Financing

MR. SHAPIRO: Bryan Urban, is project financing as we know it dead because there are no offtakers with whom to make deals?

MR. URBAN: The landscape has changed. It is different from where it was a year ago — liquidity is disappearing from the market because there are few buyers willing to enter into long-term arrangements — but the fundamentals of structured and project finance remain as before. There are always opportunities for players to be creative. There will still be room for medium- and smaller-sized companies to compete in this market through alliances or by other means.

MR. McCARTNEY: Just to add to that, the basic business cycle will prevail. You could view the last cycle in which merchant plants were built as one where greedy developers didn't want to contract long term because they thought that energy prices would remain robust over time. We have deals that had over two times coverage originally that can barely cover debt service today. One could argue the developers thought there was a lot of upside and they were greedy and didn't want to lock in the current rates by entering into long-term contracts when they were available. / continued page 20

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paid in two installments in 1997 and 1998.

US utilities that paid these taxes tried to claim them as foreign tax credits in the United States. Only "income taxes" may be credited. The IRS asserts in the coordinated issues paper that the UK windfall profit tax fails because it was a tax on hypothetical appreciation in value of the regional electric companies — rather than on actual gains — and the British government did not wait to collect the levy until the shareholders "realized" their gains by selling shares.

The IRS also rejected the argument that the US-UK tax treaty requires the US to allow the taxes as a foreign tax credit. The issue is whether the windfall profit tax is "substantially similar" to several taxes that are enumerated in the treaty. The IRS said it is not.

The UK government imposed a windfall profit tax in 1997 on shareholders of the privatized companies. The tax was 23% of the appreciation in value of each company since privatization. The appreciation was calculated by comparing the amount paid for the shares at privatization to the company's "value . . . in profit making terms." This was defined as nine times the company's average annual after-tax profits in the four years immediately following privatization.

The issue is expected to end up in court. Some commentators have suggested US utilities might have a claim against the UK government for expropriation.

THE DELHI HIGH COURT quashed a circular that had made it easy for corporations that use Mauritius as a staging post for investments into India to qualify for favorable tax treaty benefits.

Suzanne Gujadhur Bell said from Port Louis: "This has caused ructions in Mauritius but at the end of the day, it will mean that clients using Mauritius will have to build up substance in Mauritius. / continued page 21

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Now we have the other side of the market where the buy side is greedy. Buyers today say, "Great low prices. Wonderful. Why should we contract long term?" And they don't.

All it takes is one event like a heat wave and energy prices spike to $1,000 per kilowatt hour for a week to have the buyers thinking, "I guess we should contract for some power."

The cycle will move that wave forward again. Utilities will eventually conclude that a portion of their portfolios should be contracted for long term — 20 years — and a portion at 15 years, a portion at 10 years. What the balance is will be the question.

The question was asked: is project finance dead? No. There is a downturn in the cycle. It will come back alive and well, but going forward, we are all going to see things in a different light after what we have been through.

MR. SHAPIRO: Are the banks still willing to lend on a long-term basis if the offtaker is a good credit?

MR. McCARTNEY: I think those contracts are still out there.

MR. CHEW: The anecdotal reports we have heard suggest the market is giving much more credit to project structures now than probably it had in the past. We went through a period where, as long as equity markets were hot and debt was readily available, why in the world should you spend all that time documenting a project? Just take your project and send it to corporate, and you will do fine and save yourself a lot of legal costs. I think the cycle is turning. People are saying, "We want the type of due diligence that is required at the asset level even if we are lending at the corporate level."

MR. MUNCZINSKI: I agree with Bill's point. Certainly, BNP Paribas has a much greater confidence level in project finance structures than a corporate transaction. We can "ring fence" the transaction. We have many years of experience looking at such deals. There are collateral packages and single-purpose entities. We lenders can take a lot more comfort that we know what is going on within that box compared to the surprises that we have all read about and experienced personally in terms of what is going on in corporate America today.

A couple more points: One reason why project finance is not as popular today is that project finance is not really providing a true benefit to the borrower. Go back to 1999. Capital structures for merchants plants were probably 65% debt and 35% equity. Since then, we have gone from 65% debt to 60% to 55% to 50% to 45% to 40%, and I am not sure 40% is where we will stop. And at that point, a corporate borrower probably can leverage at a much higher level, or at least at that level. We project finance lenders are not really providing a great deal of leverage benefit to the sponsors of transactions.

It kind of amazed us that the bank market bought that whole mini-perm story.

The second thing of which the lenders stand accused — and we have to ascribe some guilt to the rating agencies — is we are taking the position that, even though it is a non-recourse transaction and the assets in question are "strategically important" to the sponsor — we are consolidating them in terms of how we look at leverage at the corporate level.

MR. CHEW: In the interest of equal time, we will argue not all rating agencies are equal. [Laughter] There is one rating agency — the one I speak for — that actually does try to make a specific assessment of each project with the key question being not whether the project is strategic but the economic question: will the parent support the project in stress?

MR. McCARTNEY: We differ.

MR. CHEW: Oh, absolutely. You have talked with me, and we have had the discussion on both sides. Standard & Poor's has been adamant about insisting there is no free lunch. You should not have the benefit of a halo of support without some exposure to the corporate balance sheet. There is no free lunch in the credit world. I think that's where a lot of lenders have come back to. In some quarters, it was, "How big is the type on the front page of the offering statements? That decides what we will support." I don't think so. The question you have to answer is, in times of stress, will the sponsor put money in as required to support the project? Is there an economic return seen? In some cases, we think you can make that judgment and in other cases, you can't.

MR. McCARTNEY: Back to answer your question, Bob, I think long-term contracts can still be found in the market. The identity of the counterparty is important and whether it is investment-grade quality and whether the contract is a toll or a contract to supply output to a load-serving entity who needs the power for its own native load. Tolling and power sales contracts mean two different things to bankers. I think bankers have learned a lot over the past eight months about how things should get done in the future.

No sponsor is going to get 25% equity today, but if you have a good strong offtaker for a long period of time, you are going to qualify for long-term financing. I still believe that can be done with the right deal.

Tolling Agreements

MR. SHAPIRO: Let's talk about the strength of the offtaker. There are a number of tollers in the market. At least, there were tollers last year. They have now been downgraded or partially downgraded. Would you finance with an offtaker that is not investment grade?

MR. McCARTNEY: I may finance it, but I certainly wouldn't underwrite it because I don't think the market is prepared to do it.

The first thing that everyone does in looking at a tolling agreement now is to look at the project on a merchant basis. The question is, "If the toll disappears, does the deal work on a merchant basis?" The only way that happens in a tolling agreement structure is if the sponsor puts in at least 40% equity. Does that make sense? Probably not for many developers given the returns needed on the developer side to have an economic deal.

MR. SHAPIRO: So will lenders today finance on a purely merchant basis?

MR. COOPER: Yes. Project finance is just cash flow financing, and any developer who is making an investment in something presumably expects a return. The lenders are taking the first cash flow. As long as the transaction isn't too big so that you don't have to find too many lenders — part of the problem in the industry today is that / continued page 22

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The decision is to be appealed by the Indian government."

Many large corporations make their investments in India through holding companies in Mauritius. The tax treaty between the two countries offers two benefits. One is a lower rate of withholding tax on dividends paid from India to Mauritius, and the other is an exemption from capital gains taxes in India upon sale of the investment. To qualify for these benefits, the holding company must be a "tax resident" of Mauritius.

The Central Board of Direct Taxes had issued a circular to Indian tax offices in April 2000 ordering them to accept residence certificates issued by Mauritius as proof of tax residence in Mauritius.

Meanwhile, rumors that the Indian government is pressuring Mauritius to renegotiate the tax treaty appear to be without merit. Raj Shroff with Nishith Desai Associates reports from Mumbai that the Indian finance minister told one of the leading newspapers recently that there will not be any renegotiation of the treaty.

CALIFORNIA will allocate property tax revenues from power plants to the taxing districts where the plants are located under a new law enacted in July.

The State Board of Equalization moved last year to assess power plants at the state level. This would have meant a sharing of property tax revenues across the state. Independent power companies complained that this would give local governments less incentive to agree to the siting of power plants in their areas. The state legislature fixed the problem.

Meanwhile, the Independent Energy Producers Association in Sacramento plans to file suit challenging the move to state assessment. The trade association charges that the state constitu- / continued page 23

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power plants have become too big and expensive — and as long as you have some degree of coverage — be it two times, three times, four times, whatever it is, or enough collateral based on a liquidation scenario — then some bank will get comfortable enough to lend.

The real question is how do you marry that with the long-term deals that are available today in the market. They are very few and far between. We are on both sides of these transactions. Sure, we may be willing to do a tolling deal with someone, but it is not going to provide the return on capital that a developer needs to justify investing in a plant for a long time. Larger companies like ourselves and, I'm sure, Duke don't want to contribute to the over-build scenario by lending our scarce credit to support someone else — not in the current market.

It's a different view than we may have had a year or two ago. Credit is scarce. This isn't how we want to allocate it. Also, there is the uncertainty about whether these tolling deals are going to have to be reflected eventually on the balance sheet as debt or something else. As Bill Chew said, there isn't any free lunch. Somehow you are using credit capacity whether you are building an asset yourself or are helping someone else build his or her asset by entering into a long-term agreement.

The load-serving entities should be entering into longer-term contracts to lock in these cheap prices.

MR. SHAPIRO: But there is no regulatory incentive to do so.

MR. COOPER: Right, they have no incentive to do so, and they will lock in at the peak of the market just like what happened in California, and you just perpetuate. It is a dysfunctional regulatory structure.

MR. McCARTNEY: The other big problem with financing merchant power plants today is the market consultants. There is little confidence in the market forecasts because they are all over the board. You can't trust them. They are one thing when you do a project and, two years later when the project is completed, they are completely different. Unfortunately, the market consultant is too heavily influenced by the developer. The developer sits down with the market consultant — who, by the way is supposed to be independent and working for the banks — and says, "This project is being built, and this project isn't being built, and this project is on hold and that one is not going forward." The developers have undue influence.

Market forecasts are one thing when the financing closes and, two years later when the project is completed, they are completely different.

I can give you a really good example. It was a project in which I was involved personally. We had a market consultant do a project analysis for us. The consultant did not include a project on which he was working for another developer. He was clearly aware that it was going to get financing and did not include it in our numbers. Interestingly, we looked at the other deal and — guess what — that deal did not take into account our transaction.

Mini Perms

MR. WILSON: It kind of amazed us that the bank market bought that whole mini-perm story. [Laughter] [*Ed. A "mini perm" is a short-term loan of approximately five years with principal amortization calculated as if the loan were longer term and with a balloon payment of principal due at year five. Many banks lent in recent year to finance construction and up to the first three years of operations of merchant power plants using mini perms. In effect, they were making bridge loans until the developers could find longer-term permanent financing for the projects in the capital markets.*] We took advantage of it to a limited degree, but the principle of matching assets to liabilities was violated. Fortunately, we are not a big player in project finance. We are mostly a corporate finance shop. But the banks that really pushed thought they had the magic because, at the time, the capital markets were not willing to take merchant risk.

You couldn't finance large portfolio deals. The capital markets were saying, "That doesn't work for us. We are not going to make a 20- or 30-year bet on a pool of merchant assets without any contract cover." So the banks came along and said, "We will take the bet. We think the capital markets will be there in three to five years to take us out." So the mini-perm was born. We talk about the unhedged bet that California made that has come back to haunt it; the banks at the time were making a similar unhedged bet. It was, "We can refinance in three to five years these long-lived assets in an inherently volatile, cyclical commodity industry." It was a huge bet.

Forty billion dollars of financing is coming due starting next year. Now that the sector's credit quality is perceived to be dropping, the capital markets are running from this. And the rating agencies are asking, "What are you going to do? These are core assets. This is your business, and how are you really going to walk away from that without tanking the whole company?" So they are putting that debt back on credit.

Every company and every case is different, and the rating agencies need to be open-minded about looking at the specifics of the transaction, but the feedback we are getting is mini perms in this sector should not be afforded much if any off-credit treatment.

It's going to be a massive workout starting next year. The banks are stuck with this paper. Duke will be there hopefully to start picking up the pieces because there will be some undervalued opportunities. Earlier this morning, I mentioned that maybe people don't realize just how bad things are going to get. We don't think the people trying to unload power plants today are realistic yet. We have not been as active in acquisitions as maybe a lot of people expect us to be because we think this is going to get worse going into the next year when people must start grappling with these refinancing issues.

Mexican Goulash

by Alejandro Silva, in Washington

Contrary to published reports, existing independent power projects are not in jeopardy in Mexico. However, future projects are in a constitutional limbo that could last at least a year. */ continued page 24*

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tion allows state assessment only of power plants that are owned by utilities that are required to obtain a certificate of public convenience and necessity for siting and operation. Therefore, plants belonging to independent power companies should continue to be assessed locally.

The move to state assessments could mean higher property tax bills for many power plant owners. Local assessors are barred by Proposition 13 from claiming more than a 2% a year increase in property values unless the property is sold. This limit does not apply to state assessments. Power plants that are qualifying facilities under the Public Utility Regulatory Policies Act or that have nameplate capacities of less than 50 megawatts will continue to be assessed locally.

PENNSYLVANIA moved in June to allow corporations to sell unused tax losses to another company for an amount equal to at least 75% of the transferred tax benefits.

A bill passed the House of Representatives. The measure authorizes the state tax and economic development agencies to allow a company to transfer up to $5 million a year. It faces an uncertain future in the state Senate. A Senate aide said action in unlikely this year and the outlook next year "depends on how the budget looks."

MINOR MEMOS: Two potentially significant IRS announcements are expected this summer . . . . The agency is expected to issue one or more revenue rulings that breathe new life into the "partnership anti-abuse rules." IRS regulations give the IRS a free hand to recast transactions using partnerships where the partnership was "formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present */ continued page 25*

Mexico

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Supreme Court Ruling

The headlines seemed serious and the initial reactions were alarming. Some commentators said that a ruling by the Mexican supreme court in April cast doubt on the constitutionality of private involvement in the Mexican energy sector, while others reported that it would force a nationalization of the existing independent power projects. At the other end of the spectrum, the Mexican government was giving a much narrower view of the scope and effects of the court's decision. The fact that several weeks passed between the court's press release announcing its ruling and publication of the decision allowed for more confusion and wild speculation about its contents and effects. Once published, the length and dense reasoning of the decision did not help quickly to clarify some of the prior confusion.

Although the court's ruling looks bad for private power projects, owners of existing plants and their lenders are not concerned.

Now that there has been time to review and analyze what the court said, it is clear the decision does not have the catastrophic effects that were initially feared.

Chadbourne polled a number of developers and lenders, and their Mexican lawyers, who agreed unanimously that the court's ruling does not affect the legal underpinnings of the existing private power projects nor, at least as currently conceived, does it undermine the government's program for additional private projects. The court did not order, require or authorize a nationalization of existing projects.

The clearest short-term impact of the decision is it will delay — and maybe even require a cancellation of — some Pemex-related projects that were in the early development stages; such projects relied on the ability to sell substantial excess capacity to the Comisión Federal de Electricidad, or "CFE," under authority created in the government's May 21, 2001 reforms that were declared unconstitutional by the court's ruling.

There is less consensus about the long-term effects of the court's decision. The court made clear in the ruling that the Fox administration has very little, if any, constitutional standing unilaterally to increase the scope of private-sector involvement in the power industry, putting to rest any hopes that the government would be able to introduce reforms without having to deal with the opposition parties in Congress.

There is also no denying that the court's ruling casts serious doubt on the constitutionality of private power, although some Mexican lawyers and market participants — developers, in particular — seem dismissive of the practical importance of the court's views. The government already faces political obstacles to achieve an expanded role for the private sector. The court's decision raises the question of whether a constitutional amendment, as opposed to an-easier-to-obtain legal amendment, is needed to allow for increased private sector involvement in the Mexican power market.

Constitutional Issue

The battle lines were drawn in May 2001 when the Fox administration issued a decree amending some of the rules that apply to cogeneration and self-supply projects. The amendments allowed self-supply projects to be built without any capacity limits or restrictions, and such projects could sell to CFE up to 50% of their installed capacity; the earlier regulations had set a ceiling of 20 megawatts. The amendments allowed cogeneration projects to be built without any restrictions and to sell all of the plant's excess capacity to CFE.

Congress challenged the decree before the supreme court, arguing that any such amendment required action by Congress and that, therefore, the government had exceeded its constitutional powers. The Fox administration responded that it had simply amended a prior presidential decree that was never challenged, and that the original limitations on the size of self-supply and cogeneration projects were not a matter of statute but rather presidential action.

The court sided with Congress, but did not follow Congress' reasoning. It chose to address the more sensitive and basic question of the limited role of the private sector in the power industry under the Mexican constitution, which was not what Congress had asked it to do. The court said the following.

First, article 27 of the Mexican constitution gives the state the exclusive right to undertake all activities related to the electricity public service — generation, transmission and distribution — and no private concessions in these areas may be granted. Article 28 lists the electricity sector as one of the government's exclusive strategic areas. Article 25 confirms this exclusive role.

Second, the court considers that these articles and the relevant constitutional history mean the private sector is not constitutionally authorized to render the electricity public service nor any of the specific operations needed for that purpose. In the court's view, the private sector is entitled to generate its *own* power and sell limited amounts of excess capacity to the CFE. However, it is not constitutionally possible — as the government's decree would have allowed — to have a plant where a significant portion of the capacity is dedicated to supplying energy to CFE; such generation would be for the purposes of the public service where no private party is allowed to participate. According to the court, the constitution establishes that *"the generation, transmission, transformation, distribution and supply of electricity, for the purposes of rendering the public service, belong exclusively to the Nation and may not be granted to the private sector."* The court went on to say, in its most direct and clear repudiation of private participation in the power sector, that the self-supply framework created by the government's decree is unconstitutional, as it allows the private sector to be primarily involved in the selling of power to the CFE. The concern that this immediately raises is:what is the constitutional status of private power projects whose main activity is to sell power to CFE?

Finally, in what Mexican lawyers characterize as a legal aside, the court suggested ominously that the existing "Public Services Law" that governs the electricity sector may also be at odds with the constitution and that Congress should consider amending it.

Significance

On its face, the court's ruling looks very / continued page 26

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value" of the aggregate taxes the partners have to pay. Many tax advisers read the rule narrowly to apply only to fact patterns the IRS identified in regulations. Paul Kugler, a departing senior IRS official, warned in June that rulings are on the way that apply the rule more broadly . . . . The IRS is expected to announce by September that more transactions must be reported to it as corporate tax shelters. Earlier regulations requiring that tax shelters be reported to the IRS brought few disclosures. The leasing industry flooded the IRS with tax shelter registrations, but others parsed the rules to conclude they did not have to register. The new rules will cast a wider net.

— contributed by Keith Martin, Heléna Klumpp, Samuel R. Kwon and Lynn Hargis.

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bad for private power projects. Then, why is it that owners of existing plants and their lenders are not concerned?

The reason is the constitutional review rules in Mexico allow for the filing of constitutional challenges only during a relatively brief period immediately after the enactment of a law or decree. Every Mexican lawyer with whom Chadbourne talked agreed that it is virtually impossible that the "Public Services Law," as amended in the early 1990s, could now be set aside by the supreme court. Theoretically, the CFE may have some legal standing to challenge, on a case-by-case basis, the power purchase arrangements entered into with its private power suppliers, but in the unlikely event that this cause of action were to be admitted by the courts, it would have very damaging financial and political consequences for the CFE and the Mexican government. Hence, it is not considered a likely prospect.

Future projects are in a constitutional limbo that could last at least a year.

To sum up, the mechanisms for private involvement in the power sector continue to be legally available and the court's ruling does not affect either the current legal framework or *existing* projects. However, for future projects, developers and lenders are still faced with a confusing legal picture. On the one hand, there is a Supreme Court ruling that considers private power in Mexico to violate the constitution (other than on a self-supply basis). On the other hand, the legal framework for private power remains fully valid and enforceable (as stressed even by the supreme court, which goes to great lengths in its ruling to underscore the limited scope of its decision).

Future reforms to allow for increased private involvement in the power industry are uncertain. The Fox administration has said in the past that a constitutional amendment is needed to provide the legal certainty required to allure private investors and lenders, a position that was implicitly endorsed by the supreme court in its ruling. However, the opposition parties that control Congress have rejected a constitutional amendment and have offered at most to pass an amendment to the "Public Services Law."

The government appears to have accepted political reality and will go forward with trying to introduce amendments to existing statutes rather than the constitution. However, allowing increased private sector involvement through a legal reform would not address the court's views of the intrinsic incompatibility between such involvement and the Mexican constitution. Thus, such legal reform could be challenged again before the supreme court and may succumb to the same constitutional arguments that sank the presidential decree.

Under Mexican law, Congress and the president have the primary role in challenging each other's actions in the supreme court. Therefore, a reform bill having the backing of both the government and the opposition parties faces less chance of being challenged. In any case, any reform bill would only achieve a solid legal and constitutional standing after the constitutional review period expires without any authorized party filing a challenge.

The timing and contents of any reform are unclear. Congress has not convened in special session this summer to discuss energy reform, as had been originally proposed. Therefore, any reform bill would not be discussed at the earliest until the ordinary sessions starting in the fall and as part of the regular, and traditionally crowded, Congressional calendar. It is unclear whether the government and the opposition parties would be able to reach agreement in any event on the scope of permitted private sector involvement in the domestic power supply. The expectation in Mexico is the most that is possible at the moment politically is an upgrade of the existing framework, possibly clarifying or improving certain regulations, but without any dramatic changes or major overhaul.

Pakistan Restructures

by Muhammad Bashir Chaudhry, in Karachi

The Pakistani regulatory authority allowed an unprecedented increase in electricity prices on average from 9% to 21% per kilowatt hour affecting some 10 million consumers across the country, excluding Karachi, on July 18.

However, President Pervez Musharraf asked that implementation of the tariff be put on hold in late July as the *NewsWire* was going to press. He directed the National Electric Power Regulatory Authority, or "NEPRA," to review its decision.

The increase would have varied for different consumers and for different consumption slabs for each consumer group. It was expected to yield more than $3 billion to 12 corporate subsidiaries of the Water and Power Development Authority, or "WAPDA."

The regulatory authority had viewed the increase as a fair reflection of WAPDA's financial needs to facilitate its rehabilitation for providing reliable service to consumers. The increase was less than WAPDA requested. President Musharraf asked WAPDA to put the increase on hold because of the burden it would have imposed on the common man.

WAPDA asked for the increase because it has been losing money due to higher fuel prices and has had to rely on massive budgetary support from the government. However, that support has now been disallowed under government arrangements with the international financiers. WAPDA's petition was opposed by the Planning Commission, all four provincial governments and a large number of other intervenors and experts.

While the tariff request was pending, the Ministry of Finance weighed in with news of its commitment to the international lending agencies to take certain administrative measures, including a structural tariff increase. NEPRA had little choice under the circumstances; it approved the increase, though at a much lower level than WAPDA had requested. WAPDA had hoped to cover a shortfall of nearly $9 billion over 15 months.

The Karachi Electric Supply Corporation, or "KESC," has also asked for a similar tariff increase. A decision on the request is expected in August. Public hearings on the request were completed on July 17.

Major Reforms Underway

The challenge the government faces is to improve the finances of WAPDA and KESC while keeping the economy running in good health. The utilities must reduce line losses by revamping the distribution system and controlling pilferage, by converting some power plants from furnace oil to gas, and by improving the quality of service. WAPDA and KESC not only generate electricity but also transmit and distribute it. The Pakistan Atomic Energy Commission and private power plants also generate power and sell it in bulk to WAPDA and KESC. Total nominal generating capacity in Pakistan is 18,062 megawatts, of which two thirds is in the public sector. Hydroelectric power accounts for 28% of the total while the rest of the capacity is thermal. Most capacity additions in recent years were thermal, and the share of hydroelectric power was reduced from 70% to the present level. The government is now taking steps to promote more hydroelectric power, as it is a cheaper source of supply.

The number of electricity consumers in Pakistan is 12.5 million: households 46%, industry 28%, agriculture 12%, bulk supply 9%, and the remaining 5% are commercial establishments. For faster economic growth, Pakistan must have more reliable power at competitive prices.

The power wing of WAPDA has been restructured into 12 independent companies: eight distribution companies, three generating companies and a transmission company called the National Transmission and Dispatch Company, or "NTDC." The Pakistan Electric Power Company, or "PEPCO," oversees all these corporatized entities. Ultimately, the eight distribution companies and three generating companies will be privatized.

NTDC is expected in due course to replace WAPDA as the buyer of wholesale power, including substituting for it under existing agreements. Contractual arrangements among different stakeholders will not be simple. When all the arrangements are finally in place , NTDC will sell power in bulk to the eight distribution companies and KESC. The distribution companies will supply power to consumers in their geographic regions.

The assets that were earlier under the administration of the power wing of WAPDA are in the process of being transferred to PEPCO, NTDC, and the new distribution and generating companies. Valuation of assets being transferred to each new company is critical. Matching liabilities are also to be transferred. The government has already converted its substantial loans to WAPDA into equity.

The privatization of KESC is already underway. The KESC balance sheet is being cleaned up with a / continued page 28

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view to making it more attractive to prospective private bidders. The government has already picked up KESC's accumulated losses and injected a large amount of cash to keep it going. KESC is expected to retain all its existing generation, transmission and distribution assets after privatization.

Additional generating capacity is needed in Pakistan on an urgent basis.

Other Challenges Remain

The government has already extended significant financial support to WAPDA and KESC. The increase in the tariff will help. However, other challenges remain.

Both the WAPDA and KESC systems suffer frequent breakdowns and interruptions in service and have abnormally high line losses. Both utility operations are in the red. Complaints about delays in new connections, wrong or inflated billing, and breakdowns are common. The attitude of the employees is generally unfriendly and bureaucratic. WAPDA and KESC have initiated measures to improve operational and management efficiency to redress the situation, but it will take time.

The unbundling of WAPDA, as part of the reforms of the power sector, is a complicated process, particularly when it comes to the division of assets, allocation of liabilities, transfer of contractual arrangements pertaining to supply of fuel to generation companies, and the sale of bulk power to NTDC and distribution companies. The government probably needs to inject additional capital into the new companies so that they are in a position to sustain themselves. The position will become clear after assets and corresponding liabilities are finally transferred from WAPDA to the new companies.

The conversion of government loans to WAPDA into equity and the fresh injection of cash to cover operating losses will make the government the majority shareholder in the new companies. Therefore, the government will have a major say in the composition of the boards of directors of the companies. All boards should be given powers to run the companies on purely business considerations.

KESC is currently experiencing abnormally high line losses — even higher than those in the WAPDA system. The losses can be largely controlled quickly if the distribution function were to be privatized first. It would be best if KESC were broken into four or five private-sector distribution companies during the privatization of KESC. The company's generating assets could be sold later and its transmission lines merged into the NTDC. However, it is not clear this is how the government plans to proceed.

The managing director of KESC said recently that the company had to import nearly one fourth of its power needs from WAPDA due to inadequate generating capacity of its own. The tariff increase approved for WAPDA in July would affect KESC as a purchaser of electricity from WAPDA. KESC has been enjoying a special tariff so far and, at times, it could defer payment to WAPDA. Sometimes, WAPDA supplied KESC even when it was itself experiencing shortages. WAPDA is not likely to continue with the existing arrangements after KESC is privatized. The issue needs an early resolution for a smooth privatization of KESC.

Existing power policies for thermal and hydroelectric generation have lost much of their relevance. The government needs to start work on a new policy and institutional framework. Matters requiring review include fiscal incentives for private power developers, risks assumed by the government, the roles of different institutions involved with the power sector, whether to have uniform or separate tariffs for the eight new distribution companies, the resolution of circular debts among different energy companies, and a mechanism for amicable resolution of disputes among different stakeholders. As there are now more distribution and generation companies, there is room for more circular debts and more friction as each entity will be protecting its own interests.

Available generating capacity is less than the nominal capacity of of 8,002 megawatts as some of the public sector thermal plants are old. Also, there has been less water in the rivers for the past few years. As a result, the country has experienced power outages. Additional generating capacity is needed on an urgent basis.

Pakistan, with the assistance and financial support of the World Bank and other donors, set up a "Private Sector Energy Development Fund" in 1988. Private developers can use subordinated loans from the fund for up to 30% of the capital cost. Both the grace periods and repayment periods of these loans are attractive with the result that a project's debt service profile will typically be more commensurate with the long life of power projects than would be feasible given commercial finance alone. The fund was originally administered by the National Development Finance Corporation. It is now administered by the National Bank of Pakistan.

NEPRA is committed to providing a fair return to investors while ensuring safe and reliable service at competitive rates to consumers. These are always difficult objectives to balance. WAPDA and KESC have not been fully satisfied with NEPRA's decisions. A special committee has been formed to look into the matter.

The World Bank and the Asian Development Bank are supporting the restructuring of WAPDA and the privatization of KESC. Pakistan needs additional generating plants. All new thermal capacity probably will end up in the private sector or perhaps be built by joint ventures between private developers and the three new generating companies created out of the restructuring of WAPDA. ◎

The Retreat From Emerging Markets

Global Power Report *reported in May, "In recent months, the stream of companies retreating from overseas markets has turned into a stampede." The following are excerpts from a discussion about whether US power companies are making a mistake to beat such a hasty retreat that took place at a Chadbourne conference in Quebec in late June.*

The speakers are Carol Mates, principal counsel for the International Finance Corporation, Bruce P. Robertson, vice president for petroleum markets at El Paso Corporation, Tony Muoser, managing director for global project finance at Citigroup, Robert J. Munczinski, managing director of BNP Paribas, Julie Martin, a former vice president for insurance at the Overseas Private Investment Corporation and currently vice president and a member of the political risk group at Marsh, Inc., and Eric McCartney, head of project lending in North and South America for KBC Bank. The moderator is Kenneth Hansen.

MR. HANSEN: This morning we are going to be talking about the retreat of project developers from international opportunities, in particular opportunities that were perceived some time ago in emerging markets. Before launching immediately into retreat, the thought was to spend a few minutes exploring why the initial outreach. Carol Mates, why did the US developer community go into the emerging markets in the first place?

Developer Strategies

MS. MATES: There were enormous opportunities abroad in the late 1980's and early 1990's when there were fewer opportunities at home for US companies to build more projects. You had a deregulated industry that was all dressed up with nowhere to go at home. At the same time, you had the breakup of the Soviet Union and the collapse of communism in Eastern Europe. Socialism, or state control of the economy, was suddenly out of vogue. You had the entire world on sale. You had privatizations, and nature forced a vacuum. So the US power industry went abroad.

MR. HANSEN: Bruce Robertson, is Carol's sketch a fair basis for what brought Coastal and El Paso overseas?

MR. ROBERTSON: Yes, but there was more to it. The domestic energy market is a mature market. It was difficult to find the rates of return that companies required for their investments. They had cash, and they saw the international market as a place where they could earn high returns and gain first-strike footholds in other countries.

Some investments that some companies made have proven a mistake, but most companies picked areas of the world where they had prior dealings and an understanding of the social and political climate. For example, our companies looked at sub-Asia — India, Pakistan and Bangladesh — as well as China and southeast Asia. Those were areas where the two companies had prior dealings. They understood how the markets would react not just to their investments in power projects, but also in

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complementary areas like pipelines and E&P.

Single investments are the wrong investment strategy. Companies that went into a country in just one sector are now having to shed those investments because the one industry is doing poorly.

MR. HANSEN: I was going to ask why they were leaving; was it a misperception of the opportunity or was it that the times have changed?

MR. ROBERTSON: It depends on why you went into those countries in the first place. If you were just investing in one power plant or in the power industry in a country, what we see is most of those companies fleeing the market. Most of Latin America is a good example. We have investments in China and in sub-Asia and in southeast Asia. Some of them are doing well and some of them are not doing so well, but our strategy is to maintain those assets.

There is one other point, which is that capital is a scarce resource. Many US companies are asking, "What's the highest and best use for our capital?" If they can put it to more productive use back home to shore up the balance sheet or if the capital can be redeployed elsewhere to earn a higher return, then companies will not hesitate to sell their foreign assets.

Lender Problems

MR. HANSEN: Fair enough. Speaking of capital, Tony Muoser, what is the perspective of the bankers? Are you part of the retreat?

MR. MUOSER: I think we have to go back to how this whole thing started. It was in a way a very opportunistic strategy from most of the players. There was pressure for additional growth. That wasn't possible at that time in the US markets so you had to deploy capital abroad. That goes not only for the sponsors and developers, but also the lenders and equity investors who follow their clients. That's what happened.

Things obviously have changed. A lot of the sponsors have domestic issues, domestic problems, balance sheet issues that are forcing them to cut back and retreat. If the company had only an opportunistic approach, then it makes sense to get out and focus on its core market again.

The banks are approaching things in a similar manner. It is not necessarily that capital is scarce. It is more an issue of how to allocate cross-border limits. At Citigroup, there is a single cross-border amount that is available for a country across the entire institution. Even if a project is being financed on a non-recourse basis, it still falls under this cross-border limit. Even if there is political risk insurance available, there must still be capacity to lend under the cross-border limit. These limits are another factor that is contributing to the current retreat. The banks are dealing with their own cross-border issues, which are not necessarily just related to the power industry.

> Some suggest that the emerging markets have screwed up and may need to fix things. Another perspective is they got exactly what they were trying to get — the plants.

I have a struggle inside the company to get an allocation of cross-border limit. I must fight it out with a lot of other people who want to do business in the same country.

MR. MUNCZINSKI: The problem we face within our own institution — and I am sure other banks are wrestling with the same issue — is the fact that it is very difficult to finance on hard currency basis transactions that generate a local currency cash flow. We learned our lesson in Indonesia where, in concept, power purchase agreements were indexed to US dollars, but after the massive devaluation of the local currency, the utility was unable to continue to pay very high US dollar-indexed power purchase prices. One of the conceptual problems we have with emerging market countries is how can we lend hard currency dollars into strictly indigenous transactions? It is much easier to finance export-oriented projects in emerging market countries than a power plant that is selling power to a local community and generating local currency.

MR. HANSEN: I am tempted to throw it over to Carol Mates. Carol, how are the multilateral lending agencies thinking about addressing this clear issue?

MS. MATES: It is very hard to address the issue of inconvertibility —

MR. MUNCZINSKI: It is not inconvertibility. It is devaluation.

MS. MATES: Devaluation is another issue, and I believe where we all come out is you just can't escape that risk. You can mitigate it to a degree. There are some insurance products on the market that attempt to go to that risk.

Only in the last 10 years have we as a community been financing private infrastructure in emerging markets. One thing we are all appreciating now is that when you have a private provision of a public service, you can never get out of that country. The end users are paying you in local currency, and you have the macroeconomic risk of the whole country and the whole system. To a certain extent, you are really stuck. Can this country support its currency? That's a different issue than one faces in a domestic deal.

MR. HANSEN: Let's hold the specific devaluation concern a little bit because we are going to come back to that, and we happen to have a couple of folks here who have looked at that with a lot of attention and some success. Carol, more broadly, given what appears to be at least on a net basis an evacuation of support by private sector money, private sector expertise, that has been marketed for quite a while as the brightest alternative way to develop infrastructure in emerging markets, what are you going to tell your developing member countries that they ought to do in order to produce power going forward? The folks who have marketed to them in recent years are losing interest.

MS. MATES: One thing is that both sides have to start shifting some of their expectations. Governments in developing countries are going to have to realize that the private sector has to be accommodated — that they are going to have to be more flexible. In a sense, even if you have a contract for 100% private provision of a service, the government is still there as the partner.

Now in terms of getting an allocation of hard currency toward servicing some of the payments that have to be made, that is a macroeconomic issue. In some cases, I don't think the developing countries understood really how the private sector works because their economies were state controlled.

Obsolescing Bargain

MR. HANSEN: There is a chapter in everybody's development and economics textbook on the "obsolescing bargain." There is a tendency for investors to be coaxed into a developing market, sink their capital, commit themselves and once they are there, the terms change. At the end of the day, the folks who have the longer-term commitment, which is to say the indigenous population and government, get the last laugh. They get the plant. The investor goes home wishing he had never come.

Couldn't one argue that is simply what has happened again and, at this point, the emerging markets have the plants, they got the expertise through training of indigenous experts, and now the developers can simply go home and wait for the next time?

MS. MATES: Well —

MR. HANSEN: The suggestion was the emerging markets have screwed up and may need to fix things. Another perspective would be they got exactly what they were trying to get.

MS. MATES: I think this is all going to sort itself out, but perhaps over a longer timeframe than the average US developer wants. If you are looking at your next quarterly earnings statement, it is not going to sort out in that time period. There is a need for power in these countries. The governments are going to realize they need the expertise that foreigners can provide, and I think US companies will want to be there.

What is the realignment that is going to happen? Probably there will be more local participation in projects. There will probably be more local sourcing of capital. There will probably be a better legal structure so that every time you do a plant in a country, you don't have to do one-off deals with the government and spend an enormous amount of time just getting the contracts right. A better legal system also leads to greater transparency. These things will take time. The parties are beginning to each realize what their own interests are. Institutions such as mine — the World Bank Group, the IFC in particular — have the capital. We are very eager to support this process going forward.

MR. HANSEN: Before the spasm, if you can call a decade of private investment in power projects in developing countries a spasm, the lead financier of such infrastructure was, of course, your institution, the broader institution, in particular the World Bank. The World / continued page 32

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Bank can only lend to governments. As the private model, at least as supported by US developers, steps back a bit, subsides in its interest in such development, would you expect the World Bank to come back? I guess the question is: was the World Bank one model that we have moved beyond, and now the private development of public infrastructure is another model, but we are going to move beyond it into some new place? Or are we going to go back more to the traditional model of "Let the ministry of power do it. Let the World Bank pay for it"?

MS. MATES: There isn't the political support to return to the old model. The multilateral institutions are composed of governments. The governments are shareholders. The US government is the largest shareholder, and US and western Europe — particularly the US — are not going to go back to the state-supported enterprises. My guess is we will move to more of a mixed joint venture in countries where the purely private model hasn't worked and the private sector is unwilling to take all the development risk. The risks will have to be apportioned differently.

Political Risk Claims

MR. HANSEN: Besides the project developers and the project lenders, a group of institutions that has shared in the disappointments that some projects have experienced is the political risk insurers. Julie Martin, I would be interested in your reaction as a political risk insurer to some of the comments that have been made this morning.

MS. MARTIN: September 11th knocked the insurance industry for a loop. Everyone has experienced dramatic increases in the cost of standard programs — property and casualty, directors and officers. However, the political risk insurers have not had as dramatic a downturn. Many power projects that political risk insurers supported are just now coming on line. Many such projects are having to renegotiate their terrorism or cancellation or non-payment coverage.

Political risk insurers are still in the process of sifting through recent experience with claims to figure out what lessons there are to be learned. OPIC paid its largest claim ever a couple of years ago for a project in Indonesia. Many political risk insurers are involved with the Dabhol project in India. That one is just now being sorted out. A number of projects in Argentina were supported by political risk insurance.

> Devaluation risk is the number one issue for lenders and bond investors.

My guess is the political risk insurance industry will continue to support power projects as the power industry has been a significant source of revenue in the last few years, but the insurers will adjust how they do it. They will analyze risks a little more carefully than they did in the past. Just because you have a government PPA does not mean it is a good project. You will look at how the pricing and dispatch work within the overall system.

MR. HANSEN: It is intriguing. You mentioned Argentina, Indonesia and India. At least insofar as Dabhol and Argentina are concerned, I am not aware of any political risk insurance claims actually having been paid. To some extent, the occurrence of an actual insurance payment — dramatic though it was a couple of years ago in Indonesia — is an anomaly. One of the concerns about the political risk insurance market is that, notwithstanding all the billions of dollars of coverage out there and a series of bank crises and political crises in this country and that country, it turns out to be really hard to qualify to get a claim paid. There is a concern that maybe the insurance market isn't providing the insurance that is needed. Just generally, how do you think the political risk insurance market is doing in serving infrastructure development?

MS. MARTIN: There are some risks that are clearly political, some are commercial, and there is a big grey area in between. Some of those are still being sorted out as to which bailiwick they fall into.

There was a big push starting in 1996 by political risk insurers to develop products that respond to developer needs. With the downturn in the insurance markets, some insurers are pulling back.

Some of the policies issued in Argentina have a new form of clause that responds to a fear by generators and distribution companies that they could be squeezed by regulatory-type actions that are not necessarily a violation of international law. These new policies have not been fully tested. It will be interesting to see how they fare.

On the other side of it, as Ken well knows because he was our lawyer on this transaction, after the Asian crisis when I was still at OPIC, many companies came to us and said, "We are not interested as much as in convertibility. What we are really concerned about is devaluation". OPIC didn't think it had any better way of predicting devaluation than all those smart Wall Street houses, but we did want to try to find a way to help.

What we did was we structured a liquidity facility that is available to be drawn by the AES Tiete project in Brazil when there are shortfalls in cash available for debt service as a consequence of devaluation. It worked in Brazil because Brazil has a relatively free-floating exchange rate. We would never have done it in Argentina where the peso was pegged to the dollar because we knew once you went off the peg, you were dead. It worked because we did a lot of analysis. We hired Wharton Econometrics to look at how purchasing power parity held up in a number of countries. It worked because the underlying project had a very strong and predictable cash flow. So with utilization of about $30 million of this type of capacity on a $300 million bond issue, we were able to cover the devaluation risk for the rating agency purposes. It is the only one that has been done that I know of.

Devaluation Risk

MR. HANSEN: One of the surprises for the people working on the Tiete project was when OPIC brought in the economic consultants and we analyzed what had happened after the Mexican and other crises, although everyone remembered the headlines from the other devaluations, no one remembered how long it took for rates to be restored to normal levels. Suppose you were to establish a reserve twice what would have been required to weather the worst devaluation Brazil had ever had to date for a $300 million bond offering. The size of credit facility necessary to protect the $300 million in bonds against double the devaluation that had ever occurred was only $6 million. It sounded so small. It just wasn't dramatic enough, so ultimately the facility was $30 million, or five times the size that historically could be defended.

As a business matter, it seems this wasn't such a tough nut to crack. At the end of the day, the actual product was just a credit line, with very special terms but, nonetheless, just a credit line.

Tony Muoser, why have institutions like Citibank not run into this business? Is it for lack of having examined it or is it that you have examined it and decided that it is not such a smart product after all?

MR. MUOSER: I suspect we have not explored it. The devaluation issue is the number one issue for lenders and bond investors. I don't think that expropriations are a big concern at this point. Maybe we have to go at it from different angles. Devaluation risk coverage from multilaterals or private insurers is one way to do it. I do think that we need to develop the local capital markets as Carol pointed out. Maybe the multilaterals can play a role there as well by providing local currency guarantees.

When you look at the US domestic market, at least for bank financing, it is a "mini perm" market. Maybe we should try to move in that direction for the emerging markets. That might be another way to mitigate the devaluation risk.

On the other hand, I am not sure the commercial bank market will be willing to take the refinancing risk in an emerging market. Maybe there is another role for the multilaterals to play. They can follow the Brazilian model where the BNDS, which is the Brazilian development bank, is serving as a backstop to some capital markets transactions by taking that refinancing risk. Investors have a "put" to sell the project to the BNDS after four or five years.

I doubt people will simply sit back and see what time can heal. But you are probably going to need another generation of bankers because this generation still has wounds to lick from the lending that was done in the last decade in emerging markets. Many bankers have lost their jobs over bad loans. People who are still there are going to be extra careful.

MR. HANSEN: It's intriguing. I hadn't really thought about this before, but taking the long view, it was the Bretton Woods conference that gave / continued page 34

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rise both to the establishment of the World Bank Group and a system of fixed exchange rates. The US government responded within a number of months with the first plank of its political risk insurance program in the Marshall Plan, which was currency inconvertibility insurance. It made sense in a world of fixed exchange rates. It responded to a likelihood that it would have been impossible to maintain those rates and, thus, things would go inconvertible.

Since 1972 — it's quite a while ago — we haven't been living in a fixed exchange rate world except for special countries here and there, the Dominican Republic, Argentina at different times, pegging their rates.

It would somehow seem appropriate if the offspring of the Bretton Woods conference — the World Bank Group — would come up with a way of supporting what appears to be well established as the dominant currency-related risk in emerging market investment, which is devaluation.

Carol Mates, any thoughts about following OPIC's lead or striking off in your own direction in doing something — whether it is through MIGA or the IFC or otherwise — that would help developers and lenders manage devaluation risk?

MS. MATES: I am more optimistic than Tony is. In my time at the World Bank Group, I have seen several debt crises. Going back to the early 1980's, there was a Latin debt crisis. At the end of the 1980's, there was the Mexican crisis. Everybody moans "It is terrible" and, within three years, the lenders are back in because the returns have returned to normal levels and there is money to be made in restructurings and reschedulings. In my view, people have very short memories once it seems there is a way to make some money off of something. [Laughter]

People have very short memories once it seems there is a way to make money off of something.

At the IFC, we work only with the private sector. We have recently been doing a fair number of what we call "partial credit guarantees," which are guarantees of local bond offerings, to help with capital markets in our member countries. This is to ensure there will be local currency financing in projects. It does not solve the problem of devaluation risk for hard currency loans, but it mitigates against it because a project requires less hard currency to be built.

We are willing to look at other approaches. We offer political risk insurance through MIGA. Things will evolve. The market will respond to need. Exactly how it should do so, I'm not sure, but the market tends to respond more quickly to demand than people think.

The Future

MR. HANSEN: With the time remaining, let's turn to the future of the industry in emerging markets. Bruce Robertson, what do you think is ahead? Just how are projects going to be developed in these regions that are less popular than they were some months ago? There is still a need for electricity.

MR. ROBERTSON: Very slowly and very carefully if at all. Going back to the 1980's when the emerging market boom started, everyone was trying to do a big power project. It was never a 100 megawatt facility. People wanted to do 1,000 megawatts. They wanted to do the big showcase projects. Many of these projects are just now coming on line. The local countries frequently lack the ability to distribute the power efficiently. The World Bank should be helping these countries improve their transmission and distribution facilities. In the interim, I think the best future opportunities for private developers are for smaller off-mainline-type power projects in the outlying areas. Most of these countries have baseload power plants and transmission lines to take power from these big baseload plants to the big industrial cities. The outlying areas have nothing, and they have been left behind.

The US Export-Import Bank and I believe the IFC as well are starting to support development projects in rural areas. I think that is where some of the investments are going to happen in power. It is not going to be large showcase projects.

We are a lot smarter now. These things work in cycles. The cycle is this. If you look at your power bill now that you are paying in the United States and you look at what they are paying internationally, rates are lower overseas. That's why the industry moved back to the US market. We are back home for three to five years — I don't think it will be a whole generation, Tony — but already you have the same people sitting in this room talking about where we are all going to go next.

MR. HANSEN: Tony Muoser, if we were to put together one of these smaller projects sponsored by a fully-integrated energy company and we came knocking on your door recognizing that the welcome mat actually wasn't put out that morning, what would it take to get the banks interested? Might it be multilateral support? I mean, besides the passage of time and replacement of personnel. [Laughter]

MR. MUOSER: It is even more difficult for us to get involved when you are talking about developing rural areas. The first reaction will be, "I would rather be in the city where there is a larger consumer base and higher per capita income." If you are really talking about a small project in a rural area, I would have to put it back to the multilaterals. Such projects are very difficult for the commercial banks to evaluate. The banks and capital markets have been moving away from the smaller transactions.

MR. HANSEN: What about lending shoulder to shoulder under the umbrella of a multilateral like IFC or one of the regional development banks? Would that get you there?

MR. MUOSER: That approach has been tarnished by recent experience. We do not believe that the mere fact it is a "B" loan means the lender is in a stronger position. I guess I am not very optimistic.

MR. HANSEN: The goal of this panel was to wake everybody up, not to make you wish you hadn't gotten out of bed. [Laughter]

MR. McCARTNEY: The biggest risk today for a banker is devaluation risk, and you don't get rid of that with a "B" loan. Having the IFC or the InterAmerican Development Bank involved helps, but it does not eliminate the risk.

MR. MUNCZINSKI: I wonder if we could get a reaction from the audience about the valuations that the equity markets place on companies that are sponsors of international projects. It seems to me that if you are operating in a small country that may have 3,000 megawatts of total capacity and you develop 300, you supply 10% of a very small market; even a healthy equity market is going to take a big yawn at something like that. That is not a driver of value.

I am confused by the business strategy that some of our clients have in terms of going after very small playgrounds. They may be big players but in very small playgrounds. I don't think the equity markets ascribe very much value.

Look at AES. In early 2000, AES probably had a P/E ratio of 60. It was trading at $70 a share. The company's profile probably isn't that different today than it was in early 2000. AES has been involved throughout in places like Kazakhstan and Argentina and Brazil, and the equity markets in early 2000 ascribed a great deal of value to international diversification. In the short period of a year and a half, the equity market did a complete turnaround on that issue and has driven that valuation down. Obviously, AES has also been harmed by the taint in the energy sector as a whole.

Lenders are subjected to the same type of questioning from equity analysts. When Russia hit the wall in 1997 or 1998, equity analysts asked leading international banks how much emerging markets exposure they have. From quarter to quarter, the analysts tracked whether lenders were increasing or reducing their exposure in such markets. More recently, the questions have been about telecom and energy sector exposure.

The international banks that look at trying to maximize their equity valuations are very sensitive to issues like this.

MR. HANSEN: Our master of ceremonies has been tugging me to the side.

MS. MATES: Can I just make one tiny comment?

MR. HANSEN: Please do.

MS. MATES: Emerging markets are not called emerging for nothing. They are unstable. They go up and down as anyone who has had the misfortune as I have to invest in emerging markets stock funds knows. But there are cycles, and this latest period of handwringing too shall pass. We will have a different model in a few years and people will find ways to do projects in these countries and earn a respectable return.

MR. HANSEN: By your model, this topic too shall come back again. [Laughter]

Lenders: What To Do If You Missed the July Deadline

By Luis Torres, in Washington

Project lenders who were not paying attention to their calendars may have less security in a debtor's assets than they think they do.

July 1 marked an important deadline under new "secured lending" rules adopted by most states — including New York — just over a year ago. The new rules, which are based on a revision of article 9 of a uniform group of laws called the "Uniform Commercial Code," govern lending transactions in which a lender stakes a claim in a borrower's assets as collateral for making a loan. If the borrower defaults, the lender — the "secured party" — can seize the asset. The interest a lender takes in a borrower's assets is known as a "security interest."

July 1 was the expiration date for one of the grace periods in the new rules that gave lenders time to "re-perfect" security interests that were established under the prior rules.

"Perfection" is the mechanism by which a lender puts the world on notice that he has a claim on a particular item of the debtor's property. This makes future lenders aware that the first lender has "priority" over that asset. Perfection allows the secured party to enforce its security interest against the debtor, while protecting its claim on the asset against claims of third parties such as creditors who came later in time or who agreed to stand second in line with respect to the debtor's assets.

Lenders who perfected their claims under the prior rules, but missed this deadline, need to re-perfect their security interests as soon as possible. Otherwise, they run the risk of being displaced by other creditors, who may "perfect" first and obtain a better claim over the collateral.

Background

In order to facilitate a transition to the new rules, new article 9 "grandfathered" certain security interests that had already been perfected under the old rules. New article 9 contains two key grandfather provisions. The rule that applies to a particular set of facts depends on the type of property that secures the loan. (Different types of assets are secured in different ways.) The first provision applies to types of collateral that were perfected under the old rules by the filing of financing statements. This includes property like trade instruments and general intangibles. In these cases, if the financing statement filed under the old rules was filed in the same jurisdiction in which it should be filed under the new rules, then such a financing statement — and, therefore, such perfected security interest — is valid until the earlier of its scheduled lapse date or June 30, 2006.

The second grandfather provision is the one that expired on July 1, 2002. It applies to collateral that was perfected under the old rules by methods other than filing. This category includes certain "waterfall" accounts and letter-of-credit rights that were perfected by possession. The rule provides that if the perfection requirements for this collateral under the old rules are different than the perfection requirements under the new rules, then the parties had until July 1, 2002 — one year after new article 9 entered into effect — to comply with the new requirements. If there was no compliance by July 1, 2002, then the security interest became "unperfected." In other words, the world no longer has notice of the secured party's priority over the respective collateral, and other third parties, such as creditors who should have a lower claim to the collateral, can perfect a security interest over the collateral and obtain a higher level of priority.

Areas of Concern

There are at least three areas of concern for lenders who missed the July 1, 2002 deadline.

The first area of concern to project finance lenders relates to "waterfall accounts." Often established in loan agreements or collateral account agreements, waterfall accounts are accounts through which a project's earnings are funneled so that the lender knows the borrower is using the project's income to keep the project running instead of distributing the cash to itself. Funds in waterfall accounts must often be used to service debt, satisfy operations and maintenance costs, and maintain reserve requirements, and the lender typically takes a security interest in them. Most project finance lenders treat these cash collateral accounts as "securities accounts," which have not been affected by the July 1 deadline. However, because these accounts may hold cash as well as certain securities, there is the possibility that they may be characterized as "deposit accounts," which do fall under the new secured lending rules. The consequence of characterizing a waterfall account as a deposit account is that a perfected security interest in the account should have been continued before the July 1 deadline.

There are differences of opinion about whether any steps were necessary to continue a lender's security interest in waterfall accounts prior to July 1, 2002. On one side, some argue that no additional steps were necessary because these accounts are often expressly considered to be securities accounts. Advocates of this view point out that most project finance agreements governing waterfall accounts contain a representation that the waterfall accounts are indeed securities accounts. Therefore, there is little room to argue that such accounts are better characterized as deposit accounts. Advocates of this view also argue that even if the waterfall accounts are deposit accounts, security interests in securities accounts and in deposit accounts are perfected through the same mechanism and, thus, no additional steps were necessary to continue perfection of a security interest in these accounts.

Project lenders who are not paying attention to their calendars may have less security in a debtor's assets than they think they do.

Some lenders take a conservative approach and amend a project's collateral accounts agreement to reflect the possibility that the accounts could be characterized as either securities accounts or deposit accounts. One consequence of amending account agreements this way is that financial agents that act as "securities intermediaries" in connection with the control of securities accounts have now been requested to act also as "banks" for purposes of obtaining control over deposit accounts. In practice, these are very similar roles, so most agents have accepted the change. The agents' non-adverse reaction is not surprising — these amendments or supplements do not change the basic relationship among the parties that existed prior to the entering into effect of the new rules. Instead, they simply clarify the rights of the secured parties and the role of the agents in the event that the waterfall accounts are considered deposit accounts.

The second area of concern to project finance lenders relates to security interests perfected through a "bailee's" possession of the collateral. A lender can perfect a security interest in certain types of collateral (such as goods, instruments, or CDs) by appointing a third party — known as a bailee — to hold the property for the duration of the loan. If a lender perfected a security interest in this manner prior to July 1, 2001 but took no subsequent steps to continue its perfection prior to July 1, 2002, then the lender should notify the bailee of its security interest and obtain an acknowledgment from the bailee that it holds the collateral for the benefit of the lender.

A third area of concern relates to letters of credit. If a lender perfected a security interest in a letter of credit prior to July 1, 2001 by taking possession of the letter of credit but took no further steps to continue its perfection after July 1, 2002, then the lender should obtain "control" of the letter of credit in order to continue perfection. To obtain control, the lender must obtain the issuing bank's consent to assign the proceeds of the letter of credit.

Final Thought

In addition to taking any of these steps, lenders who did not meet the July 1, 2002 deadline may wish to seek assurances that no other creditors have obtained a higher level of priority. A lender may do so by obtaining a representation from the borrower, as well as from a bank, bailee, or issuer of a letter of credit, as applicable. The representations should confirm that no other party has a security interest over such collateral and that the lender's security interest constitutes a perfected, first-priority security interest over such collateral.

Surety Bonds Compared to LCs

by Tat Man So and Dorothy Wisniowski, in New York, and Robin Mizrahi, in London

Parties to project finance transactions are sometimes asked to accept surety bonds as security in place of letters of credit. There are key differences between the two instruments. A pending lawsuit that grew out of the Enron collapse shows the dangers of choosing unwisely.

A letter of credit is a bank's promise to advance up to a certain amount of money to one deal party if the other party defaults.

A surety bond is a guarantee in which a third party — often an insurance company — agrees to assume a defaulting party's financial obligations.

Although letters of credit and surety bonds are similar in function, there are legal differences that could affect a beneficiary's ability to obtain full and prompt payment on its claim.

Enron

A recent lawsuit by JPMorgan Chase Bank, following the collapse of Enron, highlights the key distinctions.

Chase sued a group of 11 insurers for failure to pay on demand under $1 billion worth of surety bonds issued by them as security for Enron in certain forward crude oil and natural gas contracts between Enron and two offshore Chase entities, Mahonia Limited and Mahonia Natural Gas Limited. When Enron went bankrupt and failed to deliver the oil and gas to the Mahonia entities as required by the forward contracts, Chase demanded payment from the insurers on the surety bonds for the fixed replacement value of the oil and gas.

Despite a payment-on-demand provision negotiated into these bonds by Chase and other provisions that look strikingly like provisions typically found in a letter of credit, the insurance companies declined to pay on the surety bonds. In their responses to Chase's lawsuit, the insurance companies alleged, among other things, that they were defrauded by both Chase and Enron into issuing the surety bonds on the understanding that they were providing these bonds to backstop commercial oil and gas transactions instead of financial loans to Enron by Chase. The insurance companies also noted they are prohibited under New York insurance law from issuing surety bonds on financial transactions because such bonds would be tantamount to prohibited financial guarantees by insurance companies. The insurance companies had expressly waived nearly all their defenses to payment under the surety bonds, but the court nevertheless permitted them to raise defenses that they presumably waived.

The Enron-Chase forward contracts lasted years. Early on, Chase required Enron to post letters of credit as security for its obligations. It was only in the later transactions that Chase relied on surety bonds as security. Enron requested this change, with some encouragement from its insurance companies, because surety bonds were generally easier and cheaper to procure and they did not appear on Enron's balance sheets as contingent financial obligations.

The lawyers tried to draft the surety bonds as closely as possible to letters of credit in order to minimize the collection risk.

Despite their efforts, bad timing and the underlying laws of surety obligations may result in a potentially $1 billion loss to Chase.

Parties to commercial transactions have for years argued over the forms of security providing credit support to their deals. Beneficiaries, known as "obligees," prefer letters of credit over surety bonds because letters of credit generally are easier to collect upon, usually merely by presentation of certain documentation. Payment under surety bonds is usually a more drawn-out process and involves a greater risk of litigation on the underlying commercial transaction and any other defenses that may be available to the surety company. The key distinctions between letters of credit and surety bonds arise from the business concepts and legal theories underpinning these forms of security.

Letters of Credit

A letter of credit is a written instrument that is traditionally issued by a bank. It authorizes a party to draw up to a certain amount of money under terms outlined by the instrument.

Three main parties are involved in a letter of credit transaction, namely, the issuer (bank), the customer of the issuer (applicant), and the beneficiary (obligee).

Usually, the letter of credit is accompanied by a promissory note from the applicant to the beneficiary and the applicant's agreement to reimburse the issuer upon its payment to the beneficiary. Parties select either the Uniform Commercial Code of the relevant jurisdiction, or "UCC," or the Uniform Customs and Practice for Documentary Credits, or "UCP," issued by the International Chamber of Commerce to govern their letter of credit.

Two types of letters of credit are frequently used in commercial transactions: documentary letters of credit and standby letters of credit. A documentary letter of credit, which is usually governed by the UCC, is one in which the beneficiary must present specified documents to the issuer in order to draw funds from the letter of credit. Documentary credits are primarily used as direct payment devices to facilitate sales of goods transactions. The typical documents that a seller of goods (the beneficiary) must produce in order to draw from the letter of credit include a bill of lading, commercial invoice, certificate of insurance covering transport, or import/export documentation.

In a standby letter of credit, the issuer must honor the credit after it receives evidence from the beneficiary that the other party to the underlying contract is in default under the terms of the contract. Standby letters of credit are the prevalent security instruments supporting obligations under construction contracts for thinly-capitalized construction companies, special-purpose project companies or owners, power offtakers with shaky credit ratings, or any other entity that may need some credit support for its obligations.

A pending lawsuit that grew out of the Enron collapse shows the dangers of choosing unwisely between surety bonds and LCs.

Surety Bonds

Surety bonds are forms of guarantees. Under a surety or guaranty, a third party becomes liable upon the default of the principal, who is the debtor or guaranteed party. Surety bonds can be payment bonds or performance bonds and involve the following three parties: a surety (the entity that assures payment or performance of the contract between the principal and the beneficiary), a principal (the entity who has the obligation to pay or perform), and an obligee (the beneficiary, or entity that is owed the obligation). A suretyship is different from more common forms of insurance because sureties can seek repayment from principals, but insurers normally cannot seek reimbursement from those they insure, and, instead rely on payment of premiums and actuarial statistics for reimbursement coverage.

Key Distinctions

All letters of credit operate under the doctrine of independent contracts, which says that the issuing bank's obligation to honor or pay upon a properly presented draft is independent of the underlying contract or commercial relationship between the account party and the beneficiary presenting the draft. Accordingly, the issuer is required to pay on the letter of credit regardless of whether the underlying contract has been properly performed by the account party or whether the account party has proper defenses to due performance. However, the issuer need not honor a draft under a documentary letter of credit if the documents or the transaction itself are fraudulent.

Because letters of credit are independent from the underlying transactions, they are often more attractive to beneficiaries because there is no need to prove a breach of the underlying contract or the extent to which the beneficiary suffered damages. Further, the traditional defenses and claims in contract law do not apply to letter of credit transactions because a letter of credit is governed by its own set of legal

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Surety Bonds Compared to LCs

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theories. Thus, from the point of view of a beneficiary, letters of credit are enforceable against an issuer regardless of the bankruptcy of the applicant.

Unlike a letter of credit, a surety bond attaches to the underlying contract and thus must be interpreted consistently with the underlying contract. The surety bond operates like a guaranty where a guarantor's obligation is secondary. This means that the surety's obligation does not mature until the principal obligor defaults on the underlying contract. In contrast, the obligation of an issuer in a letter of credit transaction is primary.

An obligee may see surety bonds as less desirable because they are not demand instruments like letters of credit. They involve a "claim adjustment process" in which the surety investigates the underlying default. This slows down the reimbursement process. Sureties will deny claims they believe are without merit.

At the same time, surety bonds, like other financial guarantees, are attractive to principals because they do not appear on a corporation's balance sheet and their use does not diminish a company's line of credit. In addition, surety bonds are generally cheaper to procure and maintain and may not require posting of collateral to the surety by the principal obligor.

> Surety bonds are attractive to principals because they do not appear on a corporation's balance sheet and their use does not diminish a company's credit.

Making Sureties Work Like LCs

As in the case of the Chase-Enron transactions, many obligees may be pressured to accept a surety bond over a letter of credit in order to facilitate a particular transaction.

One way to minimize the disadvantages of surety bonds as security instruments is to draft the terms of the surety bond so that they provide protections to the beneficiary that are similar to those contained in a letter of credit. Since a traditional surety bond is subject to the surety's defense that no default of the underlying agreement has occurred, the obligee could change the payment trigger on the bond from one relating to the occurrence of an event of default to simply one triggered by the due presentation of a proper notice of default, notice of payment or other agreed-upon documentation.

Further, because the surety enjoys many of the same defenses that are available to a principal, the obligee should negotiate for language in the surety bond that waives the surety's ability to assert these defenses. This was done in the Enron case; however, it remains to be seen whether such waivers are enforceable against the surety. Because of the press coverage surrounding the Enron case, the uncertainty of payment under surety bonds, and the increasing premiums charged by surety companies throughout the industry, many bankers believe that many companies will no longer explore surety bonds as acceptable credit security in their commercial transactions.

One footnote to the waivers of defenses by the insurance companies in the Enron case: the insurance companies have claimed fraud as a defense to their performance under the surety bonds. Presumably, even if the Enron credit security in the transactions consisted of letters of credit instead of surety bonds, the letter of credit issuers would still retain and raise fraud as a defense to payment as a legal and public policy matter.

Transactions Governed by English Law

The use of standby letters of credit as security in English law transactions, now widely established, was originally imported from the United States where banks are prohibited from issuing guarantees. In the United Kingdom, where no such prohibition applies, the growth in international trade saw the development of a hybrid instrument known as the on-demand bank guarantee or bond. These guarantees operate like standby letters of credit by creating an autonomous payment obligation (essentially in the nature of a standby letter of credit) rather than a guarantee of a third party's performance.

Under a classic (as opposed to an on-demand) guarantee, the guarantor guarantees the performance of another party under an underlying contract and is a secondary obligor that has available to it all the defenses available to the primary obligor. In addition, the "classic guarantor" can often rely on modifications to the underlying agreement, after the issuance of the guarantee to refuse payment, on the basis that the risk it initially agreed to take has now changed. Also, the guarantor may require that the primary obligor's default be proven by the guaranteed party.

An on-demand guarantee or bond is one that is autonomous and payable on demand upon presentation of specific documents. It must state that the bank's undertaking to pay is irrevocable, unconditional and is a primary obligation. The bank must expressly waive all defenses related to the transaction in connection with which the bond is given or against the party against whose default the bond is meant to offer protection. English law mandates that a guaranty that contains such a waiver should be treated like a standby letter of credit.

Therefore, the risk for the bank is very similar whether it is issuing a standby letter of credit or an on-demand bond or guarantee. Accordingly, the security or indemnity that it will demand and the price that it will charge are likely to be the same.

An informal poll of London bankers indicates their perception is that a bank's reputation would suffer the same amount of damage from a refusal to pay under a letter of credit as it would from a refusal to honor an on-demand guarantee, although some feel that the damage would be marginally worse in the case of a letter of credit.

In view of the apparent near equivalence of the two instruments, what determines the choice of one instrument over the other in an English law transaction?

The two main factors seem to be geography and custom. The fact that American banks may only issue letters of credit seems to have led to their dominance in international transactions (including those governed by English law) as the "lowest international common denominator." Standby letters of credit are also more widely used in connection with long-term contracts (such as project finance loans) and projects involving multilateral agencies. They are also found in oil and gas projects in the Middle East. On the other hand, most British domestic infrastructure projects involve on-demand bonds, as do some construction contracts.

Another reason to choose a standby letter of credit over an on-demand guarantee is to avoid concerns regarding the robustness and comprehensiveness of the provisions of the guarantee that purport to transform it from a classic guarantee into an on-demand one. English courts have made it clear that such provisions are valid and enforceable, but they need to be very clear and explicit.

As in the United States, surety bonds under English law are by nature guarantees. Accordingly, the defenses available to a "classic" guarantor would apply but could be waived by the surety. In theory, a surety bond could be drafted as an on-demand guarantee and operate as such. However, in practice, surety bonds (at least on smaller transactions) are less negotiated and look more like classic guarantees than on-demand bonds. The reason for this is that they are issued by insurers and surety companies.

Therein lies the real difference between surety bonds and on-demand bank guarantees or standby letters of credit. A bank, when issuing a letter of credit or an on-demand guarantee, will usually require an indemnity or some form of security (sometimes even a cash deposit) and assume that if called upon, it will make the payment. An insurance company assesses the risk, underwrites the obligation and sets a premium as part of the management of its risk portfolio. It bets against a payment event ever occurring. This explains why an insurance company is less likely than a bank to accept issuing pure on-demand bonds and is more likely to use defenses available to it to avoid paying. The advantage of surety bonds over bank instruments is that they tend to be cheaper, although that is not necessarily the case depending on the terms of the bond and the state of the insurance market. Indeed, after the difficulties recently encountered by the insurance markets and the Enron debacle, some London bankers expect the demand for letters of credit and on-demand bank bonds to increase at the detriment of surety bonds.

Environmental Update

New Source Review

The US Environmental Protection Agency released long-awaited plans to reform the new source review, or "NSR," air permitting program in mid-June.

The NSR permitting program governs air permits for prevention of significant deterioration, or "PSD." Such permits are required for all new and modified plants that are major emitters.

The NSR permitting program has been criticized for making it too costly to build new power plants. The US government has been considering whether to change the program for the past 10 years.

States are being forced to rely on litigation and state-by-state regulations in the absence of a national approach to controlling greenhouse gases.

EPA said in a report to the president that accompanied the new proposals that it does not believe the NSR program significantly impedes investment in new facilities. However, it concedes that the program has been an impediment to upgrading existing plants.

EPA proposed five major reforms. Four of the reforms are not new; the Clinton administration proposed the same reforms in 1996. EPA is planning to finalize these four NSR reforms later this year in a final rule without further public notice and comment.

The first reform is to establish plantwide applicability limits, or "PALs." This means that a source would be able to make changes to its plant without obtaining a major source NSR permit, provided that the emissions do not exceed the plant-wide cap. A PAL would generally be effective for 10 years.

The second reform would allow plants that have recently installed state-of-the-art emission controls on new or modified emission units as part of an NSR permitting review to make certain future changes without trigging additional NSR permitting for approximately 10 to 15 years.

Under the third proposal, EPA's rule for calculating emission increases for power plants that have already begun normal operations — it compares past actual emissions to future actual emissions — would be expanded to other industries, including plants with industrial boilers. Currently, EPA arrives at this "emission increases" calculation for industrial boilers and non-utility plants by comparing past actual emissions to a plant's potential future emissions.

Fourth, EPA will put into law its policy of excluding pollution control and prevention projects from NSR permitting review where the projects have a net beneficial impact on the environment. EPA will provide a presumptive list of technologies that will automatically qualify for the exclusion.

The fifth — and only new — reform would clarify the agency's definition of "routine maintenance, repair and replacement." This is important because performing routine maintenance, repair or replacement at a facility does not trigger NSR permitting requirements. Under the new proposal, EPA will develop a cost-based "safe harbor" test. Projects below the cost threshold would automatically be treated as routine. EPA will also propose a list of activities that will normally qualify as routine maintenance, repair and replacement and, therefore, not trigger NSR permitting.

EPA must give notice and gather comments from the public on the fifth proposal, as well as some more minor provisions of its NSR reform package, before it can implement the changes.

The EPA proposals have already come under heavy fire from Democrats in Congress and environmental groups.

Once finalized, the reforms are expected to be challenged in court by several northeast states and various environmental groups. Both the New York and Vermont attorneys general testified in opposition to the reforms at a July 16 Senate committee hearing.

Multi-Pollutant Legislation

The Senate environment committee voted 10-9 in a contentious committee meeting on June 27 to send the "Clean Power Act of 2002" to the full Senate.

The bill calls for deep cuts in emissions of nitrogen oxides, or NO_X, sulfur dioxide, or SO_2, mercury, and carbon dioxide, or CO_2, from power plants. The committee vote was largely along party lines. One Republican — Senator Lincoln Chafee (R.-Rhode Island) joined the Democrats in supporting the measure. One Democrat — Senator Max Baucus (D.-Montana) — opposed it.

The bill imposes a tight implementation timetable and sets a stringent annual emissions cap starting in 2008 of 2.25 million tons for SO_2, 1.51 million tons for NO_X, 2.05 billion tons for CO_2, and five tons for mercury. These would be the annual limits for the entire country.

Under the bill, EPA is obligated to issue by 2008 regulations that implement the emissions caps. Absent regulations, each power plant will have to achieve the following performance standards in relation to an uncontrolled source: a 95% reduction in SO_2, an 85% reduction in NO_X, a 25% reduction in CO_2, and a 90% reduction in mercury. The implementation timeframe and the emission reduction targets are generally more restrictive than the "clear skies initiative" unveiled by the Bush administration in February.

The bill would create a market in emission allowances for each of the pollutants, except for mercury. The measure also includes a fairly dramatic departure from previous federal emission trading programs in that it directs EPA to distribute the majority of allowances (approximately 64%) to households and consumers. Twenty percent of the allowances would be allocated to electricity generators who use renewable energy sources such as wind, biomass, landfill gas, solar and geothermal. Only 10% of the allowances would be allocated to existing power plants.

The full Senate is not expected to vote on the bill. The committee voted it out largely to give Democrats a campaign issue in their efforts this fall to take back control of Congress. However, even though the opportunity for meaningful progress on multi-pollutant legislation this year has been lost, it will remain a significant issue in Congress next year.

State Actions

Attorneys general from 11 states sent a letter recently to President Bush urging national mandatory cuts in greenhouse gases. The letter highlights the recent efforts by individual states to curtail greenhouse gas emissions and advocates the adoption of a national emissions cap that would include implementation of a market-based trading system.

Attorneys general from the following states signed the letter: Connecticut, Massachusetts, Rhode Island, Maine, New Hampshire, Vermont, New York, New Jersey, Maryland, Alaska and California. The letter notes that states are being forced to rely on litigation and state-by-state regulations in the absence of a national approach to controlling greenhouse gases.

Many states are taking independent action to control pollutants from power plants without waiting for the federal government to act. The New Hampshire governor signed a measure into law earlier this year that requires the state's largest utility — the Public Service Company of New Hampshire — to reduce NO_X, SO_2, mercury, and CO_2 emissions from three of its plants built before 1977. Under the new law, CO_2 must be reduced by 2010 to the level at which it stood in 1990. Massachusetts adopted new regulations last year requiring NO_X, SO_2, and CO_2 emission reductions from the six oldest power plants in the state. Oregon has given its Energy Facility Siting Council the authority to set CO_2 emission standards for new power plants.

If more states enact programs to regulate greenhouse gas emissions, private industry may ultimately demand that the federal government step in and impose uniform rules.

Kyoto Protocol

Seventy-five countries had ratified the Kyoto protocol by late July as the *NewsWire* was going to press, including all 15 European Union member countries and Japan.

The protocol will enter into effect after it is ratified by 55 or more countries that represented at least 55% of the CO_2 emissions from industrialized nations in 1990. The countries that have signed to date represented approximately 36% of the world's 1990 CO_2 emissions.

The United States — which was responsible for 36.1% of world's CO_2 emissions in 1990 — and Australia (2.1%) have rejected the protocol. Implementation of the treaty hinges on Russia's approval. If Russia (17.4%) ratifies the treaty, only another 1.6% is needed to meet the 55% test, and either Poland (3.0%) or Canada (3.3%) are possible candidates to adopt the protocol and trigger its implementation. */ continued page 44*

Environmental Update

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Canada is continuing to press for acceptance of its request for a "clean energy export credit" that would reward Canada for its exports of natural gas and hydroelectric power to the US. The EU countries are strongly opposed to the Canadian proposal, which would credit Canada with almost one third of its Kyoto protocol reduction targets. If the EU agrees to the Canadian proposal, it may set a precedent that other industrialized nations may try to exploit.

Russia is expected to be a net supplier of greenhouse gas emission reductions to EU countries under the protocol since many Russian industrial plants have shut down since 1990. Russia is still negotiating with EU countries and Japan for a forgiveness of some of its foreign debts in exchange for ratifying the treaty. Nevertheless, it is expected to ratify the protocol either later this year or early next year.

Brief Updates

A US appeals court recently ordered the parties in *Tennessee Valley Authority v. EPA* to participate in a series of mediation sessions. TVA is challenging EPA's assertion that it made significant modifications to its plants without the requisite NSR permits. The central issue is EPA's interpretation of what activities qualify as "routine maintenance, repair and replacement" under the NSR permitting program. The judge's order to the parties to settle their differences through a mediator was surprising in a key Clean Air Act enforcement case. The judge may have felt that release of the reforms EPA is proposing to the NSR permit program created room for a settlement. Oral arguments in the case were presented on May 21, 2002.

The North Carolina government signed a new law in June — called the "clean smokestacks" law — that would significantly cut NO_X and SO_2 from the state's 14 coal-fired power plants. The law will reduce NO_X emissions from 245,000 tons in 1998 to 56,000 tons by 2009 (a 78% reduction) and SO_2 emissions from 489,000 tons in 1998 to 250,000 tons by 2009 and 130,000 tons by 2013 (a 74% reduction). The measure also requires the state division of air quality to study potential reductions of mercury and CO_2.

EPA Region XIII recently issued notices of violation to three power plants alleging a failure to undergo NSR air permitting reviews for equipment replacements and upgrades at the plants. All three plants increased their air emissions. The notices of violations assert that two of Xcel Energy's coal-fired stations in Colorado and the Minnkota Power Cooperative coal-fired plant in North Dakota failed to obtain air permits authorizing the modifications.

Finally, the federal Office of Management and Budget has rejected portions of EPA's proposed rule requiring certain existing power plants to upgrade cooling water intake structures. The budget office concluded that parts of the rule would impose burdensome paperwork requirements on utilities. EPA will have to reevaluate certain permit application requirements in the proposed rule and resubmit it to the budget office for further review.

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