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PROJECT FINANCE
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A Larger Carrot

by Keith Martin, in Washington

Windpower companies, owners of plants for making synthetic fuel from coal, and companies that use lease financing for their projects breathed more easily after reading the fine print in the huge new tax-cut measure that the US Congress enacted in late May.

Others in the project finance community found a few items in the final bill that may affect them.

Congress cut taxes by $350 billion over the next 10 years. President Bush has made the tax cuts the centerpiece of his effort to revive the US economy. The tax cuts barely passed Congress, where they came under heavy criticism for accounting gimmicky that made it look like the tax cuts are smaller than almost everyone expects them to be in fact. A sizable majority in Congress is uneasy about projections that show the federal government running record budget deficits every year into the foreseeable future.

There are four provisions in the final tax-cut measure that affect the project finance community.

First, Congress increased from 30% to 50% an existing "depreciation bonus" in the hope that a larger carrot would induce companies to build more new plant and equipment between now and 2005. Only projects in the United States and in US possessions, like Puerto Rico and the US Virgin Islands, qualify. A 50% bonus would reduce the capital cost of infrastructure projects by as much as 9%. / continued page 2

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WIND DEVELOPERS received good news from the IRS.

Wind farms in the United States qualify potentially for a "production tax credit" of 1.8¢ a kilowatt hour on their electricity output. The credits can be claimed on the electricity generated at a project for 10 years after the project is put into service. However, the amount of the tax credit is reduced to the extent the project benefits from any government grants, subsidized energy financing, or other tax credits.

The Internal Revenue Service ruled privately that a wind farm that received three kinds of government help does not have to reduce the amount of its tax credits. The IRS made the ruling / continued page 3

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Second, Congress decided to tax dividend income at only a 15% rate. (This compares to the top rate of 38.6% on most other income.) The change applies only to dividends received by individuals and not by corporations.

President Bush had proposed a much more complicated plan that would have eliminated taxes altogether on dividends, but only on dividends that are paid out of corporate earnings on which the corporation has already paid taxes. The Bush plan would have reduced the value of tax credits that the US government offers as an incentive to build windpower, geothermal, landfill gas, synfuel and other alternative energy projects. That's because it was at heart a plan to tax corporate earnings once — either at the corporate level or the shareholder level. If the United States is going to have just one tax on corporate earnings, then the tax credits must work against that one tax to be effective. They would not have. The final bill jettisoned this aspect of the Bush plan — to the relief of alternative energy companies.

Third, the final tax bill reduced the maximum tax rate for individuals on their long-term capital gains to 15%. The top rate had been 20%. Long-term capital gains are gains from the sale of assets that an individual has held for more than a year. Corporations will not benefit from the change. Their capital gains are still taxed like their other income (at a 35% rate).

Finally, the tax-cut bill lets any corporation that has an estimated tax payment due to the US government on September 15 this year delay 25% of the tax payment until October 1.

Depreciation Bonus

The increase in the "depreciation bonus" from 30% to 50% is a significant benefit, but probably more for windpower companies than developers of other power plants, unless a future Congress extends the deadline for completing projects to qualify for the bonus.

The existing bonus applies to new investments during a window period that runs from September 11, 2001 through 2004 or 2005, depending on the investment. It only applies to new projects. However, improvements to existing facilities also qualify. Construction of the project or improvement cannot have started before September 11, 2001. The project or improvement must be completed by the end of the window period to qualify.

The United States is letting companies write off 30% to 50% of the cost of new plant and equipment immediately — but only for a limited time — in the hope that this will stimulate the economy.

The bonus was 30%. It has now been increased to 50%, but only for projects or improvements on which construction work started after May 5, 2003. Projects on which work started earlier will still qualify for the 30% bonus.

The depreciation bonus is an acceleration of tax depreciation to which the owner of a project would have been entitled anyway.

The owner gets a much larger depreciation deduction the first year and smaller ones later. His depreciation allowance in the year the project is put into service — assuming a 30% bonus — is a) 30% of his "tax basis" in the project (basically the cost of the project) plus b) depreciation for the year calculated in the regular manner on the remaining 70% of basis. For example, without the bonus, the first-year depreciation deduction on a coal-fired power plant that cost $100 million to build is $3.75 million. With a 30% bonus, it is $32.625 million. Depreciation in later years is reduced commensurately, since only $100 million in depreciation can be claimed in total.

The faster write-off can be a significant benefit. The benefit is greater the longer the normal depreciation period for an asset. A 50% depreciation bonus will reduce the cost of assets that are depreciated over 20 years — for example, transmission lines and coal- and combined-cycle gas-fired power plants — by 8.98%. It will reduce the cost of gas pipelines and other gas-fired power plants that are depreciated over 15 years by 7.54%. The cost of a power plant that burns waste would be reduced by 3.61%. Wind farms and biomass projects would cost 2.61% less. These calculations only take into account *federal* tax savings from the depreciation bonus — not also the state tax savings — and they use a 10% discount rate. (At last count, 25 states have "decoupled" from the depreciation bonus — they do not allow it to be claimed against state income taxes — and another six allow only a partial or delayed bonus.)

Most alternative fuel projects must be placed in service by December 2004 to qualify for a bonus. Most gas- and coal-fired power plants, gas pipelines and transmission lines have until December 2005. The tax-cut bill did not extend these deadlines.

However, Congress did provide a small additional benefit for anyone claiming a bonus. The rule had been that the bonus can only by claimed on spending on a project through September 11, 2004. That's true even though the deadline for completing the project to qualify for a bonus is much later. The tax-cut bill allows the bonus to be claimed on spending through December 2004 — or roughly another four months of spending.

The House and Senate negotiators of the final tax-cut bill stuck an unwelcome comment in the "statement of the managers" that they issued with the final bill.

Power companies building gas-fired power plants had worried about whether they would be viewed as having started construction on projects for which they signed contracts to buy turbines before September 11, 2001. The Joint Tax Committee staff made clear in a "blue book" in January 2003 that this is not a problem. The "blue book" said the fact that contracts were signed to buy components for a project before September 11, 2001 does not taint the project. However, the "blue book" was silent about whether the turbine itself qualifies for a bonus. The staff of the tax-writing committees could not agree last January, so they left the issue for the IRS to decide.

The "statement of the managers" says the turbine will *not* qualify for the 50% bonus. It says "no inference is intended" as to what the rule should have been earlier.

Dividends

Congress reduced the tax rate on dividends to 15% for individuals in the top tax bracket, but the provision is complicated.

Dividends will be rolled into the calculation of long-term capital gains and netted against capital losses before applying the 15% rate. Under current law, an / continued page 4

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public in May.

A state agency made a lump-sum payment to the project to help cover its operating costs. The project will have to repay any money that it fails to spend on operating costs within a certain time period. Otherwise, the money is "earned" by the project as it generates electricity. The IRS said this is not a government "grant" because a grant exists only if there is no circumstance where the project might have to repay the money.

The project also benefits from a government loan guarantee. Another state agency guaranteed the bank that lent money to finance the project that it will step in and repay a certain number of months of debt service on the loan if the project fails to pay. The IRS said this is not a "grant" or "subsidized energy financing." "Subsidized energy financing" is a program aimed specifically at projects that conserve or produce energy. Presumably, the loan guarantee program from which the wind project benefits in this case has a broader focus.

Finally, the project has also applied to the state to designate the site where the project is located as an enterprise zone. This will mean the project will not have to pay sales or use taxes on the turbines and other equipment. The IRS said such a tax exemption will not require a haircut in the federal production tax credit.

The ruling is also interesting because the wind farm leases the site where the project is located under a lease that requires the project to pay the site lessor the greater of three amounts. They are a fixed rent, or an amount that is essentially a percentage of the production tax credits, or a percentage of gross receipts from wind sales. The IRS ruled that this arrangement does not require sharing any of the production tax credits with the site lessor. Such tax credits must be shared among all / continued page 5

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individual with capital gains must attach an additional schedule to his tax return. First he calculates his long-term capital gains that qualify for a reduced tax rate. Then he must subtract from the long-term gain his long-term capital losses and net short-term capital losses before applying the special rate. Dividends will be folded into the long-term capital gains that get reduced by capital losses.

The 15% rate applies only to dividends received by individuals — not by corporations.

It is retroactive: it applies to dividends received in tax years that started after 2002. It will disappear — or "sunset" — at the end of 2008.

It only applies to dividends received from domestic corporations and some foreign corporations.

Dividends from a foreign corporation qualify only in three circumstances. They qualify if the foreign corporation is incorporated in a US possession, like Puerto Rico or the US Virgin Islands. They qualify if the dividend is paid on shares of a foreign corporation that are "readily tradable on an established securities market in the United States." An example is dividends paid on American depository receipts, or "ADRs," that are traded on a US stock exchange.

Dividends paid by a foreign corporation also qualify if the foreign corporation is entitled to benefits under a "comprehensive" tax treaty between its country of residence and the United States, but only if the treaty has provisions requiring the sharing of information between tax authorities in the two countries. The foreign corporation must also be entitled to the treaty benefits on "substantially all" of its income in its tax year in which the dividend is paid. The IRS is supposed to issue regulations listing the foreign countries from whose companies it thinks it makes sense to let dividends qualify for the lower tax rate. In the meantime until the regulations are issued, Congress said taxpayers can assume any tax treaty with exchange-of-information provisions qualifies, except for the US treaty with Barbados.

Certain types of foreign corporations are ineligible. An example is any foreign corporation that the US tax laws label a PFIC — or "passive foreign investment company." This is a foreign corporation that earns a large amount of dividends, interest or other "passive" income or a sizable percentage of whose assets are the kinds of assets that generate such income. Foreign corporations are ordinarily not PFICs if a majority of the shares are owned by US shareholders.

The individual receiving the dividend must have held the shares for more than 60 days to qualify for the lower rate. Preferred shares — at least ones with a preference on dividends — must have been held for more than 90 days. The holding period is cut short if the individual takes steps to shed the shares or substantially identical shares by granting an option to someone to buy them or if he has an option himself to "put" the shares to someone else. The holding period is also cut short if he hedges his exposure to the shares so that he has a "diminished risk of loss."

"Dividend" is defined as it has been historically. It is a distribution to a shareholder out of a corporation's "earnings and profits." Dividends will qualify for the 15% tax rate even though they are paid out of undistributed earnings that a corporation accumulated in the distant past.

The Bush administration is hoping that the reduction in tax rates on both dividends and long-term capital gains will lead to a quick increase in stock prices, thereby giving a psychological boost to the US economy. The lower tax rates could make raising equity a little less expensive (since the shareholders can expect a higher after-tax return from investing). The cost of borrowing could become a little more expensive if the lower tax rates cause investors to shift capital away from debt and into shares. Municipalities worry that the tax cut for dividends will make it more expensive to borrow in the tax-exempt bond market to pay for schools, roads, hospitals and other public projects since some investors may shift their funds out of tax-exempt bonds and into shares.

Preferred stock should become more popular. One can expect to see more shares in the future that pay close to a fixed return like a debt instrument. The dividing line between preferred shares and debt is already fuzzy. However, with interest that individuals receive taxed at a 38.6% rate and dividends taxed only at a 15% rate, there could be more interest in structuring what are essentially debt offerings to look more like preferred shares. (Each company will have to consider the tradeoff. Earnings paid out as dividends on shares are not deductible by the corporation; only interest is.)

Most independent power companies lack cash to pay dividends — even if they are considered for tax purposes to have earnings out of which dividends could be paid in theory.

This could strengthen regulated utility stocks — which traditionally pay large dividends — in relation to independent power company shares.

The 15% tax rate for dividends is temporary. If 2008 approaches with no extension in sight, then companies will have to consider whether to borrow to flush out earnings while their shareholders can still qualify for the 15% tax rate.

Capital Gains

Congress also cut the tax rate for long-term capital gains to 15%. "Long term" means gains on investments held for more than one year.

This was not part of the original Bush plan. It should ease the pressure on companies to distribute more earnings as dividends. A shareholder should be indifferent whether he receives his return in the form of a dividend or as gain from the sale of his shares, since the 15% rate applies to both types of returns.

The 15% rate only applies to long-term capital gains received by individuals — not corporations.

It only applies to sales of property in tax years starting after May 5, 2003. Most individuals pay taxes on a calendar-year basis. There are transition rules in the tax-cut bill for calendar year 2003 that work out *generally* so that gains on sales of property after May 5, 2003 qualify for the lower rates, but the rules are complicated and will require a longer tax return schedule for calculating capital gains.

The rate reduction is temporary. The rate will revert to 20% after 2008.

Installment payments received after May 5, 2003 qualify for the 15% rate, even though the property was sold earlier. Individuals selling property and who expect to be paid in installments by the buyer would be wise to require that all the installments be paid by December 2008 when the lower tax rate expires.

Estimated Taxes

Most US corporations pay their income taxes in four installments during the tax year. The final tax-cut measure includes the following sentence: "Notwithstanding [what the US tax code requires currently], 25 percent of the amount of any required installment of corporate estimated tax which is otherwise due in September 2003 shall not be due until October 1, 2003." The effect is to let companies that pay taxes on a calendar-year basis keep a little cash */ continued page 6*

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persons with an ownership interest in the project in the same ratio that they share in gross receipts from electricity sales. In this case, the IRS concluded that the site lessor has no ownership interest in the wind farm.

In related news, the IRS said in April that the production tax credit will remain at 1.8¢ a kilowatt hour for electricity generated during 2003. The amount of the tax credit is adjusted each year for inflation. The IRS announces the inflation adjustment for each year in April.

The agency also said that the average contract price at which wind electricity was sold last year in the United States was 4.85¢ a kilowatt hour. This figure only takes into account sales under contracts signed in 1990 or later.

DEPRECIATION BONUS regulations are expected by September 9.

The United States is letting companies write off 30% to 50% of the cost of new plant and equipment immediately — but only for a limited time — in the hope that this will stimulate the economy. It is sometimes difficult to tell whether a bonus can be claimed on power projects that were under development before September 11, 2001 — the start of the period during which the bonus is supposed to encourage new investment. The Internal Revenue Service is at work on regulations to answer some of these questions.

The IRS will be barred by law from applying the regulations retroactively unless they are issued within 18 months after the depreciation bonus was enacted. That gives the agency until September 9 to act.

Draft regulations are circulating internally with the IRS and US Treasury Department for comment. The power industry met in mid-May with Treasury officials to talk through six issues that the industry has with the bonus. */ continued page 7*

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for two weeks. Congress expects that this will delay $6.3 billion in estimated tax payments.

Other Issues

Windpower companies, owners of plants for making synthetic fuel from coal, and companies that use lease financing for their projects breathed more easily after reading the fine print in the final tax-cut bill.

A 50% writeoff — called a "depreciation bonus" — will reduce the capital cost of infrastructure projects by as much as 9%.

Windpower companies and owners of synfuel plants were relieved that the final dividend provision did not undermine existing tax credits for generating electricity from wind or producing synthetic fuel from coal.

The leasing industry had worried about two provisions in the Senate version of the tax-cut bill. Both were dropped from the final measure. One would have had the tendency to require future lease transactions to conform to the IRS "true lease guidelines." Few transactions today conform. For example, the guidelines bar the lessee from having an option to buy the leased property for a fixed price that is set in advance. The other provision would have put an end to cross-border "service contract leases" by requiring that the service contract be counted as part of the lease term. This would have undermined the economics of such transactions.

Earlier this year, the Senate Finance Committee held hearings and published a voluminous report on the various things Enron did to reduce its taxes. The tax-cut bill that passed the Senate would have put a halt to many of these transactions. However, the Senate language was dropped from the final bill. Senators worried that by putting out a laundry list of what Enron did, they would encourage others to do the same unless Congress took quick action to shut down the transactions on the list. House Republicans and the Bush administration refused to go along.

The House also rejected Senate efforts to require that transactions have "economic substance" in the future before the government will recognize the tax consequences.

Meanwhile, the House had wanted to give corporations the ability to use any net operating losses in 2003, 2004 or 2005 to get refund checks from the US Treasury for taxes they paid as far back as five years in the past. Such losses can be carried back only two years currently. This did not make it into the final bill.

Microsoft and other high-technology companies pushed hard for a provision that would have let US companies bring home earnings that are parked currently in offshore holding companies and pay only a 5.25% income tax. The special rate would have applied only for a year. The proposal passed the Senate, but failed to make it into the final bill.

Finally, the Senate had voted to extend the deadline by one year for building wind farms and power plants that use poultry litter or "closed-loop biomass" to generate electricity in order to qualify for a tax credit of 1.8¢ a kWh on electricity output. The current deadline for these projects is the end of this year. The Senate bill would have extended the deadline through December 2004. The extension did not make it into the final bill. However, a longer extension — through December 2006 — is part of a separate energy bill that passed the House in April and is scheduled for debate in the Senate in June.

House Republicans are already talking about another tax-cut bill this year. In particular, the European Union has imposed a January deadline on Congress to act to replace a tax break for US exporters — called "foreign sales corporations" or "FSCs" — that the World Trade Organization declared is prohibited. January is when the European Union has threatened to slap retaliatory duties on US products. Some provisions that did not make it into the final tax-cut bill in May remain possible candidates for the FSC bill.

However, there is a very good chance that partisan bickering will block any further action on taxes this year. The tax-cut measure that passed in May only passed because it was brought up as part of the annual budget process and, therefore, could pass the Senate with only 50 votes (plus the vote of the vice president to break the tie). Any other tax bills this year will require 60 votes in the Senate, a seemingly impossible hurdle. ◎

Congress Moves To Modify PURPA

by Lynn Hargis, in Washington

Congress is expected to make significant changes in the Public Utility Regulatory Policies Act — called "PURPA" — this fall.

The changes should not affect power projects with existing contracts to supply electricity to regulated utilities, but they could affect projects whose power purchase agreements are amended in the future. The changes could also affect the resale market for distressed power plants.

PURPA is a 1978 law that created the independent power industry in the United States by requiring regulated electric utilities to buy electricity from two types of power plants. In so doing, it assured entrepreneurs who wanted to build power plants that they would have a purchaser for the output from their projects. The two types of power plants that are favored under PURPA are "qualifying cogeneration facilities," or power plants that produce two useful forms of energy from a single fuel, and smaller power plants that use renewable fuels. An example of a cogeneration facility is a power plant that burns coal under a boiler to make steam. The steam is used to run a steam turbine to generate electricity for sale and then reused to heat an adjacent factory.

Utilities are required to buy the output from such power plants — called "QFs" for qualifying facilities — at the avoided cost the utility would have to pay to generate or purchase the electricity itself.

Congress is expected to make two main changes in PURPA this fall.

First, it is expected to repeal the obligation that PURPA imposes on utilities to buy output from QF power plants, but the repeal would require future action by the Federal Energy Regulatory Commission before it takes effect. Second, Congress is expected to let */ continued page 8*

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TRANSMISSION CREDIT rulings have temporarily stalled.

Independent generators pay the cost to connect their power plants to the transmission grid. The cost can include not only the cost of radial lines and substation improvements, but also improvements to the grid itself so that it can accommodate another power plant. Grid improvement are called "network upgrades."

The Federal Energy Regulatory Commission is of the view that utilities that own the grid should collect the cost of network upgrades from all users of the grid through the rates they charge customers for transmitting electricity. Utilities have a timing problem. They need to make the improvements when the independent power plant connects to the grid. That's before the cost of the improvements can be collected through rates. Therefore, utilities ask owners of independent power plants to advance the funds to cover the cost of the network upgrades, but must eventually pay back the money. Utilities do this by giving the power plant owner "transmission credits" that he can work off against future charges for wheeling his electricity or receive the cash equivalent.

These arrangements are in substance a loan by the independent generator to the utility. Therefore, the utility should not have to report the advance as taxable income.

The IRS issued one private letter ruling in late February confirming this, but on a fairly simple fact pattern. It has struggled with the more complicated Entergy transmission credit program, but had been expected to rule favorably on it. IRS officials still believe advances to Entergy are loans, but they are now debating whether to issue a set of general guidelines to utilities rather than issue any more private letter rulings.

In the meantime, the queue of ruling requests is growing. */ continued page 9*

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regulated utilities own 100% of QFs. Regulated electric utilities are limited today to owning no more than 50% of a QF. Utility ownership was restricted in the past because Congress feared that utilities would engage in self-dealing. Repeal of the 50% limit on utility ownership would create an additional class of potential buyers for the QF projects that are currently on the market.

The changes are expected to be included in a national energy bill that is now working its way through Congress. The House passed the energy bill with such PURPA revision provisions in April. The Senate is expected to do the same in June. The revision provisions in these bills are complicated, and there are differences between the two houses that will have to be worked out in a "conference committee." The effort to reconcile the two repeal provisions, as well as other differences between the House and Senate bills, is expected to take until the fall.

Background

PURPA led to the creation of independent power companies in the United States. Once such a company signed a long-term contract to sell electricity to a utility at fixed rates, it could then finance its power plant. A bank would be prepared to lend against the expected revenue stream from electricity sales.

However, the fact that utilities had to buy from QF power plants was not the only benefit from PURPA. Another hugely important benefit was that the statute exempted QF power plants from most federal and state utility regulation. In particular, QFs are exempted from the Public Utility Holding Company Act, or "PUHCA," and, as a consequence, companies owning QFs can have power plants all over the country without regard to the geographical limitations on utility systems and their owners imposed by PUHCA.

The unexpected success of QFs led regulated utilities to complain to Congress about the 50% ownership restriction for utilities. As a consequence, in 1992, Congress created another type of independent power plant — called an "exempt wholesale generator," or "EWG" — that utilities could own without any percentage limit on ownership. At about the same time, the Federal Energy Regulatory Commission, which has jurisdiction over the rates at which electricity can be sold at wholesale across state lines within the United States, started allowing anyone proposing to sell electricity in the interstate wholesale electricity market to do so at whatever rate he can negotiate with the purchaser. Most EWGs have orders allowing the electricity from their power plants to be sold at such market-based rates. This made QFs less important: the practical result has been that virtually all new independent power plants built in the US since 1992 have been EWGs. EWGs enjoy the same exemption as QFs from regulation under PUHCA. Also since 1992, a number of states have allowed existing plants owned by regulated utilities that are part of their rate bases to become EWGs, which has led to significant erosion in state control over electricity generation, as California learned to its dismay when it tried to regain control over its dysfunctional market in 2001. Since state commissions are required by the supremacy clause of the US constitution to allow their local utilities to pass through FERC-approved wholesale prices in retail rates with only minor and difficult-to-prove exceptions, states lost significant control over electric generation starting in 1992.

Because QFs can only charge "avoided costs," which are at very low levels in many parts of the county, few QFs have been built since the mid-1990's.

Effects of PURPA Revisions

The proposed revisions to PURPA raise obvious questions about how existing QF projects will be affected. Many such projects still have contracts to supply electricity to utilities. The proposals also raise questions about the future makeup of the independent power industry.

Both the House and Senate bills would remove the current 50% limit on utility ownership of QF power plants, thereby opening up opportunities for utilities or their subsidiaries to own and control such power plants. This will also make it easier for private equity funds and other investor groups that may have utilities as part of their membership to own qualifying facilities without having to worry about exceeding the 50% limit if their membership changes.

Care should be taken to ensure that an existing power purchase agreement with an electric utility does not, by its terms, prevent ownership by a utility or create a default if utility ownership exceeds 50%. Many existing QF contracts with utilities contain such default or restrictive provisions.

It might make sense to amend some of these contracts in light of the changed statutory requirements.

There will still be QFs. Utilities would not be required to buy the output from such plants, but the label will still confer a benefit in terms of avoiding utility regulation. The advantage that QFs have over EWGs is they are not subject even to modest regulation under the Federal Power Act. This can be important in today's market where many power plants are up for sale. Section 203 of the Federal Power Act requires approval from the Federal Energy Regulatory Commission of mergers or "changes in control," including upstream changes in control, over companies that own power plants, including EWGs — but *not* QFs.

Thus, financial institutions that are pondering whether to take active ownership of power plants whose owners have defaulted on loans, and private equity funds that are in the market to buy generating plants, and that in either case do not want to subject their parent companies to any form of utility regulation, however "lightened," may prefer owning QFs to owning EWGs since EWGs are "public utilities" for purpose of regulation under the Federal Power Act. With QFs, such financial or other companies will not have to fear that their parent companies may require FERC approval before merging or selling their own assets if FERC finds such transactions to constitute a "change in control" of the downstream EWG.

Both the House and Senate bills would repeal the obligation by utilities to buy output from QF power plants. In the Senate bill, the obligation would disappear once the Federal Energy Regulatory Commission finds that QFs have access to "an independently administered, auction-based day ahead and real time wholesale market for the sale of electric energy." The determination would be made on a regional basis. Thus, FERC might find there is a well-developed enough wholesale market to drop the purchase obligation in one part of the country but not in another.

The Senate is focusing on the wrong thing, since an independent power company probably cannot finance the construction of a power plant on the basis of energy costs alone, not to mention changing energy costs, but must have a long-term contract that includes capacity costs. The House recognized this problem by adding that QFs must also have access to "long-term wholesale markets for the sale of capacity and electric energy" and by adding other potential criteria. The House bill also provides for the */ continued page 10*

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The agency has been holding some of the requests since last summer.

SYNFUEL projects are once again in limbo at the IRS.

The agency stopped issuing rulings in early May confirming that coal agglomeration facilities that mix chemical reagents with coal make "synthetic fuel from coal." Such a ruling is key to claiming tax credits of $1.095 an mmBtu on the output from the projects. IRS officials in Washington describe the situation as a "pause" in further rulings.

The problem is that a chemistry lab that is helping the IRS with tax audits of synfuel plants could not match the results that one taxpayer reported when the IRS issued the taxpayer a ruling. The IRS considers output from the plants "synthetic fuel" if the output is significantly different in chemical composition from the raw coal used to produce it. The IRS arranged meetings between its lab and the two main labs — Combustion Resources and Paspek — that owners of the synfuel plants use for their own testing. The meetings took place in May. In the meantime, the IRS national office is continuing to work on private letter rulings that it has in process, but there was no word as the *NewsWire* went to press June 1 when the "pause" might be lifted.

INVOLUNTARY CONVERSIONS are leading to questions on audit.

A New York utility, Niagara Mohawk, made payments of cash and stock in 1997 to owners of independent power plants that had long-term contracts to sell electricity to the utility to buy out the contracts. Electricity prices were lower in 1997 than when the utility signed the contracts. Niagara Mohawk wanted out of what, by then, had become bad deals.

The companies that received these buyout payments felt */ continued page 11*

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reinstatement of the obligation to purchase for individual QFs if a QF files an application with FERC, and FERC finds that the conditions justifying repeal of the obligation to purchase no longer exist. This will provide some protection for the owners of QFs if they are shut out of long-term wholesale contract markets.

Existing QF contracts would not be affected by the changes in PURPA — unless the contracts are amended in the future. Both bills include language that states that nothing in these revisions to PURPA affects the rights or remedies of any party under any contract or obligation "in effect or pending approval on" (the House bill) or "entered into or imposed before" (the Senate bill) "enactment of this subsection . . . including the right to recover costs of purchasing electric energy or capacity" (both bills).

Both bills are silent about the effect of future contract amendments. However, when a federal statute is amended, existing contracts are usually brought under the new rules if the contract is amended after the enactment date in a manner that is considered significant. The thought is that if the parties are going to rewrite their deal, then they ought to do so with the new rules in mind.

Another benefit that independent power companies have enjoyed under PURPA is that utilities must sell them "backup" power — for example, to restart their plants after the plants are shut down for maintenance. The Senate bill would remove the obligation of an electric utility to sell electricity to a QF if competing retail electric suppliers are "able" to provide electric energy to the QF. I pointed out in a *Newswire* article last year that being "able" was insufficient, since utilities had, prior to PURPA, been "able" but unwilling to sell electricity to QFs at non-discriminatory prices. The House bill picks up the "willing" part ("willing and able"), but it fails to provide for non-discriminatory pricing. A QF owner requiring electricity to run its plant may not have much bargaining power in the retail market.

Congress is expected to repeal parts of PURPA this fall. Projects with existing contracts to sell their electricity to utilities should not be affected, unless the contracts are amended.

The FERC rules implementing PURPA require that a qualifying cogeneration facility must supply at least 5% of its total energy output in the form of "useful" thermal energy. The House bill, but not the Senate bill, would require FERC to issue a new rule revising the operating and efficiency standards for QFs to ensure that the thermal energy output is "used in a productive and beneficial manner," used "predominantly for commercial or industrial processes and not for sale to an electric utility," and ensures "progress in the development of efficient electric energy generating technology." Although it appears that the rule was intended to apply only prospectively to new QFs, the way it is currently written in the House bill would make it apply to any existing QF that has not filed a notice of self-certification or an application for FERC certification. While most QFs have made one or the other filing, such a filing is not actually required by the statute or any FERC rule, and some QFs may not have one, or at least, not have up-to-date filings.

Finally, both the House and Senate bills would codify the holding in *Freehold Cogeneration Associates, LP v. BRC of NJ,* 44 F.3d 1178 (1995) that, once a state commission has approved a QF contract as consistent with PURPA and prudent, the state must allow recovery of the QF contract price in the purchasing utility's retail rates. In the Senate bill, the section applies only to legally enforceable obligations entered into or imposed under this section "before the date of enactment of this subsection," thereby leaving out future QF contracts. The House bill applies to all such obligations imposed under the section. ◎

Project Sales: Strategies That Work in the Current Market

by Jeff Bodington, with Bodington & Company in San Francisco

Buyers and sellers of power plants would do well to focus on a few strategies that work.

The market for power plants in the United States is both turbulent and evolving. It is also fracturing into new segments. Once-hot business models have become orphans, once-boring models have become the most sought after acquisition targets. All this activity creates both opportunities and risks for buyers and sellers. Understanding the market is the key to success.

The Market

Many speeches, articles and books describe the growth of and now tumultuous times for both independent and utility owners of electric generating capacity in the United States. A measure of the change, and one that is an indicator of whether much money is being made and lost, is activity in the market for power project ownership. After beginning in the 1980s with sales of PURPA projects and then rising rapidly as regulated utilities began to divest their assets in the mid-1990s, sales of net operating equity interests peaked at over 55,000 megawatts in 2000.

Then, most visibly beginning in mid-2000, power companies started coming under financial pressure. From the 55,000-megawatt peak in 2000, power plant sales declined during 2001 and fell to a low of approximately 12,000 megawatts during 2002. From over 150 transactions during both 2000 and 2001, the number fell to 62 last year. Buyers that buoyed the numbers during 2001 and prior years were absent or turned into sellers during 2002. AES, Allegheny Energy, Calpine, Mirant, NRG and the PG&E National Energy Group are examples of buyers during 2001 who had turned into sellers by 2002. Stock prices declined and remain low, bankruptcies have been declared or are eminent, many projects that are under construction have been abandoned or mothballed, and lenders are holding substantial amounts of troubled debt.

This distress for some in the industry / continued page 12

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that their contracts were "involuntary converted." That's because Niagara Mohawk threatened at one point in the negotiations to seize their power plants by eminent domain if they failed to agree to a buyout of the contracts. The IRS agreed, and issued private rulings to that effect to many of the companies involved. This meant that they did not have to pay taxes immediately on the buyout payments provided the money was reinvested within two years in other property that is "similar or related in service or use to the property so converted."

Some of the companies reinvested the money in new "greenfield" power plants that the companies had under development at the time. The IRS is now questioning on audit whether a power plant is "similar or related in service or use" to a contract to sell electricity.

The agency released in mid-April an internal memorandum written by an IRS associate chief counsel to the division that audits large and mid-sized businesses. The taxpayer whose case is addressed in the memo had his power contract bought out by a utility and, soon after, sold his power plant to a third party. He claimed that taxes could be deferred not only the buyout payment for the contract, but also the proceeds from sale of the power plant by using the amounts to acquire another power plant that was under construction at the time. The audit division asked the national office how much time it has to assess back taxes in the case. The memorandum is ILM 200315021.

In a related development, the IRS rejected a claim by another company on audit that insurance proceeds the company received to reimburse it for its environmental cleanup costs at contaminated sites were proceeds from an "involuntary conversion" of the contaminated sites. The IRS said the insurance policies were "commercial general liability" policies that / continued page 13

Project Sales

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means opportunity for others. Substantial sales are likely during late 2003 and 2004, but they will be a lagging indicator of the changes in value and strategy that are happening now.

Flight to Quality

Uncertainty in markets usually sends buyers toward higher-quality assets, and the prices of lower-quality assets decline. This is exactly what happened to power plants during 2002. Although many factors determine the value of a power project, the amount of merchant risk has become one of the most important. Until last year, transactions involving merchant risk were common. By last year, many merchant assets were for sale, but few sold.

Of the 62 already-operating projects that sold during 2002, only two were merchants. The other 60 transactions involved projects whose revenues were secured by long-term contracts that shifted market risks to other parties, usually the ratepayers of a regulated utility.

Another segment of the market showed a similar flight. While power projects under construction did sell last year, most were purchased by reluctant buyers who did so to protect their existing investments in the projects. Several were taken by constructors who were owed substantial sums, and several others were taken by lenders through foreclosure proceedings. At least one solicitation of a partially-constructed merchant plant attracted material interest but no bids. Although the project was 50% constructed and major components were on site, the projected spark spread did not justify the risk of completion. In another solicitation, the bids received were actually negative. Potential buyers were not willing to put up any cash, and they wanted the lenders to reduce the debt the project will have to repay in the future.

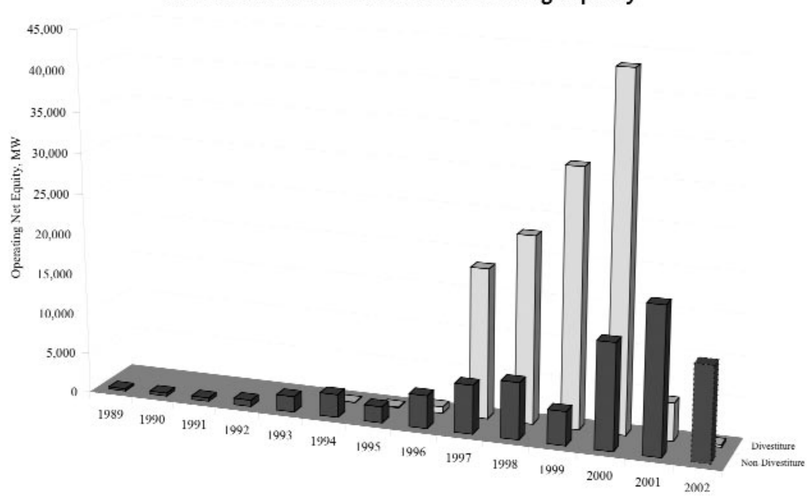
An example of why buyers were so reluctant is the plight of several recently-completed merchant projects in the western US. Although the heat rates for these natural gas-fired combined-cycle projects are nearly 7,000 Btu/kWh and they are designed for baseload operations, they have actually been operated only sparingly. Power prices have rarely been high enough to cover the fuel and variable operating costs.

The prices of projects sold also indicate a flight to quality. This is great news for sellers of projects with contract-secured revenues that involve little or no merchant risk. While $/kW is a signpost to value at best, the average price paid for an oil- or natural gas-fired facility actually increased during 2002. The average prices during 2000, 2001 and 2002 were $505/kW, $500/kW and then $561/kW last year. Deal-specific prices have occasionally topped $1,000/kW even during the first third of 2003.

More telling, but more difficult to track, is the after-tax return on equity required by buyers. As risk rises, so too does this return. Deals done during 2002 and early 2003 provide no indication that this return has increased for facilities with contract-secured revenues. Buyers are willing to accept the lowest returns for high-quality projects with well-hedged energy operating margins. Interest in this type of facility is high, and competition among buyers remains intense.

In contrast, the returns required on merchant facilities have increased so much that very few deals are closing. This is a classic flight to quality. The yields on high-quality assets do not change, and the spread between high and lower-quality deals increases. The auctions of merchant power projects noted above show that such projects often have very low value. In the case of a 7,000 Btu/kWh project that cannot cover its variable costs, even though it is already constructed

Sales of Interests in US Electric Generating Capacity



at a cost over $400 million, its capital value is nearly zero. Lenders and owners face what could be a substantial loss.

An important element of value is the willingness of lenders to finance part of an acquisition. Most of the sales of contract-secured projects have not involved new debt. The projects were already financed and only equity changed hands. Lenders have demanded some improvement in security in exchange for consenting to several transactions, but new debt financing was not necessary. Even when new financing was necessary because the existing lenders have pulled back from project loans, some lenders remain who will finance power projects with contract-secured revenues.

Again, a flight to quality among lenders makes the circumstances different for merchant projects. Most of the new debt that went into merchant projects last year went in reluctantly to protect an existing position. Many existing lenders would like to reduce their merchant exposure, and new debt for a power project with material merchant risk may be entirely a thing of the past.

Strategies and Opportunities

Standing back, buyers and sellers are pursing a few different strategies in the current market.

On the sell side, several of the most distressed sellers are pursuing what could be called a phoenix strategy. These sellers have or will seek protection from creditors under chapter 11 of the bankruptcy code, and they hope to rise from their ashes with their best power projects intact. They have or plan to default on projects with negative value, sell marginal projects when they can, and then emerge from bankruptcy still owning the best assets as a means to repay corporate-level creditors. The assets with negative value are likely to be merchants, and those assets that the owners retain are likely to be projects with contract-secured revenues. For buyers, if and when this phoenix strategy works, this means that the best assets will never be offered for sale. Only the riskiest projects with the lowest values will be sold.

An opportunity for buyers lies with owners too troubled for the phoenix strategy to work. Near-term liquidity pressures, or the need to repay some of the substantial corporate-level debt coming due within the next several years, could force several troubled firms to sell some of the lower-risk and more valuable assets. This has already begun for one of the Texas-based owners. It is / continued page 14

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protect the insured against liability to third parties. They were not received under property or casualty insurance that protects the insured from damage to his own property. The case is discussed in a "technical advice memorandum" that IRS released in late May. The number is TAM 200322017. A "technical advice memorandum" is a ruling by the IRS national office to settle a dispute between a taxpayer and an IRS agent stemming from an audit.

TAX-EXEMPT FINANCING got a little easier.

Santa Rosa, California has a sewage and water reclamation system serving 250,000 people in Sonoma County. It wanted to issue tax-exempt bonds to finance a $140 million pipeline to supply wastewater to a geothermal power company for its use in activating geysers to produce steam for generating electricity. Santa Rosa has a contract with the geothermal power company obligating Santa Rosa to deliver 11 million gallons of wastewater a day. The geothermal company will not have to pay anything for the water it receives.

Santa Rosa also plans to sign separate agreements with farmers along the pipeline route to supply them with wastewater for irrigating their fields. It plans to have the farmers pay for the water, but with total fees capped at 5% of the debt service on the bonds. The remaining 95% of the debt service will be paid out of rates charged the 250,000 Sonoma County residents for sewage services.

Tax-exempt bonds are supposed to be used only for schools, roads, hospitals and other *public* facilities — with a few exceptions. The IRS argued that there will be too much private use of the facilities being financed with the bonds in this case.

Santa Rosa asked the US Tax Court for a "declaratory judgment" that the bonds it plans to issue will be tax- / continued page 15

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also possible that managements will lose the confidence of creditors that is needed to obtain approval of a reorganization plan; chapter 7 liquidation and opportunities for buyers may ensue.

Another sell-side approach involves a seller's rationalization of its portfolio of projects. These sellers are not troubled enough to court bankruptcy, but they may sell assets in an effort to cut capital spending obligations, improve profitability, bolster capital and perhaps recover an investment-grade credit rating. Several very visible one-time developers of merchant projects have begun this process. Again, the merchant and riskier projects are the first to be considered for sale. High-quality assets are being and will be sold on a case-specific basis. As noted above, competition among buyers for these projects to date is intense.

While a buy-side strategy based on the notion that the values of high-quality projects with contract-secured revenues are temporarily depressed seems unlikely to succeed, there are opportunities for buyers. The first is a strategy focused on lenders to distressed power projects. This is where buyers purchase a project from a lender or through a foreclosure proceeding, and the lender's financing remains with the project on a restructured basis. Several transactions based on this approach have already closed, and one of the attractions is that the new owners have needed to invest little cash. This opportunity for long-term gain at low initial cost and risk has crowded the field already. More than 20 potential buyers have courted several of the lenders with large portfolios of generating asset debt. To date, lenders lean toward those with operating experience, existing portfolios and knowledge of the subject technology and regional markets. While many of the new firms courting lenders have people with many years of experience in previous jobs, these new entrants have had little success so far.

Another lender-focused strategy involves purchasing a lender's debt at a discount and then negotiating or forcing an exit of the equity. Several of the new-entrant private-equity funds are pursing this approach. Bodington & Company has auctioned projects for lenders and requested both this type of proposal and bids from new owners who would require the lender to stay in on a restructured basis. In this sample, the discount required by purchasers of the debt has been too large for lenders to accept. Lenders have elected to stay in the projects and work with new owners to add value while retaining the option to sell in the future at a better price.

Of the 62 already-operating projects that sold during 2002, only two were merchant plants.

Just moving back into view is a strategy that, so far, few can implement. Until late 2001 and early 2002, the number of trading organizations that could provide investment-grade power sales, fuel supply and tolling agreements was increasing. Today, only a few of those survive. The spark spreads and terms on offer are very cautious and cannot now support the full cost of a new facility. This will change. Several commercial banks, investment banks, commodity energy companies and utilities are exploring entries into this niche. Aggregating smaller contracts with municipal utilities and fuel suppliers is another approach under consideration. Substantial movement toward a spread of approximately 1.25¢/kWh and a term of 12 to 15 years will support a new project. Terms less optimistic will still add material value to many of the existing projects with merchant risk. At a minimum, they will contribute to covering debt now in place.

Summing up, tumult in the market has led to a flight to quality. Good power projects with contract-secured and well-hedged operating margins have retained their value, and potential buyers face intense competition. Lower-quality projects, particularly those with merchant risk, have fallen in value. Amidst these changes there is opportunity and both buyers and sellers. Both would do well to focus on what strategies work in various changing segments of the market. ◎

US Fire Sale?

Most merchant power companies in the United States have been under pressure from the rating agencies and the banks, since Enron collapsed, to sell assets in an effort to pay down debt. Private equity funds have organized to buy power plants. Yet, the big selloff that was predicted has not occurred, in part because a wide gap remains between the prices at which the current owners of the projects are willing to sell and the prices at which those with money are willing to buy. The following are excerpts from a discussion that took place in April at Chadbourne in Washington.

The panelists are Jay Beatty, a prominent investment banker with long experience in the utility sector and who is currently managing director of New Harbor, Inc. in New York, John Cooper, an independent director and consultant who was, until January, senior vice president and principal financial officer of PG&E National Energy Group, Tony Muoser, a managing director of Citibank, William Conway, a principal in a new company that is raising private equity to buy distressed energy assets, Charles Wilson, director of business unit finance for Duke Energy Corporation, Dr. John Paffenbarger, a vice president at Constellation Energy who manages the company's search for power plants to buy and who was principal administrator for electricity at the International Energy Agency in Paris from 1995 to 2000, and Robert Shapiro, a utility lawyer at Chadbourne.

The moderators are Roger Gale, president of GF Energy, an energy consultancy in Washington, and Keith Martin, a Chadbourne partner and editor of the NewsWire.

MR. MARTIN: The question before the house is whether the United States is the right place and this is the right time to be buying power plants that are for sale.

Future for Merchant Plants

MR. GALE: I recall some interesting aphorisms. Those who have the best aphorisms are not always the best performers. One aphorism that Enron used often was the New Hampshire state motto "Live Free or Die" — and, of course, it tried both. However, it had another one: "The best way to tell whether competition is working is to show that there are failures; that winners and losers prove that the underlying conditions for success are present."

With that thought in mind, I would like to ask each of the panelists, starting with Bob Shapiro, */ continued page 16*

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exempt. The court agreed. It said the pipeline will be used by the public to dispose of wastewater, not to provide a service to the farmers or the geothermal power company, and — as such, it will be put entirely to public use. The case is *Santa Rosa v. Commissioner*.

FINANCIALLY-TROUBLED COMPANIES may get an unwelcome surprise.

US multinational corporations that own assets in other countries usually do so through offshore holding companies in Holland, Bermuda, the Cayman Islands or other similar jurisdictions. They do this in order to avoid having to pay US taxes immediately on their earnings from abroad. US taxes can be deferred until the earnings are repatriated to the United States. The companies must be careful in the meantime not to be make indirect use of the earnings in the US, as that would trigger an immediate US tax. An example of indirect use is where a US parent company borrows money and pledges the assets of its offshore holding company as security for the loan.

Financially-troubled US companies that have fallen behind on contributions to employee pension plans are in for an unwelcome surprise. A lien arises automatically against not only the US company, but also the assets of all offshore companies that are part of its "controlled group," in favor of a federal agency called the Pension Benefit Guaranty Corporation if the US company fails to satisfy minimum funding requirements for its qualified retirement plans. This sudden "debt" to the PBGC — secured by assets of the offshore holding companies — could trigger immediate taxes to the US company on any unrepatriated earnings in its offshore holding companies up to the amount of the lien.

The US parent company may have no choice but to file for */ continued page 17*

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whether — despite the failures in the US power market which are obvious, and despite the terminology we are using today, "Fire Sale," which denotes things aren't going well — we have an industry that will recover, and are we going to have enough buyers and enough potent and capable, well-credited people to run this business in the future? Or are we in a very, very long insoluble kind of situation?

MR. SHAPIRO: The short answer is it will take time. Part of the problem is we have tremendous regulatory uncertainty in this country. For example, we thought that we had put to rest questions about sanctity of contracts. Yet, the California experience has shown that when things get bad enough, there will be pressure to reopen contracts. The Federal Energy Regulatory Commission has the opportunity in the next several weeks to bring more certainty to the market by how it rules on the effort by California to set aside long-term contracts it signed to buy electricity when electricity prices were at their peak. A majority of the commission has signaled an interest in maintaining the sanctity of contracts. Such a decision could begin to rebuild the confidence in the US regulatory scheme that is essential to facilitate transactions.

MR. PAFFENBARGER: The short answer is, from 1997 to 2000, something like 100,000 megawatts of generation changed hands in the US. By 2001, it was clear the party was over. In 2002, equity holders, who had taken on a lot of debt to build or acquire their generating assets, suddenly realized they were in financial trouble and started a process of trying to get some cash out of those assets. It took the better part of that year for them to come to the realization that the value they had ascribed to those was assets was too high. I think it will take some time this year to discover the true value of the assets.

MR. BEATTY: I think we are still searching for the business model where these assets can be put to use. Historically, it was thought that if you had the asset, you had a business. That is not true in other areas of the economy.

We have today investor-owned utilities where load and generation are hooked together. For businesses that are just a generation business, we need a better notion of what assets one needs to make a go of it and what a successful generation-only business model looks like.

One of the queer things that we probably have learned — and it is surprising that it took us so long — is that if you are in a commodity business, you really cannot have 50, 70, or 80% percent debt. Large oil companies have 10 to 15% debt.

MR. COOPER: Let me build on what Jay said. I do not see a long-term viable future for standalone merchant energy companies. In order to have merchant generation, you need a risk-management function — call it trading, call it whatever. In order to run a viable risk management function along with an asset portfolio, you need significant amounts of capital, much more than the model that was developed before would call for. You need less leverage. I am not sure the rates of return that can be extracted from this industry will support that level of capital.

Therefore, the longer-term model will either be merchant generation hooked to a company with a large balance sheet to support the credit needs or some sort of a longer-term contractual-based industry — in other words going back to what we had under the Public Utilities Regulatory Policies Act.

MR. MUOSER: The industry will come back together. The big question is, "In what shape and form and when?" The industry is too important not to come back together again. The regulatory issues are preventing capital from flowing back into the industry. There is a political process that must be completed before banks will feel comfortable relending to the sector. Creditworthiness must be reestablished. I agree with John Cooper; the merchant power business cannot survive without access to tremendous amounts of credit.

MR. WILSON: In the long run, it is a viable business. Supply of electric energy is a public need. The forward price curves suggest a recovery across the country in the next two to five years. In some regions it may be sooner than that. We are already seeing it in pockets of the west.

The likelihood that new power plants will be built in the future is extremely low. Significant new construction may have to wait until the next round of deregulation. We are currently in a type of halting deregulation. The last couple years proved that halfway deregulation is worse than no deregulation. Money was invested on the assumption of a continuous and basically homogenous nationwide deregulation scheme that has not come to pass. After California blew up, everybody stopped. For instance, Duke has both a regulated and unregulated business. The regulated business was teed up and ready to divest its generating assets. Divestiture has stopped cold in the Carolinas, and it probably will not restart until the Federal

Energy Regulatory Commission implements its plans for standard market design.

MR. CONWAY: There is nothing fundamentally wrong with the independent power industry. We got here because of over-exuberance and anticipation of supply, excessive leverage, and — let's not forget — greed. When you look at the industry fundamentals, they remain good. It is much too late to put the toothpaste back into the tube when it comes to competition. Yes, we will see regulatory retrenchment, but not an end to competition. Independent power is here to stay. I don't know yet what is the right business model for the industry going forward. In the short term, we are in for more financial turmoil. Obviously, the reason we are all here today is some of us see an opportunity to profit in the midst of that turmoil.

Why Few Sales?

MR. GALE: When we first began thinking about this workshop, we were of the view — a bit more than we are today — that we would see a fair number of projects sales in 2003. There would be deeper pocketed people, if we could find them, buying these distressed assets — a typical fire sale, as we called it.

Here we are in the second quarter of the year, and we are not seeing a high volume of transactions. And many people are not expecting a huge barrage of ownership changes. Why don't we have a large number of transactions? What do you foresee for the remainder of 2003?

MR. CONWAY: I think one must think of this in risk and reward terms. Transactions have closed. The deals that are closing are most with long-term offtake contracts and creditworthy offtakers. There is plenty of capital available buy those kinds of projects. At the other end of the spectrum are the projects that present pure merchant risk. You have a lot of private equity waiting around the edges, waiting for capitulation on price.

The most interesting spot is in the middle where one finds quasi-merchant situations — for example, projects with short-term rather than long-term contracts. There is an opportunity for creative people to figure out how to do deals in this middle ground.

MR. PAFFENBARGER: I'm still looking for the catalyst that makes these transactions happen. I wrote down a headline from *The Wall Street Journal* last week, "Banks Stand Tough, But Avoid Squeezing Energy Firms on / continued page 18

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bankruptcy — not only for itself but also for its offshore holding companies — to avoid the tax. A bankruptcy filing creates in an automatic stay against enforcement or perfection of the lien by the PBGC.

REPAIRS take center stage in court.

The IRS has been working this year on a possible revenue ruling to explain when money spent on maintenance at existing power plants is a "repair" or an "improvement." The cost of repairs can be deducted immediately. The cost of improvements must be added to the "tax basis" that a company has in its power plant and recovered much more slowly through depreciation. Improvements are more expensive to undertake after the tax consequences are taken into account.

The airlines worked out bright-line tests several years ago with the IRS. However, they have not been happy with what they have been able to negotiate.

Federal Express is in federal district court in Tennessee arguing about where lines should be drawn in its case.

In late April, the judge in the case declined to rule — as Federal Express has requested — that an aircraft and its engines are a single "unit of property" for purposes of determining whether maintenance is a repair or improvement. For example, if Federal Express spent $80,000, this is more likely to be a repair if the entire aircraft is the unit of property than if the unit of property is an engine blade. Federal Express argued that the judge should settle the issue of what is the unit of property after reading legal briefs from itself and the government without the need for a full-blown trial. The judge declined. The case is headed for trial.

An IRS working group told the power industry earlier this year that it cannot agree on what is the unit of property in cases involving power / continued page 19

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Loans." I think it will take time this year for creditors to come to a better understanding, through the sales that do occur, of the value of the assets underlying their loans. Until that process plays out fully, the opportunities will remain one-off transactions where individual companies are looking for a little extra liquidity and have a few assets to sell or companies are selling assets as part of a strategic repositioning where they want to get out of a certain region or market. I do not see a big wave. I do see a steady stream of individual opportunities.

MR. BEATTY: Certainly, it is true that contracted plants are a separate group. You are factoring a receivable; you push the F9 button on your Excel spreadsheet, and you know what the price should be, with the exception of projects that are selling to California,

The trouble with merchant plants is greater uncertainty. The AES Mountainview plant was a combination of merchant and California, which is probably too much for anybody to bear without breaking into tears.

The issue with most merchant plants is — let us assume someone just hands you the keys — do you have enough capital to withstand owning that merchant plant? It is clear, if you look at how the rating agencies view anyone who owns a material number of merchant facilities, you are in business position six or seven, which means that to remain a triple B credit, you need a funds flow for operations of almost six times interest.

If you don't own any merchant plants, then you need only three or four times the funds flow. So owning merchant plants is almost like a contagious disease. It is the electrical equivalent of SARS. As soon as you touch one, you are infected. Under the circumstances, how do you find anyone willing even to take the keys to the plant?

The other option is to let the banks take it. Notice that the banks — even though they need liquidity and receive ratings just like any other company — don't have this infectious disease problem, at least not at the moment.

There really are no other options. Of course, you have the private equity funds circling. The trouble with private equity for merchant plants is that they do not have credit. They have lots of cash, but they have no credit.

> Owning merchant plants is almost like a contagious disease. It is the electrical equivalent of SARS.

As John Cooper pointed out, this is a risk-management business. People do not just arrive with trucks and take electrons away every day. Somehow you have to manage risk. You have to enter into collateral agreements. You have to have credit behind contracts. The better the terms of the contract you sign, the more credit you have to put behind it. Private equity funds have lots of money, but they have no credit.

MR. GALE: So, there are no knights out there for some of these plants at this time?

MR. BEATTY: There are very few. The amount of Arab money left in this world, as you probably found, is small.

MR. PAFFENBARGER: One thing we should add to the description you have given — which to me sounds dire — is customers. A company with load-serving obligations can match the merchant risk with its customers.

MR. BEATTY: Or, another way a plant can be matched with customers is by turning it back into contracted plant. Remember, you have two choices: Do you want to play the merchant game or do you want to be a contracted plant? If you are a contracted plant, then you are back to factoring receivables. I can do that. But keep in mind the way the Financial Accounting Standards Board is heading, if you enter into a long-term contract for a specific plant, that contract must go on the balance sheet.

MR. CONWAY: It does, but I think that load-serving entities are not as tough on sell-side credit as traders. At least that has been our experience.

There may not be much ability to turn merchant plants back into contracted plants with 10- or 15-year contracts, but there is room for 3-year contracts, and if the private equity funds have enough confidence in business cycles — prices will eventually turn around — then they are going to invest.

MR. GALE: Bill Conway, with whom would you sign those contracts?

MR. CONWAY: Load-serving entities.

MR. GALE: What entities are solid enough to do that?

MR. CONWAY: Electric cooperatives, municipal utilities, and investor-owned utilities. They are not as bad as traders when it comes to sell-side credit.

MR. GALE: Tony Muoser, from the banking perspective, are there many players with whom a new merchant owner could sign a contract to supply electricity and whose credit would support financing for the power plant?

MR. MUOSER: A very small number. I agree with Jay Beatty. A much smaller number of project sales has taken place than anybody expected. The projects that have been sold have had good contracts with end users. It is difficult to finance a contract with a trading company on the other side. Anyone planning to own a merchant plant must be part of a big trading operation with credit. There are very few parties who can offer that right now. The banks are in the process of evaluating whether to take over plants or not. A key question for banks in this position is how much more money they would have to spend to put the plants into operation. Many are still under construction.

More Consolidation?

MR. GALE: The common wisdom is that competition leads to consolidation. Over the medium term, the big players get bigger and eventually four or five players command 40 or 50% of the market — just as has happened in banking. Is that where we are headed in the power sector? There may be plenty of smaller niche players, but will it take consolidation among the larger players to get these assets realigned and repackaged?

MR. MUOSER: I think there is a new process going on where new entities are entering the market specifically for the trading business. These entities have strong credit. They are still small in number, but it is progress. This opens up possible solutions to the banks' dilemma. Some risk could be shuffled to these new entities. The question is at what price.

MR. PAFFENBARGER: I'm not a student of other industries, but I think in this one, mergers will be difficult to pull off right now. The debt load of many of the / continued page 20

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plants. The group agrees that the property unit is smaller than the entire power plant, but that a turbine — perhaps something even a little larger — is a separate unit of property.

CALIFORNIA will have to change the way it taxes dividends that corporations receive from other companies. So might other states.

California collects franchise taxes from corporations that do business in the state. Farmer Bros. Co. makes and sells coffee and coffee-related products. The company is based in California. The income it reported for franchise tax purposes included dividends it received from companies in other states in which it has made investments.

California allows a "dividends-received deduction" that has the effect of excluding part of the dividends from California taxes. However, the part excluded depends on the extent to which the out-of-state company paying the dividend was itself subject to California taxes. There is a sliding scale.

A California appeals court declared in late May that the arrangement is unconstitutional because it tends to discourage interstate commerce in violation of the "commerce clause" of the US constitution. The case is *Farmer Bros. Co. v. Franchise Tax Board*.

The case is a reminder to states about the perils of writing tax statutes so as to reward doing business inside the state.

WYOMING cannot collect a tax on coal shipments — at least not from railroads.

A federal district court enjoined the state in late April from collecting a tax of .01¢ per ton of coal shipped in the state from three railroads that had challenged the tax. The tax went into effect in January 2001. The three railroads together / continued page 21

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companies that are in financial trouble prevents it. You can get a nice package of assets if you have a huge amount of cash or a strong balance sheet, but you have to accept the liabilities if you are doing a merger. That is a huge obstacle to further consolidation. It will take time for the credit deficit to work off.

MR. WILSON: Add to that the taint from the trading and marketing scandals and litigation. We don't see the picture clearing up — certainly not in California — for a while.

MR. GALE: Jay Beatty?

MR. BEATTY: There's a problem with consolidation in trading businesses. No trader really wants to own much more than 15 to 20% of a market, because if you own much more than 15 or 20%, you are the market, and that's not your business. You want to be able to lay off risk and move it around and trade. Therefore, consolidation cannot lead to a situation where you have fewer than 10 or 12 companies because below that level, you do not have a functional trading market. It is not even clear that you do at that level.

Market power creates issues, not the least of which is a financial problem for companies that hold it. How can you hold all that risk, because you have nobody to lay it off against?

MR. WILSON: The consolidation model was the one people were chasing when they thought things were going to go right. The theory was that a lot of people would jump in, and then a lot of people would sell to the bigger guys or be gobbled up like Pac-Man. Eventually, you would have five to 10 major, dominant generators because of the economies of scale. But that was all predicated on continuing deregulation, homogeneous deregulation improvement, and not degradation and strained credit.

The only people who are getting into the trading area today are banks. Banks have taken out marketing licenses, and they are just dabbling right now. They are seeing if they can make any money by brining a balance sheet to it. Even Duke has struggled in this market, and we are one of the bigger, more well-capitalized players. We don't have the appetite to consolidate, because every time anyone talks about consolidation, the rating agencies come down on you like a ton of bricks.

MR. GALE: So, we have no one who can buy the worst assets. We have no one who can manage the trading. What else don't we have?

MR. SHAPIRO: We also have the rating agencies telling us that that this is a bad business to be in. And we have regulators who are saying that they do not like the volatility of merchant or spot and who want to drive the industry back to longer-term contracts. I think most of us believe that would be a good remedy for this industry — to return to contracted assets.

The problem is you do not have a federal law that mandates it. You have standard market design proposal from the Federal Energy Regulatory Commission that is strong in content, but weak in implementation because the states are not buying into it. You do not have any real interest by state regulatory commissions to force the utilities to contract for long term power. The commissions are not sure what the regulatory model should be if they are going ultimately to deregulate, eliminate the load-serving requirement, and install pure retail choice. Why saddle their regulated utilities with long-term contracts while the outlook is so unclear?

MR. COOPER: What else do we have? We also have an asymmetric risk profile in the US power industry. Traders and merchant generators are looking to make money when prices are high or when there is significant volatility. However, because electricity is perceived as being in the public interest, when you have significant volatility or price spikes, they are likely to be capped by regulation. Thus, one ends up with all the downside, but with no ability to recoup from the upside.

MR. PAFFENBARGER: I do not want there to be left the impression that no one is willing to buy. Constellation is in the market. We are looking for assets. We have a strong balance sheet. We have a trading organization. We have investment quality credit. The ingredients are there.

We talked earlier about contracted assets. The advantage of contracted assets is they give a price signal. Merchant assets are more difficult to value, but we are looking for merchant assets as well.

MR. COOPER: Granted, there are buyers, but the problem also is the bid-ask spread. Everybody is looking at similar price curves. The banks expect that things will eventually return to normal when their loans will once again be worth 100 cents on the dollar. The bids today are significantly below that figure. There is no incentive for those who own the assets not simply to hold the assets for a couple years until the market turns around. The situation cannot get much worse than it is already.

It seems to me there is an intermediate stage. Maybe there is a risk-sharing model that could evolve between those who hold the assets and people who want to invest without actually buying them at a deep discount. There is room for people who are willing to inject capital for a share of the upside when it accrues, but without having to take a lot of the downside risk.

MR. BEATTY: I would also say that the ability or the willingness to take merchant assets in PJM [the Pennsylvania-New Jersey-Maryland power pool], or the northeastern US generally, is higher than in other places. This has been particularly true in the past couple weeks as you see the amendments that are being added to the national energy bill in Congress. Mr. Conway knows this a hell of a lot better than I do, but it looks like the ability of the Federal Energy Regulatory Commission to regulate this industry is in danger of being curtailed, and it is putting a pall over potential transactions in the southeastern US and other places where it was hoped that a single market design might emerge.

Regional Differences

MR. GALE: Let's pursue the regionality that you are raising, Jay Beatty. Do you see recovery and restructuring varying in time by region — perhaps because prices firm up in some places earlier than others and recovery of asset value is easier to determine? You mentioned PJM and the northeastern US being relatively stable, and the south being highly perplexed by what's happening in Congress.

MR. BEATTY: Well, historically no one could build in the southeast, and no one can build there today. It's a regulated box. All you have to do is walk over the line into the south central US and ERCOT to find a much different environment. The West, in many ways looks great. But you have the sense of garlic and crosses out there. You do not want to get too close to it.

MR. CONWAY: Half of life is just showing up.

MR. MARTIN: What's the other half?

MR. CONWAY: The other half is perspiration, for sure. The turmoil about which we have heard so much this morning creates opportunity for the next generation of new companies. That is why you would think there is a greater chance today than before of creating something / continued page 22

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carried 99.6% of all coal shipped in the state in 2001 and faced a tax bill of $5.7 million for that year. The court said the tax ran afoul of a federal statute — called the Railroad Revitalization and Regulatory Reform Act of 1976 — that bars states from singling out railroads for special taxes that are not generally applicable to other businesses.

The court said it did not matter in this case that the tax also applied to trucking companies that carry coal. Their share of the market is tiny. Total taxes owed by all the trucking companies combined in 2001 came to only $18,622. Therefore, this is a tax aimed in practice at the railroads. The case is *Burlington Northern et al. v. Atwood*.

The poor trucking companies: the Wyoming attorney general said in May that he sees no reason not to continue collecting the tax from truckers. The state legislature will consider repealing the tax when it reconvenes in February 2004.

WEST VIRGINIA may have to increase a tax on coal mined in the state, a state official suggested in late April. It should know for sure by July.

West Virginia collects a tax of 14¢ a ton currently to cover the cost of cleaning up abandoned surface mining sites. The money goes into a special reclamation fund. The rate is scheduled to drop to 7¢ a ton in April 2005. Charles Miller, who oversees the fund for the state Department of Environmental Protection, said new projections will probably show the fund has a significant shortfall.

SELLERS OF DISTRESSED POWER PROJECTS beware.

Most companies selling assets include in the purchase agreement both a non-reliance clause and an exclusive remedy clause.

Non-reliance clauses vary, but in substance, they make the buyer acknowledge that he has not / continued page 23

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new, precisely because the market is open only to those who are willing to take a chance.

As for what is happening in Congress, energy legislation is very hard to enact. A bad idea has an awfully long way to run before it makes it to the finish line. I don't get terribly worried about the latest crazy notion on Capitol Hill because I count on the fact that eventually it will iron itself out and someone will reconsider.

MR. WILSON: I think you need to add to the regional differences another factor, which is locational-based pricing. This is part of the standard market design that the Federal Energy Regulatory Commission is proposing. Anybody buying a power plant needs to keep it in mind. Focus first on how advanced the local deregulation is and in which direction regulation is headed. Focus next on how the power plant would fare if locational-based pricing is implemented as proposed by FERC. This takes a lot of very complicated modeling.

For instance, we have a plant in Maine. Maine is an interesting situation, because a bunch of people went up there and located plants, ignoring the fact that there is a transmission constraint. The power is needed in Boston, but it can't get there. Locational-based pricing is a way of pricing for transmission of electricity so that the right economic signals are sent to people who might build additional transmission lines.

MR. MUOSER: It has become a key criteria for the banks in making decisions about what to do with some of these assets. Regional differences are very important. We are much more aware of the transmission issues. There are situations where we have power plants with contracts, but the offtaker is in serious trouble, and it may be difficult to move the electricity to someone else because of transmission constraints. No one paid enough attention at the time to transmission issues. They are weighing heavily now in our consideration. For us, taking over a project means we have to have an exit strategy, because banks do not want to hold on to these assets long-term.

MR. MARTIN: Bob Shapiro, what is locational-based pricing?

MR. SHAPIRO: The value of a power plant depends on whether it can get the electricity to the customer, or load. There is a cost to moving electricity from the generator to the purchaser of that power.

MR. MARTIN: It is the charge for transmitting the power across the grid?

MR. SHAPIRO: There is a wheeling charge, but there is also a separate cost that must be reimbursed for adding to congestion.

MR. MARTIN: So, to pick up on what Charles Wilson said, if one buys a power plant in Maine hoping to ship the power to Boston, the cost of moving the electricity is more than just the wheeling charge. There is also a congestion charge?

MR. SHAPIRO: It can be even more expensive than appears at first glance to get the electricity to load.

MR. WILSON: The owner of the power plant realizes a lower price than he would if the plant was located near the load center. PJM is the only market that had locational-based pricing from the start. The PJM grid has as many as 1,600 different nodes. You could have up to 1,600 different prices in theory to transmit power across the grid, whereas other grids have charged a uniform price in the past to all users of the grid.

MR. MARTIN: This is the cost of transmitting the electricity. A node is a place where the owner of a power plant can connect to the grid?

MR. WILSON: The node is where the generator essentially is.

> The trouble with private equity funds acquiring merchant plants is they have lots of cash, but they have no credit. You need credit to trade electricity.

Two Kinds of Projects

MR. MARTIN: I heard the group of you talk earlier about two types of power plants — ones that have long-term contracts and pure merchant facilities that do not. John Paffenbarger, you made the point that there are buyers who are interested in both kinds of projects. But the greatest interest is for the projects with contracts? Is that correct?

MR. PAFFENBARGER: Not necessarily. We would have an interest in contracted projects, but we have a regulated utilities business as well. You can call us a merchant utility. We own merchant plants. We try to have a mix of steady cash flows from regulated activities, plants with long-term contracts, and plants where you are selling to the merchant market. There are both contracted plants and merchant plants. We are looking to grow both sides of our business.

MR. MARTIN: Are prices for projects with long-term contracts pretty much at the bottom now or are they expected to fall further?

MR. PAFFENBARGER: I don't think they have changed.

MR. MARTIN: There's no change? They are not going up, and they are not going down?

MR. CONWAY: It is a war of who has the lowest cost of capital. That's all it is ever going to be. There are plenty of players who want quasi-annuities. There will never be any end to capital that will come into those deals.

MR. WILSON: I think that you view the market as having segments. You have high-quality assets; we talked about contracted plants. You have low-quality assets that we typically call merchant. Then you can divide the contracted assets into lower and higher quality, as well.

I think the better assets have been sold. They have already changed hands because they were the ones that people who were in desperate need for cash could sell quickly. I include in this category things like gas pipelines, gas storage facilities and a limited number of old independent power projects. The people most interested in contracted assets are the financial buyers. They are financial engineers.

Then have a separate group of strategic buyers who have balance sheets, and maybe a viable trading and marketing operation. They might be a little more adventurous in a selective way and chase the lower-quality assets.

MR. MARTIN: What makes a long-term contract high or low quality?

MR. WILSON: The creditworthiness of the offtaker. All you are left with in this market are the lower-quality contracted assets. An example is a power project where the offtaker is a trading and marketing outfit that has been downgraded close to bankruptcy level.

MR. MARTIN: Bill Conway, what's the key to winning a bid for a contracted project?

MR. CONWAY: Have the lowest cost of / *continued page 24*

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relied on any statement by the seller other than the representations and warranties the seller expressly made in the purchase agreement. Exclusive remedy clauses come in different forms as well. Their purpose is to make clear that the indemnification provisions in the purchase agreement are the sole remedy each of the parties has against the other after closing.

Two recent cases decided in April — *AES Corp. v. Dow Chemical Co.,* heard by the US appeals court for the 3d circuit (reviewing a contract governed by Delaware law), and *Citibank N.A. v. Itochu International Inc.,* heard by a federal district court in New York (reviewing a New York contract and interpreting precedent in the 2d circuit) — considered whether such clauses are enforceable as a bar to federal securities fraud. In the AES case, AES claimed that Dow Chemical Co. and its subsidiary Destec Energy, Inc. committed securities fraud when it sold AES all of the international assets of Destec. One of the assets AES acquired was a Destec subsidiary whose sole asset was a contract to build a power plant in The Netherlands. AES claimed that Dow and Destec conspired to sell the subsidiary at an artificially-inflated price by misrepresenting the prospects for the project during management presentations and in computer models.

The purchase agreement between Destec and AES had no representations about the project. It also contained a non-reliance clause.

The court said that the buyer does not waive its rights under Rule 10b-5 of the US securities laws merely by signing an agreement with such a clause. However, while the non-reliance clause did not automatically bar the securities fraud claim by AES, the court did permit Destec to cite it as evidence that AES might not have relied on the statements at management presentations and in computer models that / *continued page 25*

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capital. You might get lucky and see something that no one else sees, or you might have a creative idea for restructuring, but fundamentally it's going to turn on who has the lowest cost of capital. There are new players appearing on the scene who meet this criteria who have never owned a power plant and who do have a low cost of capital and a low return expectation.

MR. COOPER: Another thing that makes contracted projects attractive is there are so few other opportunities to earn a reasonable return. Therefore, even high single-digit returns may be attractive in the current market. Where else can you buy a bond at that rate?

Price Gap

MR. MARTIN: Bill Conway, coming back to you again, you made the point earlier that what people are waiting for on the merchant assets is capitulation on prices. How big is the gap between what buyers are willing to pay and sellers want to receive?

MR. CONWAY: Wide in my experience. I am sure Tony Muoser can speak to this, but my impression is that the banks want to see 100¢ on the dollar. Perhaps if they can see 100¢ on the dollar coupled with an extension of time to repay the debt, some risk sharing and an adjustment in the interest rate, some sales of merchant assets will occur. However, the notion that there will be a fire sale on a brand new, highly-efficient, combined-cycle gas unit — it is not going to happen. The banks understand that such power plants have fundamental value. They will not let them be sold at distressed prices.

At the end of the day, the banks do not want to be in the business of power generation. If they see a reasonable deal that respects value, they will try to work it out.

MR. MARTIN: How big is the gap between bid and ask prices?

MR. COOPER: I don't know what the gap is, but the reason the expectation is there that merchant plants will at least have the value of the debt at some point is simple. And it is probably valid. Say a new combined-cycle gas-fired power plant is the most efficient asset in the fleet. The project is leveraged at 60%, and the banks take it over. At some point, it will run no matter how much over-build there is in the local region. Increasing demand for electricity and retirements of older power plants are certain over time to give the new merchant plant value. And the wait may not be very long because we have a volatile price cycle. That is the reason why the banks are willing to hold out at 60 or 70% leverage. At some point, the cycle will recover. The bank is certain to get at least 70% of the plant's value by selling it after the cycle recovers.

MR. MARTIN: Charles Wilson, how big is the gap?

MR. WILSON: The gap between bid and ask prices for new gas-fired assets, which is predominately what we are talking about, ranges from about 20% to 80%. John Cooper is right. Most of them are leveraged at the corporate level or the project level at around 50 to 60%. Our internal valuation is a hold case with very pessimistic curves. However, it justifies a 60% or more value if you have time to hold the plant. The problem is anyone purchasing one of these plants will need a lot of working capital to get through the current trough. He may not have to pay much for it, but the need to inject lots of working capital and the uncertainly about how long it will be before the market recovers is scaring off a lot of potential buyers.

Bank Attitudes

MR. MARTIN: Jay Beatty, how long can the banks sit there with these loans that are not paying?

MR. BEATTY: It depends on which banks. A lot of these syndicates have 15, 20 or 25 banks in them. A number of those banks are non-US banks — especially European banks — who are under enormous pressure in terms of their own ratings and in terms of their own political issues back home. Therefore, within the bank groups, there are distinct groups. The large US banks tend to be of the view that they have the working capital to manage this, even if the wait is three or four years before things turn around. There is another distinct group in any syndicate — 20 to 30, even up to 40% of the bank syndicate — who just want out. What's more, they are selling their participations to people with short-term outlooks. John Cooper can tell us a lot about the frustrations of dealing with bank syndicates.

MR. COOPER: Thankfully I don't have to do that any more.

MR. BEATTY: The frustration comes from having to negotiate with a whole set of people who are themselves jockeying amongst themselves in the syndicate. A lot of the issue require 100% consent within the lender group to settle.

MR. MARTIN: If the banks are able to hold on, how long do they need to hold on? Is it two years, three, four before this turns around?

MR. MUOSER: It depends on the specific situation. It could be two years. It could be six or seven years. That is an important question as the bank syndicates decide what to do. If it is a two-year holdout period, then it is easier for a borrower to persuade the bank syndicate to restructure.

There are situations where the plant is not yet completed. Equity has basically disappeared. The banks thought they would have 50% leverage, but the only way to get to completion is for the banks to inject more money — in other words, increase the leverage. This is a much more difficult situation for the banks than if the power plant is already completed, the debt is 50% of the construction cost, and the equity is wiped out. There is a reasonable expectation to recover the debt at some point.

The point is we need to distinguish between the different merchant plant fact patterns. It is impossible to make general statements about how the banks view the potential sale of merchant plants.

MR. MARTIN: Tony Muoser, you made the point on a conference call we had last week that Citibank has not received any unsolicited offers to purchase distressed power projects. What would it take — what would someone have to tell you — before you would be interested in selling?

MR. MUOSER: Well, let me point out first that there are not dozens and dozens of situations where we are being forced seriously to consider taking over assets. There are a few cases. The banks will probably end up with the assets where the sponsor is gone or lacks the ability to work with the banks.

In other situations, the banks are still trying to work with the project sponsors. If the recovery will be within a two- to five-year span, some sponsors might be willing to inject new money to buy themselves an option to get back on track. The banks might be flexible and work with them.

MR. GALE: Can we examine for a minute this two to five year cycle? It is predicated, I assume, on firmer electricity prices, and on gas prices being in a range that the spark spread is such that you can make a margin. What are the underlying assumptions?

MR. COOPER: The values of power plants are down because of significant overcapacity in the US market and. Many economists are predicting about a / continued page 26

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AES charged were false and misleading.

In the Citibank case, a federal district court in New York came closer to siding with the seller. It said the policy that buyers do not waive their rights by signing a contract with clauses that disclaim reliance on representations made outside the contract and limiting remedies to indemnification is not as broad as the AES court made it sound. The court declined to dismiss the buyer's claim of securities fraud on grounds that the buyer could point to a representation in the contract that it said was incorrect. The seller had represented that the financial statements of the company being acquired were prepared in accordance with GAAP and consistent with past practice of that company.

While non-reliance and exclusive remedy clauses may not be as effective in barring claims for securities fraud given the recent court rulings, no one is suggesting they should be discarded entirely. They continue to be useful not only to limit the scope of potential claims, but also to serve as evidence of non-reliance in the event the seller must defend itself at trial.

The cases also show that a seller under a New York contract has a better chance of defending a Rule 10b-5 claim based on statements outside the contract. The seller with the worse luck in these cases was defending a Delaware contract in the 3d circuit.

MINOR MEMOS. US states are seeing monumental erosion in their tax bases because of sophisticated tax planning by large corporations. Dan Bucks, head of the Multistate Tax Commission, said in a speech in May that the largest corporations have an effective rate of 20.9% compared to 30.9% for companies in the next tier. Bucks said two techniques that are causing the biggest headaches for states are / continued page 27

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2% load growth in a normal year in most regions. Look forward five or eight years and that absorbs 10 to 12% of capacity, which basically brings you down to reserve margins that are more in line with historical levels.

MR. CONWAY: I would say the US market will take four to five years — not two years — to recover. Fundamentally, it is demand driven.

There are limits to how much consolidation there can be in the trading business. No trader wants to own more than 15% or 20% of a market.

MR. COOPER: A lot of it has to do with what happens with deregulation. In certain regions, if electricity demand increases enough to justify construction of new power plants and utilities build their own assets and put them into rate base, then the merchant plants may be worth less than we think.

MR. MUOSER: That is an important point. We made the mistake once before with saying it is just a question of supply and demand and the markets will be perfect and balanced. Government regulation is the component that is the most difficult to assess. It may also be the case that new merchant plants will be built once demand recovers that can out compete the existing plants on which the banks are sitting. Technology could improve.

MR. CONWAY: I think lessons learned in the past couple of years will discipline the next cycle. Until you get an effective demand response in the market, you will always have boom-bust cycles. Hopefully, the next one will not be as extreme as we saw this time.

Boom and Bust

MR. MARTIN: John Cooper made the point that the merchant power companies receive asymmetric returns. They have all the downside risk of falling prices, but not all the upside benefit since electricity is too important a commodity. The regulators limit how high electricity prices are allowed to rise. Do we really have "boom and bust" or do we have "bust and a partial boom"?

MR. CONWAY: A boom-bust cycle, if it is modulated, is not the worst thing in the world. Society will tolerate it because — setting California aside — let's remember who has suffered the most in this cycle. It has been the equity, and equity takes risks. What's wrong with that from a societal standpoint?

MR. WILSON: What is truly wrong with the merchant model is that it is asymmetric. The theory was that you had a trading organization and some physical generation, and you knew there was going to be a lot of volatility, but you might even have welcomed it because traders thrive on price change. It does not matter in which direction.

It is no longer a viable model for a lot of reasons. Therefore, we have to move back to a contracting model. It sounds boring, but the United States will have to move to the old independent power project model for most of the market. You will have a small segment of the power business that will sell its output in the spot market — you need this to set prices — but it will not account for a large share of the market. Most electricity will have to be sold under long-term bilateral contracts, because that is the only financeable model in this market.

As I understand the proposal the Federal Energy Regulatory Commission made on standard market design, load-serving entities will be required to purchase a certain minimum reserve margin. Who knows whether this will be part of the final rules. However, where is the best place to look for this reserve margin? It is to contract with these existing plants that are sucking wind rather than put new iron into the ground.

MR. SHAPIRO: I am not as optimistic about the implementation of standard market design, particularly in the area of contracting. I don't see the legal authority for it. I think FERC is being extremely optimistic that all the utility industry's problems can be solved merely by giving authority to a regional transmission organization. It would take years to implement such an approach. The states are not going to permit it. They are not to allow certain resource decisions to be taken over by the federal government.

MR. BEATTY: I think it is important to get away from focusing on putting iron in the ground and what happens to the plant and focus instead on what business we can construct that uses these assets. One trouble with the IPP model is that everybody is in the business of selling rectangles, all right? A generator wants to sell "x" thousand megawatts for "y" hours a year. That's not what people want to buy when they buy electricity. They want to buy triangles. They want to buy shaped stuff. There is no power plant that makes shaped stuff.

What is needed is a business model of a well-capitalized company that is willing to take the risk to be a trading business. Trading businesses sell shaped stuff. Anyone trying to do a deal today has to go to a Morgan Stanley or UBS. Look at the characteristics of those trading organizations. They are highly capitalized, meaning they have essentially 80 or 90% equity. They can make a lot of money in this business because no one else is able to put together triangles. They can buy. There is a big competition if you put out a request for proposals to buy 1,000 megawatts for "x" thousand hours a year. You will have people biting off fingers as they try to get the RFP out of your hand.

The electricity itself is not the high-value commodity. The high-value commodity is the shape of power. There is room for a high-credit organization that can effectively deal with the wholesalers.

Look at how the natural gas industry has developed. You were aggregating small producers, primarily in west Texas, and then selling a package to Bethlehem Steel when Bethlehem Steel was still a good credit, or to somebody else. You were essentially an aggregator, and you were making a spread. You were buying at $2 an mmBtu, and you were selling at $3 an mmBtu. That is a viable business.

MR. WILSON: That is true at Duke. We have almost completely dropped out of proprietary trading — the highly volatile markets where people thought they could make a lot of money. Almost everything we do now is origination. It is trading around physical assets, structuring contracts and shaping.

MR. COOPER: What everybody is saying is a very simple premise that was lost in this business, / continued page 28

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transfer pricing where goods are sold between affiliates at artificial prices that shift income away from the state, and the use of an out-of-state holding company to hold patents, trademarks and other intangibles for which the in-state affiliates then have to pay royalties. The holding company is put in a state like Delaware or Nevada that does not tax the royalty income. Seven states have passed laws to deny deductions for royalty payments. Another 16 have dealt with the problem through combined reporting laws . . . . The IRS said it has issued 239 summonses to 78 promoters of transactions it considers tax shelters seeking to see the investor lists. Twenty-five of the promoters have cooperated by turning over the lists. Seventy-seven of the summonses have been referred to the US Justice Department for enforcement.

— contributed by Keith Martin and Samuel R. Kwon in Washington, and A. Robert Colby in New York.

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which is you need customers. But it is an integrated business as well.

That's the reason oil companies got into the integrated business from gas stations up through oil in the ground and refineries. An independent refinery is in no better position than a merchant generator. It may make money in two years out of 10. You need a marketing or trading organization in the middle to aggregate the supply. You probably need some generating assets, but you can also buy capacity in the market.

What gets lost in all this discussion is you have to start at the other end of the spectrum, which is where the demand is — not where the supply is.

MR. GALE: What, two years from now when this market starts to recover, are the customers going to want? What kind of contracts? What will the business look like as it matures — a customer-driven business that it should have been from the beginning?

MR. WILSON: Unfortunately, with electricity prices so low at the moment, the generators have little incentive to lock themselves into long-term contracts. You are going to have to have some return in price volatility before both sides feel the incentive to sign long-term contracts.

MR. BEATTY: One striking thing about the current market if you look at the load-serving entities, if you look at the industrials, is that everybody is staying short right now. But prices will eventually spike some summer and, all of a sudden, the utilities and industrials will wonder why they didn't put together a portfolio when they had the chance. Lock in some prices over a three-year period. Lock in others over five years. Buy some electricity in the day-ahead market.

MR. GALE: Who's going to bundle together these portfolios and put them before the customer?

MR. PAFFENBARGER: We're doing it.

MR. COOPER: The load-serving entities.

MR. SHAPIRO: It is most likely to happen in forward-looking states — those that want utilities to contract in that way. Some states will force the load-serving entities to sign a mix of contracts. Other states that are really interventionists will not.

Sensible Buyers

MR. MARTIN: Let me bring back the discussion to who should be buying merchant assets. I have the impression from listening to all of you that a purely financial player who lacks the ability to sell triangles — as Jay Beatty put it — should not be playing in this market. True?

MR. BEATTY: In the merchant market with merchant assets.

MR. COOPER: I think they can play. They can contract for these services. You can contract with people who have viable trading operations. The question then is the cost of laying off the market risk. Will it cut so deeply into your rate of return that the returns no longer justify what the private equity funds require to play.

MR. MUOSER: I think it will be a very high cost to buy the credit, if you don't already have it, to be able to trade. You can farm out the operational part if you do not have it, but the energy management component is key.

MR. MARTIN: Let me probe further. This view that you need a real trading operation and a big creditworthy owner in order to play in the market: isn't it called into question by the fact that the two independent power companies that are closest to the edge right now are two utility affiliates, NRG Energy and the PG&E National Energy Group? What's wrong with this picture?

MR. COOPER: Neither parent of those affiliates was able to support the subsidiary for various reasons.

MR. WILSON: They had too big an unregulated operation. It hits a crossover point where you are not going to let it drag down the good business. The model works where there is a better balance.

MR. PAFFENBARGER: In the PG&E case, there were credit issues at the parent level. The PG&E utility went into bankruptcy. Under the circumstances, the parent holding company had little room to support NEG.

MR. GALE: What do you think the bottom line will be in terms of the ratio of physical assets to contractual assets? You had the "Enron lites" who felt they could exist simply as traders. You had other entities that owned hard assets, and hard assets are in trouble today. What will the entities that are successful in the future look like?

MR. CONWAY: It will be a mix, but with a heavier weighting than in the past toward physical assets. There will still be a vital role to play — as Jay Beatty says — for the triangle builders. The lesson, if you can reason to the future from the past, is that the trading entities that survive are the ones that are backed up by big capital and are just merciless in terms of their credit requirements.

MR. WILSON: The "asset lite" model has been completely discredited, unless the environment changes dramatically. The reason is there is a lot of stealth capital. People thought they could get into it without having to lay down the capital necessary to build plants, but that was wrong because you need a balance sheet. You need lots of working capital to maintain the kind of credit required to trade. The longer the periods for which you contract, the more working capital you need. If you are downgraded, you will need even more. What all of us with trading operations discovered is that it is not that you need the capital to put immediately on the table, but you must have it available. The rating agencies are all over this. They finally figured it out. They are making very conservative assumptions about the amount of working capital required.

MR. BEATTY: If you look at the major players now in this market — Morgan Stanley, UBS and BP, certainly among the top five, if not the top six traders — if any of them has any physical assets, it does not have many. What each has is a huge balance sheet.

Foreign Buyers

MR. MARTIN: Switching gears: what would be a sensible strategy for a foreign company that is looking to invest in the US market?

MR. BEATTY: The question for a foreign company is, "Are you willing to be a trader? What business do you want to be in?" The answer to that question drives the strategy. If you want to be a trader, then you will probably need at least some assets to support the trading business. Or are you an engineering-driven company that wants to buy contracted plants because you like operating things? Those are two very different business models. People get confused because they both make electrons. If you really like operating plants, and you think you can take a contracted plant and somehow reduce the heat rate from 7,000 to 6,000, God love you, that's the business for you. If, on the other hand, you really want to be in the business of making rectangles into triangles, then you must bring a big balance sheet and you will have to figure out which and how many assets you will need to support the trading operation. What we see is people get confused. They end up with a mix of the two business models. Or I suppose another option is buying a regulated business.

MR. MARTIN: John Paffenbarger, what is a sensible strategy for a foreign company looking to invest in the US market?

MR. PAFFENBARGER: If you are coming in cold to the US market, then you should try to find a partner or talent there on whom you can draw — someone who understands what has happened here in the past few years.

MR. MARTIN: Tony Muoser?

MR. MUOSER: What John Paffenbarger said is absolutely correct. Coming in from the outside, I think you would want to team up with a partner. You will need a huge balance sheet if you want to look at merchant assets. Somebody with global reach like a multinational oil and gas company would be well positioned. Anyone who can play on the gas side has the potential to create a nice integrated business with a natural hedge.

MR. MARTIN: What I can't tell is whether there is an opportunity for such companies today in this market to pick up assets at low prices. It sounds like there is not.

MR. SHAPIRO: Those utilities or those foreign players who have lower-cost capital and lower return thresholds can play in the contracted asset game currently. And also to lower their risks, they can play in the regulated game. There are opportunities to buy transmission assets at somewhat elevated — just over typically regulated — returns in view of some new incentives that the Federal Energy Regulatory Commission has put in place. And there are still electric distribution companies to be bought at regulated returns.

MR. GALE: Let's talk about distribution and transmission for a minute. Will there be a lot of transactions in this area in the next couple of years, and who will be the transactors and transactees?

MR. SHAPIRO: You are already seeing in the transmission area some major players coming in as a form of limited partner — as the money men. You have to structure the participation in a transmission project around current restrictions under the Public Utility Holding Company Act in order to avoid becoming subject to US utility regulation as a registered holding company. For anyone willing to engage in creative structuring, I think transmission is probably a good play.

MR. BEATTY: I think there are a lot more available distribution properties for sale now than there have been in a long time. That's a function of the fact that most of those distribution properties probably have to be purchased for cash, not stock. Therefore, most of the US / continued page 30

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players really can't buy them. On the other hand, I must tell you that compared to six months ago, the interest among non-US — that is, European — players to buy distribution properties in this market is at an all-time low.

MR. GALE: Why is that?

MR. BEATTY: For political reasons. Look at the potential European purchasers of US distribution assets. They are almost all on the front page of the local papers.

MR. GALE: They are freedom players, are they?

MR. BEATTY: Yes. I don't think that goes away for a while. I think that that means that European buyers of American distribution utilities are probably not in the picture, depending on how the Iraq situation unfolds, at least for a while.

MR. GALE: What about Japanese companies?

MR. BEATTY: I don't see the demand there at all, for obvious reasons. Historically, our experience has been that the Japanese have shown less interest in distribution properties than generating properties, which is surprising.

MR. MARTIN: There is a perception among many foreign investors that the US is a pretty unstable regulatory environment. They have read about California. Maybe they are familiar with the debate about standard market design — this notion of opening up the market further for wholesale electricity providers. Is the United States almost like a developing country in terms of its regulatory platform?

MR. CONWAY: California has always been an outlier. It has always been a special case. When you set it aside, the rest of this doesn't look terribly disturbing.

MR. GALE: But what about the point that you have courts and regulatory authorities looking at whether to overturn long-term contracts that California signed two years ago to buy electricity when prices were high. Aren't there questions in the US about the sanctity of electricity contracts?

MR. SHAPIRO: If the Federal Energy Regulatory Commission comes out with an order that modifies the long-term contracts in the west that were signed during the California energy crisis, then you will have a lot of people thinking twice about investing in contracted assets.

MR. PAFFENBARGER: The US is not the only country that is still in the process of deregulating its electricity market. In fact, the Europeans are going through the same process. For example, the UK operated for almost ten years under one set of rules before realizing that the rules needed some major adjustments. The point is even in Europe, there has been a lot of discussion, debate, and changing of the rules — stop and start in certain instances. The US is no different.

MR. MARTIN: Is the trend in the US still toward deregulation — at least in the wholesale electricity market?

MR. PAFFENBARGER: I think we are at a standstill.

MR. WILSON: The trend is to hold still for a while.

MR. CONWAY: It depends on the region of the country. For example, there is no progress toward deregulation in the southeastern US.

MR. WILSON: Duke planned to get behind deregulation in the Carolinas. It put a plan in front of the regulators to sell our transmission and distribution business and retain the generating assets. We would have had a contract with the divested transmission and distribution company to supply electricity for a transition period as was done with the utilities divested in New England. However, after California, that plan stopped dead in its tracks. No one wants it because electricity prices are so low in the Carolinas. No one sees an upside. There is only downside. The regulators worry they would have California all over again.

MR. MARTIN: John Paffenbarger, you were about to say something?

MR. PAFFENBARGER: I don't mean to say there is a stand-

One problem with the IPP model is everybody is in the business of selling rectangles when the market wants triangles.

still in the will and activity to advance deregulation, but the visible signs of progress are going to stop for a while. The Federal Energy Regulatory Commission has a lot of work to do to push forward its proposal for a standard market design. The issues will take a while to work through.

MR. WILSON: We are not going back, and we are still moving in the direction of deregulation, but any progress will be halting.

MR. MUOSER: I think that's why the FERC position on the California contracts will be extremely important. If there is no sanctity of contracts, then it will be very difficult to restructure outstanding debts and create a flow of funds back into the power industry.

MR. SHAPIRO: Contracts to sell electricity in this country are subject to the continuing jurisdiction of the Federal Energy Regulatory Commission as "public utility" contracts. Until the California energy crisis, there had been consistent policy that changed economic circumstances are not a basis to modify contracts. If this changes, it will be a huge blow to independent power companies, as they need enforceable long-term contracts to sell their output in order to arrange financing for their projects.

MR. MARTIN: Jay Beatty, you get the last point before we turn it over to the audience for questions.

MR. BEATTY: One of the things I see, especially with the banks — not necessarily Citibank, but the banks with a capital B — is they appear to be looking for ways to reduce their exposure to this industry. I hear this over and over again. I show up with a triple A credit, 7,000 heat rate, the perfect plan. My banker says, "You know, I'd like to finance your project, but I can't get it past my credit committee. We have "x" billion in exposure to this industry, and I can't see us taking on any more."

MR. MUOSER: That's a fair assessment. Some players have exited the bank market. They don't want to play at the same level any longer. We have to be realistic when we talk about the size of transactions that can be placed in the market. Certainly, we are talking about smaller size now. But we also have additional sources of capital that we can access. The bond markets are much more open than the bank market given the right structure and good credit. We recently did a transaction that went very well — contract-based, all offtake contracts with very, very strong credit. Not only was the deal well received, but it was also way oversubscribed. There is capital to invest in the right deal.

Audience Questions

MR. MARTIN: Questions from the audience?

MR. SIEGEL: I'm John Siegel with Bechtel. If you could get a creditworthy offtaker, what kind of leverage can you get? What kind of leverage can you get today, and what do you think will be possible in a couple years from now when the situation is a little better?

MR. WILSON: That depends entirely on the term, the tenor, the price, the shape, and the counterparty credit risk. I think what you are striving for is 80% leverage.

MR. SIEGEL: All things being equal, is the leverage the same as it was two years ago?

MR. MUOSER: For contracted plants or assets, it has not changed much. The longer the contract, the higher leverage you can get. Lenders and equity investors are looking much harder today at the debt-service coverage ratio. That is the main factor that drives the leverage. Coverage ratios for contracted assets where you have acceptable credit as the offtaker are in the 1.5 to 1.6 times range today.

MR. COOPER: I was going to ask what the range is. That's basically what it used to be. That actually used to be a triple B minus credit. I don't know whether the rating agencies would still abide by that.

MR. RANDALL: Rich Randall from Credit Lyonnais. It was mentioned that utility holding companies must be careful about the mix between the regulated and unregulated assets they hold in order to maintain their investment grade ratings. What do you think is the proper mix between the two businesses?

MR. MARTIN: What do we think the proper mix is or what do we think the rating agencies think it is?

MR. RANDALL: What the rating agencies think it is.

MR. WILSON: That's a tough one because it depends on the stability of your regulated business. I would say that if your operating income from the unregulated businesses exceeds 50% of total operating income, then the rating agencies start getting really nervous. They will look very carefully at the business risks and leverage levels. On the unregulated side, they want to see people getting their leverage down to 40% or less, and they are willing to live with 60% or maybe more on the regulated side. That leads to a blended leverage in the 50% range. A lot of companies are way above that today, and they are working hard to reduce their debts.

MR. PAFFENBARGER: I believe our mix / *continued page 32*

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— in net income terms — is about two-thirds merchant and one-third regulated. That appears to us to be sustainable and adequate.

MR. MARTIN: The following question from one of our viewers over the web — Patrick Burdett of El Paso Corporation. "How will geographic region and heat rate affect the wait until plants are back in the black? It seems that highly efficient merchant plants in regions with less efficient power should be getting economic dispatch really quickly." Any thoughts from our panel?

MR. BEATTY: Everybody who has a plant in the south central US believes that. And it may come to pass, but it is certainly not true today. One of the problems with the dispatch models is they rely too heavily on forward price curves for electricity and overlook the fact that dispatch decisions turn on the relationship between the economics and how the market actors operate — politics with a small "P."

MR. WILSON: Look, these models were suspect from the beginning. It's the proverbial "garbage in, garbage out." You have to look closely at the region. Another huge factor that the models sometimes get wrong is the retirement of existing utility assets. Halting deregulation kept retirements from happening. You have a lot of plants that are very inefficient at the margin, but they don't have any fixed costs. The models also got wrong the expectation that environmental regulation would become increasingly stringent and start forcing retirements.

The merchant power companies and the banks put too much emphasis on the models. Depending on what region you are in, a 7,000 heat rate sounds great on the surface, but if you are competing with an 11,000 heat rate steam unit that has no fixed costs, your plant will not be dispatched.

MR. MUOSER: The problem with the credit analysis is the models got these things wrong. As we are re-evaluating some of these assets, we are learning also that the transmission aspect looks much different than it did two or three years ago.

MR. PAFFENBARGER: I'll make the sole vote as someone who says that in certain markets, the plants will be dispatched more or less as expected. I don't think all the markets are dysfunctional. .

MR. GALE: Is there a consensus about the level of retirements? Obviously it will vary from market to market, but will there be a significant number of retirements of the old amortized units?

MR. PAFFENBARGER: The biggest single factor is environmental regulation, which is not yet clear. I'm talking mainly about coal-fired power plants.

MR. WILSON: Some of these plants were bought by the merchant power companies. They are the ones who can least afford continually to invest in them. Those plants will go off line quickly.

MR. COOPER: Another assumption that was underlying these models was retirement of a lot of nuclear plants, and you are seeing re-licensing of nuclear plants, which has altered the economics in certain regions where you basically have very large units that are likely to stay on line for another 20 years.

MR. BEATTY: And gas prices at $6.00 to $7.00 have not helped this process.

MR. GALE: So, the bottom line is the higher the gas prices and the less environmental ratcheting up on the old plants, the more likely we will be to see the large old coal-fired and nuclear baseload plants continue to operate, which will tend to put more pressure on the new plants?

MR. PAFFENBARGER: I would almost take nuclear out of the equation. Unless there is some unforeseen event in the industry, they will keep operating for a very long time.

MR. MARTIN: Next question?

MR. RUSH: I'm Barney Rush. I'm currently on my own, but previously I was with Mirant Corporation. My question is: even assuming that the conventional wisdom is correct and there is some massive rescheduling of debt that will allow these merchant power companies to get through the next couple of years, what happens to them then? Assuming they are operating their power plants but they are still very weak credits, what's the future for them? Do they end up having an independent life? Do they end up being merged?

MR. BEATTY: He gets the best question of the day award.

MR. RUSH: All I need is an answer.

MR. BEATTY: I think the question answers itself. Let's take Reliant as an example. We know what the deal is. The deal is you extend the debt for five years. Reliant gives its lenders security so that they have a secured piece of paper, and the lenders extend the tenor for five years. From the banks' perspective, this is a lot better than going into a bankruptcy or insolvency proceeding because the loan doesn't become "non-accruing." On the other hand, it is no different than being in a bankruptcy proceeding because the company is as constrained in its actions as if it were in bankruptcy. If Reliant were to dip into bankruptcy in the future, its lenders are now secured, and the loan will not become non-accruing merely due to the bankruptcy filing.

Now, in view of everything we talked about this morning, if you are going to run merchant plants, what is the one thing you need? Credit.

Reliant has given its lenders security, so therefore the creditworthiness of it as a counterparty on an unsecured basis with other people in the industry just sank dramatically. It is not clear it can even be rated. Beginning with "C" doesn't even start it. Therefore, the company is stuck either giving full cash collateral on any sales it does, and the better the sale, the more the market moves with it, the better the company's income is, the better its earnings are, the more cash it has to put up or, alternatively, it is only selling the day-ahead market. I don't know how anybody is going to make money in the day-ahead market, except for that July 26th at some point when all of a sudden money comes in.

MR. CONWAY: But let me ask a question. That debt eventually gets brought down, doesn't it?

MR. BEATTY: How? I don't see how.

MR. CONWAY: Maybe the process is a slow one and the company has to do mostly day ahead marketing in the meantime, but eventually the debt burden is reduced. If it is not, then this whole notion of extending, extending and reextending eventually has to end.

MR. BEATTY: Right, but at that point, the banks are fine because they are secured.

MR. CONWAY: That means you are projecting eventual doom here, right?

MR. BEATTY: No. It's not doom. The assets come out. The parties end up in a bankruptcy proceeding.

MR. COOPER: The assets have to change hands.

MR. BEATTY: They change hands. It's not doom.

MR. CONWAY: But aren't the parties better off going through the bankruptcy proceeding now and recapitalizing the company so that it can play in this market rather than leaving it in a position merely to limp along?

MR. BEATTY: I have to tell you, I think the managements of these companies have made a Faustian bargain. They are stuck, and they will eventually go into a bankruptcy proceeding, because I don't know that they can pay down any of this debt in the day-ahead marketplace. What's more, if anything bad happens — and this is an industry where bad things seem to happen with remarkable regularity, they are sunk.

MR. CONWAY: But the market does eventually come back, right? At least that has been the premise that, within a couple of years, it comes back.

MR. BEATTY: Yes. I don't believe the day-ahead market comes back. What happens is, at some point, somebody — your load-serving entity — is willing to either buy the power plant or contract for its output.

MR. COOPER: Because the load-serving entity is worried about getting caught short.

MR. BEATTY: That doesn't help the distressed merchant power company because it cannot contract with the load-serving entity because it lacks the collateral to put behind the contract.

MR. CONWAY: That's too absolute a statement. For one thing, you are not going to have that problem with coal-fired power plants. Why? Because that counterparty is going to think, "No matter what happens, this will be least-cost electricity."

MR. BEATTY: But remember the way the contracts work is the more cost effective a contract is — the better the deal for the utility — the more collateral the generator will have to post to ensure performance.

MR. MARTIN: Mark Comora.

MR. COMORA: Mark Comora, Fortistar. I would like to ask a follow-up question. Given this bleak outlook, how do the banks get comfortable, during the next three to five years while they wait for the market to turn around, that they have professional managers of their assets? The borrowers who got into this situation are power companies. One would have thought if anyone knew the business, they do.

MR. PAFFENBARGER: If that scenario plays out, and I'm not convinced that it will, I don't know. But if the debts are restructured, the logical thing is to let the companies in trouble operate the plants and market the output as they have been. I don't think the outlook is so gloomy that they will not be able to have enough credit to trade in markets other than the day-ahead market. If the restructuring allows cash to accumulate, a company can build up collateral to allow its power marketing operations to continue. I do not think the banks will want simply to cast everything to the wind and say, "Let's get a new operator; / continued page 34

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let's get a new power marketer, and a new fuel management company." My company, Constellation, is offering that service. We do it now. We hope the banks will eventually want it, but it remains to be seen how great a demand there will be for the service.

MR. WILSON: The bargain is the bank syndicate lets you live if you operate the assets on its behalf. There is an option value to the equity investment. If things turn around, it could be worth a lot, but in the near term you are only going to be generating as much revenue and paying down as much debt as you can. I don't know if anyone thought about this, and it would probably be situational, but in some cases where the banks are pregnant with the paper, they may step up and write letters of credit to provide the necessary collateral in order to enter into the long-term contracts to sell the output. They would benefit directly from such contracts.

MR. MARTIN: Here is another question from the web audience — from Seth Parker with Levitan & Associates. Which regions of the country are most attractive today for merchant plants, and which are least attractive, and why?

MR. COOPER: The least attractive is probably the south central United States.

MR. MARTIN: The most attractive?

MR. WILSON: The west, still.

MR. MARTIN: Why do you pick the west?

MR. WILSON: The market dynamics are different than in other parts of the country. They are driven by hydroelectric projects. Prices are firming up in some parts of the west. Weather conditions are dry. It is very difficult to get regulatory approval to build a new plant. This creates a barrier to new entrants. There are also shortages of transmission capacity in the west.

MR. COOPER: Also, because the western US is so dependent on hydroelectric power, the reserve margins have to be significantly greater than in other parts of the country in order to absorb the weather flows. I think New York is also a good market because it also has barriers to entry. It is hard to build power plants near New York City.

The electricity itself is not the high-value commodity. The high-value commodity is the shape of the power.

Hard-Earned Lessons

MR. MARTIN: Final question: *The Washingtonian* magazine runs an interview in each issue. The last question asked the person being interviewed is invariably, "What lessons have you learned about life?" I want to change the question slightly. You have all been around the power industry for a while. There are many people watching this webcast who are not as familiar as you with the US market. What hard-earned lessons have you learned that you would convey to someone who is thinking about entering the US market? Bill Conway?

MR. CONWAY: My advice is, if we assume that most assets will be sold in auctions in the future, bidders will need to marry capital with an experienced management team to succeed. I would advise anyone outside the US with capital to find a capable management team as early in the process as possible. It will maximize the chances for success.

MR. MARTIN: Charles Wilson, a hard-earned lesson?

MR. WILSON: Don't extrapolate from simplified deregulation models.

MR. MARTIN: Tony Muoser?

MR. MUOSER: Don't trust anybody. Second guess everything.

MR. MARTIN: Spoken like a good Swiss since the Swiss are always neutral.

MR. MUOSER: Also, the local knowledge is extremely important. Location in this business is key. You should work with a consultant who really understands the specific local market. There is no national model or national approach to this.

MR. MARTIN: John Cooper, hard-earned lessons? You must have several.

MR. COOPER: I agree with Tony Muoser's admonition to challenge all assumptions. The popular wisdom in the past was that the fact it took $700 million to build a power plant provided a barrier of sorts to entry, and that everyone would be rational at these prices and not overbuild. That did not happen.

MR. MARTIN: Jay Beatty.

MR. BEATTY: Forget the Excel spreadsheets and discounted-cost-of-funds models and think of credit in a more abstract sense. Focus more on how the rating agencies will react and less on what the internal rate of return will be over some period of time.

MR. MARTIN: John Paffenbarger?

MR. PAFFENBARGER: Having come from Orion which was bought out by Reliant, not quite at the top of the market, my advice is timing is very important. The market is in a trough. Everyone is trying to figure out when the cycle will turn up again.

MR. MARTIN: Bob Shapiro?

MR. SHAPIRO: People forget that electricity is a vital commodity. There is no tolerance in this country for the kinds of price spikes that we have seen in California and some other places. Be advised that the volatility we saw in 2001 in California will not be permitted in the future.

Restructuring The Overleveraged Energy Company

Many merchant power companies are in talks this year to restructure their debts. Standard & Poor's has estimated that $90 billion in medium-term loans will come due in the US power sector in the period through 2006. Chadbourne hosted a workshop in Houston in late April at which two participants took the roles of a power company trying to renegotiate its debts with a bank syndicate that made the loans. Stephen Cooper played the role of the power company. Cooper is currently chief restructuring officer and interim CEO of Enron Corporation. He has had many other prominent assignments over the years, including the restructuring of Polaroid, Federated Department Stores and Laidlaw. Joseph Smolinsky, a Chadbourne bankruptcy partner, played the role of the bank syndicate. The workshop was led by Howard Seife, head of the bankruptcy and restructuring department at Chadbourne in New York.

MR. SEIFE: Our program today involves role playing. The idea is — through the give-and-take between Steve Cooper and Joe Smolinsky — to give you a feel for what happens in the debt restructuring process. We are going to take you from A to Z in a debt restructuring for a troubled company, from the initial stages of the negotiation to what we hope is a successful conclusion.

It is important before we start to understand the following about the company. Our hypothetical company — Power Co. — is a large, diversified, publicly-traded Fortune 500 company. It grew substantially in recent years. In addition to being a holding company and providing traditional energy services through a number of subsidiaries, it also developed diversified ancillary businesses.

One of its subsidiaries is Electric Co., which generates and transmits electricity throughout the midwestern United States. These are highly-regulated operations under the jurisdiction of the Federal Energy Regulatory Commission and local public utility- commissions.

Another subsidiary is Pipeline Co., which provides transportation and distribution of natural gas.

Another subsidiary is Generator Co., which operates merchant generation facilities throughout the United States. Many of its projects are still under construction at various sites. The future funding requirements of these facilities are, in many cases, guaranteed by the parent company. The structures used to finance the projects vary. They can be synthetic leases or traditional construction loans.

The company has also established a Trading Co., which engages in third-party marketing and trading. It trades natural gas and electricity and it uses third-party derivative financial instruments to hedge.

There is also a subsidiary that does construction work — generally constructing merchant energy facilities and power plants for other companies. Often performance of the construction work is guaranteed by surety bonds, and those bonds are guaranteed also by the parent holding company.

Finally, we have the catch-all subsidiary, Finance Co., that provides a variety of financial and consulting services and even has a commercial real estate portfolio. Thus, the structure is the fairly typical holding company structure with each of the different operations in a separate / continued page 36

Debt Restructuring

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subsidiary. In many cases, the subsidiaries have their own financing relationships.

As is typical with companies that have expanded and acquired new businesses in recent years, the company has incurred substantial amounts of debt. To give you a snapshot of the debt today, here is a bank revolver of $200 million. There is a bank term loan of $1.3 million, and there is a big amortization payment due next year that is looming for the company. There are also senior notes. Those are due in 2010 in the amount of $500 million. And underneath are senior subordinated notes in the amount of $200 million, and those are coming due next year as well. In short, a looming payoff or refinancing will be required.

In addition, off balance sheet, there are synthetic leases that are financings used to construct the power plants at the subsidiary level, and those leases are guaranteed by the parent. That is an additional $800 million of debt. In addition, there are various unliquidated claims, including litigation pending, performance guarantees, offtake guarantees, indemnities, employee benefit obligations, and those are largely unquantified but substantial liabilities.

The company is having problems. Recent events include losses at the Trading Co. And to make matters worse, there has been tremendous volatility in the gas and electric power markets, and volatility is cutting into profits at Electric Co. and Generator Co. In addition, the company is being investigated by the US Securities and Exchange Commission, and there are class action lawsuits by shareholders who are unhappy with the performance of the company and its reporting claiming that the financial reporting has been inadequate.

As a result of all these negative events, Moody's and Standard & Poor's have downgraded the public debt. The downgrade triggered collateral obligations at Trading Co.

Finally, two more points: Power Co. recognizes that its balance sheet is overleveraged. And as it begins to violate financial covenants with its banks and as maturity date looms for repayment of its bonds, it is evident to the company that without a consensual restructuring or refinancing of its debt, it will have to file for bankruptcy.

Furthermore, Vulture Co. has acquired 25% of the subdebt at a significant discount. And Power Co. suspects there has been significant trading in its other securities as well and that the market is discounting its prospects. This can all be summed up with the senior management sitting around the table, trying to figure out, "What happened to our mojo?"

So you understand the players and the roles that they will be playing, I am the omniscient moderator trying to stay above the fray. Eventually, I might turn into the bankruptcy judge. Steve Cooper will play the role initially of the chief executive officer of Power Co. Joe Smolinsky will represent the agent bank that has the substantial indebtedness about which it is becoming very concerned.

Steve Cooper, given the current situation, given your significant debt loads and the looming problems, what are you going to do?

CEOs by nature are optimistic. That's why banks want a chief restructuring officer appointed with whom they can deal to take a hard look at the numbers.

Buying Time

MR. COOPER: We have no problems. (Audience laughter.) I would really set out to do just one thing, which is to buy time. And I know that to buy time I'm going to need some modest liquidity support from our banks because I'm absolutely convinced that if I can just postpone a few of these issues for six, nine or 12 months, that time really will work to the company's advantage, and these problems will literally evaporate. Thus, my objective is to buy time.

MR. SEIFE: Joe Smolinsky, you are the agent bank. You have been lending to this company for many years. One might say you have been living off the fees of this company for many years.

MR. SMOLINSKY: I'm fat and happy.

MR. SEIFE: Right. That will end soon. (Audience laughter.) You see the problems I described and the sizable debt load. What is your response?

MR. SMOLINSKY: Every time I pick up the phone and give Steve Cooper a call, he always starts with the good news: "Six months from now, things are going to turn around. We're having a little glitch now. We just need a little bit of help, and we're going to get over the hurdles." I know that lurking behind all of this good news is a looming problem. I see other similar companies having similar problems. I also want to buy time. I want a performing loan. I have to make sure that my 20-bank syndicate is kept informed, so that no one accuses me later of springing a surprise. Therefore, my first priority is to get better reporting. I want more control. I start thinking about new covenants that I can ask for in order to make sure that things don't get worse. And I may ask for extra fees.

MR. SEIFE: Steve Cooper, you are starting to get a sense from your banks that they are growing uncomfortable. They see the same problems that you see. They are not as sanguine that time alone will cure things. They are not sure that the gas market is really going to shift to your advantage. You are even worried about your own position at the company. What are you going to do now?

MR. COOPER: It is becoming clear to me in my conversations with Joe that it will be difficult to tap the banks for additional liquidity. I am starting to realize that I need to assemble a team that can advise me on my options for moving forward with this situation. That will usually mean talking to either my existing law firm if it has the right restructuring capabilities, because I will need to have a good understanding of what the company's rights are, what my rights are, what the board must do as we begin to brush up against a tighter and tighter liquidity, and what disclosures, if any, I'm required to make.

Therefore, I will place a call later today to our law firm. Following that call, I will more likely than not also call our financial advisers or investment bankers because I will need someone to break the ground for me in terms of going to our banks for waivers and articulating to them why this is just a matter of buying time. I am looking for a team that can help me convince the banks that extending additional liquidity is really not a problem. I will ask both the law firm and my investment bankers to work with me on a restructuring proposal, albeit, at this stage what I have in mind is just more liquidity. And if Joe continues to be as persistent as he was on his phone calls, I may begin to think about some fallback bankruptcy planning.

MR. SEIFE: One of the things that this crackerjack law firm that you have hired will want to make clear to your board is that when a company is in the realm of insolvency, fiduciary duties start to shift. The board has traditionally been mindful of its fiduciary duties to the shareholders. The board will get the speech from the lawyers that, "As your financial problems worsen and solvency may even be questioned, you will have fiduciary duties to creditors. If things don't go well, the creditors will look to you as board members to make sure that you acted in their best interests and made all the right decisions."

Joe Smolinsky, the banks have heard through the grapevine that the company is making some moves. It has hired restructuring counsel. It is consulting financial advisers. But it is still talking about buying time. What is your next step?

Gearing Up

MR. SMOLINSKY: A meeting will be scheduled shortly with the company to start discussing what type of relief it wants and what type of relief the banks are willing to provide. Some of the banks in my group have started shifting this project to their workout departments, and I'm planning to do the same. I plan to have my workout department sit along with me in that first meeting, probably, and give me some advice about how this should play out from the bank perspective. This is somewhat undiscovered territory for me as the relationship loan officer for the Power Co. account.

I'm also going to hire counsel. Most likely, I will also need a financial adviser. I want to make sure that I can get the protections that I need for the rest of my bank group from the company.

I am going to want an indemnity from the company, for example, for any discussions that take place between the bank group and the lenders from a lender liability perspective. I am going to want a document to set out what our respective roles are. I am probably going to want the company to concede that there are events of default or facts that will turn into events of default if left uncured, to certify that there are no defenses against my claims, and perhaps some other representations as well. */ continued page 38*

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I am also going to want to form a steering committee. This group of banks is too unwieldy. I make calls to 20 banks after each development, and I certainly cannot have 20 banks at the first meeting. I will lead steering committee. Its members will be a subset of the banks who are most interested in participating.

I am going to start assessing the business so that I appear well informed before my steering committee before heading into that first meeting.

The initial challenge is to figure out what capital structure the company can support after making the most conservative earnings forecasts.

MR. SEIFE: The bank is hiring a law firm and hiring financial advisers. These professionals don't come cheap. Who will pay for all of this?

MR. SMOLINSKY: My credit agreement requires the company to pay these fees, but I'm not going to rely on that. My mandate letter that I am planning to have the company sign will also provide for current payment of all of our professional fees, making clear that it includes financial advisers as well, because we are no longer talking about the cost merely of preparing a waiver. We are now talking about some serious money to understand the balance sheet of this company and what posture to take in our discussions.

MR. SEIFE: Steve Cooper, what's your response? Will you sign such a letter that the bank puts in front of you? You are agreeing to indemnify it for its role in these negotiations? You are agreeing to pick up the tab for all its advisers? You are facing liquidity problems as it is.

MR. COOPER: I will hand it to my lawyer, and we are really going to buy time. (Audience laughter.) I see this particular letter as something that we will try to negotiate. But at the end of the day, this is something that I realize I must sign if I want to get the banks in a room and buy time. Therefore, we will negotiate the best deal we can in terms of the information we are prepared to share and the access we provide, how much we are prepared to pay, and for how long these arrangements will continue. At the end of the day, I don't see that I have much choice.

Initial Meeting

MR. SEIFE: Joe Smolinsky has to show some progress to his management. He scratches his head and, like most bankers, he calls you up and says, "We need to meet. We need to hear what you as the company want to do. It's your problem. You're the one with the cash flow problems. We're going to sit down together in a few days, and I want to hear from you what the company plans to do. How are you going to deal with the looming maturities in 2004? What are you going to do about your current liquidity problems?"

MR. COOPER: This is going to be an interesting meeting. My legal and financial advisers agree with my strategy of trying to buy time because that will allow our markets to bounce back, and we will be fine.

Therefore, our chief financial officer, our lawyers and our financial advisers will be heading to a bank meeting where they will put in a proposal that reflects this thinking. It will ask for more time — let's say five years — to repay our debts. We will mitigate our current liquidity crunch by pushing out all of the near-term amortizations that are staring us in the face. I'm prepared to give a little on the interest rates, so we ratchet them up by 50 or 100 basis points. I'm willing, if really pushed to the wall, to consider giving up some collateral, but more likely than not just a stock pledge of a couple of the subsidiaries. I don't want a lot of covenants.

We are still in a growth mode. I see that with the turmoil in the market, there are some additional acquisition opportunities. That's why I don't want to be tied down with restrictive covenants, and I certainly do not want to be forced to use my excess cash flow to repay debt as opposed to using it to take advantage of growth opportunities.

Therefore, our proposal to the banks will be nicely tailored to the buy-time philosophy that I believe is the solution here.

MR. SEIFE: Did I hear you right that you personally would not be attending that bank meeting, that you are sending your CFO?

MR. COOPER: Right. This is really not an issue. The senior executives in the company are more than capable of handling this.

MR. SEIFE: Joe Smolinsky, you are at the meeting. You have just heard the proposal from the CFO, and the CEO is back in his tower in Houston — or wherever he may be — and what's your response? Is there a little denial going on here?

MR. SMOLINSKY: Clearly there is denial. As a banker, I know this is typical of any CEO of a distressed company. By nature, CEOs are optimistic. That's why they're successful. As a relationship banker, I may receive the proposal with some optimism that something can be worked out and, "Thank you very much," but that's when the workout banker steps in and sends the relationship banker back to writing new loans for other borrowers.

The banks will have several problems with extending the current maturities under the bank financing. We have the subdebt maturing in 2004. There is no reasonable way that the subdebt will be repaid in that timeframe. We also have these large litigation claims — unliquidated claims — looming. The banks are going to want some protection against those claims ripening to judgment within that five-year life span.

The company may have offered stock pledges, something to placate the banks from the collateral side, but I know that stock pledges alone don't necessarily provide the banks with much protection. They do not make for an easy foreclosure if we need to take the collateral. The problem with foreclosing on subsidiaries is they have other liabilities.

As a workout banker, I am not happy with the strength of the financials that have been presented to me. They are probably on the back of a cocktail napkin. I am used to seeing financial professionals who are experienced with workouts and know the format. I am interested in seeing how much money the company is throwing off, and not what the income statement shows. I want reports that can be delivered to me in a way that gives me the information I need.

I am starting to think about whether the current CFO is the right person with whom to be negotiating and to be discussing the future restructuring. I might ask the company to bring in a "chief restructuring officer" to support the work of the CFO.

I will also start looking at cost cutting. Does the company really need the three corporate jets? I am also concerned about acquisitions and the continued use of the company to finance new business enterprises in Finance Co. I am very concerned about the subdebt. I want to know what the company's plans are with respect to the subdebt and the maturity in 2004.

Chief Restructuring Officer

MR. SEIFE: Joe, you mentioned bringing in a "chief restructuring officer," and Steve Cooper, as a CEO who has never had any experience with a troubled company before, asked me, "What is this CRO? How does he fit in? Why do we need such a person?"

I explain to him that this is something that the banks need to get comfortable. He is someone who has gone through the restructuring process on numerous occasions. He is someone whom the banks probably already know and in whom they have confidence. He does not have a vested interest in the company. He has no stock options. He has no history with the company that he is trying to cover or mask. He is someone who can take a fresh look and decide what is and is not possible. Some CROs report directly to the board. Other CROs report to the CEO.

Thus, the company, knowing that it must do business with the banks, has acquiesced after a lot of give and take and agreed to appoint a CRO. The banks suggested two or three candidates with whom they would be comfortable. The banks have had to waive lender liability concerns because, if they force a CRO on a company and things don't go well, they may be subject to lender liability-type lawsuits for imposing a turkey on the company who has gotten it into worse trouble. By giving the company the opportunity to choose among two or three candidates, to interview them and to get comfortable with them, the lender liability concerns are somewhat diminished.

At this point, Steve Cooper is going to change hats and act out the part of the CRO. Steve, as a CRO, how do you like to fit into the corporate structure? What are the pros and cons of the different ways of coming in?

MR. COOPER: There are one or two placements that are in vogue these days for CROs. One is to report directly to the board. When the CRO is asked to report / *continued page 40*

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directly to the board, he takes on responsibility for a couple of areas. One is the balance sheet, only because experience has shown that most CEOs have grown up on the operating side of a business. They understand very, very well the profit and loss statement and operations, but the balance sheet is oftentimes a mystery. The second thing the CRO does is become responsible for cash management, cash planning and cash forecasting, so that he can put a bridge between the balance sheet and operations. If the CRO reports to the CEO, we usually recommend that the CRO have primary responsibility over those two areas.

MR. SEIFE: As a CRO, do you come in as the Lone Ranger, or do you typically bring members of your firm with you to assist in the restructuring process? How do you deal with the interdynamics of current staff? How do they view you? How do you overcome the suspicions?

MR. COOPER: It is difficult to come in as the Lone Ranger. We work mainly with middle-market capitalized companies — $300 million and above. It is difficult for one person to get a handle on a company that size. So we typically bring a team.

As the company moves down that slope from stress to distress, there is a collapsing of resources. You find that with the overlay of trouble, the demands of the banks — they want information, want access, want this, want that, and if the other constituents get organized, they replicate those demands — rarely, if ever, does the company have enough time and human resources to do all of this on its own.

MR. SEIFE: Joe Smolinsky, you have shown progress. You are able to report up to your management that you have compelled the company to hire a CRO. The company has hired someone in whom you have confidence. You plan to give the CRO a two-week period to get his feet wet, to get his people in place, and to start reviewing operations. What are you going to do during this two-week process?

MR. SMOLINSKY: If this is a secured bank facility, I would probably be doing an extensive collateral evaluation at this point. But in our hypothetical, the banks are unsecured. So we are going to be putting together our team of lawyers and financial advisers. The financial advisers will be reviewing financial material received from the CRO and starting to understand the business.

The bankers are concerned about the totality of the business. The debt is at the parent level. As long as there was enough money available, they did not have to worry about each individual business unit. However, now the focus is going to be on each business unit down the chain, what is valuable and what is not so valuable.

The lawyers will be reviewing all of the documents not only at the parent level, but also at the subsidiary level. They will find that these power companies have very complicated project documents and financial documents. We have the synthetic leases that will have to be evaluated for the likelihood that those guarantees will become parent obligations. We have to make sure that there are no covenants in the subsidiary lending facilities that would preclude the granting of assets as collateral for our distressed loan.

MR. SEIFE: Steve Cooper, while the bank is doing that, you are at the company. You have your team in place. You know that you have a bank meeting coming up and the banks will want to see progress and a different approach. What will you do over this short-term period?

MR. COOPER: Three things. The first is to begin to stem the loss of credibility. The second is to make sure that we can present the company's position and go-forward program in a clear, concise way. The third is — at every step of the way — make sure that we maximize the alternatives available to the company. Part of being able to restructure successfully is to

> Companies try in restructuring talks to buy as much time as possible and to preserve options by deflecting covenants and holding on to collateral and cash.

ensure at every step of the way that you have not foreclosed alternatives that would otherwise be available to the company.

Specifically, we will spend the two weeks reevaluating the company's business plan and projections. The banks either want their money back or they want to protect it. From the company's perspective, we don't want to — nor are we in a position to — give it back, and we want to give the banks to have as few protections as possible in order to ensure that our alternatives remain as broad and as deep as possible.

We will retool the business plan, so as to show what concessions we are prepared to make — realistic concessions by way of acknowledging that it is our responsibility to do what we can to turbo-charge liquidity. We will modify the restructuring proposal to get back to planet Earth. If there is a dramatically different view of the company's prospects that exists between the company's internal world and the banking world, you have to bridge that. Otherwise, you will have a meltdown between two sides.

We will continue the bankruptcy planning to ensure we have the right leverage with our lending institutions. They are unsecured lenders. We will approach debtor-in-possession lenders that are not part of the banking syndicate.

MR. SEIFE: You made a point that this is an unsecured bank group. Would you approach this differently if the banks already had the available collateral?

MR. COOPER: Yes. By securing the assets, a couple of things happen. Number one, you have reduced your alternatives by way of additional borrowing, and you have hampered to whom you can go to for debtor-in-possession financing. If those assets are secured and there isn't enough free collateral, the only group you can deal with are your existing lenders.

There is often a pixie dust view that you can convince a court to ignore their interests and bring somebody in over them. But by the time you win that fight, which is impossible to win in practice, it is no victory because your company will have melted down. The granting of collateral eliminates two or three alternatives that you might otherwise have had available.

The Unexpected

MR. SEIFE: So where are we in our scenario? The CRO is involved. His team is involved, and it is carefully revising the business plan. It is revising the projections, it is ready to deliver all of that to the banks, and it is feeling pretty good. The CRO's team has the business under control. It thinks it has realistic projections. And then, of course, the unexpected happens.

Out of the blue, one of the speculative trades that was in place — you may recall there is a subsidiary that does trading — went awry. Trading Co. calls the CEO on the phone, and he calls in the CRO. "We just lost $85 million. It's absolutely all of our cash. It throws off all of our projections." The CRO, being an experienced guy, knows that communication with the banks is paramount. He calls Joe Smolinsky and says, "We have some bad news. You know we have the trading operation. It moved the wrong way. We fired the guy, but we have a hole, and the projections that we have shown you, they don't work any more."

Joe has to tell his boss that things aren't going as well as anticipated.

MR. SMOLINSKY: I am starting to see that things are getting serious. We will have to make wholesale changes in order to protect our claims. Steve Cooper is making me nervous because he now realizes, after talking to his lawyers and financial advisers, that if we banks don't come to the table, he can file for bankruptcy protection under chapter 11 and then maybe bring in a DIP lender and pledge all the assets to our detriment. Therefore, I have to balance my need to get something corralled at the company to prevent further surprises with my need to come to a deal outside of bankruptcy.

One of the things I want him to do is to get out of the speculative trading. The company trading its own portfolio is considerably dangerous. With a flush balance sheet, perhaps it's a prudent business for the company to be in. But now it's just plain dangerous.

I also want the company to start thinking about selling assets in order to raise some liquidity, and perhaps to use a portion of the cash raised from asset sales to pay down debt. I'm also trying to assess whether I should condition a refinancing on meeting certain benchmarks — for example, getting out of trading by a certain date, selling assets by a certain date. Do I truly want this? It certainly improves my position, but I have to be concerned about tying management's hands. Certainly Steve Cooper will tell me that he doesn't want to agree to that because it will tie his hands. And he may be forced to sell out-of-the-money derivatives at large losses or sell assets at distressed prices. / continued page 42

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I'm also looking for the business plan. I want the in-depth analysis that Steve can bring to the table to help us better understand what the alternatives are for the restructuring.

There is one other thing that is looming large in my mind. We have a fairly large letter of credit facility and we have troubles at the subsidiaries. As a banker, I know that because of the downgrades in credit, counterparties are going to start requesting additional letters of credit that don't currently exist. That will increase my exposure. Therefore, I will want the company to try to negotiate out of those letter of credit obligations or else find some way to reduce that contingent exposure.

MR. SEIFE: Of course, Steve Cooper's response to the problem with the speculative trade was, "It wasn't in our plan," which, obviously, was the case. But Steve has now been in the company some time. He has worked into the business plan and the model this $85 million loss, and he has had time, with the CEO, to put together a serious restructuring proposal. He has listened to the banks. He has understood the concerns, and he also now fully appreciates the liquidity problems that the company has and realizes there are looming debt payments due next year. He has to buy more time and the ability to deal with those problems. Steve, lay out your business plan. How are you going to turn this company around?

Restructuring Proposal

MR. COOPER: Well, I know a couple of things by now. One is we can't continue to follow business as usual. The other is, by this time, with any luck, we have gotten a very, very good handle in a very conservative case as to what the real liquidity needs of the company will be. That is essential because we're going to have to focus now, both internally and externally, on how we fill the money gap.

One of the things I am convinced of is that there isn't enough cushion — in terms of collateral or equity — to persuade the banks to pony up all of the liquidity needed to work our way through the crisis. With the speculative trade gone bad and the increasing demands of the banks — "Get out of trading," "Begin selling assets" — distress levels have been ratcheted up a couple of additional degrees.

The typical bank syndicate today has domestic banks, foreign banks, asset-based lenders, prime funds and hedge funds — each of them with a different agenda.

At this next cut, we will look at a very, very, very conservative business plan, and we will begin to jettison projects or businesses that don't make sense over the long haul. It will take too much capital to bring them to fruition. It is unclear, given the state of the markets, that they will provide the payback that we originally thought, and so on and so forth.

MR. SEIFE: Does that mean you are prepared to cease construction on a number of new merchant plans that are in the works?

MR. COOPER: Yes. Anything that doesn't work at the moment and anything that requires enormous amounts of capital. In this particular case, we have a couple of power development projects and an Internet project. We will cut capital expenditures in this plan by a $1+ billion over the next several years.

MR. SMOLINSKY: You are not going to do it without asking me, right, because that would affect my claims against the parent?

MR. COOPER: This is presenting the business plan. So aggressive, these bankers. (Audience laughter.) They become more and more aggressive every step of the way.

We will then look internally to the organization to see what other possibilities we have on the operating side of the business, whether it be head count reduction, whether it be the ability to squeeze operating and maintenance budgets, travel budgets, expense budgets. Anything becomes fair game to reduce the outflow of cash and to begin to build and maintain liquidity. We would, in that event, incur a benefit on one side which is the cost reduction or the head count reduction. The offsetting side of the ledger is employee severance costs.

We would look to asset sales and see what, if anything, makes sense to dispose of or to unwind or to defer commitments in order to bring in cash sooner rather than later.

If the bank agreements do not require it or, said differently, if the banks are unsecured lenders and there are no prepayment provisions in the loan documents, I would ensure that when I got my hands on that cash, the cash is deposited in a bank that has no link to the 20 banks in our lender syndicate.

I will also look at the current side of the balance sheet to see what, if anything, can be done to accelerate the collection of receivables and what, if anything, can be done to decelerate the outbound flow of cash by way of payables.

MR. SEIFE: Does that mean you're stretching your trade creditors?

MR. COOPER: It means I'm stretching the trade creditors because, again, the name of the game is to preserve optionality, and to the extent you have no cash and no liquidity, they have you as opposed to you having them, particularly if the facilities are unsecured. The real mission is not only to describe the business going forward, but also to have a very precise handle on how that business is going to reflect prioritizing the creation of liquidity.

Once you see what you can provide from internal sources — the canceling of projects, the disposition of assets, the cost reductions, squeezing the balance sheet — you can then quantify the money gap and how much cushion will be required to pull through. We will then go back to the bank group with more realistic pricing. Obviously, we will be looking to perform against this plan. They will want to figure out how to ensure our performance. They will do that through tighter covenants.

If we are asking for additional liquidity — which has to be real as opposed to tied up in a legal document that looks like you get it but you really can't get your hands on it — we will consider offering up additional collateral.

MR. SEIFE: Steve Cooper has now put his proposal to the banks. And this isn't quite how he presented it: "That's our final offer," which is never a good negotiating tactic. But while the banks are considering the proposal, we have another adverse change. We have a spike in the natural gas prices. And, again, that wreaks havoc with projections because this company is heavily dependent on natural gas. It has not fully hedged its position to protect against a change in prices. Once again, Joe Smolinsky has to tell his management that the projections do not work any longer. The business plan is flawed, and there is an even greater liquidity crisis looming.

Steve Cooper has to pull yet another rabbit out of his hat. We can now see clearly down the road the possibility of running out of cash if natural gas prices don't come down. Worse, if gas prices rise further, the company will be in serious trouble.

It's back to the drawing board for Steve. You will have to redo the projections once again. Joe, what is the reaction among the banks, and how do you view the proposal that was put on the table?

MR. SMOLINSKY: The most exciting thing that I have heard is that the company might be willing to give up some collateral. I realize that there is a lot of debt all around me, and I want to be at the top of the heap. My best way of getting protection, even if this plan ultimately comes crashing down, is to grab some collateral. But I'm not so sanguine that he will be able to deliver enough collateral to make me happy. While he certainly has valuable assets in the form of, for example, the gas pipeline, it belongs to a joint venture and I'm not sure yet how he will be able to deliver that as collateral.

The Generator Co. and Utility Co. have merchant power plants, but they have their own financing that probably includes negative covenants that prevent pledges. And there may be regulatory restrictions on the ability to pledge those assets anyway. Likewise, since this is a holding company that we have claims against, we're looking to take pledges from subsidiary corporations.

I am concerned about the possibility that upstream pledges will be viewed as fraudulent conveyances because the subsidiaries may not derive the benefit of this renewed financing. Yet, the company is pledging their assets to satisfy the obligations. I know that some of those entities are troubled as well. Trading Co., for example, has a lot of out-of-money positions. Its creditors will not be happy when they wake up one day and find that whatever assets that existed are now pledged to the parent company's banks.

MR. SEIFE: Generally, are you getting a positive reaction from your own management and from the banks in your group to the latest proposal? How can we move this process forward? We have weathered another */ continued page 44*

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crisis. We are running out of time. If we don't restructure, then you know what the company's option will be.

MR. SMOLINSKY: Most of the banks are supportive at this point. They feel the company has a plan that is, for the most part, workable. It may need some improvement around the edges, but it's something that we definitely are very interested in pursuing. There are a couple of banks that are still not quite sure. They want to understand a lot more about the facts. They are suspicious about my intentions as the agent bank because they know that I have loans to other affiliated entities. I'm in a synthetic lease. I'm in a couple of the other loans, and I have a true desire to get this thing restructured perhaps more than they do. Thus, there are suspicion within the bank group, but generally we are all moving positively toward a deal.

MR. SEIFE: Let's not forget that merely resolving the bank issues is not enough. You have a looming maturity on your subdebt next year. That is $200 million that is not in the projections. Steve Cooper, it's great that you have made so much progress with the banks. You have most of them comfortable, but you have subdebt coming due. What are you going to do about that?

MR. COOPER: In the next year, we have a financing gap. I'm convinced that the banks are not prepared to fill that hole. Therefore, we look at our alternatives for addressing the subdebt. One of the assumptions is some vultures bought into the issue at attractive prices. We will try to find out on what terms and conditions they would be prepared to exchange the 2004-coming-due debt for something with a longer maturity. We will negotiate such an exchange on terms and conditions that are acceptable to the company and acceptable to the subdebt holders, but push the maturity out beyond the senior bank facilities and before the maturation of the junior facility.

We are looking to re-layer the balance sheet in a way that further mitigates the cash calls on the company for the next year or two or three. In this case, we will propose an exchange offer with some PIK notes plus some warrants. As long as we can layer it properly and as long as they see the right yield to maturity, this might be something that these distressed investors will find attractive.

It is more difficult to restructure public debt because changes in terms almost always require unanimous consent among the bondholders.

MR. SEIFE: Okay. We're close to a bank deal, as Joe Smolinsky said, there are at least two banks that are not on board, and this type of restructuring will require the unanimous consent of the banks because you are talking about changing maturity dates and interest rates, and you cannot force that on any individual bank. Joe's work is cut out for him. He will need unanimity to do this as an out-of-court restructuring.

At the same time, Steve is going to have his hands full dealing with the subdebt. He will have to get all the bondholders to agree to stretch out the debt. And realistically, you can't get all the bondholders who hold this debt. The debt is too widely held, and you will always have some holdouts. Therefore, the company must decide what percentage of that debt it needs to be able to restructure and then deal with the consequences of having to pay off the holdouts. If that dollar number is too big, if the company can't get enough bondholders on board, then the restructuring will not work.

That's the current dynamic. We have a deal with which at least the agent bank is comfortable. We have a deal with which the majority of the subdebt is comfortable. We don't have unanimity, and we still have our work cut out for us.

Speeding the Process

MR. SEIFE: Steve Cooper, how do you expedite the process? The longer it goes out, the more expensive it is, the more damage there is to the business, the more collateral your trading partners are going to see. Other than hiring expert professionals, what do you do?

MR. COOPER: You have three discreet problems. On the company side, you almost always have to deal with denial. That takes time. We have a phrase inside our organization called the "Triumph of hope over experience." It's particularly prevalent in retail. "The weather was too good; the weather was too bad." There are only four retail days a year when the weather is just right for retail sales. Inside the company, there is a denial factor. It exhibits itself in two ways. One is there is little or no recognition of all the things that could go wrong. The company has an upside focus. When someone must take steps to analyze the downside and preserve options, people really resist it.

The other discrete problem that takes time to work through is that the bank groups today are less homogenous than in the past. If you look at a typical syndicate today, it has domestic banks, foreign banks, asset-based lenders, prime funds, hedge funds, on and on and on. Each of those players has a different agenda.

Problem number three is public debt. If you read your typical indenture, there are no governance mechanisms in public debt. And public debt almost always requires unanimity to make changes in terms. This is impossible, particularly on widely-distributed issues.

Thus, you have three distinct factors that work against collapsing the timeframe. When it is just a balance sheet reorganization as opposed to both operations and the balance sheet, all of these disparate interest groups would be much, much, much, much better off doing it out of court. But because of either denial, the lack of a homogeneous bank group, or lack of a governance mechanism in public debt, it is very, very difficult to get all three of those planets aligned in such a way that they act in their best interests. It is just remarkable that it ever occurs.

MR. SMOLINSKY: The only thing I would add is we have a situation where we have covenant default or potential covenant default under the bank facility. We will have a payment default shortly. What will happen once we have a payment default is that it will cause a cross default of the bonds and give the bondholders — especially the 2010 bondholders who currently cannot do anything but wait — a seat at the table and may ultimately cause the house of cards to crumble.

That may provide some impetus for the bank group to move more quickly. We will be watching those cross defaults and making sure they don't turn this into a much larger reorganization than just at the parent level.

Bank Group Tensions

MR. SEIFE: The story to date: the company and the agent bank have come to terms as to what the restructure might look like. The banks would be agreeable to a refinancing to stretch out the term of the loan for a period of four and a half years or so. In return, the company would provide collateral to support the loan, and the pledge would be for virtually all the free assets that the company has. We covered the difficulty in getting liens on a lot of the collateral in the operating companies. There are regulatory issues. There are issues with joint venture partners. The company, though, is willing to pledge whatever is pledgeable, and that includes the stock it owns in all of the subsidiaries. The parties have come to terms on the interest rate, LIBOR plus 400 basis points, which reflects to some degree the risk inherent in the loan going forward.

However, there are problems, and the problems are there are two banks in the syndicate of 20 banks that have not agreed to the terms of the restructure. Those two banks are foreign banks that do not have big pieces of the facility. Because we are changing the terms, the tenor and the interest rate on the loan, it requires unanimity. In order to do this consensually, each and every lender has to agree to it. And Joe Smolinsky has not yet been able to deliver all 20 banks.

At the same time, there is the problem with the subdebt. It matures in 2004, and Steve Cooper has been negotiating vigorously with the subdebt holders, and he has on board of the $200 million the major holders that represent $160 million of the issue. The remaining $40 million in bonds are held by small holders and by venture funds that don't want to play ball, that want to use their leverage, and they are hoping that the exchange offer will go forward without them, and the company will be forced to pay them in full at maturity as holdouts. They are looking for huge returns having bought the debt at a significant discount.

That is the current state of affairs. The company is still faced with trying to do this as a voluntary out-of-court restructure. Steve Cooper has mentioned how that is certainly the preferable path in terms of impact on the company and expense. But an alternative / *continued page 46*

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remains, and that is a chapter 11 bankruptcy filing. Under chapter 11, there are various options available.

Joe, you are faced with the two holdouts. You know the problems that the company is having with its bondholders. What's your next step? How do you move the process along?

MR. SMOLINSKY: I am not going to give up. I recognize that this is important to my bank, and I'm going to use every effort I can to convince the holdout banks to sign onto the deal. I also know that if a chapter 11 petition is filed, the company will need good financing. I do not want another bank to come in and take a secured position. So, I will probably want to participate in the debtor-in-possession, or "DIP," financing which will be a much more protected loan because it will be fully secured. The banks that are holdouts may not participate in the DIP loan and that may create further relationship issues among the various banks in the syndicate.

Looking ahead at a bankruptcy, we have two options. We can try to get this deal done as we negotiated it. Hopefully the company can bring along enough of the bondholders to do a prepackaged plan of reorganization at the parent level, which would leave the remaining companies unaffected except for the various pledges that will result from the refinancing of the bank facility.

The only alternative is a freefall chapter 11. That is a horrible resolution for my clients as unsecured creditors. If we were secured, it would be a very different situation. We would be able to control the flow and tenor of the chapter 11 and be a formidable constituency with which to deal. But as an unsecured claim heading into a freefall chapter 11, I am not going to be paid interest post filing because the automatic stay will accelerate my financing. I will have a $1.5 billion unsecured claim against the estate.

MR. SEIFE: Under what circumstances would you be entitled interest in a chapter 11 proceeding?

MR. SMOLINSKY: The only time the banks will receive interest on their claim is if they are secured and have sufficient collateral to satisfy not only their principal but also accrued interest and fees and expenses and the like. A general unsecured claim would not receive interest during the chapter 11 case.

The potential for more ratings downgrades and cross defaults may provide some impetus for the bank group to move more quickly.

Also, in a freefall chapter 11, presumably there would be cross defaults that would require the subsidiaries to file as well. Unliquidated claims all across the corporation would accelerate. The litigation claims that may not otherwise ripen into a judgment for the next several years would now hold large unliquidated claims against the estate. We have forward contracts and other derivatives that are not stayed by the bankruptcy filing, with the result that the counterparties to those contracts could set off and terminate the positions.

Given the spike in natural gas prices, some of those gas contracts may be further out of the money than we anticipated earlier, which would, again, lead to large, unsecured claims that would water down our claim in a freefall chapter 11.

We would have no further covenants because of the acceleration, so there would be nothing to call a default on, and we would be constantly worrying about the assets being pledged to a third party during a chapter 11 case.

Lastly, because of the nature of the chapter 11 process, there would be certain claims that would be elevated to the status of a priority higher than our claims. For example, you would have the administrative expense claims of running the estate. You would have professional fees, employee retention programs, payments of prepetition claims to persons who are considered critical vendors. My bank group will end up a small fish in a big pond if the group is not careful.

In a prepackaged bankruptcy, we could still get this deal done without ever affecting the subsidiary entities or accelerating those liabilities.

Dealing With Holdouts

MR. SEIFE: Before we jump ahead to a prepackaged bankruptcy, note that both from the banks' perspective and the company's perspective, there are significant inducements to stay away from a traditional chapter 11 filing. Joe Smolinsky just outlined from the banks' perspective some of the reasons they would try to stay away. It would create a nonperforming loan on their books, they will have to create reserves, and that will affect the profitability of the banks. They will also not receive current interest.

Steve Cooper, what about from the company's perspective? Is a traditional chapter 11 a bad thing? What's the impact on operations? What's going through your mind?

MR. COOPER: In my mind, the decision turns on what the company will be left with. When you do a prepackaged bankruptcy filing, essentially what you are doing is dealing with one limited strip of your capital structure. Everybody else stays in place.

In this particular instance, you put the bank deal in place and you take a little out of the bondholders. Everybody else stays in place. So, when you assess whether to do a prepackaged bankruptcy filing, you have to ask as management or the board, "Do I want to end up with this capital structure? Am I convinced that I have all of my business problems behind me? Am I convinced that other mistakes that I could mitigate or rectify in a freefall chapter 11 I don't need to mitigate or rectify?"

Thus, the decision turns on how deeply you want to go in correcting your balance sheet or your operations. The main benefit of a prepackaged bankruptcy is it takes a lot less time and money. Parenthetically, it can take a while to put all of the components in place so that you are prepared to do a prepackaged filing.

Another benefit of a prepackaged bankruptcy — compared to the more traditional bankruptcy filing — is a lot less laundry gets washed in public because you have cut the deal in advance. Everybody else is unimpaired and, so, as a practical matter, they have nothing to say about it. Let's see.

MR. SEIFE: Let's talk mechanically about what we are doing. In a prepackaged bankruptcy, the company files a petition in bankruptcy under chapter 11 of the federal bankruptcy code. The difference between a prepackaged bankruptcy and a traditional bankruptcy filing is that you have all your ducks in an order before you file your petition. What does that mean? It means you have your plan of reorganization prepared. You have a disclosure statement prepared that gives creditors adequate information to assess whether the plan makes sense, and you have a vote by the creditors that are affected by the plan before you file for bankruptcy.

In this case, whose rights are being affected? Two groups — the bank group and the subdebt, or the bondholders. And to speed the prepackaged bankruptcy, we will leave alone the rights of all the other creditors. We will not reject contracts. We will not try to restructure debt due in 2010. We will not affect debt at the project levels, at the subsidiary levels.

The fact that we are dealing with two discrete classes of debt makes the process more manageable. The company and the banks have already fully negotiated the terms of a long-term restructure of the debt. Their agreement is attached to the back of a plan of reorganization. The restructure with the bondholders that was negotiated but has only been agreed to by $160 million of the $200 million will be part of the prepackaged bankruptcy filing as well.

The company sends the disclosure statement and the plan to all the voting creditors in these two classes. The ballots come back. In order to get the plan approved by the bankruptcy court, you will need support from creditors holding two-thirds of the affected debt. You will also need 50% of the total number voting. In the instance of this bank group, we have 18 of the 20 banks on board. That's the requisite over-50% number. And it is well in excess of two-thirds of the total bank debt that is outstanding. So we have enough votes to carry that class.

Turning to the bondholders, we have had to do a lot of running around to find out how widely held this bond issue is because it can be difficult to make sure we have 50% in number. If there are many tiny holders who don't want to vote in favor of this, that could create a problem. However, not everyone votes, and only those who vote get counted for the determination. We know we are okay because we have signed up an agreement with holders of more than two-thirds of the subdebt that they support the plan. Court approval is assured.

Why go through this process?

The reason is to impose the deal on the holdouts. Even though outside the bankruptcy the deal requires unanimity and it requires 20 of 20 banks to agree to these new terms, through the magic of the bankruptcy court, if we get the requisite majorities, we can impose the / continued page 48

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new deal on all of the banks and on all of the bondholders.

Joe Smolinsky, if we have the required votes and we file for a prepackaged bankruptcy, what can these holdout banks do? What if they really don't like the deal? What if they don't like being stretched out for four and a half years? What if they think the interest rate is too low? Can the two foreign banks try to torpedo this the prepackaged bankruptcy?

MR. SMOLINSKY: They certainly can. They would focus on things like feasibility — whether, looking ahead at the projections of the company over the next two, three, five years, the company can realistically pay back all of the debt at maturity. Very often in a disclosure statement, you would attach three years of projections. The maturity of these new bank facilities is four and a half years.

They may make the company demonstrate that when these facilities mature, there will be enough money or assets to refinance at that point. They may get into issues like where natural gas prices will be five years from now. Given the complexity of this business, there are a lot of arguments that could be made on feasibility.

Weighing Alternatives

MR. SEIFE: Steve Cooper, you referred to the cost of a traditional chapter 11 bankruptcy. Is that a significant part of your decision to steer this toward a prepackaged filing as opposed to a traditional bankruptcy? What has been your experience with the cost of running a major chapter 11?

MR. COOPER: Very expensive. I have a somewhat different view. I think a prepackaged filing makes sense when you have good grounds for believing that a limited correction in the capital structure works. Our capital markets are generally pretty efficient. When bank debt is selling at 60¢ on the dollar and subdebt is selling at 30¢ cents, that is a sign that there is no equity value in the company. More often than not, what really happens in any bankruptcy filing at the end of the day for the bondholders is they get — if not all — substantially all of the equity in the company.

In a freefall you have the opportunity to correct all of the other deficiencies, both in operations and in the balance sheet. That is what makes a freefall attractive.

Thus, my view is that while the professional fees are an important consideration, they are less important than making sure that the operation and the capital structure are put back in equilibrium. Without that, you will be back in chapter 22, or in certain really wonderful circumstances, chapter 33. It just means that it wasn't done right the first time. The mistakes that could have been corrected were not.

A "prepackaged" bankruptcy fixes only a piece of the capital structure, and that may not be enough.

MR. SEIFE: How do the interests of the shareholders of your company enter into this because you are a public company? If we can get the prepackaged bankruptcy done, we will leave the equity unimpaired. The public will still own the company. Your management's stock options will remain in place. There might be stay bonuses in conjunction with keeping senior management in place. If you go into a traditional bankruptcy, the bondholders and perhaps the banks will end up as the new owners of the company, and you are wiping out your shareholders. How do you balance those competing concerns?

MR. COOPER: I would distinguish between the equity can still trade versus the equity being unimpaired. This is just one man's view. The reason equity is paid a higher return is equity is prepared to take bigger risks. I don't know anyone with a perfect investment record. In the long haul, it is better to correct properly both the balance sheet and the operations, so that the long-term cash flow of the business is adequate to support the capital servicing requirements.

To leave a company impaired, even if the shareholders can still trade, is equivalent to nicking a major vein. The company will slowly bleed to death. It will be crushed by the capital structure.

If you don't bring things into equilibrium, then all a prepackaged bankruptcy does is defer the inevitable. And in deferring the inevitable, you will lose a lot more value at the end of the day for all of the economic stakeholders than if things are done right the first time.

I know that when you look at the capital markets and you are realistic with yourselves, you cannot have bank debt selling for 60¢ and subdebt selling for 40¢ and junior subdebt selling for 20¢ and believe that there is still substantial equity value in a company. It defies gravity.

MR. SEIFE: Joe Smolinsky, what about from the bank perspective? Are you getting pressure from your management to keep this out of the traditional chapter 11? Is your management pressing you to keep this as a current loan on the books with current interest payments? How does that enter into your analysis?

MR. SMOLINSKY: Certainly in this environment, yes. We have probably already taken substantial hits over the course of the last couple of years, and the last thing we need is another nonperforming loan on the balance sheet with a reserve. In five years, I'll consider foreclosing if the company does not create larger rates of return on its assets. And I will be happy for the next five years if I can keep a performing loan on my balance sheet.

MR. SEIFE: There is something else that happens in a traditional chapter 11 that might be costly to the banks. Are there other payments — besides professional fees — that are going to be paid ahead of the banks as unsecured creditors? Isn't there a further subordination that occurs in a traditional chapter 11 proceeding.

For example, who are payment vendors? Why are payments to prepetition creditors permitted in a chapter 11 while the banks have to sit tight and wait until the end of the process before they will receive any payment?

MR. SMOLINSKY: A company heading into a chapter 11 proceeding always identifies several categories of creditors who must be paid. These are creditors whom the company feels strongly it must pay in order to keep operating. They provide critical and necessary goods and services. The company will tell its attorneys before filing, "We have to find a way of getting those creditors paid."

The banks' attorney will often negotiate with the debtor about how critical those are because we all know as practitioners that the company post-filing always gets the credit that it fears will be unavailable, and it is always able to preserve key relationships that it fears it will be unable to preserve.

Ultimately, the bankruptcy court in most jurisdictions recognizes a doctrine called the "necessity of payment doctrine" that allows the court, in the interest of the reorganization, to order that certain creditors can be paid post petition on account of their prepetition claims.

MR. SEIFE: Okay. You have identified a number of payments in a traditional chapter 11 case that will be made before the banks see a dime. We have retention payments to employees. We have payments to critical vendors. We have professional fees to see the company through the process. What about contracts that the company has, valuable contracts that it may want to preserve through the chapter 11 process? Are there any payments there that are going to prime the banks as well? How does the whole contract process work in chapter 11?

MR. SMOLINSKY: Contracts that continue to have performance obligations on both sides are known in the bankruptcy world as executory contracts. The contracts have to be assumed or rejected. If the contracts are assumed, then all prepetition defaults plus any postpetition defaults would be cured and the company would continue to be obligated after the assumption for the remaining term. It could also assume the contract and assign it to a third party.

The alternative is rejection where it would pay just the amount during the case to which the company benefited from the contract, and then the remainder would be a prepetition unsecured claim. These would have the same priority as our unsecured bank claims and could, in fact, swamp our prepetition claim once again. If a bank is secured, then it would be subordinate to that bank's interests.

The timing for assumption is important to lenders because, obviously, if the contracts are cured during the chapter 11 case, then the prepetition claims get satisfied before the lender gets anything on its claims. Under the new bankruptcy legislation, a debtor will have to decide within 120 days whether to assume or reject nonresidential real estate leases. Normally, a debtor and the lenders would want the decision on assumption or rejection to take place at the end of the process. That way, the creditors know that when those prepetition claims are being satisfied that a restructuring deal is in place.

MR. SEIFE: This is legislation that has been sitting in Congress for several years. Who knows / continued page 50

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whether this will be the year that it finally gets passed.

So, Joe, you have an acceptable deal for your bank group. You have a few banks that don't like it. You can get the bondholders locked up or you can do a total remake of the company by taking advantage of chapter 11. The banks might well end up owning the company. Where do you come out? And then I'm going to ask Steve whether he has a different idea or will he follow the lead of his banks.

MR. SEIFE: Steve Cooper, your lawyers have checked your directors and officers insurance, and it doesn't begin to cover the bank debt. Despite what Joe just told us in private, your board heard a speech from your bankers that they have a fiduciary duty to protect the interests of creditors. You have an independent obligation to all your creditors, not just the banks.

MR. COOPER: I'll tell you a funny story. I was in a creditors meeting, and a banker looked at me and said, "You know, your job is to keep us happy." And I said, "No. My job is to maximize values. Happiness is your problem." He's still not speaking to me. (Audience laughter.)

Banker: "Your job is to make us happy."
Chief restructuring officer: "No. My job is to maximize values. Happiness is your problem."

I don't think there is an obligation in a distressed situation to keep banks either happy or whole. The obligation of the board and management is to maximize the value of the estate for all of the economic stake holders, to deliver that value to those stake holders as expeditiously as possible, and within the context of effective and efficient economic models to preserve jobs.

So, my view would be: When you look at the debt structure, you look at the fact that there are trading operations falling apart, and you look at the fact that they have substantial, unliquidated claims that haven't even begun to hit the balance sheet. I believe, in this particular instance, the board and management should go the freefall route. That would be my view.

MR. SEIFE: That's not how we scripted it, Steve. (Audience laughter.)

MR. COOPER: Well, I understand, but I didn't get all the assumptions until a half hour before. (Audience laughter.)

MR. SEIFE: I think we all understand that unless the market improves and the company is able to sell substantial assets, it is not going to be able to refinance the bank debt in four and a half years or pay off the bond debt that, under the restructuring plan, would come due shortly thereafter. We had hoped that if we put this restructure in place and bought four and a half years, the company would have access to the capital markets, and be able perhaps to raise some equity or public debt in order to pay down the bank debt. A lot of people in this industry think we're at the bottom right now and it can only get better. Obviously, Steve

MR. SMOLINSKY: I have 10 more files on my desk that I need to turn to, so I will look for a fairly quick and reasonable resolution. I don't like the idea of ending up with stock in the company. I would only do that as a last resort. As a result, I am either going to want to do a deal like this one that secures my position or potentially get other lenders, maybe hedge funds or other nontraditional lenders, to do the new financing and take me out. And I want to do whatever is done as quickly and as cheaply as possible.

MR. SEIFE: Is it realistic to hope in this market that a nontraditional lender will put up the funds to cash out the bank group?

MR. SMOLINSKY: I may be forced to take a haircut, but some of the members of my bank group may want that. I know that this is going to be a very long freefall bankruptcy, and that will be a consideration for me. If I am unsecured, that means years of not getting any interest and having to monitor it and expend manpower and other resources. Therefore, I may very well consider taking a haircut to get paid now if I can get comfortable with things like preference issues and other potential liabilities for getting paid now rather than later.

Cooper took a more sober view given the assumptions with which we saddled our hypothetical company. He saw the problems of this particular company as much more serious than we thought, and he opted for the traditional bankruptcy. ◎

When Banks Foreclose

by Chris Groobey, in Houston

As more borrowers slip from full performance to covenant default, and then from covenant default to payment default, lenders are reviewing security packages and planning whether and how to exercise their remedies. Some borrowers will contest a bank's foreclosure on a project; others will willingly hand over the keys. However, in all cases the lender needs to ensure it complies with applicable law and contracts so as to avoid becoming liable to the borrower, subordinated lenders and others as a result of its actions.

Previous articles in the *NewsWire* have addressed the bankruptcy, tax and other implications of purchasing a distressed project. Many of the same issues apply as well when a lender forecloses on the equity in its borrower. However, the focus of this article is the legal requirements under the Uniform Commercial Code, or "UCC," for a lender to foreclose successfully on a borrower. The article is based on a senior secured lender's recent foreclosure on a portfolio of power generation facilities located in the United States.

What's Available?

The first step in preparing for a foreclosure is cataloguing the available collateral and determining which parts of the collateral are desirable to own or control. A properly-documented loan relating to a power plant generally includes the following collateral:

1. A series of waterfall accounts controlled by a trustee for the benefit of the lender.
2. Pledges of the equity in the borrower and its subsidiaries.
3. Pledges of the assets of the borrower and its subsidiaries (including the physical assets and contracts relating to the power plant).
4. Mortgages on the real property interests relating to the power plant.
5. Consents from contract counterparties detailing the lender's rights to assume contractual obligations of the borrower and its subsidiaries.

Once the lender has catalogued the available collateral, the next analysis is whether to proceed generally against the equity or the assets.

Foreclosure on equity is usually preferable as, in one relatively simple and quick transaction, the lender can obtain control over an entire project. However, with equity also comes exposure to all of the liabilities of the foreclosed-upon entity, including possible tax, environmental, pension and litigation exposures and all existing contractual obligations. The prudent lender contemplating foreclosing on equity learns as much as possible about the current operations of its borrower before becoming the owner of a troubled entity.

Lenders usually benefit from equity pledges at more than one level of a project's ownership structure. Careful consideration needs to be given to which entity or entities the lender will foreclose upon so as to insulate the project as much as possible from, for example, parent company tax or pension liabilities, bankruptcy proceedings, pending or threatened litigation and undesirable contractual commitments. Care must be taken to preserve tax benefits and regulatory exemptions, as well.

The alternative to foreclosing on equity is to foreclose selectively on individual assets.

Under this approach, the lender identifies all physical, contractual and intangible assets necessary to ensure the continued operation of the facility (or, alternatively, to sell a complete facility to a third-party investor). This is a daunting task and should only be considered by a lender when the borrower faces significant troubles that would not be able to be cured with a reasonable expenditure of time and money following a foreclosure on equity.

The remainder of this article assumes that the lender has performed the analyses described and determined to foreclose on the equity in the borrower.

Laying the Groundwork

Before a lender can begin to foreclose on equity, it must first determine who else might also have an interest in the equity. This is usually accomplished by reviewing the equity and debt documents relating to the borrower and the project, including subordinated debt documents and guarantees, and also performing UCC and real property searches for liens that have been filed by others against the / continued page 52

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assets of the borrower. The results of this research dictate who must be notified of the lender's plan to foreclose and what rights the recipients of the notice have to object to the lender's plans. If a lender fails to notify another lienholder of its proposal to foreclose on collateral, then the lender will be liable to the lienholder for any damages suffered in connection with the foreclosure.

A lender who is foreclosing must be careful lest it become liable to other creditors as a result of its actions.

Next, the lender must decide whether the foreclosure will satisfy all or only part of the borrower's obligations to the lender. Again, the result of this analysis will guide the lender's rights and actions going forward.

In addition, it is also important for the lender both to have notified the borrower of the event of default and, assuming it is permitted under the loan documents, to accelerate the full amount of the secured obligations. Notice to the borrower usually enables the lender to begin to exercise its rights under the security documents, including the right to trap cash in the waterfall accounts and to exercise the various pledgors' rights to vote the equity in the borrower. Acceleration of the loan makes it more difficult for a borrower or third party to cure the outstanding event of default by paying only the unpaid amount, delaying the lender's ability to foreclose on, and maximize its recovery from, the collateral.

Full or Partial Satisfaction?

Under the UCC, secured lenders have a choice when foreclosing on collateral: they may take collateral in full satisfaction of the obligations it secures, or they may take collateral in partial satisfaction of the obligations and continue to pursue the borrower for the remaining unpaid obligations. The UCC is drafted to encourage the former option, largely to protect borrowers less sophisticated than those usually involved in power project financings. (The UCC applies equally to $300 loans for sofas and $300 million loans for power plants.) Lenders who offer to take collateral in full satisfaction need not obtain the borrower's consent to the foreclosure. Rather, the foreclosure automatically occurs 20 days after notice is given to the borrower and if the lender does not receive a written objection from the borrower to the proposed foreclosure. The borrower may also give its consent to the foreclosure, in which case the foreclosure occurs immediately, but borrowers are more likely to let the clock run out to protect themselves against claims from other secured parties and also to preserve any claims they may have against the foreclosing lender for failure to comply with its obligations under applicable laws and contracts.

In contrast, if the lender offers to forgive only a portion of the borrower's obligations in return for the collateral, then the lender must obtain the borrower's written consent to the foreclosure. If the lender does not receive the borrower's consent, then the lender must either make a revised offer to foreclose on the collateral, but this time in full satisfaction of the obligations, or proceed with a sale of the collateral.

No matter whether the foreclosure is proposed to extinguish all or part of the borrower's obligations, the lender must also notify subordinated lenders and other creditors who have liens on the interests on which the lender desires to foreclose. Each of these lienholders also has the right to object to the proposed foreclosure, in which case the lender must conduct a public (as opposed to private) sale of the collateral under the UCC. The lender is permitted to purchase the collateral at such a sale, but the "public" sale requirement increases the time and costs involved in the sale process and the presence of other bidders may increase the price that the lender must pay to retain the collateral if it so desires.

The UCC imposes no requirements on the relationship of the value of the collateral to be foreclosed upon and the amount of the obligations that will be extinguished upon foreclosure. This means that a lender is just as entitled to the full collateral package at the beginning of a loan's term (when the owed amount is greatest) as at the end of the term (when the value of the collateral may be much greater than the remaining unpaid amount of the loan). This also means that a lender may offer to foreclose on collateral in return for extinguishing only a very small portion of the borrower's obligations. Although unlikely, if the borrower accepts these terms, then the lender could receive both valuable collateral and, subsequently, significant cash to pay the remaining amount of the borrower's obligations.

Effect of Foreclosure

Assuming a successful foreclosure on equity in accordance with the UCC, the borrower's obligations to the lender are extinguished to the extent agreed between the borrower and lender — namely whether the obligations are extinguished in whole or in part. In addition, foreclosure extinguishes subordinate security interests in the collateral (which is why other lienholders must be notified of, and given an opportunity to object to, the proposed foreclosure) and vests with the lender all of the borrower's rights in the collateral, free and clear of subordinate liens.

The foreclosing lender need take no further action to complete the foreclosure and accept the collateral after all applicable parties agree, are deemed to agree, or fail to object to the collateral. For example, in the case of a foreclosure in full satisfaction of the debt, if the lender receives no objections to the foreclosure within 20 days after the date of the foreclosure notice, then the equity automatically transfers to the lender on the 20th day.

Unenforceable Contract Provisions

The traditional documentation governing project loans contains a litany of remedies that are supposedly available to the lender. However, many of these remedies are unenforceable.

The UCC contains numerous protections for borrowers and dictates that many of those protections cannot be modified or negated, even by contract between two sophisticated parties. If a lender attempts to avail itself of such remedies, it opens itself to lender liability claims from the borrower and others with interests in the collateral. Examples of unenforceable provisions include those that purport to permit the lender to purchase collateral at a private sale (which the UCC does not permit if the borrower objects), to excuse the lender from giving various notices to the borrower, or to limit the lender's liability for failure to follow the provisions of the UCC when dealing with collateral.

In order to protect against lender liability claims and ensure a successful foreclosure, the lender should first catalog the rights it believes it has under the loan documents and then confirm the validity of those rights under the UCC and other applicable laws before attempting to exercise them.

Lender Liability

The UCC imposes the overarching requirement on lenders that all of their actions in connection with collateral must be "commercially reasonable." The UCC itself does not define what actions are or are not commercially reasonable, but it does permit lenders and borrowers to agree as to the standards for commercially reasonable behavior in the contracts between them. For example, lenders and borrowers may agree to various notice and time periods, methods of sale or other disposition matters. The only restriction on such agreements is that they not be "manifestly unreasonable."

Lenders must also act in "good faith." For purposes of the UCC, good faith is defined as "honesty in fact."

The UCC imposes many obligations on lenders when dealing with collateral. If a lender fails to act in compliance with the UCC, then the borrower may pursue remedies against the lender. For example, a borrower may petition a court to order or restrain collection, enforcement or disposition of collateral on appropriate terms and conditions. A borrower may also seek damages from the lender in the amount of the borrower's loss due to the lender's failure to comply with the UCC, including losses caused by the borrower's inability to obtain, or increased costs of, alternative financing. The UCC instructs the court to award damages for violation of the UCC in the amount reasonably calculated to return the borrower to the position it would have occupied had the lender not violated the UCC.

Interestingly, however, a lender's failure to comply with the UCC will not unwind a foreclosure on collateral. Even after failing to act in a commercially reasonable manner, for example, the lender will still have title to the collateral, but it will face possibly substantial monetary liability to the borrower.

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Foreclosures

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In sum, foreclosure on equity in a borrower is often the most attractive option to a lender following a default — but the proper procedures must be followed and the proper resources consulted to ensure immunity from lender liability claims. ◎

Use Of Power Lines For Other Services

by Hwan Kim and Kemal Hawa, in Washington

The Federal Communications Commission launched an investigation in late April into the use of electric distribution lines to provide telephone and Internet access services, called "power line communications," or "PLC," and "broadband over power line, or "BPL."

The investigation is expected to lead to FCC regulation of electric utilities that provide telephone and Internet access services. Such services have not been regulated by the FCC to date. It will almost certainly also mean that electric utilities will have to obtain FCC licenses to operate in the spectra that they previously operated in on an unlicensed basis.

The FCC set an August 6 deadline for comments.

Some believe the ultimate decision will be even more far-reaching. For example, the investigation might also lead to imposition of open-access requirements for power lines. It could also jumpstart the nascent BPL industry, thus providing electric utilities with a potential new market — the broadband access market — and a possible new revenue opportunity.

Background

BPL systems use existing electric distribution lines to transmit high-speed communications through radio signals on power lines. Because power lines reach every community in America, FCC chairman Michael Powell has heralded BPL as potentially the "third wire to the home." That is, it represents a possible alternative to cable modems and Internet access services that today run through telephone lines. Powell believes BPL may be the only chance for broadband communications in many rural communities that are underserved by cable and telephone companies.

BPL services have been under development for some time. Development of the technology suffered setbacks starting in the late 1990s as companies with BPL projects began withdrawing from the market. Both Nortel Networks Corp. and Siemens AG withdrew, causing some observers to question the feasibility of the technology. However, work on the technology continues in Europe. There were more than 60 PLC sites around the world in September 2002, with thousands of PLC customers.

Within the US, BPL developers like Amperion, Current Technologies and Main.net Power Line Communications have partnered with utilities to demonstrate the technology in limited field trials. More than a dozen utilities are currently involved in such field trials. They include American Electric Power, Southern Company and Consolidated Edison. Both Pennsylvania Power & Light and Ameren have plans to launch test services later this year.

Part of the FCC's enthusiasm for BPL service stems from a recent visit by the FCC chairman, Michael Powell, to a demonstration of the technology by Current Technologies in Germantown, Maryland in cooperation with the Potomac Electric Power Co. Current Technologies is also running field tests in Cincinnati in partnership with Cinergy. The US is widely believed to have fallen behind other countries in making the Internet available to all consumers. The FCC believes that BPL might be one way to narrow that gap quickly. It also believes that BPL can aid electric utilities by adding "intelligent networking capabilities" to the electric grid. These are the ability to do such things as manage energy supply during periods of peak usage, notify consumers about power outages, and do automated meter reading.

The FCC opened the latest investigation at the behest of companies and quasi-industry associations that want access to utility distribution lines for BPL services. The FCC is using its jurisdiction to regulate "harmful interference to radio communications" as a hook to get involved. Electrical wiring can act as an antennae, thereby causing such interference.

To date, BPL systems have operated on an unlicensed basis and with limited capabilities under FCC rules at radio frequencies below two megahertz. The only regulatory constraint on BPL services today is rules limiting the amount of radio energy that can be transmitted over power lines.

New BPL devices are expected to operate on a wide range of spectra at frequencies between 4.5 MHz and 21 MHz. In view of this development, the FCC became concerned about potential harmful interference from unlicensed BPL systems, particularly interference to other devices that are connected to electrical wiring and the possibility for interference with police and fire radios and radios used for navigation over waterways.

Investigation

The FCC expects to divide BPL services into two categories: "access BPL systems" and "in-house BPL systems." Access systems are analogous to a telecommunications network: they allow consumers to have access to services that come from a central grid. An in-house BPL system allows voice and data signals to be carried between the wiring and electric outlets inside a building, like the local area network that a company creates among its own computers so that they can communicate with one another.

A number of issues are expected to come up during the FCC investigation. For example, FCC Commissioner Michael Copps has suggested that a central issue for the proceeding is how to ensure that there is no potential for electricity prices to be affected by what the agency does with BPL services. "How do we avoid cross subsidy from a corporation's regulated energy business to its communications business and resulting price hikes for energy customers in non-competitive markets?" Copps asked. The FCC may also examine whether BPL systems should be subject to universal service contribution requirements — essentially a telephone tax — in order to subsidize services for consumers in rural communities, schools, libraries and hospitals.

Interest among electric utilities in entering the telecommunications market has ebbed and flowed in recent years. There was an initial burst of interest three or four years ago. However, given the state of disarray the telecommunications industry has been in for the last few years, most utilities have been hesitant to commit large resources to the sector. The FCC investigation comes at a time when utility interest in the telecommunications sector has waned, although if BPL trials prove successful, such interest may rebound. The FCC hopes to adopt rules for BPL services by the fall 2004. ◎

Environmental Update

Senate confirmation hearings on a new person to head the US Environmental Protection Agency are expected to be contentious and will provide a forum for Congress to complain about the Bush administration's environmental policies.

Such hearings are expected this summer. The current agency head — Christine Todd Whitman — will leave her post on June 27.

Clean Air Act

President Bush had set as a goal this year to get his "clear skies initiative" through Congress, but the effort is losing momentum. The "clear skies initiative" is a plan to ratchet down the level of acceptable air emissions from power plants.

The Senate Environmental and Public Works Committee has another hearing on the administration's plan scheduled for June 5. This will be its third hearing on the subject this year.

The committee chairman, Senator James Inhofe (R-Oklahoma), has said he intends to try to send a clear skies bill to the full Senate after the committee finishes work on a surface transportation bill. That could be a few months from now. The big question is whether the Bush plan has the votes to get out of committee. The plan would require substantial reductions in nitrogen oxides, or "NO_X," sulfur dioxide, or "SO_2," and mercury emissions from power plants. However, it does not require reductions in carbon dioxide, or "CO_2," a greenhouse gas, and the implementation timetable and overall reductions are less stringent than the major competing proposals.

Meanwhile, the House is even farther behind than the Senate. The House Energy and Commerce Committee plans to delay any hearings on the clear skies initiative until after a comprehensive energy bill is signed into law. That bill is tentatively scheduled to be taken up in the Senate in June, and most observers expect that it will be fall — if then — before Congress is ready to send the energy bill to the president.

The Bush clear skies plan proposes a mandatory "cap and trade" emission allocation program similar to the federal acid rain program and would set nationwide emission caps for NO_X, SO_2, and */ continued page 56*

mercury in a two-phase process. The emission reduction targets are as follows: caps of 2.1 million tons of NO_X in 2008, 4.5 million tons of SO_2 in 2010, and 26 tons of mercury in 2010. These caps would decline in 2018 to 3.0 million tons of SO_2, 1.7 million tons of NO_X, and 15 tons of mercury. The president's proposal translates into a 67% cut in NO_X, a 74% reduction in SO_2, and a 69% reduction in mercury emissions from 2000 levels by 2018. The emission reductions would be required of all fossil fuel-fired power plants with a capacity of more than 25 megawatts that generate power for sale.

There are two major competing plans that have been introduced in the Senate. The most draconian approach was introduced by Senator James Jeffords (I-Vermont), whose bill advocates steep cuts in SO_2, NO_X, and mercury emissions as well as reductions in CO_2 emissions on a much tighter time frame. Senator Tom Carper (D-Delaware) introduced a multi-pollutant bill in April that he portrays as a "compromise" between the Bush plan and the Jeffords bill. The Carper bill would mandate approximately a 69% cut in NO_X and an 80% reduction in SO_2 and mercury by 2012 from a 2000 baseline. The Carper bill would also cap CO_2 emissions at 2005 levels in 2008 and roll back CO_2 emissions to 2001 levels by 2012.

In the House, the major competing proposal is one introduced in May by Reps. Henry Waxman (D-California) and Sherwood Boehlert (R-New York). It would impose stringent caps on NO_X, SO_2, CO_2, and mercury emissions from power plants similar to the Jeffords bill.

Whether any multi-pollutant legislation might pass before the presidential election in November 2004 remains uncertain. While there is basic agreement that tighter limits on NO_X, SO_2 and mercury emissions from power plants would benefit the environment and lend more certainty to the regulated community, there are deep divisions on the stringency of the limits and whether limits on CO_2 emissions should be included as part of the package.

One thing is certain: if enacted, multi-pollutant legislation would completely overhaul the current Clean Air Act provisions that apply to power plants, and many older power plants will face costly pollution control technology retrofits or the prospect of spending millions of dollars on purchasing emission allowances.

Many older power plants will have to install costly new pollution control equipment or spend millions of dollars on emission allowances when a "multi-pollutant" bill is enacted.

Climate Change

The US Senate is gearing up for a fight over whether to add climate change provisions to a national energy bill the full Senate is scheduled to debate in June.

The House passed the energy bill in April without any such provisions. The Bush administration is opposed to them.

Nevertheless, two high-profile Senators — John McCain (R-Arizona) and Joseph Lieberman (D-Connecticut) — are expected to offer an amendment in the Senate that would place caps on greenhouse gas emissions and create a national trading program. The amendment will require the reduction of greenhouse gas emissions to 2000 levels by 2010. Greenhouse gases are gases that absorb infrared radiation in the atmosphere. Greenhouse gases include carbon dioxide, methane, nitrous oxide and hydroflourocarbons.

Two other amendments on the same subject are also expected. The senior Democrat on the Senate Energy Committee — Senator Jeff Bingaman (D-New Mexico) — is expected to offer an amendment that would create a national greenhouse gas emissions database and require the mandatory reporting of greenhouse gas emissions by 2006. Another amendment intended to encourage carbon sequestration by the agriculture and forestry sectors is reportedly being developed by Senator Ron Wyden (D-Oregon).

The debate over the climate change amendments will be contentious. The sponsors probably lack the votes in the Senate to pass mandatory greenhouse gas emission reduction targets, but it is possible that mandatory *reporting* requirements and carbon sequestration incentives could be attached to the Senate energy bill. Carbon sequestration refers to the idea that carbon is captured and stored in forests and farmland. Trees, plants and soil absorb carbon dioxide, release the oxygen, and store the carbon.

NSR Reforms

Thousands of comment letters were filed with the US Environmental Protection Agency on the agency's proposal to define what qualifies as exempted "routine maintenance, repair and replacement" under the federal "new source review," or "NSR," air permitting program. The comment period closed on May 2 after EPA held five public hearings in Michigan, New York, North Carolina, Texas, and Utah. EPA expects to publish a final rule by the end of the year.

The proposed NSR rule would create two categories of "routine maintenance, repair, and replacement" that would not require a new air permit if undertaken at a power plant. The first category is an annual maintenance, repair and replacement allowance where certain types of activities that fall under a cost threshold would qualify for the exemption. The other category is an equipment replacement approach where the replacement of existing equipment with functionally-equivalent new equipment would generally qualify for the exemption.

The "routine maintenance, repair, and replacement" proposal is highly controversial and, if finalized as proposed, it will undoubtedly be challenged by certain states and environmental groups in court.

The Bush administration is already defending itself against similar suits from the last time it altered the NSR program rules last December. The December rule changes were extensive. Some of the changes included allowing factories and other industrial plants to calculate their emission increases by comparing past actual emissions to projected future emissions and permitting the calculation of emissions baselines for industrial plants to be based on using any consecutive 24-month period in the past 10 years.

Several Democratic state attorneys general from mostly northeastern and mid-Atlantic states and California filed suit challenging the December rule changes. Several environmental and health-related organizations have also joined the litigation, and the cases have been consolidated into one lead case (*New York v. EPA* (DC Cir. No. 02-1387)). A decision by the DC Circuit court is expected in late 2003 or early 2004.

Several state legislatures have started to take action to accept or reject the new NSR rule changes made last December. Bills have been introduced in the California legislature to reinstitute the pre-December 2002 NSR rules in the state. Governor Frank O'Bannon (D-Indiana) recently vetoed legislation that would have adopted the new NSR rule provisions in Indiana. The Indiana legislature has scheduled a special session on June 19 to consider whether to override the governor's veto. Bills have been introduced in Alaska and Texas to implement the new rules as EPA proposed them. States have the ability to adopt state air emission standards that are stricter than the federal regulations implementing the Clean Air Act.

NSR Litigation

The on-going high profile US government action against utilities that modified older power plants is now yielding some significant results. Many older existing facilities built before 1970 were exempted from changes to the Clean Air Act that occurred in the early 1970s. However, utilities must exercise care not to modify older plants so extensively as to bring them under the scheme.

In April, the US government announced the settlement of two major NSR enforcement actions against Dominion and Wisconsin Electric Power Co. Under the Dominion settlement — the largest Clean Air Act enforcement settlement with a utility to date — the company agreed to spend upwards of $1.2 billion by 2013 on the installation of new pollution controls or the upgrading of existing pollution controls at eight coal-fired plants. The company also agreed to pay a $5.3 million civil penalty and to spend at least $13.9 million on environmental mitigation projects.

Dominion will install flue gas recirculation systems or scrubbers at two plants to reduce SO_2 emissions and selective catalytic reduction systems at three plants to control NO_x emissions. One other Dominion plant will be converted from coal to natural gas.

Wisconsin Electric Power Co. */ continued page 58*

agreed to spend approximately $600 million to reduce SO_2 and NO_X emissions from five coal-fired plants. It will install state-of-the-art pollution controls or shut down operations at 80% of its coal-fired power plants. All of the company's coal-fired units will be subject to a system-wide cap on SO_2 and NO_X that will result in upwards of a 70% reduction in emissions by 2013. The utility also agreed to pay a $3.2 million penalty and spend $20 million on environmental mitigation projects.

In April, the US government also announced major settlements with Archer Daniels Midland and Alcoa, Inc. to resolve alleged violations of the NSR permitting program. ADM agreed to spend roughly $340 million to install state-of-the-art controls on some units, adhere to emission caps, or retire other units at 52 plants. ADM also agreed to a $4.6 million penalty and will spend roughly $6.3 million on supplemental mitigation projects. Alcoa agreed to equip a new coal-fired plant with state-of-the-art controls in order to eliminate the existing electric generating units at its aluminum production facility in Rockdale, Texas. The new plant is expected to cost approximately $330 million; however, Alcoa does have the option of shutting down operations at the plant within three years. Alcoa was also assessed a $1.5 million penalty and will pay about $2.5 million for environmental mitigation projects.

The US government filed suit in each of the above NSR cases on the premise that the plants made equipment modifications and upgrades over the years that did not qualify as exempted "routine maintenance, repair, and replacement" activities. The flurry of settlements may have been sparked by recent decisions where federal district courts have largely agreed with the federal government's position that violations of the NSR program occurred. For example, in *United States v. Southern Indiana Gas and Electric Co*., the a federal district court in Indiana rejected several affirmative defenses raised by the utility. Most notably, the court determined that the utility had fair notice of EPA's interpretation of its "routine maintenance, repair and replacement" exemption.

Several of the higher-profile utility enforcement cases are scheduled to go to trial later this year, and two cases have already been argued and are awaiting decisions. In February 2003, a federal district court in Ohio heard oral arguments in *United States v. Ohio Edison Co.*, a case involving Ohio Edison's alleged failure to undergo NSR permitting for plant upgrades at its Sammis power plant. A decision is expected by the end of June. Last year, a US appeals court heard oral arguments in a similar case involving the Tennessee Valley Authority, and a decision is expected any day.

One other notable development occurred in a March 27 decision by a federal district court in New York in *New York v. Niagara Mohawk*. In the case, New York filed suit against Niagara Mohawk, the previous owner of two coal-fired plants, and NRG Energy, the current owner. The court rejected Niagara Mohawk's motion to dismiss the action, which alleged that the company failed to obtain the requisite NSR permits for prior plant modifications. The court also considered the state's allegation that NRG Energy violated the NSR preconstruction permitting requirements. The court dismissed the NSR claims against NRG Energy based on the fact that the company did not own the assets at the time the alleged plant modifications were made. The court's ruling suggests that equitable relief may not be available if a plant was modified in violation of the Clean Air Act before it was purchased by the current owner. However, the court suggests in its ruling that NRG Energy, as the current owner, may have some ongoing liability under its operating permit to address past unpermitted modifications. The issue of NRG Energy's compliance with the plant's operating permit was not raised by New York in the case. New York may appeal this decision.

Air Toxics

The US Environmental Protection Agency has set final deadlines for the submittal of new air permit applications for major air toxic emitters in source categories where EPA has not yet issued standards. Applications for major air toxics sources with combustion turbines are due by October 30, 2003. Major emitters with industrial boilers, institutional or commercial boilers, and process heaters are required to submit air toxics applications by April 28, 2004. Major air toxics sources with reciprocating internal combustion engines greater than 500 horsepower are also required to meet the April 28, 2004 deadline.

Under the 1990 Clean Air Act amendments, EPA was required to issue maximum achievable control technology, or "MACT," standards for all major categories of air toxics emitters by May 15, 2002 — the so-called "MACT hammer" deadline. Since EPA missed the deadline for over 60 source categories and subcategories, the Clean Air Act allows state and local air permitting agencies to step in and issue case-by-case standards for these major emitters. EPA originally proposed a two-year extension to submit applications to comply with the MACT hammer deadline.

After a challenge by environmentalists to the MACT hammer application deadlines, a settlement was reached that created staggered application due dates. Plants subject to the MACT hammer rule should begin preparing their applications now since it may take several months to pull together the detailed information on air toxic emissions from the facilities and other information relevant to establishing a case-by-case MACT standard. Failure to file the requisite air toxics permit application would constitute a violation of the Clean Air Act, and penalties could run as high as $27,500 per violation.

Once the detailed permit application is submitted, the state and local air permitting agencies will have 18 months to issue a case-by-case MACT determination. Within this 18-month period, EPA anticipates that it will be able to propose and finalize most, if not all, of the MACT standards applicable to the MACT hammer categories. The EPA standard is expected to take the place of a case-by-case determination. Nevertheless, most major air toxic emitters will still be required to bear the costs of preparing comprehensive permit applications.

Chemical Security

Legislation to enhance security at chemical and power plants may pass Congress later this year. The Bush administration's chemical security legislation was introduced in May by Senator James Inhofe (R-Oklahoma) and it is expected to be sent by the Senate Environment and Public Works Committee to the full Senate in the next few months.

The legislation defines "chemical sources" to cover facilities that are required to complete a risk management plan in accordance with section 112(r) of the Clean Air Act. Section 112(r) applies to accidental releases of hazardous chemicals. Power plants storing anhydrous ammonia for use in selective catalytic reduction systems are typically subject to the 112(r) requirements. Under the bill, the US Department of Homeland Security would develop a list of "high priority" chemical sources based on a number of security-related factors, including the quantity of substances of concern at the site, the likelihood that the plant may be a target of terrorism, and the cost and feasibility of implementing enhanced security measures.

The legislation would require listed "high priority" plants to prepare vulnerability assessments and site security plans. The plants would be required to submit certifications to the Department of Homeland Security verifying that the assessment has been completed and the plan prepared. Upon request, copies of the assessments and plans would need to be submitted to the department.

Senator Jon Corzine (D-New Jersey) has introduced a competing bill that would also require "high priority" sources to prepare vulnerability assessments and site security plans; these assessments and plans would be required to be submitted to the Department of Homeland Security for review. The Corzine bill would also require affected plants to implement, whenever possible, so-called "inherently safer technologies." The Bush administration's proposal does not include this provision. Critics assert that requiring the use of inherently safer technologies may lead to costly process changes and product switching to use less toxic chemicals. A companion bill to Senator Corzine's measure has been introduced in the House of Representatives by Rep. Frank Pallone (D-New Jersey).

Congress is expected to enact some form of chemical security legislation by next year. As drafted, the president's proposal vests the Department of Homeland Security with the authority to identify affected plants. The detailed vulnerability assessments and site security plans could lead to costly plant upgrades to enhance security, particularly for plants near population centers.

Brief Updates

Local environmental groups recently gave notice that they plan to file a citizen suit against the owners of a landfill in Indiana. The environmental groups allege that coal combustion ash disposed at the landfill caused groundwater and surface water contamination in violation of the Resource Conservation and Recovery Act and the Clean Water Act. The dispute highlights lingering objections from environmental groups on EPA's approach to regulating coal ash as a solid waste instead of as a hazardous waste. EPA is scheduled to propose new solid waste rules on the use of coal ash in minefilling */ continued page 60*

Environmental Update

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and the disposal of coal ash in surface impoundments and landfills in 2004. A final rule is expected to be released in 2005.

The New York Department of Environmental Conservation proposed a new policy in May that would require the evaluation of impacts from fine particulate emissions (diameters of 2.5 microns or less) whenever anyone applies to build a new project or modify an existing plant that is subject to the New York "Article X" power plant siting law or the State Environmental Quality Review Act. A project would generally be deemed to have a potentially adverse impact if coarse particulate matter emissions (diameters of 10 microns or more) are at least 15 tons per year, and an environmental assessment would need to be submitted. The proposed policy is currently subject to a 30-day public comment period.

A federal district court in southern California ruled in early May that the US Department of Energy failed adequately to consider the environmental impacts of two power plants being built across the US-Mexico border in Mexicali, Mexico. The plants are being built by subsidiaries of two US power companies, and approximately 50% of the power from one of the plants and 100% of the power from the other plant would be exported to the US. The US Department of Energy was required to issue a so-called "presidential permit" for each of the transmission lines connecting the plants to the US grid. Since a federal permit was required, DOE had to conduct an environmental impact review under the National Environmental Policy Act. In *Border Power Plant Working Group v. Department of Energy*, the court concluded that the DOE's environmental assessment and finding of no significant impact were deficient because they failed adequately to evaluate certain impacts from the two plants that the court concluded should be evaluated along with the transmission lines as part of the same project.

Mexico is developing new regulations that will require companies to provide the environment ministry with annual reports on air emissions, wastewater discharges and pollutant transfers. The rules are being developed in part to satisfy an obligation under the North American Free Trade Agreement to develop a registry of pollutant releases. The new rule will replace the current voluntary registry maintained by the environment ministry. The proposed rules are currently subject to a 30-day public comment period.

Attorneys General from New York, Connecticut and Rhode Island filed a petition with the North American Free Trade Agreement Commission for Environmental Cooperation requesting that air emissions be reduced from three coal-fired power plants in Ontario. The commission cannot directly impose emission reduction requirements on the Canadian plants, but it will prepare findings that could conclude that the Ontario provincial government is not adequately enforcing applicable emission standards. The petition by the northeastern states is reportedly the first effort by US states to address transboundary air pollution through a NAFTA proceeding.

— contributed by Roy Belden in New York

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