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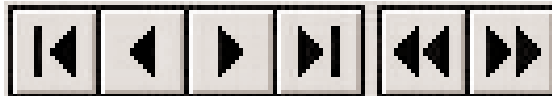

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PROJECT FINANCE NEWSWIRE

March 2000

Governments Start To Address Legal Issues Raised By E-Trading

by David Schumacher, in Washington

The United States has started to address the legal issues raised by trading in electricity, gas and other products over the Internet.

Two states — California and Pennsylvania — have adopted a "Uniform Electronic Transactions Act," and another nine are on the verge of doing so. Others are expected to follow suit.

European countries are grappling with the same issues.

The main problems with trading over the Internet are the law is unclear about when contracts will be enforced if not on paper, what qualifies as evidence in legal proceedings, what constitutes acceptance of an offer to enter into a contract, and the form of electronic signature required in order to have a binding agreement. Existing state laws vary on these issues. The "Uniform Electronic Transactions Act" is an effort to bring uniformity in dealings at least within the United States.

The main purpose of the uniform act is to ensure that electronic records and electronic signatures are treated the same as paper records and manual signatures under relevant substantive laws.

Four Basic Rules

The act establishes four basic rules. First, a record or signature may not be denied legal effect or enforceability solely because it is in electronic form. Second, a contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation. Third, if a law

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THE BUDGET THAT PRESIDENT CLINTON SENT CONGRESS in February has many provisions that would affect the project finance community.

Most are proposals he made last year but that Congress failed to enact. However, three new proposals are interesting.

Most US power companies with foreign projects own their projects through offshore holding companies in Holland or in the Cayman Islands, Bermuda and other tax havens. Clinton said the US Treasury

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requires a record to be in writing, an electronic record satisfies the law. Finally, if a law requires a signature, an electronic signature satisfies the law.

The basic premise of these rules is that where a law requires that there must be a signed writing between the parties in order for there to be an enforceable contract, an electronic record that is signed with an electronic signature will suffice. This means, for example, that if a gas supplier sent an e-mail to a potential customer stating "I offer to sell you 10,000 MMBtu of gas @ $2.50 per MMBtu. /s/Supplier" and the customer responded in an e-mail message "I accept your offer to purchase 10,000 MMBtu of gas @ $2.50 per MMBtu. /s/Customer," the transaction, which would meet the requirements of the Uniform Commercial Code — a separate set of state laws governing sales of goods — as to the content of a required writing for the sale of goods, could not be denied effectiveness merely because the transaction was embodied in an e-mail and included an electronic signature.

The uniform act also provides rules for determining when an electronic record has been delivered and received in cases where timing is important.

An electronic record is delivered when it is addressed properly to the information system designated by the recipient of the electronic record and from which the recipient can retrieve the record, the electronic record is sent in a form that can be processed by the recipient's system, and it enters a system that is out of the control of the sender or under the control of the recipient.

An electronic record is received when it enters the recipient's designated system and from which the recipient is able to retrieve the electronic record, and the electronic record is in a form capable of being processed by that system. These rules may be relevant, for example, to determine whether an offer has been properly sent and received.

While the uniform act validates electronic records as a matter of law, it does not eliminate requirements imposed by other substantive law to make a writing enforceable. For example, like a sale of goods embodied in paper, an electronic record will be an enforceable contract for the sale of goods under the Uniform Commercial Code only if it expressly states the quantity of goods that are being sold.

Valid Signature?

Many things can qualify as an "electronic signature." The uniform act defines the term as an "electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record." What this means is that most any mark or process intended to sign an electronic record will constitute an electronic signature. For example, a typed name at the bottom of an e-mail message, a faxed signature or even a "click-through" process on a webpage, whereby a person clicks "I agree" on a vendor's webpage, could constitute an electronic signature. The important elements for determining whether an electronic signature exists are that the person providing the mark or executing the process intended it to act as a signature and the act can be attributed to that person. While some states have enacted statutes that require a formal "digital signature" process to indicate that an electronic record has been signed, the uniform act does not take this approach; under uniform act, formal digital signatures may simply provide evidence of a party's intent to have signed an electronic record.

The act also makes clear that transactions can be completed through the use of electronic agents. This means that human activity is not necessary to validate a transaction. Thus, a computer program that automatically lists the terms of a transaction and to which another party assents cannot be invalidated merely because a computer process produced the terms to which the other party indicated its assent.

Valid Credit Documents?

The uniform act is mainly a set of procedural rules to ensure that trading conducted over the Internet will be given legal effect. However, it also forges new substantive law in the area of "transferable records." These are such things as promissory notes and certain title documents, like bills of lading. Under the uniform act, a transferable record can be created only if the issuer of the transferable record agrees that the electronic record creates a transferable record. If a person has "control" of a transferable record, which serves as a substitute for delivery, endorsement and possession of a note or document of title embodied in paper, that person will be entitled to rights and defenses available to a holder and, perhaps, a holder in due course.

The significance of the provisions on transferable records is that they form the basis for the development of systems for the creation, enforceability and transfer of these important commercial documents through electronic means.

Other Jurisdictions

The uniform act is not the only effort to create a standard body of rules governing electronic transactions. Both houses of the US Congress have passed bills recently on the enforceability of electronic transactions. Ultimately, any federal law that is passed on electronic contracts is likely to act as a gap filler, effectively imposing on the individual states rules that are very similar to those found in the uniform act until they enact their own version of the act.

Internationally, the United Nations Commission on International Trade Law, or UNCITRAL, has come out with a "Model Law on Electronic Commerce." A number of the provisions found in the uniform act that is the focus of this article are based on provisions found in the UN model law.

The European Union also issued a directive

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will publish a list of "identified tax havens" that "facilitate tax avoidance and evasion . . . through strict confidentiality rules and restrictive information exchange practices." He proposes to deny US tax deferral, foreign tax credits and foreign sales corporation, or "FSC," benefits for earnings run through such tax havens.

The proposal may have the effect of encouraging tax havens to make more information available to the US authorities even if the proposal is not enacted ultimately by Congress. For example, Cayman Islands officials went to London in December for talks with the British government about steps to take to avoid being targeted by a similar OECD (Organization for Economic Cooperation and Development) effort aimed at discouraging use of tax havens.

The budget also takes aim at certain cross-border lease transactions where the lessor is in the United States. Owners of power plants, telecom equipment and rail cars in Europe, for example, have entered into so-called "Pickle-service contract leases" with US lessors as a way of getting value for US tax depreciation on their assets. Since a US lessor must depreciate assets located outside the United States over the "class life" or 125% of the lease term, whichever is longer, the trick is to keep the lease term as short as possible and then convert to a "service contract" after the lease ends. For example, a power plant in Germany might be leased for a short term from a US lessor and then, after the lease ends, the German lessee might continue buying the output.

Clinton proposes to treat the service contract as part of the lease term for purposes of calculating US tax depreciation. The change would apply to leases entered into after the date of "first committee action." Even if Congress goes for the proposal — which it may not — the "first committee action" would probably not occur before June.

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Issues Raised By E-Trading

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recently that sets guidelines for legal recognition of electronic signatures, defines the responsibilities of entities that act to certify digital signatures, and outlines the requirement of devices that create secure digital signatures. Other countries, including Argentina, Canada, Germany, Ireland, Japan and the United Kingdom, also have taken steps to create a legal regime in which electronic records and signatures are given legal effect.

Studies indicate that business-to-business e-commerce transactions will grow from $43 billion in 1998 to $1 trillion by 2003. In the energy industry alone, e-commerce transactions are predicted to be worth $266 billion by 2004. The likely growth of e-commerce in the energy industry was signified recently by announcements from Chevron, Royal Dutch/Shell and Statoil that each of these major oil companies is undertaking significant investments in Internet-based platforms for the procurement and sale of oil and other goods and services. ■

Tax Strategies For Restructuring Power Purchase Agreements

by Keith Martin, in Washington

Many US electric utilities are in talks to buy out or restructure contracts that commit the utilities to purchase electricity from independent power projects. These contracts were signed in the 1980's when electricity prices were higher than they are today. Deregulation has given an added push to such contract talks since the utilities often need to fix the amount of their stranded costs to ensure recovery after deregulation.

The negotiations present an interesting challenge. The utility wants an immediate tax deduction for any payment it makes to cancel the contract or revise its terms. Meanwhile, the owner of the independent power project wants to delay reporting the payment as taxable income for as long as possible. These positions are hard to reconcile — but not impossible.

A new idea for satisfying both aims appears practically every couple of months. Here are some of the approaches that companies are taking.

Utility

The utility usually cannot deduct an amount until it is actually paid. A utility used to be able to claim a deduction when the obligation to make the payment accrued, but "economic performance" rules in the tax code now rule out deductions until the payment is actually made. Moreover, if the utility is viewed as paying money to cancel one contract so that it can enter into a new one, then the buyout payment is viewed as a cost of the new contract and must be deducted ratably (in equal amounts) over the term of the new agreement.

Thus, the main strategies on the utility side are as follows:

Simple buyout

Pay an amount to buy out the contract. Do not replace it with a new agreement. The amount is deductible when paid. If the amount will be paid over time, it is deductible over time.

Buydown with assignment

Pay an amount to buy down the electricity prices to market, but let the contract remain in force. This gives the utility additional tax basis in the contract that it would ordinarily have to amortize over the remaining term. However, the utility then assigns the contract to a power marketer and claims an immediate loss for its unrecovered basis.

Scrip

Buy out the contract using shares in the utility. The Internal Revenue Service told Niagara Mohawk Power Corp. in a private letter ruling last year that the utility could deduct the fair market value of shares it issued for this purpose. It is as if the utility issued its own scrip to make the buyout. Since the shares were publicly traded, the independent power companies receiving them could convert the shares readily into cash.

Auction

Take bids from power marketers to assume the obligation to buy power under the contract without any adjustment in the contract prices but for a payment from the utility. The payment to the power marketer should be deductible when paid.

Independent Power Company

The independent power company must report the payment from the utility when the amount "accrues," meaning when all the events have occurred that give it a legal right to the payment and enable it to estimate with reasonable accuracy the amount it will ultimately receive. Thus, there is a danger for independent power companies that they will have to report taxable income before they actually receive the cash — for example, where a utility commits to pay a fixed amount over time. The main strategies on the independent power company side are as follows:

Avoid accrual

If the utility will pay an amount over time to buy out or buy down the contract, avoid having to accrue payments before the cash is received by making either the legal right or the amount of each future payment contingent on a future event. (This may be hard to do in practice.)

Advance payment

In buydown situations (where the power contract

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Finally, Clinton wants to extend a so-called section 45 tax credit of 1.7 cents a kWh for generating electricity from wind and closed-loop biomass and also expand the list of eligible fuels. "Closed-loop biomass" refers to plants grown specifically for use as fuel in a power plant. Credits can be claimed for 10 years from when a power plant is placed in service.

Clinton would broaden the credit so that it could also be claimed by power generators using other types of biomass or landfill gas, or co-firing with biomass and coal. The credits for landfill gas would be at a reduced rate. The rate is 1.0 cents per kWh in cases where the landfill is already obligated by federal "new source performance standards" the US Environmental Protection Agency issued in 1996 to dispose of the gas. It would be 1.5 cents per kWh for gas from other landfills.

Lobbyists for biomass groups tried to persuade the Clinton administration — so far without success — to let projects that qualify potentially for section 45 credits use lease financing. Section 45 requires that the owner of the power plant also be the same person using it to generate electricity. A memo from a lobbyist to a Treasury official shortly before the budget was released said, "We hope you have not TOTALLY ruled [this] out."

Clinton proposed a cogenerator tax credit in each of the last two years, but the proposal failed to gain any traction on Capitol Hill. It was not included in this year's budget.

The summary of the Clinton tax proposals was 153 pages two years ago, 198 pages last year, and 221 pages this year. This is a sign of how little in the budget the Republican Congress has been willing to enact. Past proposals keep being reproposed each year with a few new additions.

BULGARIA reduced its corporate tax rate by 2% effec-

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Tax Strategies

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will remain in place but with the electricity price adjusted to market), structure any lump-sum payment from the utility as an "advance payment" for electricity to be delivered in future. IRS regulations allow a manufacturer who receives an "advance payment" for widgets to wait to report the amount as income as the widgets are delivered in future years. (However, there is room for argument about whether electricity is close enough to widgets to qualify for this special treatment.) The utility adds the buydown payment to its tax basis in the power contract and would ordinarily recover it over the remaining life of the power contract. However, to get an immediate deduction, it assigns the obligation to buy power under the contract to a power marketer and claims a loss for its unrecovered basis.

Borrow

Most new restructuring ideas recently have involved borrowing. For example, the power contract is amended to reduce the contract price for electricity, but not all the way to market, in exchange — among other things — for an agreement by the utility that the electricity does not have to come from a particular power plant. The independent power company then locks in an electricity supply over the same term from a power marketer at market prices. It takes the two contracts (the amended power contract plus the agreement to buy electricity from a power marketer) to the bank and borrows against the spread. The independent power company ends up with a large amount in cash at inception. The cash is not income (because it is borrowed money). The utility makes no cash payment.

Alternatively, the power contract is amended so that the energy price increases, the capacity payments are reduced slightly, the utility is freed from any obligation to buy energy but must make the capacity payments, and the independent power company can supply the capacity from any source. The independent power company assigns the right to the capacity payments to a special-purpose company. The special-purpose company "securitizes," or borrows against, the capacity payment stream in the public debt market. A parent company with suitable credit guarantees the capacity payments.

Involuntary conversion

The IRS ruled recently that power contracts were "involuntarily converted" where the utility made a credible threat to seize power plants by eminent domain if the owners of the projects did not agree to buyouts of their contracts. When a power contract is "involuntarily converted," the independent power company does not have to pay income taxes immediately on the buyout payment provided the money is reinvested within two years in other property that is "similar or related in service or use." It is probably also an involuntary conversion where there is a credible threat of government action to strip the power contract of its value — for example, a curtailment order by a court or regulatory body or a unilateral change in contract terms.

Like-kind exchange

Taxes can be avoided on a buyout payment by entering into a three-way like-kind exchange. The utility acquires the power plant (which has the effect of cancelling the power contract), but pays the purchase price into escrow. The independent power company has 45 days to designate another power project in which to reinvest the money. The utility then uses the escrowed funds to purchase the other project and completes the "like kind" exchange of the new project for the old one. The utility then auctions off the old power plant (assuming it has no interest in owning generating assets). The independent power company can probably buy the power plant back at auction if it chooses.

Swap and "put"

In New York, some independent power companies have accepted a smaller buyout payment and entered into a "swap" and "put" with the utility. The "swap" is an agreement to pay the difference between the market price for electricity each month and a contract price on a notional amount of electricity. In months when the market price is below the contract price, the utility pays the independent power company the difference. In months when the market price is above the contract price, the independent power company makes payments to the utility. The "put" is an option to sell the notional amount of electricity to the utility each month at the market price. The two contracts together distill to a right to sell electricity at the contract price. It may be a lower contract price than what was in the original power purchase agreement.

Shelter

An independent power company usually has little tax basis in its power contract. However, if it conveys the power plant to the utility or abandons the power plant, it can use its unrecovered tax basis in the power plant as shelter for the buyout payment. Some independent power companies have looked into selling and leasing back the power plant as a way of realizing a loss.

Cancel other contracts

Another way to create shelter is to spend the buyout payment in a way that gives the independent power company a tax deduction. For example, if the money is used to cancel fuel supply and other contracts, provided the contracts are not replaced with new agreements, the payments to get out of these other contracts can be deducted. There has been a debate among independent power companies about whether the payment is a "capital loss" as opposed to an ordinary loss, but a tax bill that Congress enacted last November has helpful language on this issue. ■

In Other News *cont.*

tive January 1. The combined corporate and municipal tax rate dropped from 34.3% to 32.5%.

POWER PLANTS MOUNTED ON BARGES probably do not qualify for faster depreciation as "vessels," the IRS suggested.

An IRS agent in the field went to the national office with a question about how to depreciate a three-story building mounted on a barge docked somewhere in the US. The owner of the barge was depreciating the entire asset over 10 years as if it were a "vessel." The national office urged the agent to get more facts, but said it thought that a structure built on top of a barge should be depreciated as a "building" over 39 years. The IRS made its comments in a recent "field service advice" to the agent.

US companies must depreciate assets located in foreign countries on a straight-line basis over the class life — usually 22 or 28 years in the case of a power plant. However, a US-flag vessel used in US foreign or domestic commerce can be depreciated over 10 years using the 200% declining-balance method — even if located abroad. Some US companies have considered claiming, where a power plant is mounted on a barge, that the entire asset is a US-flag vessel.

INTERTIES AT MERCHANT PLANTS will receive more study from the IRS.

The IRS declined to rule recently on whether a utility had to pay income taxes on the value of an intertie to connect a merchant plant to its grid. Power plant owners typically pay the cost of interconnecting their plants with the grid. The utility takes title to the intertie. Usually when a company receives property from a customer or supplier, it must report the value as income. However, the IRS issued a notice in 1988 that said utilities do not have to report the value of interties

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Utilities Keep Tax Benefits In Asset Divestitures

by Heléna Klumpp, in Washington

The Internal Revenue Service said in a private letter ruling recently that utilities must be allowed to retain balances in certain tax accounts kept for regulatory purposes when they divest themselves of assets.

Anyone bidding on assets in a divestiture should probably take this into account as a benefit to the utility when computing his bid price.

The ruling was released to the public on January 28. Since it applies only to one utility, the National Association of Regulatory Utility Commissioners, or NARUC, sent the US Treasury a letter asking it to issue broader guidance.

Background

Utilities generally pass through their taxes to ratepayers as a cost of service. However, Congress directed that utilities be allowed to keep the benefits from accelerated depreciation and investment tax credits without having to share them with ratepayers in the form of lower rates. These tax benefits are supposed to induce companies to invest in additional plant and equipment that will create jobs. The argument was that if utilities had to "flow through" the tax benefits to ratepayers, they would not have the same incentive as other industries to make new investments.

This requirement that utilities use "normalization" accounting — rather than flow-through accounting — led (in the past before deregulation) to distortions since a utility might report higher taxes for purposes of rates in some years than it actually paid. The distortions were caused by three factors.

One was the difference in tax and regulatory depreciation. Tax depreciation could be claimed on an accelerated schedule. Regulatory depreciation is generally straight line. Thus, the amount of taxes a utility is treated as having paid for purposes of setting rates is higher than it actually paid — at least initially after it has made significant capital investments. Over time, the depreciation reverses, but the utility has effectively had an interest-free loan from ratepayers. The utility keeps a "deferred tax account" to track the benefit.

Another factor creating distortion is that tax rates change during the period in which the utility is depreciating its assets. For example, Congress reduced the maximum corporate tax rate from 46% to 34% in 1986. Prior to the change, ratepayers had been paying prices for electricity based in part upon calculations of future taxes at the higher rate. Because of the reduction, the utilities had more money in their deferred tax accounts than they would be required to pay out at the 34% rate. To that extent, the interest-free loan became a grant. The regulators made utilities keep a separate "excess tax reserve" account for the overpayments attributable to the reduction in the tax rate. The utility returns the balance in the account to its ratepayers ratably under one of two methods that link the recovery period to the regulatory life of the asset.

Finally, utilities often have a third account to reflect the benefit of any investment tax credits the utility claimed. The federal government used to let US companies claim a tax credit for a percentage of the cost of new equipment as a further inducement to invest. The credit was repealed at the end of 1985, but could still be claimed on many power plants and other equipment placed in service as late as 1990. The IRS has interpreted the normalization accounting requirement that Congress imposed on utilities to mean that the lower taxes due to tax credits can be reflected in rates charged to utility customers, but not more quickly than a schedule determined by reference to the plant's useful life for regulatory purposes.

Issue

The question arises: what happens to the balance in these tax accounts when a utility divests itself of its assets?

Consumer advocates have argued that the

balances in the accounts ought to be used as an offset against the "stranded costs" the utility will be allowed to recover after deregulation.

The utilities argue that the benefits are illusory since, when a utility sells generating assets that have been fully depreciated, it has a large capital gain on which it must pay taxes. These taxes are not passed through to ratepayers and therefore effectively recapture some of the earlier benefit — at least in the deferred tax account.

IRS Ruling

Now the IRS had waded into the picture. The IRS told one utility in a private letter ruling that its regulators must allow it to keep the balances in its tax accounts when assets are sold or else the utility will not be considered to have used normalization accounting — the accounting method that is a precondition to its ability to qualify for accelerated tax depreciation and investment credits in the first place.

The utility in the ruling was required to sell its generating assets as part of state-wide electricity deregulation. It had claimed investment tax credits and thus, under the normalization rules, had a balance in the related account. Similarly, it depreciated its power plants using an accelerated method and had a balance in its deferred tax account. Income tax rates had dropped, so the taxpayer also had a balance in its excess deferred tax account. The utility asked the IRS whether it would violate the normalization rules if it returned to the ratepayers the balances in its excess deferred tax account and its investment tax credit account by amortizing them to a transition cost balancing account.

With respect to the investment tax credit account, the IRS said that when the plant is sold the property upon which the tax credits were claimed would no longer be available for computing regulatory depreciation expense. The normalization rules only permit utilities to pass along to ratepayers the benefits of the tax credits ratably

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from QFs, or "qualifying facility" projects, as income. The IRS later expanded this to independent power projects in general.

Pacific Gas & Electric Company applied for a ruling confirming this is still the correct tax treatment in the case of a merchant plant. The IRS declined to rule, saying it wants to make sure it has a better understanding of the fact patterns that come out of deregulation before issuing any further guidance in this area. A group is organizing to discuss the issues further with the US Treasury.

FOREIGN SALES CORPORATIONS are an illegal export subsidy, the World Trade Organization said again on February 24.

The US is expected to negotiate a settlement in the case but not by the October 1 deadline the World Trade Organization set to avert trade sanctions. European officials seem prepared to agree to another 12 to 15 months to work out a compromise.

US companies that run their exports of US-made goods through offshore companies called "foreign sales corporations" are able to reduce US taxes on their export earnings by 15% to 30%. FSCs have been incorporated into lease structures where US-made equipment — like airplanes and turbines — are used overseas. This reduces the US taxes on rents paid to the US lessor of the equipment.

Approximately one in every four US export dollars is run through a FSC.

A DUTCH FINANCE SUBSIDIARY was denied benefits under the US-Dutch tax treaty.

A Canadian parent company borrowed $14 million from the Royal Bank of Canada and then ran the money down a chain of offshore companies as equity contributions. The money passed from Canada to successive subsidiaries in the Cayman Islands,

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Utilities Keep Tax Benefits

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over the regulatory depreciation period. At the point of the sale, reasoned the IRS, "there could no longer be any correlation between the property and the credit." As a result, no portion of remaining balances in the utility's tax credit account could be returned to customers without violating the normalization rules.

The IRS also held that under the normalization rules the utility's deferred tax reserve and its excess deferred tax account would disappear upon sale. Therefore, any flowthrough of benefits to ratepayers after the sale would violate the normalization rules. In addition, like investment tax credits, the IRS noted that the benefits of accelerated depreciation and lower tax rates could only be passed along to consumers slowly, over the asset's regulatory life. When the asset is sold, that regulatory life evaporates and, thus, no further benefits may be passed along to ratepayers without violating the normalization rules.

A private letter ruling only applies to the taxpayer to whom it was issued. NARUC, the association of regulatory commissioners, sent Treasury Secretary Lawrence Summers a letter in November — after the ruling had apparently been shown to a regulatory commission but before the text was released to the public — asking the government to issue formal regulations addressing the issue because of its significance to state deregulation of electric utilities. ■

France Takes First Steps To Open Electricity Market

by Robin Mizrahi and Lynne Gedanken, in London

France took modest steps last month to open its electricity market to competition.

Although the extent of liberalization looks limited at first glance, it should not be underestimated in a country with a long tradition of governmental provision of public services.

The *Assemblée Nationale* voted in early February for competition after months of friction with the European Commission over when France would take the first step towards implementing EU Directive 96/92/EC, which provides for phased competition in the European electricity sector. (See "Off to the Races in Europe" in the March 1999 issue of the *NewsWire* for earlier coverage on the European directive.)

Key Provisions

The main provisions of the new French law (No. 2000-108) are as follows.

- The energy minister is required to set a multiyear program of generation investment that allocates capacity by primary energy source, production technique (for example, cogeneration) and region (article 6).
- A procedure is set for the energy minister to grant authorizations to operate the production facilities included in the generation investment program (article 7). The energy minister is also given the right to issue tenders for new capacity if the objectives of the generation program are not reached (article 8). *Electricité de France,* or EdF, may participate in these tenders. It must enter into a power purchase agreement with the winning bidder, in accordance with the tender provisions, if it does not win the bid.
- The law establishes a right for any eligible customer — currently consumers of more than 20 GWh per year, dropping to consumers of more than 9 GWh per year by 2003 — to enter into a power purchase contract with any producer situated in an EU country. Eligible customers also include power producers who may purchase an as yet unspecified percentage of their electricity production for resale (article 22). *Power in*

Europe, a *Financial Times* publication, reports that 800 customers (excluding producers) will become eligible this year and that the number will increase to 2,500 by 2003.

- The law establishes a right of access to transmission and distribution networks to allow performance of contracts between eligible customers and producers and the supply of power by a producer to its affiliates. Access is to be provided at a nondiscriminatory tariff based on the networks' costs (including expansion costs) and set by the ministers in charge of energy and the economy (articles 4 and 23).
- The transmission and distribution network managers are required to expand their respective networks in order to enable connection of producers and consumers (articles 14 and 18).
- The law sets up a procedure for granting authorizations to build lines in addition to those of the existing transmission and distribution networks (article 24).
- Finally, EdF is required to provide emergency power for unforeseen outages to producers and eligible customers at a tariff set by the ministers in charge of energy and the economy, which tariff cannot be lower than cost (articles 2 and 4).

It is not yet certain whether the European Commission will be satisfied that the new law complies with the EU directive. There are several points of potential controversy. The 3-year minimum term imposed on power purchase agreements between eligible customers and producers may be viewed as anticompetitive and unnecessarily intrusive. The European Commission may also be concerned that the criteria listed in the directive for granting operating authorizations without a tender do not include the need for capacity, while the law imposes that criterion. The provisions

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Netherlands Antilles and finally to the finance subsidiary in Holland. The Dutch finance subsidiary then onlent the $14 million to Del Commercial, a real estate company in the United States that was owned by the Canadian parent company.

The United States normally collects a 30% withholding tax on interest payments that are made to offshore lenders. However, the tax is reduced to 15% under the US-Canadian tax treaty, and it is reduced to 0% under the US-Dutch tax treaty.

Del Commercial paid no withholding taxes. The IRS said this was really a Canadian borrowing — so the 15% rate in the US-Canadian treaty should have applied. It assessed back withholding taxes plus penalties that added another third to the total tax bill. The taxpayer argued the case recently in the US Tax Court, but lost. The court said the Dutch shell company was a "mere conduit" for what was essentially a Canadian borrowing.

The case is Del Commercial Properties, Inc. v. Commissioner.

TWO INTEREST DOUBLE-DIP STRUCTURES came under fire.

John Staples, assistant IRS commissioner (international), questioned at a conference in Washington in December whether one of the structures works. A US parent company borrows in the United States and makes a loan to a subsidiary in the United Kingdom that is "disregarded" for US tax purposes — in other words, the subsidiary is treated as if it does not exist. The UK subsidiary claims an interest deduction against its UK tax base. "Dual consolidated loss" rules in the US normally bar US corporations from claiming essentially the same deduction in both the US and a foreign country, but the US parent argues these rules do not come into play since the interest deduction claimed in the UK is not the same deduction claimed

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France Opens Electricity Market

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relating to employment matters in the electricity and gas industries are another area with which the European Commission may take issue.

Network Access?

The law designates EdF as manager of the transmission network. EdF is also the main manager of distribution networks and by far the largest producer of power.

This leads to the central question of whether the law, with EdF as a substantial producer and transmission network manager, provides an adequate structure to ensure actual nondiscriminatory access to, and sufficient expansion of, the transmission and distribution networks. This is a particular concern because as manager of the transmission network, EdF will be making the projections that serve as the basis for the government's generation program and will advise the energy minister on whether to issue tenders for new capacity. In addition, other transmission users will need to enter into contracts for transmission service with EdF. Therefore, EdF, in its capacity as transmission network manager, will have a direct involvement in decisions related to the type of capacity to be built and whether to issue tenders for capacity in which it may participate as a producer, as well as the ability to affect other transmission users through the contracting process.

The law has rules designed to ensure that the EdF department responsible for managing the transmission network functions in strict independence from the rest of the company. Moreover, it has an obligation to act in a nondiscriminatory manner and in accordance with a concession approved by the *Conseil d'Etat*. As distribution networks manager, EdF also has obligations to act without discrimination, but the rules designed to ensure the independence of "EdF distribution networks manager" from "EdF producer" are less clear than in the case of its transmission network manager capacity. A risk lies in the fact that access to both the transmission and the distribution networks will be governed by contracts between the EdF as network manager and its users. Although the *Conseil d'Etat* has the authority to lay down procedures for transmission contracts, entering into these contracts may involve difficult negotiations with EdF.

In the end, the law's success in achieving nondiscriminatory access will depend on the *Commission de régulation de l'électricité,* or CRE, an independent body created by the new law. It will have broad powers to issue rules on access, use, operation and development of the networks, to settle disputes between managers and users of the networks, and to punish breaches of their obligations with respect to the networks. Possible sanctions include up to a one-year ban from access to the networks and fines in amounts of up to 3% — or 5% in case of a second breach of the same obligation — of turnover. The law requires the CRE to settle disputes within six months. Decisions by the CRE on dispute resolution may be appealed through a potentially lengthy judicial review process. On the other hand, the alternative remedy provided under the law for the producer to receive an authorization to build its own lines may not be a practical alternative in view of the conditions that would have to be satisfied. The CRE can also refer cases of anticompetitive behavior to the French antitrust authorities.

Although the law may not always be clear and straightforward, the fact that it passed at all may still be seen as an achievement in view of the French historical and social context. As is so often the case, what effect the law eventually has will depend on the political will of the government, the strength of the local regulating institutions and antitrust authorities (with the added weight of the European Commission) and the willingness of EdF to perform as a true independent system operator. In this latter regard, EdF may well draw on its substantial experience outside France to provide open nondiscriminatory transmission access. The hope of those who support the opening of the market to competition is that the law will create enough momentum to continue further. ■

Turkish Arbitration Issue Resolved

by Joel Baranowski and Peter Fitzgerald, in Washington

The Turkish parliament passed implementing legislation at the end of January that allows international arbitration in most contracts for public services.

International arbitration can now be applied to all new contracts and concessions, and companies who are parties to existing contracts were given the right to request that international arbitration apply to their contracts.

Requests for retroactive application of the new arbitration law must have been made by February 22, 2000.

Background

Turkey has long sought to increase the flow of inward foreign investment through the privatization and development of large-scale infrastructure and energy projects. While Turkey has a substantial economy, is a member of the OECD and NATO, has a record of strong economic growth and huge energy and infrastructure needs, few of the projects proposed by the Turkish government have moved ahead. One major deterrent to foreign investors in such projects had been Turkey's laws on arbitration, which had the effect of denying investors the right to seek international arbitration in an offshore venue.

Before last August, the Turkish constitution reserved to Turkey's top administrative court, the Council of State or "Danistay," the final call on issues surrounding interpretation of contracts for public services. Prevailing legal opinion in Turkey was that all contracts relating to power plants and other infrastructure projects were considered public service contracts and international arbitration was prohibited in resolving disputes under such contracts.

Last August, Turkey amended its constitution to

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in the United States. Staples said, "I think this really does give us some concern."

Lee Sheppard, a contributing editor of *Tax Notes* magazine, took aim at another structure in an article in late December. The other structure involves a joint venture formed in the US between a US and foreign partner. The joint venture is treated as a "reverse hybrid" — as a corporation for US tax purposes but as a partnership for tax purposes where the foreign joint venture partner resides. The joint venture borrows. It deducts its interest payments in the United States. The foreign partner also deducts its share of the interest payments in its home country.

Sheppard argues that new rules the IRS proposed in late November to attack "extraordinary transactions" that exploit "check-the-box" regulations should apply to this transaction. (See "IRS Moves to Limit Certain Foreign Tax Planning" in the December 1999 issue of the NewsWire *for prior coverage.)*

EFFORTS TO ESCAPE ARBITRATION for a dispute in the Dominican Republic failed.

Smith Cogeneration had a contract to supply power to the government utility, Compañia Dominicana de Electricidad, or "CDE." It faced strong competition from Enron. The two companies decided to form a joint venture. Smith was to put the power contract and some capital into the joint venture, but when it came time to contribute the capital, Smith had trouble raising funds. Enron sought to submit the dispute to binding arbitration in keeping with a mandatory arbitration clause in the joint venture agreement. Smith tried to block the arbitration by filing a lawsuit in the Dominican Republic. Enron went to court in the United States.

Smith argued that the arbitration clause in the joint venture agreement could not be enforced, among

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Turkish Issue Resolved

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leave the decision to parliament whether particular public service contracts are governed by Turkish law and accordingly are subject to the authority of the Council of State, or to allow foreign law or international arbitration to apply to such contracts. This amendment laid the groundwork for January's legislation.

The new law should allow stalled projects to get back underway and encourage the development of new projects. Examples of projects likely to move forward in the near future include a $1.8 billion suspension bridge across the Izmit bay, a third Bosphorus crossing at Cannakkale, the Bodrum water supply project, a $200 million container terminal at Derince, a 336-MW lignite-fired power plant in Tufanbeyli, Adana, a 206-MW power plant to supply Alapi, Zonguldak and a 200-MW gas-fired power station in Eskisehir.

New Opportunities

The Government of Turkey has big plans for new energy projects. The Turkish Ministry of Energy estimates that electricity consumption in Turkey will nearly treble from 103 billion kWh in 1997 to 290 billion kWh in 2010. Analysts estimate that Turkey will need to spend $4.5 billion each year on electricity generation and distribution. Independent forecasters estimate that an additional 87,000 megawatts of installed capacity will be needed to meet the growth in demand for energy in Turkey over the next 20 years.

A number of new pipelines are also in the works. Turkey already imports 60% of the raw energy it uses and this percentage is projected to increase to 75% by 2020. As a result of this demand for imported energy, the Turkish government has proposed several natural gas and oil pipeline projects. The largest of these is the proposed $2.5 billion Baku-Ceyhan oil pipeline project. If completed this pipeline would transport one million barrels of oil per day from Azerbaijan through Georgia to the Mediterranean port of Ceyhan in Turkey.

US Support

The US Government strongly supports the "western route" Baku-Ceyhan pipeline, as well as investment in Turkish energy and infrastructure projects generally. Ambassador John Wolf, special advisor to the President and Secretary of State for Caspian basin energy diplomacy, has made it clear that the US government will play a significant role in providing financing and political risk insurance for energy and infrastructure projects in the region through the Overseas Private Investment Corporation and the US Export-Import Bank. As part of this initiative, the US government recently established The Caspian Financial Center in Istanbul, staffed with employees of OPIC, US Ex-Im and The US Trade and Development Agency. (For more information on the Center, see the website at www.caspianfinance.com.) OPIC's first political risk insurance contract for a capital markets financing was also recently issued for a project in Turkey. ■

Peru Launches Ambitious Plan To Privatize Assets

by Luis Torres, in Washington

Peru's privatization program for this year is underway and it includes some high-profile concessions, most notably the Camisea gas project, Lima's international airport and possibly the Callao seaport. The need to finance these sizable projects has attracted the interest of project financiers, especially large commercial banks and multilaterals active in Latin America.

The Commission for the Promotion of Private Investment (known by its Spanish acronym as "COPRI") released an updated schedule of privatizations for the year 2000 in January. After a lackluster

1999 in which the government only raised $300 million in privatization revenues (rather than the $800 million that had been targeted originally), this year COPRI expects to raise $600 million in revenues and $5 billion in investment commitments. However, government officials have acknowledged that the program may proceed at a slower pace than scheduled due to their limited experience with infrastructure concessions.

Electric Utilities

Most of the revenue will derive from the sale of shares that the government maintained in a handful of partially-privatized electric utilities. The government raised approximately $85 million by selling its 17.5% stake in generator Edegel in January. In upcoming months the government will sell its remaining stakes in generators Etevensa (38%) and Empresa Eléctrica de Piura (40%) and distributor Edelnor (36%), the largest electricity distributor in Lima with 50.6% of the market. The stock will be sold through public bid or tender in Lima's stock exchange. The shares will be priced using the Dutch auction system, and all offerings are open to international investors. There is no limit on the amount of shares that a single investor may purchase.

Airports

Investment commitments will relate mostly to concessions in the gas and transportation sectors. Concession of the Jorge Chávez international airport, the country's largest, is tentatively scheduled for the second week of March. The airport has attracted the interest of international operators partly because Lima's location in the central western part of South America gives it the potential of becoming a hub for air traffic from North and Central America to South America and from Brazil to the Orient. The winner of the public tender will administer, operate, maintain and develop the airport for a period up to thirty years. The concession will include all the airside and landside

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other reasons, because the US courts had no jurisdiction over the joint venture.

It lost before a federal district court and lost again on appeal before the 2d circuit court of appeals in December. The appeals court ordered Smith not only to submit to arbitration, but also enjoined the lawsuit in the Dominican Republic.

CHINA is expected to drop special tax incentives for foreign investment when it is admitted into the World Trade Organization. Foreign joint ventures usually qualify for an income tax holiday for the first two years and a reduced 15% income tax rate for the next three years. There is no timetable for dropping these incentives, but a new unified tax code is working its way through the government and is expected to take effect in 2001. Existing investments are expected to be grandfathered.

FLORIDA is debating whether to drop a tax on debt instruments and other intangibles. Florida Governor Jeb Bush called on the state legislature in his budget message in January to phase out the tax over the next two years. A Senate committee voted in late February to reduce the tax, but not eliminate it.

FRANCE is expected to impose a carbon tax on industrial energy users in 2001.

The Jospin government released an action plan in mid-January of 96 measures to reduce greenhouse gas emissions. The centerpiece of the plan is a tax of 150 to 200 francs ($23 to $31) per ton of carbon emissions to take effect in 2001. The tax would increase gradually until it reaches 500 francs ($77) a ton in 2010. Many details remain to be filled in. Energy intensive industries, like aluminum, cement and chemical producers, have been fighting the tax on grounds that it will erode their competitiveness with

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Peru Privatizes Assets

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services, with the exception of the air traffic control and meteorological services.

Eight companies, mostly consortia consisting of local and international operators, have pre-qualified to bid. The government is requiring a minimum investment of $120 million for the first eight years. The original deadline for presentation of bids was February 20, but it has been postponed indefinitely because the licensing contract is undergoing substantive revisions related to the construction of the airport's second runway and the expropriation of lands to expand the current terminal. Once the Lima airport is given in concession, the government will begin to work on the concession of four other international airports: Iquitos, Trujillo, Cuzco and Arequipa.

Ports

The Callao port, the country's largest, is expected to raise $50 million in revenues and $350 million in investment commitments. The concession process is tentatively scheduled for the last trimester of this year. Bidding documents are being prepared. Smaller regional ports are expected to be given in concession throughout the year.

Toll Roads

COPRI also expects to give eleven toll roads in concession this year totalling 6,750 kilometers in length and covering 75% of the national highway network. The first scheduled concession is Road Network No. 5, a 410-km road that connects Lima with mining towns in the central part of the country and requires approximately a $140 million investment. The concession will consist of a twenty-five year build-own-transfer, or BOT, contract that requires the concessionaire to build a second lane on an existing road, an additional highway, crossroads and bridges, as well as perform maintenance work. Ten consortia that include European companies have pre-qualified for the bid. The original deadline for submission of bids (January 25) has been postponed due to requests by the pre-qualified bidders.

Camisea Gas Field

A consortium consisting of Pluspetrol from Argentina, Hunt Oil from the US, and SK Corporation from South Korea won the upstream concession of the Camisea gas reserves last month, one of the world's largest gas fields. Bids for the downstream license are due on March 6 and the government is expected to announce the winner on March 9.

The Camisea gas fields contain an estimated 13 trillion cubic feet of gas and over 600 million barrels of condensate. The winning consortium won a forty-year concession by offering the highest royalty, 37.24%, almost two percentage points higher than the second bid, 35.5%, offered by a consortium of Total and Elf. Each of Pluspetrol and Hunt Oil has a 40% stake in the consortium with SK Corporation controlling the remaining 20%. Pluspetrol, which is already active in Peru's oil industry, will be the operator of the project.

The project consists of extracting natural gas from the fields and transporting it to Lima and Callao, the capital city and main seaport, through two pipelines, one for the dry gas and one for the liquids. The dry gas will be distributed in Lima and Callao for domestic consumption; the liquids are likely to be exported overseas. Before transporting the gas, the upstream licensee will separate the gas into dry gas and liquids. It must sell the dry gas at the wellhead, where the price will be set and the government royalties will be calculated based on that price. The buyer will have to pay transportation costs separately. The upstream licensee is not required to sell the liquids at the basin; hence, the licensee, for a fee, will transport the gas liquids to a processing plant in Lima and then sell them. No export restrictions apply to the sale of the dry gas or the liquids.

The winner of the downstream concession will have the right to transport the gas (both the dry gas and the liquids) to Lima and distribute it there. The winner also has the right to assign the distrib-

ution portion of the concession within the first five years of operations.

Financing Camisea will probably require a great deal of creativity. Commercial risk is high since Peru's market for natural gas is green. However, the government has undertaken efforts to develop the market as quickly as possible.

The government commission in charge of the project, known by its Spanish acronym as "Cecam," has signed a "take-or-pay" contract with Electroperú, a state-owned utility, and a second contract with a consortium made up of six large industrial consumers.

According to press reports, additional "take-or-pay" contracts with other industrial consumers are on the works. Sources indicate that these contracts would guarantee a flow of income sufficient to get the project started. The government also has put in place other incentives, including a reduction in the minimum royalty from 15% to 10%, substantial tax deductions for the importation of capital goods, a five-year moratorium in the concession of hydroelectric projects and is drafting legislation to encourage the development of a petrochemicals industry.

Infrastructure risk is also significant given the location of the gas fields and a nonexistent distribution infrastructure. Camisea is located in the remote jungle east of the Andes while the main markets, Lima and Callao, are located west of the Andes. Also, Camisea is located in the tropical rainforest. Thus, extraction of the gas is likely to demand an engineering effort.

The bidders for the downstream phase of the project are large and experienced international companies, and so far they seem willing to face the infrastructure challenge. Supply risk should not be disregarded, although this seems to be one of the lesser risks. Camisea is close to another large gas basin, the Parogeni gas fields, also discovered by the Shell/Mobil consortium, that could guarantee enough supply of gas for high-demand consumers. ■

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producers from other countries that do not impose a similar tax.

Jospin said in a January 19 speech that he is "conscious of the need to exonerate certain sectors that would be particularly penalized by this tax."

TELEPHONE POLE REMOVAL COSTS can be deducted immediately even though the poles will be replaced, the IRS said in February.

This came as a surprise to many companies who had thought costs of removing property had to be added to the tax basis of the replacement property and recovered over time by depreciating the new asset. The IRS made the statement in Rev. Rul. 2000-7. The ruling is written very broadly so that it applies across industries.

Christine Turgeon, a lawyer at the US Treasury, said there are only two exceptions where removal costs cannot be deducted. Section 280B of the US tax code requires the cost of demolishing structures be added to the tax basis of the land, and IRS regulations under section 165 of the US tax code deny a deduction where someone buys an asset intending to demolish it.

GOVERNMENT TAKEOVERS OF PRIVATE WATER COMPANIES would be made more difficult under a bill that Rep. Phil Crane (R.-Ill.) introduced in Congress. Crane is a senior member of the tax-writing committee in the House.

The bill would label any bonds that a state or municipality issues to "acquire a water utility (or any facility thereof) by exercise of eminent domain power" a "private activity bond." This means that the state or municipality would have to borrow at taxable — rather than tax-exempt — rates in order to finance the takeover. The bill makes two exceptions. One is where the acquisition is approved in a public referendum. The

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IRS Moves Against "Tax Products"

by Keith Martin, in Washington

Corporations will be required to attach forms to their US tax returns disclosing details about transactions that the US authorities will probably want to examine on audit under new rules issued by the Internal Revenue Service in early March.

The new rules are part of an all-out war the US Treasury is waging against aggressive US tax planning by corporations. The government is alarmed at the growing market in "tax products" being peddled by the big accounting firms and investment banks. It has asked Congress for more tools to combat the trend and is hoping, in the meantime, that greater disclosure of the details of these transactions will act as a deterrent.

The new rules also require promoters of corporate tax shelters to register them with the Internal Revenue Service before the shelters are offered to corporations and to keep a list of companies they persuade to invest in case the IRS wants to see it.

The IRS has scheduled a public hearing for June 20 to collect comments.

Disclosure

Under the new rules, any corporation that participates "directly or indirectly" in a "reportable transaction" must attach a form with the details of the transaction to its tax returns for each year the transaction affects its US tax position. A copy of the form must also be sent the first year to a special office the IRS has set up to monitor aggressive tax schemes.

Two things must be true before a tax maneuver rises to the level of a "reportable transaction."

First, either it must appear on a list of transactions the government considers abusive — so-called "listed transactions" — or it must possess some of the following characteristics. Any two of these characteristics will require reporting.

- The corporation participated in the transaction "under conditions of confidentiality." An example is where the transaction was pitched to the corporation as a proprietary idea by an outside tax adviser.
- The corporation has contractual protection against the possibility that some of the tax benefits will be disallowed. Examples of contractual protection are an unwind clause, a right to a partial refund of fees, fees that are contingent in the first instance on the tax benefits from the transaction, or a tax indemnity. However, a tax indemnity from another participant in the transaction who had no role in promoting it – such as the tax indemnities that lessees give lessors in big-ticket lease transactions — are not a problem.
- The advisers who "promoted, solicited or recommended" the transaction to the corporation are expected to receive more than $100,000 in aggregate fees. However, fees only count if they are contingent on closing the transaction.
- The expected treatment of the transaction for tax purposes is expected to differ from its book treatment by more than $5 million in any single year.
- One of the other parties to the transaction is in a different tax position — like a tax-exempt entity or foreign person — and this lets the corporation realize tax benefits that it could not have gotten otherwise.
- The transaction is a hybrid in the sense that "any significant aspect" is expected to be characterized differently by the tax authorities in the US and a foreign country.

Second, the expected tax benefits from the transaction must be large enough to warrant IRS attention. A "listed transaction" satisfies the dollar thresholds if the corporation expects to reduce its federal income taxes by more than

$1 million in a single year or more than $2 million in any combination of years. The thresholds for other transactions are more than $5 million in a single year or more than $10 million in any combination of years.

The IRS published an initial list of "listed transactions" on February 28. It has on it 10 items. They include LILOs, or lease-in-lease-out transactions where a foreign entity or US municipality leases a power plant, gas pipeline or other equipment to a US equity and subleases it back, certain tax plays involving foreign tax credits that are described in IRS Notice 98-5, "lease strips," and ACM Partnership-type transactions.

There is one important exception from disclosure. This exception should exempt plain-vanilla lease transactions in the US domestic market from disclosure; whether the exception covers cross-border lease deals is less clear. A transaction does not have to be reported if the corporation "participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice" and either would have participated on substantially the same terms irrespective of tax benefits or "there is a long-standing and generally accepted understanding" that the transaction works from a US tax standpoint. The exception does not cover "listed transactions."

The new disclosure requirement applies to tax maneuvers entered into after February 28, 2000.

Some closed deals may also have to be reported. Any "listed transaction" closed during 1999 will probably have to be reported. The rule is that a listed transaction that already closed can escape disclosure only if the corporation already claimed tax benefits from it on an annual tax return it filed with the IRS before February 28, 2000.

Companies are barred from disposing of any documents relating to disclosed transactions, even drafts. These include all internal e-mails and memos and all communications between the company and outside promoters, advisers, lenders

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other is where there is a finding by a state public utility commission that the water utility "on a continued basis has been in violation of state or federal laws or regulations governing the provision of water services."

The main beneficiary of the bill would be the American Water Works Co. The company supplies water to 900 communities in 23 states. It faced hostile takeover attempts last year by city governments in Chattanooga, Tennessee and Peoria, Illinois. Pekin, Illinois was also considering a takeover at year end.

BRIEFLY NOTED: The US Treasury is expected to report to Congress around March 31 on whether recent technological advances require shortening any depreciation periods. Both the Edison Electric Institute and the Electric Power Supply Association argued for shorter lives for power plants. The Treasury is expected to avoid specifics in the report and to focus, instead, on a procedure for ensuring that depreciable lives are updated in future. The IRS used to set depreciable lives, but Congress took away the power in 1988 . . . . Tampa Electric Company argued in a case in federal district court in Florida that payments it received from customers to run underground power lines to their properties did not have to be reported as income on grounds that they were "advance payments" for electricity. A special rule in IRS regulations lets a manufacturer who is paid in advance to deliver goods in future report the payment as income over the period the goods are delivered. This has been an area of some controversy whether the provision applies to electricity. The court did not rule out claiming the provision on electricity sales, but said it had no application here: "Just because payments are necessary to receive electricity and are made prior to electric service beginning does not mean they are 'advance' payment *for* electricity." ■

— contributed by Keith Martin in Washington.

Tax Products

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or other parties to the transaction that the company had in its possession at any time on or after February 28, 2000. IRS officials admit the ban is probably too broad. The new rules are "temporary and proposed" and may undergo some revision before they are reissued in final form. They are effective as written in the meantime.

Advance Registration

The new rules also require promoters of corporate tax shelters to register them with the Internal Revenue Service before the shelters are offered to corporations.

Three things must be true about a transaction before registration is required.

First, it must have "avoidance or evasion" of federal income taxes as a "significant purpose." So-called listed transactions fall into this category automatically. Other transactions where federal income tax benefits are "an important part of the intended results" do also, but only where the promoter expects to offer the transaction to more than one potential participant. Thus, unless the transaction is a one-off deal that will never be repeated, it will trip this "avoidance or evasion" test. Transactions that lack economic substance also involve avoidance or evasion. A transaction lacks economic substance if the pre-tax profit the company expects from the transaction — "after taking into account foreign taxes as expenses and transaction costs" — in present-value terms is insignificant compared to the expected tax savings. The economic substance of transactions to raise debt or equity capital is tested differently. They lack economic substance if the present value of the tax deductions to the borrower significantly exceeds the pre-tax return expected by the lender or equity participant.

Second, the transaction must be offered "under conditions of confidentiality." The accounting firms expected this condition would be easy to avoid. The IRS said there can be implied confidentiality for a transaction — for example, where the accounting firm leads the company to believe the idea is proprietary. The IRS effectively issued a challenge: a transaction is *not* offered under conditions of confidentiality if the promoter signs a written agreement with everyone with whom he discusses possible participation "expressly authoriz[ing] such persons to disclose every aspect of the transaction with any and all persons, without limitation of any kind."

Finally, the promoters must be expected to receive more than $100,000 in total fees. Fees from all "substantially similar" deals the promoter does must be aggregated. Thus, if he expects to repeat the deal several times with other companies, the fees add up to a much larger number.

Registration applies to tax shelters offered after February 28, 2000. If a shelter was offered before, registration will be triggered the first time it is offered again after February 28. Registration must occur before interests in the transaction are "offered for sale." However, the IRS is giving promoters a grace period until August 26 this year to file registrations required by the new rules. None is required before then.

Many tax shelters were already subject to IRS registration, but tax schemes offered to corporations often escaped these rules. The new rules broaden the net. Registrations are filed on IRS Form 8264.

Tax maneuvers engaged in by foreign companies may have to be registered. These will be viewed as involving indirect participation by a US company — and, therefore, as potentially involving the "avoidance or evasion" of US taxes — if a US company owns at least 10% of the shares by vote or value of the foreign company that is the direct participant in the scheme. If the foreign company is a partnership for US tax purposes, ownership by the US company of at least a 10% capital or profits interest, or expected receipt of at least 10% of loss allocations, will be enough to require US registration.

Investor List

Promoters must also keep a list for seven years of companies they persuade to invest in corporate tax shelters in case the IRS wants to see it.

Lists are required even for corporate tax shelters that do not have to be registered. While three things must be true about a corporate tax shelter before the promoter has to register it, he must keep a list of investors in any transaction that has US tax "avoidance or evasion" as a significant purpose, regardless of whether it was offered under conditions of confidentiality or the amount of fees paid. ■

US Adopts Market Rates For Gas Transportation Over Interstate Pipelines

by David Schumacher, in Washington

The Federal Energy Regulatory Commission last month ordered regulated interstate gas pipelines in the United States to be more flexible in the services they provide and authorized market rates to be charged for gas transportation.

FERC took the action in Order No. 637. The order will take effect at the end of March.

It reflects the agency's view that competition has increased enough in interstate gas markets to ensure efficient allocation of interstate gas pipeline capacity without the need for command-and-control regulation by the federal government.

The following rules will apply in future to gas transportation over interstate pipelines.

Firm Transportation Rights

Until September 30, 2002, FERC will allow holders of firm transportation capacity rights on interstate pipelines to release, or assign, these transportation rights to third parties at whatever price the market will bear, if the term of the release is less than one year.

This means that firm transportation customers, which include many independent power producers, could temporarily release their firm capacity rights at a rate above the rate that the customer is paying the pipeline for the service. However, FERC will not allow the pipelines similarly to charge rates above the maximum regulated rates for short-term transportation services that they sell directly to customers.

On one hand, this policy change could allow holders of firm capacity rights to earn a profit on the firm capacity rights for which fixed demand charges are usually paid. At the same time, those transportation customers that rely on short-term transportation services purchased on the capacity release market could see prices for such service increase above the regulated transportation rate established by FERC, particularly during peak demand periods.

Seasonal Rates

In an effort to make the cost-based, regulated rates that the pipelines can charge for transportation services more accurately reflect the market value of the transportation capacity, FERC will allow the interstate pipelines to implement seasonal rates and term-differentiated rates. More specifically, pipelines will be permitted to establish rates for short-term (*i.e.*, less than one year) firm and interruptible services that differ depending on season.

This means a pipeline could charge higher rates during the peak period over which the short-term service is being provided.

In addition, pipelines will be permitted to charge rates that vary depending on the term for which the service is contracted. For example, transportation rates for services under a ten-year contract could be less than the transportation rates charged under a two-year contract. These changes in FERC's rate design policy will impose more price

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Gas Transportation

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risk for transportation customers seeking to rely on shorter-term transportation services.

Managing Imbalances

In an effort to make pipeline services more market responsive, the interstate pipelines will be required to implement imbalance management services and limit the assessment of imbalance penalties to instances when necessary to maintain reliable service. While this new policy should provide shippers with more flexibility to utilize the pipeline system to manage their gas flows and reduce the impact of imbalance penalties on the end-users' cost of gas, it also may require shippers to purchase additional services from the pipelines to manage imbalances.

Disclosure

FERC is requiring the pipelines to disclose more information about the transportation arrangements they enter into with their customers. Among the information that each pipeline will now be required to provide publicly, upon entering into a transportation transaction, is the name of its customer, the rate being paid relative to the maximum rate it can charge for the service, receipt and delivery points being used, the contract quantity, and the duration of the transaction.

In addition, the pipelines will be required to provide daily information on available, scheduled and design capacity.

FERC's intent is to create a more transparent transportation market, which it believes will have the effect of mitigating pipeline market power. However, from the perspective of the pipelines' customers, FERC's requirement may result in the disclosure of sensitive commercial information, including specially-negotiated rates.

Refusal Rights

FERC has decided to maintain its right-of-first refusal, or ROFR, procedure, which allows shippers having a firm transportation contract of at least one year in duration and requiring payment of the maximum approved rate for service to retain the capacity rights available under the contract at the end of the contract's term by matching the highest rate bid (up to the applicable maximum regulated rate) and the longest term bid (up to five years) for that capacity.

By keeping this policy in place, shippers with long-term contracts will have the means, as a matter of law, to retain their firm capacity rights when their contracts expire.

Public Hearings

FERC believes that further changes to its policies may be necessary as the open-access transportation markets become more mature. Therefore, FERC will be convening public conferences during the year to discuss whether its policies need to change to increase liquidity in the gas markets, whether changes in its policies are needed to accommodate increasing convergence in the gas and electricity markets, and whether its policies regarding the design of pipeline rates need to be further revised to enhance quality and efficiency of pipeline services. ■

Creating An Effective Security Package Using Commercial Insurance In International Projects

by Noam Ayali, in Washington

A key feature of infrastructure project finance is the allocation of risks among the numerous parties involved. One of the most important risk management tools for project finance, to which both project sponsors and

lenders should look in order to allocate risks to a third party, is commercial insurance.

Although it is an area where the interests of both project sponsors and lenders converge to a large degree, a potential "win-win" situation, commercial insurance is a discipline with its own unique "rules of the game," which are not always clearly understood by the main parties involved in the project negotiations.

Understanding what lies behind the inevitable insurance jargon and how successfully to incorporate insurance into a lender's security package is critical to achieve a successful project financing.

Basic Jargon

In most project finance transactions, the main credit agreement will include detailed insurance provisions. In some cases, there will be a separate insurance agreement that will govern the insurance requirements and the parties' interests. Although the specific scope of insurance coverage and amounts will differ in the case of individual projects, it is safe to say that in virtually all cases, these provisions will include a requirement that the project insurance policies include the lenders (acting through an agent or security trustee) as "additional insured" and name the lenders as "loss payee." In addition, there will be a requirement that the project insurance policies include a "breach of condition" clause, also called a "non-vitiation" clause.

In the case of complex infrastructure project financing, and in the case of projects located in jurisdictions with a legal framework that mandates domestic insurance, but where the capacity and financial health of the domestic insurance industry may be an issue, insurance arrangements will require that the project's insurance program be reinsured in the international markets with reinsurers acceptable to the lenders and with appropriate "cut through" provisions.

Another typical requirement is that the project insurance policies include a waiver by the insurer of any rights of subrogation against the lenders (a "waiver of subrogation"). Finally, there will be miscellaneous provisions regarding modifications (prohibiting the project company from modifying the insurance without lenders consent), notices (requiring the insurer to notify the lenders before canceling the project company's insurance policies), and other information delivery (copies of policies, renewals, etc.).

Additional Insured

As the term implies, an "additional insured" is any entity other than the project company which is specified as such on the insurance policy.

There has been some discussion among commentators whether to distinguish between an "additional named insured" and an "additional insured." The former has been used to refer to an entity added to a pre-existing insurance policy, while the latter has been used to refer to an entity insured at the same time as the insurance policy is issued to the project company. However, New York courts have consistently refused to make this distinction and have ruled that the additional party's rights are the same, regardless of whether the party was named as an additional beneficiary of the policy at the same time or later than the named insured.

As an additional insured, lenders are treated as if they were separately covered under the insurance policy. Most importantly from the lenders' perspective, an additional insured has no obligation under the insurance policy and is not liable to the insurer to pay the premiums. Absent a "loss payee" clause (discussed below), it is important that the insurance policy state that proceeds would be payable to the named insured (the project company) and the additional insured (the lenders) "as their interests may appear." This will enable the lenders to receive payment of insurance proceeds to the extent of their interest in the insured property ahead of the project company in

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the event of insured loss. Absent a provision that specifies payment "as their interest may appear," the project company and the lenders are presumed to share the insurance proceeds equally.

Loss Payee

A "loss payee" is entitled to receive the entire insurance proceeds, or amounts in excess of a certain threshold if so specified (but other than proceeds under third party liability insurance which are payable to the injured third party), regardless of whether it has an interest in the insured property. Under New York law, a loss payee is deemed to have a separate contract right to be paid against the insurer and may bring a suit against the insurer in its own name.

As in the case of being named an additional insured, the loss payee has no obligations under the insurance policy and is not liable to the insurer for the payment of premiums. However, lenders should be aware that absent a "breach of condition" or "non-vitiation" clause (discussed below), being named *solely* as loss payee may not be sufficient from their perspective. That is because a default by the project company under, or in connection with obtaining, the insurance policy could give the insurer a defense against a claim by the insured (the project company), thus avoiding payment and in some cases entitling the insurer to void the policy, effectively barring the lenders from recovering the insurance proceeds.

Until recently, under English law, being named as loss payee or having a loss payable endorsement served only as a direction to the insurer to pay the insurance proceeds to the lenders. Absent other language in the policy, being named as loss payee would not have entitled the lenders to enforce any rights to receive payment against the insurer. This is because under the so-called "third party rule," English law did not recognize rights of third party beneficiaries, and there is no direct privity of contract between the insurer and the loss payee. That has now changed with the recent passage of the "Contracts (Rights of Third Parties) Act 1999," which became effective on November 11, 1999. (See "Third Parties Gain Right to Enforce Project Contracts" in the December 1999 issue of the *NewsWire* for earlier coverage.) It remains to be seen whether being named as loss payee will be sufficient to create a third-party beneficiary right for purposes of the new law, which would allow the lenders to enforce such right directly against the insurer.

Non-Vitiation Clauses

Because of the potential exposure, it is easy to see why "breach of condition" or "non-vitiation" clauses are distasteful to, and highly negotiated by, insurers. In general, mistake, misrepresentation, non-disclosure, or breach of warranty on the part of the project company may provide sufficient grounds for the insurer to void the policy. Lenders are particularly concerned about these factors because they are inherently difficult to investigate in the normal course of project appraisal and because lenders may have no effective control over the project company's behavior in this respect.

Including a breach of condition or non-vitiation clause in the insurance policy prevents the insurer from voiding the policy or refusing payment on the basis of defenses it might otherwise have against the project company. As noted, these provisions are usually carefully negotiated, and their inclusion in a policy is in many cases a function of capacity and other general conditions which at any particular moment in time may affect the international insurance industry.

A possible alternative for lenders facing insurers that are reluctant to include breach of condition or non-vitiation clauses is to try and obtain, at the project company's expense, so-called standard mortgage insurance. Standard mortgage insurance

covers a lender/mortgagee precisely for the risk that as between the insurer and the mortgagor, the insurer may have grounds to void the policy. However, the availability of this kind of insurance is limited for much the same reasons that insurers are reluctant to include breach of condition or non-vitiation clauses in the first place, and because of the generally large amounts involved in infrastructure project finance.

Reinsurance

In some emerging markets jurisdictions, project companies are required by law to obtain all or a portion of the commercial insurance through domestic insurers. In others, even if specific legislation pertaining to the insurance industry doesn't exist, exchange controls may have the same effect of requiring the project company to maintain domestic insurance in local currency. Because of potential concerns regarding the legal framework and the capacity and credit quality of the domestic insurance industry, lenders in these cases will generally require that the project company's insurance program include reinsurance of all or a substantial portion of the risk in the international markets. In addition, because of the sheer size of many infrastructure projects, reinsurance will be required directly as a result of capacity restraints on individual primary insurers, who will also, as a matter of prudent industry practice, want to pass on some of the risks to the international reinsurers.

It is important for both project sponsors and lenders to understand that a reinsurance policy is an indemnity contract between the primary insurer and the reinsurer. It is distinct and separate from the original insurance policy issued to the project company and does not generally create any privity between the reinsurer and the project company. Neither does the naming of lenders as additional insureds and loss payees on the primary insurance give the lenders any rights against the reinsurer. Because neither the project company nor the lender has any contractual relationship with the reinsurer, generally only the primary insurer may bring an action against the reinsurer to recover reinsurance proceeds, unless additional steps are taken.

What, then, can lenders do in order to overcome the lack of privity with the reinsurer and avoid the credit risks of the primary insurer in domestic emerging markets jurisdictions?

Cut-Through Endorsement

If the project's finance documents and insurance policies are subject to New York law, lenders should require that the project company's insurance program include reinsurance with "cut-through" provisions. A number of different cut-through endorsements are in use in the reinsurance industry, each with different legal effect. A pure cut-through changes the direction of payment of the reinsurance proceeds from the primary insurer to a designated beneficiary. A cut-through guarantee endorsement also changes the direction of payment, but guarantees not only the reinsured loss but also any exposure that may have been retained by the primary insurer. A cut-through endorsement can also constitute a novation, placing the reinsurer in the position of the primary insurer for full payment to the designated beneficiary, including all claims handling. New York law specifically recognizes "other loss payees," which may be the lenders, as the beneficiaries of a cut-through endorsement.

The basic function of a cut-through endorsement is to provide that in the event of insolvency of the primary insurer, the reinsurance proceeds are paid by the reinsurer directly to the lender rather than to the primary insurer or its liquidator, thereby eliminating the insolvency risk at the primary insurer level. Without a cut-through endorsement, in the event of insolvency of the primary insurer, the reinsurer will make payment

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to the insolvent insurer's liquidator and the reinsurance proceeds will go to increase the size of the funds available for distribution to all of the insurer's creditors, or as otherwise specifically provided by the domestic insurance and bankruptcy laws of the insurer's jurisdiction of incorporation.

By way of illustration, under New York law, in that scenario, the project company and the lenders would have no right to any preference over other policy holders or general creditors of the primary insurer and would share ratably with other policy holders in the distribution of the primary insurer's assets. In other words, without a cut-through endorsement, the lenders are taking on, in addition to project company and project risk, credit risk of the primary insurer. This is unlikely to be acceptable to lenders where the primary insurer is itself weak or is subject to the financial and business vagaries of emerging markets.

As previously noted, English law until recently did not recognize the rights of third-party beneficiaries, with the result that cut-through endorsements were unenforceable under English law because of the lack of privity between the project company and the lenders on the one hand, and the reinsurer on the other. Thus, if a project's finance documents and insurance policies were subject to English law, in order to have had an enforceable cut-through, lenders would have needed to have required that the project company, primary insurer, and reinsurer enter into a tripartite agreement to that effect.

According to one commentator, although such an agreement would have addressed the lack of enforceability issue, there was a concern that it created a possible problem as a voidable preference under the UK "Insolvency Act of 1986." However, under the new "Contract (Rights of Third Parties) Act," the need for such an agreement has been obviated, and it can be expected that a properly worded cut-through endorsement should suffice to give the lenders enforceable rights.

The best protection for lenders is clearly a cut-through endorsement from the reinsurer that guarantees the full amount of the insurance (not just the excess reinsured) and which also acts as a novation, allowing the project company and the lenders to deal directly with the reinsurer in all matters relating to insurance under the policies.

Ultimately, the type of cut-through endorsement which reinsurers will be willing to provide will be a matter for negotiation and may depend upon, among other things, whether the reinsurance is facultative reinsurance (*i.e.*, reinsurance of part or all of the insurance provided by a single policy, with separate negotiation for each unit of insurance passed — or ceded — to the reinsurer) or treaty reinsurance (*i.e.*, reinsurance provided pursuant to a standing agreement between the reinsurer and the primary insurer for the — usually automatic — cession and assumption of certain risks).

Subrogation Waiver

A "waiver of subrogation" is usually required by lenders to protect themselves from the possibility of any action by an insurer, who, upon payment to an insured project company would become subrogated to any and all of the project company's rights against third parties. However, if the lenders are named as an additional insured, this protection is probably not necessary, both under New York law and English law, since it is well established in both jurisdictions that an insurer does not have any right of subrogation against its own insured for any claim arising from the very risk for which the insurer contracted to provide insurance coverage. As previously noted, by being named additional insured the lenders would automatically enjoy this protection.

Security Interests

In addition to naming the lenders as an addi-

tional insured, specifying the lenders as loss payee, and obtaining reinsurance with a cut-through endorsement, it has become customary in most project finance transactions to have the project company assign all of its rights, title and interest in and to all insurance proceeds and the insurance policies to the lenders, either as part of the general security agreement governing project intangibles or under a separate insurance assignment agreement.

A typical formulation of the granting provisions would read as follows:

> "As security for the prompt and complete payment of the secured obligations, the project company hereby assigns, charges, conveys, sets over and transfers unto the lenders and hereby grants to the lenders a continuing first priority security interest in all of the right, title and interest of the project company in, to and under all of the following, whether now existing or hereafter acquired, […] and all insurance proceeds and insurance contracts."

While such a security agreement does not, as between the lenders and the insurer, add anything to that which the lenders will have by virtue of being named as additional insureds and designated as loss payees, it would seem to be good protection for lenders, enhancing their position as secured creditors *vis-a-vis* the project company and its other potential creditors in case of bankruptcy of the project company. However, if the project's finance and security documents are subject to New York law, lenders should be aware of several issues regarding the creation and perfection of a security interest as it relates to insurance under article 9 of the Uniform Commercial Code, which is the statutory scheme in the US governing secured transactions where personal property is provided as collateral.

A key issue to be aware of is that UCC article 9, by its terms, does not apply to "a transfer of an interest or a claim in or under any policy of insurance . . . except as provided with respect to proceeds and priorities in proceeds." Article 9 does provide that "[I]nsurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement" (sections 9-104 and 9-306). Thus, by purporting to convey and transfer all insurance contracts, the broad language of a typical security agreement may create a problem for lenders, inasmuch as the creation and perfection of that security interest will no longer be governed by a filing under UCC article 9. Instead, it will be governed by other, non-UCC provisions applicable in the jurisdiction.

New York courts have held that creation and perfection of a security interest in an insurance policy itself is governed by the common law of pledge. Although a pledge of an insurance policy as collateral is valid absent a prohibition in the policy, to perfect the security interest in this case will require the project company to physically deliver the insurance policies to the lenders.

Another concern is that by purporting to convey and transfer all insurance contracts, the broad language of the typical security agreement may create a practical problem for lenders, since they may find themselves primarily responsible for the insured's obligations under the insurance policies, including the obligation to pay the premiums.

Other Lender Issues

One particularly troublesome issue for lenders that has arisen under UCC article 9 provisions relates to delay-in-start-up insurance (insurance which covers a project company from the financial consequences of a delay in project completion) and business interruption insurance (insurance which covers a project company from the

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financial consequences of an interruption in commercial operations, post project completion).

Do proceeds of delayed start-up or business interruption constitute "insurance payable by reason of loss or damage to collateral?"

The argument in favor is clear enough. There is a direct cause and effect between a loss or damage to collateral, *i.e.*, to the physical plant and property given as security to the lenders, and the payment of delayed start-up or business interruption insurance. Unfortunately, New York courts have not provided such a clear answer.

While no case directly on point exists, the federal district court for the eastern district of New York in *Peacock Holdings, Inc. v. Mass. Mutual Life Ins. Co*. cited with disapproval and criticized the decision of the federal district court for the eastern district of Pennsylvania in *in re Bell Fuel Corp.,* which held that proceeds from business interruption insurance constituted "insurance payable by reason of loss or damage to collateral." The New York court cited with approval a decision of the bankruptcy court in the western district of Pennsylvania, *Premium Fin. Specialists, Inc. v. Remcor, Inc*., in which that court found the *in re Bell Fuel Corp*. decision to be both "dictum and incorrect." The New York court went on to also cite with approval a decision of the bankruptcy court in the district of Minnesota, *in re Investment & Tax Servs., Inc*., in which that court held that the reasoning in *in re Bell Fuel Corp*. is flawed because, among other things, business interruption does not insure any of the creditor's collateral, but simply insures the debtor against interruption of its business and the proceeds of business interruption are not proceeds of the creditor's collateral.

Accordingly, there is a possibility that New York courts will reject an attempt to have UCC article 9 govern the creation and perfection of lenders' security interest in proceeds of delayed start-up and business interruption insurance.

Finally, it is worth noting that an assignment of insurance proceeds under a security agreement, in and of itself without the additional protections of being specified as additional insured and loss payee and having a non-vitiation clause in the policy, may not be sufficient protection for lenders. One reason for this is that as assignees, lenders' rights cannot exceed those held by the assignor (the project company) at the time of assignment. Hence, an assignment in and of itself, absent a non-vitiation clause contained in the insurance policy, will not protect the lenders in situations where the insurer can successfully raise a defense against the project company.

If the project company would not be entitled to insurance proceeds, neither would the lenders as assignees.

Another reason is the issue of notice. New York courts, as well as courts in several other US jurisdictions, have held that in order for an insurer to pay directly to a secured party, it must have sufficient notice of the secured party's security interest over insurance proceeds. These courts have refused to recognize constructive notice on the part of the insurer on the basis of a UCC filing. Thus, absent designation as loss payees, lenders should take the necessary precaution, in addition to filing UCC financing statements, to provide specific notice to the insurer and even obtain an express acknowledgment from the insurer of their security interest. ■

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