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The Tax Equity Market

Only five developers in the United States are in a position currently to use the large tax subsidies that the United States government offers as an inducement to build power plants that run on wind, sunlight, geothermal energy, biomass and other forms of renewable energy. Everyone else must try to benefit indirectly from the subsidies by finding a large institutional investor to own a project in a partnership with the developer, claim the tax subsidies and inject some of the value into the project.

The following is a transcript from a roundtable discussion about the state of the US "tax equity" market. The discussion took place at the Infocast Wind Power Finance & Investment Summit 2007 in La Jolla, California in February. Wind farms account for roughly 80% of the current market in terms of dollar volume. The panelists are John Eber, managing director of energy investments for JPMorgan Capital Corporation, Tim Howell, managing director and origination leader for renewable energy projects at GE Energy Financial Services, Lance Markowitz, senior vice president and manager of the leasing and asset financing division of Union Bank of California, and Robert Sternthal, a director in the tax credit group at Credit Suisse. The moderator is Keith Martin from the Chadbourne Washington office.

MR. MARTIN: John Eber, how many tax equity deals were there in 2006 involving wind farms, and how many are expected this year?

MR. EBER: We believe 15 deals were done last year for about $3.1 billion of tax equity. There should be at least that many in 2007. The dollar amount should */ continued page 2*

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PARTNERSHIP FLIP structures will be addressed by the Internal Revenue Service in a "revenue procedure," perhaps as early as this summer.

Partnership flips are used by developers of wind, solar, geothermal and other renewable energy projects to get value for tax subsidies that the developers are unable to use.

The developer brings in an institutional equity investor as a partner to own one or more projects. The investor is allocated 90, 95, 99 or 100% of the economic returns from the projects — apart possibly from cash — until a future "flip date," after which the investor's interest in the partnership drops to as little as 5% and the developer */ continued page 3*

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be a little higher — perhaps $3.5 billion or even $4 billion depending on whether a large acquisition occurs.

MR. MARTIN: Tim Howell, do those figures sound right?

MR. HOWELL: Yes. There are two wild cards. One is what happens with production tax credits. As long as the market believes that another extension of the credits is a near certainty, then the market will continue to grow at a rapid rate. If the credit has not been extended by mid-2008, you will begin to see a slowing in the market. We expect to see 2,500 to 3,000 megawatts of wind capacity this year in the tax equity market; that is consistent with the dollar volume that John mentioned. It does not take into account some mega deals that could come to market this year where entire companies are sold with tax equity providing some of the acquisition financing.

MR. MARTIN: You are referring to Horizon, I assume?

MR. HOWELL: That is an example, yes.

MR. MARTIN: Was there anything unusual about the deals that were done in 2006 compared to the year before?

MR. HOWELL: Yes. There was an evolution in the marketplace. Deals used to involve all equity. During 2006, we began to see deals with leverage at the project or partnership level. The market will continue to evolve this year as the market tries to respond to the situation on the ground. Developers are feeling squeezed: the cost of projects is rising faster than prices for electricity under long-term power contracts. Project costs are rising in part because of high demand for turbines. The stop-and-start nature of production tax credits does not help. Turbine manufacturers are reluctant to make the long-term commitments required to build new factories in such a market.

MR. MARTIN: Lance Markowitz, Tim Howell said leveraged deals are becoming more common. What is a leveraged deal?

MR. MARKOWITZ: A leveraged deal is a three-party transaction, while the unleveraged deals in the past involved just two parties — the sponsor and an institutional equity investor willing to take part of its return in the form of tax benefits. There was no debt in earlier deals. There may have been back leveraging, or borrowing by the sponsor, but this was outside the partnership. In a leveraged deal, the debt is inside the partnership. There were a number of leveraged deals in the market in 2006. We closed one at the end of the year.

There were 15 tax equity deals done in 2006 involving wind farms with a total of $3.1 billion invested.

MR. MARTIN: So Union Bank has done one. John Eber, has JPMorgan done any leveraged deals?

MR. EBER: We did one last year, and we did one in 2003. Of the 15 deals that we saw last year in the market, three had project-level debt. There were leveraged deals during the period 2003 through 2005, but at roughly the same low percentage.

Equity Squeeze

MR. MARTIN: One of the most difficult issues in a leveraged deal, where the tax equity comes in as a partner and the project has debt, is the risk that the equity might be squeezed out of the deal if the project is unable to pay debt service. How is that risk addressed? Is there one approach today that is "market"?

MR. EBER: If the equity is making ongoing capital contributions to the partnership tied to production tax credits, then it is usually not much of a concern. The expectation is the lenders will not want to squeeze out the equity under such circumstances. If there are no ongoing capital contributions, then the equity will want some type of equity squeeze protection before it will buy into the deal.

MR. MARTIN: Like an agreement by the lenders not to foreclose on the project until the production tax credits have

run? Surely the lenders will want some recourse. What recourse do the lenders end up with, Tim Howell?

MR. HOWELL: At least in deals in which we have participated, GE has deep pockets and the ability to fix projects if it needs to, so the banks normally do not want to squeeze it out of the deal. They want the debt to be repaid. GE has been in deals in the past where there has been an equity squeeze. Frankly, we don't like to take losses; we would rather fix the project and pay off the debt.

MR. MARTIN: So GE does not get any special relief from lenders?

MR. HOWELL: We want the ability to fix the project. As long as the tax equity investor has that right clearly in the documents, that would be fine.

MR. MARTIN: So it is enough for the lenders to have to give the tax equity investor notice and time to fix things before the lenders can throw the project into default. John Eber, I get the impression you don't want to get into more detail on this. Is the GE solution acceptable?

MR. EBER: It depends on the deal. Every deal is different. There are banks that are offering more flexible terms than what Tim described to induce the equity to come into the deal. The market is driving the banks to do so. However, keep in mind you are talking only about a small number of transactions with project-level debt.

MR. MARTIN: Lance Markowitz, have you seen any other market solution to the equity squeeze problem?

MR. MARKOWITZ: I don't think there is a standard approach for dealing with the problem. Companies like GE and Union Bank are veterans of the project finance market. We may be more comfortable taking project risk than many of the newer entrants. People are trying to make the equity as risk-free as possible in order to broaden the number of potential tax equity participants. Consequently, I think you will see some deals where the lenders agree to forbear from foreclosure long enough to let the equity claim all the production tax credits. This is a business negotiation with tradeoffs.

MR. MARTIN: Rob Sternthal, do you think that the drive to broaden the market will lead to guaranteed return structures where the equity is promised a minimum return?

MR. STERNTHAL: There has been a lot of discussion about such structures. As you know, Credit Suisse is an arranger while the rest of the panelists invest for their own accounts. The affordable housing market, where investors are used to guaranteed returns, is a $9 billion-a-year / continued page 4

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has an option to repurchase the investor's interest. The flip date is often the later of when the tax benefits have run or the investor reaches a target internal rate of return. Most of the tax benefits in a wind farm or geothermal project, for example, take 10 years to run.

The IRS issued two private letter rulings in November 2005 confirming that partnership flip transactions work to transfer tax benefits. However, it placed a hold on any further rulings in May 2006.

The IRS is expected to draw lines in guidance this summer about what terms it is prepared to accept in such transactions. Transactions that fall outside the guidelines may face questions on audit.

The agency is expected to say that no more than 95% of partnership items can be allocated to the equity investor. It will require that the investor retain at least a 5% interest in the partnership after the flip. It will bar deals where one of the partners guarantees the investor at least a minimum return from the transaction.

IRS officials caution that the guidelines still face a review process within the IRS and Treasury. The content may remain in flux until the end.

PRODUCTION TAX CREDITS are 2¢ a kilowatt hour for generating electricity from wind, geothermal energy or "closed-loop" biomass during 2007.

This is an increase from 1.9¢ a kWh during 2006.

The IRS said production tax credits for generating electricity from "open-loop" biomass, landfill gas, municipal solid waste and water in irrigation ditches at small incremental hydroelectric facilities will remain 1¢ a kWh during 2007.

The credits are adjusted each year for inflation.

Production tax credits are tax credits that reward owners of power plants for using renewable fuels. The credits are claimed on the electricity generated and sold to third parties for 10 years after a project is originally put into service. Projects must be put into / continued page 5

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tax equity market. Investors in the housing market have earned yields below 6% historically, and you see some of them wanting to move into the wind sector. If that happens, there will be pressure to move to guaranteed returns. Lance was right that most such investors do not have the experience with energy deals to be able to evaluate project risk. If someone solves the legal questions with guaranteed returns, then you will see a huge increase in the number of potential tax equity participants.

MR. MARTIN: What do you think is the biggest legal question?

MR. STERNTHAL: You probably know better than I do. We haven't really focused yet on what it would take to market such a structure.

Depth of Market

MR. MARTIN: How deep is the tax equity market? How many players bid routinely on wind deals?

MR. STERNTHAL: More than a dozen. Focusing again for a moment on affordable housing, that segment of the US tax equity market alone accounts for $9 billion in annual deal volume. Every deal is four times oversubscribed. That suggests the tax equity market is capable of investing at least the $36 billion a year, and that is in a market where some of the largest bidders sat out last year because of low returns.

MR. MARTIN: Lance Markowitz, everyone has said he sees new equity still entering the wind market. Have you seen anyone exit in frustration over inability to win a bid?

MR. MARKOWITZ: I have seen a couple people exit. I don't know the reasons, but it could be due to declining yields or increased tax risk in deal structures or it may have more to do with their own portfolios.

MR. MARTIN: Let me ask the other panelists for their impressions. Is the number of tax equity investors increasing or decreasing?

MR. EBER: It is increasing, but you are still talking about small numbers. My best estimate is that 12 institutions supplied tax equity to wind deals in 2006, but that's only an increase from about eight or nine the year before. Last year was a huge year in terms of volume and commitments. The number of potential equity investors is growing, but at a slow pace. There are other big institutions that would like to invest, but they lack the experience or knowledge to do it. There may be new entrants as the market expands further.

About a dozen large institutions put money into such deals in 2006, up from eight or nine the year before.

MR. STERNTHAL: It may get harder. Smart developers are now combining four, five and six projects. You are seeing $500 million equity investments. Who can commit to deals that size? It takes a GE or a JPMorgan. Where you may see the new entrants is in the secondary market where they might take small pieces of deals that have already been done.

MR. MARTIN: Tim Howell, where are returns today? How much does tax equity money cost?

MR. HOWELL: Thank you. [Laughter.] We charge as much as we can and still win. It depends on our assessment of the risk in a particular project. There are real risks on the wind side, construction side, on the O&M side, all of which are factors in setting yields.

You asked a question earlier about people entering or exiting the market. We have seen people leave as returns decline and structures become more aggressive.

Responding to another question, we don't feel comfortable with guaranteed return structures, and we do not think the IRS does either. They create tax ownership issues.

MR. MARTIN: What would you say is the current range for tax equity yields?

MR. HOWELL: You said yesterday in a workshop that

returns are falling into the 6% range. I would say the upper end of the range is approaching 10%. It depends on the deal and the deal structure.

MR. STERNTHAL: If returns in the housing market are moving back up toward 6%, that provides a floor for the wind market. It is hard to argue that wind returns should be lower than affordable housing returns given the additional project risk.

MR. EBER: There should be a premium for taking risk associated with these projects as compared to housing. We have been investing in housing for 15 years. I am not sure we ever had a loss in affordable housing. I can't say the same thing about energy projects.

MR. MARTIN: I spoke to an affordable housing syndicator over the weekend who said his last deal was in the high 4% range after taxes.

MR. STERNTHAL: The syndicator in that deal is losing money by selling at such a low yield.

MR. EBER: There are two types of housing: guaranteed housing, which goes at a cheaper rate where the guarantee is provided by someone like AIG, which is double-A rated, and direct housing development where you deal directly with a developer. Rates in the direct market are usually 100 to 150 basis points higher.

MR. MARTIN: John Eber, is it fair to say that wind returns are lowest in portfolio deals where there is diversification of risk across a number of projects?

MR. EBER: It should be, yes. The lower the risk and the more product you can offer to an investor, the greater efficiency and better pricing you will achieve.

MR. MARTIN: Is it fair to say that the return will be higher in a leveraged deal than an unleveraged deal and by, maybe, 200 to 250 basis points?

MR. EBER: Yes.

MR. MARTIN: So, Tim Howell, going back to you, you think the current range in equity returns is high 6% to as high as 10%, depending on whether the deal is leveraged or unleveraged?

MR. HOWELL: Right.

MR. MARTIN: Lance Markowitz, does that sound right to you?

MR. MARKOWITZ: I guess, but I think the market is much more complicated than that. Every deal has a different structure. Someone suggested I should tell everyone for the next couple days that I have money available / continued page 6

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service by December 2008 to qualify. Congress is expected to extend the deadline in an energy tax bill later this year or early next year.

The credits will be withdrawn if electricity prices reach a phase out range. The IRS said the bottom end of the phase out range is 10.75¢ a kWh in 2007. Credits would phase out as electricity prices move across a range of another 3¢ a kWh.

The IRS looks at the average price for electricity sold from the particular renewable energy source under contracts signed after 1989. Spot prices are not taken into account.

The agency said the average price for contracted electricity from wind farms was 3.29¢ a kWh last year. It said it has been unable to calculate the average contract price for electricity from other renewable sources, but is exploring methods for doing so with the hope of being able to announce prices next year.

The average price for electricity sold under contract from wind farms has fluctuated over the last several years. It fell from 4.85¢ a kWh in 2004 to 2.89¢ a kWh in 2005, before increasing last year.

A LAWSUIT IN INDONESIA is a warning to banks not to lend into questionable structures that reduce withholding taxes on interest payments.

An Indonesian paper company borrowed $480 million in 1994. Morgan Stanley underwrote the notes and sold them to international investors. However, rather than borrow directly, the paper company set up a subsidiary in Holland to issue the notes and relend the money to the Indonesian parent company. Borrowing this way produced two benefits. First, it reduced an Indonesian withholding tax on interest payments from 20% to 10%. The rate is only 10% under a tax treaty between Indonesia and Holland. It also ensured that the lenders would not have to pay capital gains taxes if they sold the notes at a profit.

Nine years later in 2003, the Indonesian paper company filed suit in the Indonesian courts to have the debt declared void. It argued, among other things, that the / continued page 7

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at 4%. Each deal in the handful of deals you actually get done is different. A lot of it may depend on whether you catch the person at the right time, depending upon his or her requirements.

MR. MARTIN: Okay. Let me ask you this. Are returns going up or down?

MR. MARKOWITZ: Last year, they certainly went down.

MR. MARTIN: What about this year?

MR. EBER: I think they are stabilizing.

MR. STERNTHAL: Some returns are still going down, but some of the panelists may be reluctant to say it in a public forum.

Timing

MR. MARTIN: Back to John Eber, how long should a developer in our audience expect it to take to do a tax equity deal?

MR. EBER: I think it depends on the experience of the parties. I always tell people we get a deal closed in 45 days, but I don't know whether you can.

MR. MARTIN: I have been across the table from you and heard that, but I think the ground rules are they have to accept your papers, right? [Laughter.]

MR. EBER: It is even possible to do a deal in 30 days with your papers. [Laughter.] One of the problems in the business is there are new investors, there are new lawyers, and there are new sponsors. If you have not done a deal before, it will take longer for you to get through the process. We have seen deals that have taken more than six months to close and others that have closed in 30 days. The experience of the parties is very important.

MR. MARTIN: Lance Markowitz, do you agree with that timetable?

MR. MARKOWITZ: My background is project finance. It is not the financing that takes a long time. It is the project part of the process, or the time it takes to get your arms around the potential risks in a particular project. You will see a wide range of time periods. In my experience, what really sets the pace is the status of the project and what remains to be done, and not the actual financing itself.

MR. MARTIN: Suppose a developer plans to start working today on a tax equity deal. On what long-lead-time item should he start immediately?

MR. MARKOWITZ: If you have a well-organized data room, the due diligence can start and you have cut the amount of time it will take to close.

Returns on equity range from a mid-6% yield to close to 10%, depending on whether there is leverage and the riskiness of the project.

MR. MARTIN: Are there any new reports that will have to be delivered and that take time to prepare?

MR. EBER: The engineering reports are becoming an issue; the equity will want a report from an independent engineer. The sponsor should probably get this going early. It can be finalized once the equity is brought into the process. Land issues can also hold up things. Some sponsors are better organized than others in terms of documentation relating to the land.

MR. HOWELL: It is also useful to know that wind consultants are stretched really thin right now. Many projects are coming to market with less on-site data and, in some cases, less long-term reference data. It takes a while to sift through the available data to assess wind risk. The equity will want a reputable wind consultant to help.

MR. STERNTHAL: Sponsors are coming to market earlier with projects. Long-lead-time items are having to be produced earlier in the process. You have sponsors bringing four or five projects at a time to market, with two of the projects not yet in service, and trying to get to closing on the entire portfolio. When you add hedging, it adds structural complexity.

MR. MARTIN: Rob Sternthal, why would two or more equity bidding on the same project come in with different target returns?

MR. STERNTHAL: I think that's a common misconception in the market that the equity is only looking for a yield. Tax equity investors have very different appetites. Some tax equity are happy if the base case model shows them breaking even by year 10 based solely on the P99 output. Others may be willing still to be in a loss position by year 10 as long as they can get out by year 20 with a full return. The latter party is willing to invest a lot more money up front and take more equity risk, but will demand a higher return for doing that.

MR. MARTIN: John Eber, any other thoughts about why the returns would vary among bidders?

MR. EBER: Timing is a big issue. Some people are more anxious to get a deal done and might be more aggressive on yield. Risk diversification might also be an issue. Someone might be a little more aggressive in bidding for a deal that lets him diversify his portfolio in terms of geography, turbine types or sponsors. For example, Texas is a bit of a problem today. Something like 35% of the projects coming to market recently have been in Texas. Many investors may not be willing to bid aggressively to win another Texas deal.

MR. MARTIN: Do you prefer to pay the entire purchase price in cash up front or to pay the purchase price partly over time as contingent payments tied to tax credits?

MR. EBER: We are truly indifferent. We have done both. It doesn't matter to us from an accounting standpoint. I don't think it matters to us from a yield standpoint. It may matter to some other investors, but we are indifferent.

MR. MARTIN: Tim Howell, does GE have a preference?

MR. HOWELL: We have done both. There are pros and cons. As long as we have the right risk balance, pricing and structure, we can do either.

MR. MARTIN: Lance Markowitz, does Union Bank have a preference?

MR. MARKOWITZ: We can do both, but my preference is to pay the full purchase price at closing.

MR. MARTIN: Why? I would have guessed you would rather pay as you receive tax credits.

MR. EBER: There is a lot of administrative work in a pay-as-you-go deal.

MR. MARKOWITZ: There is more complexity. You are not putting your money to work as quickly.

MR. MARTIN: I was going to ask / continued page 8

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transaction was an illegal tax evasion intended to circumvent the 20% Indonesian withholding tax. It also argued that use of a trustee in connection with the security arrangements for the loan violated Indonesian laws on loan collateral since the concept of a trust is unknown in Indonesia.

The Supreme Court recently confirmed the transaction was illegal. The case is *Indah Kiat Pulp & Paper Tbk v. U.S. Bank National Association et al*.

The paper company may have shed its obligation to repay the loan, but the Indonesian tax authorities could come after it for the back withholding taxes that were evaded. It could also have income in the amount of the canceled debt.

A British court declared that a similar treaty-shopping effort involving an Indonesian borrower and a loan run through Mauritius did not work in March 2006 in a case called Indofood International Finance Ltd. v. JPMorgan Chase Bank, N.A., London Branch. *The difference is the British court found the transaction did not qualify for treaty benefits without declaring the underlying loan void.*

RENEWABLE DIESEL is defined broadly by the IRS.

The IRS settled a feud, played out over the past year in a string of letters to the government, between oil refiners who wanted a broad definition of "renewable diesel" and more traditional biodiesel producers who feared being muscled out of the market by the oil majors.

The IRS said what the oil refiners produce qualifies as renewable diesel.

At stake are tax subsidies of $1 a gallon.

The United States encourages "biodiesel" to be mixed with diesel fuel by awarding anyone doing such blending tax credits of $1 for each gallon of biodiesel used in the mixture. Biodiesel is a fuel or fuel additive made from plant oil or animal fat. An example is fuel made from used restaurant cooking oil or from imported palm oil. In cases where the biodiesel is sold straight for use in automobiles and trucks, without mixing, as a pure fuel called B100, tax credits are given to the retail service station owner. / continued page 9

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whether a contingent payment structure ultimately gets the developer a higher price. It sounds like the answer is no.

MR. EBER: I don't think it does.

MR. MARTIN: Does it get him a lower price?

MR. EBER: I think it is the same. I don't see much difference between paying a purchase price that is partly contingent and paying a price that is entirely fixed. The required yield is the same. You are still utilizing tax capacity. There is the same utilization of tax capacity whether we invest up front or over time.

Equity participants usually price on a P50 basis, but then run a series of sensitivity analyses.

MR. STERNTHAL: If the yield were the same, you would assume that the contingent payment structure is better for the developer. Why pay the equity a return for its money from the start when you could take the equity over time and you could leverage the contingent payments to some extent? Some developers would rather have all the money up front. Others don't need it as quickly.

MR. EBER: Most developers are looking for capital, and they want it today. Sometimes there are accounting implications that will cause a developer who has capital to want to use a contingent payment structure.

MR. MARTIN: Is the accounting benefit the possibility that a public company might spread its gain from the transaction over time?

MR. EBER: Maybe.

MR. HOWELL: One structure is not necessarily better than the other. Different developers have different costs of capital. One may be able to backlever its equity, and that might drive its decision. Another might have more cash to put in the project. A developer might be yield-driven versus income-driven. Some developers prefer to put as little money in as possible at the project level on a non-recourse basis and maximize their yields. Other developers don't have the same objectives. That's why there are so many structures in the marketplace at the same time.

MR. MARTIN: Which probability case, Lance Markowitz, do you use to price? Is it a P50, P80, P99?

MR. MARKOWITZ: I think most people do a range of sensitivity analyses. Most want to make sure the downside is well protected. In most of the deals we have done, we have looked at four or five cases, not just one.

MR. MARTIN: Do you agree with that, Tim Howell?

MR. HOWELL: The management case is based on a P50 model, but then you analyze your risk by doing sensitivity analyses at different P factors.

MR. MARTIN: Are all wind companies the same? Does every wind company, regardless of size, have an equal shot of doing a tax equity deal with someone like you?

MR. HOWELL: Certainly. We have done a lot of deals with smaller companies, but what we look for in such circumstances are people with a lot of experience who know how to get a project done. The structure will be different, of course, because a smaller company has less cash to invest. At the end of the day, this isn't corporate finance. It is project finance. It is all about a stack of paper and the participants in the project.

MR. MARTIN: Lance Markowitz, do you agree that it is a project financing; therefore, you look at the viability of the project and don't really care who the developers are as long as they are competent?

MR. MARKOWITZ: Yes. For us, I agree, but if you look at the whole market, the big boys definitely have an advantage because they are more likely to have access to turbines. Smaller companies have a harder time laying out cash 18 or more months in advance to reserve turbines. It is easier for smaller companies to do a tax equity deal than it is to get turbines.

MR. EBER: I think that has been true of the market for some time. All of us prefer to work with developers with capital in the project alongside ours so that they have

something to lose if the project underperforms, but you don't need to ask in this market whether they have capital. You need to ask whether they have turbines. That answers the question. If you have capital, you can get the turbines.

MR. MARTIN: John Eber, what has been your experience with projects once you do the deal? How well have they performed?

MR. EBER: The ability to predict output is not as good as we would like. We are invested in 26 wind farms, and 21 of them have been in service for some time. Some go back three years, some two years, and some one year. Our portfolio has performed at 91% of the P50 level through the end of 2006. That would put the portfolio somewhere between the P75 and P80 forecast.

What varies is significant. We have four or five projects that are overperforming and another four or five that are barely operating at a P95 level of output. The science of wind forecasts is imprecise. Investors should expect volatility.

MR. MARTIN: Lance Markowitz, how much say do you want as an equity investor in business decisions? Are you happy to let the developer run things and consult you only on major decisions?

MR. MARKOWITZ: Major decisions. We are not in the business of running wind farms.

MR. MARTIN: Tim Howell, is same thing true of GE?

MR. HOWELL: Yes. We have investments in 25 wind farms. We have experienced the whole range of problems that developers have faced — power plant failures, transformer failures, labor problems, environmental issues. We pick experienced partners. We really don't want to be in the business of running wind farms. We want to be consulted about major decisions, like whether to divest assets or liquidate the partnership or make a big spending commitment.

MR. MARTIN: John Eber, how often have you been consulted on major decisions in practice?

MR. EBER: Not very often. But if you are talking about major decisions along the lines that Tim just described, those are things that you do not expect to occur. We have a say in significant decisions that take the project in an unexpected direction like whether to add leverage to a deal or to bring in additional partners. We would just as soon have our partner handle all the operating decisions.

Deal Structures

MR. MARTIN: Moving to questions / continued page 10

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The tax credits expire at the end of 2008. They are expected to be extended in some form by Congress.

The Energy Policy Act in August 2005 expanded the definition of biodiesel to include "renewable diesel," defined basically as fuel made from "biomass" using a thermal depolymerization process. Biomass is anything that was once living. An example is poultry remnants or corn stalks. Oil, natural gas and coal do not qualify as suitable raw materials.

However, the additional subsidy has been mired in controversy over what Congress meant by renewable diesel. Congress said to qualify for a subsidy, renewable diesel must be produced using a thermal depolymerization process as described in one of two testing manuals published by the American Society for Testing and Materials — D975 and D396. Oil refiners have been urging the Treasury Department to define "thermal depolymerization process" expansively. They argue that by mixing biomass and oil as raw inputs, renewable diesel is produced as a component of the diesel fuel turned out by the refinery. Traditional biodiesel producers argue that mixing together biomass and petroleum feedstocks in a single process is not what Congress had in mind.

The IRS settled the controversy on April 2. It said oil refiners should be able to claim tax credits. The IRS position is in Notice 2007-37.

The agency also said that anyone producing renewable diesel will be considered a "blender" — and, therefore, be entitled to tax credits — if he or she mixes at least one gallon of diesel fuel with each 999 gallons of renewable diesel. This is the same rule that applies to traditional biodiesel producers.

NONCONVENTIONAL FUEL CREDITS for producing landfill gas and synthetic fuel from coal were 81.4¢ an mmBtu during 2006, the IRS said in early April.

These are tax credits that the US government offers as an inducement to look in unusual places domestically for fuels / continued page 11

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about deal structures, Rob Sternthal, we talked earlier about guaranteed-return structures. Do you see a unmet need in the market for such structures and do you think we will see a guaranteed-return deal done this year?

MR. STERNTHAL: I think there is a need in this market because there are so many potential equity investors sitting on the side line that want to do deals but can't because they lack the experience to evaluate project risk. A guaranteed return structure would widen the market. However, it would probably take one of the equity investors on this panel to close first on the project and then add a guaranteed return in the secondary market.

MR. MARTIN: Lance Markowitz, did I hear you say you would not do a deal with a guaranteed return?

MR. MARKOWITZ: There are two issues. One is I am guessing your tax risk would increase exponentially. For anyone who would rather not take a lot of tax risk, it would be best to avoid such structures. The other issue is equity returns would be lower because the guy who is guaranteeing a minimum return will want a large component of the return.

MR. MARTIN: John Eber, do you see the market moving to guaranteed returns? Is there a need to move in that direction in the current market?

MR. EBER: I would say no to both. The guaranteed deals we see in housing are not only guaranteeing returns. I don't think it is possible to mirror them in the wind market. You can provide protection against some risks, but I agree with Lance that a fully guaranteed return creates too much tax risk. Also, yields would be low because an intermediary will want a return for covering what is probably a risky project. I just don't think such deals will work economically.

MR. MARTIN: Rob Sternthal, your response?

MR. STERNTHAL: I don't disagree with some of the comments. Tax risk is a problem. How about shedding it to the guarantor? The next question is whether the economics work. From my point of view today, they do not.

MR. MARTIN: Why not?

MR. STERNTHAL: Because if you buy an unleveraged deal at 6.5% and you sell it at 4.5% with a guarantee, you are getting 200 basis points. Now compare the 200 basis points to the risks that you are taking. You have to find a pretty sophisticated guarantor. None of the triple A actors can afford to do it because you would have to have the deal rated. It will be difficult to find someone to take that kind of risk on a $400 million wind farm for such a small return. Now, if you are starting with a leveraged deal at 10% and can guarantee it down to 4.5%, then you have a different story. You will still have to get over the tax risk.

MR. MARTIN: Another new structure in the market is the prepaid service contract where a utility buys the electricity under a long-term power contract and prepays for a large share of the output and pays additional amounts over time as excess electricity is delivered. Sometimes operating costs are passed through. Lance Markowitz, have you looked at any service contract deals? Is Union Bank comfortable with the structure?

MR. MARKOWITZ: We've looked at the structure. On a high level, we would probably say we are comfortable with it, but we haven't gone far enough down the road on a real deal to know for sure.

MR. MARTIN: John Eber?

MR. EBER: We looked at one; I think it was about nine months ago. At that time, the advice of tax counsel was not satisfactory enough for us to want to proceed with it.

MR. MARTIN: Tim Howell, what has been the most time-consuming issue in the wind deals GE has done?

MR. HOWELL: Probably the wind and the technical side of

The average wind farm has performed in fact at only 91% of the P50 forecast.

the underwriting. Everything else is pretty straightforward.

MR. MARTIN: John Eber, what has been the most time-consuming issue for you?

MR. EBER: I probably won't make any friends, but dealing with inexperienced lawyers.

MR. MARTIN: Tim Howell, will GE do 100-0 allocations?

MR. HOWELL: Yes.

MR. MARTIN: Lance Markowitz, is Union Bank at 100-0?

MR. MARKOWITZ: Probably for a period of time.

MR. MARTIN: What about pre-tax returns? Do you require them and, if so, how much?

MR. EBER: We are looking for a satisfactory pre-tax return, and we treat the production tax credits as equivalent to cash for purposes of calculating the return.

MR. MARTIN: Is there a minimum return you require?

MR. EBER: Yes, we do.

MR. HOWELL: We require one as well. The IRS has never said you will be considered a part-owner of the wind farm without one. We also treat the credits as equivalent to cash.

MR. MARKOWITZ: I think everybody does.

MR. MARTIN: The IRS is working on guidelines for partnership flip deals. It is hoping to issue them this summer. The IRS has tentatively decided to draw the line at 95-5 allocations and require at least a 5% residual interest. If this ends up the IRS position, do you think the market will move to 95-5 allocations as the standard?

MR. EBER: I think it would limit the market in terms of the number of investors who are willing to compete outside of any safe harbor the IRS creates.

MR. MARTIN: Tim Howell, do you think people will wait for the guidelines actually to be issued before changing their behavior?

MR. HOWELL: In terms of a 5% residual, that is pretty much market currently. Some deals may have higher residuals, but I don't know anyone who is going lower. My guess is we would wait to change until new guidelines are issued.

Other Renewables

MR. MARTIN: Rob Sternthal, what else is competing for your attention besides wind, and how significant is wind in the total pool?

MR. STERNTHAL: Wind will probably account for 80% of the tax equity market in renewables over the next two years. Solar is gaining market share rapidly. There will be a little geothermal and biomass. / continued page 12

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that might displace US oil imports. The tax credits are winding down. They used to be given for producing a large list of fuels. They only remain available through the end of 2007 and then only as a reward for producing two types of fuels: gas from biomass — into which category landfill gas falls — and synthetic fuel from coal. The facilities used to produce these fuels must have been put into service no later than June 1998. Credits may also be claimed, but at a reduced rate, for producing coke or coke gas.

The credits would have been $1.212 an mmBtu last year were it not for high oil prices. The credits phase out in any year when oil prices return to levels reached during the Arab oil embargo in the 1970s. In such years, Congress felt the market itself should provide enough incentive to look for alternative fuels without the need for tax subsidies.

The IRS said the average wellfield price last year for domestic crude oil was $59.68 a barrel. It said the credits were subject to a phase out last year as oil moved across a range of $55.06 to $69.12 a barrel. Since the average oil price for the year was one third into that range, the credits suffered a one-third reduction last year.

The IRS made the announcement in Notice 2007-38. The credit and phase-out range are adjusted each year for inflation. Producers will not know until April next year how much the credit is during 2007.

CLEAN RENEWABLE ENERGY BOND applications must be received by the IRS by July 13 this year, the agency said.

The bonds are bonds that municipal utilities, electric cooperatives and Indian tribes can issue to finance power plants that generate electricity from wind, sunlight, geothermal energy, biomass, landfill gas, municipal solid waste and some other fuels.

The bonds do not require payment of any interest. The lender gets tax credits instead from the federal government.

The IRS allocated $800 / continued page 13

Tax Equity

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MR. MARTIN: John Eber, what percentage of your deal flow is wind?

MR. EBER: Wind is probably 75% to 80% of it. We are spending time on solar and geothermal now and, in the last year and a half, we have also looked at some biomass projects. We hope to remain very active in all the renewables.

MR. MARTIN: Tim Howell, what is the hierarchy of equity returns in wind, solar, geothermal and biomass projects? In which type of project are returns the highest? In which type are they lowest?

MR. HOWELL: Returns are less technology-driven and more driven by the deal structure. For example, biofuels deals have a lot of commodity price risk. That makes them much more risky investments than contracted wind deals. The supply of capital in the different markets is also a factor. The competition is more focused in the wind space. Therefore, there may be a random biomass deal or other type of project where the equity can command a higher price because it is willing to commit scarce resources to a small niche market. Nothing else has the same scale as wind. We are certainly spending time on the other technologies. We have more than $500 million invested in renewables that are not wind.

MR. MARTIN: Do developers of other renewables projects pay the same amount for tax equity as wind developers?

MR. HOWELL: It depends on the project.

MR. MARTIN: Lance Markowitz, any sense of the hierarchy of returns?

MR. MARKOWITZ: Wind is probably the most competitive, so it receives the most attractive financing terms.

MR. MARTIN: As for solar, geothermal and biomass, which do you suspect is most risky?

MR. MARKOWITZ: That is really deal specific. We have been involved in geothermal projects for many years. The technical aspects of solar projects are not particularly frightening because the basic technology has been around for many years. I agree with Tim that the perception of risk is driven in large part by the deal structure. You have solar deals in the market with varying coverage ratios.

Wisdom

MR. MARTIN: John Eber, you have invested in 26 wind farms. What do you wish you had known early on that you know today?

MR. EBER: I wish I had known the yields were going to fall so far, because we would have invested a lot more money in 2003 and 2004 in wind than we did. We took fairly small pieces of deals then because we were not yet fully comfortable with the risks. We took $20 million pieces of $50 million deals then. Today, we are taking $75 and $90 million pieces in $200 million projects. If I had known what I know today, we would have put more money in sooner.

MR. MARTIN: Tim Howell, what wisdom have you gained?

MR. HOWELL: We have learned that no matter how much you plan, problems will crop up on wind farm investments. Our earliest wind farm is working fine now, but it took some work to get there. It helps to be experienced.

MR. MARTIN: Are there any market developments that we failed to mention?

MR. STERNTHAL: Most of the market has stopped insisting that projects have long-term power purchase agreements. We are looking at leveraged, merchant, hedges, dirty hedges, non-wind hedges, portfolios. I could be wrong, but I suspect that as equity investors get more aggressive, we could see fully merchant deals. Will lenders also be willing to finance merchant wind deals? It is within the realm of possibility — eventually.

MR. HOWELL: A big challenge in the current market is how to project revenue from electricity sales at merchant plants and from sales of environmental attributes. ◎

Tactics When Caught in an Expropriation

by Kenneth Hansen, in Washington

What to do?

The new president of a country decrees all foreign-owned assets in your line of business to be the people's property. Rumors reach you that military officers are being dispatched to various corporate headquarters and operational sites to ensure the smooth transition of management and the speedy expatriation of foreign managers.

Or, perhaps the decree declares that foreign business owners must sell a controlling interest in their businesses to domestic owners within 100 days.

Or it might decree that existing concession agreements with foreign project sponsors are terminated effective in six months, subject to prior renegotiation of their respective terms.

Such headlines have greeted foreign investors in a number of Latin American countries in recent months. What would you do? What would you wish you had already done?

Crisis Management

The first concern is physical security of managers, staff and their families. An expropriation may be implemented in orderly fashion through local legal process. However, such actions have also occurred, amidst popular rebellion or military crackdowns against foreign interests.

Debating national economic policy with the master sergeant who arrives to assume control of the executive office is probably not the right move.

However, imagining the scene does suggest the importance of corporate disaster recovery arrangements. Such arrangements are typically designed with earthquake, fire, flood or terrorist attack in mind. Host government intervention could also create a circumstance in which the ability to communicate with employees from off-site and to access corporate records, notwithstanding loss of physical control of headquarters, would be invaluable.

An effective means of communications could be critical to coordinate management and staff, whether for purposes of evacuation or orderly turnover of the facilities or the shutdown of operations. It might also assist, should the opportunity arise, in taking steps that could improve one's bargaining position in subsequent negotiations with the government. In one Asian power project that ultimately became the subject of expropriation claims against the host government, certain computer disks needed to operate the facility departed the project site with the foreign managers. These became a source of some bargaining strength in subsequent settlement negotiations.

In extreme cases, there may be little to be done immediately except evacuation. At the other end of the spectrum, there may be time and opportunity to attempt to persuade the government to rescind its actions. This article assumes that the government is committed to the expropriatory actions it has declared and that the inventor's challenge is to cope with them. / continued page 14

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million in bond authority in November. There were 709 applications. The largest single allocation to a wind farm was $31 million. Most of the money was allocated for small solar projects.

Congress authorized another $400 million in bond authority last December for allocation this year.

Like last year, the IRS will allocate the bonds among applicants starting with the applicant asking for the smallest amount of bond authority and working up the list. However, unlike last year, it will ask applicants to consent to disclosure of their names if they are awarded bonds. The IRS refused last year to disclose the awards, arguing that the information is taxpayer data that it is required by law to keep private.

INDIA said only part of the fee a construction contractor earned from a turnkey contract to build an LNG terminal was taxable in India.

Companies undertaking construction jobs in another country usually break the job into two contracts. Work that will be done outside the country where the project is located is addressed in an "offshore" contract. The work that will be done at the project site in the country is in an "onshore" contract. Most countries only tax income that has its source in the country. Fees are generally treated as earned where the services are performed.

Ishikawajima-Harima Heavy Industries signed a single turnkey contract to build a large terminal to receive liquefied natural gas from tankers and regasify it.

The contract quoted separate prices for the onshore and offshore work. The contractor applied for a ruling confirming that it had to pay taxes in India only on the fees for the onshore work. The Authority for Advance Rulings refused, responding that the contract was an integrated whole. The work done outside India was too closely linked to the work in the country, with the result that the entire contract would collapse if the offshore work was not done.

The Supreme Court sided with the contractor in a decision in January. It said that a contract will not be considered an / continued page 15

Expropriation

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Legal Claims

Once personnel and, to the extent feasible, property have been secured, attention turns to the legal front and preparing for what will likely become an international legal action against the offending government.

The first step is to inventory possible bases for legal claims. Rights might be found in contracts, local law and applicable treaties or conventions to which the host country is a party. Assemble and carefully review the documents and, if applicable, the local laws pursuant to which the project was undertaken. Possibilities include any concession agreement, license or project contract with a governmental authority. What do those documents say about expropriation, termination, liability or compensation? Are there local laws providing any protections to foreign investors or generally to holders of private property? Is the host country party to any bilateral investment treaties or other international conventions that could protect investments in your project? This inquiry should obviously be undertaken with the assistance of local counsel, whose role is discussed further below.

Might the developing political circumstances constitute the basis for a claim under any political risk or other insurance policies? Might the project company's, or the project sponsor's, obligations to third parties be affected by political force majeure clauses?

Pressing legal claims will probably entail one or more of the following: an arbitration under project-specific documents, an international arbitration pursuant to a bilateral investment treaty, or asking one's home country to espouse a claim diplomatically (which will require prior exhaustion of legal remedies in the host country). In each case, you will face a problem of proof. Even if what the host government did is perfectly clear, it may be of critical legal relevance to show why the government acted as it did. Was its motivation national security? Politics? Theft?

A core question will be whether the government's actions were justifiable under international law. Did those actions constitute a "taking without prompt, adequate and effective compensation" — thus an illegal expropriation — or were they an exercise of police power in a time of economic crisis or possibly regulatory actions within the proper scope of governmental discretion? Wrongful intent is not required for a government to be held responsible for an expropriation of property or rights, but a government may be excused from any obligation to compensate for losses cased by bona fide regulatory measures. (Both regulatory discretion and police powers have been offered by Argentina as defenses for its "pesification" of foreign currency-denominated contracts in 2001.)

> When an expropriation is threatened, look for any rights under local laws, concession agreements, other project contracts and bilateral investment treaties.

Analysis of the appropriateness of the government's actions under local circumstances, including local law, will require, if available, the assistance of local counsel. Such counsel might offer both strategic and tactical advice about negotiating with the host government if that opportunity arises. Local counsel can also supply useful legal and factual data for the brief against the government in whatever forum that brief might be filed. Local counsel may be able to make a case that the government's actions were illegal even under local law. If the expropriation was engineered carefully to include legislative approval, the contribution of local counsel may be limited to elaborating arguments as to why local circumstances did not justify the government's actions under international law. Whether through legal analysis, fact finding or facilitating negotiations, local counsel can be useful, perhaps critical, participants in the process of pressing an international law claim.

The problem is that local counsel may not, as a practical matter, be able or willing, to help. Among the criteria likely to

have been carefully weighed when local counsel was selected was a close and influential relationship with the host government. When the crisis comes, that counsel may not be prepared to antagonize those relationships by acting on your behalf. Even if he or she might otherwise be inclined to help, the counsel is likely to lack an important option available to you, namely, the opportunity to leave the country and go home. The local counsel is home and will need to navigate the crisis, professionally and personally, as best he or she can. Zealous representation of your interests may not fit well with a local survival strategy. If the counsel were to leave the country, his or her usefulness would be diminished.

So, what is to be done? Possibly not much. One is unlikely to choose local counsel up front for the person's lack of intimacy with local government authorities. There may be value, however, in recognizing the issue and, as circumstances in-country for foreign investors deteriorate, in cultivating a relationship with alternative counsel who, ideally through offshore offices, may be able to provide effective support of a subsequent expropriation claim.

Some mitigation of the adverse impact of a lack of effective local counsel may be found in the fact that the validity of one's expropriation claim will depend on international, not local, law. There are mechanisms beside local counsel for finding the facts and proving your claim. Appropriate international counsel will certainly be part of the process.

Litigation: A Long Road

Here, however, you face some harsh realities of international legal claims. First, to date, the world offers no international court where aggrieved investors can sue a host government that violates their rights under international law. Your sole option may be to ask your home state to "espouse" your claim diplomatically, which under international law it has the right, but no obligation, to do. Further, under customary international law, a state's right to espouse the claim of its national arises only after that national has exhausted local remedies, so you would be required first to seek redress through the offending host country's own courts. Even if your home country eventually agrees to take up the cause, espousal is no guarantee of results. It is not a lawsuit with a reasonably high probability of reaching a decision, whether favorable or adverse. Rather, it offers at best a long-term hope of negotiation, but with no end necessarily in sight.

The more direct approach requires / continued page 16

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integrated whole simply because it is a turnkey contract. It also said it is immaterial that the contract was signed in India.

The case is Ishikawajima Harima Heavy Industries Ltd. v. Director of Income Tax, Mumbai.

SERVICE FEES that foreign subsidiaries of US companies earn for work outside the United States should be easier to insulate from US taxes in the future.

US multinational corporations struggle to avoid having to pay US taxes on their foreign earnings before the earnings are physically repatriated to the United States. The United States taxes American companies on worldwide income. However, it does not tax foreign corporations (unless they have US earnings). Therefore, most US multinational corporations operate abroad through one or more foreign corporations set up as subsidiaries. The foreign corporations act as "blockers" that prevent offshore earnings from hitting the US tax net.

Most blockers are in places like the Cayman Islands, Luxembourg or Holland that do not impose heavy taxes.

Thus, for example, a US company with an active business managing power plants in Africa might have a Dutch subsidiary to conduct this business.

This strategy only works for income earned from an active business.

The US will look through a blocker corporation and tax its US parent on any interest, dividends, rents or other passive income the foreign corporation earns.

It will also look through and tax the US parent on any fees earned for services provided outside the United States if two things are true. First, the blocker corporation is in a different country than where the services are performed. Second, the services require "substantial assistance" from the US parent or another affiliate. An example of substantial assistance is where US personnel or performance guarantees from the US parent are needed to help / continued page 17

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finding a forum where you, the aggrieved investor, can assert your claims directly against the offending government. The most obvious route, if applicable to your case, will be through the dispute resolution mechanisms built into your concession agreement or project documents. The government may well have consented to offshore arbitration. If so, the next steps for holding the government to account will be as clear as the relevant provisions in those documents.

Such a consent to arbitration of disputes might also, or alternatively, be found in a "bilateral investment treaty" (or "investment protection agreement") binding the host government with respect to investors from your home country (or possibly those from a jurisdiction through which your investment was structured). Today, roughly 10,000 such agreements are in force, so the chances are significant, though not assured, that you may be able to take advantage of the government's promise in such a treaty to settle disputes with foreign investors in an independent, offshore forum (often the International Centre for the Settlement of Investment Disputes, or "ICSID," of the World Bank Group in Washington).

Absent arbitration rights based in project documents or a bilateral investment treaty, your right to effective litigation against an offending host government is likely to lie somewhere between illusory and non-existent.

The fourth and probably final, but perhaps best, option for recourse, or at least recovery, could be to your political risk insurer — if any. If your investment was insured against expropriation, your course of action will be clear. The first step, of course, will be to re-read the policy. Are you out of compliance with any covenants or conditions that could excuse the insurer from paying a claim? Can any such circumstance be quickly remedied? Are there obligations or conditions under the policy with respect to operating under the present crisis — for example, to act non-provocatively or, alternatively, to act as if uninsured? Almost certainly there will be an obligation to keep the insurer fully informed of the circumstances of the potential claim as they develop. Failure to comply with such obligations could result in rejection of the claim regardless of its merits.

Full attention should turn, of course, to the requirements for proving a claim -– proof both of the nature of the government actions and of the amount of the investor's related loss. Local counsel has already been identified as likely to play a potentially key role in the process. So, too, may accountants — both local and offshore. Proof of loss will be aided immensely by the project's books being in order.

> The harsh reality of international legal claims is it may be hard to find a suitable forum. The best result is if the government consented in the concession agreement to offshore arbitration.

Being Prepared

So, what would you wish, upon the onset of such a crisis, that you had done in advance? That follows fairly directly from the steps that you would want to be able to take in the event the crisis comes.

As already noted, you would want to be able to maintain communication with critical staff and to access and preserve corporate records. This becomes yet another good reason for having an effective disaster recovery plan.

You will want to hold the government to account for the losses that it has caused. Thus, going into an investment, you need to think carefully about what legal recourse you would have in the event that things should subsequently turn sour. A real premium should be attributed to an applicable bilateral investment treaty. Even if your home country lacks such an agreement with the prospective host country, perhaps the host government has concluded agreements with other countries through which your investment might be structured. All of the equity investors in Enron's infamous Dabhol power project structured their investments in the project company through Mauritius for tax reasons. When the project was shut down and eventually abandoned in 2001, those

investors became the beneficiaries less of tax advantages than of the India-Mauritius bilateral investment treaty, which gave them the right to initiate offshore arbitrations against the government of India for the expropriation of their respective investments, a right that two of the three equity investors exercised. At the time settlement was reached, offshore lenders were exploring their options to bring similar claims through an assortment of jurisdictions. The pressure on the Indian government attributable to these arbitrations contributed greatly to achieving a settlement of all foreign debt and equity claims.

The value of finding an arbitral forum is somewhat countered by the harsh reality that winning an arbitration is no guaranty that an award will be paid. The risk of an uncollectible award is not, of course, unique to investor-state arbitration. Any civil defendant may be judgment proof. While governments will normally have the ability to pay, they may not be willing to do so, and the process of enforcing an award is both speculative and expensive. Enforcement through the host country's own courts is unlikely to be fruitful, so the process necessarily entails a search for host government assets located outside the host country. Though a challenging exercise, it is certainly not pointless, and a number of international lawyers earn their livings seeking and, once found, attaching offshore assets of governments. Bank accounts, real estate (if not covered by a diplomatic protection treaty) and state-owned aircraft (that land unaware in a foreign jurisdiction) are all popular targets. There can, however, be no assurance going into an arbitration that any such asset will ultimately be found to satisfy an award.

One way to avoid the risk of a winning but fruitless arbitration is political risk insurance. Both public agency political risk insurers — such as OPIC and MIGA — and commercial political risk insurers are typically willing to insure a host government's payment of an arbitral award that results from an arbitration brought against it under project documents.

With such coverage, the investor has the burden of initiating arbitration against the host government and of achieving an award in its favor. Then, reasonable steps must be taken to enforce and collect that award. If, after a waiting period (typically six months), the respondent government has not paid the award, then, in exchange for an assignment of the award, the insurer will pay the insured investor the insured amount of the award. Thus, such insurance provides the investor with a reasonable assurance that */ continued page 18*

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with a job or secure a contract. The assistance is "substantial" if it is worth at least 50% of the cost of the services or is otherwise a "principal element" in performing them.

The IRS changed its rules in January in a manner that makes it easier to defer US taxes on offshore fee income. The same rules apply as before, except the IRS said it will not claim the services require substantial assistance from an affiliated company unless what the affiliate contributes accounts for at least 80% of the cost of the services. It does not matter if they are a principal element of the services. The affiliate is not treated as having contributed anything if it is paid full price for its help.

The IRS announcement is Notice 2007-13.

US power companies with projects in foreign countries sometimes try to pull income out of the project country in the form of fees. The fees are deductible in the project country. This is a way of reducing taxes on the project earnings in the host country. The IRS change should make it easier to do such tax planning without subjecting the income immediately to US tax.

TIMBER properties can be converted into cash without having to pay taxes immediately on the gain.

Temple-Inland Inc. announced a restructuring plan in late February to stave off a takeover attempt by corporate raider Carl Icahn. Among the steps the company plans to take is a sale of its timber properties. It plans to sell them for a note requiring installment payments over time. It will then borrow against the note and distribute the cash to its shareholders.

There are two problems with this strategy in most ordinary situations. One is the United States lets anyone selling property for installment payments over time report gain from the sale over the same period the installment payments are received. However, the seller must pay interest to the government on the deferred taxes as if taxes were due on the entire gain at inception. The interest charge is at a government borrowing rate. */ continued page 19*

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an award will be paid, a result that cannot be assumed or even expected when initiating arbitration against a host government.

Details in this arena are important. For instance, the typical insurance policy requires the arbitral award to be assigned to the insurer free and clear of any lien or other encumbrance. If the claim arises from a project that was project-financed, the project lenders' collateral package may well include a lien over any such award. A carve-out from, or a release of, that lien will need to be negotiated, or the equity investor may not be able, so long as the project debt remains outstanding, to satisfy the requirements for a claim under the political risk insurance policy.

Collection of any arbitration award may be difficult. The main benefit from political risk insurance is it pays such awards.

While arbitral award coverage is typically available for awards arising from project documents, no such coverage is offered "off-the-shelf" by any public or private sector insurers for arbitral awards achieved pursuant to bilateral investment treaties. This void in traditional coverages appears to be a function of the relatively recent arrival, in significant numbers, of bilateral investment treaties as well to the failure of investors to think to ask for it. There is no clear impediment, other than novelty, to such coverage being offered. I have asked several political risk insurers, including both public and private sector shops, whether they would be willing to offer such coverage. Each indicated that it would seriously consider offering such coverage if an investor were to ask for it.

Conclusion

What is the risk that, through one mechanism or another, your foreign investment will be expropriated? Political predictions are notoriously unreliable, making planning difficult and hedges important. The risk of expropriation is doubtlessly higher in some sectors, such as extractive industries, banking and public infrastructure, than in others. In some countries — Bolivia, Ecuador and Venezuela, for instance — such risks appear obviously higher now than one would have expected a few years ago. Indeed, a long record of pro-Western, pro-business policies is no guarantee against a radical change of course. Consider the ultimate fate of Iran under the Shah. On the other hand, a notorious track record of expropriating foreign enterprises is no proof that a country cannot offer a safe platform for foreign investment. Consider Chile.

Until recently, it had become nearly axiomatic among political risk professionals that "conventional expropriation," in which the host government explicitly nationalizes foreign-owned investments, though a common feature of the international investment landscape in the 1960's and 1970's, was passé. The international legal obligations, and therefore liabilities, of host governments were too well established for host governments to be expected to behave in a fashion that would invite adverse legal, financial and reputational consequences. That is particularly the case when the same objective — abandonment of local operations by foreign investors — might be achieved through a cocktail of regulatory actions that are, or at least can be argued to be, legally defensible: for example, taxes, licensing requirements, environmental regulations and national security policies.

Political risk coverage has evolved since the 1970's to cover "creeping expropriation" as well as outright nationalization, but proving the merits of a claim against a government that claims to have acted for reasons of economic emergency or other defensible public policy, or not to have acted in any targeted fashion at all, is likely to be more challenging than where the government has admitted, indeed declared explic-

itly, the circumstances that, under a project document, a bilateral investment treaty or a political risk insurance contract, must be proved by the investor to win the case.

Consequently, one advantage of the recent expropriatory actions of the governments of Bolivia, Ecuador and Venezuela is that any claims that manage to find a forum where they can be asserted, whether in arbitrations or insurance claims, should be easier to prove than the claims that arose, for instance, out of Argentina's "pesification" in 2001 or the government contract cancellations that occurred in Indonesia and Pakistan amidst the 1997 Asian economic crisis.

Any such contemporary claims pressed in arbitrations will face the inevitable challenge of converting an award against a host government into cash. Any affected investors who armed themselves with political risk insurance will prove to be the lucky — or wise — ones.

Recent developments in Bolivia, Ecuador and Venezuela and actions threatened by the unsuccessful presidential contender in Peru are all against the tide of the global tendency over the past 20 years of ever-increasing private sector involvement in the development, financing and operation of public infrastructure. Are current cases of host governments showing foreign investors the door merely anachronistic curiosities, or is there a spreading revisionism as to the proper roles of the public and private sectors and of foreign versus domestic interests, particularly where public infrastructure is involved?

The issue arises at home as well as abroad. Consider the recent Dubai Ports fiasco. The acquisition by Dubai Ports World of the UK's Peninsular and Oriental Steam Navigation Company (P&O) would have resulted in Dubai Ports having management responsibilities at major U.S. port facilities in New York, New Jersey, Philadelphia, Baltimore, New Orleans and Miami. After months of attack in the US Congress, and under threat of retaliatory legislation, Dubai Ports resold its interest in P&O to a US firm (to AIG). Much of the political rebellion was doubtlessly attributable to the politics of the home region of Dubai Ports, but the principle argued was that critical national infrastructure cannot be trusted to foreign private management.

Whether backlash against foreign private investment proves to be widespread or localized, foreign investors would do well to think carefully about, and to plan appropriately for, the possibility that the welcome mat may be withdrawn. In that circumstance, your fate is likely to */ continued page 20*

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In addition, if the installment note is pledged as collateral for a loan, the entire gain becomes taxable immediately. That's because the seller has essentially received the full gain up front.

Both problems disappear under a special rule in the tax code for sales of property "used or produced in the trade or business of farming." Farming is defined as growing crops or fruit or raising livestock and cultivating trees or preparing them for market.

STEAM TURBINES and reactor vessel heads at a nuclear power plant are "separate assets," the IRS said.

As a consequence, a utility that owns a nuclear plant was able to deduct its costs to remove them. The agency made the statement in a private letter ruling that it released to the public in mid-March.

The utility asked for the ruling to confirm that it did not have to add the removal costs to the "tax basis" that it has in the nuclear plant as a whole and recover it over time through depreciation.

The ruling is Private Letter Ruling 200711015.

The IRS has wrestled for years, without reaching any clear conclusion, about what is a unit of property at a power plant. The question also has a bearing on whether spending to fix components of the plant can be deducted immediately as "repairs." The larger the unit of property, the more likely spending will be a repair. For example, $10,000 spent on fixing a component is more likely to be a repair if the component is worth $100 million than if it is worth only $15,000. As a corollary, the more significant the work as a percentage of asset value, the more likely to it is to be an "improvement" rather than a repair and have to be recovered through depreciation.

BELGIUM eliminated withholding taxes on dividends paid by Belgian subsidiaries to shareholders in countries with which it has tax treaties.

The move should help make Belgium more attractive as a venue for offshore holding companies.

Most countries collect */ continued page 21*

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depend on international law rights to arbitration and political risk insurance. Those arrangements need to be assured when first going into an investment. By the time of the xenophobic election, coup d'état or expropriatory decree, the options for mitigating losses may be limited. ◎

Implications of the Next Capital Spending Spree

Capital spending by US power companies is cyclical. US utilities are about to embark on a huge capital spending spree. The last such surge in new investment was during the period 1965 to 1985. The surge will have consequences for both the regulated and unregulated sides of the US power business. Hugh Wynne, a senior utility analyst with independent research house Sanford Bernstein & Co., held a call in late February to discuss the possible consequences. The following is an edited transcript.

We are talking today about potential retirements of US fossil-fuel power plants over the next 10 years and the implications for unregulated generators, on the one hand, and regulated generators, on the other.

To cut straight to the conclusions, on the unregulated side of the business, aging power plants and the need to comply with increasingly-stringent emissions controls will require a level of capital expenditures that is a threat to unregulated coal-fired generators. The capital spending required to replace existing plants and to install required emissions controls will not only deplete distributable cash flow, but the future depreciation and interest expense tied to such spending will also erode ongoing earnings power. We believe that Reliant, Dynegy and NRG are at most risk among the unregulated merchants.

There is a positive effect on the regulated side of the business. The upswing in capital spending to replace plants and install emissions controls could bring about a material acceleration in rate base growth and, therefore, in the growth of regulated earnings. We are particularly heartened by that in view of the very wide gap between the cost of equity to regulated utilities, which we estimate to be less than 8% currently, and the returns on equity that the utilities are permitted to earn on their incremental investments, which range from 10% to 13%. That type of margin over the cost of capital, when applied to investments of the scale that we are talking about, should add materially to shareholder value.

Large utilities that combine attractive returns on equity with rapid rate base growth include Xcel, Southern Company, Entergy, American Electric Power and Duke. *[Editor's note: Mr. Wynne owns Duke and TXU stock and has a "market-perform rating" on both. The parent company of Sanford Bernstein & Co., AllianceBernstein L.P., owns 1% of the common stock of American Electric Power.]* Smaller utilities faced with these types of investment programs and attractive regulatory regimes have become targets in the recent past for private equity investors. We believe they will remain such targets in the future.

Past Lessons

The last time there was a major upswing in capital investment of this magnitude among regulated utilities was during the period 1965 to 1985.

There are risks associated with an upswing of capital investment on this scale. Two factors that caused erosion in utility stock prices during the last upswing are unlikely to be repeated today. They are accelerating inflation and rising long-term bond yields. However, other factors that led investors to sour on utilities the last time clearly persist. They include the threats to credit quality deriving from such large capital expenditures, the potential for construction delays and cost overruns, and resistance among regulators to the rate increases required to recover such large capital expenditures.

During the past three decades, coal-fired power plants have been retired at about 50 years of age. If the same rule holds going forward, then 195,000 megawatts of generating capacity is likely to be retired over the next 10 years. That is a little under a fifth of the current installed generating capacity of the United States and a little under a fourth of the generating capacity using fossil fuels.

A relatively conservative estimate of the cost to replace this generating capacity is $180 billion.

The implications for regulated utilities should be broadly positive. Forty- and 50-year-old power plants in the rate base of a regulated utility contribute very little to earnings. Investing in a new coal-fired power plant at an average cost of $1,500 a kilowatt, or installing emissions controls for sulfur dioxide, nitrogen oxide and mercury at a combined cost of

$400 a kilowatt, represents a material opportunity to increase rate base and, with it, regulated earnings.

Consequences for Merchant Generators

The implications are much more negative for a merchant generator.

An aging coal-fired power plant can be robustly profitable, with an operating cost of about $20 a megawatt hour given the cost today of coal. That type of plant can generate a very robust gross margin when it is in a market where gas-fired power plants set the price of power and may sustain the plant at levels of $50 a megawatt hour or higher.

Older power plants are largely or fully depreciated, meaning there is little depreciation expense to charge against this gross margin. Book earnings at these older facilities are high. Cash flow is also high because the owners tend to avoid outlays for emissions controls for as long as they can and minimize capital outlays for capacity upgrades.

The need to replace an aging power plant implies not only a drain on distributable cash flow for merchant generators, but also an erosion of earnings power in the future as replacement costs start to register on income statements. Investors would be wise to monitor the age of power plants of merchant generators. We were surprised when we sat down and estimated it. For example, Reliant generates more than a third of its power from plants within five years of normal retirement age. The figure for Dynegy is a quarter. For NRG, it is a fifth.

It is not only the replacement of existing power plants that these companies have to worry about, but also compliance with the "clean air interstate rule" that will require heavy environmental spending on emissions controls for sulfur dioxide, nitrogen oxide and mercury through 2015. The cost of complying with the new emissions limits can be substantial for the major unregulated generators, particularly when the amount of spending is considered in relation to the EBITDA, or earnings before interest, taxes, depreciation and amortization, of some of the major unregulated generators.

This spending has implications for electricity prices. Prices must be high enough to recover not only the operating cost, but also the capital invested in building a new power plant before new plants will be built.

We estimate that the long-run marginal price of power must be at least $50 an mWh for the cost of a new coal-fired plant to be recovered, and it runs as high / continued page 22

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withholding taxes at the border when earnings are withdrawn in the form of dividends. Belgium does not collect withholding taxes on dividends paid to parent companies elsewhere in the European Union. It has now extended the same exemption to parent companies in other countries, like the United States, that have tax treaties with Belgium.

The parent company must be at least a 15% shareholder (10% starting in 2009) and have held its shares for an uninterrupted period of at least one year by the time the dividend is paid. The new policy is retroactive to January 1.

THREE FOREIGN TAX CREDIT schemes are shut down by the IRS.

The US tax authorities proposed new regulations at the end of March that would shut down three types of arrangements that US companies are using to generate foreign tax credits.

The United States taxes US companies on worldwide income, but allows credit for income taxes paid to another country so as to prevent double taxation. Credits may only be claimed for compulsory taxes, not taxes that a company pays voluntarily to another country.

One of the transactions the IRS is targeting is used by US companies that borrow money from foreign banks. Rather than borrow directly, a company might borrow in a three-step arrangement that lets it borrow more cheaply after the tax results are taken into account.

The US company forms a special-purpose subsidiary, or "SPV," in the home country of the bank. It then "sells" the SPV to the bank for the amount it wants to borrow and agrees to return the money to the bank in five years as purchase price to buy back the SPV. Immediately before transferring the SPV to the bank, the US company makes a capital contribution of the amount borrowed from the bank to the SPV and the SPV lends the money to another US subsidiary of the US company. At the end of the day, the US subsidiary pays interest on regular payment dates, and it repays the principal in five years. The SPV has to pay taxes / continued page 23

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as $70 an mWh in the case of a combined-cycle gas-fired plant assuming $8 gas.

In the gas-fired markets of Texas and New England, New York and the mid-Atlantic states, power prices last year were at levels that seem to justify investment in new power plants. The risk to generators in these regions is the possibility that electricity prices will fall due to falling gas prices or installation of lower-cost sources of power from renewable or coal-fired sources.

Independent power companies with heavy investments in coal-fired power plants may struggle because of the need to spend large sums on pollution control.

One need only look at the experience of merchant generators who built combined-cycle gas-fired power plants in the late 1990s and the early years of this decade to see the risk that investors run due to major changes in economic assumptions.

What is interesting is the failure of power prices in the midwest in 2006 to compensate generators for construction of new facilities. This suggests that plants reaching retirement age in that part of the country may not be economical to replace.

Regulated Opportunities

Moving to the regulated side of the business, the best way to predict earnings growth is to track total invested capital. This reflects the regulatory paradigm in this country that a monopoly utility is required to provide electricity service, but it is allowed to recover its cost of doing so, including a return on net investment. There is a 90% correlation between invested capital and aggregate earnings of regulated utilities as a group.

When it comes to estimating future growth in invested capital, there is about a 90% correlation between such growth and megawatt hours of electricity sales.

However, if you plot both electricity sales and invested capital, you will see relatively long periods of time when total capital investment by regulated utilities was either materially below or materially above the trend line for electricity sales. This reflects an inherent cyclicality to capital spending by utilities. This cyclicality is evident even just in the last 10 years. Capital spending was less than $20 billion in 1996. It swung to more than $60 billion in 2001 before settling back to a range of $40 or $45 billion currently.

This suggests the utility industry as a whole swung from being cash-flow positive to cash-flow negative and is back to cash-flow positive.

Looking forward, we think the industry is entering another cycle of huge capital spending driven by the need to replace aging fossil fuel plants. A large number of regulated utilities are expecting rate base growth over the next 10 years of between 75% and 125% as a result of the need to replace these aging generating units.

The need to comply with emissions controls will also drive future capital spending. For the largest coal-fired generators in the country, we foresee capital outlays equivalent to 10% to 20% of current rate base in order to comply with the clean air interstate rule by the 2015 deadline.

The surge in expected capital expenditures comes at a very propitious time for utilities because it is a time when the cost of equity to the industry is probably less than 8%, but when the return on equity allowed by regulators is some 225 to 500 basis points higher, or between 10.25% and 13%.

The gap suggests the opportunity to invest substantial capital at returns well in excess of cost and, therefore, substantial present value to the existing shareholders of regulated utilities.

In selecting potential investments in utilities, there is

merit in focusing on regions of the country where capacity is likely to be constrained over the next decade. In regions where capacity is abundant, regulators will be tempted to deny requests by regulated utilities to replace existing plant and suggest that they contract for power instead from underutilized wholesale generators. The markets where there is potential for significant capacity shortfalls are Florida, the Great Plains states, the area from northeastern Illinois through the rust belt to Pennsylvania, New Jersey and Maryland. These are markets where utilities are most likely to receive regulatory approval for capacity additions.

The nature of the capacity that utilities in the Great Plains states and rust belt are proposing to build is interesting. These are regions with relatively abundant supplies of coal. The bulk of the planned capacity additions are coal-fired power plants. The benefit to the utilities proposing such plants is a coal-fired power plant costs about $1,500 a kilowatt to build, which is three times more expensive than a gas plant with a capital cost of about $500 a kilowatt. The implication for the utilities in this region is rate base growth will be more substantial than it might be in regions that historically have favored gas, such as Florida or the western states.

These growth opportunities have not gone unnoticed by private equity funds. There have been a series of completed or proposed transactions in the sector, including the acquisition of PacifiCorp by MidAmerican, the proposed acquisition of Duquesne by Macquarie and the proposed acquisition of Northwestern Energy by Babcock & Brown. In each case, an entity backed by private equity sought to take control of a rapidly-growing regulated utility.

There is an opportunity to put substantial amounts of capital to work at rates of return that are well in excess of cost. Indeed, if you read Warren Buffet's letter to shareholders explaining the motivation behind his acquisition of PacifiCorp, he frames it very much in these terms.

Over the next 10 years, capital spending to replace aging power plants and comply with the clean air interstate rule will accelerate growth in rate base and drive regulated earnings higher. The wide gap between the returns on equity allowed to utilities and their cost of equity, which is 225 to 500 basis points, means the large amounts of capital spending expected should permit utilities to add very materially to shareholder value. Among the large utilities, Xcel, Southern Company, Entergy, American Electric Power and Duke stand to benefit the most, but interesting opportu- / *continued page 24*

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on the interest in the home country of the bank. The bank is credited with having paid the taxes by its home country since it owns the SPV in form while the loan is outstanding. However, the US company takes the position for US tax purposes that it owns the SPV all along because it is bound to repurchase it. The US company claims foreign tax credits.

The IRS says in new proposed regulations that any foreign tax the US company has to pay in such a case is a voluntary tax. The tax cannot be credited.

However, the regulations are so complicated that they will invite more planning to circumvent the new rules.

The IRS said it will treat foreign taxes paid in "certain structured passive investment arrangements" as voluntary taxes.

It then used almost 6,000 words to explain what it considers such an arrangement, with cross references to more than a half dozen other tax code sections that the reader must stop to read along the way. The agency would have done better to state what it will not allow in more general terms rather than try to describe the transaction structures at so granular a level.

The IRS also reassured taxpayers who operate through groups of companies that they will not be viewed as paying foreign taxes voluntarily where a foreign loss is transferred from one group member to another.

For example, company A may have a tax loss that it cannot use immediately. It allows the loss to be used to shelter income of its affiliate, company B. Company A will end up paying more foreign taxes in a future year because it no longer has the loss. The IRS said the higher tax company A will have to pay is not a voluntary tax. However, it did not say it as simply as this, which will require companies to pay careful attention to details. It said companies A and B will be treated as a single entity where a common US parent owns at least 80% of both companies directly or indirectly. The US parent must own at least 80% by both vote and value of any foreign entity that is a corporation for US tax purposes. It must have at least an 80% / *continued page 25*

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nities may arise among smaller utilities as a result of the interest of private equity investors in this sector.

Risks

During the period 1965 to 1985, utility rate bases expanded by 10% a year for almost 20 years.

That was also a period when utility stocks deteriorated markedly against the S&P 500.

Particularly during the early part of the last capital expenditure boom — from 1965 to 1972 — the price-to-earnings ratio and price-to-book value of utilities trailed the S&P 500 average. During this period, there was a sharp deterioration in both of these valuation metrics.

The primary reason this occurred was declining real electricity rates as accelerating inflation was met with regulatory lag. The regulators were slow to adjust rates upward to recover increases in fuel and other costs that utilities were incurring. The declining real price of electricity was reflected in falling returns on equity. Thus, the utility industry was placed at a competitive disadvantage relative to long-term investments. This was a period when long-term Treasury yields in particular were rising rapidly and, as a result, investors bid utilities down to levels that reflected the returns available on alternative, lower-risk instruments. Another factor behind the decline in stock prices was the financial situation of the utilities deteriorated markedly as construction outlays mounted. Another factor was the business risk of the industry became materially worse over this period, reflecting both cost overruns and completion delays in the construction programs, particularly on nuclear power plants, and also regulatory opposition to the rate increases that utilities required to recover their investments in new plants.

Accelerating inflation contributed to a 14% decline in real electricity prices between 1965 and 1972. As a result, the average return of equity of utilities fell from 10.9% in 1965 to 9.4% in 1972. During the same period, yields on 10-year Treasury bonds rose from 4.3% to 6.2%. Investors began to bid down the average price-to-book value ratio of utilities from a level well in excess of 2.0 in 1965 to just 1.0 in 1972.

It was also a period of deteriorating credit quality for utilities. The combination of declining real revenues and increased construction outlays drove the industry's average debt-to-capital ratio from 51% in 1965 to 55% in 1972. Because this was a period of rapidly rising interest rates, the industry's average earnings-to-interest coverage ratio fell from 4.5 in 1965 to 2.6 in 1972. Lenders began to demand higher returns on utility loans. Utility credit spreads over Treasuries rose from about 30 basis points in 1965 to 130 basis points in 1972.

Similarly, equity investors began to demand much higher prospective returns to compensate them for the increased financial and business risk of the industry. Price-to-earnings ratios fell from 20 in 1965, equivalent to an earnings yield of 5%, to 11% in 1972, equivalent to an earnings yield of 9%.

The effect on regulated utilities is the opposite. They may welcome the chance to add to rate base.

The markedly deteriorating business risk of the utility industry reached its nadir around 1984 or 1985 when utilities were trading between 5 1/2 and 6 1/2 times earnings, a 35% discount to the S&P 500.

History has taught us that there is risk associated with major capital expenditure cycles of the kind we are about to enter. It is important to assess which problems in the last cycle are likely to repeat. Some past problems are unlikely to repeat today. They are rapidly accelerating inflation and rapidly rising long-term bond deals. On the other hand, investors have to remain on the lookout for other risks associated with large capex programs that we think are much more difficult to avoid, and those include deteriorating credit

quality, cost overruns and construction delays, and regulatory resistance to rate increases. Investors seeking to capitalize on the benefits of the expected increase in capital spending must monitor individual utilities to make sure that these risks don't materialize. ◎

Foreign Acquisitions of US Companies

by Benjamin Mojuyé, in Washington

The US House of Representatives voted unanimously in late February to require more rigorous review of foreign investments in US companies that might affect US national security interests.

The US government already requires review of proposed foreign takeovers of US companies by an interagency committee called CFIUS. The acronym stands for Committee on Foreign Investment in the United States.

CFIUS has the power not only to review proposed acquisitions, but also to set aside completed transactions that were not submitted for prior approval if they are found later to raise national security concerns.

The House bill would take away some discretion from the President about how CFIUS operates. It would also require formal votes by committee members to approve transactions. The bill is a reaction to the failed takeover of the UK company Peninsular and Oriental Steam Navigation Company (P&O) by Dubai Ports World. The acquisition would have given Dubai Ports World operating control over six US ports. CFIUS approved the transaction, but the parties canceled the deal after an outcry from Congress.

More than 1,600 transactions have been reviewed by CFIUS since the committee was established in 1975. During that period, only one transaction has been formally vetoed, but about a dozen deals have been withdrawn, and the parties to others have agreed to measures to mitigate national security concerns in order to get their transactions approved. The vast majority of deals are approved without any conditions or mitigation measures.

The parties to a deal are under no obligation to notify CFIUS. However, they run the risk of having the deal set aside later if they fail to have it approved.

The bill the House passed is H.R. 556. It */ continued page 26*

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profits interest — as opposed to voting interest — in any foreign entity that is a partnership for US tax purposes.

The new rules are in section 1.901-2(e)(5) of the IRS regulations.

SOME SALES OF STATE TAX CREDITS are running into trouble with the IRS.

The IRS national office said it has trouble with partnerships that are being used to transfer state tax credits to investors who invest in the partnerships solely for the tax credits. The agency criticized the transactions in an internal legal memorandum.

Some states allow certain tax credits to be sold directly for cash to taxpayers who can use them. Other states do not. The IRS said that promoters are forming partnerships of investors to buy unused state tax credits. In states where the credits can be sold directly, the partnerships use cash contributed by the investors to buy the credits. The promoter is a partner and has an option to repurchase the investor interests for fair market value as soon as the tax credits have been claimed. That value is expected to be close to nil since the partnerships have no other business. When their interests are repurchased, the investors deduct the amount each contributed to buy the tax credits as a capital loss.

In other states where unused credits cannot be sold, the investors are brought into a partnership with the company whose tax credits are being transferred.

The internal legal memorandum is AM 2007-002.

The IRS said in the memo that it does not believe the investors are real partners since they are not engaged in a joint business undertaking with the aim of sharing profits.

It said any investor whom a state allows to claim credits anyway has bought a form of property. If he then uses the credits to reduce his state taxes, he has effectively cashed in the property and used the proceeds to pay his state income taxes. He will have a gain from disposition of the property, or tax credit, if the face amount of the credit exceeds what he paid for it. */ continued page 27*

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must also clear the Senate. The Senate is expected to take it up later this year.

Rep. Carolyn Maloney (D-New York), the chief sponsor of the bill in the House, said it contains "very tough provisions to protect national security, including the ability for CFIUS to reopen reviews when companies don't comply with mitigation agreements designed to reduce security risks." Todd Malan, president of the Organization for International Investment, which represents US subsidiaries of foreign companies, also expressed satisfaction with the bill: "From a business standpoint, [this bill] does not screw anything up . . . . It maintains CFIUS' role as a screening process, not as a barrier to foreign investment." The US Chamber of Commerce also praised the measure. Bruce Josten, the Chamber executive vice president, declared: "This bill strikes an appropriate balance between keeping Americans safe and keeping our economy open to the world . . . . We can't expect other countries to welcome U.S. investment if we discourage theirs. We urge the Senate to follow the balanced model for reform adopted by the House."

The Bush administration said it "supports House passage of H.R. 556," but expressed "concerns with some of the provisions and looks forward to working with Congress to address these concerns."

CFIUS has been moving recently to reinvent itself without waiting for Congress to act. As the recent Alcatel-Lucent and CNOOC-Unocal merger fiascoes demonstrate, reviews are taking longer, costs for companies are mounting and CFIUS-imposed conditions are either tougher or more rigorously enforced, making it difficult for companies to secure approval of their business ventures. In 2006, there were 113 filings (up 73% from 2005), seven second-stage investigations (up 250% from 2005) and five withdrawals (up 150% from 2005) during the second-stage investigation period.

In addition, starting in 2006, CFIUS has broadened the scope of its interventions. CFIUS no longer restricts itself to acquisitions of a US entity by a foreign company. A merger or acquisition between two foreign entities that results in a transfer of US subsidiaries to a new entity, or that affects in any way US critical infrastructure, is also within the CFIUS ambit. For example, the merger between Nokia of Finland and Siemens of Germany to create Nokia Siemens Networks was recently reviewed by CFIUS. CFIUS gave its approval in November 2006, after the parties signed a mitigation or national security agreement, known as a "special security arrangement," that restricted the ability of the merged company to do business with Nortel in Canada, which counts the US Army and Navy among its customers. More such national security agreements have been negotiated in 2006 in order to gain CFIUS approval. From 2003 to 2005, the Department of Homeland Security was a party to 13 national security agreements, while in 2006 alone there were 15 such agreements.

> Congress is moving to require more rigorous review of foreign takeovers of US companies that might affect US national security interests.

These types of agreements now contain stricter provisions. Notably, for the first time since its creation, CFIUS conditioned its approval of the December 2006 purchase of Lucent Technologies, Inc. by Alcatel of France on an "evergreen" stipulation that gives CFIUS authority to order divestiture of Lucent in the future if the merged company fails to comply with any of the security conditions.

Background

CFIUS was created in 1975 by executive order of President Gerald Ford.

It was originally a committee with representatives from four federal agencies — the Departments of State, Defense, Treasury and Commerce — and the White House.

Ford charged it with "monitoring the impact of foreign

investment in the United States, both direct and portfolio, and for coordinating the implementation of United States policy on such investment." CFIUS originally had merely an advisory function: if "the need arises," it made recommendations to the National Security Council and National Economic Policy Board in the White House. The executive order creating CFIUS did not claim power for the President to block or otherwise interfere with any merger or acquisition that might jeopardize US national security.

In 1988, Congress strengthened the President's hand. The "Exon-Florio amendment" gave the President authority to review proposed foreign takeovers of US companies and block any that threatened national security. In the late 1980s, there was heightened concern in Congress about Japanese investment in the United States. The House committee report on the amendment characterized a proposed takeover of Fairchild in 1987 by Fujitsu Corporation as "tantamount to loss of the [US] ability to produce airplanes during World War II." The amendment also gave the President the power to unwind completed transactions. Under the Exon-Florio amendment, action by the President to block or unwind an acquisition is final: there is no appeal to the courts.

President Reagan delegated the new power to CFIUS by executive order in December 1988.

CFIUS currently has 12 members. Six agencies are represented: State, Defense, Treasury, Commerce, Justice and Homeland Security. Another six White House offices are represented: the national security and economic policy advisers to the President, the US trade representative, CEA (the Council of Economic Advisers), OMB (the Office of Management and Budget), and the President's science adviser. The panel is chaired by the Treasury secretary.

The Exon-Florio amendment established a four-step process for reviewing any foreign acquisition of a US company.

The review process generally begins with the two parties involved filing a notice of the planned transaction with CFIUS. CFIUS may also initiate its own review. In addition, CFIUS may reopen transactions it already approved if the parties submitted false or misleading information or the parties fail to take actions that CFIUS ordered to mitigate any national security concerns.

Transactions involving an entity owned or controlled by a foreign government can be subject to a more stringent process. The President is required by a 1993 */ continued page 28*

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He should also have a federal tax deduction for the state income taxes paid with the credit. However, the IRS said that most investors in the partnerships cannot use the tax deductions because they are on the alternative minimum tax.

IDAHO replaced its property taxes on wind farms with a new tax on gross receipts from electricity sales.

The state enacted the new tax in late March. It is retroactive to January 1. All property used to generate, transmit, distribute or measure electricity generated from wind is now exempted from property taxes, but will be subject to a 3% gross receipts tax. The new policy does not apply to public utilities. The tax will be collected annually on July 1. It is supposed to be revenue neutral.

PRIVATE EQUITY FUND takeovers of energy companies are requiring more careful attention to antitrust issues.

The Federal Trade Commission filed a complaint in late January challenging a proposed $22 billion purchase of an interest in pipeline company Kinder Morgan by the Carlyle Group and Riverstone Holdings. The FTC charged the purchase would have led to too much market concentration in the operation of gasoline terminals in 11 cities in the southeastern United States. The two private equity groups already had significant holdings in a competitor of Kinder Morgan called Magellan Midstream.

The parties worked out a consent order to address the competitive issues. Among other steps, they agreed to internal controls to prevent the exchange of sensitive information between the two companies and agreed to drop off the Magellan board.

The two private equity funds were luckier than the parties in two other energy M&A deals this year. In March, the FTC voted to block the purchase of Peoples Natural Gas Co. by Equitable Resources. The two companies are rival natural gas suppliers in Pittsburgh. */ continued page 29*

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"Byrd amendment" in such cases to submit a written report to Congress, together with a "detailed explanation" of his findings and the factors upon which they are based. In addition, the Byrd amendment requires an investigation in cases where the acquirer is controlled by or acting on behalf of a foreign government.

Under the current regime, since notification of CFIUS is completely voluntary, parties to a planned merger or acquisition may choose not to notify the committee if they believe their transaction does not raise any US national security issues. However, they do so at their own peril: there is no limitation period for CFIUS to act, so an acquisition could be unwound by CFIUS years after it closes.

There is nothing to stop parties to a deal from checking with the office of international investment at Treasury to confirm there is no need to seek approval. Even if approval will be required, such pre-filing discussions can help identify possible issues.

H.R. 556

H.R. 556 would maintain the current architecture of CFIUS as an interagency committee, but with three notable differences. First, CFIUS would no longer be a creation of presidential executive orders. H.R. 556 establishes CFIUS by statute. The direct consequence is to restrict the President's power to amend the status of or to repeal CFIUS without Congressional action. Second, the bill would leave the Treasury secretary in charge of the panel, but elevate the Commerce and Homeland Security secretaries to vice chairmen. Third, it would add another member: the Department of Energy.

It would also make substantial changes in the way CFIUS conducts its reviews.

The staff work of the committee is done currently by the office of international investment at the US Treasury. Reviews are highly confidential. Treasury calls on different agencies for input depending on the industry involved. For example, the Departments of Defense and Homeland Security will be more actively involved in the acquisition of a US aerospace and defense company by a foreign entity. Agencies that are not members of CFIUS may also be called upon to take part in the review process, particularly where they have oversight responsibilities over the industries the proposed merger or acquisition will affect. In the Dubai Ports World-P&O transaction, for example, CFIUS invited the Departments of Transportation and Energy to participate in the review process.

Congress wants stronger controls after an interagency government committee approved a plan by a Dubai company to acquire a UK company that operates six US ports.

The Bush administration is unhappy about having Congress set the membership of CFIUS in stone. It wants to retain flexibility to adjust the membership and operating procedures over time.

CFIUS retains the authority under H.R. 556 to order a transaction that poses national security risks to be unwound. There is no time limit within which CFIUS must act. H.R. 556 makes clear that the committee "may move to initiate a review" of any "covered transaction" at any time. In theory, a deal could be unwound years after it was concluded if the damage to US national security interests became clear in hindsight.

30-Day Review

A notice by the parties to CFIUS triggers a 30-day review.

This notice should provide a detailed description of the planned transaction, its motivations and timeline. CFIUS will want a list of the assets that each party controls currently. It will want to know who is on the board of each party and the backgrounds of the board members. It will also want a sense of the long-term business plan of the combined entity.

H.R. 556 gives CFIUS the ability to compel the testimony of "such witnesses and the production of such books, records, correspondence, memoranda, papers, and documents" as the committee feels it needs to evaluate a proposed transaction.

Under current law, if there is a consensus among CFIUS members that no national security threat exists, or that the threat has been adequately mitigated by some action by the parties, then CFIUS is supposed to clear the transaction within 30 days.

Currently, member agencies reach a consensus through an informal process. H.R. 556 formalizes the review process by requiring a "roll call vote" of CFIUS member agencies. The review or investigation of a covered transaction will be considered "complete" only if two conditions are met: the results of the review or investigation "are approved by a majority of the members of the Committee in a roll call vote," and the results are certified by the secretaries of Treasury, Homeland Security and Commerce.

The bill requires additional action by the President and analysis by the Director of National Intelligence in cases where a party to a covered transaction is a government, an entity "directly or indirectly" controlled by a government, or a citizen of a country led by a government that has been determined by the US State Department as having "repeatedly provided support for acts of terrorism." In such cases, no review or investigation shall be treated as final or complete until the results are signed by the President. This is a response to the failed Dubai Ports deal that CFIUS and President Bush approved, but that the parties decided to cancel after an outcry from Congress. H.R. 556 stresses the independent role of the Director of National Intelligence: he cannot be a member of CFIUS and shall serve "no policy role" with CFIUS other than providing the intelligence analysis of the covered transaction.

In the past, 30 days have proved insufficient to allow CFIUS to complete its initial review. As a result, CFIUS has sometimes encouraged parties to withdraw their notification of a pending or completed acquisition and to refile at a later date. By doing so, the parties can avoid entering the extended 45-day investigations period that is described below. While any subsequent refiling will be considered as a new, voluntary refiling that restarts the clock, information gained by CFIUS in the initial filing will allow it to conduct an informal review of the planned transaction. Some parties choose a permanent withdrawal. Parties may withdraw their notice at any stage of the review. / continued page 30

IN OTHER NEWS

The agency could also vote in April to block a $1.13 billion purchase of Giant Industries by Western Refining Inc. The companies are oil refiners.

Private equity funds accounted for 26% of all merger and acquisition activity in 2006.

MINOR MEMOS. A bill that is gaining ground in the US Senate would create a blacklist of 40 countries considered tax havens. Corporations in such countries that are subsidiaries of US parent companies would be taxed on worldwide income as if they were American companies. The bill is S. 396. It is being promoted by Senators Byron Dorgan (D-North Dakota) and Carl Levin (D-Michigan). The blacklisted countries include the Cayman Islands, Bermuda, the British Virgin Islands and Mauritius. One commentator said the day before any such new law takes effect, there will be no subsidiaries of US corporations in any of the blacklisted countries . . . . Another bill that is picking up support in the House would shut down a lucrative business being done by some US banks in hybrid loans to foreign corporations. The loans are structured to qualify as an equity investment for US tax purposes, but as debt in the foreign country where the borrower is located. Payments received by the US lender are reported as dividends that qualify for a reduced tax rate of 15% through 2010. However, because the payments are reported as interest by the borrower in its home country, they can be deducted by the borrower. The bill, introduced by Rep. Richard Neal (D-Massachusetts), would deny the 15% tax rate for dividends that the payor treats as deductible in its home country or on instruments that are not treated as stock in the foreign country. It is H.R. 1672. Neal is a senior member of the House tax-writing committee.

— Contributed by Keith Martin, Laura Hegedus and David Blonder in Washington and Edward Vergara in New York.

CFIUS

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45-Day Investigation

Under the current system, if there is any evidence that a threat to national security exists, or if CFIUS members fail to agree as to the existence of such national security threat, CFIUS is required to conduct an investigation for an additional 45 days.

Under the House bill, this second stage of review is triggered in four situations. There must be an investigation in cases where the initial review shows that the covered transaction threatens to impair US national security and "that threat has not been mitigated" during or prior to such review. An investigation is required if the transaction is a "foreign government-controlled" transaction, unless the three main agencies — State, Homeland Security and Commerce — agree it poses no national security threat. The transaction moves to an investigation if a roll call vote "results in at least 1 vote" by a member agency against approving the transaction. Lastly, it moves to an investigation if the Director of National Intelligence identifies "particularly complex intelligence concerns that could threaten to impair" US national security and member agencies "were not able to develop and agree upon measures to mitigate satisfactorily those threats during the initial review period."

The bill allows the 45-day period to be extended upon a two-thirds vote by the committee.

Even before notice of a transaction is filed, counsel to the parties would usually explore with the office of international investment at Treasury what mitigation measures, if any, are required to get approval for a transaction. Any such discussions might continue after a notice is filed, particularly if the matter moves to a formal investigation. The parties might make commitments regarding the composition of the board of directors (adding American citizens or guaranteeing that a board will only be composed of Americans), allow full access to their premises and operations to US law enforcement agencies, promise not to increase the level of foreign control of the post-merger entity, or even commit to conduct any research and development in the United States. Alcatel Lucent promised, for example, to restrict Alcatel's access to sensitive work done by Lucent's research division, Bell Labs, and the communications infrastructure in the US.

In cases where mitigation measures are promised, one federal agency is usually appointed to monitor the agreement. The agency must file a report every six months with CFIUS confirming that the mitigation measures are being implemented as promised. Any "significant modification" to such mitigation agreements must be reported to the Director of National Intelligence and to any other "Federal department or agency that may have a material interest in such modification."

The committee has reviewed proposed acquisitions since 1975. Of more than 1,600 deals reviewed, only one was vetoed and a dozen were withdrawn.

The Exon-Florio amendment gave the President 15 days to make a decision after CFIUS has finished its work. He may permit, permit with conditions, suspend, prohibit, or prohibit and order a divestiture of the merged entity if the merger was already consummated by the date he issues his decision. No action by the President during the 15-day period generally means the parties are free to proceed.

Out of 1,604 foreign acquisitions of US companies reviewed by CFIUS since Exon-Florio became law in 1988, only 25 cases have gone through the second stage of review. Of the 25 cases, 13 cases were submitted to the President by CFIUS for decision. In 11 of the 13 cases, the President took no action, and the parties to the proposed acquisitions were free to proceed. In one case, the President ordered the foreign acquirer to divest itself of all its interest in the US company. That was in 1990. President George H.W. Bush ordered the state-owned China International Trust & Investment Corporation (CATIC) to divest itself of its interest in Mamco Manufacturing in Seattle, following a unanimous recommendation in that regard by CFIUS members. CFIUS reviewed the transaction and the merger took place. CATIC had strong ties to the Chinese

military. The President was concerned that the Chinese firm could have used Mamco to acquire jet fighter engine technology and to gain "unique access" to US aerospace companies, thereby circumventing technology export control restrictions. CATIC's acquisition of Mamco is the only transaction to have been formally blocked. In 12 of the 25 transactions that were subjected to the 45-day investigation, the parties withdrew their notices before the conclusion of the investigations.

The Dubai Ports World's acquisition of P&O was approved by CFIUS in January 2006 after a 45-day investigation. It was a $6.8 billion acquisition that would have given Dubai Ports operating control over at least six major US ports. CFIUS negotiated several mitigation measures with Dubai Ports, including a commitment by Dubai Ports to cooperate with any future investigations by the US government of the company's US port operations.

"National Security"

The Exon-Florio amendment gave the President authority to block any proposed investment allowing a foreign party control over a US company if the investment threatened national security and there was inadequate protection under US law.

The term "national security" was not defined, perhaps deliberately to give the President and CFIUS broad discretion in determining whether to block a transaction. However, Exon-Florio has a list of suggested possible national security concerns. These include domestic production of oil, the capacity of domestic industries to meet national defense requirements, the potential effects of the transaction on sales of US military goods or technology to a country that supports terrorism or proliferates missile technology or chemical and biological weapons, and the potential effects of the transaction on US technological leadership in areas affecting US national security.

H.R. 556 takes a different approach. While the President keeps his power to block foreign acquisitions, the examples of possible national security concerns listed in Exon-Florio are no longer discretionary: the President "shall" consider them in evaluating the threat to national security of a foreign takeover. In addition, the term "national security" is defined as including "those issues relating to 'homeland security,' including its application to critical infrastructure." The term "critical infrastructure" echoes the term "critical industries" used in the USA Patriot Act. The Patriot Act defines "critical industries" as those "so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters." Thus, under H.R. 556, in a post-September 11 world, the term national security is no longer limited to national defense, but clearly extends to national economic security.

Covered Transactions

Under H.R. 556, CFIUS has the power to set aside any "covered transaction." H.R. 556 defines the term "covered transaction" as "any merger, acquisition, or takeover by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States." While H.R. 556 directs CFIUS to adopt regulations defining the term "control," it defines the term "foreign government-controlled transaction" as "any covered transaction that could result in the control of any person engaged in the United States by a foreign government or an entity controlled by or acting on behalf of a foreign government."

H.R. 556, like current law, is extraterritorial in reach: it would prohibit conduct by some non-US parties. Thus, a merger of one foreign company with another is subject to review and US action if either foreign party has access to technology or information that is considered central to US national security. ◎

Iran Trade Sanctions May Tighten

by Laura Hegedus, in Washington

Two bills introduced in the House would strengthen trade sanctions against Iran by increasing US penalties against violators.

The House Foreign Affairs Committee marked up the "weaker" of the two bills, H.R. 957, in mid-February. The bill would close a "loophole" in the existing Iran sanctions by extending the sanctions to insurers and export credit agencies and by directing that US parent companies can be held liable when a foreign subsidiary in which the US company owns more than 50% of the equity violates the sanctions.

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The "stronger" bill, H.R. 1400, has not yet been considered in any committee.

Five House committees share jurisdiction over the measures. Some version of the two bills is expected to be sent eventually to the full House.

The Senate must also act. Senator Chris Dodd (D-Connecticut), chairman of the Senate committee with jurisdiction over sanctions issues, said the subject will be on the agenda this year. He has not set a date for Senate action.

In the meantime, the US State Department is moving to remind companies of the financial and reputational risks of doing business in Iran. R. Nicolas Burns, the US undersecretary of State for political affairs, told the House Foreign Affairs Committee in March that Iran is one of the largest beneficiaries of official export credits and loan guarantees, with $22.3 billion in such help from OECD countries reported at the end of 2005. The US government is pressuring allies to reduce the official export credits they provide to Iran.

Stronger Sanctions

H.R. 957 would "expand and clarify" the entities against which sanctions may be imposed under the existing Iran Sanctions Act of 1996. Supporters of the bill want to make clear that foreign subsidiaries of US companies doing business with Iran may be subject to sanctions. However, this is already clear in the law as currently drafted. The greater significance of the bill is that it signals a new focus in Congress on enforcing the Iran Sanctions Act, including against foreign subsidiaries of US companies.

H.R. 1400 attributes to a US parent company the trade sanction violations of its foreign subsidiary. If a non-US entity violates US trade sanctions against Iran, then the bill permits penalties to be imposed on any US company owning, directly or indirectly, more than 50% of the equity interests in the foreign company violating the sanctions without the need to show direct participation in the sanctions violation by the parent company.

The existing Iran Sanctions Act curtails foreign business investments in and with Iran that are likely to aid development of that country's natural resources or military capabilities. Some legislators believe that the law is not being vigorously enforced. As of the end of 2006, no foreign company had ever been subject to sanctions under the act.

The Iran Sanctions Act is distinct from the "Iranian transaction regulations" issued by the office of foreign assets control — called "OFAC" — in the US Treasury Department. The Iranian transaction regulations are very broad in scope, but apply only to US persons. They prohibit US persons from making a wide variety of investments in Iran, engaging in operations involving Iran, or exporting goods, services or technology to Iran, unless an exception permitting the transaction applies or unless a license is obtained from OFAC. Prohibited transactions are not limited to those involving petroleum resources or weapons. A US person is prohibited from exporting *any* goods to Iran, or to a middleman if the US person knows that the middleman will deliver the goods into Iran. Despite the stiff penalties for violating the regulation — criminal penalties of up to $500,000 per violation and 20 years in prison — many US companies use foreign subsidiaries and middlemen to supply goods into Iran, relying on an exception in the regulations for cases in which the US parent does not "facilitate" the transaction of its subsidiary. However, these regulations do not apply to foreign businesses; they only apply to "US persons" and, in some cases, to non-US persons acting within the United States.

Neither House bill would change the scope of the Iranian transaction regulations that apply to US persons directly (other than by allowing penalties to be imposed on US persons due to violations by their foreign subsidiaries). Both bills would widen the scope of the sanctions that may be imposed due to the activities of foreign investors and suppliers with Iran. Discussion and media reports surrounding the bills suggest that members of Congress may be especially concerned about Iranian petroleum transactions that are being contemplated by foreign affiliates of US companies.

Existing Sanctions

Originally enacted as the "Iran and Libya Sanctions Act of 1996," the law prohibited an investment in Iran that met certain monetary thresholds and "directly and significantly" contributed to Iran's development of its petroleum resources, although penalties against investors could be waived by the President. Investments in and exports to Libya were prohibited if they significantly and materially contributed to Libya's access to weapons, aircraft or development of its petroleum

resources. Sanctions relating to Libya were "mandatory," not discretionary, although the President retained some authority to modify them.

The main potential sanctions against investors and suppliers under the act are denial of assistance from the Export-Import Bank, denial of US export licenses, and denial of credit from any US financial institution.

The sanctions were enacted for an original five-year period, which was extended for five additional years in 2001. Last year, the sanctions were extended again through 2011, but Libya was removed from the sanctions statute. Sanctions concerning Libya were dropped in September 2004 by Presidential executive order due to a finding that the country was committed to eliminating its weapons of mass destruction programs and its missile technology control regime.

The "Iran Freedom Support Act of 2006" amended the Iran sanctions in two principal ways. Congress narrowed the President's ability to waive sanctions against persons who violate them. The statute was also broadened to cover not only investment that aided Iran's development of petroleum resources, but also the supply of goods, services, technology or other items that would "contribute materially" to Iran's ability to acquire or develop chemical, biological or nuclear weapons or significant numbers or advanced types of conventional weapons.

The Iran sanctions as currently in force may be imposed on any "person" that "has, with actual knowledge, . . . made an investment of $40,000,000 or more . . . that directly and significantly contributed to the enhancement of Iran's ability to develop petroleum resources of Iran." The sanctions may also be imposed on any person that has "exported, transferred, or otherwise provided to Iran any goods, services, technology, or other items knowing that the provision of such goods, services, technology, or other items would contribute materially" to Iran's ability to acquire or develop chemical, biological, or nuclear weapons or related technologies, or significant conventional weapons.

House Bills

Both bills would make two changes in key definitions in the Iran Sanctions Act of 1996. First, they would expand the definition of a "person" to whom sanctions apply expressly to include a "financial institution, insurer, underwriter, guarantor, any other business organization, including any foreign subsidiary of the foregoing." The statute already defines "person" broadly to include an individual and "a corporation, business organization, partnership, society, trust, any other nongovernmental entity, organization, or group, and any governmental entity operating as a business enterprise," including any successor of any of these. Second, the bills would expand the definition of petroleum resources to include not only petroleum and natural gas resources, but also petroleum by-products and liquefied natural gas.

H.R. 1400 was introduced in early March with 60 cosponsors (36 Democrats and 24 Republicans) and is a broader, more significant piece of Iran-focused legislation than H.R. 957.

Congress is moving to apply Iran trade sanctions to insurers and export credit agencies and to hold US parent companies accountable if their foreign subsidiaries violate the sanctions.

Under H.R. 1400, a US parent company would be held accountable for any trade sanctions violations of its controlled foreign subsidiaries, with "control" defined as beneficial ownership of a greater-than-50% interest. The bill would also increase the import and export sanctions against Iran, expand the definitions of "petroleum resources" and foreign "persons" that are prohibited from engaging with Iran, direct the President to report every six months to appropriate Congressional committees on investment activity that could contribute to Iran's development of petroleum resources, and restrict nuclear coopera- / continued page 34

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tion with countries assisting Iran's nuclear program. The bill would also reduce US contributions to World Bank programs by the percentage of World Bank funds provided to entities in Iran or to projects located in Iran.

H.R. 1400 also contains a provision denying amortization of geological and geophysical expenditures to US taxpayers that are part of affiliated groups with a foreign parent company, if any member of the group has been subject to US trade sanctions.

If enacted, the measure would permit sanctions to be imposed on US parent companies who do not possess actual knowledge of the investments or exports of their affiliates and are not otherwise engaged in prohibited activities. US parent companies would be "strictly liable" for the trade sanctions violations of their controlled foreign subsidiaries.

In its efforts to broaden the role of diplomacy and economic incentives in influencing Iranian policy, Congress may also take a look at the loopholes in the OFAC regulations that prohibit the activities of US persons in and with Iran.

The companion to the sanctions bills in the Senate is S. 527. It would amend the "Iran, North Korea and Syria Nonproliferation Act" to allow penalties for act violations to be imposed on subsidiaries and on any upstream entity owning more than 50% of (or having de facto control of) a person who violates the act. ◎

US Trade Sanctions Are a Trap for the Unwary

by Christopher Man and Keith Martin, in Washington

The United States maintains trade sanctions of varying severity against dozens of countries. Anyone doing business with sanctioned countries must be careful not to violate them. The sanctions not only vary from country to country, but they also change periodically.

They can have extra-territorial reach.

For example, sanctions usually apply to US citizens working abroad, even if they work for foreign companies over which the United States has no direct legal jurisdiction. Many of the sanctions also either expressly cover foreign subsidiaries of US companies or apply in any situation where a US company is found to have provided "approval or other facilitation" to a foreign company. Even where foreign subsidiaries are not expressly covered, a US parent can be charged with a violation if it is found to have conspired with or otherwise helped its subsidiary circumvent the sanctions.

The extra-territorial reach can put companies in an awkward position. Some countries have enacted "blocking" legislation designed to thwart compliance with controversial US measures, like the continuing US embargo against Cuba.

The most stringent US measures are import-export restrictions against seven countries: Cuba, Iran, Iraq, Myanmar, North Korea, Sudan and Syria. US presidents have issued executive orders blocking property and other transactions with persons affiliated with the governments of another six countries or regions: the Balkans, Belarus, Ivory Coast, Democratic Republic of the Congo, Liberia and Zimbabwe.

Import-Export Restrictions

Import-export restrictions bar US persons from exporting US goods to a sanctioned country absent a license or other authorization and, in some cases, they also bar re-exports of US goods by persons or entities in foreign countries. There is no single definition of "US person"; it varies by sanction.

Cuba: Virtually all exports and imports between the United States and Cuba are banned. Transactions between Cuba or Cuban nationals by US citizens, wherever located, are prohibited, including "dealing in or assisting the sale of goods or commodities to or from Cuba, even if done entirely offshore." Some exemptions apply — for example, goods licensed for export or re-export by the US Department of Commerce, like medicine, food and agricultural commodities. Criminal penalties for violating the sanctions range up to 10 years in prison, $1 million in corporate fines and $250,000 in individual fines. Civil penalties of up to $55,000 per violation also may be imposed. Persons who traffic in property confiscated by the Cuban government that is subject to a legal claim by a US person can be denied admission into the United States. The Helms-Burton Act also provides for a private civil right of action against persons who traffic in such property, but Presidents Clinton and Bush have exercised their authority under the statute to suspend this private cause of action.

Iran: No goods, technology or services may be exported to Iran or sold to the Iranian government by US persons

wherever located, unless licensed by the office of foreign assets control, called "OFAC," in the US Treasury Department. The prohibition extends to re-exports to Iran by intermediaries in foreign countries and it also blocks offshore transactions by US persons that benefit Iran or the Iranian government. US persons are restricted from exporting goods that are "intended specifically for use in the production of, for commingling with, or for incorporation into goods, technology or services to be directly or indirectly supplied, transshipped or re-exported *exclusively or predominantly* to Iran or the Government of Iran." Certain exemptions apply. In addition, the sanctions bar "[n]ew investments by US persons, including commitments of funds or other assets, loans or any other extensions of credit, in Iran or in property (including entities) owned or controlled by the Government of Iran." With only minor exceptions, imports *from* Iran are also prohibited. Criminal penalties are up to $500,000 for corporations and $250,000 for individuals, up to 20 years in jail, or both. Civil penalties of up to $50,000 may also be imposed. The United States is trying to broaden the reach of US sanctions in the face of deteriorating relations with Iran over its nuclear ambitions. (See related article in this issue.)

Iraq: All exports or re-exports to Iraq must be licensed by the office of foreign assets control in the US Treasury Department or otherwise authorized by the US Department of Commerce. All financial transactions with Iraq are allowed except for those involving individuals and entities appearing on a "specially designated nationals" list maintained by the office of foreign assets control. Criminal penalties range up to 12 years in jail and $1 million in fines. Civil penalties of up to $325,000 per violation may also be imposed. Violation of Iraq-related presidential orders can also result in 10 years in prison, $500,000 in corporate fines and $250,000 in individual fines. Civil penalties are up to $11,000 per violation.

Myanmar: No US person may make a "new investment" in Myanmar or "facilitate" such an investment by a foreign person. Nearly all imports *from* Myanmar are banned. Exports to Myanmar are generally permitted, but not exports of financial services. Criminal penalties for willful violations can be up to $500,000 in fines for a corporation or up to $250,000 for an individual, or up to 10 years in jail. Civil penalties of up to $11,000 per violation also may be imposed administratively.

North Korea: A ban on exports to North Korea was lifted in 2000; however, in April 2006, the office of foreign assets control issued an order prohibiting US persons from owning, leasing, operating or insuring any vessel that operates under a North Korean flag. Imports *from* North Korea must be approved by OFAC, and exports *to* North Korea must still clear a number of regulatory hurdles. Criminal penalties range up to 10 years in prison, $1 million in corporate fines, and $250,000 in individual fines. Civil penalties of up to $65,000 per violation also may be imposed.

Sudan: Exports of "any goods" to Sudan by US persons "wherever located" are prohibited. The sanctions also block transfers of property of certain persons connected with the conflict in Darfur and restrict US persons from transacting business with these individuals and entities. In addition, the sanctions prohibit US persons from "facilitating" the direct or indirect export or re-export of goods, technology or services to *or from* Sudan. Financial dealings with Sudan are generally prohibited, "including the performance by any US person of any contract, including a finance contract, in support of an industrial, commercial, public utility or governmental project in Sudan." Imports from Sudan, with few exceptions, are banned. Criminal penalties range from up to 20 years in prison, up to a $50,000 penalty, or both. In addition, civil penalties of up to $50,000 per violation may be imposed.

Syria: Goods on a US munitions list and a separate list of controlled products maintained by the US Department of Commerce, as well as certain other items, / continued page 36

The US has trade sanctions against dozens of countries.

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may not be exported or re-exported to Syria. Criminal penalties range up to 10 years in prison, $500,000 in corporate fines and $250,000 in individual fines. In addition, civil penalties of up to $11,000 per violation may be imposed.

Some of the sanctions bar exports of US goods to particular countries. They can also apply to re-exports of US goods through third countries.

Executive Orders

Presidents have issued executive orders freezing bank accounts and other property and prohibiting transactions with persons considered threats to US interests.

Balkans: One order blocks property of, and prohibits transactions by, US persons with certain persons believed to be or to have been destabilizing forces in the Balkan region.

Belarus: A separate order blocks property of, and prohibits transactions by, US persons with certain persons affiliated with the Belarus government.

Democratic Republic of the Congo: A similar order applies to property and transactions with certain persons affiliated with the conflict in the Democratic Republic of the Congo.

Ivory Coast: Property of persons linked to the conflict in the Ivory Coast has been frozen, and US person are barred from engaging in financial transactions with persons named in the order.

Liberia: The sanctions block property and transactions with restricted persons affiliated with conflict in Liberia. It also prohibits dealing in rough diamonds not controlled by "Kimberley process certification scheme."

Zimbabwe: US persons, wherever located, are barred from engaging in transactions with certain persons who are believed to have undermined the democratic process in Zimbabwe.

Additional Sanctions

The United States has imposed other sanctions that limit the sale of arms, nuclear technology and other equipment with military uses. These apply to the following countries: Albania, Bulgaria, Cambodia, the Czech Republic, Estonia, Latvia, Lithuania, North Korea, Mongolia, China, Poland, Romania, the Slovak Republic, Vietnam and all former Soviet Republics. An additional executive order prohibits transactions with certain persons or entities believed to be involved in the proliferation of weapons of mass destruction. There also are significant limits on importing diamonds into the US that have not complied with the Kimberley process to prevent trade in "conflict diamonds."

The United States also blocks property and transactions with a long list of persons or entities suspected of being involved with illicit trafficking of narcotics and terrorism. Many of the named persons or entities may sound and even appear to be legitimate businesses or even charities, and persons involved with terrorism or narcotics trafficking may even have otherwise legitimate business interests. US companies should not assume their business partners cannot be on such a list simply because they do not fit the image of a terrorist or drug dealer.

Tax Penalties

Separate tax penalties apply to US taxpayers doing business in Middle Eastern countries that participate in the Arab boycott against Israel. These are Bahrain, Iraq, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates and Yemen. The US taxes American companies on their worldwide incomes. However, US multinationals often find ways to structure foreign business operations so that US taxes can be deferred until income is repatriated to the United States.

A US multinational doing business in an Arab boycott country may find itself unable to defer US taxes on a portion of its income from foreign operations, and not necessarily solely from operations in the Middle East. For example, it may lose the ability to defer US taxes on a portion of its income from a project in Peru. In addition, it will suffer a haircut on foreign tax credits. This has the potential to reduce returns from foreign operations

after taxes. However, US multinationals are only subject to these penalties if they "cooperate with or participate in the boycott."

The key to avoiding penalties is to avoid signing any document that says the US multinational or a member of its "controlled group" will participate in the boycott. For example, the US Treasury Department said in a notice in 1978 that it is not cooperation with or participation in the boycott merely to *acknowledge* in incorporation papers when setting up a local subsidiary to conduct business that the subsidiary is subject to local laws and regulations. However, one goes too far if one signs a contract that *requires* the subsidiary to comply with local law. ◎

Russian Oil Companies Dominate Libyan Tender

by Nabil L. Khodadad, in London

Russian oil companies are the big winners in the latest licensing round for oil and gas rights in 14 contract areas in Libya. The contract areas are divided into a total of 41 blocks.

The contract areas auctioned in the latest round include three in the Cyrenaica basin, two in the Ghadames basin, two in the Sirt basin (Libya's most prolific basin), two in the Murzuq basin, two in the Kufra basin and three offshore in the Mediterranean.

This is the third competitive tender organized by the National Oil Company, or NOC, under its new model exploration and production sharing agreement called "EPSA-4."

Third Round Results

There was keen interest in the third round, with 31 companies submitting bids for the contract areas on offer. Unlike the first round where US companies won, or were in consortia that won, 11 of the 15 exploration areas, or the second round where European companies won 10 of the 23 areas, only one US and only two European companies won (or were in a consortia that won) a contract area in the third round. The Russians were the big winners.

All three licensing rounds have been widely praised for their transparency. As in the first and second rounds, the bids from each bidder in the third round were opened in front of representatives from all bidders.

Libya is expecting the third licensing round to generate about $1 billion worth of exploration activity and to result in significant new discoveries.

The winning bids for the third licensing round are shown in the table. As there were one or no bids for four of the contract areas, the NOC awarded only 10 contract areas. (A more detailed description of the business deal offered by the NOC in the first and second licensing rounds can be found in "Libya Launches Second Exploration Tender" in the June 2005 *NewsWire* and "Asian and European Oil Companies Outbid US in Libyan Tender" in the October 2005 *NewsWire*.)

An important criterion for selecting a winner was the production allocation, or "X factor." The X factor is the percentage of oil production allocated for recovery of the international oil company's costs and for the profit split. The international oil company will receive a percentage of production equal to the X factor until its costs are recovered.

Thereafter, the oil company's share of excess produc- */ continued page 38*

Third Licensing Round Under EPSA-4

Area	Block	Winner	Work Program (2D-km)	Work Program (3D-Km2)	Work Program (Wells)	Production Allocation to International Oil Company (X Factor)	Signature Bonus (USD)
Offshore							
19	1+2+3+4	Gazprom	4,000	2,000	6	10.0%	$10,100,000
20	1+2+3+4	Exxon/Mobil	20,000	1,000	4	22.3%	$10,000,000
43	1+2+3+4	ONGC	1,000	4,000	1	28.0%	$10,000,000
Sirt							
69	1+2+3+4	Tatneft	5,000	750	6	12.0%	$10,000,000
137	3+4	PetroCanada/ Repsol	1,000	500	1	18.0%	$10,000,000
Ghadames							
82	1	Tatneft	2,000	750	5	10.4%	$10,000,000
98	2+4	Tatneft	2,500	500	5	10.4%	$10,000,000
Murzuq							
162	1+2	Chinese Petroleum (Taiwan)	1,600	0	3	7.8%	$5,000,000
113	3+4	Inpex/Mitsui	1,000	500	3	12.9%	$10,000,000
Kufra							
196	2+4	None	N/A	N/A	N/A	N/A	N/A
201	1+2+3+4	Wintershall/Mitsui	3,000	0	1	13.5%	$3,000,000
Cyrenaica							
57	1+2+3+4	None	N/A	N/A	N/A	N/A	N/A
59	1+2	None	N/A	N/A	N/A	N/A	N/A
77	1+2+3+4	None	N/A	N/A	N/A	N/A	N/A
Total	**41**		**41,100**	**10,000**	**35**		**$88,100,000**

Libya

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tion, or "profit oil," is determined in accordance with the following formula: the amount of profit oil multiplied by the "base factor" multiplied by the "A factor." The base factor is expressed as a percentage and can vary with the average daily production of oil. The base factor for oil produced from onshore blocks declines as the average daily production exceeds certain levels, but the base factor for oil produced from offshore blocks, and gas produced from all blocks, is set at a constant 100%. The A factor is also expressed as a percentage and varies with the ratio (commonly known in the oil industry as the "R factor") of cumulative revenues received by the international oil company to its cumulative capital and operating costs. As the R factor increases, the A factor decreases in a manner predetermined for each contract area.

Unlike in the first and second licensing rounds where the X factor was the primary selection criterion, the winners in the third licensing round were selected based on a formula that took into account not only the X factor, but also the amount of 2D and 3D seismic and exploration wells that the bidders committed to carry out in their work programs. The average amount of 2D and 3D seismic work committed by the winners was 4,110 kms and 1,000 kms, respectively, and the average number of wells was 3.5.

The selection formula also took into account the amount bid as a signature bonus, which in the first and second licensing rounds had been used only to break a tie. The total in signature bonuses for all 10 contract areas awarded was $88.1 million, with an average of about $8.81 million per contract area.

Comparison to Earlier Rounds

The results of the latest bidding round confirm the keen interest of international oil companies in Libya. The average winning X factor was about 20.5%. This is similar to the results of the first round where the average X factor was 19.5%, but not as favorable as the second round where the average was 13.2%. However, these are still considered excellent results for Libya. As the X factor just determines the amount of oil available for purposes of cost recovery and the profit split, it understates the take of the NOC and the Libyan government since the NOC is entitled to share in profit oil.

The results of the third licensing round may foreshadow the emergence of Russian companies as key players in upstream oil and gas. With many Russian oil companies harboring international ambitions, we are likely to see Russian companies compete more actively for upstream assets in North Africa, the Middle East and elsewhere.

With the successful conclusion of the first, second and third EPSA-4 licensing rounds, Libya has compiled an impressive track record and confirmed its status as one of the leading destinations for foreign investment in upstream oil and gas. ◎

Mongolian Mining: A Golden Opportunity?

by Rubin Weston and Matthew Hinxman in London, and D. Khand with the Tsets law firm in Ulan Bator

The Mongolian mining industry is at a crossroads.

A new mining law and a windfall profits tax law enacted at the end of 2006 have been widely interpreted as hostile to foreign investment. However, the true impact of these developments cannot be assessed until an investment agreement is concluded between a foreign company and the Mongolian government under the new statutory regime.

Vancouver-based Ivanhoe Mines — one of Mongolia's most successful and, certainly, its most high-profile foreign mining company — is currently negotiating such an investment agreement with the government for the giant Oyu Tolgoi project in southern Mongolia.

The resolution of these negotiations will have a massive impact on the short-to-medium future of the Mongolian mining industry.

Vast Potential

Mongolia has vast potential in unexploited minerals, particularly copper and gold, and over the last 15 years has undergone a period of major political, economic, social and legal reform, moving inexorably from a communist centrally-planned economic system with a Soviet-model legal system to a democratic, market economy founded upon a system of civil law. Significantly, Mongolia has recently become a country of operations for the European Bank for Reconstruction and Development.

The Mongolian minerals sector contributes 20.3% of the country's gross domestic product, accounting for 65.4% of the

country's industrial output and 42.7% of its export revenue. Mongolia has extensive and largely untapped mineral resources, but, owing to poor infrastructure, only about 15% of its total area has been fully mapped to date.

Today, more than 200 foreign and joint venture companies are operating in the Mongolian mining sector. The sector employs more than 39,800 people, which in a country with one of the world's lowest population densities, amounts to more than 32% of the total manpower for the industrial sector.

Mongolia has already yielded world-class deposits of copper, coke and coal, and many analysts predict that significant deposits of uranium, gold, silver, lead and a number of other minerals may also exist.

The jewel in the crown of Mongolia's discovered deposits is the Oyu Tolgoi project in southern Mongolia, which is often credited as being the largest undeveloped copper-gold project in the world. If this project is successfully developed, the GDP of Mongolia could double in a relatively short period of time.

Ivanhoe Mines lists the Oyu Tolgoi project as one of its key assets. Ivanhoe has long-standing operations in Mongolia that include the already-successful Nariin Sukhait coal project in southern Mongolia. Unfortunately for Ivanhoe, there have been growing tensions between it and local interest groups who fear that Mongolian resources are being exploited. Such sentiment was boosted when Ivanhoe's chairman announced to the company shareholders in 2005 that developing a part of the Oyu Tolgoi mine would be akin to making "*t-shirts for five bucks and selling them for $100*"; although Ivanhoe says these comments were taken out of context, they caused a considerable stir in Mongolia.

It is no secret that $303 million has been put up by Rio Tinto for a stake in Ivanhoe (and, therefore, a stake in the Oyu Tolgoi project). An additional amount of up to $1.5 billion has been pledged by Rio Tinto, albeit contingent, in part, upon the conclusion of a satisfactory investment agreement with the Mongolian government in connection with the Oyu Tolgoi Project.

Recent Developments

The full significance of this investment agreement can only be appreciated in the context of recent changes to both law and taxes.

During the late 1990s and early 2000s, Mongolia concentrated its efforts on wooing international investors. A 1997 Minerals Law aimed to do just that and to ensure that the country's mining sector would be competitive at an international level. The 1997 law applied to all mineral resources except water, petroleum and natural gas and aimed to provide for a fully transparent system for the processing of exploration and mining license applications, security of tenure in respect of the licensees' land utilization and for a reduction in the taxation and royalty burden on all investors.

In 2002, royalty payments for all types of minerals were reduced to 2.5% of gross sales and gold mining royalties were reduced from 12.5% to 7.5% for both hard rock and placer deposits.

> Foreign mining companies already operating in Mongolia are waiting to see the terms of the first investment agreement under a new mining law.

Since then, the political climate has shifted. On May 15, 2006 the Mongolian parliament adopted a windfall profits tax that, at a stroke, imposed taxes of up to 68% on mining profits in certain circumstances in the case of gold, when prices exceed $500 an ounce and, in the case of copper, when prices exceed $2,600 a ton. (All figures in this article are in US dollars.) Notably, these thresholds are significantly below the current spot price for both gold and copper.

The passing of this law prompted a unanimous outcry from resident (largely foreign-owned) mining companies. The announcement caused the share prices of many of the resident mining companies to plummet initially. There have been numerous calls for this new law to be abolished.

On July 8, 2006, a revised version of the 1997 law was adopted by the Mongolian parliament that was much less encouraging to foreign investors. The */ continued page 40*

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revised law requires all applicants for mining licenses to be legal persons duly established and operating under the laws of Mongolia and be Mongolian taxpayers, although this does not stop an international investor from setting up a wholly-owned subsidiary in Mongolia.

More significantly, the revised law has also modified the licensing requirements and license transfer procedures. Most notably, it gives the Mongolian government the right to hold a stake of up to 34% in strategic mineral deposits found by privately-funded explorations (*i.e.*, deposits that may have an effect on national security, the economic and social development of the country, or that produce or have the potential to produce more than 5% of the country's GDP in any given year). It is for the Mongolian parliament to determine what constitutes a deposit of "strategic importance."

The revised law also increased royalty rates from 2.5% to 5.0%, although it is anticipated that this may be balanced at some point against a corresponding decrease in corporate taxes and VAT.

While these developments generated some alarmist headlines in the international press, international mining companies, including Ivanhoe, have done much to play down the significance, stressing that the government only has the option of acquiring *"up to"* 34% of such mineral deposits discovered without the use of state funds and that, even if the Mongolian government *did* exercise such an option, it would likely only do so through investment by means of equity participation and by the purchasing of shares or, alternatively, in conjunction with tax concessions.

This, in turn, has led to some dissatisfaction among local interest groups who argue that the revised law does not go far enough and does not provide a proper mechanism for state participation and investment in strategic deposits. Under the revised law, state participation and investment in strategic deposits would be effected by means of an acquisition agreement between the investor and the government.

Local interest groups are lobbying for a further overhaul of Mongolian mining legislation.

Investment Agreements

Under the revised law, investors who undertake to invest more than $50 million within the first five years of their mining operations in Mongolia are eligible to enter into "investment agreements" with the Mongolian government (meaning, in this context, the 'cabinet of ministers') for periods of up to 30 years.

Any investment agreements will cover eight main issues. The issues are the maintenance of a stable tax regime, the sale and export of the products at international market prices, guarantees of the investor's right to dispose of the income gained, the amount and period of the investment, the conduct of mining operations with minimal harm to public health and the environment, environmental protection and rehabilitation, regional development and the creation of local employment, and compensation for any damage caused.

However, this does not mean that the Mongolian government can enter into an agreement with a mining company with a view to insulating the company from Mongolian laws currently in force (such as the windfall profits tax).

It remains unclear exactly how the Mongolian government and investors will deal with the procedure for, and the extent of, the Mongolian government's exercise of its rights to hold a minority stake in strategic deposits pursuant to the revised law. (Presumably, the compensatory regime for any expropriation will feature heavily in negotiations. The Mongolian industry and trade minister, Mr Jargalsaikhan, said recently that the Mongolian government would not "confiscate" a share of mining projects, but rather would obtain a stake on a commercial basis, through agreement, although no details are available as to how such an agreement might be concluded, nor how the process would be managed in the event of a deadlock in negotiations.

Ivanhoe Mines is optimistic that an investment agreement will be concluded for the Oyu Tolgoi project shortly. If this is the case, then it will represent the first such agreement entered into under the revised law and since enactment of the windfall profits tax. Hence, the terms of any such investment agreement will be hugely influential for the short-and-medium-term development of the Mongolian mining sector. The apparent success of the initial stages of this project could be a green light for other western developers to get involved in mining initiatives in Mongolia, encouraged by the combination of a resources-rich country and an acceptable legal and regulatory regime.

Mongolia is a country to watch in 2007. ◎

Environmental Update

The US Supreme Court decision in early April confirming that the US government has legal authority to regulate greenhouse emissions from new motor vehicles could lead eventually not only to federal regulations on auto emissions, but also on greenhouse gas emissions from power plants.

The court held in a 5-4 decision that the Clean Air Act requires the Environmental Protection Agency to regulate air emissions from new classes of vehicles or engines that "in [its] judgment cause, or contribute to, air pollution which may be reasonably be anticipated to endanger public health or welfare." The case is *Massachusetts v. EPA*. The court released its decision on April 2.

In a separate decision released the same day, the court sent back to a federal appeals court a case that Duke Energy won before the appeals court. The lower court had said Duke did not need a permit from EPA under the prevention of significant deterioration, or "PSD, program before making changes to some of its coal-fired power plants that extended the life of the plants and increased their electricity output. The appeals court held that none of the changes was significant enough to be a "major modification requiring a permit." The Supreme Court said the lower court improperly reconciled the definitions of modification used in the "new source performance standard" and PSD programs. The case is *Environmental Defense v. Duke Energy*. The appeals court has been instructed to consider the issues further.

Climate Change

The debate over what to do about global warming has begun in earnest in Congress. Four bills are competing for attention. Most observers do not expect final action on a plan this year, but the broad outlines of a plan are starting to take shape.

Each of the four bills has a common element: it relies on a "cap-and-trade" scheme to limit emissions.

Otherwise, the bills differ in greenhouse gas emissions targets, how fast the emissions reductions would be achieved and how greenhouse gas emissions allowances would be distributed.

No discussion of possible action on global warming at the federal level is complete without noting that many states have been moving to control greenhouse gas emissions without waiting for the federal government to act. Five states on the west coast (Washington, Oregon, California, New Mexico and Arizona), eight states in the northeastern US (Massachusetts, New Hampshire, Vermont, New York, Connecticut, Massachusetts, New Jersey, and Rhode Island) and Illinois have already set their own greenhouse gas emissions targets. Illinois has set a goal of reducing greenhouse gas emissions to 1990 levels by 2020. The eight northeastern states are moving to set up a regional cap-and-trade system for trading in carbon dioxide or CO_2 emissions called the "regional greenhouse gas initiative," or RGGI.

Turning to the main competing proposals in Congress, one of the main bills is a Lieberman-McCain proposal in the Senate. (The chief sponsors are Joseph Lieberman (I-Connecticut) and John McCain (R-Arizona).) The bill, S.280, would restrict greenhouse gas emissions from electrical power, transportation, industrial and commercial sectors that emit more than 10,000 metric tons of CO_2 equivalents a year. The bill defines a "covered entity" that would have to limit its emissions as one that

(A) owns or controls a source of greenhouse gas emissions in the electric power, industrial, or commercial sectors of the United States economy . . . refines or imports petroleum products for use in transportation, or produces or imports hydrofluorocarbons, perfluorocarbons, or sulfur hexafluoride; and

(B) emits from any single facility owned by the entity, over 10,000 metric tons of greenhouse gas per year, measured in units of carbon dioxide equivalents, or produces or imports—

 (i) petroleum products that, when combusted, will emit,

 (ii) hydrofluorocarbons, perfluorocarbons, or sulfur hexafluoride that, when used, will emit, or

 (iii) other greenhouse gases that, when used, will emit, over 10,000 metric tons of greenhouse gas per year measured in units of carbon dioxide equivalents.

The bill would set a cap on carbon dioxide equivalent emissions starting in 2012. Starting in / *continued page 42*

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2012, a covered entity would have to have an allowance for each metric ton of carbon dioxide equivalent emissions that it emits. For producers or importers of petroleum products and other chemicals, allowances would be required for the carbon dioxide equivalents that their products will emit in the US.

The bill would direct EPA to decide how to allocate allowances to covered entities and to a new Climate Credit Corporation (for auction).

The broad outlines of a plan on global warming are starting to take shape in Congress.

The allowances would be tradable. The bill would set the total number of annual allowances at 6,130 million metric tons in 2012, but this figure would be reduced by the projected emissions that year from non-covered entities. The number of allowances would steadily decrease. It would fall to 2,096 million metric tons by 2050 (again reduced by emissions that year from non-covered entities). Covered entities could also use pre-certified international emissions credits, approved reduction projects in developing countries, domestic sequestration or reductions from non-covered entities.

The companion to the Lieberman-McCain bill in the House is H.R. 620. There are differences between the Senate and House versions. One difference is that the House bill calls for a sharper reduction in greenhouse gas emissions. The US cap on emissions would be 6,150 million metric tons in 2012 but would fall to 1,504 metric tons in 2050.

A separate Senate bill sponsored by Senator Bernard Sanders (I-Vermont) and cosponsored by Barbara Boxer (D-California) would give EPA the discretion to establish a program to reduce greenhouse gas emissions, but specifically directs EPA to limit emissions from power plants and automobiles. Boxer is chairman of the Senate Committee on Environment and Public Works. The Sanders bill has a goal of capping greenhouse gas emissions at 1990 levels by 2020, but it would then move to reduce emissions by 80% from 1990 levels by 2050.

Starting in 2015, the bill would require certain emission standards from power plants that began operation after 2011 and were intended to provide electricity at a "unit capacity factor" of at last 60%. All power plants would be required to meet certain standards by December 31, 2030 regardless of when they began to operate. In addition to these requirements, the proposal would require power plants that

(A) ha[ve] a rated capacity of 25 megawatts or more; and

(B) ha[ve] an annual fuel input at least 50 percent of which is provided by coal, petroleum coke, lignite or any combination of those fuels

to provide a minimum amount of their base quantity of electricity in specified calendar years from low-carbon generation. Under the proposal, this requirement would begin in 2015 and steadily increase the required percentage of low-carbon generation. Compliance with low-carbon generation could be achieved through the use of low-carbon fuels, the purchase of electricity generated through the use of low-carbon fuels, the purchase of low-carbon credits or any combination of the above. .

A third serious proposal in the Senate is a bill, S. 317, sponsored by Senators Diane Feinstein (D-California) and Thomas Carper (D-Delaware). The bill would regulate power plants with nameplate capacities greater than 25 megawatts that combust greenhouse gas-emitting fuels and generate electricity for sale.

The bill would also move to stop power companies from rushing new coal-fired power plants using conventional pulverized coal technology into service. Under this proposal, coal plants entering operation after January 1,

2007 would not receive free allowances unless the coal plants used clean coal technologies.

The bill would set emissions caps. From 2011 to 2014, the cap on emissions from affected power plants would be the total emissions in 2006. The cap would fall to the 2001 level of emissions starting in 2015 and for the next four years through 2019, it would decrease by 1% a year. Starting in 2020, the cap would decrease by 1.5% a year.

Under the bill, a set percentage of annual allowances would be allocated and a set percentage would be auctioned with a move over time to annual auctions of all the allowances. Allowances would be allocated based on the amount of generated electricity. The bill would also provide limited credit for certain early greenhouse gas or sequestration reduction measures, going back as far as reductions achieved in 2000. In addition, recognition may be accorded to international credits, use of other greenhouse gas trading programs and a system proposed for the use of offset credits for greenhouse gas reduction land-use sequestration projects.

In addition to these three bills, Senators Jeff Bingaman (D-New Mexico) and Arlen Specter (R-Pennsylvania) released the draft text of a bill soliciting comments. Bingaman is chairman of the Senate Energy Committee. The proposed bill would apply to coal, petroleum products, natural gas, natural gas liquids, and "any other fuel derived from fossil hydrocarbons (including bitumen and kerogen)." Allowances would be distributed to both industry and the states. An increasing percentage of allowances would be auctioned as the overall number of the allowances is reduced over time. For example, in 2012, 10% of the allowances would be auctioned (with 55% of that 10% allocated to industry and 29% to the states). In 2021, 20% would be available for auction (with 45% of that 20% allocated to industry and 29% to the states). The bill also proposes a "safety valve price" that would cap the cost required to emit a metric ton of carbon dioxide equivalent. Under the proposal, allowances would be provided based on the carbon content of a facility's fuel.

In order to predict what type of legislation Congress might fashion, it is important to look past the halls of Congress and into the US at large. There is an increasing clamor from both industry and environmental groups for legislation. Action on global warming is inevitable. Many companies would rather know sooner than later what will be required of them. In addition, some companies feel they would be better off with a climate change bill enacted this year or next while Bush is still president than with a Democrat in the White House.

One large industry group pushing for action is the United States Climate Action Partnership, or "USCAP." Its members include Alcoa, BP America, Caterpillar, Duke Energy, DuPont, Environmental Defense, FPL Group, General Electric, Natural Resources Defense Council, the Pew Center on Global Change, PG&E Corporation, PNM Resources and the World Resources Institute. USCAP advocates an economy-wide federal cap-and-trade program covering as many greenhouse gas emissions as politically and administratively as possible. It recommends a system of free allowances, at least in the initial stages of a program, and emission offsets (through domestic sinks and sources not subject to a cap or projects outside the US), as well as credit for reductions made in anticipation for any mandatory greenhouse gas program. The group proposes going as far back as 1995 as long as eligibility for any credit was based upon accurate data.

The US record with the sulfur dioxide and nitrogen oxide emission reduction programs that were enacted in 1990 suggests that cap-and-trade programs work. There are two main approaches for carbon controls — a tax on carbon or cap and trade. While there have been calls outside Congress for a tax, there seems little support for a new tax on Capitol Hill. Cap and trade is a strong early favorite. All the major 2008 presidential candidates — including John McCain (R), Hillary Clinton (D) and Barack Obama (D) — have gotten behind cap-and-trade proposals. USCAP also favors that approach.

Congressional leaders have set a goal of completing action on climate change legislation before the presidential election in 2008. Many interesting issues will have to be settled by then, including what limits to impose on emissions, what types of facilities to subject to a cap, how to distribute allowances, whether to "grandfather" existing power plants that are locked into long-term contracts to sell their electricity at fixed prices and whether existing state programs will remain intact.

The Bush administration has acknowledged the need for action on global warming, yet President Bush remains adamant that he will veto legislation implementing a cap-and-trade system. He believes */ continued page 44*

Environmental Update

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only in voluntary action. However, the President signed an executive order in late January establishing renewable energy benchmarks for federal agencies. The order requires federal agencies with fleets of 20 or more motor vehicles to increase non-petroleum based fuel consumption 10% a year compared to a 2005 baseline.

Various climate change litigation theories such as "common law nuisance" have been attempted in the courts in an effort to force local companies to reduce their emissions. An example is *Comer v. Murphy Oil*, a case last year in Mississippi where claims were brought against oil and coal companies for the damage caused by Hurricane Katrina. Although the full ramifications of the US Supreme Court decision on April 2 in *Massachusetts v. EPA* remain to be seen, the impact of this decision, along with the threat of more litigation, are additional factors that will force the federal government to act. As long as there remains a vacuum at the federal level, states and citizen groups will try to take matters into their own hands. The result is a patchwork of controls that vary across the country.

Some utilities are not waiting for the federal government to act and are moving vigorously to invest in wind farms, solar and other forms of renewable energy. Other companies have engaged in voluntary carbon emission trading on the Chicago Climate Exchange or have already completed carbon emissions inventories, implemented reduction strategies and even started drafting contract templates in anticipation of emissions allocation trading.

IFC Standards

The International Finance Corporation issued 10 new environmental, health and safety guidelines for public comment in early February. The new guidelines set minimum standards with which the following types of projects will have to comply before the IFC will provide financing: liquefied natural gas facilities, nitrogenous fertilizers, health facilities, pharmaceuticals and biotechnology manufacturing, oleochemicals manufacturing, natural gas processing, coal processing, forest management, integrated steel mills and foundries.

The IFC guidelines are important because they establish benchmarks that commercial banks also tend to follow.

The new guidelines supplement 39 other industry guidelines the IFC issued earlier. The earlier guidelines cover such sectors as wind farms and geothermal projects.

— contributed by Andrew Giaccia and Sue Cowell in Washington.

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