

## DOE Loan Guarantees

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the DOE to declare as broad programmatic policies positions that were developed for the first project to pose the question. That can work well enough where what matters is that the program has a clear and consistent standard. Then one can plan appropriately. The fact that DOE now knows how it wants to approach a quite wide range of potential issues helps explain the quicker pace at which term sheets are currently being negotiated. The down side is that the program's emergent policies are at risk of being inappropriate for projects that pose similar questions in dissimilar contexts. It can be an uphill climb, and time-consuming, to persuade DOE that a predetermined policy is inappropriate in fresh circumstances.

Such growing pains are inevitable in a new financing program, but, for applicants trying to find workable terms, it can be challenging to be on the receiving end of new and unexpected policy pronouncements. An important judgment call in negotiating term sheets and final documentation is when to accept DOE policy requirements as just that—requirements that must be accommodated—and when to push back on putative policies as inappropriate for a given project. The good news there is that the loan programs office is well staffed with project finance professionals. They may not be able to address all your concerns, but they will at least understand them, which is half the battle.

### A Final Note

Applicants under the commercial manufacturing solicitation will benefit from that solicitation's correction of some issues that plagued prior solicitations. Most importantly, unlike the FIPP, this solicitation permits direct borrowing from the Federal Financing Bank, an arm of the US Treasury, opening the way to attractive rates and minimizing the transaction costs of structuring a co-financing between the DOE and one or more commercial lenders. On the other hand, perhaps appropriately given the challenges of financing manufacturing projects, DOE has stepped away from presuming a limited recourse project financing model and notes a preference for projects that contemplate "full recourse to the balance sheet of the Applicant and/or a full guarantee from the Project Sponsor, a credit-worthy parent or a third party acceptable to DOE." ©

# California Cap-and-Trade Program Takes Shape

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A cap-and-trade system for controlling greenhouse gases that the California Air Resources Board adopted on December 16 is expected to affect all GHG-emitting power plants in the state as well as companies that import power from other states for sale in California.

As this article went to press, the board—called "CARB"—had not yet published the final adopted resolution. Also, CARB staff will be developing important details of the cap-and-trade program over the next several months. Nevertheless, the broad outlines of the program are already clear enough to be able to comment on the effect on electricity generators.

The cap-and-trade system is one of the key tools CARB will use to meet strict greenhouse gas emission reduction targets that California set for itself in Assembly Bill 32. Under AB 32, California must reduce its GHG emissions to 1990 levels by 2020 and begin work toward a longer-term goal of reducing GHG emissions by 80% by 2050.

CARB expects more than 25% of the 2020 emissions reductions to come from the cap-and-trade system.

CARB expects additional emissions reductions (16% of expected 2020 emissions reductions) from a recently-adopted "renewable electricity standard" that requires both investor-owned and municipal utilities to supply 33% of their loads from renewable resources by 2020.

CARB will also rely on a massive expansion of end-use energy efficiency, GHG emissions standards for light-duty vehicles, a low-carbon standard for transportation fuels and a number of other programs to reduce GHG emissions to the levels required by AB 32.

### Program Overview and Scope

The cap-and-trade program creates "allowances" for emitting greenhouse gas emissions, with the overall number of allowances being reduced each year. Each allowance represents the equivalent of a metric ton of CO<sub>2</sub> emissions.

"Covered entities" that are subject to the program must

have allowances equal to the difference between their GHG emissions and any allowed offsets.

As the cap on the overall supply of allowances declines, the cost of allowances should increase, making emitting greenhouse gases more expensive. This, in theory, will provide covered entities with an economic incentive to improve operating efficiency or otherwise reduce emissions.

As presently structured, starting in 2012 so-called “first deliverers” of electricity (such as generators located in California or entities that sell imported electricity in-state) and certain large industrial facilities will be covered entities unless they receive exemptions from the cap-and-trade program. In 2015, the cap-and-trade system will expand to cover distributors of transportation fuels, natural gas, and other fuels. When the new covered entities join the program in 2015, the overall cap on GHG emissions will increase to accommodate the expanded program scope.

Entities that emit less than the equivalent of 25,000 metric tons of CO<sub>2</sub> per year are exempted from the cap-and-trade program. Exempted entities, such as low GHG-emitting renewable generators, may participate on a voluntary basis.

## Mechanics

CARB will distribute allowances for free to certain covered entities.

Covered entities that do not receive from CARB enough free allowances to cover their emissions must purchase allowances from other entities. CARB will hold annual auctions at which covered entities can purchase allowances.

To reduce the cost of purchasing allowances, covered entities may use offsets to reduce the quantity of allowances needed for compliance by up to 8%. CARB defines offsets as the reduction or removal of GHG emissions not covered in the cap-and-trade program. CARB will closely scrutinize any offsets used by covered entities to ensure that the offsets are legitimate.

The cap-and-trade program is not expected currently to provide any free allowances to electric generators. However, CARB has instructed its staff to continue to consider whether it should provide free allowances to certain generators that are unable to pass the cost of allowances to their offtakers. CARB expects that these details will be worked out by July 2011.

It is expected that electricity costs will increase as generators pass along their allowance costs to their offtakers or as the utilities purchase greater levels of renewable resources under the renewable energy standard. / continued page 14

credits are for 30% of the project cost. They are claimed on the cost of new equipment used to equip a factory that makes products for the new green economy.

However, a company risks losing the credits if there is a significant change from what it told the IRS it planned when applying for the credits. The IRS national office said in an internal memo written in April 2010, but not released until December 30, that companies are asking lots of questions.

Responding to the two most frequent questions, it said the credits are not at risk if the rights to the credits are transferred to a “successor in interest” to the project, including in a sale leaseback of the factory equipment within three months after it is first put into service, but what happens if the project changes location is more difficult. It said the issue when a company decides to put the factory some place else is whether that would have caused the US Department of Energy, which helped review the applications for tax credits, not to have chosen the company’s project. It said the Department of Energy has promised to give a view on proposed changes on an “expedited basis.”

*The IRS has suggested privately that a company should compare the unemployment rates in the counties where the original project was supposed to be located and where it has been moved. If the unemployment rates are comparable and the number of jobs created in the new location is the same or greater than in the old location, then the relocation should normally not be a problem.*

**BRAZIL** took steps in December to stimulate the provision of long-term capital to infrastructure projects.

The country is host to the soccer World Cup in 2014 and to the summer Olympics in 2016.

It eliminated a 15% withholding tax at the border on interest that domestic borrowers pay to foreign lenders, provided the loans have an “average life,” calculated / continued page 15

## Cap and Trade

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The cap-and-trade program will provide no-cost allowances to the state's investor-owned and municipal utilities. The investor-owned utilities must sell their free allowances in the annual CARB auctions and use the proceeds from these sales for specific actions to help mitigate costs of the GHG program to their customers. If the investor-owned utilities' own power plants need allowances to comply with the requirements of the cap-and-trade program, the utilities must purchase these allowances in the CARB auction; they cannot use their free allowances for program compliance. Municipal utilities have the option either to sell their allowances in the CARB auction or to use them to cover the allowance requirements for their own power plants.

### Costs and Cost Control

It is hard to predict how much allowances will cost. The California Public Utilities Commission has proposed using three different allowance price forecasts in its current long-term procurement proceeding, with allowance prices in 2020 ranging from \$32.44 to \$54.06 per ton (see Table 1).

**Table 1: GHG Allowance Prices Assumed by the CPUC (in nominal dollars per metric ton)**

Year	Low Carbon Price Estimate	Base Carbon Price Estimate	High Carbon Price Estimate
2011	0	0	0
2012	10.00	10.44	13.05
2013	13.37	17.83	22.29
2014	15.81	21.08	26.35
2015	18.26	24.35	30.44
2016	20.93	27.91	34.89
2017	23.62	31.49	39.36
2018	26.53	35.37	44.21
2019	29.47	39.29	49.11
2020	32.44	43.52	54.06

While CARB cannot directly control allowance prices in its auctions, it does have ways to try to influence the price, if needed.

To ensure that allowance costs are not so low that they

provide little incentive for covered entities to reduce their GHG emissions, the cap-and-trade program has a floor price for allowances sold at auction. This floor price starts at \$10 per metric ton of CO<sub>2</sub> and increases each year at inflation, as measured by the Consumer Price Index, plus five percentage points.

To prevent costs from rising too high, CARB will hold a certain number of allowances in reserve (123.5 million allowances out of 2.7 billion allowances issued through 2020). CARB will use these allowances to increase market supply if allowance prices spike at auction. Some stakeholders are worried that the proposed reserve will not provide adequate protection against high prices.

CARB also established other rules to give covered entities an opportunity to control the cost of compliance. Covered entities can buy their allowances up to three years at a time rather than annually, and they may bank allowances in excess of their compliance obligation in the event that lower-cost allowances become available. They may also use offsets in place of allowances to meet up to 8% of their compliance obligations. Since offsets are expected to cost less than allowances, this could reduce overall compliance costs for some entities.

### Interaction with Regional Program

The CARB cap-and-trade program is the first mandatory cap-and-trade program in the western United States, but it has not been developed in a vacuum.

California has been an active participant in the Western Climate Initiative or "WCI," a cooperative effort to reduce GHG emissions on a regional basis. California's rule development schedule is being coordinated with the WCI timeline for development of a regional cap-and-trade program.

In order to enable trading across jurisdictions, WCI has proposed a number of program elements that CARB has included in its cap-and-trade program, such as allowance banking, limited offsets, three-year compliance periods and auction floor prices. These linkages will allow California entities to trade allowances freely with entities covered by cap-and-trade programs in other WCI partner jurisdictions. It is currently expected that California entities will have trading partners in four WCI partner jurisdictions in 2012: New Mexico, British Columbia, Ontario and Quebec. CARB is working with five other states and one other Canadian province that are planning cap-and-trade programs that will not be operational until after 2012. ☺

## Environmental Update

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lines for existing facilities by July 26, 2011 and finalize the standards by May 26, 2012. EPA has said that it is unlikely that existing facilities would need to reduce greenhouse gas under any such new source performance standards until 2015 or 2016. Owners of many existing power plants may determine that it is not economical to comply with the new standards.

### Clean Air Act New Source Review

Setting aside possible closures resulting from implementation of any new source performance standards, many fear that implementation of the tailoring rule and BACT for controlling greenhouse gas emissions will accelerate closures of coal-fired power plants across the country.

Even if such plants are not planning any modifications that would trigger the need to get a new permit under the tailoring rule, EPA and citizens groups may force shutdowns by pursuing new source review program violations.

Certain plant modifications that are considered major trigger review under the new source review program and may require adoption of new pollution control measures. Even though these modifications may have been made years ago, EPA can require facilities to comply with current BACT even if the modifications that were made many years ago would have triggered a less stringent BACT.

If new source review violations are found, it may make economic sense to close a plant rather than install a new BACT. For example, in May 2010, American Municipal Power announced that it would permanently retire its coal-fired power plant near Marietta, Ohio under a settlement to resolve violations of the new source review program. As part of the settlement,

American Municipal Power must pay a civil penalty of \$850,000 and spend \$15 million on an environmental mitigation project. The settlement resolved allegations that certain work performed at the facility during the period 1981 to 1986 (before American Municipal Power even had an interest in the facility) and during the period 1988 to 1991 (after American Municipal Power had an interest in the facility) triggered the new source review program.

Although EPA will continue targeting investor-owned utilities for new source review violations, it now appears to be moving on to state- and municipally-owned utilities. It has been reported that dozens of Clean Air Act section 114 letters were sent to state- and municipally-owned utilities in Wisconsin and Ohio in December. Section 114 letters ask for information about past modifications at a facility and are considered by many to represent the start of an enforcement action.

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