Political and Regulatory Risk—The U.S. Challenge

Michael J. Zimmer
Baker & McKenzie
Washington, DC

The independent power (IPP) industry faces the highest dimension of political risk, regulatory uncertainty and market challenges in its brief dynamic history over the next five years. A number of key market issues in the U.S. driven by regulatory changes are pending for resolution impacting the long term health and performance of the industry.

Originally, the industry was spawned by the provision of strong regulatory and tax incentives to promote successful non-utility generation and development. These initial inducements were overtaken by the forces of competition and project development through the provision of regulatory market supports, competitive bidding and least cost planning at the state level.

Finally, competitive market forces were in control during the past decade as power matured into more of a commodity industry with price (through marketing and trading) becoming the critical arbiter of service. **This created the current transitional environment in the U.S. in which regulatory risk is at the largest level the industry has faced in its brief history. When converged with the threats of overbuilding and plummeting asset valuations, the combination, until 2005, could be deadly.**

Frequently, IPP developers have faced regulatory risk and its consequences in the development of international projects during the past decade. Special forms of political risk insurance coverage and supportive government programs have been established to manage the volatility and uncertainty associated with the political and regulatory dimension of project development in international markets.

However, political and regulatory issues loom large for future development in the U.S. The imposition of new patterns of regulation raise concerns in several critical areas. These risks cannot be managed through political risk insurance in the U.S. but will require transmission

system management, contracting risk management, technology, sophisticated counsel, and market intelligence techniques to avoid generation ownership disasters. Key regulatory considerations include:

- SO_x and NO_x regulations and the impact of implementing new requirements of the Clean Air Act and regulation of precursor emissions for NO_x and ozone in a 22-state region. Emissions trading and credits will be part of the solution.

- The prospect for new **World Trade Organization** (WTO) regulation impacting foreign companies entering the US marketplace and the reciprocal treatment of US companies as they pursue the next phase of international project energy marketing and trading and energy services. Knowledge and active participation are required to remove and avoid artificial market barriers.

- New incentives to provide emissions credits to implement on a market basis the impact of the Kyoto Accords and drastic reductions in emissions to enter world and global compliance by the year 2010. Contracting and financing techniques are in the process of emerging.

- New FERC forms of regional regulation, regional transmission organizations and the prospect for impacting new forms of concentrated service for transmission in the future. This is just an interim step before the final end game, while managing new layers of regulation, pricing dysfunction and jurisdiction.

- Regulatory approvals for mergers creating new generation concentration in the marketplace whereby 20 companies are forecast to control 75% of the generation, and 10 companies will control 80% of the gas and power marketing and trading in the near future. The pricing, competition and market concentration impacts are yet to unfold.

- The lack of standard tariff requirements governing interconnections on individual systems and regional transmission organizations. These negotiations have emerged as the next major tool for market disruption and delays, along with standby and backup

power rates. Interconnection and standby power procedures must be streamlined, standardized, and timely posted in public tariffs to eliminate market concerns. Experienced management of these issues is critical.

- Generation imbalances on energy and capacity as a critical issue is emerging nationwide. How generation imbalances are monitored and measured, and the cost for imbalance services, is arising with frequency in the Southeast and Southwest. Behind-the-meter generation issues are also appearing in New England and Texas.

- EPA regulations under the Clean Water Act could change how states manage water quality and set discharge limits for power plants and other facilities. This needs to be anticipated with knowledgeable environmental counsel.

- EPA is considering that new and significantly expanding discharges along certain critical bodies of water will need to obtain offsets for 1.5 times their increased discharges. This proposal would disfavor new projects, and repowering projects and could harm plant acquisitions and divestitures.

- Dispersed generation faces an array of regulatory burdens from regulated utilities, thus impeding its success. The next five years will be critical for its ultimate success or failure.

- Particulate and air toxic regulation will impact generation facilities within the next five years. Impacts could be more harsh on new projects, repowering facilities and new plant acquisition strategies.

- Changing state tax policies (because of utility restructuring compounded by the Internet tax debate) are pending. The fiscal impacts and possible changes in strategies and asset management are still being devised.

- E-commerce will impact pricing, jurisdiction and tax treatment of energy transactions. These matters are just being discussed.

Knowledge and experience will ensure the proper management of

these regulatory issues. Management will require development of increased asset development and management skills built around:

- regulatory market knowledge
- increased knowledge of transmission systems and ISO procedures
- impacts of these regulatory considerations on the private sector's site/market selection and asset management
- environmental regulation strategies shaping technology options and deployment
- use of partnerships and alliances to better manage regulatory risks and unique financial risks
- capacity operational efficiencies and opportunities
- managing the impacts of price capping in certain markets i.e., California, PJM and NEPOOL
- state tax planning

Owners, operators and developers without this focus own generation assets at their peril. When regulatory and political risks converge with the specter of overbuilding, plummeting asset valuations, and weak O&M capabilities and technology deployment, the combination could be deadly for industry stability, project economics, and reliability. Pro formas and economic models and forward curves do a poor job of modeling panic. Artificial regulatory intervention, asset hoarding, asset dumping and volatile manifestations of market behavior will evolve in the future.

Managing the dynamic of political and regulatory risk is a major U.S. market challenge and opportunity for the future. Otherwise these forces may be converging to make power failure and reliability the next major energy crisis.

ABOUT THE AUTHOR

Michael J. Zimmer is a partner in the Washington, D.C., office of Baker & McKenzie, specializing in U.S. banking, finance and major projects.

He has represented energy concerns for over 20 years in matters before the Department of Energy, the FERC, the SEC and Congress. He has represented domestic and international industrial and manufacturing companies, electric utilities and their unregulated subsidiaries, energy project developers, natural gas pipeline and distribution companies, trade associations, financial institutions, universities, and embassies in over 30 states and 15 foreign countries. Since 1977, he has been an invited witness on various energy and energy tax proposals before Congressional committees, various federal departments and agencies, and state commissions and agencies. Mr. Zimmer has been involved in several mergers, acquisitions and project financings in the IPP industry including some of the largest undertakings in the United States. He has also been responsible for major precedents before the FERC involving issues under the Federal Power Act, PURPA, the Natural Gas Policy Act and PUHCA.

Mr. Zimmer is a member of the Bars of the District of Columbia and Virginia. He is a member of the American Bar Association Natural Resources and Public Utility Law Sections, and the Federal Energy Bar Association (FEBA).

Baker & McKenzie, 815 Connecticut Avenue, NW, Washington, DC 20006-4078; (t) 202-452-7000; (f) 202-452-7074.