

# The Effect of Regulatory Issues on Power Financing Plans

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## INTRODUCTION

As a result of deregulation, the power industry is enmeshed in a new and complex undertaking. It is seeking opportunities from both traditional corporate managers and entrepreneurs, who themselves are still trying to anticipate the future market impact of regulatory developments.

They in turn are dealing with an environment where politicians are still getting a fix on which such developments really will be beneficial to them; regulators, concerned with the public interest, are just realizing what it will take to pick up the pieces; and a few canny players are tipping the regulatory board toward their market advantage.

Under these circumstances, we should look at the probably most active business strategies and supportive financial trends and, then to consider, what emerging political and regulatory developments are likely to be of most importance in that context. By doing so, perhaps we can extract some general guidelines as to how to evaluate the significance of developments as they emerge.

## THE BUSINESS STRATEGIES

Key financial opportunities must be identified which are associated with each of the several categories of players in the power market.

The ones clearly presenting opportunities are the traditional utilities, the market niche entrepreneurs, and the emerging mega players. Each has key business strategies requiring financial support.

### **Traditional Utilities**

For traditional utilities, three key core strategies, with many variants on themes, are those that:

- Sell off existing assets, and becoming transmission and distribution companies—possibly of multiple energy resources through energy trading or other entry into other end user markets through acquisitions or alliances.
- Make possible these approaches by providing a financial balance wheel for transition by securitizing stranded generation assets not capable of competing in the new environment.
- Seek to broaden market presence in selected competitive areas through mergers or large scale strategic joint ventures, and continued control of transmission and distribution facilities.

### **New Market Entrants**

By contrast, new entrants into markets for generation, either to fill perceived niches (cleared by the fall of non-competitive older assets or to backstop power market trading) have followed variants on the following themes:

- Developing new merchant facilities selling into the grid.
- Repowering newly acquired existing facilities or upgrading existing sites.
- Reexploring the “make vs. buy” decision by industrials which previously have served themselves.

### **Mega Energy Companies**

The emerging mega energy and service companies, seeking to differentiate themselves from geographically linked utilities, have pursued the following strategies, among others:

- Volume competition in fuel and electric trading in the power marketing field.
- Provision of major aggregation services to public power and not-for-profit institutions.
- Financial transaction profit through trading and ultimately through securitization.

## REGULATORY ISSUES

It is useful think about regulatory issues, first, in terms of how the crosscutting general themes will affect different competitors, and then what the specific issues which make up those themes are.

### **General Themes/Relationship to Legislation**

The general regulatory themes which impact realization of these respective strategies are somewhat different. While they overlap, they should be recognized for their impacts on different strategies and therefore on different players.

Basically, these regulatory themes may be categorized as follows:

- Economic Profile. Those which sort out the treatment of stranded costs through securitization or otherwise, and thereby mold the economic profile of the market, and ability of the players to profit from it, in the near term.
- Operating Profile of Markets. Those which impair certainty as to the future operating profile of the regulatory market and therefore increase project risk and also make some form of securitization-based project finance more difficult.
- Network Integration—Introduction of Price Transparency. Those which prevent the kind of broad gauge national network and market integration necessary for mega energy enterprises to grow rapidly.

It is more useful to focus on these developments than on major Federal legislative possibilities which could sweep across the board and

modify the relative attractiveness of all strategies, such as mandatory introduction of retail ratemaking; abolition of PUHCA; implementation of new environmental initiatives. Keyed to global warming, their time, if any, of occurrence and their form is at best currently problematic. What we can be sure of is that whatever form they do assume will take into account the key ongoing regulatory trends which are summarized below.

### **Specific Regulatory Issues**

The specific regulatory issues—which drive these general themes—to be played out in significant measure outside the regulatory arena are the following: (1) permissible scope of mergers and other exercises of market power; (2) feasibility of regulatory asset securitization; (3) creation of orderly power purchase and transmission markets; (4) limitations on convergence of deregulated utility enterprises and (5) restructuring of the municipal and cooperative power markets.

- (1) Mergers and Other Exercises of Market Power. All strategies of traditional investor owned utilities have hanging over them concerns regarding impropriety of utility exercise of market power, even after functional disaggregation of the basic services to be provided by them. Thus, we are increasingly seeing rejection of projected mergers or participant withdrawal from such proposed mergers, under regulatory and consumer fire.

A great deal of State regulatory attention has been and is likely to be focused on whether, as a result of mergers or other activity, undue market power may be exercised; barriers to entry may be created; and whether there will be satisfactory mitigation of the exercise of market power.

Unlike Federal regulators, State and local regulator concerns include attempts to identify and allocate merger related savings and to maintain quality of service and to continue involvement in the community, rather than focusing on overall goals of restructuring as Federal regulators do. These trends may be seen both in mergers that have not gone through like Northern States-Wisconsin Electric; ones that have like Union Electric—CIPSCO; and ones that have been abandoned, e.g. PEPCO-BG&E.

At the FERC level, there has been acceptance of Justice Department guidelines-based analysis of whether industry consolida-

tion or concentration of market power comports with federal goals for electric deregulating and restructuring. Recently the Justice Department has taken to lecturing the FERC that structural issues should not be addressed by palliative consumer benefit type measures.

More recently, FERC has indicated that it proposes to publish a Notice of Proposed Rulemaking aimed at improving its interface with Federal merger regulatory agencies (as well as with federal environmental initiatives).

It may be expected that this point of view will find its way into more decision making, and that less regulatory credence may be given to formulaic market mitigation measures which assume that the theoretical presence of competition equates to the reality its existence.

An initial example of this trend, which may affect future utility generation strategies, is a FERC Order which requires utilities that wish to charge market-based rates for ancillary services such as reactive power to provide separate economic analysis showing lack of market power in each service.

In short, utility restructuring into different forms of generating entities through M&A may become more problematic, i.e. there may not be as many contiguous blocks of regional mega-utilities, as some experts have predicted. Whether the blockbuster, non-contiguous mergers, such as that between CSW and AEP, actually will be consummated also remains to be seen. It will be a function in part of the way in which operational future system integration will be addressed.

The treatment of market power clearly affects not only utilities, but also the new mega energy companies now competing on a national basis whose strength will be evaluated regionally, and the developmental entities trying to wrest market share away from them.

- (2) System Integration. Strategic implementation by all players is clouded as well by the disordered state of the market. For example, affecting the ability of private parties to rely upon the new deregulated markets to support new merchant plants will be the rapidity with which both independent system operators (ISOs) and viable power exchanges (PXs) can be established in parallel, notwith-

standing the slow state-by-state unfolding of retail deregulation.

The split between the dispatch and the market price setting mechanisms in California has yet to be subjected to market shake-down. The prospect of additional power exchanges being established is still a matter of regional determination. Transparency of prices over large market areas is necessary to facilitate both merchant plant development and the success of new acquisitions, since, the key issue is the extent to which forward price risk may jeopardize future sales. It affects the extent of mitigation.

Remaining to be sorted out by FERC on a basis that facilitates merchant plants is the treatment of transmission pricing so as not to be effectively discriminatory against private generators. Evaluating issues of constraint pricing on the transmission system will impact the attractiveness of different plant locations, and will affect the market power issues. FERC seems to think ISOs are the answer.

While acknowledging the possible limitations on its jurisdiction, in mid-April FERC launched a series of major hearings designed to focus on what should be the appropriate rules for ISO management. The need for such attention has become clearer as proposed ISOs have come apart before launch, and the possibility of differentials in prices between ISO regions has become a source of greater concern.

Whether this will affect approved ISOs is problematic.

Effective use of ISO transmission management has been a key unstated part of many utility strategies. Rationalized operation of transmission has become an increasing focus of the mega energy companies. Niche players welcome market order but fear market exclusion.

- (3) Securitization. Stranded cost securitization has become one battlefield where the visions of regional and national utilities are playing themselves out. The ability to securitize stranded cost regulatory assets is of considerable significance to the viability of contemplated financial transactions by utilities in many of the jurisdictions where utility disaggregation as a means of alleviating market power and facilitating restructuring has been introduced.

After California's securitization, this gambit may have appeared to be a well oiled machine. However, the significant extent to which securitization serves to mask through wire charges the

theoretical flow through of benefits to consumers having to pay line charges, has led to resistance in Massachusetts; the prospect of resistance in other jurisdictions as well; and general lack of support for deregulation, because prices don't fall as much as expected.

Enron's challenge to PECO's securitization has added new dimensions to the issue as it may shape up nationally. Basically, the discrepancy between the size of the securitization stranded cost coverage proposed by PECO and the small amount of consumer gain was highlighted. Enron indicated its willingness to offer a greater consumer discount and to itself be a purchaser of securitization bonds.

Obtaining future securitization has thus become a more complex regulatory gambit, which may pit mega-energy companies against traditional utilities. In addition, to the extent securitization blurs or deters price competition, it works against new market entrants. To the extent that certain utilities cannot obtain securitization, their credit rating will be affected adversely, and the types of transactions into which they can enter will be limited.

- (4) Convergence and State Regulation. The national major electric utility/major pipeline firm population—reflecting the convergence of energy supply and trading capabilities—will continue to grow. Canadian firms may be entering the U.S. market through convergence as well.

FERC has now indicated that in evaluating merger proposals, it will consider convergence effects as well.

Convergence, coupled with energy services, has not been an issue with which State regulators have dealt in the past—other than in the form of individual combination utilities. At the state level there has not been full retail access extending the deregulation of natural gas from the production and its transportation to the burner tip.

Increasingly, however, as state regulated utilities compete through the establishment of energy service companies, which offer multiple energy buying capabilities, this will be a matter that will be scrutinized. It is also through the offering of combinations of selected services that some major entrepreneurs hope to compete.

Overall, it is likely that greater regulatory attention to approvals of this type will be forthcoming in the future, particularly

after Federal PUHCA limitations on holding company combination ownership is repealed.

Future convergence and niche plays may be more difficult to effectuate than in the past.

- (5) Municipal and Cooperative Power Restructuring. One fallout of the advent of competition and the possible multi-sourcing of power by residential as well as commercial and industrial customers is that significant competitive pressure has been placed on public power agencies and cooperatives, which historically have been linked through long term supply contracts to IOUs (who in some cases today now are high cost providers). While munis can issue tax exempt debt for financing purposes, applicable tax rules will likely prevent them, after a transition period currently available under an IRS rule, from competing in deregulated markets with facilities financed with tax exempt debt.

Further, while municipal agencies can raise their own rates to pay for their own supply, the resultant pricing may be non-competitive. Cooperatives face analogous pressures, given their low utilization factor notwithstanding availability of Federal government funds.

Because they are wholesale purchasers, these institutions can transform themselves into "aggregators" with superior competitive characteristics, and have begun to form a variety of special purpose entities to enable them to do so. Meanwhile, all of the privately owned players have begun to examine the feasibility of either muni/coop asset acquisition, or the formation of special purpose arrangements, e.g. sale to them of replacement power, in consideration for rights to utilize the assets.

In effect, over time, a significant segment of the market in certain regions is being put in play.

While generally affected as a market opportunity by general market wholesale and retail power deregulatory developments, muni development is particularly influenced by future tax code developments.

Conversely, the extent to which a level playing field standard is not extended to the taxation and regulation of munis could impact the profile of financing opportunities available, since munis potentially can be formidable competitors.

## CONCLUSIONS

### Methodology for Assessing Regulation

Focus on these five key areas of uncertain future regulation: market power regulation; regulatory asset securitization; regional transmission management; convergence and municipal system taxation. These highlight the numerous regulatory factors which can impact particular proposed financial transactions and their possible intersection. But it also suggests the broad outlines of a systematic methodology for your evaluation of the numerous types of transactions in which you may be involved:

- (1) Consider the proposed financing in the context of the particular project proponent's overall strategy: is it likely to be so hampered by regulatory uncertainties as to either be delayed for an excessive period or abandoned prior to closure as being outside its focus?
- (2) Are there regulatory trends whose acceleration could either enhance the competitive position of those vying with the proposal; undercut the competitiveness of the proposal; or delay its timing?
- (3) Is there sufficient flexibility in the overall approach of regulators to the type of transaction contemplated that the transaction can be restructured so as to fall within applicable parameters, if regulation does not develop as desired?
- (4) Can the proposed transaction be financed in such a way that even if there are regulatory risks, they can be dealt with through sustainable contingency arrangements?

These are:

- Backup mechanics or redundant collateral to protect against that risk
- Hedging mechanisms which can be obtained on a consistent enough basis to minimize risk
- Financing rates obtainable from the project proponent which can be accommodated by the projected economics

We're no longer dealing with either first mortgage bonds or PURPA machines; we're dealing with the production and distribution of fungible energy commodities. While the legal overlay is still that of public interest utility regulation, it's derived from several different bodies of law. In this type of fluid legal environment, a wide range of creative transactions can be effectuated, as long as we keep one eye cocked on regulatory constraints' impact on individual transactions.

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#### ABOUT THE AUTHOR

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