

C onvergence Commoditization:

A Survival Guide for Corner Grocery Store Owners (And the Private Power Industry)

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The Pacificorp acquisition of The Energy Company, last year, which is itself a fuel and power marketing amalgam, served to emphasize to the private power industry an ascending ladder of realities:

- The PURPA-based IPP industry is history (Old News)
- Linkage of power marketers and fuel suppliers is a logical development (Accepted Wisdom)
- “Convergence” of energy supply techniques will be the foundation of the new consolidated energy industry (Rapidly Accepted Wisdom)

To cling to this newest rung of the ladder, private power industry members face a classic quandary: finding an appropriate response to the deregulation genie whose escape from the regulatory bottle it has so long promoted. The challenges are clear enough: prevent unfair exercise of competitive advantage by the new convergence mega-companies; facilitate merchant project financing in the new world of shorter term energy arrangements; reestablish a useful, functional role in the foreshortened energy food chain. In short: figure out what to sell from the corner grocery once the supermarket comes to town.

The trick, of course, is to do all of these things without taking positions or establishing strategic business alliances which inadvertently have the effect of perpetuating the old regulatory order.

SECURITIZING THE GROCERY STORE — REGULATORY NEEDS & COMMERCIAL FUNDAMENTALS

The underpinning to achieving these results is to institutionalize responses to the underlying “commoditization” of the industry which convergence accelerates. On the regulatory front, this means recognizing the fact that Btus, not kWh or Matz, are the new stuff of energy commerce, and therefore that the current legislative focus on assuring electric transmission access, because electric supply competition already exists, is too narrow. Assurance of fair, full service ESCO (multi-energy) competition in a broadly defined Btu market needs to be the target. With respect to FERC regulation of mergers, it means an examination of the potential for undue concentration of market power arising from regional vertical integration. It even may suggest reexamination of the possibility of exercise of Btu market power by the ESCO affiliates of combination mega-utilities.

But such ornery populism would serve only limited purposes for the private power industry, if it did not search the competitive energy thickets for new types of project finance by private power developers who have not (yet?) engaged in convergence. For that to be the case, private power must itself sponsor a variety of innovative financing measures, keyed to participation in the unencumbered emerging competitive Btu markets.

For a source of such innovation, looking backward— to technologies used in natural resource financing—may be more productive than looking “forward” to seeking to finance with multiple short term contracts as security. Perhaps private power should seek to share *that* type of market risk with its larger convergent brethren by becoming their suppliers. The reason is that this approach would open up new opportunities for “securitization.”

Future power production is really a natural resource, producing pools of receivables— income streams to be monetized through public offering in the same manner as more familiar mortgage loans, credit cards, etc. Such “securitization” takes place through a special purpose vehicle purchase (“SPU”)—whose credit rating is separated from that of the sponsor, or indeed from any *individual* contract (to make financing arrangements which characterized old-style IPPs).

Such separation allows potential investors in private power project packages to focus on the economic risks presented by the private power

company's *portfolio*, (including such hedging and other power marketing arrangements it may have made), without having to factor in the credit risks and restructuring, default and bankruptcy profiles presented by the private power company itself.

Like oil and gas, financial assets derivative of operating assets can constitute the asset underlying the issuance of securities. In principle, they can be an amalgam of spot market and longer contract term arrangements—particularly if some type of credit enhancement or swap arrangement can be entered into. [Production payments are another type of securitized payment—in this case, free of operating costs and only available until a specified volumetric amount has been delivered. “Concessions” of a right for maximum exploitation of assets for a period of time are a third type.]

If private power/energy marketing enterprises are to levelize the playing field with larger competitors, and thereby finance their ability to be suppliers to such competitors, it will be necessary for commercial law to permit them to acquire, bundle, and securitize energy supply contracts as readily as their larger competitors. For example, an asset transfer (including the transfer of receivables) as part of a securitization must be characterized as a “true sale,” or the assets may be included in the sponsor's bankruptcy estate, should the securitization sponsor enter bankruptcy.

Obviously, this would make securities issued on the strength of these non-bankruptcy proof assets markedly less attractive. At present, whether a transfer constitutes such a sale is ultimately a legal conclusion based on the legal and economic terms of the transfer, rather than on clear-cut legal permissibility. There remains, in short, a residual commercial ambiguity as to the full feasibility securitization of Btu-contract backed securities financing, which the private power industry should seek to remove. Skillful securitization of sales of Btu production to the “mega entrepreneurs” may be a key future strategy for private power firms.

In a nutshell:

- “Convergence” means faster commoditization of energy;
- Commoditization can have the effect of squeezing out non-full energy line private power suppliers, even if they are well run;

- Levelization of the playing field “post-commoditization” requires not only Hill smarts, but (Wall) Street smarts via “securitization.”

It is better to supply commodities to the supermarket chain than to be a closed-down corner grocery store. It is smarter for private parties to work for an environment where that strategy can be followed, than to use all its political capital on supermarkets’ problems and all of its commercial savvy on worn-out project finance solutions.

ABOUT THE AUTHOR

Roger D. Feldman is co-chairman of the 40-person Project/Structured Finance Group of the 250+ attorney firm of Bingham Dana, based in Washington, DC. He has represented the Power Marketers Association and individual power marketers, and also has represented power purchasing trade associations and aggregators. He is Washington editor of *The Cogeneration and Power Marketing Letter* and of *The Construction Business Review*. In his more than 25 years of practice, he has participated in the closing of over \$8 billion in transactions.

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