ENERGY INDUSTRY

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Energy Industry Updates for October 2010

Offshore Wind Hits Land

With many states eager to create jobs in connection with the offshore wind industry, Massachusetts has recently identified the precise location where some of those jobs may someday be located. Governor Deval Patrick recently announced that New Bedford, Massachusetts has been selected as the construction staging area for the Cape Wind project in Nantucket Sound. Facilities for the selected 20-acre staging area will cost $35 million, including a new 1,200-foot bulkhead. Between 200 and 300 jobs will be created during construction.

The Cape Wind project, a 130-turbine wind farm, currently plans to begin commercial operation in late 2012. The Massachusetts Department of Public Utilities is still reviewing the Cape Wind's power purchase arrangement with National Grid. Massachusetts estimates that work associated with the Cape Wind project will create another 600 to 1,000 jobs for the area.

FERC Clarifies Order on California's Feed-In Tariff Program

FERC recently clarified its July 15, 2010 order regarding California's proposed feed-in tariff program, confirming that the program's multi-tiered avoided cost rate structure met the avoided cost standard and could require utilities to procure a certain percentage of energy from specific types of generations. The decision also addresses the way in which a "bonus" adder to an avoided cost rate could properly be determined.

The program was created to comply with California AB 1613, requires the California Public Utilities Commission (CPUC) to set standard rates that California utilities must offer to combined heat and power (CHP) generators with capacities of less than 20 MW. The CPUC submitted a petition for declaratory order requesting that FERC find that the plan was not preempted by federal powers under the Federal Power Act (FPA) or the Public Utility Regulatory Policies Act of 1978 (PURPA).

The key issue in the initial order was whether the California feed-in tariff plan essentially set wholesale rates, a function reserved to the federal government. FERC found that there would be no preemption of the California program. As long as the CHP generators participating in the feed-in tariff program were QFs, and the rate established by the CPUC did not exceed the utility's avoided cost rates, the feed-in tariff program would not be preempted by federal law.

The CPUC sought clarification on two issues. First, the CPUC requested clarification that its proposed multi-tiered avoided cost rate structure met the avoided cost standard. FERC affirmed its previous rulings that a state has wide latitude both to set avoided cost rates and to require utilities to procure a certain percentage of energy from generators with certain characteristics. The state could evaluate "avoided cost" with reference to a particular class of generators.

Second, the CPUC requested clarification of whether the avoided cost rates it set could include a 10-percent "bonus" for CHP systems in transmission-constrained areas to reflect the avoided costs of distribution/transmission upgrades that otherwise would be needed. FERC clarified that while an avoided cost rate could not include a bonus to provide additional compensation for environmental externalities above avoided costs, "if the environmental costs are real costs that would be incurred by utilities, then they may be accounted for in a determination of avoided cost rates." That is, the CPUC could not simply add 10 percent on to rates for CHP facilities in transmission-constrained areas above the full avoided cost rates. The CPUC could, however, base an avoided cost adder on "an actual determination of the expected costs of upgrades to the distribution or transmission system that the QFs will permit the purchasing utility to avoid." Thus, a bonus could be included within the calculation of avoided costs, but it could not be a stand-alone bonus in addition to the avoided cost calculation.

FERC did not address whether the specific 10-percent adder requested by the CPUC was justified by avoided costs.

FERC Issues Final Rule on RTO/ISO Credit Reforms

A long-awaited order on credit reforms for wholesale electricity markets was issued this month. The order attempts to standardize RTO/ISO credit practices and could ease compliance issues for participants active in multiple wholesale markets.

The adopted proposals include:

- Shortening billing and settlement cycles to seven days each in an attempt to reduce default risk
- Capping unsecured credit at $50 million per market participant and $100 million per corporate family to reduce the magnitude of potential defaults
- Eliminating unsecured credit for financial transmission rights (FTRs) because of the unique characteristics and risk profile of FTRs
- Requiring RTOs/ISOs to submit proposals clarifying their status as a party to each transaction so as to eliminate any ambiguity or question as to their ability to net and manage defaults through the offset of market obligations
- Mandating minimum capitalization and risk-management criteria for market participants
- Requiring RTOs/ISOs to specify conditions under which they will request additional collateral due to a material adverse change
- Limiting the grace period to “cure” collateral posting to two days after a collateral call

While FERC acknowledged that the rules may increase costs in the short-term, reducing default risk and the resulting socialization of costs provides benefits to the market as a whole. RTOs/ISOs must submit compliance filings by mid-2011 to implement the credit reforms mandated by the new rule.

DOE/ARPA-E Green Tech Funding: Opportunities and Risks

To promote cutting-edge research and development of advanced energy technologies, including the development of “clean” or “green” technology, the Advanced Research Projects Agency-Energy (ARPA-E) was created within the U.S. Department of Energy (DOE). With many companies receiving ARPA-E contracts, companies should consider several key patent issues both before and during contract performance that could affect a company’s proprietary rights and subsequent revenues. A company’s rights in inventions and related requirements under an ARPA-E contract require a complex assessment of the (i) particular technology, (ii) status of preexisting inventions, (iii) timing of development, and (iv) applicable provisions under the ARPA-E award.

Title to Subject Inventions

A fundamental consideration is whether certain technology constitutes a “subject invention.” A subject invention is defined as an invention that is conceived or first actually reduced to practice in the performance of work under the government award. Generally, actual reduction to practice refers to the invention being put into physical form and shown to be operative in the environment of its practical contemplated use. Companies must realize that the filing of a patent application does not constitute an actual reduction to practice. Rather, this is referred to as a constructive reduction to practice.

Provided that the company complies with the government’s rigorous notice, election, and other reporting requirements concerning patent protection, a contractor may retain title to its subject inventions. However, the government obtains a non-exclusive, nontransferable, irrevocable, paid-up license to practice or have practiced the subject invention by or on behalf of the U.S. government throughout the world.

Manufacturing of Subject Inventions

ARPA-E agreements include two domestic manufacturing requirements for subject inventions: the Preference for U.S. Industry and U.S. Competitiveness provisions. Both obligations require that, under specified circumstances, products embodying any subject inventions, or produced through the use of any subject inventions, must be manufactured substantially in the United States, unless a waiver is obtained from the DOE. A determination of what constitutes substantially manufactured in the United States requires a complicated assessment of not only the physical manufacturing process, but the make or buy decisions down to the component level of the product.

Recommendations

A company’s scrutiny of its portfolio of inventions when working with the government will minimize the likelihood of potential loss of proprietary rights and maximize opportunities for enhancing corresponding revenues. Failure to do so could have onerous outcomes for companies participating under ARPA-E or other types of government agreements.

New Application Process for Cash Grant Applicants Qualifying Under the “Begun Construction” Test

The U.S. Department of the Treasury (Treasury) and the National Renewable Energy Laboratory (NREL) recently revised the application process for certain projects seeking to qualify for cash grants in lieu of tax credits under Section 1603 of the American Recovery and Reinvestment Act of 2009 (Section 1603). To be eligible for a Section 1603 cash grant, applicants either must have placed their projects in service during 2009 or 2010 or "begun construction" of their projects before January 1, 2011. In short, there are two ways to meet the "begun construction" test before January 1st: (1) by performing "physical work of a significant nature" on the qualifying project, or (2) by incurring five percent of the total project cost.

Prior to the recent application revision, all applicants had to submit a single application before October 1, 2011. Now, however, applicants who do not place their projects in service in 2009 or 2010, yet meet the begun construction test, must complete two applications: (1) a "Begun Construction" Application, and (2) a "Placed in Service" Application. Applicants who place their projects in service in either 2009 or 2010 need only submit a Placed in Service Application before October 1, 2011.

Ostensibly, the Treasury and NREL intended this new two-step application process to provide greater clarity to applicants regarding qualification under the begun construction test. Accordingly, the Begun Construction Application features two sections not found in the prior application process:

- Section 2E requires an explanation of the construction timeline for a project if the construction period is "unusually long"
- Section 6B provides greater specificity regarding the types of documentation required to establish that a project meets the begun construction test

Foley Partner Jeffery R. Atkin recently led a Web conference that provided further clarity and guidance on Section 1603 eligibility. A recording and materials from "Section 1603 Cash Grants: Guidance for Qualifying Your Project by December 31, 2010" is available at: http://www.foley.com/news/event_detail.aspx?eventid=3481.

Dodd-Frank Swaps Regulation Update — Pre-Enactment Swaps

The CFTC and SEC have been fast at work developing rules to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which establish the framework for comprehensive regulation of the swaps derivatives markets. The two agencies have held several open meetings, including a joint meeting on further defining key Dodd-Frank terms, such as "swap" and "security-based swap," "swap dealer" and "security-based swap dealer," and "major swap participant" and "major security-based swap participant." The CFTC also has issued proposed rules for comments on matters such as financial resource requirements for derivatives clearinghouses and limitations on ownership and control of clearinghouses, futures exchanges, and swaps execution facilities.

Notably, the CFTC and SEC have adopted nearly identical interim reporting rules for "pre-enactment swaps," which are swaps that were entered into prior to Dodd-Frank's enactment on July 21, 2010 and were still open on that date. Dodd-Frank requires reporting of pre-enactment swaps to a swaps data repository or to the CFTC or SEC, as applicable, if a swap data repository does not exist that will accept the transaction report. That reporting infrastructure is not currently in place, however, and reporting is not expected to occur until late next year or early 2012. Once reporting takes effect, all pre-enactment swaps will have to be reported, even if they are no longer open. In the meantime, the interim rules instruct parties to pre-enactment swaps to keep all information related to the terms of such transactions, to the extent and in the form they currently have such information available, so that they will have the requisite information to report. The rules specifically identify the following information that should be retained:

- Any information necessary to identity and value each pre-enactment swap transaction
- The date and time of execution of the transaction
- Information related to the price of the transaction
- Whether the transaction was accepted for clearing and if so, the identity of the clearing organization
- Any modification to the transaction
- The final confirmation of the transaction

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