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Copenhagen and New Renewable Energy Investment in North America

By Ed Feo | Partner, Milbank Tweed Hadley & McCloy LLP

Environmental news in December was dominated by the story of COP 15 in Copenhagen. After days of debate over protocol crafting appeared headed to an indefinite resolution, a handful of countries initiated a late but fast finishing memorandum of understanding. So, as the Copenhagen meetings disappear in the mist of time, one might ask: what consequence does this meeting have for renewable energy in North America?

The Copenhagen Accord is a non-binding commitment by a number of the major global economies to reduce carbon emissions. Other key provisions include forest protection, transparency on levels of emission, and financial aid of up to \$100 billion annually for developing countries. In some respects, it is a step backwards from the Kyoto Protocol. On the other hand, the long simmering differences between developed and developing countries have never been fully resolved and, so, a reset of the international debate may be the most appropriate step at this time.

While climate negotiations will continue in Germany and Mexico in 2010, individual countries will continue to pursue their own policies consistent with the Copenhagen Accord. In the case of the US, that will mean a continued process of developing climate policy at the state and federal levels. As federal and state policies continue to evolve, a front running beneficial effect for clean energy projects can already be seen.

On the federal level, the Senate will re-focus on a climate bill. This past September, Senators Boxer and Kerry introduced S.1733, the Clean Energy Jobs and American Power Act. Any bill passed by the Senate will need to be reconciled with the Waxman Markey bill

passed by the House in the spring. Current expectations are that federal climate change legislation will not be passed until the end of 2010. The failure to reach a full agreement in Copenhagen means the incentive to pass legislation ahead of the international agreement has vanished. If there is any pressure to move on a federal climate bill, it is from the EPA's finding of endangerment with respect to greenhouse gases under the Clean Air Act. The EPA action may be a ploy to spur passage of a federal climate bill—potentially regulated industries prefer legislation in which they have a say over the club of the EPA under the Clean Air Act. But, even under a federal bill, the ultimate regulation of greenhouse gases is years away given the time required to enact legislation and to adopt the implementing regulations.

The slow pace at the federal level leaves the field open for states and regional compacts. As one example, California continues to implement AB 32, the Global Warming Solutions Act of 2006. AB 32 mandates that greenhouse gas emissions in the state be reduced to 1990 levels by 2020. The California Air Resources Board (CARB) is directed under AB 32 to develop both discrete early action plans, as well as a broader long-term plan, with regulations to be implemented by 2012.

In September 2007, CARB issued a list of early actions, which included reduction of high carbon content gases in consumer products, electrification of ships in ports, improved landfill gas control, and a low carbon fuel standard. The more comprehensive scoping plan was first issued in June 2008. The plan includes a cap and trade program for targeted industries, a 33% renewable portfolio stand-

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ard, installation of 3,000 MW of solar generation capacity, preservation of forests, and expanded use of biomass. The CARB scoping plan also proposes a low carbon fuel standard, regional greenhouse gas emissions reductions for passenger vehicles, high-speed rail systems, and expanded green building practices, among other measures. It is, in short, a comprehensive re-orientation of the California economy toward a low carbon diet.

The AB 32 cap and trade program is directed at a number of key industries, which account for 85% of greenhouse gas emissions. In mid-December, the CARB Economic and Allocation Advisory Committee issued draft recommendations for the proposed cap and trade scheme. The group recommends that allowances be auctioned through a uniform price, single auction process. The allocation of allowances may be warranted to address leakage issues with energy intensive, trade exposed industries. The proceeds of allowance auctions are recommended to be used to mitigate adverse impacts on communities and businesses through either a dividend or reduced taxes. A significant share of the allowance value would also be used for financing of both public and private clean energy investments.

The process of AB 32 implementation highlights the complexity of the shift to a low carbon economy. Transportation, electricity, and major industrial activities are all affected. So too will be building construction, waste disposal, and consumer products. California state agencies and private parties have dedicated an enormous amount of time to AB 32 implementation programs. It is mind-numbing to contemplate a comparable effort carried out on the national or international level.

Climate change regulation, even if not fully enacted into law, is already having positive effects on clean energy investment in at least three respects.

First, are the effects of potential increased costs of compliance on fossil fuel plants. The potential requirement for purchasing allowances under cap and trade is affecting the valuation of existing fossil fuel power plants. In one recent transaction, we were asked to analyze the potential cost of the Waxman Markey cap and trade regime on a portfolio of fossil plants. Under Waxman Markey, a portion of the allowances for the electric sector are allocated to independent generators but, ultimately, the projects will need to purchase allowances. Not surprisingly, the power purchase agreement terms did not fully address the ability to pass through change in law costs. The potential effect of Waxman Markey would be a significant increase in operating cost and, therefore, reduction in value of the affected plants.

In California, the issue of compliance with AB 32 under power purchase agreements is being addressed through a negotiated resolution among the state utilities and independent generators. Although the outcome is not yet final, the general approach is to address the impact of compliance through an adjustment of the heat rate component of the energy rate calculation. The additional costs will, ultimately, be borne by ratepayers on the theory that the change in law for decarbonization will in any event end up being reflected in energy costs. A similar approach will be pursued in connection with any federal cap and trade regime. In the meantime, of course, the uncertainty of how the costs will be imposed and recovered reduces the value of fossil fuel generators. Renewable energy plants would not have the same costs imposed and should be more competitive with fossil fuel plants—in terms of value and power prices.

The second benefit to clean energy sources is the implementation of demand policies. In California, the expansion of the state renewable portfolio standard to 33% is justified on the basis of climate change. Current state law imposes a 20% renewable portfolio standard, but an Executive Order issued in 2009 has already set in motion the transition to the 33% standard. The effect of the California renewable portfolio standard is that new generation is largely renewable. The financial community loves to finance long-term purchase agreements with creditworthy utilities. And, in states like California, those contracts are largely going to renewable energy projects.

Finally, climate change is pushing government research and development funding to renewables. For example, the American Recovery and Reinvestment Act of 2009 includes funding of programs that will mitigate the use of fossil fuels. When cap and trade is implemented—whether at a state or federal level—funds generated by allowance auctions will support deployment of clean energy technology and projects.

In summary: though Copenhagen did not result in the grand solution on a global basis, it opened the door for signatory states to pursue climate change initiatives around broad principles. In the US, the most relevant activity has been at the state level, with legislation expected at the federal level in 2010. In the meantime, existing energy policies are being recast to have a climate change basis. Developers, utilities, and investors are modifying their behavior in light of possible climate change regulation.

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