

Power

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Each bimonthly issue of the *Washington Energy Update* highlights useful energy regulatory tips and a wide range of issues impacting the energy markets.

If you have any questions or would like more information about anything appearing in this issue, please contact the editors or your White & Case relationship lawyer. Please let the editors know if you would like a particular topic covered in a future issue or have suggestions on how this newsletter can be improved.

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Energy Highlights

- On January 17, 2013, FERC issued a policy statement permitting merchant transmission developers and non-incumbent, cost-based, participant-funded transmission developers to allocate up to 100 percent of a project’s capacity to anchor customers if developers (1) engage in a broad solicitation of interest from potential customers and (2) demonstrate that FERC’s solicitation, selection and negotiation process criteria set forth in the policy statement are satisfied.
- FERC issued a notice on January 18, 2013, stating that the entity and tag code “FERC” should be used to designate FERC as an addressee on applicable e-Tags. In Order No. 771, FERC amended its regulations to require e-Tag authors and balancing authorities to take appropriate steps to ensure FERC can access e-Tags used to schedule the transmission of electric power interchange transactions in wholesale markets. The requirement goes into effect March 15, 2013.
- The Department of Energy’s recently released LNG study is creating unlikely bedfellows, with the manufacturer coalition America’s Energy Advantage, environmental groups and several influential congressmen attacking the study and generally opposing LNG exports.

Congress Keeps Wind Credit Alive, Adds New “Begin Construction” Requirement

Linda Carlisle

With no time to spare, Congress began the year by passing legislation that extends the production tax credit (“PTC”) for wind and other renewable energy sources and adds a new, more generous qualifier for facilities not yet in service. The new law (PL. 112-240), signed by the President on January 2, 2013, also permits qualified facilities to take an investment tax credit (“ITC”) in lieu of the PTC if construction begins before 2014.

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Wind Production Tax Credit

Electricity generated from wind accounted for more than five percent of total energy production in the United States in 2012. Although this represents a relatively small share, wind energy production has been increasing rapidly in recent years. Two decades ago, wind accounted for less than one percent of electricity production. Since 1992, wind-generated electricity has increased from 1,500 megawatts to 50,000 megawatts.

Last year, the United States added 13.2 gigawatts of new wind-generating capacity, which was more than twice the capacity added in 2011. Demand for wind power was largely driven by the PTC, which allows taxpayers to claim a 2.2 cents-per-kilowatt-hour tax credit for electricity produced for a ten-year period from a wind facility placed-in-service by the end of 2012. The fiscal cliff legislation enacted this year extends the wind PTC through 2013 and allows renewable energy facilities that begin construction before the end of 2013 to claim the credit when placed in service.

Replacing the placed-in-service qualification requirement with a “begin construction” requirement is a critical change that will need to be defined by the Treasury Department in future regulations. However, it is clear that this change effectively qualifies facilities that are placed in service before the end of 2013. It also encourages additional facilities to start construction immediately. Most expect such regulations to largely follow previously issued regulations to define the start of construction for projects that qualified under the 1603 grants in lieu of tax credits program (the “1603 program”). Treasury guidance issued under the 1603 program defines the beginning of construction as “when physical work of a significant nature begins.” Such work includes excavation for a foundation, pouring concrete and similar activities. Not included are activities such as planning and designing, exploration, securing financing, clearing a site or test drilling.

Treasury also allows for an alternative “expenditure test” under the 1603 program. A taxpayer can qualify as beginning construction when more than five percent of the cost of property has been paid or incurred. Again, Treasury has not explained how it will define “begin construction” for the wind PTC, so it is possible that an entirely different regulatory definition could emerge. However, that seems unlikely, especially given the similar industries covered by the 1603 program and the wind PTC.

The wind PTC has been extended seven times since it was first put in place in 1992. Although it was again extended after a two-day lapse, many expect the PTC to face even stiffer scrutiny this year as Congress considers the arduous and ambitious task of rewriting and simplifying the tax code.

Investment Tax Credit in Lieu of Production Tax Credit

The fiscal cliff legislation also expanded and extended the tax law affecting the election of the 30 percent ITC for qualified project capital costs in lieu of the PTC. The ITC regime in 2012 limited the ITC to solar, small wind, geothermal and certain other niche renewables. Congress broadened the ITC in the fiscal cliff legislation to cover all facilities otherwise qualified under the PTC under IRC section 45 (i.e., electricity produced from wind, closed-loop biomass, open-loop biomass, geothermal, small irrigation, hydropower, landfill gas, waste-to-energy and marine renewable facilities). Like the wind PTC, the new ITC regime replaces the placed-in-service requirement with a begin-construction requirement before the end of 2013. Financing experts in the renewable energy sector note that this change will, in particular, benefit offshore wind facilities, which typically have lengthier development and construction timelines (five to seven years) than onshore wind facilities.

FERC Approves NERC’s “Bright-Line” BES; Revised Rules of Procedure

Caileen Gamache

On December 20, 2012, the Federal Energy Regulatory Commission (“FERC”) approved revisions to the North American Electric Reliability Organization’s (“NERC”) definition of the Bulk Electric System (“BES”) and various revisions to NERC’s Rules of Procedure (“ROP”).

The revised BES definition creates a “bright-line” test for determining whether a facility is part of the BES and, therefore, subject to NERC’s regulation under Section 215 of the Federal Power Act (“FPA”). The new definition states that “all Transmission Elements operated at 100 kV or higher” along with all “Real Power and Reactive Power resources connected at 100 kV or higher” are part of the BES unless they are local distribution facilities or are otherwise excluded from the definition. The revised definition is designed to eliminate regional discretion regarding the identification of BES elements. If an element is part of the BES under the new definition, the expectation is that a user, owner or operator of such element will be a Registered Entity responsible for executing any Reliability Standard requirements applicable to such element. Under the Federal Power Act (“FPA”), all “users, owners, and operators of the bulk-power system shall comply with [applicable] reliability standards.” (16 U.S.C. § 824o(b)). Moreover, per FERC’s regulations, “[e]ach user, owner and operator of the Bulk-Power System...shall register” with NERC and the applicable Regional Entity pursuant to NERC’s rules

(18 C.F.R. § 39.2 (2013)). NERC's Statement of Compliance Registry, in turn, states that "[e]ntities that use, own or operate Elements of the [BES] as established by NERC's approved definition of [BES] are (i) owners, operators, and users of the Bulk Power System and (ii) candidates for Registration" per NERC's functional model. Order No. 773 contemplates that there may be some Registered Entities that will de-register if their facilities do not fall under the revised BES definition. Compliance obligations for new BES elements will begin 24 months after the effective date of the new BES definition (i.e., April 1, 2013, or the first day of the second calendar quarter following approval). Note that the effective date of the revised BES definition is different from the effective date of Order No. 773 (i.e., March 5, 2013, or 60 days after the Order was published in the Federal Register).¹

The definition incorporates the five specific Inclusions and four specific Exclusions listed below. All capitalized terms not defined herein are defined in NERC's Glossary of Terms Used in Reliability Standards.

Inclusions:

- **I1** Transformers with the primary terminal and at least one secondary terminal operated at 100 kV or higher unless excluded under Exclusion E1 or E3.
- **I2** Generating resource(s) with gross individual nameplate rating greater than 20 MVA or gross plant/facility aggregate nameplate rating greater than 75 MVA including the generator terminals through the high-side of the step-up transformer(s) connected at a voltage of 100 kV or above.
- **I3** Blackstart Resources identified in the Transmission Operator's restoration plan.
- **I4** Dispersed power producing resources with aggregate capacity greater than 75 MVA (gross aggregate nameplate rating) utilizing a system designed primarily for aggregating capacity, connected at a common point at a voltage of 100 kV or above. (FERC has stated that "dispersed power producing resources" are typically variable generation resources such as wind and solar that aggregate their output.)
- **I5** Static or dynamic devices (excluding generators) dedicated to supplying or absorbing Reactive Power that are connected at 100 kV or higher, or through a dedicated transformer with a high-side voltage of 100 kV or higher, or through a transformer that is designated in Inclusion I1.

Exclusions:

- **E1** Radial systems: A group of contiguous transmission Elements that emanates from a single point of connection of 100 kV or higher and:
 - a) Only serves Load. Or,
 - b) Only includes generation resources, not identified in Inclusion I3, with an aggregate capacity less than or equal to 75 MVA (gross nameplate rating). Or,
 - c) Where the radial system serves Load and includes generation resources, not identified in Inclusion I3, with an aggregate capacity of non-retail generation less than or equal to 75 MVA (gross nameplate rating).
- **E2** A generating unit or multiple generating units on the customer's side of the retail meter that serve all or part of the retail Load with electric energy if: (i) the net capacity provided to the BES does not exceed 75 MVA; and (ii) standby, back-up and maintenance power services are provided to the generating unit or multiple generating units or to the retail Load by a Balancing Authority, or provided pursuant to a binding obligation with a Generator Owner or Generator Operator, or under terms approved by the applicable regulatory authority.
- **E3** Local networks (LN): A group of contiguous transmission Elements operated at or above 100 kV but less than 300 kV that distribute power to Load rather than transfer bulk-power across the interconnected system. LN's emanate from multiple points of connection at 100 kV or higher to improve the level of service to retail customer Load and not to accommodate bulk-power transfer across the interconnected system. The LN is characterized by all of the following:
 - a) Limits on connected generation: The LN and its underlying Elements do not include generation resources identified in Inclusion I3 and do not have an aggregate capacity of non-retail generation greater than 75 MVA (gross nameplate rating);
 - b) Power flows only into the LN and the LN does not transfer energy originating outside the LN for delivery through the LN; and
 - c) Not part of a Flowgate or transfer path: The LN does not contain a monitored Facility of a permanent Flowgate in the Eastern Interconnection, a major transfer path within the Western Interconnection, or a comparable monitored Facility in the ERCOT or Quebec Interconnections, and is not a monitored Facility included in an Interconnection Reliability Operating Limit (IROL).

¹ These two dates have led to inconsistent reports of compliance deadlines. The effective date of Order No. 773 is the date that is 60 days after it was published in the Federal Register. NERC's approved Implementation Plan, however, is based on the date FERC issued an order approving the definition, or December 20, 2012. (See NERC's Petition, at n.39 ("For example, if the revised BES Definition were approved by the Commission at its June 2012 meeting, and the effective date were the first day of the first calendar quarter following approval (July 1, 2012), the industry would have only a few weeks before the new BES Definition became effective. With the proposed effective date, the new BES Definition would be effective on October 1, 2012 in this example."))

- **E4** Reactive Power devices owned and operated by the retail customer solely for its own use.

Also in Order No. 773, FERC approved ROP revisions that create an "Exception Process" to petition for exceptions to the bright-line BES definition. The process is designed to allow Registered Entities to petition NERC to exclude facilities that fall within the BES definition. Facilities that are granted such an exclusion will be subject to periodic filing requirements to justify continued exemption. Interested parties can also petition to include facilities that are not within the BES definition.

Notably, FERC rejected NERC's proposal to include the identification of "local distribution facilities" in the Exception Process, opting instead to retain jurisdiction. Section 215 of the FPA states that "facilities used in the local distribution of electric energy" are not included in the definition of the bulk-power system. FERC concluded that it was the more appropriate body to conduct the jurisdictional analysis necessary to determine whether a facility is "used in local distribution." A party interested in obtaining a finding that an element is a local distribution facility and therefore exempt from the BES definition must petition FERC and provide "information that will assist the Commission in making such determination." In response to commenters' requests, FERC stated that it would apply the "Seven Factor Test," developed in FERC's Order No. 888, for determining whether a facility is a local distribution facility. There is established precedent that supports the use of the Seven Factor Test. The petition procedure is interesting in that a local distribution facility that otherwise satisfies the BES definition would, in fact, be deemed part of the BES and subject to regulation until such a time FERC rules on its petition. This could result in a jurisdictional quandary if NERC attempts to enforce compliance with respect to a facility that FERC later finds non-jurisdictional. It might also prompt challenges to FERC's authority to require non-jurisdictional entities to file petitions in order to prove that they are exempt from regulation.

In a separate order on December 20, FERC approved a series of other ROP revisions proposed by NERC in Docket No. RR12-8-000. Importantly, despite some opposition, NERC modified the sanction guidelines to state that "previous violations by affiliates of the violator" will be taken into account in evaluating an entity's compliance history. This opens the door for NERC to consider, and even deem an aggravating factor, the compliance of separate entities that share the same upstream parent entity, but, in reality, have no overlap in matters related to compliance. Among other substantive and nonsubstantive revisions, the revised ROP also creates the right for the Regional Entity to appeal decisions of the Regional Entity Hearing Body and added that the "Compliance Enforcement Authority has authority to collect Documents, data and information in the manner it deems most appropriate" in order to monitor compliance.

Exercising Its Muscle—Enforcement Actions by the Federal Energy Regulatory Commission in 2012

Jennifer Mersing

Due to the increased focus on enforcement and the amount of resources devoted to those efforts in 2012, it is not surprising that 2012 was a record year for enforcement penalties, with the Federal Energy Regulatory Commission (FERC) obtaining \$148 million in civil penalties as well as over \$119 million of disgorgement of alleged unjust profits.

With the passage of the Energy Policy Act of 2005, Congress granted FERC increased enforcement and civil penalty authority (including the ability to impose fines of \$1 million per day per violation) over the regulated energy markets. In recent years, FERC, through its Office of Enforcement (OE), has increased its enforcement efforts by focusing on matters involving perceived fraud and market manipulation, serious violations of reliability rules, anticompetitive conduct and conduct that threaten the transparency of the regulated energy markets. The 2012 Report on Enforcement indicates that OE's priorities will remain the same in 2013. In 2012, a number of interesting trends and developments emerged.

Creation of the Division of Analytics and Surveillance.

FERC created the Division of Analytics and Surveillance (DAS) within OE to evaluate transactional and market data in order to discover potential manipulation, anticompetitive behavior and other potentially anomalous activities in the energy market. FERC also increased the amount of market data that is available to be analyzed, including data on physical and virtual bids and offers and financial transmission rights from the organized wholesale markets. For example, in Order No. 771, the Commission granted itself access to all electronic tags (e-Tags), which "document the movement of energy across an interchange over prescribed physical paths, for a given duration, and for a given energy profile(s), and include information about those entities with financial responsibilities for the receipt and delivery of the energy" (Order No. 771 at P 3). Notably, all relevant market participants must ensure that FERC has access to e-Tags data by no later than March 15, 2013.

Investigation of Financial Institutions' Participation in the Organized Markets. The rise in FERC enforcement efforts has coincided with an increased role of financial institutions in the US regulated energy markets. As a result, investigations of financial institutions increased significantly in 2012. For example, OE recently alleged that a financial institution and four named traders participated in loss-generating trading of next-day electricity

products in order to benefit the institution's financial swap positions at primary electricity trading points in the Western United States. Based on those allegations, FERC proposed to impose a \$435 million fine and order disgorgement of \$34.9 million of alleged unjust profit (see FERC Docket No. IN08-8). In an investigation involving another financial institution, OE alleged that the California markets were manipulated by a trading scheme that scheduled unprofitable physical exports at a California intertie in order to benefit its financial positions in the California markets. Last week, FERC approved a settlement in this case, wherein the financial institution agreed to pay a civil penalty of \$1,500,000, disgorge unjust profits of \$172,645 plus interest, and implement improved compliance training and procedures (see FERC Docket No. IN12-4). In addition to imposing penalties for alleged manipulative behavior, entities have been sanctioned for conduct during the course of an investigation. For example, in response to repeated refusals to provide information on bidding activities, FERC suspended the financial institution's ability to sell energy at market-based rates for six months (see FERC Docket No. EL12-103).

Investigation of Participation in Demand Response Programs.

Coinciding with FERC's increased focus on demand response and the development of programs for the participation of demand response in organized markets, OE also issued show cause orders to four demand response providers over the summer, alleging fraud in the ISO-New England Day-Ahead Load Response Program through falsification of the market participants' baseline load underlying their offers of demand response. If FERC concludes that violations occurred and assesses penalties, the cases could end up in federal district court under de novo review. OE's Division of Audits has also begun to conduct audits focused on demand response activities.

In sum, in light of FERC's enforcement role and the amount of resources devoted to investigating market manipulation, especially trading activities, market participants should have an effective compliance program in place to help prevent enforcement issues from occurring (and, if enforcement issues do occur, to mitigate their consequences). Components of an effective compliance program include: involving senior management (such as having an independent compliance officer supported by a meaningful compliance budget), implementing preventive measures (such as conducting training in FERC compliance), encouraging prompt detection and reporting (such as through an internal monitoring and audit program) and establishing disciplinary action for employees who engage in violations. If 2012 is any indication of what to expect in 2013, market participants would be well-served to revisit their compliance programs at the outset of this new year.

Energy Department–Commissioned Report Supports Increasing LNG Exports

Scott Lincicome
Justin Miller

The Department of Energy (DOE) released on December 3, 2012, a report demonstrating clear benefits to the US economy of permitting greater export volumes of liquefied natural gas (LNG). US law largely prohibits LNG exports to countries with which the United States does not have a free trade agreement (FTA) if the Department of Energy finds that the LNG exports to such non-FTA partners would be adverse to US public interests. Accordingly, LNG producers in the United States must obtain a permit prior to exporting LNG, and DOE is currently engaged in the process of adjudicating several high-profile applications for such export permits.

The report, titled "Macroeconomic Impacts of LNG Exports from the United States" ("Report"), concludes that net economic gains to the United States increase as US LNG exports increase. At the request of DOE, Nera Economic Consulting examines in the Report the effects on US national income of increased LNG exports and the likely resulting changes to employment and real wages, i.e., wages adjusted for inflation, and capital-, labor- and resource-derived income. The Report makes multi-scenario assumptions about US and world LNG production costs, demand and prices for the sake of this examination. The Report argues that increased overall US income from LNG export expansion outweighs expected declines in capital-derived income, i.e., income from positive returns to capital, and real wages.

DOE must now decide whether to take action based on the Report's recommendation to allow for greater LNG exports. Meanwhile, congressional reaction to the Report is mixed:

- **Rep. Upton (R-MI)** welcomed the Report's findings, noting that LNG production is a "bright spot" in the US economy;
- **Sen. Murkowski (R-AL)** lauded the Report's findings, noting that increasing US LNG exports is an opportunity to [...] tilt the balance of trade in [...] favor [of the United States] for the first time in decades"; but
- **Rep. Ed Markey (D-MA)**, who introduced in February 2012 the "Keep American Natural Gas Here Act" (H.R. 4025), rejected the Report's findings, noting that the winners would "mainly [be] those in the natural gas business and those holding their stock."

In addition, Center for Liquefied Natural Gas President Bill Cooper welcomed the Report's findings, noting that the United States "can export LNG without adversely affecting the availability or affordability of [the United States'] abundant natural gas supplies."

The existing DOE LNG export permit policy is a politically contentious issue both in the United States and abroad. Recent low-cost LNG production from shale, combined with the US export permit requirement, is a boon for US LNG commercial and individual consumers who enjoy depressed LNG prices. Likewise, it is a potential point of contention between the United States and many of its non-FTA trading partners who do not currently enjoy such benefits of this low-cost LNG production.

Click [here](#) for a copy of the Report.

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