HUNTON& WILLIAMS

BASELOAD

Current Topics in the Power and Energy Capital Markets



January 2015

Contents

Will the EPA's Recent Determination that Coal Ash is Solid Waste Reignite the Tax-Exempt Bond Market?

In December 2014, as part of its long-awaited federal standards to regulate the storage and disposal of coal ash[1], the Environmental Protection Agency (EPA) issued rules making clear that coal ash would be regulated as a solid waste rather than as a hazardous waste. For utilities and other owners of coal fired generation plants, the EPA's new standards clarify their ability to finance the disposal or recycling of coal ash through tax-exempt bonds.

Tax Analysis For 'Solid Waste' Tax-Exempt Bonds

As a general background, the Internal Revenue Code of 1986, as amended, and

[1] "Coal ash" is residue, including fly ash, bottom ash, and boiler slag, that remains after power plants burn coal to generate electricity.

related tax regulations provide that tax-exempt bonds can be issued to finance a number of "exempt facilities," including solid waste disposal facilities. A solid waste disposal facility generally includes any land, building or other property functionally related and subordinate to such facility. In 2011, the Treasury Department issued regulations that redefined a "solid waste disposal facility" to be a facility that processes solid waste in a qualified solid waste disposal process, performs a preliminary function to solid waste disposal or is functionally related and subordinate to such a facility.

Under the regulations, a facility qualifies as a solid waste disposal facility if it is used in a qualified solid waste disposal process, which includes final disposal, energy conversion or recycling, employing any engineering, industrial or technological method. "Final disposal" specifically includes placing the solid waste in a landfill, including spreading the waste over land in

an environmentally compliant manner with no intent to remove it, the incineration of the waste or containment with a reasonable expectation as of the date of issue of the bonds that the containment will continue indefinitely.

A recycling process is one that reconstitutes, transforms or otherwise processes solid waste into a useful product. The recycling process begins at the point of the first application of a process to reconstitute or transform the solid waste into a useful product, such as decontamination, melting, re-pulping, shredding or other processing of the solid waste to accomplish this purpose. The recycling process ends at the point of completion of production of the first useful product from the solid waste.

Because the EPA has now classified coal ash as solid waste, some or all of any facility that is acquired and constructed either to dispose of the coal ash or to recycle it into a different product is eligible for tax exempt bond financing as a solid waste disposal facility.

Initial Steps Necessary to Issue 'Solid Waste' Tax-Exempt Bonds

In order to issue tax exempt bonds to finance a solid waste disposal facility, the coal plant owner (the "borrower") must identify a governmental issuer (typically a local or statewide industrial or economic development authority) that would issue the bonds and lend the proceeds to the borrower. In order to preserve its ability to issue tax exempt bonds and reimburse itself for costs incurred for such a facility prior to the issuance of the bonds, the tax regulations require the governmental issuer to adopt a reimbursement resolution or otherwise indicate its intention to allow the borrower to reimburse itself for costs previously paid out of the proceeds of an eventual tax exempt bond issue. Borrowers should consider obtaining such a reimbursement resolution or other expression of official intent to reimburse from the governmental issuer in order to preserve the ability to issue tax exempt bonds, even if it ultimately decides not to use them. Such an official intent remains valid until 18 months after the facility financed is placed in service or three years after the expenditure is made, whichever occurs sooner.[2]

Solid waste disposal bonds also require an allocation of volume cap under the tax regulations. Each state has a limit of the total amount of tax-exempt bonds that can be issued for a variety of exempt facilities and industrial development bonds in each calendar year. That limit—or "volume cap"—is calculated under the tax regulations each year.[3] Volume cap can either be used in the current year, or, if the state allocation agency permits it, can be carried forward for as much as three years for a particular purpose. Although there is some competition for the volume cap for single-family mortgage bonds and affordable housing, in many states much of the volume cap goes unused by the end of the year. Therefore, borrowers should consider working with the appropriate governmental issuer to obtain an allocation of volume cap for solid waste disposal bonds to be used to finance disposal or recycling facilities for coal ash.

Most coal plant owners will want to coordinate with experienced bond counsel to accomplish these two initial (and crucial) steps.

Conclusion

Although the EPA's coal ash regulation has been hailed as a victory for coal-fired utilities and industries that rely on coal, the final rule is nevertheless expected to be costly for many coal plants. The final rule, which becomes effective 180 days following publication in the Federal Register, establishes a comprehensive set of requirements for the management and disposal of coal ash from coal-fired power plants. The final rule, among other things, mandates regular inspections of surface impoundments, establishes technical requirements for landfills, sets out recordkeeping and reporting requirements, and requires closing of certain facility sites that are either structurally deficient or are polluting groundwater.

The EPA's promulgation could have a material impact on capital expenditures relating to coal ash. While reviewing and analyzing the implication of the final rule in detail, coal plant owners should be aware that the final rule provides certain financing benefits by clarifying the ability to finance certain coal ash facilities with tax-exempt bonds. Owners of facilities should consider steps that will preserve their ability to utilize such financing in the future.

[2] Those limitations do not apply to preliminary expenses such as architectural, engineering, surveying, soil testing and similar costs incurred prior to the commencement of construction, up to 20 percent of the aggregate issue price of the bond issue.

[3] For 2015, that limit is the greater of $100 multiplied by a state's population (determined on the basis of the most recent census estimate released by the Bureau of Census before the beginning of 2015) or $301,515,000. Thus, every state will have volume cap ranging from as little as $301,515,000 for smaller states to as much as $3.7 billion for California.

2014 Review of Dedicated Utility Rate Securitization Financing

2014 may well be remembered as the year dedicated utility rate bonds expanded beyond their traditional roots. First conceived to allow electric utilities to recover stranded costs associated with the transition to a competitive market, dedicated utility rate bonds have also been used over the past decade to recover costs associated with storms and environmental remediation. The past year saw transactions that went beyond these traditional categories of costs to include costs resulting from early retirement of certain assets and the costs of setting up a government program to support the development of roof-top solar generation. In addition, the types of sponsors and issuers doing dedicated utility rate structures have also expanded; in addition to the traditional electric utility sponsor and wholly-owned subsidiary issuers, governmental agency sponsors and issuers have joined the list of participants. This article summarizes the dedicated utility rate securitization transactions that were completed during 2014 and recently enacted state statutes to enable similar transactions in the future.

Consumers Uses Dedicated Utility Rate Securitization to Recover Costs Associated with Retiring Generation Units

In July 2014, Consumers Energy Company (Consumers) sponsored a transaction to recover the remaining book value of seven coal-fired generating units as well as three smaller gas-fueled electric generating units that were being retired by Consumers earlier than planned, due to changes in environmental regulations. Consumers 2014 Securitization Funding LLC, a wholly-owned subsidiary of Consumers, issued $378 million of securitization bonds pursuant to a Michigan statute originally adopted in 2000 in connection with Michigan's transition to retail competition. The Michigan Public Service Commission determined that the unrecovered book value associated with the referenced generating units qualified for treatment as a regulatory asset and as "qualified costs" in accordance with the existing statute.

Subsidiaries of Entergy Corporation Issue System Restoration Bonds

In August 2014, Entergy Louisiana, LLC (ELL) and Entergy Gulf States Louisiana, L.L.C. (EGSL), two wholly-owned subsidiaries of Entergy Corporation that provide generation, transmission and distribution service in Louisiana, sponsored separate offerings of system restoration bonds (the 2014 Bonds). Similar to prior system restoration bonds issued in 2008 and 2010, the 2014 Bonds were issued by a conduit municipal issuer, in this case, the Louisiana Local Government Environmental Facilities and Community Development Authority, pursuant to a Louisiana statute that allows securitization financing to recover storm costs. The 2014 Bonds were sold in accordance with separate financing orders of the Louisiana Public Service Commission (LPSC). The 2014 Bonds are secured by system restoration property that includes the irrevocable right, created by the financing orders and vested solely in the Louisiana Utilities Restoration Corporation (the "Borrower" of the 2014 Bond proceeds and a political subdivision of the State of Louisiana), to impose, collect and receive the non-bypassable consumption-based system restoration charge from all existing and future LPSC-jurisdictional electric customers of ELL or EGSL, as the case may be. The proceeds from sale of the 2014 Bonds were loaned to the Borrower and then transferred to ELL and EGSL as non-shareholder capital contributions. ELL and EGSL used the cash to fund a portion of their storm damage reserves and to fund recovery projects resulting from Hurricane Isaac.

Hawaii Uses Dedicated Utility Rate Bonds to Develop Individual Solar Generation

In December 2014, the State of Hawaii Department of Business, Economic Development, and Tourism completed an offering of $150 million Green Market Securitization Bonds (GEMS Bonds). The issuance of GEMS Bonds was conducted pursuant to a state statute enacted in June 2013 that provides for the on-bill financing of ratepayers' investment in clean energy technology infrastructure, such as solar panels. The offering in Hawaii marked an entirely new approach for dedicated utility rate bonds. Unlike other utility securitizations that had mutual benefit for utilities and their ratepayers, Hawaii's transaction will be primarily for the benefit of those Hawaiians participating in a specific program to install clean energy technology. In contrast to traditional utility securitization structures, the proceeds of the GEMS Bonds were not provided to the electric utility, but were instead deposited into a statutorily created special fund. This special fund is to be used by the State of Hawaii to make customer loans to finance investments in green energy technology infrastructure. The loans from the special fund are to be repaid through charges on the bills of customers obtaining the loans. Separately, the debt service on the GEMS Bonds is to be paid solely through the imposition of a "utility-wide non-bypassable surcharge" on customers of Hawaiian Electric Company, Inc., Hawaii Electric Light Company, Inc. and Maui Electric Company, Limited. Neither the loans made from the special fund nor other assets of the loan program itself serve as security for the GEMS Bonds.

Upgrading Utility Infrastructure in the District of Columbia

In response to a series of storms in 2012, the District of Columbia created a taskforce to study how to underground electric wires within the District. In March 2014, the District of Columbia enacted the Electric Company Infrastructure Improvement Financing Act of 2014 (the Act), which permits the District to issue up to $375 million of securitization bonds to finance, in part, the costs of construction of facilities to be used by Potomac Electric Power Company (Pepco) in connection with the undergrounding of certain electric power lines and facilities. The structure of the transaction authorized by the Act is different from traditional utility securitizations in that the issuer will be the District of Columbia itself, as opposed to a special purpose entity owned by the sponsoring utility. The bonds are expected to be sold pursuant to an irrevocable financing order of the District of Columbia Public Service Commission (DCPSC) issued in November 2014 that permits a dedicated charge to be included on the utility bills of substantially all of Pepco's customers. The proceeds of this charge would be used for debt service on the bonds as well as associated financing costs. The financing order, as outlined by the Act, contains the customary provisions found in traditional utility securitization transactions, including a formulaic adjustment mechanism for the dedicated charges as well as non-bypassability provisions. While the District of Columbia will be the issuer of the bonds and own the right, title and interest in the dedicated charge, Pepco will act as servicer for the bonds, collecting the dedicated charges and, among other duties, requesting any required adjustments to the dedicated charges.

California Water Statutes

While dedicated utility rate bonds have traditionally been used in the electric utility space, California passed two statutes in 2013 and 2014 to permit their use by water utilities for water infrastructure projects. Assembly Bill 850, enacted in October 2013, will permit dedicated utility rate bonds to be issued to finance capital improvement projects of publicly owned water utilities. Although no transactions have been initiated pursuant to the statute, it represents the first statute to apply the dedicated utility rate bonds model to the water utility space. In September 2014, California adopted another securitization statute for water utilities, this time addressing the specific needs of the Monterey Peninsula Water Management District. Senate Bill 936 will permit California American Water to issue dedicated utility rate bonds to finance projects necessary to develop new sources of water supply for the Monterey Peninsula.

Update: Court Reverses and Rules Against Chesapeake Over Par Call

In the June 2013 issue of *Baseload*, we included the article "A $400 Million Devil in the Details: The Cautionary Tale of the Chesapeake Par Call." On November 25, 2014, the Second Circuit US Court of Appeals overturned a 2013 ruling by US District Judge Paul Engelmayer and remanded the case back to him.

A brief recap of the facts: on an aggressive schedule, Chesapeake Energy Corp. issued unsecured notes off their shelf registration statement in 2013. The notes contained a very unusual optional redemption feature allowing Chesapeake to call the notes at par for several months after issuance.[1] Chesapeake's view was that under the indenture it had until March 15, 2013, to give notice to noteholders that it was calling the notes and, by meeting that deadline, would avoid paying the make-whole premium on the notes. The trustee, on behalf of certain noteholders, took the position that in order to avail itself of the early par call, Chesapeake was required under the indenture to *complete* the redemption by March 15, 2013.

In May 2013, the lower court had ruled that the indenture unambiguously required only that the redemption notice be provided by March 15. The Second Circuit (by majority) reversed the lower court's decision and held that the indenture unambiguously required that the redemption itself needed to take place by the March 15 deadline. The majority came to its conclusion, in part, by focusing on the meaning of the word "redeem," as such term was used in the indenture. The majority concluded that the use of such term constitutes the specific act of returning the notes to the issuer. Interestingly, the dissenting judge on the Second Circuit in the most recent decision noted that:

> Both the district court and the majority have it half-right: the majority [of the Second Circuit] is correct that Section 1.7(b) of the Supplemental Indenture cannot be read to unambiguously support Chesapeake's position, and the district court is correct that it cannot be read to unambiguously support BNY Mellon's position. The text is ambiguous…"

The Second Circuit remanded the case back to the lower court.

1 The language in the supplemental indenture was as follows: "At any time from and including November 15, 2012 to and including March 15, 2013 (the "Special Early Redemption Period"), the Company, at its option, may redeem the Notes in whole or from time to time in part for a price equal to 100%...; The Company shall be permitted to exercise its option to redeem the Notes pursuant to this Section 1.7 so long as it gives the notice of redemption…during the Special Early Redemption Period."

Steven C. Friend, Editor
212.309.1065
sfriend@hunton.com

Kevin C. Felz, Editor
212.309.1053
kfelz@hunton.com

BASELOAD is prepared from time to time to provide general information about selected power and energy capital markets developments and issues for attorneys at Hunton & Williams LLP, and is provided to clients and friends of Hunton & Williams LLP. It is not intended to provide legal advice or legal opinions and must not be relied on as such.

If you have questions related to "Will the EPA's Recent Determination that Coal Ash is Solid Waste Reignite the Tax Exempt Bond Market?" please contact:

Mary Nash Rusher
919.899.3066
mnrusher@hunton.com

If you have questions related to any of the articles in this issue, please contact any of the below members of the Capital Markets Group of the Energy and Infrastucture practice at Hunton & Williams LLP:

Dee Ann Dorsey
212.309.1174
ddorsey@hunton.com

Bud Ellis
212.309.1064
ellisb@hunton.com

Kevin C. Felz
212.309.1053
kfelz@hunton.com

Michael F. Fitzpatrick, Jr.
212.309.1071
mfitzpatrick@hunton.com

Steven C. Friend
212.309.1065
sfriend@hunton.com

Peter K. O'Brien
212.309.1024
pobrien@hunton.com

The editors wish to thank Amy E. Wolf and Michael D. Koch for helping make this issue possible.

Atlanta · Austin · Bangkok · Beijing · Brussels · Charlotte · Dallas · Houston · London · Los Angeles
McLean · Miami · New York · Norfolk · Raleigh · Richmond · San Francisco · Tokyo · Washington

HUNTON & WILLIAMS
www.hunton.com