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Global Energy Industry Review

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In this edition of Mayer Brown's *Global Energy Industry Review*, we look at the ways China is trying to curb its excessive energy consumption and reduce its emission of greenhouse gases. We also look at the new UK Bribery Act and its potential extra-territorial reach. This expansion of its coverage makes it more aggressive than past acts, and businesses should be aware of the changes.

Feed-in-tariffs are widely regarded as a key component of European renewables generation economics. They are beginning to appear on the radars of many US states, though some significant legal hurdles need to be cleared. Our lawyers look at the potential impact of FiTs in the United States.

While this update is intended to look at trends in the energy industry, we regularly develop legal alerts on timely issues. To view a complete list of our legal energy alerts visit us online at http://www.mayerbrown.com/energy/index.asp and browse News & Publications.

If you have any questions or comments on any of the articles in this edition, please contact us. ◆

China's Pledge to Cut Energy Consumption

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China faces the extremely urgent and important task to curb excessive growth in energy consumption and the emission of greenhouse gases. Though China has positioned itself as the world leader in clean energy efforts in recent years, and ranked second in the world in terms of installed wind generating capacity in 2009, coal still accounts for more than 70 percent of the country's total energy consumption.

To tackle these issues, China's 11th Five-Year Plan (2006-2010) targeted cutting 20 percent by the end of 2010 from its 2005 per-unit gross domestic product (GDP) energy consumption, and has implemented key laws, regulations and policies to lower its energy consumption. According to data from the National Bureau of Statistics, during the period from 2006 to 2009, China obtained an encouraging 15.6 percent reduction. However, due to the increasing demand for heavy energy-consuming products this year, the index disappointingly rose 3.2 percent in the first quarter.

In order to meet the 20 percent reduction target by year's end, local governments have taken drastic steps to cut energy consumption. In August, the government ordered closure of more than 2,000 outmoded steel, cement and other energy-intensive plants. In recent months, there have been reports of arbitrary power outages and shutdowns by the local government in various provinces. For example:

- One city in Hebei Province cut power to hospitals and shut off traffic lights that are not powered by solar cells;
- Wu'an cut power to plants for 20 days;
- Tangshan ordered 30 steel mills to reduce output by half; and
- Anping County south of Beijing blacked out power to homes and turned off pumps for water supplies.
- These administrative measures taken by the local governments have been criticised as irrational and caused serious disruption to the business operation of the affected enterprises.

New Rules

As a new move to step up the efforts to boost energy conservation across the country, the National Development and Reform Commission (NDRC), China's top economic planner, unveiled the "Provisional Measures for Energy Efficiency Evaluation and Review of Fixed-Asset Investment Projects" on September 17, 2010. The new rules became effective on November 1, 2010. It is anticipated that this new energy efficiency evaluation system can replace those drastic, and somewhat random, measures taken by the local governments.

Under the new rules, new fixed-asset investment projects must undergo an independent energy efficiency evaluation as well as a government review in order to obtain approval for project commencement from the regulators. Projects that fail to meet energy efficiency requirements will be rejected while approved projects will be subject to strict supervision of their actual energy use. Therefore, it is believed that the new rules can significantly help the government keep energy consumption from increasing too rapidly and promote a reasonable use of resources.

Energy efficiency evaluations are classified according to the annual energy consumption of projects upon their completion. The classifications are set out below.

Annual Energy Consumption of Projects	Energy Efficiency Requirements
• Annual comprehensive energy consumption at 3,000 tonnes of coal equivalent or more; Annual power consumption at 5 million kilowatt-hours (kWh) or more; • Annual oil consumption at 1,000 tonnes or more; or • Annual natural gas consumption at 1 million cubic meters or more.	A detailed and independent energy efficiency report must be submitted to the government regulators.
• Annual comprehensive energy consumption of 1,000 to 3,000 tonnes of coal equivalent; • Annual power consumption of 2 to 5 million kWh; • Annual oil consumption of 500 to 1,000 tonnes; or • Annual natural gas consumption of 500,000 to 1 million cubic meters.	A brief energy efficiency report must be submitted to the government regulators
• Low energy consumption	A government energy efficiency registration form must be completed by the applicant and filed with the government regulators.

The energy efficiency report submitted by the applicants shall include the following contents:

1.	Basis of the energy conservation analysis	The energy conservation analysis should comply with: • The relevant laws and regulations concerning the project • The entry requirements of the subject industry • The catalogue of the energy conservation technologies and energy efficient products recommended by the government, as well as the equipment or production processes declared by government to be obsolete • The details of the project construction and any engineering contracts
2.	Overview of the project	This will include: • Basic information of the applicant and an overview of the business operations • Basic information of the project, including the project name, construction location, nature of the project, the construction scale, the project implementation plan, the general layout, the main economic indicators and the project schedule • An overview on the energy usage of the project, including the initial selection of the main source of energy supply, energy systems and equipment, the type and quantity of energy required for the project and distribution of the energy usage of the project
3.	Assessment of the energy supply situation	This will include descriptions regarding: • The energy supply and consumption at the sites of the project • The project's impact on the consumption of the energy resources near the location of the project
4.	Analysis of the energy conservation for construction of the project	This will include descriptions regarding: • The impact on energy consumption by the location of the project and design of the project • The impact on energy consumption by the operations of the project and technologies used • The technologies used and procedures taken for the project operation, and their energy consumption indicators and energy efficiency • The main energy-consuming equipment, and its energy consumption indicators and energy efficiency • The ancillary production facilities, and their energy consumption indicators and energy efficiency

5.	Assessment of the energy consumption and efficiency of the energy use of the project	This will include assessments with respect to: • The type, source and quantity of energy consumed • Any energy processing, energy conversion and energy utilization • The energy efficiency of the project, including the overall energy consumption and comparable energy consumption per unit of product, energy consumption of the main process, actual energy consumption and overall energy consumption per unit of floor area, and energy consumption per investment unit
6.	Assessment of the energy conservation measures	This will include descriptions regarding: • Energy conservation measures > technical measures adopted for the energy conservation (e.g., those adopted for the production process, construction, drainage, air conditioning, lighting and other aspects, new energy conservation technologies, new equipment applications, recycling of combustible gas, comprehensive utilization of resources, utilization of new energy and renewable energy) > management measures adopted for the energy conservation (e.g., the management systems and policies, relevant divisions and employees for energy management, measurement and supervision) • Energy conservation measures for each unit of project > in respect of energy conservation projects that are not included in the main construction process or to be built in different phases, this includes details of the operation flow, equipment to be used, calculation of the quantity of energy saved for each unit of project, estimate of the investment and the period for the return on investment • Computation of the project's energy consumption indexes (in respect of each unit of product, the main process, each unit of investment) and comparison of such indexes representing the most advanced level in China and in the world • Assessment on the cost-effectiveness of the energy conversation measures
7.	Others	• Description of any potential issues arising from the project and the proposed solutions to them

Energy efficiency reviews will then be conducted by governmental departments in accordance with their respective authority f or project management under the relevant laws and regulations. Upon receiving the energy efficiency report, the local government will appoint independent consulting agencies to examine the energy efficiency of the project and the consulting agencies will issue an opinion within the prescribed time. The opinion will form an important basis for the energy efficiency review by the local government.

China's Ten Key Projects to Save Energy

In preparation for the intense focus on energy-efficient projects by the Chinese government, enterprises may consider applying for funding under the "Ten Key Projects" launched by NDRC since 2004. The Ten Key Projects program is funded by China's Ministry of Finance, which provides financial support for energy-saving projects. Projects that target technological improvements in the following areas may be qualified for financial support under the Ten Key Projects:

- Renovation of coal-fired industrial boilers
- District-level combined heat and power projects
- Waste heat and pressure utilisation
- Oil conservation and substitution
- Motor system energy efficiency
- Energy systems optimization
- Energy efficiency and conservation in buildings
- Energy-efficient lighting savings
- Government procurement of energy-efficient products
- Monitoring and evaluation systems

Applicants will have to undergo a comprehensive energy audit by the authorities and must be able to show that the project will save at least the equivalent of 10,000 metric tonnes of carbon. The more energy the projects can save, the more funding the enterprises can obtain under the scheme. Qualified applicants will secure 60 percent of the funding up-front (which will be calculated according to the estimated amount of energy the project can save), with the remaining 40 percent to be provided after the technology is installed and the energy conservation is evaluated.

In 2007, the Chinese government allocated RMB 23.5 billion to projects to improve energy efficiency and reduce pollution. This funding supported the launch of the Ten Key Projects, the elimination of inefficient facilities and the implementation of measures to protect the environment. In 2008, the total allocation for energy conservation, emissions reduction and ecological improvement doubled to RMB 42 billion. This funding includes RMB 7.5 billion for the Ten Key Projects and RMB 4 billion for phasing out inefficient industrial plants. In 2010, the funding for the Ten Key Project has been substantially increased, as the Chinese government has allocated RMB83.3 billion to the scheme.

Green Economy

Today, China is an acknowledged leader in pursuing green economic development and its energy efficiency program is the most ambitious in the world. Not only has China introduced the Ten Key Projects, the Top 1,000 Energy-Consuming Enterprises Programme and shut down old power plants and production facilities, it has also enacted and amended the Renewable Energy Law and revised the Energy Conservation Law and implemented a variety of financial and tax incentives to encourage energy conservation.

China's 12th Five-Year Plan (2011-2015) will emphasize a low carbon economy and green development. Undoubtedly, enterprises (representing both domestic and foreign investment) that are interested in investing in China should pay close attention to any new policies and incentives introduced by the Chinese government and examine methods to make their projects more energy-efficient. ◆

The Bribery Act 2010—Are you ready for it?

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The UK bribery laws have long been criticised, both domestically and internationally, for their complexity and uncertainty. These concerns have, in turn, given rise to enforcement difficulties. All that is set to change, however.

The Bribery Act 2010 (the Act) was enacted on April 8, 2010. And, while it was originally envisaged that the Act would become operative in October 2010, the change in government following the UK General Election in May 2010 caused this to be delayed. In July 2010, it was announced that the Act would now become operative in April 2011.[1] For many, the extra time was very welcome because once the Act is operative, there will be no grace period to enable those who are subject to it to get their houses in order.

If you need a wake-up call, now is the time to act before it is too late.

Why Is the Act So Important?

The Act marks a radical change to the existing UK bribery laws and has wide extra-territorial reach. It has been described by *The Wall Street Journal* as a "...caffeinated sibling of the Foreign Corrupt Practices Act..."[2] and is potentially a far more aggressive statute with far-reaching implications not only for UK citizens and UK-registered companies, but also for all other commercial organisations that have a business presence in the United Kingdom, irrespective of where they may be formed or incorporated.

The new bribery offences introduced by the Act include the following:

- Two general offences of bribing another person and being bribed
- A discrete new offence of bribing a foreign public official
- A wholly new offence if a commercial organisation fails to prevent bribery by persons associated with it acting in the course of its business

The Act recognises that a bribe may take many different forms (it is referred to in the Act as "...a financial or other advantage...") and is not limited to the archetypal brown envelope stuffed with bank notes. Indeed, overly extravagant corporate hospitality and promotional activities are likely to fall afoul of the Act and this is particularly so where that corporate hospitality or promotional activity is directed at a foreign public official. Great care must be taken as it will be very easy to commit an offence contrary to the Act; whether or not a prosecution will ensue is left to an exercise of prosecutorial discretion.

Understandably, this is considered by many to be an unsatisfactory state of affairs and it is hoped that before the Act comes into force, guidance will be issued to clarify what conduct falls on which side of the line of acceptability.[3]

The Two General Offences

The first general offence focuses on the conduct of the person who offers, promises or gives a bribe; the second general offence focuses on the conduct of the person who requests, agrees to receive or accepts a bribe. In both offences, it is immaterial whether the bribe is offered or requested directly or through an intermediary or whether it is actually given or accepted.

Both general offences involve an improper performance of a relevant function or activity, which, in the context of the Act, may be of a public or private nature. As the definition of what constitutes a relevant function or activity is so widely drawn, it is difficult to conceive of any function or activity that will not fall within the operation of the Act. It should also be noted that the function or activity need have no connection whatsoever with the United Kingdom and may be performed wholly outside the United Kingdom.

The Act provides that a relevant function or activity may be performed improperly if the person performing it is in breach of an expectation that it will be performed impartially, in good faith or in accordance with an obligation of trust. This expectation is to be assessed by what is considered reasonable in the United Kingdom and without regard to any local custom or practice (unless forming part of the written law) of the jurisdiction in which the relevant function or activity is performed. So, for example, a lavish gift provided as a mark of respect that is given in accordance with local custom in one jurisdiction may still contravene the first general offence, giving rise to the risk of prosecution in the United Kingdom.

For the first general offence of bribing another person, in contrast to the existing UK bribery laws, there is no requirement to establish an intention to corrupt. It is sufficient if there is an intention to induce a person to act improperly, or to reward improper performance. In the case of the second general offence of being bribed, in certain cases it is not even necessary to establish any knowledge by the person who is committing the offence (the person being bribed) that what he/she is doing constitutes improper performance.

The Discrete Offence of Bribing a Foreign Public Official

A person will be guilty of this offences if he/she offers a "...financial or other advantage..." to a foreign public official with the intention of influencing that official in his/her capacity as a foreign public official, thereby obtaining or retaining either business or a business advantage. In contrast to the first general offence, no intention to induce improper performance is required—indeed, no dishonesty or criminal impropriety need be established. In this respect, this offence is more stringent than the equivalent contained in the Foreign Corrupt Practices Act (FCPA) and the requirements of the OECD Anti-Bribery Convention of which the United Kingdom is a signatory.

A foreign public official includes: (i) a person holding a legislative, administrative or judicial post (whether appointed or elected) in a country or territory outside the United Kingdom; (ii) a person who exercises a public function on behalf of a country or territory outside the United Kingdom or for a public agency or public enterprise of that country or territory and (iii) a person who is an agent or official of a public international organisation.

In certain jurisdictions, small facilitation (or "grease") payments to foreign public officials to ensure the timely completion of routine administrative tasks are part of the local custom and culture, even if not permitted by the local written law. However, the UK government has signalled a zero-tolerance approach to bribery in all its forms—a bribe is a bribe no matter what its value. A facilitation payment made to a foreign public official therefore gives rise to the risk of prosecution for this offence.

Failure of a Commercial Organisation to Prevent Bribery

The Act makes it an offence for a commercial organisation to fail to prevent bribery by persons associated with it acting in the course of its business. An "...associated person..." includes those persons who provide services for or on behalf of the relevant commercial organisation. This will include employees, subsidiaries and agents but is not limited to these and may include persons, natural or legal, over whom the commercial organisation has no direct control (for example, joint venture partners or consortium members) or even with whom it has no direct contractual relationship (for example, a sub-contractor).

The term "…commercial organisation…" is defined in the Act as including those companies or partnerships incorporated or formed in the United Kingdom and that carry on business in the United Kingdom or elsewhere, and those companies and partnerships incorporated or formed overseas that "…carry on a business or part of a business in the UK…." The Act does not clarify the meaning of these terms and it will be left to the UK courts to determine on a case-by-case basis. It is likely, however, that this business presence test will be very easily satisfied (for example, by having a UK subsidiary or branch office or even a UK agent or distributor) and therefore this new offence should be a concern for all non-UK commercial organisations that are or may become subject to this part of the Act. The Serious Fraud Office (SFO), the lead UK law enforcement agency in cases involving overseas bribery, has indicated that it intends to take broad jurisdiction in respect of this new offence. Indeed, as Richard Alderman, the current Director of the SFO, recently stated in a speech to members of the Commerce & Industry Group:

> For the first time, non-UK companies will be brought within the jurisdiction of the SFO if they have some business presence in the UK. What this will mean is that a foreign corporate which is involved in corruption anywhere in the world will be within the SFO's jurisdiction if it has a business presence here even if the corruption has no connection with that business presence. This is a very important provision for us. I believe that foreign corporates are waking up to the significance of this.[4]

The bribery by the person associated with the commercial organisation may take place wholly outside the United Kingdom and it is irrelevant whether the commercial organisation is aware or has any knowledge of it. Indeed, for this reason the new offence has been described as being one of strict liability, but the Act does provide that it is a defence if the commercial organisation can establish that it had "adequate procedures" in place to prevent such bribery from occurring. This, however, is the only defence to this new bribery offence.

Although there is no statutory definition of adequate procedures, the UK government accepted a statutory duty (incorporated into the Act) to issue guidance as to what commercial organisations could do to ensure that bribery by persons associated with it did not occur. That guidance is expected to be finalised and published in January 2011, three months before the Act becomes operative. That leaves very little time for commercial organisations to consider and implement any necessary changes to their existing policies and procedures.

In September 2010,[5] the UK government issued a draft of the guidance it proposed to issue (focusing on Section 9 of the Act) and commenced a mini-consultation exercise to seek comments on it. As expected, that draft guidance is principles-based and is neither prescriptive nor standard-setting, the view being that it was not appropriate to take a "one size fits all approach." Instead, the guidance sets out six management principles that all commercial organisations might use when considering whether its procedures are adequate: (i) risk assessment, (ii) top-level commitment, (iii) due diligence, (iv) clear, practical and accessible policies and procedures, (v) effective implementation and (vi) monitoring and review.

The draft guidance does not specify the particular policies and procedures that should be introduced—that is left for determination by each individual commercial organisation that is subject to the Act. This is a potentially difficult and time-consuming exercise, and those that operate in what are perceived to be high-risk geographies, that use third-party intermediaries, local agents or consultants, that conduct business through joint ventures or other commercial structures which they may neither own nor control, and that regularly interface, directly or indirectly, with foreign public officials, may find that they have a steep hill to climb by April 2011.

Penalties for the New Bribery Offences

Individuals who are convicted may face up to 10 years imprisonment and/or an unlimited fine. Companies face an unlimited fine. In addition to the penalties provided in the Act, there is a wide array of other penalties that may be imposed both before and after conviction, including an order to disgorge any benefits that may have accrued from the bribery offence[6] (the starting point for this will be the value of any business obtained by bribery which will not be limited to the net profits made or the value of the bribe that is paid) and, if convicted, debarment from tendering for public sector contracts in the European Union.[7]

Liability of Senior Officers

If a commercial organisation commits one of the two general bribery offences or the discrete offence of bribing a foreign public official, then a "...senior officer..." (including a director, manager, secretary or partner of that commercial organisation as well as a person who purports to act in any of those capacities) who has "...consented or connived..." in the commission of that offence is liable as if he/she had committed the offence. While the phrase "consented or connived" is not defined in the Act, both terms require some awareness of the material facts. While "consent" requires some agreement to the course of action followed, "connive" requires only tacit agreement or the turning of a blind eye.

Extra-Territorial Application

If the act or omission constituting either of the general bribery offence or the discrete offence of bribing a foreign public official occurs in the United Kingdom, then the UK courts will have jurisdiction whatever the nationality or origin of the person committing the offence.

A person who is "closely connected" to the United Kingdom may also be prosecuted for a bribery offence that occurs overseas, provided it would have constituted an offence if it had occurred in the United Kingdom. The Act provides that persons who are closely connected to the United Kingdom include, among others, British citizens, those who have British citizenship rights or are considered British subjects or British protected persons, and those of whatever nationality who are ordinarily resident in the United Kingdom as well as UK-incorporated companies.

As outlined above, however, where the Act has the greatest extra-territorial reach is in relation to the new offence of a commercial organisation failing to prevent bribery by associated persons in the course of its business. The SFO has signalled its intentions in relation to enforcement and, as there is only one available defence, it is important to take all necessary action now to ensure that you are best prepared for when the Act comes into force next April.

If you don't take action now, the consequences could be very costly indeed. ◆

Endnotes

1 Bribery Act Implementation—Written Ministerial Statement from the Lord Chancellor and Secretary of State for Justice, Kenneth Clarke QC MP (20 July, 2010).

2 "SFO Anti-Corruption Chief Talks Grease Bribes" by Joe Palazzolo, *The Wall Street Journal*, September 23, 2010.

3 Joint Guidance from the Director of Public Prosecutions and the Director of the Serious Fraud Office to those involved in the investigation and prosecution of bribery offences is in the course of preparation and is expected to be available early in 2011; also, a Circular providing further information on the Act is expected to be published by the Ministry of Justice in early 2011.

4 Speech by Richard Alderman, Director of the Serious Fraud Office to members of the Commerce & Industry Group (in association with Mayer Brown LLP), London, October 13, 2010.

5 Guidance about commercial organisations preventing bribery (section 9 of the Bribery Act 2010) (reference number: CP11/10).

6 Parts 2 and 5 of the Proceeds of Crime Act 2002.

7 EU Public Sector and Utilities Procurement Directives as implemented in the United Kingdom by the Public Contract Regulations 2006 (SI 2006 No 5) and the Utilities Contracts Regulations 2006 (SI 2006 No 6).

Industry Current: FiTs in the United States

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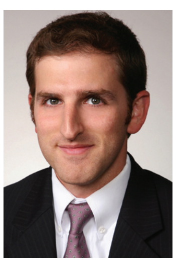

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At least 18 US states are considering, or are reported to be considering, adopting feed-in-tariffs (FiTs) to stimulate renewable energy development. While many states have renewable portfolio standards (RPS) in place, some legislators must feel that their state's RPS do not provide sufficient incentive for targeted renewable energy development.

A renewable portfolio standard is a state policy that requires power providers to obtain a minimum percentage of their power from renewable energy resources by a certain date. As of September 2010, 31 states and the District of Columbia have passed mandatory RPS programs, with six additional states approving conditional or non-mandatory renewable energy goals. Wide disparity exists in state RPS requirements, including what qualifies as a renewable resource, what specific target must be met and by when, and whether there are special set-asides or similar preferences for currently favored renewable sources (e.g., the solar preference in Nevada and the wind preference in Illinois).

Enter FiTs, widely regarded as a successful stimulus to renewable energy development in Europe. However, FiTs face significant legal impediments in the United States because of their potential to raise wholesale power prices of renewable energy, risking preemption by federal law under the Supremacy Clause of the US Constitution. In addition, to the extent that FiTs require or otherwise prefer in-state renewable resources, they risk violating the Constitution's Commerce Clause. Notably, in-state RPS restrictions and similar protectionist policies such as local "multipliers" have raised Commerce Clause concerns with some state RPS.

Despite these significant legal barriers to states' FiT policies, solutions do exist. Through careful legal structuring, states can encourage renewable energy development through FiTs without running afoul of federal law limitations. In our view, using existing federal law (or established exemptions), a European-style FiT is certainly feasible as a legal matter and, we believe, still reasonably practical. For example, by permitting a utility to levy special tariffs for the purpose of making supplemental payments to the renewable energy supplier, states may be able to avoid the constitutional issues that prevent them from directly imposing a FiT. Based on the successful European FiT experience, the ability of states to effectively implement FiTs will play a central role in expanding renewable energy development in the United States.

Constitutional Limits on RPS...

Not only have state RPS programs apparently failed to stimulate renewable energy production as desired, they have also spawned litigation under the Commerce Clause of the US Constitution. Many sta te RPS programs contain protectionist provisions favoring in-state over out-of state facilities. These may include outright bans of out-of-state production or bonuses for in-state production, in the form of incentive multipliers or set-asides. For example, New Jersey requires that its suppliers and providers procure at least 2,518 GWh from in-state solar generators during "energy year" 2021, and 5,316 GWh during "energy year" 2026 and each year thereafter. Under New Mexico law, when all else is equal, preference must be given to renewable energy generated in New Mexico. Ohio law requires that at least 50 percent of the renewable energy requirement be met by in-state facilities. Similar protectionist measures can be found in the RPS laws of many other states as well. While significant variation exists across state RPS requirements, the law is quite clear: programs that favor in state producers are unconstitutional *per se*.

The Commerce Clause grants Congress the power to regulate interstate commerce. An important corollary of that power is that states generally may not pass protectionist laws that discriminate against interstate commerce. The US Supreme Court has long struck down facially discriminatory state laws by applying a "virtually *per se* rule of invalidity," as stated in *Wyoming v. Oklahoma*[1]. For such a law to survive, the enacting state must show that it had no other means to protect a unique local interest than to facially discriminate against interstate commerce, a test that is almost impossible to meet. Even where state and local laws are not facially discriminatory, they still may be unconstitutional if their burden on interstate commerce clearly exceeds local benefits.

Wyoming v. Oklahoma offers an example of a constitutional challenge to state economic protectionism in the energy sphere. In that case, the state of Oklahoma enacted a law that required all electricity generators to purchase at least 10 percent of their coal from in-state coal mines. The Supreme Court found that the law unconstitutionally discriminated against out-of-state coal, for no strong reason other than protectionism. It made no difference that Oklahoma's statute affected only a "small portion" of the Oklahoma coal market; the Court explained that Commerce Clause invalidated state and local laws that provide *any* type of facial economic protectionism. Cases like *Wyoming* raise serious doubts as to the constitutionality of many states' RPS programs.

As expected, states' RPS restrictions have spawned legal challenges. In *TransCanada Power Marketing Ltd. v. Bowles*,[2] TransCanada sued a number of officials in Massachusetts seeking a declaration that the Massachusetts RPS program was unconstitutional insofar as TransCanada's out of state renewable resources were not eligible. While these parties are reported to have settled their dispute, *TransCanada* promises to be just the first of many battles against facially protectionist state RPS measures.

The Supreme Court has recognized (in *FERC v. Mississippi*[3]) that the market for energy production is one of the most "basic element[s] of interstate commerce." In another electric power case (*Ark. Elec. Coop. v. Ark. Pub. Serv. Comm'n*[4]), the Court has also stated that "uncontrolled regulation by the States can patently interfere with broader national interests." In light of comments such as these, as well as the Court's recognition that renewable energy generated out-of-state is virtually identical to renewable energy generated in-state, states will be hard-pressed to justify their facially discriminatory RPS measures.

State FiTs will obviously need to be structured in light of the outcomes of the Commerce Clause challenges to RPS programs. We now turn to review Constitutional limitations affecting state FiT programs.

...And on FiTs

In addition to the Commerce Clause restrictions on state protectionism, state FiT programs face limitations under the Supremacy Clause of the US Constitution. Every "wholesale" energy sale in interstate commerce, which can include sales that take place entirely within a state if the interstate transmission grid is used, implicates federal law, and requires either compliance or exemption. To the extent that a FiT applies to such sales, technically the FiT obligations are imposed on the purchaser rather than the seller; however, whether this is effective to avoid the otherwise applicable federal law remains uncertain.

The Federal Power Act (FPA) governs the transmission and sale for resale (i.e., "wholesale") of power in interstate commerce. The FPA makes it unlawful to make a sale at wholesale without a contract, and without US Federal Energy Regulatory Commission (FERC) approval of that wholesale contract (which can include FERC approval of a tariff authorizing the seller to make sales for resale at market-based rates, rather than pursuant to individually approved contracts). This effectively means that a state FiT cannot lawfully force a utility to purchase power at a state-set price. As a result, any FiT imposed under the FPA could not be an unconditional obligation to purchase the renewable energy produced. Instead, the purchase price would remain subject to approval by FERC, using a "just and reasonable" and not "unduly discriminatory" standard as defined by Sections 205 and 206 of the FPA.

One exemption from the FPA is under the Public Utility Regulatory Policies Act of 1978 (PURPA), which allows renewable energy producers to make certain sales of power to utilities without FERC approval. To be eligible, however, a facility must receive FERC certification as a "qualifying facility" (QF), which is limited to a subset of renewable energy technologies and project sizes, and the sale must be pursuant to a state program implementing PURPA. In addition, the price to be paid by the utility cannot exceed the utility's avoided cost.

Because of the QF exemption from FPA compliance, PURPA would appear to be a viable FiT implementation structure. But it is far from perfect. Most wind farms and large-scale solar projects are too large to meet the requirements of a qualifying facility, so a state FiT would have to target individual users and small renewable producers. Additionally, a utility's avoided cost is most likely still well below the price necessary to provide adequate compensation to the renewable energy producer. While the first issue will not disappear, short of an amendment to PURPA, it makes the second issue, sufficient compensation to the producer, critically important. Qualifying facilities (and their developers/investors) will only participate in the FiT if they receive compensation adequate to cover costs and earn a reasonable return on their related investment.

This means that states must find a way to supplement avoided costs. Doing so will allow US FiTs to stimulate renewable energy production, as they have done in Europe. A review of the situation in California, which has become the battleground for deciding the constitutionality of state FiT programs, illustrates how difficult and complex such a process can be.

Recent California FiT Challenges

Introduced at the end of 2008, California's FiT pays $0.096 per kilowatt hour (kWh) for combined heat and power generating facilities of 20 megawatts (MW) or less installed in 2010. This price is based on the Market Price Referent (MPR), set at the avoided cost of a natural gas-fired plant and includes a greenhouse gas adder to reflect the anticipated cost of carbon mitigation. Specifically, the MPR assumes that the opportunity cost for wholesale power mirrors the hypothetical cost of operating a base-load combined-cycle gas turbine (CCGT) unit over a 10-, 15-, 20- or 25-year period. The MPR also incorporates the likely future cost of greenhouse gas emissions control efforts, such as a carbon tax. The MPR is also used under the state's accelerated RPS, adopted in 2006.

Because the total FiT ends up above avoided costs, the three major retail utilities, Southern California Edison, Pacific Gas & Electric and San Diego Gas & Electric, filed a complaint with FERC in May 2010, alleging the FiT amounts to unconstitutional state regulation of interstate power at wholesale. In their complaint, they based their claims on previous FERC rejections of state pricing above avoided costs inside of PURPA and made the policy argument that inconsistent pricing across states could impose a significant burden on investor-owned utilities, giving rise to prohibitively high wholesale renewable energy prices that destroy their competitive advantage.

Newly elected Governor Jerry Brown, who was then the California Attorney General, responded to the complaints by claiming that California is not setting rates for the wholesale generator. Instead, he asserted, it is establishing a price that utilities must offer to generators in order to comply with state law; the generator retains discretion to sell (or not) at the offered rate. A January 2010 report by the National Renewable Energy Lab (NERL) lent support to Brown's position, claiming that a state FiT would not violate the FPA if designed as the utility's offer to buy at a state-specified price. The NREL based its conclusion on FERC's 1997 ruling in *Midwest Power Systems, Inc.*[5] In that case, FERC held that Iowa's 6-cent FiT (versus a 1.5-cent avoided-cost rate) was pre-empted as unlawful because it fell outside of PURPA.

Yet while California took care to ensure that its FiT would fall outside of PURPA, it is unclear whether this is indeed the case. Most of the generation facilities meeting the state's efficiency standard could be QFs under the PURPA standard in any event, meaning there may not be federal preemption. But California doesn't require eligible generators to obtain QF status, so it can disclaim any intent to act under PURPA.

Brown also defended the FiT under the state's police power, as a public health and safety law. As a result, he asserted, it should be presumed lawful and not preempted absent a clear and manifest purpose by Congress. According to Brown, due to the impending threat of global warming, PURPA and FERC should be interpreted liberally to give states flexibility in avoided-cost rate setting to accommodate important state environmental objectives. And, because the California MPR has been deemed to be *de facto* reasonable in the context of the RPS, the same standard should carry over to a FiT.

But FERC was not persuaded by Brown or the California Public Utilities Commission (CPUC), the California agency responsible for implementing the FiT. In a July 15, 2010, order, it found that certain CPUC decisions are preempted by federal law, except in limited circumstances. While California was relying on the fact that its FiT controlled power purchases, not power sales, FERC elevated substance over form, holding that the California FiT attempted to establish wholesale prices above the avoided cost of the purchasing utility. As FERC has exclusive authority to regulate wholesale power sales, it held the California FiT to be preempted under the Supremacy Clause of the US Constitution. This means the FiT must comply with the FPA and PURPA, which requires that eligible facilities are QFs and the established "offer" price does not exceed avoided cost. This victory for the retail utilities has broad implications for other California FiT programs and for all states that currently have, or are considering, FiTs.

Based on the FERC order, states must now find an alternative method for setting total payments, or equivalent feed-in tariffs, above avoided costs, to avoid triggering federal preemption under the FPA. We believe this can effectively be done under PURPA by providing supplemental payment mechanisms to generators of power rather than directly addressing the price of power, which as we have seen is problematic. Such supplemental payments mechanisms are generally outside of FERC's jurisdiction and might take the form of: (i) renewable energy credits/certificates, which generators would sell to purchasers needing to comply with RPS or other state-law mandates; (ii) subsidies/cash grants directly to generators from states; (iii) utility tax credits for purchasers of renewable energy equivalent to the amount of the additional payment required for the renewable source, effectively offsetting the economic impact of such additional charge or (iv) standard offer contracts implemented through state RPS, with sellers either exempt from FPA rate requirements or authorized to charge market-based rates. These payments legally "top-up" the avoided cost, so that the total tariff received by generators can more closely reflect the cost of generation.

The German FiT program is widely viewed as one of the most successful in Europe, in terms of stimulating renewable energy production. The German FiT program includes a top-up payment that comes from a pool known as the Systems Benefit Charge, collected from ratepayers. In contrast to the Swiss program, where the pool is fixed and collected in advance, the German pool is flexible and applied to ratepayers after the fact. So, as more renewable energy production is added to the system, the pool expands and charges ratepayers proportionally (including a reasonable return on investment).

A similar program adopted in the United States would not only give states legal cover under PURPA, but, as long as the top-up payments are made to utilities to offset higher purchase prices (rather than being made to generators directly), would also help shift the investment risk of renewable energy, as a public good, to the utility ratepayers. Utilities would then be faced with identifying the optimal method of financing these additional costs. We believe that, in particular, stranded-cost securitization could then be used to finance renewable energy development, by monetizing the FiT charges and transferring the production risk to the capital markets, with low transaction costs and capital markets efficiencies.

States to Proceed with Caution on FiTs

Feed-in-tariffs can be used by states to stimulate renewable energy development where RPS alone have fallen short. Currently, 10 states are contemplating the adoption of above-wholesale-cost FiTs for state-regulated investor-owned utilities; we believe that they should continue doing so if they desire realistically to encourage greater renewable energy generation. Yet the legal obstacles require great care in structuring the FiT. While a state FiT cannot exceed avoided costs, supplementary payments under PURPA can be used legally to avoid federal preemption, encouraging desired levels of generation while allowing developers and investors to earn a reasonable profit.

Although the supplemental payment approach should help avoid federal preemption, there is still the lingering problem that US energy law treats renewables as a supplement to the existing utility system. While states could attempt to level the playing field through uncapped FiTs, thus allowing for a diversity of energy sources, federal energy law continues to be a major hindrance, as most wind farms and large-scale solar projects are too large to be considered qualifying facilities under PURPA. This explains why California has seen no significant increase in in-state renewable energy production, while foreign countries with FiTs, where there are no size restrictions, have seen demand for renewables surge in recent years.

But California and other states can use supplemental payments under PURPA to provide push aggregate prices above avoided costs, providing incentives for producers, while sidestepping the FPA. Eliminating any uncertainty that surrounds state implementation of FiTs through supplemental payments will allow the United States to follow Europe's lead and see a major expansion in renewable energy production. ◆

Endnotes

1 502 U.S. 437, 454 (1992).

2 Case No. 4:10-cv-40070 (D. Mass.).

3 456 U.S. 742, 757 (1982).

4 461 U.S. 375, 377 (1983).

5 Docket EL95-51, 78 FERC ¶61067

Brazilian Pre-Salt: PSA Regime Approved in the Congress

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On December 2, 2010, the Brazilian House of Representatives gave its final approval to the creation of a new regime for the exploration of the pre-salt reserves through the adoption of a production sharing agreement model (the "PSA regime"). The PSA regime was previously discussed in the Brazilian Senate, which approved the bill on June 10. Under the PSA Regime, Petrobras will own at least a 30 percent participating interest in every new venture within the pre-salt area, which is estimated to hold recoverable reserves of roughly 50 billion barrels of oil.

Petrobras will have the right, either solely or in consortium with other partners, to conduct all the exploration and production operations required within the pre-salt blocks, at its cost and risk, and, in the event of a commercial discovery, be entitled to reimbursement of the costs incurred (cost oil) and a share of the surplus production (profit oil). The oil produced becomes government property after both the cost oil and profit oil are deducted.

Government leaders believe that the PSA regime will enhance the development of the petrochemical industry. They believe that by increasing the state control over production will allow them to sell oil under more favorable conditions and to use oil to execute strategic agreements with trade and political partners. The government also aims to exert more control over the industry's supply chain by imposing even stricter local content requirements.

The PSA regime was originally provisioned by one of four separate bills proposed in August 2009, each of them dealing with specific matters related to the exploration of the pre-salt reserves. However, since their submission to the Congress, the four bills have been subject to many amendments, and several of the provisions have become quite different from the Executive Branch original proposals.

One of these significant changes was the incorporation of the PSA regime into the bill initially intended to regulate the creation of an oil wealth fund to manage the revenues from the pre-salt reserves and support social and economic development in Brazil (the "Social Fund"). According to Senator Romero Jucá, the Social Fund is part of the PSA regime and, therefore, both matters should be discussed and voted together as a single bill.

The Congress has also approved a very controversial amendment establishing that the royalties from all offshore fields (even those outside the pre-salt areas) must be equally distributed among all states and municipalities, instead of being directed mostly to the oil producing regions. This provision also determines that the government will compensate the producing states (mainly Rio de Janeiro and Espírito Santo) for their loss of funds, although it is unclear when and how this will occur.

President Lula has already asserted that he will veto this amendment, since the original proposals were not supposed to affect the royalties from the existing concession contracts. Lula believes that the pre-salt reserves have enough resources for a satisfactory distribution and that any change to the existing rules shall be discussed in the future under a separate bill.

A veto to the amendment will not affect the approval of the remaining subjects, particularly the PSA regime and the Social Fund, and the bill is now only awaiting for the sanction of the President.

Observations in this article about Brazilian law are by Tauil & Chequer Advogados. They are not intended to provide legal advice to any entity; any entity considering the possibility of a transaction must seek advice tailored to its particular circumstances.

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