

Energy Industry Updates for February 2009 – Overview of Energy-Related Stimulus

Energy Stimulus: Overview of Provisions Applicable to the Energy Sector in the American Recovery and Reinvestment Act of 2009

Significant provisions affecting the energy industry are included in the \$787 billion economic stimulus package passed by Congress on February 14, 2009. The American Recovery and Reinvestment Act of 2009 (Act) is being signed into law on February 17, 2009. A summary of energy provisions is provided below. Additional information on energy tax provisions and the Act's most controversial subject, decoupling of utility rates, are provided in the following articles of this Foley Legal News: Energy edition.

Transmission Items

- **Funding for electricity delivery and reliability.** The Act includes \$4.5 billion for smart grid-related projects selected by the U.S. Department of Energy (DOE) for: (i) modernizing the electric grid with demand-responsive equipment, (ii) enhancing security and reliability, (iii) energy storage research, development, demonstration, and deployment, (iv) facilitating recovery from disruptions to the energy supply, and (v) otherwise implementing the smart grid program that was authorized under the Energy Independence and Security Act of 2007 (EISA). No time limit was placed on funds disbursement. *See Conference Report, Division A, Title IV, p. 11.*
- **Amendments to the Smart Grid Program**
 - **Federal matching for smart grid technology.** The Act amends the EISA in order to increase federal matching for smart grid technology from 20 percent to 50 percent. *See Conference Report, § 405(5).* Within 60 days of passage of the bill, the Secretary of Energy must establish procedures for applicants, who can obtain grants of not more than one-half of their documented costs. *See Conference Report, § 405(8).*
 - **Jumpstart smart grid demonstration projects in geographically diverse areas.** The Act requires the secretary to provide financial support to smart grid demonstration projects in geographically diverse areas (i.e., urban, suburban, tribal, and rural areas, including areas where electrical system assets are controlled by nonprofit entities and areas where such assets are controlled by investor-owned utilities). *See Conference Report § 405(1).*
 - **Requirement for open protocols and public disclosure of projects.** As a condition to receiving financial assistance, a utility or other participant in a smart grid demonstration project will be required to: (i) utilize open protocols and standards, (including Internet-based protocols and standards), if available, and (ii) make data concerning the project publicly available through a new DOE smart grid information clearinghouse. *See Conference Report § 405(3), § 405(8).*
- **Funding for WAPA and BPA transmission projects.** The Western Area Power Administration (WAPA) and the Bonneville Power Administration (BPA) receive \$3.25 billion each in loans to finance improvements to transmission lines and related facilities necessary to deliver power generated from renewable sources. WAPA also receives additional staff and \$10 million in direct funding for construction, rehabilitation, operations, and maintenance. *See Conference Report § 401, § 402 & Division A, Title IV, Environmental and Other Defense Activities, p. 15.*
- **Regional transmission plans.** The DOE Office of Electricity Delivery and Energy Reliability receives \$80 million to conduct a resource assessment and analysis of future demand and transmission requirements for the purpose of facilitating the development of regional transmission plans. Consultation with the Federal Energy Regulatory Commission (FERC) is required. *See Conference Report, Division A, Title IV, Electricity Delivery & Energy Reliability, p. 12- 13.*
 - **ERCOT and Eastern and Western Interconnections Interconnection-based transmission plans.** The DOE Office of Electricity Delivery and Energy Reliability, acting in coordination with FERC, also is required to provide technical assistance to the North American Electric Reliability Corporation, regional reliability entities, the states, and other transmission owners and operators for the formation of interconnection-based transmission plans for the Eastern and Western Interconnections and Energy Reliability Council of Texas (ERCOT). Such assistance may include modeling or support for the development of coordinated state electricity policies, programs, laws, and regulations. *See Conference Report, Division A, Title IV, Electricity Delivery & Energy Reliability, p. 12- 13.*
- **Transmission study — obstacles to renewable energy.** The DOE must include an analysis of the transmission issues facing renewable energy in the pending 2009 National Transmission Corridor study due to be issued in August 2009. The analysis must include recommendations for achieving adequate transmission capacity and will focus on (i) potential sources of renewable energy

that are constrained in assessing appropriate market areas by lack of adequate transmission capacity, (ii) the reasons for failure to develop adequate transmission capacity, and (iii) the extent to which legal challenges filed at the state and federal level are delaying construction of transmission necessary to access renewable energy. *See Conference Report § 409.*

DOE Loan Guarantees for Renewables and Transmission Projects

- The Act designates \$6 billion for a new loan guarantee program for rapid deployment of renewables and transmission technologies authorized pursuant to an amendment to the DOE Loan Guarantee Program established by the Energy Policy Act of 2005. The \$6 billion allocated for such guarantees is expected to support more than \$600 billion in loans for these projects. (Earlier versions of the bill had included up to \$50 billion in guarantees.) Eligible projects must commence construction no later than September 30, 2011 and could include the following:
 - **Renewable energy system.** Wind and solar electric generation facilities, incremental hydropower, and facilities that manufacture related components.
 - **Transmission projects.** Factors to be considered: (i) the viability of the project without guarantees, (ii) the availability of other federal and state incentives, (iii) the importance of the project to meeting reliability needs, and (iv) the effect of the project to state/regional environmental (including climate change) and energy goals.
 - **Biofuels.** Leading-edge biofuel projects (up to \$500 million) that use technologies performing at pilot or demonstration scale that are likely to become commercial technologies and will produce transportation fuels that substantially reduce life cycle greenhouse-gas emissions compared to other transportation fuels.

See Conference Report § 406.

\$16.8 Billion in DOE Grants for Energy Efficiency and Renewable Energy

- **Energy efficiency and conservation block grants.** \$3.2 billion for Energy Efficiency and Conservation Block Grants awardable to states, eligible units of local government, and Native American tribes pursuant to subtitle E of title V of the EISA. Of that amount, \$2.8 billion will be awarded pursuant to a formula to be published in the Federal Register no later than 90 days prior to the beginning of each fiscal year. The Act explicitly requires that \$400 million shall be awarded on a competitive basis. *See Conference Report, Division A, Title IV, Department of Energy, Energy Programs, Energy Efficiency & Renewable Energy, p. 9 - 10.*

Among several other purposes, Energy Efficiency and Conservation Block Grants may be awarded to: (i) provide grants to nonprofit organizations and government agencies for the purpose of performing energy efficiency retrofits, (ii) develop and implement energy efficiency and conservation programs for buildings and facilities within the relevant jurisdiction, (iii) develop and implement building codes, (iv) implement energy-distribution technologies that increase efficiency (e.g., distributed resources, district heating, and cooling systems), (v) purchase and implement technologies to reduce, capture, and use methane and other greenhouse gases generated by landfills and similar sources, and (vi) implement or install on or in any government building on-site renewable technology (e.g., solar, wind, fuel cell, or biomass). *See EISA, Title V, Subtitle E.*

- **Weatherization assistance program.** \$5 billion to help low-income families reduce their energy costs by weatherizing their homes. *See Conference Report § 407.*
- **State energy program.** \$3.1 billion to the State Energy Program authorized under the Energy Policy and Conservation Act (EPCA). The receipt of such funds in an amount exceeding the base allocation established for a state under the EPCA is conditioned upon the governor of the recipient state notifying the Secretary of Energy in writing that the governor has obtained certain necessary assurances. Such required assurances are that: (i) the applicable state regulatory authority will seek to implement a general policy that (a) ensures that electric and gas utility financial incentives are aligned with helping customers use energy more efficiently and (b) provides timely cost recovery and timely earnings opportunity for utilities in a way that enhances customers' incentives to use energy more efficiently; (ii) the state or applicable local government authorities will implement certain building codes; and (iii) the state will prioritize the grants toward funding energy efficiency and renewable energy programs. *See Foley's article on decoupling in this Legal News. See Conference Report, Division A, Title IV, Department of Energy, Energy Programs, Energy Efficiency & Renewable Energy, p. 10; See also Conference Report § 410.*
- **Advanced battery manufacturing grants.** \$2 billion for grants for the manufacturing of advanced batteries and components in the United States, including advanced lithium ion batteries, hybrid electrical systems, component manufacturers, and software designers. *See Conference Report, Division A, Title IV, Department of Energy, Energy Programs, Energy Efficiency & Renewable Energy, p. 10.*
- **Remaining \$3.5 billion for energy efficiency and renewable energy.** The remaining \$3.5 billion of the \$16.8 billion authorized for energy efficiency and renewable energy is not allocated to specific programs by express language in the conference agreement. According to the legislative history set forth in the Joint Explanatory Statement of the Committee of Conference, the conference agreement includes the following appropriations for this remaining \$3.5 billion:

- **Research and development.** \$2.5 billion for applied research, development, demonstration, and deployment activities, to include \$800 million for projects related to biomass and \$400 million for geothermal activities and projects.
- **Alternative fueled vehicles pilot grant program.** \$300 million.
- **Transportation electrification.** \$400 million.
- **Energy efficient appliance rebate program.** \$300 million.

See Conference Report, Division A, Title IV, Department of Energy, Energy Programs, Energy Efficiency & Renewable Energy, p. 9; See Joint Explanatory Statement of the Committee of Conference.

Federal Buildings Going Green

The Act requires that not less than \$4.5 billion of the \$5.5 billion allocated to the Federal Building Fund be used to convert federal facilities to High Performance Green Buildings. Not less than \$5 billion of the funds provided for the Federal Building Fund must be obligated by September 30, 2010, and the remainder must be obligated by September 30, 2011. *See Conference Report § Title V, General Services Administration, Real Property Activities, Federal Buildings Fund, p. 3 – 4.*

Federal and State Procurement of Fuel-efficient Vehicles

The Act makes \$300 million, available until September 30, 2011, for procurement of motor vehicles with higher fuel economy, including hybrids, electric vehicles and commercially-available, plug-in hybrid vehicles. Before obligating any of such funds, the General Services Administration must submit a plan for expenditure detailing the current inventory of the federal fleet and the strategy to expend such funds to replace a portion of the federal fleet with the goal of increasing energy efficiency, including fuel efficiency and reduced emissions. *See Conference Report § Title V, General Services Administration, Energy Efficient Federal Motor Vehicle Fleet Procurement, p. 5 – 6.*

Energy Efficiency for U.S. Department of Defense Facilities

The Act provides \$2.075 billion for operation and maintenance funds to be used, in part, to invest in the energy efficiency of the Department of Defense. Specific allocations for each of the Army, Navy, Marine Corps, Air Force, Reserves, and Coast Guard, will be available until September 30, 2010. *See Conference Report, Title III, p. 1 – 4.* Separate provisions of the stimulus package allocate \$100 million to the Navy and Marine Corps for energy conservation and alternative energy projects and \$120 million to the Department of Defense Energy Conservation Investment Program. *See Conference Report, Title X, p. 2 – 3*

Coal and Carbon Capture Research and Development

The Act includes \$3.4 billion for fossil energy research and development. The conference agreement does not include several provisions proposed by the U.S. Senate delineating funding within this account. *See Conference Report, Division A, Title IV, Fossil Energy Research and Development, p. 13.* According to the legislative history set forth in the Joint Explanatory Statement of the Committee of Conference, such funding includes \$800 million for additional amounts for the Clean Coal Power Initiative Round III Funding Opportunity; \$1.52 billion for a competitive solicitation for a range of industrial carbon capture and energy efficiency improvement projects, including a small allocation for innovative concepts for beneficial carbon dioxide reuse; \$50 million for a competitive solicitation for site characterization activities in geologic formations; and \$20 million for geologic sequestration training and research grants

Energy Tax Provisions

The Act provides \$20 billion in energy tax incentives designed to promote investment in renewable energy and transmission expansion and \$13.5 billion in business tax incentives. See our article on energy tax provisions in this Legal News: Energy edition. *See also, Conference Report, Division B, Title 1, Subtitle B, Part 1.*

Energy Tax Provisions: American Recovery and Reinvestment Act of 2009

The Act also includes \$20 billion in energy tax incentives as detailed below. The Conference Report containing these provisions can be found at <http://www.rules.house.gov/>.

- **Extension of production tax credits.** The Act extends the period during which qualified facilities producing electricity may be placed into service for the purpose of the electricity production tax credit (PTC) under Section 45, as follows:
 - **Wind facilities:** three-year extension, through December 31, 2012
 - **Other qualified facilities:** three-year extension for closed-loop biomass, open-loop biomass, geothermal, municipal solid waste, and qualified hydropower projects, through December 31, 2013; two-year extension for marine and hydrokinetic renewable energy sources, through December 31, 2013

See Conference Report § 1101.

- **Option to elect investment tax credit.** Rather than taking the PTC over 10 years, a taxpayer may make an irrevocable election to

have qualified facilities otherwise eligible for the PTC take a 30 percent investment tax credit (ITC) when such a qualified facility is placed into service. Qualified property eligible for the election generally consists of tangible personal property or other tangible property (not including a building or its structural components), but only if the property is used as an integral part of the qualifying facilities and is depreciable or amortizable. *See Conference Report § 1102.*

- **Repeal of limitations on credit for renewable energy property.** The Act eliminates the cap on the ITC for small wind energy property. Under current law, businesses are allowed to claim a 30 percent tax credit for small wind energy property (capped at \$4,000). In addition to repealing the cap, the Act removes the rule that reduces the basis of the property for the purposes of claiming the credit if the property is financed in whole or in part by subsidized energy financing or with proceeds from private activity bonds. *See Conference Report § 1103.*
- **Grants for specified energy property in lieu of tax credits.** The Act authorizes the Treasury Secretary to provide a grant to each person who places specified energy property in service during 2009 or 2010, or during subsequent years so long as construction begins in either 2009 and 2010 and is completed before the credit termination date, which is 2013 (in the case of wind facility property), 2014 (in the case of other renewable power facility property eligible for credit under Section 45), or 2017 (in the case of any specified energy property described in Section 48). Under this provision, if a grant is paid, no renewable energy credit or energy credit may be claimed with respect to the grant eligible property. Qualifying property must be depreciable or amortizable to be eligible for a grant. The grant amounts include:

The following categories of qualifying property are eligible for a 30 percent of facility cost grant:

- Certain (but not all) qualified facilities under IRC § 45(d)
- Qualified fuel cell property under IRC §48(c)(1)
- Solar property under clause (i) or (ii) of IRC § 48(a)(3)(A)
- Qualified small wind energy property under IRC § 48(c)(4)

The following categories of qualifying property are eligible for a 10 percent of facility cost grant:

- Geothermal property under IRC § 48(a)(3)(A)
- Qualified microturbine property under IRC §48(c)(2)
- Combined heat and power system property under IRC § 48(c)(3)
- Geothermal heat pump property under clause (vii) of IRC § 48(A)(3)(A)

The Treasury Secretary is required to make payment of such grants during the 60-day period beginning on the later of (a) the date of the application for such grant, or (b) the date that the specified energy property for which the grant is being made is placed into service.

Legislative history indicates that Congress intends that the grant provision mimic the operation of the credit under Section 48. For example, the Act amends Section 48 so that the amount of the grant is not includable in gross income but the basis of the property is reduced by 50 percent of the amount of the grant. In addition, some or all of each grant is subject to recapture if the grant eligible property is disposed of by the grant recipient within five years of being placed into service.

See Conference Report § 1104, § 1603.

- **New manufacturing investment tax credit.** Creates a new 30 percent ITC for facilities that manufacture “advanced energy property,” including facilities for the manufacture of renewable energy, energy storage, energy conservation, and carbon capture and sequestration. Manufacturing ITCs worth \$2.3 billion would be available through a competitive bidding process. Subject to a few exceptions, a “qualifying advanced energy project” includes a project that re-equips, expands, or establishes a manufacturing facility for the production of property that is:
 - **Solar, wind, or geothermal.** Designed to be used to produce energy from the sun, wind, geothermal deposits (within the meaning of Section 613(e)(2)).
 - **Fuel cells and energy storage systems.** Designed to manufacture fuel cells, microturbines, or an energy storage systems for use with electric or hybrid-electric motor vehicles.
 - **Transmission line.** Designed to manufacture electric grids to support the transmission of intermittent sources of renewable energy.
 - **Carbon capture and sequestration.** Designed to capture and sequester carbon dioxide emissions.
 - **Renewable fuels and conservation.** Designed to refine or blend renewable fuels or to produce energy conservation technologies, including energy-conserving lighting technologies and smart grid technologies.
 - **Electric vehicles.** Designed to manufacture any new qualified plug-in electric vehicle (as defined by Section 30D(f)(2)) or any component that is designed specifically for use therewith.
 - **Other.** Determined by the Treasury Secretary to reduce greenhouse-gas emissions.

In selecting projects, the Treasury Secretary (in consultation with the Secretary of Energy) must consider those projects with the greatest potential for technological innovation and commercial deployment as well as the greatest potential for domestic job creation and reduction of greenhouse gases.

Each application must be submitted during the two-year period on the date the certification program is established. An applicant for certification has one year from the date of acceptance of the application to demonstrate that the requirements for certification have been met. Upon certification, the applicant has three years to place the project in service.

See *Conference Report § 1302*.

- **Clean Renewable Energy Bonds (CREBs).** The Act authorizes issuance of up to an additional \$1.6 billion of new CREBs. CREBs may be issued by qualified issuers to finance facilities that generate electricity from the following resources: wind, closed-loop biomass, open-loop biomass, geothermal, small irrigation, hydropower, landfill gas, marine renewable, and trash combustion facilities. Qualified issuers include: (i) public power providers; (ii) governmental bodies; (iii) cooperative electric companies; (iv) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (v) clean renewable energy bond lenders. See *Conference Report § 1111*.
- **Qualified energy conservation bonds.** The Act authorizes an additional \$2.4 billion of qualified energy conservation bonds to finance state, municipal, and tribal programs designed to reduce greenhouse-gas emissions. The bonds may be issued to make loans or grants for capital expenditures to implement green community programs. See *Conference Report § 1112*.
- **Modification of credit for carbon dioxide sequestration.** The Act requires that carbon dioxide used as a tertiary injectant and otherwise eligible for a \$10 per metric ton credit must be sequestered by the taxpayer in permanent geological storage in order to qualify for such credit. The term permanent geological storage includes oil and gas reservoirs in addition to unminable coal seams and deep saline formations. See *Conference Report § 1131*.
- **Homeowner tax credit on energy efficiency improvements.** The Act increases the value of the energy-efficient existing homes credit to 30 percent for 2009 and 2010, modifies the standards for qualifying property, and sets the per-dwelling maximum for this period at \$1,500 per taxpayer (i.e., a per-dwelling cap, rather than a per-taxpayer cap). See *Conference Report § 1121*.
- **Residential energy property, solar thermal and geothermal.** The Act removes the \$2,000 cap on the 30 percent credit for solar thermal and geothermal property as well as the \$4,000 cap on small wind property. The proposal also eliminates the current-law basis reduction for subsidized energy financing. See *Conference Report § 1122*.
- **Credits for electric vehicles.** The Act creates a new 10 percent credit for low-speed vehicles, motorcycles, and three-wheeled vehicles (\$2,500 maximum), and a 10 percent credit for the cost of converting any motor vehicle into a qualified plug-in electric drive motor vehicle (\$4,000 maximum). The Act also modifies the plug-in electric drive motor vehicle credit by limiting the maximum credit to \$7,500 regardless of vehicle weight. The Act also eliminates the credit for low speed plug-in vehicles and for plug-in vehicles weighing 14,000 pounds or more. Among other changes, the Act replaces the 250,000 total plug-in vehicle limitation with a 200,000 plug-in vehicles per manufacturer limitation. See *Conference Report, Title V, Plug-In Electric Drive Motor Vehicles*.
- **Temporary increase in credit for alternative fuel vehicle refueling property.** Under current law, the alternative refueling property credit provides a tax credit to businesses (e.g., gas stations) that install alternative fuel pumps such as fuel pumps that dispense E85 fuel, hydrogen, and natural gas. For 2009 and 2010, the Act increases the current 30 percent alternative refueling property credit for businesses (currently capped at \$30,000) to 50 percent (capped at \$50,000). Hydrogen refueling pumps remain at a 30 percent credit percentage; however, the cap for hydrogen refueling pumps is increased to \$200,000. See *Conference Report § 1123*.

The Act also includes \$13.5 billion in business tax incentives. The following two of such provisions may be of particular interest to energy companies:

- **Extension of bonus depreciation.** Last year, Congress temporarily allowed businesses to recover the costs of capital expenditures made in 2008 faster than the ordinary depreciation schedule would allow by permitting these businesses to immediately write-off 50 percent of the of the depreciable basis of qualifying property acquired in 2008 (after any Section 179 deduction and before figuring out the regular depreciation deduction). Qualifying property includes, among other categories, tangible property depreciated under the modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less. Among other requirements, the original use of the property must have begun with the taxpayer in 2008. (See *Department of Treasury, IRS Publication 553, Rev. April 2008*). The Act extends this temporary benefit for capital expenditures in 2009 (and 2010 for certain longer-lived and transportation property). See *Conference Report § 1201*.
- **Five year carry back of net operating losses.** The Act allows “small businesses” to elect to carry back net operating losses for taxable years ending in 2008 (or if the small business elects, for taxable years beginning in 2008) for a period of up to five years. An applicable eligible small business is a taxpayer meeting a \$15 million gross receipts test. See *Conference Report § 1211*.

Federal Energy Policy Debate on Decoupling State Utility Rates

One of the major energy policy issues in the debate over the stimulus bill was whether certain federal grants to states should be conditioned upon a state's having adopted or committed to a policy of "decoupling" of electric and gas utility distribution rates.

Decoupling involves the restructuring of a utility's rates so as to tie the recovery of the cost of providing distribution services to the level of such costs rather than on the volume of electricity or gas that it delivers to its customers, as has traditionally been the case. Decoupling generally is advocated as a means of eliminating the "throughput incentive", that is, to remove the utility's perceived incentive to promote consumption (or to oppose energy efficiency or conservation). Proponents state that decoupling promotes more accurate recovery of the fixed costs of distribution service.

The U.S. House of Representatives version of the stimulus bill contained a fairly strong decoupling mandate as a condition of a state's eligibility for certain funds. Some groups supported that mandate while others opposed it on the merits. The National Association of Regulatory Utility Commissioners (NARUC) opposed it on federalism grounds, complaining of federal intrusion into the traditional realm of utility ratemaking governed by state law. NARUC also expressed practical concerns regarding how quickly states could comply.

The final version of the bill contained a more general rate design-related commitment. The final language conditions a state's eligibility to compete for a share of \$3.1 billion in grants for state energy programs above a baseline allocation under Part D of Title III of EPCA upon the state's governor's notifying the Secretary of Energy in writing that the governor has obtained "necessary assurances that each of the following will occur: (1) the applicable state regulatory authority will seek to implement, in appropriate proceedings for each electric and gas utility, with respect to which the state regulatory authority has ratemaking authority, a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and that provide timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measurable and verifiable efficiency savings, in a way that sustains or enhances utility customers' incentives to use energy more efficiently" (Subsection (2) of the same section of the stimulus bill relates to building codes. Subsection (3) relates to funding of energy efficiency and renewable energy programs.)

At the NARUC winter meeting in Washington, D.C. on February 15, 2009, this language was discussed by members and others. Some participants felt that the final language in substance still in effect is a decoupling mandate, perhaps offset by the observation that there does not appear to be any penalty if the state ultimately does not adopt the policy despite the governor's notification.

Counterparty Bankruptcy Risk for Physical Delivery Natural Gas Contracts Affected by New Decision

Parties to physical-delivery natural gas contracts may qualify for creditor safe harbor protections under Bankruptcy Code (Code) provisions applicable to swap participants and swap agreements as the result of a recent decision. According to a ruling this month from the United States Court of Appeals for the Fourth Circuit (Fourth Circuit), natural gas forward contracts involving the actual, physical delivery of the commodity may be covered by the Code definition of a "swap agreement," as a "commodity forward agreement," *Hutson v. E.I. du Pont de Nemours & Co., Inc (In re: Nat'l Gas Distributors, LLC)*, No. 07-2105 (4th Cir. 2009). Commodity forward agreements were added to the swap agreement definition as part of the 2005 amendments to the Code, but the term is not defined in the statute. A party to swap agreements receives special protections in the Code when its counterparty files for bankruptcy. Specifically, the swap agreement is exempt from the Code's automatic stay provision, from the prohibition against invalidation of contractual termination rights and from the preference recovery scheme. Comparable protections also may be available to parties to physical-delivery forward agreements under Code provisions applicable to "forward contract merchants" and "forward contracts." Notably, however, the Fourth Circuit decision states that the undefined term "commodity forward agreement" should be read more broadly than the Code definition of "forward contract."

In the underlying bankruptcy proceeding in this case, the Chapter 11 trustee brought actions under Code Section 548(a) seeking to void certain North American Energy Standards Board (NAESB) contracts between the debtor, Natural Gas Distributors, LLC, and its customers. The trustee alleged that under the contracts the customers paid less than market value for the natural gas they received, and sought to recover the alleged amount of the underpayment (over \$4 million) from the customers. Two of the customers, du Pont de Nemours & Co. and Smithfield Packing Company, filed motions to dismiss, arguing that the contracts were swap agreements as commodity forward agreements, and thus could not be voided. The bankruptcy court denied the customers' motions, holding that the supply contracts were not, as a matter of law, swap agreements covered by the expanded definition because they involved physical-delivery of a commodity and were insufficiently linked to the financial markets. In the absence of a Code definition of "commodity forward agreement," the court relied upon legislative history to the 2005 Code amendments indicating that traditional commercial supply agreements should not be treated as swap agreements.

The Fourth Circuit rejected the bankruptcy court's reading of the term "commodity forward agreement" as too narrow. At the same time, it agreed with the bankruptcy court that the legislative history supports differentiating between traditional supply contracts and commodity forward agreements. The appellate court criticized the bankruptcy court's conclusion, though, because it "overlooks the fact that the

contracts in this case contained real hedging elements," suggesting that a hedging use could move supply contracts outside the traditional realm into the commodity forward/swap agreement realm. *Hutson*, No. 07-2105, at 19.

The Fourth Circuit remanded the matter to the bankruptcy court for further proceeding to determine, factually and legally, whether the contracts at issue are commodity forward agreements. To assist in this endeavor, the court identifies several "non-exclusive elements that the statutory language appears to require" for a contract to be classified as a commodity forward agreement. One element, which appears to be linked to the hedging concept, is that "substantially all of the expected costs of performance must be attributable to the expected costs of the underlying commodity, determined at the time of contracting," so that the "benefits or detriments depend on future fluctuations in commodity prices." *Id.* at 22.

The Fourth Circuit opinion may prove notable for indirectly underscoring the challenge of interpreting another part of the swap agreement definition. The 2005 amendments, coupled with additional clarifying changes in 2006, added "a spot ... or other commodity agreement" to the definition, without defining those terms. In *Hutson*, the appellate court essentially relied upon the "futures" aspect of forward delivery contracts and the ability to lock in prices against future price changes as the basis for finding a potential hedging use for such contracts. It would seem more difficult to identify similar hedging potential for physical delivery spot contracts where delivery occurs within two days to differentiate such contracts from traditional supply contracts.

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