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April 17, 2002

By Hand Delivery

Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423-0001



Re: STB Docket No. 42070, Duke Energy Corp. v. CSX Transportation, Inc.

Dear Mr. Williams:

Enclosed for filing on behalf of Defendant CSX Transportation, Inc. ("CSXT") in the above-referenced proceeding are a signed original and ten copies of CSXT's Motion to Sever Duke's Synfuel Rate Claim in a Separate Docket or, in the Alternative, to Reopen Discovery. Also enclosed are three computer disks each containing a copy of this submission in Word-Perfect 9.0 format.

Please note that CSXT has requested *expedited handling and consideration* of the enclosed motion.

Please acknowledge receipt of these papers for filing by date-stamping the enclosed duplicate paper copy and returning it with our messenger. Thank you for your attention to this matter.

Very truly yours,

G. Paul Moates
Vincent F. Prada

Enclosures

cc: Counsel for Complainant (w/encls.)

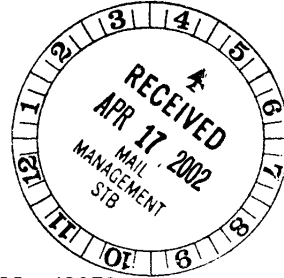
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EXPEDITED HANDLING AND CONSIDERATION REQUESTED

BEFORE THE
SURFACE TRANSPORTATION BOARD



DUKE ENERGY CORPORATION,

Complainant,

v.

CSX TRANSPORTATION, INC.,

Defendant.

STB Docket No. 42070

**MOTION TO SEVER DUKE'S SYNFUEL RATE CLAIM IN A
SEPARATE DOCKET OR, IN THE ALTERNATIVE, TO REOPEN DISCOVERY**

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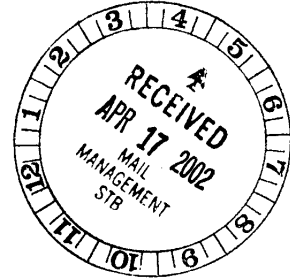
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DATED: April 17, 2002

BEFORE THE
SURFACE TRANSPORTATION BOARD



DUKE ENERGY CORPORATION,

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v.

CSX TRANSPORTATION, INC.,

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SEPARATE DOCKET OR, IN THE ALTERNATIVE, TO REOPEN DISCOVERY**

Pursuant to 49 C.F.R. § 1104.13(a), Defendant CSX Transportation, Inc.

("CSXT") hereby moves for an order severing, for consideration in a separate docket, that portion of the April 5, 2002 "Supplement-Amendment to the Verified Complaint" ("Amended Complaint") of Complainant Duke Energy Corporation ("Duke") in which Duke challenges the reasonableness of CSXT's common carrier rates applicable to Duke's shipment of synthetic fuel derived from coal ("synfuel"). In the alternative, if Duke is allowed to join its newly asserted synfuel rate claim with its previous challenge to the reasonableness of CSXT's common carrier coal rates, CSXT moves for an order reopening discovery in this proceeding and adjusting the current procedural schedule to accommodate CSXT's need to pursue discovery concerning Duke's new synfuel rate claim. CSXT further requests, for the reasons stated below, that the Board grant this motion *expedited consideration and decision*.

INTRODUCTION

Duke commenced this complaint proceeding over four months ago to challenge the reasonableness of CSXT's common carrier rates applicable to Duke's shipment of coal to several of its electric generating stations. Now, with the discovery period having closed and opening evidence due in only six weeks, Duke has filed an Amended Complaint. Without a word of explanation, the Amended Complaint broadens Duke's rate challenge to include not only CSXT's (recently revised) coal rates, but also CSXT's common carrier rates for synfuel shipments. The Amended Complaint also includes, for the first time, a vague and conclusory "unreasonable practices" claim which, Duke's counsel has recently advised CSXT, is directed (at least in part) to CSXT's publication of common carrier synfuel rates.¹

Although derived from coal and used by some utilities (such as Duke) as fuel for electricity generation, synfuel is a distinct commodity that, in order to qualify for substantial federal income tax credits, must differ significantly from coal in chemical composition (*i.e.*, there must be a change in the molecular structure) and must be produced by a party unrelated to the purchaser of the synfuel. In part because of the very substantial tax credits that coal-based synfuel enjoys (approximately \$26 per ton), synfuel is governed by different market and competitive conditions than coal, and raises potentially different rail pricing, costing and operating issues.

¹ Duke's inclusion of a new "unreasonable practices" claim in its Amended Complaint is addressed in CSXT's separate Motion to Strike or, in the Alternative, to Make More Definite Duke's Unreasonable-Practices Claim. Insofar as Duke's Amended Complaint challenges the reasonableness of the amended coal rate schedules established by CSXT to replace the "interim" rates challenged in Duke's original Complaint, CSXT does not object to the proposed amendment.

Until recently, and without CSXT's knowledge, Duke has been shipping synfuel via CSXT and improperly coding the shipments on waybills as coal (STCC Code 11), rather than the correct classification (STCC Code 29, which applies to petroleum and coal products). After CSXT learned of Duke's practice, it established common carrier rates applicable to synfuel shipments, and requested Duke to identify which of its previous shipments involved synfuel traffic. To date, Duke has failed to provide this information.

Allowing Duke at this late juncture to broaden its Complaint to include a challenge to the rates applicable to a different commodity and different traffic movements than those covered by the original claims would be unfair and prejudicial to CSXT. Duke provided no indication, prior to its Amended Complaint, that it was complaining about anything other than CSXT's coal rates. By asserting this new rate challenge after the close of discovery and only a few weeks before the scheduled filing of opening evidence, Duke has prejudiced CSXT by denying it an adequate opportunity to pursue necessary discovery of information from Duke and to prepare appropriate evidence addressing variable costs, market dominance and stand-alone costs with respect to the newly challenged synfuel rates, as well as evidence rebutting whatever "unreasonable practices" claim Duke is asserting with respect to the synfuel rates.

Among other things, CSXT will require discovery from Duke of information about the origins, destinations, volumes and operating characteristics of Duke's synfuels shipments, the feasibility of transporting synfuel by other modes and carriers, and Duke's forecasts and analyses of future synfuel consumption, volumes and prices. Even if Duke takes the position (as an unreasonable-practices claim or otherwise) that synfuel is indistinguishable from coal and should not be governed by a separate commodity classification, the adjudication of that issue -- which

would itself significantly broaden Duke's original Complaint -- would require additional discovery from Duke concerning its uses of synfuel in electricity generation and the market and operating conditions associated with synfuel movements.

CSXT should not be put to the task of attempting to defend itself against Duke's synfuel rate challenge without the opportunity for discovery and adequate time to prepare evidence. But allowing Duke to include its new synfuel rate claims in this proceeding would place CSXT in precisely that untenable position. Accordingly, if Duke wishes to mount an unreasonable-rate or unreasonable-practices challenge to CSXT's common carrier synfuel rates, Duke should do so in a separate docket, with a separate schedule providing a reasonable opportunity for discovery before the submission of evidence. If Duke instead wishes (for litigation efficiency reasons or otherwise) to pursue its coal and synfuel rate claims in a single consolidated proceeding, then it must allow CSXT a fair opportunity to pursue discovery and submit evidence directed to the newly added claim. What Duke cannot do, and what the Board should not allow it to do, is to broaden its original Complaint to bring in new traffic movements, new legal theories and new issues while denying CSXT a fair opportunity to prepare a defense to the new claims.

Thus, as explained more fully below, the Board should either (1) sever Duke's synfuel rate claims in a separate docket, with a separate procedural schedule providing for orderly development of the record, or (2) reopen discovery and suspend the existing evidentiary schedule in this proceeding to permit CSXT to complete additional necessary discovery regarding the synfuel rate issues raised by Duke's Amended Complaint.

BACKGROUND

1. The original Complaint in this proceeding, filed by Duke on December 19, 2001, challenges the reasonableness of certain common carrier rates established by CSXT for the transportation of coal between various origins in Virginia, West Virginia and Kentucky, on the one hand, and Duke's Cliffside, Lee and Riverbend electric generating facilities in North Carolina and South Carolina, on the other hand. Complaint at 6-7. Prior to December 31, 2001, CSXT's coal transportation service to these Duke facilities was provided under a privately negotiated contract, which Duke elected to terminate approximately one year before its scheduled expiration. Duke's Complaint seeks prescription of maximum reasonable rates, and reparations for coal shipments made since January 1, 2002 under the common carrier rates challenged as unreasonably high. *Id.* On January 8, 2002, CSXT filed an Answer to the Complaint ("Answer"), denying in all respects Duke's allegations that the challenged rates exceed a maximum reasonable level.

2. Duke requested, and CSXT established, the common carrier coal rates challenged in the Complaint when the parties could not reach timely agreement on a mutually acceptable coal transportation contract to replace the contract that was terminated effective December 31, 2001. In response to Duke's request for common carrier coal rates, CSXT in letters to Duke dated November 30, 2001 and December 10, 2001, established a schedule of *interim* common carrier rates and service terms ("CSXT-CORE-105"), to be effective for application to coal shipments made during the period between January 1, 2002 and February 28, 2002. *See* Complaint, Exhibit C. These interim common carrier rates applied to Duke's coal shipments between various specified origins, on the one hand, and Duke's Cliffside, Lee, Marshall and Riverbend facilities, on the other hand. CSXT established these common carrier rates on an

interim basis in order to provide the parties additional time in which to attempt to negotiate a mutually satisfactory replacement contract and to provide CSXT sufficient time to develop more appropriate common carrier rates to apply to Duke's coal shipments. *See Id.*, Exhibit C at 2; Answer ¶ 8.²

3. Rather than await CSXT's establishment of long-term, volume-based common carrier rates, Duke filed its Complaint on December 19, 2001. Duke's Complaint challenged, as unreasonably high, the interim common carrier coal rates established by CSXT in CSXT-CORE-105 insofar as they applied to Duke's Cliffside, Lee and Riverbend plants. Complaint ¶ 11 & Exhibit C. Duke did not challenge the reasonableness of CSXT's common carrier rates applicable to coal shipments to Duke's Marshall electric generating plant (located in Terrell, NC), which is jointly served by both CSXT and Norfolk Southern Railway Company. The Complaint did not suggest that Duke was complaining about anything other than the maximum reasonableness of CSXT's coal rates.

4. Consistent with its previously stated intention to establish long-term, volume based common carrier rates to replace the interim common carrier rates challenged in Duke's Complaint, CSXT, by letter to Duke dated February 22, 2002, established a new schedule of common carrier coal rates to replace the interim rates established by CSXT and to apply to Duke's common carrier coal shipments to the Cliffside, Lee, Marshall and Riverbend facilities on or after March 1, 2002. *See Answer to Supplement-Amendment to the Verified Complaint of*

² On January 8, 2002, at Duke's specific request, CSXT established and disclosed to Duke additional schedules of interim common carrier rates with loading and unloading parameters (4-hours or 24-hours) designed to accommodate Duke's specific needs. *See Answer ¶ 8 & Exhibit B* (attaching rate publications "CSXT-CORE-105," "CSXT-CORE-109," "CSXT-CORE-115" and "CSXT-CORE-117"). Each of these interim rate publications expired on February 28, 2002.

Duke Energy Corporation (dated April 17, 2002) ("Amended Answer"), Attachment A. The new, non-interim coal rates are contained in a publication, "CSXT-CORE-120," which was attached to CSXT's letter.³ The CSXT-CORE-120 publication expressly provided that the "[r]ates herein *do not apply* to chemically altered coal, or synthetic fuel within the meaning of Internal Revenue Code Section 29" (emphasis added). *See also* Amended Complaint, Exhibit G at 2. Duke's common carrier coal shipments to the Cliffside, Lee and Riverbend facilities have been governed by CSXT-CORE-120 for all shipments made since March 1, 2002 (the effective date of the rate terms).

5. During its negotiations with Duke over a possible transportation contract to replace the contract that was terminated effective December 31, 2001, and in its consideration of appropriate common carrier rates to apply to Duke's shipments, CSXT learned that Duke had been shipping substantial volumes of synfuel to the electric generating plants served by CSXT. Duke had improperly been identifying such shipments in waybills as "bituminous coal."⁴ Synfuel is a product that is derived from coal but is chemically altered through processing performed by a party unrelated to the buyer of the synfuel. Producers of qualifying synfuel enjoy a substantial Federal income tax credit (approximately \$26 per ton) which, under normal commercial arrange-

³ By letter dated February 26, 2002, CSXT amended CORE-120 (with certain provisions having an effective date of March 14, 2002). *See* Amended Answer, Attachment B.

⁴ Duke's steam coal shipments are coded in waybills as STCC Code No. 11-212 (prepared bituminous coal). Synfuel shipments should be coded as STCC Code No. 29-919 (coal or petroleum products). CSXT has recently applied for establishment of a new seven-digit STCC code to apply specifically to coal-based synthetic fuel.

ments, results in substantial reductions in the cost of fuel for coal-fired electric utilities like Duke.⁵ Although Internal Revenue Service ("IRS") rulings establish that tax credits are available only to coal-based synthetic fuel that undergoes a chemical transformation, an IRS ruling in April 2001 made it clear that chemically altered coal could qualify for the favorable tax treatment even if it were processed at or near a coal mine and even if it were produced by coal feedstocks other than waste coal. This ruling has resulted in the growth of synfuel production, particularly in the Appalachian mine regions served by CSXT.⁶

In response to Duke's request for common carrier rates, and in recognition of the fact that Duke had been transporting synfuel that it unilaterally (and improperly) billed as "bituminous coal" under the parties' now-expired transportation contract, CSXT established and disclosed to Duke on March 12, 2002, a schedule of common carrier rates and associated service conditions applicable to Duke's shipment of synfuel from various mine origins to the Cliffside,

⁵ Internal Revenue Code, Section 29; *see generally* Kesten, "Section 29 Tax Credits for Synthetic Fuel From Coal," 21 Energy & Min. L. Inst., Ch. 11 (2001) (available at <http://www.emlf.org/Papers/Resources/Kesten_01.pdf>); Nyden, "Appalachian Synfuel Growth Ongoing," *Charleston Sunday Gazette*, Mar. 24, 2002, at 8A (Attachment A hereto); Hawthorne, "Latex-Coated Coal Brings Utilities Millions in Tax Credits," *Columbus Dispatch*, Mar. 17, 2002, at 1A (Attachment B hereto). The processing of coal to produce synfuel, often involving the spraying or mixing of coal with other chemicals to produce the required molecular change, frequently takes place at or near the location at which the coal is mined and tendered to the railroad for transportation. In the processing, the coal may also be pulverized or injected with various chemicals or water. The per-ton income tax credit for coal-based synfuel is so substantial in relation to the market price of feedstock coal that operators of synfuel processing facilities can purchase feedstock coal from mine companies, incur expenses to process the coal into synfuel, and still sell the resulting product to electric utilities and other end users for substantially less than it cost to purchase the feedstock coal. *Id.*

⁶ *See* Internal Revenue Service, Rev. Proc. 2001-30, 2001 IRB LEXIS 148 (April 20, 2001); Bowling, "IRS Expands Eligibility for Synfuel Tax Credit Ruling," *Charleston Daily Mail*, May 8, 2001, at 2C (Attachment C hereto); Javetski, "Changing Rules for Synfuel Tax Credits?," *Global Energy Business*, May-June 2001, at 48 (Attachment D hereto).

Lee, Marshall and Riverbend electric generating facilities. This schedule of common carrier synfuel rates was contained in a publication denominated CSXT-CORE-128. *See* Amended Complaint, Exhibit H. In a letter dated March 12, 2002, CSXT requested Duke to identify the synfuel shipments it had previously billed as coal. *See* Amended Answer, Attachment C. To date, Duke has failed to provide this information.

6. On April 5, 2002, Duke filed what it styled as a "Supplement-Amendment" to its original Complaint. The Amended Complaint attaches copies of the common carrier rate publications issued by CSXT since the filing of the original Complaint. These publications include the amended interim rates that CSXT established to accommodate Duke's operating requirements (CSXT-CORE-109, -115 and -117), the coal common carrier rates that CSXT established to replace the interim rates challenged in the Complaint (CSXT-CORE-120), and the common carrier rates that CSXT established for application to Duke's synfuel shipments (CSXT-CORE-128). Amended Complaint, Exhibits D-H. The Amended Complaint alleges that the "new and/or changed rates, charges, practices, and other provisions" contained in these rate publications "are unlawfully high and/or constitute unreasonable practices." *Id.* at 4. Duke prayed that its Complaint be "supplemented and amended so that allegations of unlawfulness and unreasonable practices extend to all of the schedules" attached to the Amended Complaint. *Id.* at 5.

ARGUMENT

The Board's Rules of Procedure set forth the minimum requirements for formal complaints. The Rules provide that a complaint initiating a proceeding must clearly and plainly identify the facts and legal provisions on which the complainant's claims are based, advise the Board and the defendant fully in what respects these provisions have been violated, and provide a

detailed statement of the relief requested. 49 C.F.R. § 1111.1(a). The purpose of these pleadings requirements is obvious: to provide fair notice to the defendant of the legal claims against it, so that the defendant has an adequate opportunity to develop the record and present a defense. *See, e.g., Metropolitan Edison v. Conrail*, 5 I.C.C.2d 385, 397 (1989) (“[a] complaint must clearly identify its boundaries so that due process can be accorded defendant(s)”).

The Board’s rules also authorize the tendering of amended or supplemental complaints. 49 C.F.R. § 1111.2. Although the rules contain no express limitations on the timing of such amendments or supplements, proposed amended or supplemental complaints are subject, as under the Federal Rules of Civil Procedure,⁷ to consideration of the same due process principles of notice and fair hearing that underlie the Board’s notice pleading requirements. *See, e.g., Metropolitan Edison, supra* (expansion of rate-reasonableness complaint to include additional movements not identified in complaint, whether offered as a new complaint or in an amended complaint, is permissible if the defendant is not prejudiced); ICC Docket No. 41191, *West Texas Utilities Co. v. Burlington Northern Railroad Co.* (served Dec. 30, 1994) (allowing

⁷ Like the Board’s rules, Rule 15 of the Federal Rules of Civil Procedure authorizes amendment of complaints under certain circumstances. In ruling on requests for amendment of complaints after the filing of an answer, courts consider whether the timing or breadth of the proposed amendment would prejudice the defendant’s rights. *See, e.g., Dougherty v. Town of North Hempstead Bd. of Zoning Appeals*, 282 F.3d 83, 87-88 (2d Cir. 2002) (leave to amend complaint should not be granted when it would result in undue prejudice to the defendant) (citing *Foman v. Davis*, 371 U.S. 178, 182 (1962)); *United States v. Davis*, 261 F.3d 1, 59 (1st Cir. 2001) (late amendment to the pleadings will be permitted only to the extent that they do not prejudice the party opposing the amendment); *Thornton v. McClatchy Newspapers, Inc.*, 261 F.3d 789, 799 (9th Cir. 2001) (liberal rules for granting a motion to amend a complaint is tempered by any prejudice it may cause defendants). In particular, amendment of a party’s complaint after the close of discovery has been held to be prejudicial. *See, e.g., Larocca v. Borden, Inc.*, 276 F.2d 22, 32 (1st Cir. 2002); *Bethany Parmacal Co. v. QVC, Inc.*, 241 F.3d 854, 861-62 (7th Cir. 2001); *Coleman v. Quaker Oats Co.*, 232 F.3d 1271, 1295 (9th Cir. 2000); *Cleveland v. Porca Co.*, 38 F.3d 289, 297-98 (7th Cir. 1994).

amendment of rate complaint to expand claims where agency established a new discovery and evidentiary schedule to govern further proceedings on amended claims).

In this case, allowing Duke to proceed with its newly added synfuel rate claims under the existing procedural schedule would prejudice CSXT's rights and ability to prepare an adequate defense to the new claim. Insofar as Duke's Amended Complaint introduces an unreasonable-rate or (as Duke's counsel has advised) an unreasonable-practices challenge to CSXT's common carrier synfuel rates, it significantly broadens the scope of the original Complaint both in terms of the volume and nature of the traffic movements at issue and the legal issues raised in the case. Before Duke's filing of the Amended Complaint, CSXT had no reason to believe that this case involved anything other than the reasonableness of its rates for Duke's coal shipments.

Duke should have filed its synfuel rate challenge as a separate complaint. Had it done so, CSXT's rights would have been protected. By attempting instead to bring its synfuel rate challenge into the present proceeding through an Amended Complaint filed after the close of discovery and only weeks before the scheduled due date for opening evidence, Duke would deprive CSXT of any opportunity to obtain discovery of information relevant to the issues raised by the new synfuel rate claims and to develop appropriate evidence defending the lawfulness of CSXT's challenged synfuel rates and practices.⁸ It is revealing that, in the only other recent

⁸ As the Board is aware, CSXT has filed a pending motion to compel discovery and, in that motion, requested that the March 4, 2002 discovery cut-off date be extended. Despite the formal close of discovery, the parties have continued working to complete responses to previously served discovery requests, but have not served new requests. Indeed, even Duke agrees that, unless or until the Board extends the discovery cut-off, neither party may serve additional discovery requests. Duke Energy Corporation's Reply to Motion to Compel (dated Mar. 15, 2002), at 24.

railroad rate complaint proceeding in which a shipper has amended its complaint to bring in new traffic movements, the Board responded by *suspending* the procedural schedule indefinitely. STB Docket No. 42058, *Arizona Electric Power Cooperative, Inc. v. Burlington Northern & Santa Fe Railway Co.* (served Dec. 31, 2001). CSXT has located no prior case in which the Board or its predecessor allowed a complainant to amend its complaint, as Duke is proposing here, to add new claims *after* the close of discovery.

CSXT would be prejudiced by Duke's attempt to amend its Complaint to include a challenge to CSXT's synfuel rates because CSXT needs discovery from Duke in order to develop evidence responsive to Duke's new claim. These discovery requirements involve, at least, the following subjects:

- Applicable Rates: As an initial matter, CSXT requires discovery from Duke in order to determine which schedule of rates (coal or synfuel) applies to particular Duke shipments covered by the Complaint. CSXT has established separate rates for coal and synfuel shipments but, because Duke improperly shipped synfuel as coal and has thus far refused to produce records identifying which previous coal shipments involved synfuel traffic (which may originate at the same rail origins as coal), CSXT cannot reliably determine which rates apply to which traffic movements. Moreover, CSXT is concerned that, despite its publication of separate synfuel rates, Duke may be continuing to make synfuel shipments under waybills denominating (and thus rating) the shipments as coal, in effect ignoring CSXT's lawfully applicable synfuel rates. In order properly to calculate

revenue-variable cost ("R/VC") ratios and determine the amount of any rate relief that may be warranted, CSXT must obtain information from Duke necessary to determine the rates applicable to particular Duke shipments.

- Variable Costs and R/VC Ratios: Until the filing of Duke's Amended Complaint on April 5, 2002, CSXT did not anticipate that it would be required to defend the reasonableness of its synfuel rates including, in the first instance, presentation of variable cost and R/VC evidence. Although CSXT's prior discovery requests to Duke included some general inquiries about synfuel, those requests -- which Duke has refused to answer in any event -- were not focused on obtaining information relevant to variable costs.⁹ In order to develop evidence calculating the variable costs and R/VC ratios for the challenged synfuel rates, CSXT will require information about the specific traffic volumes, origins and destinations, and operating characteristics (e.g., lading weight per car, cars per train, cycle times, switching requirements, operations related to the processing of the coal

⁹ See Defendant's First Motion to Compel Answers to Interrogatories and Production of Documents (Dated Mar. 4, 2002), Attachment A (Document Request No. 25); *id.*, Attachment B (Document Request No. 73). CSXT's two synfuel-related discovery requests sought general information about how Duke's potential future use of synfuel might affect the future coal traffic volumes and revenues of the stand-alone railroad. In response to these requests, Duke interposed a series of objections, including a confidentiality objection, and has not produced *any* responsive documents. Both of CSXT's synfuel-related discovery requests are included in CSXT's pending motion to compel.

into synfuel) of Duke's synfuel shipments.¹⁰ CSXT requires discovery of this information because, due to Duke's improper billing of synfuel shipments as "coal," CSXT possesses no reliable records distinguishing Duke's coal shipments from its synfuel shipments. Only Duke possesses this information, which it has to date refused to furnish to CSXT.

- Qualitative Market Dominance: CSXT would also require information to assess the existence and effectiveness of potential intramodal and inter-modal competition for Duke's synfuel shipments. In particular, given the need for intermediate processing of the feedstock coal used to produce synfuel, the feasibility of truck transportation may well be different than in the case of large-volume coal shipments. In addition, because synfuel qualifies for an income tax credit of \$26 per ton, and thus enjoys a commensurate cost advantage over coal on a delivered-cost basis, the economics of truck transportation may be quite different than in the case of coal shipments. CSXT needs to explore these issues in discovery, and obtain from Duke any studies, analyses or information bearing on them.
- Stand-Alone Costs: In order to develop stand-alone cost ("SAC") evidence defending the newly challenged synfuel rates, CSXT would require discovery from Duke in a number of areas. In addition to information (also

¹⁰ Even if (as Duke may allege) synfuel is indistinguishable from coal for variable costing purposes, it is necessary to obtain movement-specific operating characteristics in order to match the costs of serving the synfuel shipments with the rates and revenues applicable to these shipments, just as it is necessary to develop separate operating characteristics for each origin-destination pair of coal movements and each distinct rate.

relevant to variable costs) concerning the specific operating conditions and requirements of Duke's synfuel shipments, CSXT would need information about Duke's forecasts or projections of future synfuel consumption, including assessments of the likelihood that the synfuel tax credit program will be continued after its scheduled expiration in 2007. In addition, CSXT would require information about contractual commitments in the future to purchase synfuel from specific origins or producers, as this would affect the future traffic volumes available to the stand-alone railroad. Some of this information may be responsive to the discovery requests previously served by CSXT but, as noted, Duke has not produced the information.

- Unreasonable Practices: Although not alleged specifically in the Amended Complaint, Duke's counsel have advised that Duke is also challenging CSXT's separate synfuel rates as an "unreasonable practice."¹¹ In that event, CSXT would require discovery in order to develop information relevant to the resolution of those very issues and to rebut any unreasonable-practices theory Duke may be asserting. Among other things, CSXT would need information about the synfuel production process, chemical or other physical differences between synfuel and coal and how those differences affect Duke's choice of synfuel or coal as fuel

¹¹ CSXT has separately moved to strike or, alternatively, for a more definite statement of Duke's unreasonable-practices claim. To the extent that Duke's unreasonable-practices claim is focused on CSXT's synfuel rates, and if the claim is allowed to go forward at all, it should be treated together with Duke's maximum-rate challenge to the synfuel rates, either in a severed docket or in the instant proceeding following the reopening of discovery.

for electricity generation, how synfuel is used by Duke in comparison with coal, differences in the competitive and market conditions affecting the relative usage of synfuel and coal for electricity generation, the impact of any contractual arrangements between Duke and synfuel producers that bear on the distinctiveness of synfuel from coal, the impacts of the synfuel process on rail car loading and unloading practices and other subjects. The defining characteristic of synfuel is that it must be chemically distinct from coal. If Duke is taking a different view in this case, CSXT is entitled to obtain discovery of information that might rebut such a position.¹²

It is no answer to say, in response to CSXT's need for such discovery, that CSXT could have pursued such discovery at the outset of this case or that it can do so now within the confines of the existing procedural schedule. Prior to the filing of Duke's Amended Complaint on April 5, 2002, CSXT had no reason to pursue specific discovery necessary to defend the reasonableness of its common carrier synfuel rates and practices because Duke -- which has been aware at least since February of this year that CSXT regarded coal and synfuel as separate commodities and that its coal common carrier rates did not apply to synfuel shipments -- gave

¹² IRS regulations make clear that, in order to qualify for federal income tax credits, synfuel derived from coal "must differ *significantly* in chemical composition, as opposed to physical composition, from the substance used to produce it," and such "*substantial* chemical changes" must affect "the *entire* coal feedstock rather than changes that affect only the surface of the coal." Internal Revenue Service, Rev. Proc. 2001-30, 2001 IRB LEXIS 148, at *4 (April 20, 2001) (emphasis added). If Duke claims that synfuel and coal should be regarded as the same commodity or otherwise treated as indistinguishable in this case, it will be necessary for CSXT to pursue any information that might suggest Duke (or the synfuel producers with which it has contracts) take a different view when it comes to claiming federal income tax credits.

CSXT no indication that it was challenging CSXT's synfuel rates.¹³ Because the discovery period in the instant proceeding has now closed, CSXT is not entitled to pursue additional discovery now, as even Duke admits. *See* note 8, *supra*. And even if CSXT could serve additional discovery requests now, it would not obtain responsive information in sufficient time to make effective use of it in its opening evidence.¹⁴ The Board's procedural rules for SAC cases provide a minimum of 75 days for completion of discovery, with an additional 45-day period for preparation and filing of opening evidence. 49 C.F.R. § 1111.8. Requiring CSXT to pursue discovery concerning Duke's synfuel rate claim now would short-circuit these procedures.

For these reasons, allowing Duke to proceed with its newly raised challenge to CSXT's synfuel rates and practices in this proceeding and under the existing procedural schedule would be grossly prejudicial to CSXT. The Board should remedy this prejudice in either of two ways. The Board could direct that Duke's synfuel rate claims be severed for consideration in a separate docket, in which CSXT would be allowed to pursue discovery and prepare evidence under a procedural schedule comparable to the one entered at the outset of this case.

Alternatively, the Board should reopen discovery in this proceeding to permit CSXT to pursue in discovery information relevant to Duke's new synfuel rate claims. To accommodate CSXT's legitimate discovery needs and permit both parties an opportunity to make appropriate use of discovery materials in preparing evidence, the Board should also adjust the

¹³ As noted, CSXT's letter of February 22, 2002 clearly advised Duke that CSXT's common carrier coal rates did *not* apply to synfuel shipments. *See* Amended Answer, Attachment B; Amended Complaint, Exhibit G at 2.

¹⁴ This assumes, of course, that Duke would produce the requested information and that there would be no need for a Board decision on a motion to compel. This assumption, experience shows, may be unrealistically optimistic.

existing schedule for submission of evidence, either by suspending the schedule pending completion of discovery (as the Board has done in other recent coal rate complaint cases), or setting new evidentiary filing dates at appropriate intervals following the completion of the reopened discovery.

Whatever course of action the Board decides to take in response to Duke's attempt to amend its Complaint to challenge CSXT's rates on synfuel traffic, an expedited resolution of these issues is warranted. With only a few short weeks before the current scheduled filing of opening evidence, CSXT (like Duke) needs to know what traffic movements are at issue in this case and what legal claims are being asserted with respect to CSXT's established synfuel rates. CSXT therefore requests that Duke be required to file an expedited reply to this motion and that the Board consider and decide it as promptly as possible following the receipt of Duke's reply. If necessary, the Board should also enter an order suspending the procedural schedule to accommodate a decision on this motion.

CONCLUSION

For all of the foregoing reasons, the Board should sever, for consideration in a separate docket, that portion of Duke's Amended Complaint that asserts a challenge to the reasonableness of CSXT's common carrier rates and practices for synfuel shipments. Alternatively, the Board should reopen discovery in this proceeding and adjust the procedural schedule to accommodate CSXT's need for additional discovery concerning the new synfuel rate claims. In addition, the Board should grant this motion *expedited consideration and decision* and should adjust the procedural schedule in this proceeding as necessary to render a decision on this motion.

Respectfully submitted,



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HEADLINE: Appalachian synfuel growth ongoing

BYLINE: Paul J. Nyden

BODY:

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With dropping coal prices, coal synfuel operations continue expanding throughout central Appalachia. Along the Kanawha River, synfuel producers qualify for federal tax credits up to \$26 a ton, roughly what a ton of coal sitting in a river barge is worth today.

Last year, synfuel tax credits totaled about \$1 billion.

Critics charge many synfuel producers misuse lucrative tax credits created under Section 29 of the 1980 Oil Windfall Profits Tax Act. Congress created synfuel credits to encourage entrepreneurs to develop ways to produce fuel from waste products, making the U.S. more energy independent.

Last April 20, the Internal Revenue Service issued a six-page ruling defining how coal synfuel processes qualify for tax credits. It appeared to restrict, or even prohibit, some companies from claiming those credits.

But apparently, the IRS has done little or nothing to restrict synfuel production, even by companies like Progress Energy, which routinely use already-marketable coal and spray it with oil emulsions or pine-tar resins to create a "synfuel."

U.S. Treasury Department spokeswoman Tara Bradshaw said on Friday that she did not know whether the IRS has taken any actions to restrict synfuel production. Bradshaw said she had not received any other inquiries about coal synfuels this year.

Today, a handful of electric utilities control most of the nation's 55 synfuel plants: Progress Energy from Raleigh, N.C.; DTE Energy (Detroit Edison) from Ann Arbor, Mich.; TECO Energy from Tampa Bay, Fla.; PacifiCorp; and South Carolina Electric & Gas Co.

Last April, J. Steven Griles, then a coal consultant who became U.S. Deputy Interior Secretary, said he believed the ruling "significantly curtailed the abuses that were occurring. The IRS ruling

appears to reinforce the original intent of Section 29 that synthetic fuels must be produced and must be ~~chemically altered~~. They really restricted the types of coals that could be used."

But in its latest 8K report filed with the U.S. Securities and Exchange Commission, Progress Energy reported IRS has granted it permission to claim tax credits at all six synthetic fuel plants it operates in Southern West Virginia and eastern Kentucky.

"The production and sale of the synthetic fuel from these facilities qualifies for tax credits ... if certain requirements are satisfied, including a requirement that the **synthetic fuel differs significantly in chemical composition** from the coal used to produce such synthetic fuel.

"All entities have received private letter rulings from the IRS with respect to their synthetic fuel operations. The PLRs do not limit the production on which synthetic fuel credits may be claimed."

The 8K report warned, however, "Should the tax credits be denied on future audits, and [Progress Energy] fails to prevail through the IRS or legal process, there could be a significant tax liability owed for previously taken Section 29 credits, with a significant impact on earnings and cash flows."

Progress stated it believes it does comply with all requirements.

DTE Energy is expanding its synfuel operations, partly in coordination with American Electric Power.

DTE recently completed a deal with AEP to spray latex over 6.1 million tons of coal annually at the AEP James M. Gavin plant on the Ohio River in Cheshire, Ohio, according to a March 17 article by Michael Hawthorne in the Columbus Dispatch. The deal could qualify for up to \$159 million in tax credits a year.

To qualify for synfuel credits, a plant must have been in operation by June 30, 1998.

DTE plans to move existing plants in Morgantown, W. Va., and Cadiz, Ohio, to a site next to the Gavin plant. There, DTE will spray latex over coal before dumping it onto conveyor belts leading into the Gavin plant. Under the deal, DTE will sell coal to AEP at a cheaper price, company officials told Hawthorne.

Dave Henry, vice president for operations for Beard Technologies in Pittsburgh, has helped investors develop synfuel technologies that transform waste materials into usable fuels, making those materials more valuable.

Henry believes much of today's coal synfuel industry has "turned into a scam."

In a telephone interview on Friday, Henry said, "I am working with people on Section 29 projects. They use waste coals at a slurry impoundment operation to create the synfuel. To me, that is legitimate. You take something of lesser value and create something of greater value.

"Most plants that have been relocated [from western states to Appalachia] are not using a waste product to make synfuel," Henry said. "The basis of the credit is a molecular change within the coal molecule. I doubt many of these people understand what a molecular change is."

The big expansion of coal synfuel plants began in late 1998 and 1999.

Criticism of the synfuel credits is coming from industry and government officials in other countries.

In December, officials from Canada and Australia protested an IRS private letter ruling allowing Appalachian Synfuel, then a Massey subsidiary, to produce more than 1.1 million tons of synfuel annually at the Marfork Mining complex in Raleigh County.

"Coal Export Report," an industry weekly, quoted a Canadian official who said, "We think the U.S. government should just call it what it is: a big subsidy for coal producers."

The newsletter said Australian officials are planning to file a complaint with the World Trade Organization about a threat to free markets posed by U.S. synfuel exports. Australian officials believe synfuel credits have cut back their exports to Japan.

Mark O'Neill, an Australian Coal Association official, said in that nation's "Mining Monthly" that "government-subsidized coal production is particularly galling, especially when practiced by 'free-trading' countries like the United States."

Four other companies have plans to move synfuel plants into Southern West Virginia that might qualify for up to \$330 million in tax credits, according to permit applications filed with the state Office of Air Quality. They are:

- s Rum Creek Sales, a Massey Energy subsidiary, which wants to open a synfuel operation at its Bandmill preparation plant in Dehue, Logan County. With an annual capacity to produce 4.8 million tons, the Bandmill plant could qualify for \$124.8 million in tax credits.

- s Kanawha River Terminals, a subsidiary of Progress Energy, which wants to bring a synfuel plant to its Marmet dock to produce 4.4 million tons of synfuel and qualify for \$114 million in tax credits.

But facing a weak coal market and an ongoing dispute about overweight coal trucks, Kanawha River Terminals has not made any changes at its Marmet dock. Progress Energy already operates plants in Quincy, Ceredo and Big Sandy.

- s MRJ Partners Inc., based in Forestdale, Ala., has a permit to move a synfuel plant to a Cannelton Industries coal plant site near London on the Kanawha River. With plans to produce 3.5 million tons of synfuel a year, MRJ could qualify for \$91 million in tax credits.

s Enron Global Markets LLC also planned to move a synfuel plant to a location on the Kanawha River. But OAQ officials said that is unlikely after the financial collapse of its parent, Enron Corp. in Houston, Texas.

To contact staff writer Paul J. Nyden, use e-mail or call 348-5164.

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HEADLINE: LATEX-COATED COAL BRINGS UTILITIES MILLIONS IN TAX CREDITS

BYLINE: Michael Hawthorne, Dispatch Environment Reporter

BODY:

Spraying coal with latex won't make one of the largest power plants in North America more environmentally friendly, but the coated fuel could be worth up to \$159 million in federal tax credits.

American Electric Power has brokered a deal with a Michigan-based utility, DTE Energy, to coat up to 6.1 million tons of coal each year for AEP's Gen. James M. Gavin plant along the Ohio River in Gallia County.

If Ohio regulators approve, DTE will spray latex on the coal just before it is transported by conveyor belts to power the Gavin plant's two steam turbines, which generate enough electricity for everything within the Columbus Outerbelt and still have some to spare.

The coated coal has the same energy content as regular coal and burns similarly. But there is an important difference: Coated coal gets a "synthetic fuel" tax credit of up to \$26 a ton, enabling DTE to make a lucrative, taxpayer-subsidized profit, some of which will be passed on to AEP in the form of cheaper fuel.

Critics say DTE and a handful of other companies are taking advantage of a 1980 law intended to encourage alternatives to imported oil. The businesses reaped nearly \$1 billion in tax subsidies last year, often by merely spraying coal already destined for the energy market with asphalt, waste oil, pine tar or latex.

"It's turned into a scam," said Dave Henry, vice president of operations for Beard Technologies, a Pittsburgh company that specializes in extracting coal from old mines and waste ponds. "When you start taking regular coal and don't enhance its value, you've really lost what this law was supposed to do."

Under rulings from the Internal Revenue Service, only 55 coal-based plants qualify for the synthetic-fuel credits, though the ownership and location of the plants can be sold and transferred. DTE, for example, wants to move equipment to the AEP plant from sites in Morgantown, W. Va., and Cadiz.

To qualify for the credit, the IRS has ruled, coal must undergo a "significant chemical change." Absent further guidance from Congress, the agency has authorized the tax credits for companies that coat or spray coal with various substances.

DTE is among a handful of electric utilities and coal companies that began buying synthetic-fuel plants in the mid- 1990s and moved them to Appalachia from Western states.

The region's high-quality coal made the tax credits more lucrative, because the subsidy levels are based on the energy content of the final product.

"We have spent millions on research to ensure we are following tough rules enforced by the IRS," said Guy Cerullo, a DTE spokesman. "Our synthetic fuel is coal that has undergone a chemical change, and that's what allows it to qualify for the tax credits."

Cerullo acknowledged the fuel burns like regular coal and offers no environmental benefits other than a slight reduction in dust generated during transportation.

Traditional coal companies and their political allies complain the subsidies give synthetic-fuel operators an unfair advantage because the companies can afford to sell coal more cheaply and still make money.

"If the coal were untreated, it would still be burned in a power plant and produce as much electricity," Kentucky Gov. Paul Patton, a former coal operator, wrote the U.S. Treasury Department last year. "The way this program is being used is an outrage."

Tax credits generated by DTE's synthetic-fuel plants enabled the company to lower its federal income-tax bill by \$130 million in 2000. The company only lowered its tax bill by \$1.9 million in 1996, according to documents filed with the Securities and Exchange Commission.

The company's effective tax rate dropped to 1.9 percent, down from 35 percent. Most of the savings came from the synthetic-fuel credits.

By negotiating a deal to supply AEP's Gavin plant with coated coal, DTE may increase the value of its tax credits. Most of the coal shipped to the plant will be market quality, Cerullo said.

AEP, meanwhile, will get less-expensive coal. "The motivation for us is financial," said Tom Ayres, a spokesman for the Columbus-based company.

A subsidiary of another utility that got into the synthetic-fuel business, North Carolina-based Progress Energy, reported a net income of \$218.8 million during the nine months that ended Sept. 30, nearly three times the net income generated during the same months the previous year.

"The increase in earnings for this segment is primarily due to the tax credits generated by Progress Energy's synthetic-fuel operations," the company told the SEC.

Enron Global Markets, a subsidiary of the embattled Enron Corp., obtained a permit from the Ohio EPA to operate a synthetic-fuel plant next to FirstEnergy's W.H. Sammis plant near Steubenville.

Though it is unclear whether the facility will be built, the permit authorized 4.7 million tons of coal, which would make the company eligible for tax credits worth up to \$122 million.

Federal officials and lawmakers envisioned something very different when they created the synthetic-fuel tax credits two decades ago.

Faced with skyrocketing prices for imported oil, the government directed subsidies to domestic companies that tried to extract oil from shale and natural gas from coal.

But when oil prices plummeted in the mid-1980s, even the tax credits couldn't make the projects cost-effective.

"The original intent was to find something that was really going to replace oil and gas, but it didn't work out," said Robert Hanfling, a former U.S. Energy Department official who helped create the program. "Nobody talks about shale oil anymore."

Other companies stepped in and won approval from the IRS to use the credits to subsidize efforts to recover low-grade or waste coal by pressing it into charcoal-like briquettes.

A handful of financially savvy companies later figured out they could make the tax credits even more lucrative by using coal already headed to market, rather than undergoing more costly recovery efforts.

Some of the equipment that DTE wants to move to the Gavin plant is now sitting idle near a coal-waste pond outside Morgantown, W. Va.

Although several coal-state members of Congress pressured the IRS to review the credits last year, the government's policy did not substantially change as a result. Other lawmakers, working at the behest of synthetic-fuel operators headquartered in their states, pressured the agency to retain the subsidies.

"It is too late in the day for the IRS to define new rules applicable to investments already made and facilities already in service," three Florida congressmen wrote the agency last year.

DTE is waiting for approval from the Ohio Environmental Protection Agency to move its synthetic-fuel equipment next to the Gavin plant, though the agency already has allowed the company to begin building access roads and erecting temporary utilities.

Residents in Cheshire, a tiny village next to the power plant, are concerned that the burning of latex will add to the environmental woes they've suffered.

Government scientists recently confirmed that blue acidic clouds from the Gavin plant endangered village residents last summer, particularly those suffering from asthma. Residents also have complained about fallout and white specks from the plant that ate the finish off their vehicles.

DTE and AEP officials said adding latex to what's already burned at the power plant will not create more pollution or damage the environment. State regulators, though, must determine whether the synthetic-fuel plant is required to obtain federal permits that place strict limits on air pollution.

"Burning a chemical additive to their coal doesn't make us feel any better," said Cheshire Mayor Tom Reese. "But it does give them a tax break. So maybe only because of dollars we are going to be environmental guinea pigs all over again."

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GRAPHIC: MAP, Map

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HEADLINE: IRS expands eligibility for synfuel tax credit ruling

BYLINE: BRIAN BOWLING

BODY:

DAILY MAIL STAFF

A wider range of synfuel operations can now ask the Internal Revenue Service to rule ahead of time on whether they qualify for a \$26 per ton synfuel tax credit.

The agency has modified its "private letter ruling" procedure originally issued on April 20 so that companies that use larger pieces of coal can seek a ruling.

Although the ruling was originally reported as changing companies' eligibility for the credit, U.S. Treasury Officials have since said that neither the original procedure nor the May 4 amendment changes the qualifications for the credit.

As is the case with most tax procedures, any synfuel operation can claim the credit and take its chances on the IRS approving or disallowing it.

The private letter ruling procedure affected by the April 20 and May 4 announcements, however, allows companies to seek an IRS guarantee that they'll qualify for the credit as long as they don't change the conditions under which the ruling was issued.

Given disputes over how to interpret the federal law authorizing the credit, however, the agency is only willing to even consider issuing such a guarantee when a company fits certain criteria.

Treasury officials were still checking as of press time today as to how many companies are now eligible to seek such a ruling.

In the April 20 procedure, that criteria included using coal that was mostly smaller than one-eighth inch. The May 4 amendment increases that limit to three-eighth inch.

The amendment also removes a requirement that the coal go through an acid bath if the company wants to qualify for the credit by using a procedure that mixes coal with styrene or other monomers.

Writer Brian Bowling can be reached at 348-4842 or by e-mail at brianbowling@daily mail.com.

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HEADLINE: Changing rules for synfuel tax credits?

BYLINE: BY JOHN JAVETSKI

HIGHLIGHT: Congress will soon debate a bill that proposes to change the placed-in-service deadline for synthetic-fuel production facilities qualifying for tax credits from 1998 to 2011. If the bill becomes law, it will trigger a second round of construction of synfuel machines and turn the economics of today's synfuel tax-credit 'industry' upside down

BODY:

Owners of facilities that produce synthetic fuel from coal can claim a substantial credit against their income taxes under Section 29 of the U.S. Internal Revenue Code. Section 29 and its predecessor, Section 48, were added to the code about two decades ago in response to the oil crises of the mid-1970s. Both aimed to encourage production of energy from alternative sources by subsidizing it; the desired effect was to reduce the price of alternative fuels relative to that of imported oil.

During the early and mid-1980s, the IRS expanded the list of alternative energy sources eligible for tax credits to include synthetic fuels. Borrowing language from Section 48, Section 29 was modified to include in its definition of qualifying energy sources "liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks."

Setting the rules In 1986, the Internal Revenue Service (IRS) modified Section 29 a final time in several important ways. In the process, it determined the requirements that taxpayers within and outside the energy industry would have to meet to claim a credit for producing synfuels. The IRS:

- Set the amount of the tax credit at \$3 per barrel of oil equivalent (BOE) produced, and defined the heating value of a barrel of oil at 5.8-million Btus to enable owners of facilities producing alternative energy not measured in barrels to calculate their credit. The IRS also decided that the tax credit would be adjusted each year for inflation.

- Defined a synthetic fuel as any fuel that differs significantly in chemical composition from the alternative substance used to produce it. Section 48 defines coal as one of several alternative substances. So in 1986, the IRS essentially defined synthetic fuel from coal as coal that has been subjected to a significant chemical change.

-- Established a "placed-in-service" date -- July 1, 1998 -- by which a taxpayer would have to have put his synfuel production facility on line to qualify for the tax credit.

-- Designed several provisions to limit abuses of the subsidy and increase its chances of achieving the desired effect -- less dependence on foreign oil. Among the most important of these are restrictions on relocations and extensive modifications of synfuel facilities, and a requirement that the synfuel produced be sold to an unrelated party -- that is, an entity whose interest in the production facility does not exceed 49.9%.

-- Established a "sunset date" for the tax credit; producers can only claim it for synfuel sold before Jan. 1, 2008. The objective here was to reduce the market value of synfuel production facilities over time. The fewer years of qualifying service a facility has left, the less it is worth.

Since 1986, neither the Office of the Chief Counsel of the IRS nor the U.S. Treasury Department has issued any regulations related to Section 29. This stability was a good thing during the decade prior to the 1998 placed-in-service deadline because it allowed taxpaying investors to be more certain that they were following the rules. To meet the statutory requirements, all they had to be sure of were three things: that their facility came on-line on time, that the IRS would consider what it was producing was synfuel, and that the buyer of the synfuel was unrelated to them.

For additional assurance that the IRS would agree that the fuel they are producing complies with the definition of a synthetic fuel under Section 29, facility owners took to asking the service for a so-called private letter ruling (PLR) verifying that. To support the request, they submitted expert reports showing that the coal feedstock they send into the facility indeed comes out the other end with a different chemical composition.

During the late 1990s, both before and after the placed-in-service passed, the IRS issued a series of favorable PLRs to owners of synfuel facilities and investors in them. Some owners got the IRS to sign off on their chemical changes, and others gave taxpayers the ability to buy a facility from its original owner and move it to another location. The net effect of those rulings was to make large coal companies and electric utilities more willing to invest in synfuel R&D and production plants. Several, for example, gave the IRS's blessing to the use of run-of-mine coal as a synfuel feedstock.

Prior to those rulings, what many of the investors in and developers of synfuel machines thought they had to do to qualify for the tax credit -- and make synfuel production pay off -- was use essentially valueless coal fines as feedstock. So they went out in search of fines, drained them off, dried them out, added a binder, and agglomerated the fines into pellets or briquettes -- a costly process. But once the IRS issued three PLRs authoring the use of run-of-mine coal as a feedstock, the coal-fines crowd realized that they had misinterpreted Section 29, and that all they really had to do was subject their coal feedstock to a significant chemical change. Gradually, they got rid of their pelletizing and briquetting machines, truncated their production processes, and increased their output.

Following the money Since 1998, the synthetic-fuel industry to which Section 29 gave birth has grown considerably. Utilities now routinely burn significant quantities of synfuel, purchased under long-term contracts, at their coal-fired power plants. According to a comprehensive study of the

industry by Resource Data International, Inc. (RDI), Denver, total "optimal" production from the 55 extant synfuel facilities amounts to 55.3 million tons per year of equivalent coal input. The RDI study (available at resdata.com for a price) defines "optimal" synfuel production capacity as working at something less than, but close to, 24/7.

Thanks to Section 29, the synfuel industry is also a very lucrative one. Reason: The tax credit for which facilities owners can qualify is enormous. For example, a plant producing synfuel from 500,000 tons of 12,000-Btu coal was entitled to a tax credit of \$12,413,793 for 1999. The IRS has not yet determined the size of the credit for 2000 by adjusting the 1999 credit for inflation.

However, the enormity of the tax credit for which most synfuel plants qualify makes the usefulness of the credit problematic. So said Daniel L. Kesten, an attorney with the law firm Frost Brown Todd LLC, Lexington, Ky., at a meeting of the Energy & Mineral Law Foundation, (emlf.org), in Baltimore, this March. Kesten can be reached at daniel.kesten@hotmail.com.

Because the credit is not subject to the alternative minimum tax, cannot be used to generate a refund, and cannot be carried forward or back, it is of little use, Kesten explained, to any taxpayer without -- in our example -- at least a \$12.4-million federal income tax liability. Coal companies typically don't pay much in federal income taxes because they take advantage of depletion deductions and other tax breaks. The same can be said for many of the entrepreneurial companies that developed synfuel-from-coal technologies in the early 1990s.

What made the industry lucrative was a late-1990s IRS ruling that outside investors can participate in the production of synfuel through a pay-as-you-go structure that allows facility owners to monetize their tax credit. Figure 1 shows how the money flows in such structures. At the top right is a founding partner -- someone who owns a qualifying synfuel facility, but doesn't have a big tax liability. To monetize the tax credit, the founding partner seeks out and convinces a corporation with a very large taxable income -- a major insurance company, for instance -- to become an investing partner in a synthetic fuel partnership. The other parties shown on the diagram are a coal supplier on the left, a utility with a coal-fired power plant on the right, and a synfuel facility operator on the bottom.

Here's how the monetization process works both in theory and practice. In theory, the coal supplier mines a ton of 12,000-Btu coal and sells it for \$22 to the synthetic fuel partnership. The partnership converts the ton of coal to synfuel of equivalent heating value, and then sells it to the utility for the same price. Meanwhile, the investing partner puts \$20 into the partnership, which it nearly completely owns. For that \$20 investment, it recoups a tax credit that in 1999 was worth \$24.83, increasing its year-end, after-tax profit by nearly \$5. So far, so good; neither the coal supplier nor the utility have made or lost any money, and each is used to doing business at \$22 a ton. Meanwhile, the facility operator takes a fee for running the synfuel plant.

In practice, however, what the investing partner's injection of \$20 into the synthetic fuel partnership does is nearly double the size of the pie. Now everyone scraps for it. Because the founding partner owns the synfuel facility, he is entitled to the lion's share of the larger pie. But in practice, many utilities have been savvy enough to figure out what's going on, so they negotiate for a discount on the price of the synfuel. They know that there's an extra \$20 on the table, and that the

investing partner has made \$5, so they offer to pay \$18 -- rather than \$22 -- for the ton of fuel. Kesten said he hasn't heard of any coal suppliers negotiating for a premium on the price of the feedstock they sell to synthetic fuel partnerships.

The haves and have-nots Kesten pointed out that apart from monetization structures for which IRS PLRs created a favorable climate, Section 29 has also led to a situation that he calls the haves and the have-nots. Although 55 facilities made it on-line before the July 1998 deadline, he said that some of them don't work very well and/or use older technology, and their owners can't upgrade them without taking a risk that the IRS will disqualify them for the tax credit. Kesten said that only about 40 are worth much today.

Here's where the law of supply and demand collides with the value of the Section 29 tax credit. To reap the considerable benefits of the credit, an investor could just buy one of the 40 working facilities outright. But because the owner of that facility knows that an investor would then be in a position to save \$100 million in taxes between now and the sunset date of 2008 by buying it, he is more likely to set its price at \$50 million to \$70 million -- rather than the \$2 million it cost him to build it.

There are signs that the status quo of synfuel haves and have-nots may soon be upset, however. Public pressure is mounting against it, led by a governor and at least five congressmen who have questioned the integrity of the Section 29 tax credit and whether its practical application any longer serves the purpose for which it was intended. Remarkably, the synfuel credit has become an international trade issue as well.

According to the RDI study, the 55 qualifying facilities today produce 55.3 million tons of synfuel annually. Assuming 12,500-Btu synfuel and today's \$6 per BOE credit, Section 29 generates about \$1.4 billion of synfuel tax credits each year. However, even those who decry "corporate welfare" would probably have to agree that synfuel tax credits represent a miniscule loss of government income compared to HOPE scholarships, home sale exclusions under which married taxpayers can write off up to a half-million dollars of capital gains from the sale of their primary residence, and -- the big kahuna -- home mortgage-interest deductions (Figure 2).

Synfuel gets political The battle lines on Section 29 began to take shape last summer and fall. At that time, and with the support of several congressmen, the Council for Energy Independence (CEI) -- whose members include GE Capital, four utilities, and two coal companies -- came out in favor of the status quo and emphasized that synfuel is a good thing. A CEI position paper stated that "the [Section 29 tax-credit] program was enacted to encourage development of alternative fuels to increase America's independence from foreign oil -- and it's producing economic, efficiency, and energy benefits."

Speaking out against the status quo were the governor of Kentucky (Paul Patton, who called Section 29 a "scam") and congressmen from two Powder River Basin states and another coal-producing state, Virginia. In July 2000, Rep. Rick Boucher of Virginia sent a letter to the IRS Commissioner and the acting Assistant Secretary of the Treasury that savaged Section 29 and complained about the way the IRS was -- and wasn't -- enforcing its provisions.

The essence of Boucher's complaint was that Section 29's requirement that the synfuel producer merely subject coal to a chemical change to qualify for the tax credit doesn't result in his doing anything beneficial to the coal. He proposed a two-part test: The first would require the taxpayer to demonstrate that his process adds appreciable value to the coal feedstock, and the second would require him to prove that his coal supplier would be unable to market the feedstock in the absence of the credit. In other words, Boucher was saying, "Don't give out tax credits for run-of-mine coal, for which there is already a domestic market. Reserve tax credits for people who are doing something environmentally beneficial, like recovering pond fines, or mining coal which otherwise would not get mined."

Canada and Australia, two major coal producers, then weighed in on Boucher's side by threatening to file a complaint against the U.S. last fall with the World Trade Organization for an unfair trade practice. Section 29, they said, subsidized America's coal producers without preventing them from marketing their product internationally.

Then came the backlash. Rep. Dennis Moore of Kansas said that with oil and gas prices on the rise and blackouts in California, why not create a new placed-in-service deadline 10 years out so everyone who wants to can build a synfuel facility? He introduced a bill that would do just that last fall and reintroduced it in this session of Congress on March 1.

By this spring, the rhetoric was so pervasive and loud that it even caught the attention of the IRS. On March 19, it issued Revenue Procedure 2000-47. No more PLRs, it said, would be issued to taxpayers with synfuel facilities unless they use 100% waste coal as feedstock -- which few if any do today. RP 2000-47 also solicited public comment on three proposed changes to Section 29 -- whether chemical change should be the appropriate test to qualify a synfuel facility, whether a taxpayer should also have to demonstrate that his production will increase America's domestic energy resources, and whether a taxpayer should have to prove that the market value of his synfuel is greater than that of his feedstock.

Comments have been pouring in. The Edison Electric Institute, Washington, argued for the status quo, and Boucher and Patton against it. Some of the smaller coal producers said they'd be satisfied with the 100% waste coal requirement because that would create a market for their pond fines. Canada and Australia told the IRS that Section 29 should have a provision that asks, "Is the final product truly an alternative fuel?" Although the IRS didn't ask for comments on its stoppage of issuance of PLRs, no more PLRs should really cool off the monetizers. An investor will be much less inclined to put \$20 million up front and an additional \$20 million or so a year in a synfuel project without a PLR in hand guaranteeing that the facility will qualify for tax credits.

What will Congress do? According to Kesten, the fate of Section 29 and its tax credits will be determined by the U.S. Congress. In the middle of the 135-page Energy Security Tax Policy Act of 2001 sponsored by Senate Majority Leader Trent Lott (R.-Miss.) and others is a provision that would end the haves and have-nots divide. It adopts the basic scheme of Congressman Moore by creating a new placed-in-service deadline for synfuel production facilities of Jan. 1, 2011, and a new sunset date of 2013.

If that bill becomes law with the new Section 29 dates, what effect will it have on the market for synfuel tax credits and the synfuels industry as a whole? Kesten believes the effect will be both chilling and angering. It will be chilling because big investors will no longer be willing to pay the owner of a qualifying synfuel facility \$80 million for something they can have built for them for an order of magnitude less. And it will be angering because those who have already spent \$80 million for a tax credit of \$100 million over time will feel that they have been taken to the cleaners.

The extension of the placed-in-service deadline by the energy bill is an interesting compromise, because it will eliminate the complaints of the coal and energy industry people who are now the have-nots. That will leave only the politicians, and Kesten questioned how vocal they'll be once the have-nots are no longer pushing them to argue their case.

URL: <http://www.platts.com>

GRAPHIC: Table, Illustration: Chart: How outside investors can participate in the production of synfuel. ; Illustration: Chart: Syfuel is a relatively small tax deduction.

LOAD-DATE: June 28, 2001

CERTIFICATE OF SERVICE

I hereby certify that, on this 17th day of April, 2002, I served the foregoing
"Motion to Sever Duke's Synfuel Rate Claim in a Separate Docket or, in the Alternative, to
Reopen Discovery" by causing a copy thereof to be delivered, in the manner indicated, to each of
the following:

William L. Slover
Robert D. Rosenberg
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