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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 Strike or, in the Alternative, to Make More Definite Duke's Unreasonable-Practices Claim. Also enclosed are three computer disks each containing a copy of this submission in WordPerfect 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.

ENTERED
Office of the Secretary

APR 18 2002

Part of
Public Record

Very truly yours,

Vincent F. Prada
G. Paul Moates
Vincent F. Prada

Enclosures

cc: Counsel for Complainant (w/encls.)

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 STRIKE OR, IN THE ALTERNATIVE, TO MAKE
MORE DEFINITE DUKE'S UNREASONABLE-PRACTICES CLAIM**

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DATED: April 17, 2002

BEFORE THE
SURFACE TRANSPORTATION BOARD

DUKE ENERGY CORPORATION,

Complainant,

v.

CSX TRANSPORTATION, INC.,

Defendant.



STB Docket No. 42070

**MOTION TO STRIKE OR, IN THE ALTERNATIVE, TO MAKE
MORE DEFINITE DUKE'S UNREASONABLE-PRACTICES CLAIM**

Pursuant to 49 C.F.R. §§ 1104.13(a) and 1111.5, Defendant CSX Transportation, Inc. ("CSXT") hereby moves for an order striking or, in the alternative, directing Complainant Duke Energy Corporation ("Duke") to provide a more definite statement of the "unreasonable practices" claim alleged in the "Supplement-Amendment to the Verified Complaint of Duke Energy Corporation" filed on April 5, 2002 ("Amended Complaint"). CSXT further requests, for the reasons stated below, that the Board grant this motion *expedited consideration and decision*.

INTRODUCTION

Nearly four months after Duke commenced this maximum rate reasonableness complaint proceeding and barely six weeks before the scheduled filing of opening evidence (currently due May 24, 2002), Duke filed an Amended Complaint that alleges -- for the first time and in extraordinarily vague and conclusory terms -- that some *unspecified* terms of CSXT's common carrier rate schedules applicable to Duke's coal shipments or some *unspecified* aspects

of CSXT's transportation services to Duke constitute, in some *unspecified* respect, "unreasonable practices." Amended Complaint at 4, 5. Nowhere in its original Complaint (filed December 19, 2001) did Duke assert any unreasonable-practices claim. And nowhere in its Amended Complaint does Duke identify what "practices" of CSXT it claims are unreasonable (or otherwise unlawful), or why.

After receiving Duke's Amended Complaint, CSXT counsel informally asked Duke counsel to identify the CSXT "practices" that Duke is alleging are unreasonable or otherwise unlawful. In response, Duke's counsel advised that it is challenging as an "unreasonable practice" CSXT's recent establishment of a schedule of common carrier rates applicable to Duke's shipments of synthetic fuel derived from coal ("synfuel"), a commodity distinct from coal. Nowhere does Duke's Amended Complaint identify CSXT's synfuel rates as an unlawful "unreasonable practice."¹ When CSXT counsel asked whether Duke was challenging any other CSXT "practices" as unreasonable, Duke counsel stated that Duke was challenging certain other provisions of CSXT's common carrier rate schedules applicable to Duke's shipments, and referred generally to the "complexity" of CSXT's schedules and the provisions in them authorizing a capital improvement recovery charge and an alternative route rate adjustment. Counsel did not indicate that these were the only matters challenged by Duke, nor indicate why Duke believes they are unreasonable or otherwise unlawful.

¹ Duke's attempt to amend its Complaint to incorporate a legal challenge to the reasonableness of CSXT's common carrier synfuel rates is the subject of CSXT's separate Motion to Sever Duke's Synfuel Rate Claim in a Separate Docket or, in the Alternative, to Reopen Discovery.

By failing to identify the factual and legal basis for its unreasonable-practices claim, Duke's Amended Complaint is patently deficient under the Board's procedural rules, and it fails to meet even the most basic due process requirements of notice to CSXT of the nature of the legal claims against it. Duke's conclusory amendment does not apprise CSXT what provisions of its common carrier rate publications, or what aspects of its coal transportation services, Duke is challenging as an unlawful "unreasonable practice." For this reason, CSXT has no meaningful ability to prepare a defense to Duke's unspecified claims. Moreover, the timing of Duke's Amended Complaint leaves CSXT no opportunity whatsoever to pursue Duke's new claims in discovery which, under the procedural schedule previously adopted by the Board, was supposed to have concluded on March 4, 2002.²

This situation is procedurally unfair, and prejudicial, to CSXT. For the reasons explained more fully below, CSXT requests that the Board strike Duke's Amended Complaint insofar as it alleges an "unreasonable practices" claim going beyond the coal maximum-rate claims contained in its original Complaint. In the alternative, CSXT requests that the Board order Duke promptly to amend its pleadings to provide CSXT (and the Board) a more definite statement of the factual basis and legal grounds for its unreasonable-practices claim. Should the Board direct Duke to furnish this more definite statement, CSXT would be entitled to, and may -- depending on the substance of Duke's unreasonable-practices claim as revealed in its supplemental pleadings -- require additional discovery from Duke in order to prepare an adequate defense to Duke's

² On March 4, 2002, CSXT filed a motion to compel discovery and, in connection with the motion, requested the Board to extend the discovery schedule. Since the filing of that motion, which is pending, the parties have worked to complete responses to previously served discovery requests, but have not attempted to serve new requests.

amended claims. Until the nature and basis of Duke's unreasonable-practices claim are identified, however, it is impossible for CSXT to assess such discovery needs. The Board therefore should authorize such additional discovery (as necessary) and adjust the existing procedural schedule to accommodate any additional discovery and factual development necessitated by Duke's late attempt to introduce new and additional legal claims to its Complaint.³

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.

³ The Board's procedural rules provide that averments in a complaint not denied by a defendant are deemed admitted. 49 C.F.R. § 1111.4(d). In light of this provision, and solely as a protective measure, CSXT is filing a separate Answer to the Amended Complaint ("Amended Answer") denying in all respects the claims of unlawfulness contained in the Amended Complaint even though Duke has not identified -- and, therefore, CSXT cannot know -- what "unreasonable practices" Duke alleges that CSXT committed.

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.

As explained in its letters to Duke and in its Answer to the Complaint, 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* Complaint, Exhibit C at 2; Answer ¶ 8.⁴ In its decision served

⁴ CSXT's November 30, 2001 letter specifically apprised Duke that its request for common carrier rates based on four-hour loading and unloading time was inconsistent with the operating conditions at certain of the origins and destinations for which Duke requested the establishment of common carrier rates. CSXT offered to make appropriate adjustments in the common carrier rate publications to reflect these operating conditions, if Duke so desired. 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.

February 5, 2002 (at 1 n.1), the Board made reference to CSXT's stated intention to replace the interim common carrier coal rates challenged in the Complaint.

3. Rather than await CSXT's establishment of such long-term, volume-based common carrier rates, Duke filed its Complaint on December 19, 2001. Duke's Complaint challenged, as "unreasonably high in violation of 49 U.S.C. §§ 10701(d)(1) and 10702," the interim common carrier 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's prayer for relief requested that the Board find that the challenged common carrier coal rates are unreasonably high, prescribe maximum reasonable rates, and award reparations for shipments made under the allegedly unreasonable rates. *Id.* at 6-7. Apart from its maximum rate-reasonableness claim, the Complaint alleged no other unlawful conduct or statutory violation by CSXT.

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 in CSXT-CORE-105, CSXT-CORE-109, CSXT-CORE-115 and CSXT-CORE-117 and to apply to Duke's common carrier coal shipments to the Cliffside, Lee, Marshall and Riverbend facilities on or after March 1, 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. By letter dated February 26, 2002 ,

CSXT amended CORE-120 (with certain provisions having an effective date of March 14, 2002).

Id., Attachment B.

As stated by CSXT in its earlier letters and Answer, the common carrier rates established in CSXT-CORE-120 include various volume discounts, incentive payments to Duke conditioned upon its implementation of certain efficiency-enhancing measures, and other provisions. The common carrier rate schedule also includes provisions establishing a specific charge for costs incurred by CSXT to make certain capital improvements in facilities needed to serve Duke's coal shipments, and to re-route Duke's coal shipments via a more circuitous rail route when capacity constraints prevent CSXT from using the preferred, more direct rail route to Duke's plants. The new rates are also substantially lower than the interim common carrier rates that they replaced. 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 common carrier rates to apply to Duke's shipments, CSXT learned that Duke had been shipping substantial volumes of synthetic fuel derived from coal ("synfuel") to the electric generating plants served by CSXT. Duke had improperly been identifying such shipments in waybills as "bituminous coal."⁵ Synfuel is a product that is derived from coal but is chemically

⁵ 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.

altered through processing performed by a party unrelated to the buyer of the synfuel. Producers of qualifying synfuel enjoy a very substantial Federal income tax credit (approximately \$26 per ton) which, under normal commercial arrangements, results in substantial reductions in the cost of fuel for coal-fired electric utilities like Duke.⁶ 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.⁷

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

⁶ 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.*

⁷ *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).

disclosed to Duke on March 12, 2002, a schedule of common carrier rates and associated service conditions applicable to shipments of synfuel from various mine origins to the Cliffside, Lee, Marshall and Riverbend electric generating facilities.⁸ 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. 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.

⁸ CSXT's February 22, 2002 publication CSXT-CORE-120, establishing non-interim common carrier rates for Duke's coal shipments, expressly provided that "[r]ates herein do not apply to chemically altered coal, or synthetic fuel within the meaning of Internal Revenue Code Section 29."

ARGUMENT

The Board's Rules of Practice authorize, under certain circumstances, the filing of an amended or supplemental complaint. 49 C.F.R. § 1111.2. Such amendments or supplements must conform to the requirements applicable to formal complaints, including the elementary requirement that the pleading provide the defendant adequate notice of the facts and law upon which the complainant's claim for relief is based. "A complaint must clearly identify its boundaries so that due process can be accorded defendant(s)." *Metropolitan Edison Co. v. Conrail*, 5 I.C.C.2d 385, 397 (1989). *See also McCarty Farms v. Burlington Northern Inc.*, 4 I.C.C.2d 262, 266 (1988) (amended complaint must "clearly advise both the Commission and defendant as to the expanded scope of the proceeding").

The Board's rules therefore set forth minimum notice pleading requirements that complaints must satisfy:

A formal complaint . . . should set forth briefly and in plain language the facts upon which it is based. It should include specific reference to pertinent statutory provisions and Board regulations, and should advise the Board and the defendant fully in what respects these provisions have been violated. The complaint should contain a detailed statement of the relief requested.

49 C.F.R. § 1111.1(a). If a complaint or amended complaint fails to meet these minimum pleading requirements, the claims are substantively defective and should be stricken, unless the deficiencies can be cured (without prejudice to the defendant) through the requirement of a more definite statement. 49 C.F.R. § 1111.5.

Duke's Amended Complaint fails to satisfy -- indeed, it makes no attempt to satisfy -- these minimum notice pleading requirements. The Amended Complaint alleges, for the first time in this proceeding, a distinct "unreasonable practices" claim against CSXT. Amended

Complaint at 4, 5. The original Complaint was expressly limited to a claim of “unreasonably high” coal rates (Complaint ¶ 11 & pages 6-7), and made no allegation of any unreasonable practices. The Amended Complaint introduces an unreasonable-practices claim but, apart from attaching copies of CSXT’s various common carrier rate publications, provides no facts or legal authority supporting that claim. CSXT is therefore left to guess what (if any) provisions of these rate publications or what (if any) aspects of its transportation services Duke claims are being challenged as an unlawful unreasonable practice. CSXT is also left to guess what provision of law or Board regulations has allegedly been violated by the unspecified unreasonable practices CSXT is alleged to have committed, or why Duke believes CSXT has acted unlawfully.

In response to Duke’s filing of an Amended Complaint, CSXT counsel informally inquired of Duke counsel what “practices” of CSXT were being challenged by Duke as unlawful. Duke counsel indicated that Duke was challenging as an “unreasonable practice” CSXT’s establishment of a separate schedule of common carrier rates applicable to synfuel (as opposed to coal) shipments.⁹ When asked if Duke was challenging any other “practices” of CSXT as unlawful, Duke counsel referred vaguely to the “complexity” of CSXT’s common carrier rate schedules and mentioned in particular Duke’s belief that the provisions establishing a capital improvement cost recovery charge and a train re-routing charge were unreasonable practices. But it remains unclear whether there are any other aspects of CSXT’s common carrier rate schedules or services that Duke will be challenging as an “unreasonable practice.” Even with respect to the

⁹ To the extent that Duke’s unreasonable-practices claim is directed at CSXT’s establishment of a separate schedule of common carrier rates for synfuel shipments, the proper treatment of that rate claim is also the subject of CSXT’s separate Motion to Sever Duke’s Synfuel Rate Claim in a Separate Docket or, in the Alternative, to Reopen Discovery.

provisions that Duke counsel identified as challengeable, moreover, Duke has not furnished CSXT (or the Board) any explanation of why Duke believes CSXT's challenged "practices" are unreasonable or otherwise unlawful.

If Duke's new unreasonable-practices claim is intended as mere verbiage adding nothing of substance to its original challenge to the maximum reasonableness of CSXT's common carrier coal rates, the new claim is patently deficient as a matter of law and should be stricken. Under settled law, allegations that railroad rates are excessive or unreasonably high do not state a valid free-standing claim of unreasonable practices. *See, e.g., Union Pacific Railroad Co. v. ICC*, 867 F.2d 646 (D.C. Cir. 1989).¹⁰ If Duke's unreasonable-practices claim instead is, as Duke's counsel have suggested, intended as a separate challenge to some aspect of CSXT's services other than the level of the common carrier coal rates it has published, the new claim is likewise deficient because Duke has not identified in its pleadings the nature of the challenged practices or why they are unreasonable or otherwise unlawful.

For these reasons, the Board should strike (or dismiss) Duke's Amended Complaint insofar as it asserts an independent unreasonable-practices claim. The Board's pleading requirements are clear and well-known to Duke, and they are not difficult to satisfy. Neither CSXT nor the Board itself should be forced to speculate about the nature of a claim asserted, without any supporting facts or legal authority. This is especially true where, as here, the parties

¹⁰ *See also* STB Docket No. WCC-105, *DHX, Inc. v. Matson Navigation Co.*, 2001 STB LEXIS 998, at *12 (served Dec. 21, 2001) ("parties may not use the unreasonable practice provisions of the statute to bolster a weak rate case"); *National Grain & Feed Ass'n v. Burlington Northern Railroad Co.*, 8 I.C.C.2d 421, 432 (1992) ("complainant simply cannot disguise a rate reasonableness challenge as a challenge to the mechanism used to establish the rate levels").

are nearly four months into this proceeding, discovery has formally concluded, and opening evidentiary submissions are due in the near future. The purpose of the Board's pleadings rules is to ensure that defendants are apprised at the outset of a complaint proceeding of the nature of the claims against them, and the legal and factual basis for those claims. Duke's Amended Complaint fails to afford CSXT such minimal notice of the unreasonable-practices claim against it and, for that reason, the claim should be stricken.

Alternatively, and at a minimum, the Board should order Duke promptly to provide a more definite statement of the factual and legal basis of its claim of unreasonable practices. 49 C.F.R. § 1111.5.¹¹ Duke should be compelled to supplement its pleadings by identifying, with some precision, the specific provisions of CSXT's challenged common carrier rate publications or the specific aspects of CSXT's transportation services that Duke claims constitute unreasonable practices.¹² Duke should further be required to identify the statutory

¹¹ CSXT also asks that Duke clarify its Amended Complaint in one other respect. Duke's original Complaint did not challenge the reasonableness of CSXT's common carrier coal rates to the Marshall electric generating station, even though CSXT's rate schedules included rates for shipments to that plant. The Amended Complaint prays that Duke's Complaint be amended to "extend to *all* of the schedules" of common carrier rates attached to the Amended Complaint. Amended Complaint at 6 (emphasis added). Because these schedules also include common carrier rates to Marshall, Duke's Amended Complaint, construed literally, extends its rate challenge to Marshall, a result that would significantly broaden the scope of the Complaint. CSXT presumes that Duke did not intend to challenge the Marshall rates, but Duke should immediately clarify its intent in this regard.

¹² Cf., ICC Docket No. 41191, *West Texas Utilities Co. v. Burlington Northern Railroad Co.* (served Feb. 14, 1995) ("*WTU*") (declining in part to require more definite statement when, in response to defendant railroad's filing of tariff rates replacing class rates originally challenged in complaint, complaining shipper filed petition objecting to specific operating-related provisions of the railroad's tariffs). In contrast to the situation in *WTU*, Duke has not identified any specific provision of CSXT's common carrier rate publications that Duke believes constitutes an unreasonable practice.

provisions or agency rules that it believes have been violated by CSXT's challenged practices, and to describe the relief that it is seeking from the Board to remedy those alleged violations.

If the Board declines to strike Duke's new unreasonable-practices claim, CSXT would be entitled to additional discovery from Duke in order to prepare an adequate defense to the claim. Until Duke specifies which CSXT practices are claimed to be unreasonable, however, neither CSXT nor the Board can practicably assess the need for additional discovery or the scope of such discovery.¹³ In light of the procedural schedule currently in place, these matters must be resolved quickly. The authorized discovery period in this proceeding has already concluded (although there is a pending request by CSXT to extend discovery), and opening evidence by both parties is currently due in a matter of weeks (May 24, 2002). As a matter of procedural fairness and due process, CSXT must be afforded an opportunity to develop through appropriate discovery facts and information necessary to defend itself against Duke's unreasonable-practices claim (if that claim is allowed to proceed at all). That opportunity must include sufficient time to collect the relevant information and prepare evidence.

Accordingly, CSXT requests that the instant motion be accorded expedited consideration and decision. Specifically, CSXT 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

¹³ It would be pointless now for CSXT to attempt through discovery to seek from Duke a description of its unreasonable-practices claim and the basis for it. As an initial matter, the discovery period has formally concluded in this proceeding. Even Duke agrees that, 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. In addition, Duke has previously asserted blanket objections to all "contention" interrogatories served by CSXT, and requiring CSXT to serve such requests and then file a motion to compel discovery would only result in additional, needless delay in the resolution of the issue raised here.

following the receipt of Duke's reply. The Board should also, as necessary, adjust the existing procedural schedule in order to accommodate a decision on this motion, and provide CSXT a fair opportunity thereafter for any discovery and factual development that may be necessitated by Duke's late filing of its unreasonable-practices claim.

An adjustment of the procedural schedule, should it become necessary, would not be unfair or prejudicial to Duke. If Duke wishes to challenge the lawfulness of CSXT's practices on grounds not included in its original Complaint, it is free to do so if it can allege a legally cognizable claim. If Duke chooses to assert such a claim, however, it must both afford CSXT and the Board adequate notice of the nature and basis of the claim, and permit CSXT a fair opportunity to litigate the issue. Duke's unreasonable-practices claim should be stricken; but, if it is not, CSXT should be granted a fair opportunity to defend itself, which may well require additional discovery and an adjustment in the procedural schedule.

CONCLUSION

For all of the foregoing reasons, the Board should strike Duke's Amended Complaint insofar as it asserts a claim of unlawful "unreasonable practices" or, in the alternative, order Duke to provide a more definite statement of its unreasonable-practices claim. 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 and afford CSXT an opportunity for any additional discovery necessitated by Duke's unreasonable-practices claim.

Respectfully submitted,



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HEADLINE: Appalachian synfuel growth ongoing

BYLINE: Paul J. Nyden

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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.kestens@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 Strike or, in the Alternative, to Make More Definite Duke's Unreasonable-Practices
Claim" by causing a copy thereof to be delivered, in the manner indicated, to each of the
following:

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Christopher A. Mills
Andrew B. Kolesar III
Slover & Loftus
1224 Seventeenth Street, N.W.
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