When you think of the risks facing energy companies, you probably envision major disasters like the Gulf oil spill or San Bruno gas explosion. These are certainly the most frightening and catastrophic threats. But there are many other less sensational concerns that energy companies encounter. Because today, the major players in the industry are invested in much more than simply petroleum and pipelines. They are heavily embedded in the commodity market and derivatives trading and must deal with mundane issues of bankruptcy liquidation and compliance. The following risks may not be the stuff of blockbuster movies, but they are some of the emerging issues that all energy company executives must plan for now.

1. Margin and Collateral Changes
Dodd-Frank seeks to move most of the over-the-counter (OTC) derivatives market onto regulated clearing exchanges. The backers of the legislation assert that the move to cleared exchanges will increase transparency and thereby spread the risks of default across market participants.

There is a flip side to that transparency, however. To collateralize their positions, energy companies will be required to post margin. Those in the sector may be accustomed to posting some collateral or guarantees in their OTC transactions, but it is likely that clearinghouses will require significantly more margin (and in a more liquid form). The margin required by clearinghouses will include both initial margin, which is independent of market movements, and variation margin, which changes based on daily market fluctuations. The combination of the two may dwarf the liquid collateral that energy companies have traditionally posted in OTC transactions.

In the OTC market, many participants are given some degree of unsecured credit exposure, or credit thresholds. Those thresholds represent a general level of business risk that a counterparty will take, based on...
the participant’s creditworthiness. Exchanges, however, will not allow any such thresholds. So it is safe to assume that energy companies will be forced to change their strategies based on the clearing requirement.

2. Documentation Changes
At first blush, it may appear to be a positive development for derivatives trades to move away from lengthier forms like the International Swaps and Derivatives Association’s (ISDA) “master agreement.” The ISDA and similar forms consisted of many pages and often caused negotiations to last several months.

On the other hand, cleared swaps will now be documented on entirely different types of agreements, potentially reducing the consistency and predictability that the ISDA brought to the marketplace. Depending on the energy company’s choice of futures commission merchant (FCM), each of which may have its own form of “cleared swaps documentation,” there may be material differences related to the changes from the ISDA master agreement.

As one example, the “events of default” under the cleared swaps documentation may be incompatible with most OTC players’ understanding of the term. Although the documentation will include many traditional defaults, it may also include a discretionary default, which would allow an FCM to declare a default anytime it is necessary for the protection of the FCM. Energy companies may want to attempt to negotiate such terms, or else make risk management adjustments to allow for the fact that the FCM can declare a default at any time.

3. Supply of Goods to a Bankrupt Counterparty
In its 2005 amendments to the Bankruptcy Code, Congress passed a new law that served as a boon to suppliers of goods, including many physical commodities. The new law provides for an administrative expense claim—usually meaning payment in full—for the value of goods supplied in the 20 days preceding a debtor’s bankruptcy.

Congress gave no indication of its intention in passing the new law, but some have speculated that it was a countermeasure against debtors’ hoarding of goods (without payment) in the days leading to bankruptcy.

Whatever the intention, the effect of the new law has been significant. Previously, such suppliers of goods were usually left with unsecured claims, receiving only ratable distributions. Elevating such claims to a priority level that generally allowed for payment in full has been a great benefit for those suppliers, but a potential detriment to debtors. The harmful effect on debtors has led to two results.

First, debtors fight aggressively to limit the scope of the provisions. Litigation has ensued over the meaning of virtually every word in the statute, such as the meaning of “goods” or the meaning of “value,” as well as other logistical requirements. Of particular relevance for energy companies are questions of whether electricity constitutes goods and whether utility providers sell goods. As a result of debtors’ aggressiveness on such issues, even if a supplier prevails in establishing its higher priority claim, it will likely be only after paying significantly more in attorneys’ fees.

Second, a movement has begun to repeal the statute, based on the perception that the harm to debtors is too

PROTECTING SOLAR ENERGY INVESTMENTS

Solar is among the fastest-growing renewable energy sources. While this presents new risks for energy companies, it also creates new exposures for all the many businesses jumping on the solar bandwagon. In fact, according to the Solar Energy Industries Association, the U.S. solar market grew to a $6 billion industry in 2010, up 67% from $3.6 billion in 2009, and solar photovoltaic installations are projected to double in 2011. While the advantages of solar are considerable, the costs can be steep. Those willing to make the investment in solar systems should be aware of the potential risks and limit exposures in three key ways.

INSTALLATION
Correct installation is vital. While this may seem intuitive, given the relative newness of the industry, issues associated with improper installation are more common than one would expect. Hire a contractor experienced in installing solar photovoltaic panels in accordance with local electrical codes and industry standards. Ensure that all safety precautions are being followed to mitigate risks that workers could be exposed to during the installation process.

For rooftop installations, there could be devastating consequences if the roof and weight-bearing systems are not designed or modified to accommodate the additional load of the panel system. The increased weight of the photovoltaic modules, racks, mounts and support systems alone could lead to a roof collapse. If you are in a region where it snows, that must also be factored in. Furthermore, the system may change the rainwater runoff or snowmelt patterns, which could add weight or lead to water intrusion.

Wind is another concern. Each installation is unique, and a professional engineer should be hired to design the system to ensure that it can handle expected gusts for the area. A poorly designed and installed system and its components could become airborne and fly off the roof. The roof membrane could also be damaged during panel installation, exposing the building to water intrusion—something that anyone with experience knows to avoid at all costs.
great. In other industries—most notably, retail—the requirement of paying such suppliers in full has significantly limited debtors’ ability to reorganize. Some have attributed the liquidation of high-profile retailers like Circuit City and Sharper Image to the 2005 amendments. Although repeal of a statute is rare, the liquidation of major companies may make for a more compelling argument than usual, particularly in an era when unemployment is such a major concern to politicians.

4. The Orderly Liquidation Authority
A separate section of Dodd-Frank creates a new insolvency regime, intended to prevent the bailout of entities that grow “too big to fail.” The statute allows the U.S. government to appoint the Federal Deposit Insurance Corporation (FDIC) to oversee a slow and orderly liquidation of some companies that are at risk but whose failure would present a systemic risk to the country’s financial stability.

Financial companies are subject to the Orderly Liquidation Authority (OLA) regime. The term “financial company” is broadly defined, however, and may include any company predominantly engaged in financial activities. So it is conceivable that the SEC could deem the major players in the commodity markets to be financial in nature.

The OLA follows the Bankruptcy Code in many respects. It also has similarities to the Federal Deposit Insurance Act, which contains the insolvency regime for the liquidation of national banks. One striking difference from those two regimes, however, is the wide authority and discretion the OLA grants the FDIC to take actions necessary to liquidate the relevant company.

Similarly, energy companies may face some surprises in the OLA’s treatment of derivatives contracts. Like the Bankruptcy Code’s safe harbor provisions, the OLA does provide some beneficial treatment of “qualified financial contracts,” which includes most derivatives. The OLA, however, places some limitations on the ability to terminate, liquidate and accelerate such contracts. Under the Bankruptcy Code, the exercise of such rights is absolute under the safe harbor statutes. The OLA also specifically invalidates any contractual provision that suspends payment or delivery obligations based on the debtor’s financial condition, a result that arguably is not specified in the Bankruptcy Code.

The risk for energy companies does not arise solely from the differences between the OLA scheme and the Bankruptcy Code. Rather, it comes from the combination of those differences and energy companies’ inability to know beforehand which of its counterparties will be subject to the OLA. As outlined, the discretion of whether to commence OLA proceedings rests primarily with the secretary of the Treasury, with the consultation of the president. Energy companies do not know whether their counterparties would be debtors under the OLA or under the Bankruptcy Code, and accordingly, do not know which of their traditional risk management tools will be effective.

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MAINTENANCE
When it comes to maintaining solar systems, ensure that service technicians are able to access the panels and related equipment to perform routine maintenance checks. Loose electrical connections may cause equipment to break down sooner. Devise inspection plans for combiner boxes and air filters, which need to be changed or cleaned regularly to keep the inverters running coolly and efficiently.

The panels themselves must also be cleaned to maintain their output. Make sure a water source is available nearby for cleaning purposes. Vegetation growth or rodent infestations could become problems if left to fester. Efficiency can drop—or worse if a critter chews through a wire.

SAFEGUARDING SOLAR INVESTMENTS
With the number of installations on the rise, the incidence of thefts is also rising, so safeguarding solar panels and the related components is more important than ever. Don’t let your investment be stolen.

Some security systems make it difficult to physically remove the panels. One security product is a customized stainless steel fastener that locks the panels to the mounting rack and requires a key. There are also systems that connect the solar panel to an alarm panel. If a solar panel is removed, it will cause a circuit disruption, both sounding an audible alarm and alerting local law enforcement. Another security system uses microchips embedded in the panels to communicate wirelessly with a monitoring unit. If the chip is tampered with or the wireless communication is interrupted, it sends out an alert. Additionally, the panel cannot be put back in service without a unique code to activate it.

Finally, there are theft recovery measures available to etch an identifying code onto the solar panel and frame. The etching of identification information makes it easier for the police to identify the owner of the stolen panels.

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