



Wall Street cleans up on 'clean coal'

U.S. investment firms rake in ‘staggering’ returns on clean coal tax credits

Goldman Sachs, Fidelity and other companies have jumped into the coal business, chasing subsidized profits from an environmental policy that shows little evidence of reducing smog, a Reuters analysis shows.

By [TIM MCLAUGHLIN](#) | Filed Dec. 4, 2018, noon GMT

Earlier this year, the chief financial officer of global insurance giant Arthur J. Gallagher & Co. explained to analysts how the company had turned a little-known U.S. energy subsidy into a profit machine, worth hundreds of millions of dollars to its bottom line.

The money came from the U.S. “clean coal” tax credit, a provision of the American Jobs Act of 2004 meant to encourage the use of chemically treated coal to cut pollution in the nation’s power plants. To capitalize on the subsidy, A.J. Gallagher arranged investor partnerships to produce vast quantities of refined coal, as the fuel is known in the industry, for utilities across the nation, splitting the benefit of the lucrative government incentive – now worth more than \$7 per ton.

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“Our return on investment is staggering,” CFO Douglas Howell told analysts in the March 14 call. “Oh, 200 percent, 300 percent, 400 percent, 500 percent. I mean, just because it costs so little to develop” clean coal facilities.

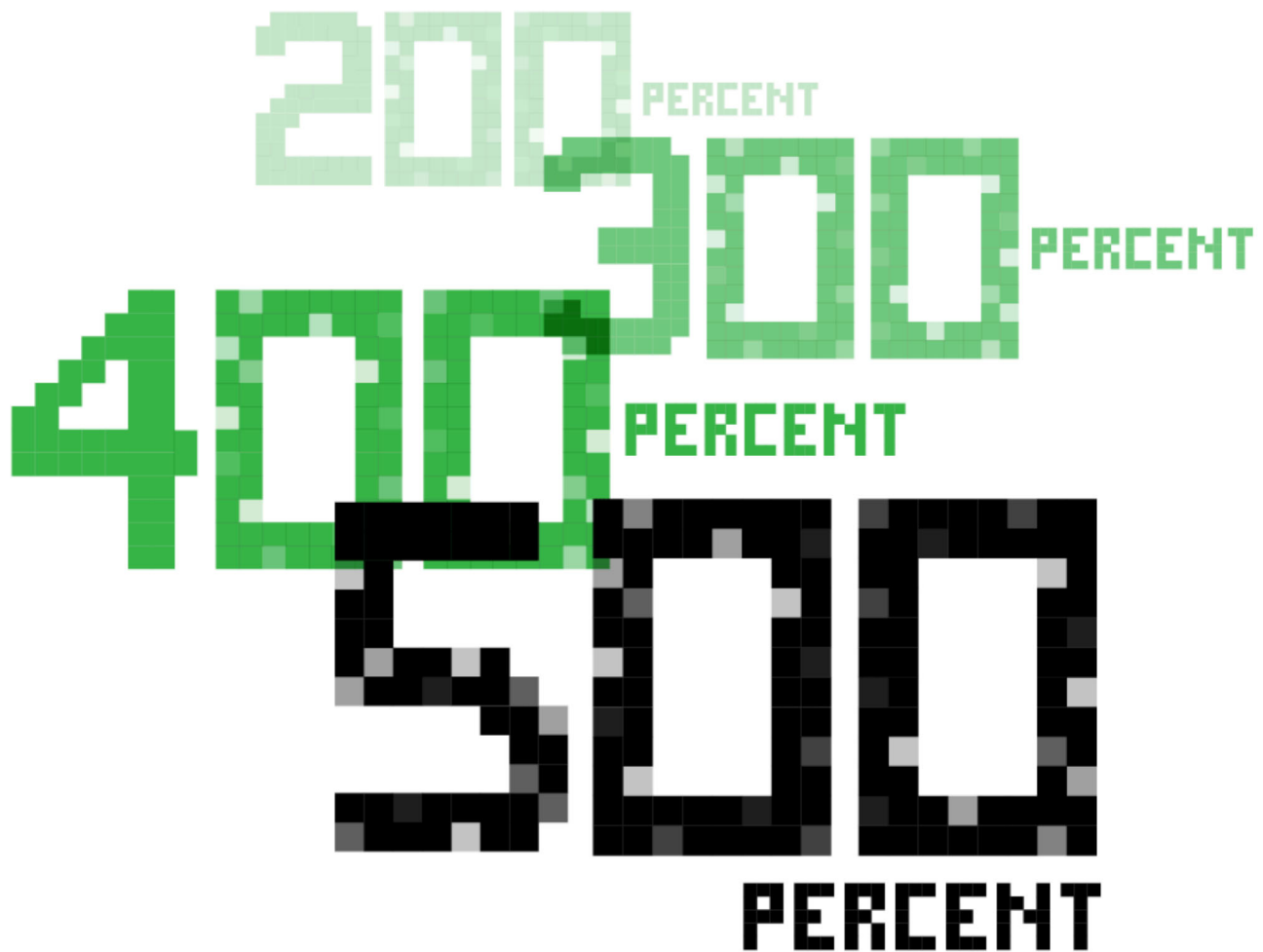
A.J. Gallagher’s experience reflects a truth about the U.S. refined coal tax credit, a subsidy that now costs taxpayers about \$1 billion a year: While coal mining firms, utility companies and power consumers can benefit indirectly from the subsidy, the big winners are a diverse group of investors – ranging from Wall Street’s most powerful banks to insurers, meat packers and drug makers – who identified the incentive as an easy way to make money.

Over the past decade, these companies have financed the construction of facilities to produce refined coal, which are situated next to coal-fired power plants and typically cost about \$4 million to \$6 million each to develop. They then sell the resulting coal to utilities below cost, but make eye-popping returns from the subsidy rather than the underlying business, according to regulatory documents and interviews.

A.J. Gallagher’s Howell took credit for designing a business model to maximize profits from the subsidy in his March call with analysts.

“It is our machine,” he said. “We developed it. We pioneered it.”

The company has accumulated about \$850 million worth of tax credits, mostly from its side business in taxpayer-supported refined coal, Howell said on an Oct. 25th conference call with investors and analysts.



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CFO Douglas Howell told analysts in the March 14 call

“And at current production levels” of refined coal, he said, “that may total another \$700 million through 2021.”

Howell declined to comment for this story. A.J. Gallagher spokeswoman Linda Collins minimized the importance of clean coal to the company.

“Refined coal is not a part of our core brokerage and risk management business,” Collins said in an email.

Refined coal activities, however, accounted for 25 percent of the company’s \$5.28 billion in total revenue during the first nine months of this year, according to AJ Gallagher financial statements. They also made up about a fifth of the company’s \$516 million in net earnings attributable to controlling interests during that period.

While the subsidy has proven a boon for investors, it has often failed to achieve the intended reductions of nitrogen oxides, or NOx, the primary contributor to smog and acid rain. Utilities that burn refined coal have trailed competitors burning raw coal in lowering NOx emissions, and 22 of 56 plants burning refined coal have seen NOx emission rates rise instead of fall, according to a

The refined coal tax subsidy is scheduled to expire in 2021. But lawmakers, including Republican Senator John Hoeven of coal-producing North Dakota, have introduced legislation to extend it another 10 years. They argue it helps the environment, extends the life of the ailing coal industry – a centerpiece of the Trump administration’s energy policy – and reduces power prices by giving utilities a cheap, subsidized source of coal.

“This is really an incentive to operate in a way that’s more environmentally friendly while keeping power costs low,” said Hoeven, whose state sits atop an 800-year supply of lignite coal.



FRIEND OF COAL: Senator John Hoeven (R-ND) speaks to delegates at the Republican State Convention in Grand Forks, North Dakota, U.S. April 7, 2018. Picture taken April 7, 2018. REUTERS/Dan Koeck

If the extension goes through, those best placed to gain from the subsidy are an eclectic list of refined coal investors, including Wall Street banks Goldman Sachs Group Inc, JPMorgan Chase & Co Inc and Capital One Financial Corp; wealth management giant Fidelity Investments; drugmaker Mylan NV; U.S. affiliates of global commodities trader Noble Group Ltd; industrial supplier W.W. Grainger Inc; Kansas-based pork producer Seaboard Corp; and ethanol plant investor Rex American Resources Corp, according to disclosures with the U.S. Securities and Exchange Commission, state environmental regulators and the U.S. Tax Court.

CapitalOne, Goldman Sachs, JPMorgan, Mylan, Noble, Rex American, Seaboard and W.W. Grainger declined to comment on refined coal’s impact on NOx pollution.

These and other refined coal investors stand to gain at least \$10 billion in tax incentives over the next decade if the law is extended, based on the current annual consumption of refined coal and the existing level of the inflation-adjusted tax credit.

BIRTH OF THE BUSINESS

As originally drawn in 2004, the refined coal tax credit required producers to increase raw coal’s market value by 50 percent to qualify for the subsidy. The market-value clause made cost-conscious utilities unwilling to buy the specialized product. Prospects for the clean coal business were dim.

But in the wake of the 2008 financial crisis, two U.S. senators changed the landscape by deleting the market-value clause – a subtle tweak tucked away in the massive \$700 billion U.S. financial rescue package.

A.J. Gallagher, along with utility firms Ameren Corp and DTE Energy, also had been lobbying on the issue of refined coal, according to lobbying disclosure filings, though it is unclear if they lobbied specifically on the market-value clause. Officials at Ameren and DTE declined to comment on the lobbying.

The policy edit – by Democrat Max Baucus of coal mining state Montana and Republican Chuck Grassley of Iowa – made it possible for refined coal producers to receive the subsidy even if they sold their product to utilities below cost. That paved the way for investors to set up operations and to ultimately make billions of dollars building refined coal to its current share of about a fifth of the U.S. coal market.



HELP IN WASHINGTON: Max Baucus, formerly a Senator from Montana and now a U.S. ambassador to China, played a key role in a policy change for 'clean coal' subsidies that made them lucrative for industry and investors. September 14, 2015. REUTERS/Kim Kyung-Hoon



SENATE BACKER: U.S. Senate Judiciary Committee Chairman Senator Chuck Grassley (R-IA) speaks during a news conference on October 4, 2018. REUTERS/Yuri Gripas

Baucus said he does not remember the change to the refined coal tax credit. “It was a tax-credit blizzard; a deluge of credits was being discussed,” Baucus said. “It’s very easy to change the code to give credit to companies to spur investment. The code gets crusted with barnacles of credits, and then they’re removed. It’s the natural ebb and flow of things.”

Grassley declined to comment for this story.

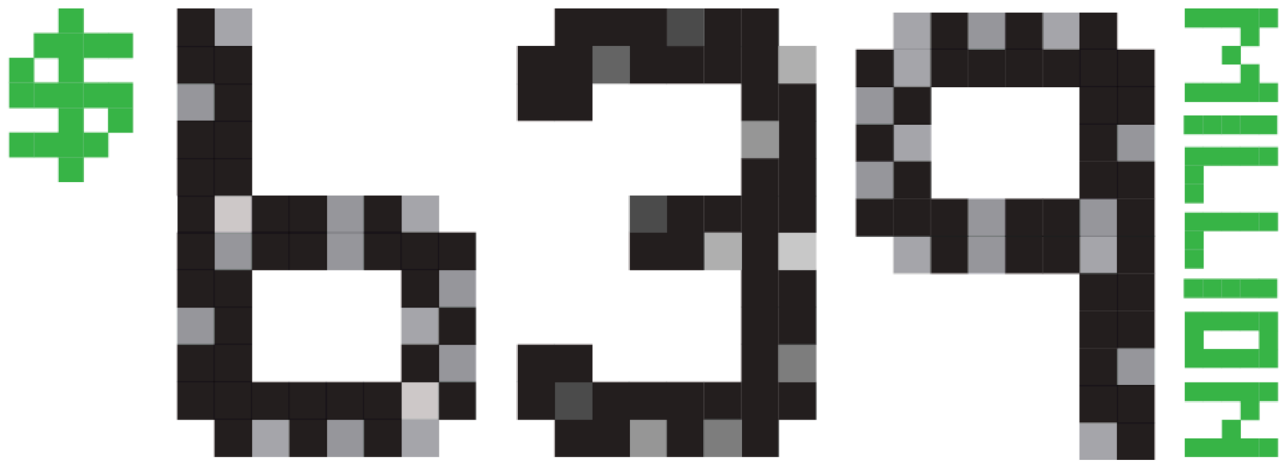
The subsidy is now worth more than \$7 a ton, an amount that covers losses on the discounted pricing and the operations that produce refined coal, while often leaving a profit that can amount to tens or hundreds of millions of dollars per year per investor, according to disclosures by tax credit investors. Because some of the operating expenses of running a refined coal facility are deductible, the tax credit’s effective value can top \$9 a ton.

Goldman Sachs, one of the world’s most powerful banks, is currently generating estimated annual gross tax credits of about \$50 million from two Missouri power plants alone, according data from the U.S. Energy Information Administration showing refined coal consumption patterns at the plants. Goldman declined to comment.

“It was virtually impossible to make money producing clean coal for utilities,” said Roger Jones, senior counsel at McDermott Will & Emery LLP in Chicago, who has represented refined coal tax investors. “But as soon as the credit was there, people thought about capital-raising to engage in this activity.”

After the tax credit was revised, A.J. Gallagher led the race to build refined coal facilities, constructing them next to power plants that burned the most coal in the country so as to maximize credit volumes.

It now has investments in 34 refined coal facilities in the United States, along with a 46.5 percent controlling stake in Chem-Mod LLC, a leading supplier of chemicals used to refine raw coal, according to A.J. Gallagher SEC filings.



DTE has received some \$639 million in refined coal tax credits since 2012.

Gallagher's main rival, Colorado-based Advanced Emissions Solutions Inc, holds interests in 19 refined coal facilities with tax credit investors, through a joint venture with Goldman Sachs and NexGen Resources Corp. Affiliates of Goldman Sachs account for most of those investors, SEC filings show.

Goldman Sachs, in 2011, purchased a 15 percent stake in the joint venture, a refined coal operator called Tinuum Group LLC, formerly known as Clean Coal Solutions, for \$60 million. Advanced Emissions owns a 42.5 percent stake in Tinuum, whose operations produced and sold about 60 million tons of refined coal during the 12-month period that ended Sept. 30, SEC disclosures show.

DRUG, TRASH FIRMS GET INTO COAL

Some partnerships include players even farther afield from the energy business. In one of refined coal's earliest and biggest financial commitments, trash collector Waste Management Inc teamed up with JPMorgan Chase to invest in the refined coal facility at Coal Creek Station in North Dakota.

The bank and the trash company invested in a facility that treats coal by preheating it in a process that dries out several million tons of soggy lignite coal each year, increasing its energy output. Electric cooperative Great River Energy, the owner of the plant, agreed to lease its refined coal facility to JPMorgan and Waste Management for \$530 million over 16 years, according to a January 2011 deal disclosed by the co-op.

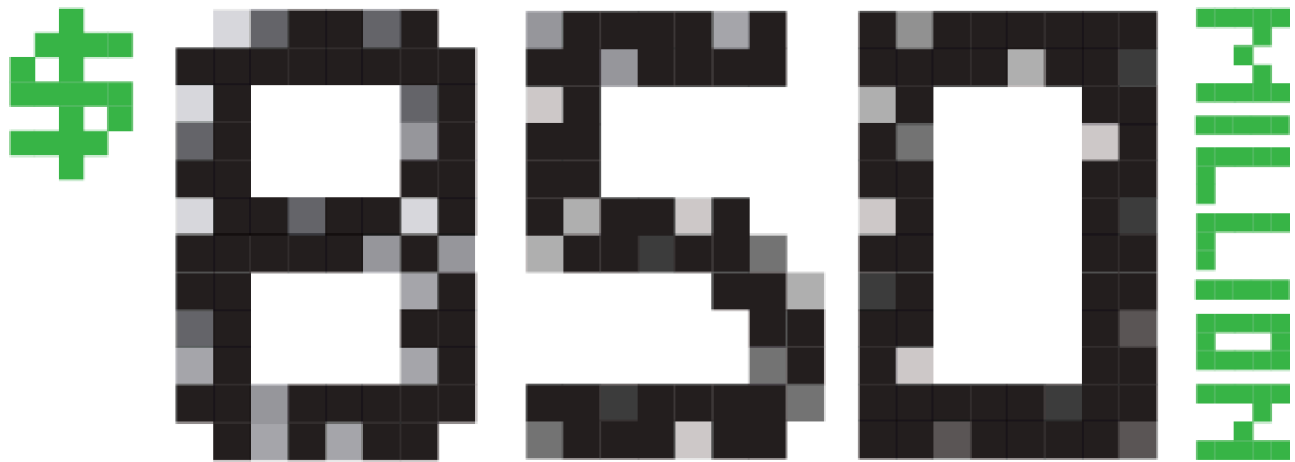
JPMorgan and Waste Management declined to comment for this story.

Another big beneficiary is drug maker Mylan. Refined coal tax credits were the second biggest component in producing a tax benefit of \$358.3 million in 2016, according to Mylan's annual report. That tax benefit lifted its consolidated earnings for the year to \$480 million, from \$121.7 million.

Power plant owners typically sell their coal at cost to refined coal operations controlled by tax credit investors. Once the coal is treated with chemicals or dried out at an on-site refined coal facility, the tax credit investors sell the coal back to the power plants at a discount that can be anywhere from 75 cents to \$2 per ton – a way to ensure utilities get some benefit from the subsidy, according to agreements filed with state regulators. Central-Appalachian coal, which has high energy content for power generation, costs about \$75 a ton.

Coal plant owners also may structure deals with refined coal producers to collect coal-handling and licensing fees or to charge rent through leases of their land used for the facilities, the disclosures show.

Last year, Louisville Gas & Electric and Kentucky Utilities, a unit of PPL Corp, struck a deal with an affiliate of Goldman Sachs to burn refined coal at the utility's Ghent power station. The utility stands to receive \$10 million a year in incentives and would bear no expense for running the refined coal operations, according to disclosures with Kentucky regulators.



Net earnings from its “clean energy” investments are estimated to be \$115 million in 2018, or 17 times more than what the company reported in 2010. Looking ahead, the company can carry forward its stockpile of \$850 million in credits to reduce its taxes in future years.

For Goldman and any other tax credit investors in the deal, the gross annual tax credit, before refined coal operating expenses and incentives for the utility, is \$39 million, Reuters estimates. That estimate is based on Ghent’s average annual coal consumption of 5.5 million tons multiplied by the \$7.03 per ton tax credit.

Goldman declined to comment on the revenue or profit it derives from clean-coal tax credits.

Utility companies themselves haven’t been in the vanguard of capitalizing on the refined coal subsidy. That’s because the original wording of the refined coal tax credit, passed in 2004, stipulated that the producer of refined coal had to sell it to an “unrelated person.” So, utilities couldn’t invest in clean coal and sell it to themselves.

The IRS issued new guidance in 2009, however, that opened the door for affiliates of utilities like Detroit-based DTE Energy to control or take stakes in refined coal production facilities in recent years. DTE has received some \$639 million in refined coal tax credits since 2012, SEC disclosures show. DTE declined to comment for this story.

PAYING NO TAXES

In today’s thriving clean coal industry, A.J. Gallagher’s early moves to monetize the tax credit seem prescient.

Months before the subsidy first entered the tax code in 2004, the company paid \$300,000 for a 5 percent ownership stake in Chem-Mod, which at the time was developing chemical treatments designed to reduce coal pollution. A core group of five people at A.J. Gallagher was overseeing the move into the business, according to the company’s disclosures to investors.

A.J. Gallagher was among several investors who paid Washington firms to lobby on refined coal, according to lobbying disclosure filings. In 2008, before Congress modified the refined coal tax credit to erase the market-value clause, the company paid two law firms – Winston & Strawn, and Steptoe & Johnson – to lobby on “refined coal” and “energy and tax” issues, respectively. The

lobbying disclosure documents do not detail what specific objective the companies had in their lobbying activities.

Officials from those law firms involved in the lobbying declined to comment.

David Lowman, a partner at Hunton Andrews Kurth LLP, was lobbying on refined coal on behalf of a different company at the time. He said the refined coal industry successfully pushed to have the market value clause eliminated. In return, the industry agreed to double the pollution reduction requirement on mercury and sulfur dioxide to 40 percent from 20 percent.

By the end of 2008, Gallagher had built up a 42 percent stake in Chem-Mod for a total investment of \$13.3 million, according to company disclosures. Now it was ready to launch into developing facilities.

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The dive into a newly subsidized business was part of the company's strategy to find profits in taxpayer-financed incentives. Dating to the 1980s, Arthur J. Gallagher has sought out opportunities, for example, in subsidized low-income housing and the so-called synfuel tax credit, designed to promote domestically-produced synthetic fuels that can reduce U.S. import dependence.

Gallagher's approach to refined coal, however, has made it a heavyweight, and it has been pivotal in recruiting tax investors to help finance refined coal operations throughout the country. In 2009, it negotiated partnerships with Fidelity and the U.S. subsidiary of France's Schneider Electric SE to produce refined coal for a utility at three South Carolina power plants, U.S. Tax Court disclosures show. Gallagher also has struck deals to put refined coal operations inside the fence of power plants owned by DTE and St. Louis-based utility Ameren Corp.

Net earnings from its "clean energy" investments are estimated to be \$115 million in 2018, or 17 times more than what the company reported in 2010. Looking ahead, the company can carry forward its stockpile of \$850 million in credits to reduce its taxes in future years.

"We will not be paying much, if any, U.S. federal income tax for many years to come," CFO Howell said this spring during a conference call with investors.

Sooty Secrets

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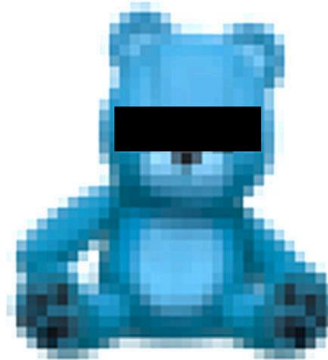
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