

E-ALERT | Clean Energy and Climate

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THE AMERICAN POWER ACT: AN ANALYSIS OF KEY PROVISIONS FROM THE KERRY-LIEBERMAN ENERGY AND CLIMATE LEGISLATION

On May 12, 2010, Senators John Kerry (D-Mass.) and Joe Lieberman (I-Conn.) released their long-awaited climate and energy draft legislation titled the “American Power Act” (“APA”). Following in the footsteps of last year’s House passage of H.R. 2454, the American Clean Energy & Security Act of 2009 (“House Bill”), the APA sets a mandatory cap on economy-wide greenhouse gas (“GHG”) emissions combined with a mechanism for GHG emissions trading. The APA also proposes to transform the energy infrastructure and promote energy independence of the United States by creating substantial incentives for nuclear power, expanded offshore drilling (though with a state veto power), carbon capture and sequestration, and certain energy conservation and efficiency measures.

The purpose of this e-Alert is not to provide a comprehensive summary of the bill but instead to offer some perspective and observations on the APA and to highlight issues that may be of particular interest as energy and cap-and-trade legislation continues to move through the Senate.¹

NUCLEAR

The APA provides various incentives for the research, development, and commercial deployment of nuclear power plants. The key provisions include:

Funding

The APA increases the amount of funding available for nuclear power facilities under the Department of Energy’s (“DOE”) Innovative Technology Loan Guarantee Program from \$18.5 billion to \$54 billion, consistent with the Administration’s budget submission. This would allow DOE to increase the number of new plants it supports from two or three to as many as eight or nine. It also provides a substantial number of new and expanded tax incentives for nuclear power facilities. These incentives include a five year accelerated depreciation period for new nuclear power plants and a new 10% tax credit for qualified nuclear plant construction expenditures. Tracking an innovation that has been successful in promoting non-nuclear low carbon generation, nuclear projects could obtain a cash grant from the Treasury Department in the amount of 10% of qualified project expenditures in lieu of the tax credit. The APA also makes nuclear technologies eligible for the existing \$2.3 billion Advanced Energy Project Credit. Finally, the APA expands tax credit programs and the use of tax-exempt bonds for advanced nuclear power facilities to include public-private partnerships.

¹ A helpful summary of the APA has been produced by the staff of Senators Kerry and Lieberman (available at <http://kerry.senate.gov/americanpoweract/pdf/APASectionbySection.pdf>).

Streamlined Approvals

In order to speed the approval of new nuclear facilities, the APA calls on the Nuclear Regulatory Commission to develop an expedited procedure for issuing combined construction and operating licenses for qualified new reactors. The bill also streamlines requirements for environmental review and public hearings. To mitigate the financial risks of regulatory delay, the APA would increase from six to twelve the number of reactors eligible for up to \$500 million in regulatory risk insurance under the Energy Policy Act of 2005.

Research and Development

The APA requires the Secretary of Energy to designate a National Laboratory as a Center of Excellence to lead research and development of spent fuel recycling. The bill also authorizes research initiatives on lowering the cost of nuclear reactor systems, including research on modular and small-scale reactors, and on increased nuclear proliferation controls.

OIL

Offshore Drilling

In the wake of the recent oil spill in the Gulf of Mexico, Senators Kerry and Lieberman included language in the bill to limit oil operations off the Atlantic and Pacific coasts. As currently written, the bill permits coastal states to enact a law prohibiting leasing for exploratory oil drilling up to 75 miles from their shores (compared to just three miles today).

The APA also gives the Department of Interior new power to assess the environmental impact of drilling. The bill requires the Secretary of the Interior to study the environmental and economic impact of any potential oil spill in areas newly available for revenue sharing. If a study of a proposed offshore oil lease found that a state could suffer significant adverse impacts in the event of an accident, the state's legislature could vote to prevent leasing from proceeding.

Despite those recent revisions, the originally agreed upon provisions for expanded offshore oil drilling remain largely intact. The bill establishes a revenue-sharing system where 37.5 percent of royalties from new offshore rigs would be directed to states, and 12.5 percent of royalties would be deposited in the Land and Water Conservation Fund for federal and state parks and land acquisition, compared to the current regime in which only Alaska benefits from revenue-sharing. This provides states a strong financial incentive to permit oil development in coastal regions.

Refinery Credits

Producers and importers of refined products would not participate in the carbon market. Nevertheless, the APA's allowance scheme sets forth certain obligations for refinery facilities and refined products that enter the market. Specifically, domestic producers and importers of refined petroleum must purchase allowances for their "refined products" to offset GHG compliance costs.

Refined Product. Beginning in 2013, the title holder of a "refined product" must purchase allowances from EPA to demonstrate compliance with the targets for refined products. The price of the allowances will be linked to the most recent clearing price of emission allowances established by auctions that start with the utility sector and then expand to manufacturers in 2016. Refined products include motor gasoline, distillate fuel oil, kerosene, aviation fuel, emissive natural gas liquid, residual oil, and coal-based liquid fuel. Removing transportation

fuels from the cap and trade system and instead imposing the equivalent of a gas tax led major oil companies such as BP, ConocoPhillips, and Royal Dutch Shell to endorse the legislation.

Refinery Facilities. The bill requires EPA to distribute allowances to owners and operators of petroleum refineries (and to other energy-intensive, trade-exposed industrial emitters) in the United States for each year between 2013 to 2026. The size of the allowances will depend on the intensity and production characteristics of each individual refinery facility. In addition, EPA must develop regulations governing the distribution of emission allowance rebates for new petroleum refineries and major expansions or upgrades at existing refineries.

COAL

Carbon Capture and Sequestration (“CCS”)

The APA establishes a special funding source for the development and deployment of CCS technologies. A newly created Council including members from industry and consumer groups will approve grants from the fund to electric utilities, academic institutions, government facilities, and nonprofits. Funding will come from a special assessment on electricity sales of not less than, by fuel type, \$0.00145/kwh for coal, \$0.00074 for natural gas, and \$0.00108 for oil. The Secretary of Energy will adjust the amount of the assessment so that it generates approximately \$2 billion per year for CCS research and deployment. (This provision is similar to the Boucher legislation included in the House-passed bill.)

The APA also supports the commercial deployment of CCS technologies in electric power generation and industrial operations through the distribution of emission allowances. Facilities are eligible to receive allowances based on the amount of carbon dioxide they capture (in other words, based on their avoided emissions). In all, facilities capturing an aggregate of approximately 72 gigawatts of carbon will be eligible to receive emission allowances for their first ten years of operation.

Finally, the APA establishes various working groups to study barriers to commercial-scale deployment of carbon capture and storage technologies, as well the effects of existing laws on risk management, financial responsibilities, and environmental liabilities associated with CCS. These measures lay the foundation for a regulatory framework to smooth the deployment of carbon capture and storage technology.

Incentives for Efficiency and Fuel Switching

The APA provides for accelerated depreciation and an as-yet unspecified investment tax credit for coal-fired power plants seeking to implement more energy efficient technologies, to transition to lower GHG emitting fuel sources, or to retire the unit.

Performance-Based Standards

As part of its bid to incentivize the early adoption of CCS technologies, the APA amends the Clean Air Act (“CAA”) by adding stringent new performance standards for new or modified coal-fired power plants. Plants that are permitted between January 1, 2009 and December 31, 2019 must achieve a 50% reduction in annual carbon dioxide emissions, while plants permitted on or after January 1, 2020 must achieve a 65% reduction.

Plants that receive preconstruction permits or approvals prior to one of the triggering dates are still subject to the standards if administrative review or appeal of the approval or permit has not been exhausted. The deadline for achieving these reductions is the earlier of four years from the date the EPA Administrator reports that industry has achieved specified benchmarks

with respect to CCS technology deployment, or January 1, 2020. If necessary, the Administrator and the Secretary of Energy may make a finding (which must be approved by Congress) that this date should be extended to January 1, 2022. The Administrator may extend the compliance date for individual sources by up to 18 months if the source can show that it would be “technically infeasible” for it to meet the deadline.

CAP AND TRADE

The APA calls for a mandatory cap on economy-wide GHG emissions combined with a mechanism for GHG emissions trading. Similar to the House Bill, the APA establishes a market-based auction system whereby certain sectors will receive allowances to help offset their compliance costs. The details of the climate provisions of the bill are set forth below.

Targets

The APA sets an overall goal to reduce greenhouse gas emissions by 4.75% below 2005 levels by 2012, 17% below by 2020, and 83% below by 2050. These targets match those in the House Bill passed last year and the Obama Administration’s announced policy goal. The cap for 2012 is set at 95.25% of 2005 emissions and by 2020 it is set at 83% of 2005 GHG emissions and it then continues to reduce incrementally to reach 17% of 2005 emissions for covered sectors by 2050. The emission limitations apply to designated GHGs.

Emission Allowances

Like the House Bill, the APA creates a limited supply of “emission allowances.” Each covered entity must surrender, at the end of each year, a number of emission allowances corresponding to the GHG emissions that are attributable to it under the statute. To demonstrate compliance, all “reporting entities” have an obligation to inventory and report their GHG emissions. Reporting entities would include, for example, any entity that would have been a “covered entity” but which emits 25,000 tons of CO₂ equivalent (CO₂-e) on or after 2008, or a motor vehicle fleet with emissions of more than 25,000 tons of CO₂-e on an annual basis (if so designated by the EPA). The APA imposes certain standards on what continuous monitoring or other technologies must be used to this purpose.

Cost Containment

A key innovation in the APA is a new approach to cost containment. The APA provides for auctioning of a portion of the allowances for each year on a quarterly basis. Auctions under the APA are open to covered entities only and regulated greenhouse gas market participants, who are subject to purchase limits for each auction. The identities of bidders as well as the quantity of allowances acquired and the price are subject to public disclosure.

Each auction is subject to a reserve auction price of \$12 (plus CPI plus 3% for each year from 2014 on an annual basis). The APA also includes a “Cost Containment Reserve” consisting of 4 billion allowances (from vintage future compliance periods) which may be purchased by covered entities in an amount up to 15% of the covered entities compliance obligation at a base price of \$25 from 2013, increasing at 5% plus CPI thereafter. In other words, the APA includes a “hard price collar” with a floor starting at \$12 (increasing 3% annually above CPI) and a ceiling starting at \$25 (increasing 5% annually above CPI).

The APA also includes several of the cost containment features from the House Bill including: (a) a 2-year rolling compliance period which allows entities to borrow an unlimited number of allowances from 1 year into the future; (b) entities may satisfy up to 15 % of their compliance

obligation by borrowing emissions allowances from vintage years 1 to 5 in the future, at an 8% interest rate; (c) the possibility of trading allowances and of importing “international allowances” for compliance purposes into the U.S. if they meet certain specified criteria.

Market Oversight

The bill creates two markets for the buying and selling of greenhouse gas allowances or related instruments. There is a primary market which is a quarterly auction run by EPA and only covered entities and certain other designated entities can participate in the auction, and the number of allowances they can purchase in any one auction is limited. The bill also contemplates creation of a secondary market, and it gives the Commodity Futures and Trading Commission (“CFTC”) responsibilities to protect against manipulation and fraud in the secondary market. The carbon market oversight provisions of the bill are more stringent than a number of the broader approaches to financial market reform currently being considered by Congress. The bill provides that all trading of “greenhouse gas instruments” must be conducted on an exchange and cleared through a greenhouse gas clearing organization (which may be a carbon exchange such as the NYMEX “Green Exchange”), though there are some exceptions to this broad requirement. The CFTC would be responsible for establishing strict position limits, eligibility criteria, oversight procedures, and anti-fraud and market manipulation penalties for all carbon market participants.

Participation in the auction process and the carbon market is restricted to compliance entities registered with the CFTC and regulated carbon market participants. This approach may create barriers to entry in this market by project developers, particularly offset developers, who either are unable or unwilling to be regulated on an exchange (involving such issues as posting appropriate margin and other collateral requirements to conduct trading on such exchange).

Offsets

Like the House Bill, the APA permits covered entities to demonstrate compliance with their emissions caps through the use of offsets. The APA allows for the use of up to 2 billion tons of offsets annually, divided between domestic offsets (1 billion tons) and international offsets (1 billion tons). However, unlike the House Bill, for each covered entity, the percentage of offsets which may be used to demonstrate compliance is limited to that entity’s percentage of the overall compliance cap. This limitation may be adjusted for new entrants.

Domestic Offsets

The APA mirrors the role of domestic offsets established under the House Bill, but is more generous in spelling out the kinds of projects that will be eligible. The APA establishes a “Greenhouse Gas Emission Reduction and Sequestration Advisory Committee” which is tasked with providing scientific and technical advice on the establishment of the domestic offset program. But, the APA directs that a wide variety of categories of offset projects be accepted including continuation of prior ongoing agricultural sequestration practices and avoided deforestation. The Act further provides that each of its designated types of offset projects can be eliminated for eligibility by the relevant agency. However, there is a presumption against the removal of eligible project types and such removal may only be performed subject to EPA rulemaking. The APA allocates responsibility for offset projects relating to emission reductions from domestic agriculture and forestry to the Department of Agriculture.

International Offsets

In comparison to the House Bill, the APA adopts a more conservative approach to the use of international offsets. For instance, for each covered entity, no more than 25% of the allowable

percentage of offsets may be used by holding international offsets (as compared to 50% under the House Bill). Further, the EPA retains discretion to increase the number of international offsets by up to 1 billion tons (as opposed to 1.5 billion tons under the House Bill) if domestic supplies prove to be limited (subject to the 2 billion ton cap). The APA specifies a “discount” for the use of international offsets in comparison to emission allowances or domestic offsets from 2018 of 1:1.25 (this replicates the House Bill requirement).

Disposition of Allowances

The APA provides for emission allowances to be distributed for three primary goals: (a) to protect consumers from energy price increases; (b) to assist industry in the transition to a clean energy economy; (c) and to spur energy efficiency and the deployment of clean energy technology. The principal beneficiaries of allocations under the APA are electricity and natural gas consumers. The full allocations are set out below.

Sector	Allowance Allocation (%/ per select year)					
	2013	2016	2019	2020	2029	2034
Electricity consumers	51	35	35	35	8.5	-
Natural gas consumers	-	9	9	9	1.8	-
Home heating oil and propane consumers	1.9	1.5	1.5	1.5	0.3	-
Universal trust fund	-	-	-	-	47.1	54.5/77.8 (2035 onwards)
Consumer relief	12.3	12.3	12.3	10.6	10.6	11.5/12.5 (2035 onwards)
Trade-exposed industries	2	15	15	15	3	-
Industrial energy efficiency	0.5	-	-	-	-	-
Refiners	4.3	3.75	3.75	3.75	0.75	-
Deployment of carbon capture and sequestration technology	-	-	-	4.5	8	10
Clean vehicle technology	1	1	1	1	-	-
Low-carbon industrial technologies research and development	1	1	1	1	-	-
Clean energy technology research and development	2	2	2	2	-	-
Investment in energy efficiency and renewable energy	2.5	2	1	1	-	-
Rural energy savings program	0.5	-	-	-	-	-
Adaptation	-	-	1.5	1.5	5.5	6
Early Action	1	-	-	-	-	-
Transportation infrastructure and efficiency	12	9.2	7.6	6	5.8	6.7

In addition to these specific allocations, the APA provides discretion for the President to allocate 5% of the emission allowances to funds in developing countries that meet certain eligibility requirements for adaptation purposes.

The APA follows the House Bill and incorporates significant consumer protection provisions through its designation of the distribution of allowances. For example, Section 3001 of the APA requires EPA to distribute the quantity of emissions allowances allocated for each given year to electricity local distribution companies for the benefit of retail ratepayers. These allowances must be used exclusively for ratepayer benefit and “may not be used to support electricity sales or deliveries to individuals or entities other than those ratepayers.” Ratepayer benefits are to be distributed among ratepayers on a pro rata basis.

In addition, Sections 3201 through 3207 of the APA provide additional consumer relief through auction proceeds, including funding for households at 250 percent of the poverty level through a Working Families Refundable Relief Program for calendar years 2013 through 2029, monthly cash energy refunds under the Energy Refund Program of the Social Security Act beginning in 2013, and a Universal Refund to consumers based on household size beginning in 2026.

State Pre-emption, State Allowances. The APA pre-empts States, such as California under AB32 or the New England States under RGGI, from implementing or enforcing a “cap-and-trade” program. This raises the question as to whether the APA would also pre-empt other provisions contained in California’s AB32 including the offset provisions of that regulation. However, the APA permits the EPA to promulgate regulations allowing any individual or entity in the US to exchange state allowances issued at the time of enactment for emission allowances established under APA. In terms of the distribution of early action credits, the EPA may distribute 1/3 of the allowances allocated for early action to any individual entity in the US to exchange instruments in the nature of offset credits issued by a state, local or voluntary offset program. 2/3 of the allowances will be allocated to states that by the date of enactment have issued a limited number of tradable instruments in the nature of emission allowances.

CLEAN TRANSPORTATION

The APA provides substantial support for improvements to transportation infrastructure, efficiency, and technology, and to the reduction of transportation emissions.

Infrastructure Funding

The APA provides over \$6 billion annually to support transportation infrastructure. Section 1721 of the APA defines the use of a Highway Trust Fund to “promote the safety, effectiveness, and efficiency of transportation.” A maximum annual allowance of \$2.5 billion would be deposited in the Highway Trust Fund. In addition, proposed Section 781 of the CAA provides a maximum of \$1.875 billion in annual allowances to be distributed by the Secretary of Transportation for surface transportation discretionary grants. That section also provides \$1.875 billion maximum annual allowance for investments in the transportation greenhouse gas emission reduction programs described in Section 1712. These programs support development of targets and strategies for transportation greenhouse gas reductions and financial assistance for transportation planning.

Hybrid and Electric Vehicle Infrastructure and Technology

Section 1701 of the APA outlines the development of a “national transportation low-emission energy plan” to identify needs for electric vehicle refueling infrastructure and deploy electric vehicle infrastructure by January 1, 2020. This infrastructure would include standardized public charge access ports that support electric vehicles and plug-in hybrids and have wireless or smart card billing capability. Pilot projects would be implemented throughout the United States to demonstrate the functionality of the infrastructure.

Section 4111 establishes a “Clean Vehicle Technology Fund” in the Treasury. The fund would be supplied pursuant to proposed Section 781 of the CAA. The funds would be distributed by the Administrator of the EPA to provide facility conversion funding grants. Specifically, the grants would support reequipping or expanding existing facilities in the United States to produce clean technology vehicles and components and integrating engineering of clean technology vehicles and components in the United States.

Natural Gas Incentives

The APA provides tax incentives and encourages the use and development of natural gas vehicles.

Section 4121 of the APA extends and doubles the alternative fuel tax credits for the purchase of qualifying natural gas vehicles for a period of 10 years. Specifically, the proposed legislation

expands the credits for natural gas vehicles greater than 8,500 pounds that are either 1) “only capable of running on compressed or liquefied natural gas”; or 2) “capable of operating for more than 175 miles on 1 fueling of compressed or liquefied natural gas” in addition to operating on gasoline or diesel fuel. The APA also expands the credits for natural gas vehicles less than 8,500 pounds that meet these requirements and are part of a commercial fleet of ten or more vehicles where the taxpayer purchases at least three such natural gas vehicles. Section 4121 also includes, within the definition of mixed fuel vehicles for the purposes of the alternative fuel tax credit, vehicles that can operate on and use at least 65 percent compressed or liquefied natural gas.

The APA also allows state and local governments to issue tax credit bonds to finance natural gas vehicle projects pursuant to Section 4122. The national limit on these bonds is \$3 billion annually. Furthermore, Section 4124 amends the itemized deductions of the Internal Revenue Code to allow taxpayers to deduct the full cost of natural gas manufacturing facilities placed in service prior to January 1, 2015. Taxpayers would be able to deduct half of the cost of such facilities placed in service after this date and before January 1, 2020.

Finally, Section 4124 of the APA directs the Administrator of General Services to study, within 180 days, means by which to increase the number of natural gas and liquefied petroleum gas vehicles in the Federal fleet.

Transportation Emissions Reductions

The APA amends the CAA to direct the Administrator of the EPA and the Secretary of Transportation to develop regulations establishing GHG emission reduction goals. The final regulations would be promulgated within 18 months of the enactment of the APA. The Administrator and Secretary would also establish standardized emission models and methods to provide to states, metropolitan planning organizations, and air quality agencies to achieve these goals. In addition, the Administrator and Secretary would establish mechanisms to gather data on transportation GHG emissions and publish successful strategies.

To meet these regulations, states and metropolitan planning organizations would implement strategies to reduce GHG emissions, including increased public transportation ridership and non-motorized transportation; zoning and land use regulations; programs to manage travel demand; improvement of surface transportation systems; passenger rail, intercity bus, and freight rail improvements; selective choices of construction materials and equipment for transportation projects; and public electric vehicle refueling facilities.

Section 4141 amends the CAA to direct the Administrator of the EPA to promulgate GHG emissions standards for certain mobile sources, including new heavy-duty motor engines and vehicles and non-road engines and vehicles, as well as setting motor vehicle standards for model years after the 2016 model year.

Greenhouse gas emissions for international aviation are also addressed. Specifically, the proposed legislation declares the importance of promoting development of a global framework for regulation of civil aircraft GHG emissions. It directs the Administrators of the EPA and Federal Aviation Administration to distribute compensatory allowances for GHG emissions of the fuel used for air carriers engaged in foreign air transportation.

RENEWABLE ENERGY AND ENERGY EFFICIENCY

The APA contains limited provisions directly targeting renewable energy. It does not contain a renewable portfolio standard or renewable electricity standard since those are in the Senate Energy Committee passed bill (the “Bingaman bill”). Because there are no renewable electricity standard or electric transmission provisions, and limited provisions on energy efficiency, we would expect that for any viable comprehensive energy and climate legislation to move through the Senate this year, the APA would need to be combined with the Bingaman bill and perhaps other pending energy legislation.

That said, Section 1601 does set forth Congressional findings that “large-scale deployment of renewable energy and substantial improvements in energy efficiency” are crucial to improving energy security, reducing GHG pollution, and creating jobs. Although the APA does not implement these approaches, it encourages future measures to address clean and renewable energy mandates, funding mechanisms for clean and renewable energy, improved transmission to support clean and renewable energy, and improved building codes and appliance standards.

Other provisions provide some support for renewable energy. Section 1602 amends the Consolidated Farm and Rural Development Act to make available loans to fund “structural improvement and investments in cost-effective, commercial off-the-shelf technologies to reduce home energy use.” These loans are to be allocated pursuant to proposed Section 781 of the CAA in years 2012 through 2015.

Section 1603 provides guidance for the distribution of allowances pursuant to proposed Section 781 of the CAA among and between states and Indian tribes in years 2012 through 2021. These allowances must be used for energy efficiency purposes or programs, renewable energy purposes, Smart Grid development, or surface transportation capital projects.

Finally, Section 1604 finds that “voluntary renewable energy markets can be efficient and effective programs for allowing consumers and businesses to voluntarily use or support renewable energy.” In view of this finding, the proposed legislation declares that the United States supports “the continued growth of voluntary renewable energy markets.”

REGULATORY PREEMPTION

The EPA’s authority to regulate GHGs under the CAA is curtailed but not eliminated, similar to the House Bill. Under the APA, the EPA Administrator may not list any GHG as a hazardous or criteria pollutant under the CAA solely due to its effect on climate change or ocean acidification. This prohibition effectively prevents EPA from setting nationwide ambient air quality standards for GHGs. The Act also precludes regulation of GHG emissions from new or modified major (upgraded) stationary sources under the CAA’s New Source Review permitting program — a regulatory regime that EPA is currently in the process of implementing under its existing CAA authority. Finally, the Act stipulates that no stationary source shall be required to apply for, or operate pursuant to, a CAA permit solely on the basis of its GHG emissions by providing that participation in the cap-and-trade program implemented under the APA constitutes automatic compliance with existing Title V permitting requirements under the CAA.

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