The Energy Policy Act of 2005:
A User-Friendly Guide to the Rules and Repercussions of the Electricity Title

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A User-Friendly Guide

To the Rules and Repercussions of the Electricity Title

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The President signed the Energy Policy Act of 2005 (Act) into law Monday and electric and gas companies will soon be experiencing its repercussions. We present here a User-Friendly Guide to the Electricity Title of the Act which includes analysis and insights into its likely effects on the electric industry.

This guide is organized as follows. We first provide an Executive Summary that describes in a nutshell the Electricity Title's most sweeping changes and outlines their probable impact on day-to-day business and near-term strategic planning in the power sector. Then, we go through the Electricity Title section by section in more detail. For each subtitle we identify the key features of the legislation and offer some insights into their likely repercussions. Finally, we provide two tools for lawyers and businessmen. The first is a red-lined electronic version of the U.S. Code that shows each change made by the Electricity Title and compares the new statute to the old (Appendix A). Secondly, we provide a descriptive list of the FERC rulemakings and other FERC proceedings that Congress mandated or may be initiated under the Electricity Title of the Act (Appendix B).

We hope that this User-Friendly Guide will help the reader quickly get up to speed on the Electricity Title and its implications for his or her work and strategic thinking.

AN EXECUTIVE SUMMARY OF THE ELECTRICITY TITLE'S KEY FEATURES AND THEIR IMPLICATIONS

REPEAL OF PUHCA AND STREAMLINING OF FERC'S MERGER REVIEW PROCESS

The Act repeals PUHCA, effective in six months. At the same time, it streamlines FERC's merger review process and makes it applicable to holding company mergers. The Act requires FERC to identify more clearly which mergers and acquisitions will obtain FERC's approval without detailed review. And for mergers that it does review in detail, FERC must make a decision on merger approval within six months in ordinary cases (twelve months in exceptional cases). Thus, the Act removes the barriers to consolidation posed by PUHCA and expedites the merger approval process at FERC.

An obvious question arises: Will these changes result in a wave of mergers and industry consolidation? Many, if not most, major industries in the U.S. have fewer than ten major players. Some industry analysts have predicted for years that the electric power sector inevitably faces similar consolidation. The new Act makes this prediction thinkable from a regulatory standpoint -- at least at the federal level. We offer the following observations and thoughts on this question:

- The abolition of PUHCA clearly does remove regulatory constraints that have impeded foreign companies, U.S. electric and transmission utilities, and U.S. companies outside the power sector from attempting mergers and acquisitions.

- Foreign companies now will have opportunities to enter the U.S. power sector without facing the labyrinthine regulation of PUHCA or its restrictions on non-utility businesses. U.S. electric, transmission, and gas utilities now can seek greater geographic diversity free of PUHCA's single system integration and single "region" requirements. And U.S. companies not currently in the power sector can now enter and acquire utility businesses that generate large amounts of cash and reliable returns without subjecting themselves to extensive regulation under PUHCA.

- Investment bankers around the globe can be expected in short order to present to their clients potential merger and acquisition opportunities along such previously forbidden lines. Indeed, many companies consider such strategic opportunities regularly in-house. Thus, it will not be long before the Act's changes affect firms' strategic thinking, and undoubtedly this process commenced when passage appeared likely.

- Experience teaches that mergers occur in waves for a reason. In rapidly consolidating industries the "targets" perceived as most attractive typically

represent only a portion of the total sector. Once mergers start occurring, and the most attractive targets begin to disappear, the progression of consolidation tends to accelerate as other firms rush to the dance to avoid facing a depleted, "picked over" list of potential merger partners. In addition, once some rivals adopt a consolidation strategy, others tend to follow to match their competitors.

- All of the factors bulletized here lead us to believe that there will rapidly be a very large amount of consideration of M&A activity. Much of the activity considered will likely consist of geographic market extension or conglomerate mergers that were not previously legally feasible in the electric industry.

However, most if not virtually all such mergers will require state approvals. An often overlooked fact is that the utility mergers that have foundered due to regulatory constraints have hit the shoals at the state, not federal, level (*e.g.*, BG&E/PEPCO, Con Edison/Northeast Utilities). It remains to be seen whether geographic market extension mergers or conglomerate mergers in this sector can generate the kind of savings and benefits to regulated customers that state regulators have at times insisted upon. Moreover, state commissions have blocked two recent major transactions (Portland General/Texas Pacific Group and Unisource Energy/Saguaro Utility Group). These merger rejections were due in significant part to concerns about the heavily debt-financed nature of the deals and the fact that the prospective acquirers were not in the business of meeting public service obligations. Finally, in most state merger proceedings concerns emerge about preserving localized control.

For these reasons, in our view:

- Merger and acquisition activity will come under serious consideration by virtually all electric and transmission utilities. This is true whether or not a wave of such mergers breaks immediately.

- Whether or not such a wave occurs may depend on the state regulatory treatment of the first major new M&A transactions that respond to the new Act by seeking approval of geographic market extension mergers or conglomerate mergers of the type that heretofore have not been realistic.

ESTABLISHMENT OF A NEW REGIME FOR RELIABILITY STANDARDS

The Act provides for the establishment of mandatory reliability standards to be enforced by an Electric Reliability Organization (ERO) selected by FERC. The ERO will propose standards and FERC must review and approve them. The ERO will almost certainly be a variation on NERC. It appears that:

- The details of how this new regime will be regulated remain to play out. However, creation of this new reliability regime coincides with the

enlargement of FERC's penalty authority (discussed below) to $1 million per day, and the Act provides both the ERO and its regional progeny with authority to levy civil penalties directly. Thus, the institution of this new regime warrants new legal department attention for electric and transmission utilities.

- Moreover, under the new legislation, the reliability standard is defined broadly to include requirements for "cybersecurity protection."

- The boundary lines of authority between the ERO and the states, which still have authority under the Act over resource adequacy, appear murky. The Act may lead to litigation in this area to the extent it diminishes state authority without clearly demarcating the line between federal and state jurisdiction.

TRANSMISSION INFRASTRUCTURE

The Act contains provisions intended to clear the way for new transmission investment by giving FERC siting authority as a "backstop" to the states and by mandating that FERC provide rate incentives. Significantly, the Act does not mandate membership in RTOs to obtain such benefits.

As to transmission siting authority:

- The Act directs DOE to study and identify "national interest electric transmission corridor[s]" where new construction will eliminate critical constraints and benefit consumers. How DOE chooses to exercise this authority, *i.e.*, whether it identifies only a few critical corridors or establishes a broad list of transmission constrained areas, will determine the significance of FERC's new siting authority.

- If a state, or a group of contiguous states acting together as a regional compact under the Act, fails for a year to approve a proposal to build transmission in such a corridor, FERC can step in. FERC can also act within such a corridor, without waiting a year, upon a showing that a state does not have authority to approve a particular application to site a facility. Federal courts are given eminent domain authority to enable the construction of transmission facilities approved by FERC. On the other hand, if a group of three or more states forms an "interstate compact" for the purpose of permitting transmission projects, FERC will have no authority to issue or modify construction permits unless the interstate compact fails to reach an agreement.

FERC's backstop authority on paper represents a potential "sword of Damocles" to expedite state approvals of construction that will alleviate constraints identified by DOE. If FERC chooses to act aggressively, it may also use its new authority to promote transmission construction by new entrants that are not public utilities in the states where

they want to build new transmission. The siting provisions therefore create potential conflicts between FERC and state regulators over who should build new transmission. However, the process by which FERC's authority will be exercised has not yet been defined. It remains to be seen to what extent and how rapidly FERC and DOE will act to trump the states if a disagreement about transmission expansion arises. Nonetheless, we believe that FERC under the new Chairman's leadership is likely to be effective in using this process to facilitate the construction of needed new facilities.

As to incentive rates:

- The Act requires FERC to establish rules for incentive-based rates for transmission facilities, including a return on equity that attracts new investment.

- We would expect FERC, after holding a rulemaking on the subject, will endorse transmission rates that include an enhanced rate of return and likely will also permit inclusion of CWIP in rate base, shortened depreciation periods for new facilities, and performance-based incentives.

- Significantly, the Act does not indicate that the rate incentives it mandates should be limited only to RTO members and independent transmission companies, although it expressly authorizes the use of rate incentives for transmission owners that join Transmission Organizations (which is defined to include RTOs, independent transmission companies and ISOs).

In short, the opportunity for utilities and new entrants to build and earn attractive returns on new facilities appears to be real and will likely persist for a significant time period. The types and extent of the incentives will be established in a rulemaking proceeding that will commence shortly.

EXPANDED PENALTY AUTHORITY

The Act provides FERC with authority to levy civil penalties of up to $1 million per day for a violation of any provision of Part II of the FPA -- which includes virtually all of FERC's regulation of rates, markets, mergers, affiliate relationships, and now reliability requirements in the electric power industry. Some commentators on the draft legislation voiced concern that the increased penalty authority might create regulatory uncertainty that could undermine the goal of the Act to spur infrastructure investment.

The expanded penalty authority clearly is in part a reaction to the tactics of Enron and others during the California power crisis. Indeed, the Act explicitly makes it a violation of the law willfully to report false information or use any manipulative device or contrivance in breach of the Commission's rules. The current FERC, under the

leadership of Chairman Kelliher can be expected, we believe, to use its new penalty authority judiciously.

Nonetheless, the existence of the new penalty authority puts a greater premium than ever before on careful FERC compliance. Those companies that have not undertaken a hard review of their compliance recently may wish to consider doing so.

ELIMINATION OF MUST-BUY AND UTILITY OWNERSHIP PROVISIONS OF PURPA

The Act limits the scope of PURPA's requirement that utilities must buy the output of QFs, but protects existing QF contracts. The Act therefore dissipates most of the reason to construct new facilities as QFs. However, the Act affects older QF facilities that have contracts that will expire before the end of their useful life. One result may be that owners of those plants may wish to modify their facilities to increase output and efficiency when their QF contracts expire, as there may then be little incentive to remain subject to the limitations that PURPA applies to QF plant.

The Act also eliminates the limitations on a utility owning more than 50% of a QF. This creates opportunities for utilities that are partners in such ventures to buy out the remaining interests, although that has the potential to raise affiliate and market power issues at FERC.

CONCLUSION

The new legislation will likely increase industry consolidation and investment in new transmission facilities, and confers upon FERC a new and important role in policing reliability and transmission expansion. The new penalty authority is likely to result in more focus on FERC compliance and greater efforts on the part of traders and marketers to secure increased specificity in FERC's rules. The current FERC supported passage of the new legislation, and appears prepared to deal conscientiously with its many new provisions.

TABLE OF CONTENTS

Page

SUBTITLE A: RELIABILITY STANDARDS (Section 1211)

OVERVIEW OF ACT

- The Act creates FPA Section 215 to provide for the establishment of mandatory, enforceable electric reliability standards with which all users, owners, and operators of the bulk-power system must comply.

- The Act authorizes FERC to exercise authority over the reliability of the bulk power system (including the energy needed to operate the system) through the establishment of an Electric Reliability Organization (ERO).

  - It is expected that the ERO will be the North American Electric Reliability Council (NERC); NERC already has issued a press release indicating that it is prepared to move quickly to transition to the ERO envisioned in the bill.

  - The Act allows FERC to delegate certain authority to the ERO, including the authority to hold hearings and levy sanctions, while retaining oversight authority.

- The ERO will develop electric reliability standards that are mandatory, enforceable, and subject to FERC review.

  - The ERO, in turn, may delegate to a regional entity (RE) the authority to propose and enforce reliability standards (including imposing sanctions), as long as the RE meets certain criteria.

  - The Act provides the ERO/RE authority to impose a penalty on a user, owner, or operator of the bulk power system after a hearing. Notice and the record of the proceeding will be filed at FERC and penalties are subject to FERC review. FERC hearings to review an ERO/RE-imposed penalty may consist solely of the record before the ERO/RE and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the penalty.

- FERC itself also may impose a penalty against a user, owner, or operator of the bulk-power system if the Commission finds, after convening a hearing, that such entity has engaged, or is about to engage, in acts or practices that constitute a violation of a reliability standard.

  - Penalties imposed under FPA Section 215 must bear a "reasonable relation" to the seriousness of the violation and must take into consideration the user, owner, or operator's efforts to remedy the violation in a "timely manner."

- A regional advisory body may be formed to provide advice to the ERO/RE or FERC, and FERC "may give deference" to the advice of such body organized on an Interconnection-wide basis.

- The ERO and REs will collect funds to carry out their reliability responsibilities. The most likely scenario appears to be that the ERO will assess fees on its members, consistent with NERC's current practice, such that the ERO mainly will be funded by electricity end-users.

- The ERO will take appropriate steps, after certification, to gain recognition in Canada and Mexico.

ANALYSIS

Reliability Standards. The ERO will establish and enforce reliability standards for the bulk-power system, subject to Commission review. Because adjudicative orders can have the same precedent-setting effect as rules, it will be important to keep a close eye on all FERC proceedings adjudicating reliability standards as rulings in those cases may have industry-wide applicability. When evaluating a proposed reliability standard, the Commission must give "due weight" to the technical expertise of both the ERO and a regional entity organized on an Interconnection-wide basis (*e.g.*, the WECC) with respect to a reliability standard to be applicable within that Interconnection. Because the Commission is not permitted to defer to these organizations with respect to "the effect of a standard on competition," there could be significant litigation over what constitutes an "effect on competition."

Changes to the Regional Reliability Councils. The term "regional entity" (RE) most likely refers to NERC's regional reliability councils. Indeed, more than a year ago, NERC leadership indicated in correspondence with Congress that at least one of NERC's regional reliability councils (the East Central Area Reliability Coordination Agreement (ECAR)), was engaged in restructuring to ensure that it would meet the governance and other requirements for regional reliability organizations as set forth in the then-pending reliability legislation. Although some have suggested that the REs could be RTOs, that seems unlikely in view of recent developments on the international stage involving the Bilateral Electric Reliability Oversight Group, which was established in February 2004 to address issues concerning an international framework for electric reliability and is comprised of representatives of the governments of the United States and Canada. In a May 26, 2005 document, entitled "Draft Principles for a Reliability Organization that Can Function on an International Basis," the Bilateral Group explicitly stated its view that: "Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs) should not become Regional Entities. The Regional Entity should be independent from the operators of the system." However, because most RTOs and ISOs are not-for-profit entities that pass through all of their costs, it is difficult to see how economic

sanctions can be used to motivate them to comply with reliability requirements of an ERO or RE.

Regional Advisory Boards. As the Act adopts a "one-state, one-member" approach, small States will be represented on regional advisory boards in ways that are out of proportion to their size and populations.

Expansion of FERC Jurisdiction. The new law substantially expands federal jurisdiction. For purposes of approving electric reliability standards and enforcing compliance therewith, FERC has jurisdiction over the ERO that it certifies, any REs that receive delegated enforcement authority, and all users, owners, and operators of the bulk-power system, including state and municipal entities and electric cooperatives, without regard to size. The Act further provides for limited federal preemption if a State's actions to ensure the safety, adequacy, and reliability of electric service are inconsistent with federal reliability standards. Upon application by the ERO or other "affected party," FERC may determine whether a state action is inconsistent with a reliability standard and may stay the State's action pending the determination.

Federal jurisdiction over reliability is not unbounded, however, as the Act appears to have stopped short of giving the ERO the authority to set or enforce mandatory standards for adequacy, apparently preserving for the States the authority both to set adequacy standards and to require the expansion of transmission or generation to meet such standards. In this regard, the Act is likely to lead to litigation over the precise line of demarcation between state authority over adequacy and federal authority over reliability.

Cybersecurity. Under the new legislation, penalties potentially will be assessed for violations of FERC-approved cybersecurity standards because Congress defined "reliability standard" broadly to include requirements for "cybersecurity protection." Since August 2003, NERC has had in place a limited cybersecurity standard known as Urgent Action Standard 1200 or the NERC 1200 Standard. NERC 1200 was intended to serve as an interim standard during the development of a permanent standard. Financial penalties are not currently assessed for noncompliance with NERC 1200; NERC merely sends out non-compliance letters. NERC 1200 is set to expire in August 2005, and cannot be renewed under current rules. NERC has balloted a measure to change the rules and extend NERC 1200 for a third year. If passed, NERC 1200 will be in force until August 2006, or until a permanent standard is approved, whichever is sooner. The permanent standards on which NERC is working are known as NERC 1300 or NERC CIP standards and are likely to be approved prior to August 2006.

SUBTITLE B: TRANSMISSION INFRASTRUCTURE MODERNIZATION (Sections 1221-1224)

OVERVIEW OF ACT

- New FPA Section 216: 1) gives the Department of Energy (DOE) authority to establish national transmission corridors; 2) provides FERC siting jurisdiction within national transmission corridors; 3) directs the federal agencies to expedite and coordinate related-siting reviews; and 4) allows States to retain siting jurisdiction in the national corridors by creating a regional entity covering three or more states.

  - The Act directs DOE to conduct a study within one year, and every three years thereafter, in consultation with affected States, designating any area experiencing transmission constraints or congestion that adversely affects consumers as a "national interest electric transmission corridor." The corridor may be established in any interstate geographic area of the country, except ERCOT.

  - The Act provides FERC with so-called "backstop" siting jurisdiction within the national corridors designated by DOE when the States cannot act, or fail to act on a siting application within a reasonable time. FERC can exercise siting jurisdiction if it finds that siting is in the public interest and promotes national energy policy, and any of the following apply:

    - a State in which the facility is to be constructed or modified does not have authority to approve the siting or to consider the interstate benefits of siting in the state;

    - the applicant does not qualify to apply for a permit in a state because it does not serve end-users in the State; or

    - a State commission has authority to approve the siting, but either it has withheld approval for more than one year after filing of an application or designation of a corridor (whichever is later), or it has conditioned approval such that the proposed construction or modification will not significantly reduce congestion or will not be economically feasible.

- A permit holder can obtain rights-of-way to construct transmission facilities by using public property and/or exercising a new federal right of eminent domain against private parties. The right of eminent domain can be exercised by initiating a proceeding in a federal district court where the property is located.

- The Act permits three or more States to retain collective jurisdiction over siting decisions in national corridors by entering into an interstate compact. However, the

agreement to form the interstate compact must be approved by Congress and each state entering the compact.

ANALYSIS

The goals of this portion of the Act are to improve the Nation's transmission infrastructure, regionalize transmission siting decisions, expedite and coordinate federal agency reviews, and promote an open, transparent federal permit process. The federal eminent domain provision and FERC's backstop siting authority provide new federal tools to help break the logjam on new transmission investment.

If DOE chooses to construe narrowly its authority to identify national transmission corridors, and limits its designations to only a few areas with significant constraints, the impact of the Act's siting provisions may be fairly limited, since FERC is given backstop siting authority only where DOE has designated a national corridor. On the other hand, if DOE establishes a broad list of affected areas, FERC's jurisdiction will be extensive and considerable investment in new transmission can be expected, whether approved by states under threat of federal intervention, or by FERC itself.

It remains to be seen how aggressive a reading of its new responsibilities FERC will take, but the Act appears to give FERC authority to promote investment by new entrants that do not serve electric load in states where only existing load-serving utilities can be granted siting approval to build new transmission. In addition, FERC may step in whenever a state cannot consider interstate benefits or where a state imposes conditions on siting approval that make the upgrades economically infeasible. Thus, if FERC acts aggressively, it may use the new siting provisions to promote non-utility investment in transmission and competition among potential investors.

New FPA Section 216(h) provides the right to appeal to the President when "any agency has denied a federal authorization required for a transmission facility" or when an agency fails to act by a deadline. Significantly, FERC decisions on siting are *also* subject to the appellate review process, meaning that there may be dual review proceedings following any *denials* of permit applications. In the face of such denials, it will be important to carefully monitor the appeal processes so as to maximize rights provided under the Act.

Finally, the Act gives States an opportunity to preempt FERC's siting authority. An agreement between three or more states to establish an institution with the power to site transmission facilities based on regional needs would eliminate FERC's authority to issue permits within a participating state, unless DOE finds that the members of the compact have withheld approval for more than one year or conditioned their approval in a manner that will not significantly reduce congestion or is not economically feasible. Establishing an interstate compact likely will be a complex process, raising potentially

thorny staffing and voting issues. Moreover, all of the participating states and Congress must approve the compact's founding agreement.

SUBTITLE C: OPEN NONDISCRIMINATORY TRANSMISSION ACCESS (SECTIONS 1231-1236)

OVERVIEW OF ACT (SECTION 1231 -- UNREGULATED TRANSMITTING UTILITIES)

- The Act creates a category of "unregulated transmitting utilities" and authorizes FERC to require such utilities to provide open, nondiscriminatory access to their transmission assets. This section applies to entities, such as municipals, that are not public utilities under the Federal Power Act.

- FERC is authorized to require that such a utility charge a rate "comparable" to the rate it charges itself, the standard it had articulated under its existing safe harbor policy. FERC also may require that non-rate terms and conditions are comparable to those under which the utility provides service to itself. These provisions do not apply to local distribution facilities, and explicitly prohibit FERC from requiring an unregulated utility to join a Transmission Organization.

- Exempted from the scope of FERC's new authority are certain small utilities: those that sell less than 4 million MWh per year; are not necessary for operating an interconnected transmission system; and meet other criteria that FERC determines to be in the public interest."

- The Act provides that the procedures used by regulated utilities for changing rates under Section 205 shall apply to rate changes sought by unregulated utilities. The Act also provides that the Commission may remand a rate back to the unregulated utility if it does not meet the substantive requirements.

- The Act prohibits FERC from taking any action with respect to an unregulated transmitting utility that would violate a "private activity bond rule" under the Internal Revenue Code.

OVERVIEW OF ACT (SECTION 1232-- FEDERAL UTILITY PARTICIPATION IN TRANSMISSION ORGANIZATIONS)

- The Act allows Federal power marketing agencies, such as Bonneville Power Administration or the Tennessee Valley Authority (collectively "Federal Utilities") to enter a contract, agreement, or other arrangement transferring control and use of all or part of the transmission system of the Federal utility to a Transmission Organization (*i.e.*, an RTO or ISO).

- The Act vests the authority to enter an arrangement with a Transmission Organization with the Secretary of Energy in the case of Federal Power marketing agencies (PMA) and with the TVA Board of Directors in the case of TVA.

- The Act provides that the contract, agreement or arrangement between the Federal Utility and Transmission Organization shall include performance standards, monitoring provisions and "a provision that allows the Federal utility to withdraw from the Transmission Organization."

OVERVIEW OF ACT (SECTION 1233-- NATIVE LOAD PRIORITY)

- New FPA Section 217 (Native Load Service Obligations) generally provides that load serving entities (LSEs) are entitled to use their transmission facilities and transmission contract rights (or equivalent tradable or financial transmission rights) to meet their native load service obligations.

- The Act does not affect an existing Transmission Organization's method for allocating or auctioning transmission rights if the organization was authorized to do so as of January 1, 2005. If the Transmission Organization never allocated financial transmission rights for the period prior to January 1, 2005, and subsequently seeks to change its methodology, the Act requires FERC to consider the policies of protecting transmission for native load.

- The Act has special provisions addressing existing ISOs in the Western Interconnection that appear to apply only to the California ISO. For example, if an ISO in the Western Interconnection had allocated financial transmission rights prior to the enactment of the Act, but had not done so with respect to one or more LSEs' firm transmission rights, FERC cannot require the LSE to convert its firm transmission rights to tradable or financial rights, except where the load serving entity had voluntarily joined the ISO.

OVERVIEW OF ACT (SECTION 1234-- STUDY OF THE BENEFITS OF ECONOMIC DISPATCH)

- The Secretary of Energy is required, no more than 90 days after enactment and yearly thereafter, to convey to Congress and the States the results of a study on economic dispatch, with recommendations for legislative and regulatory changes. The study must cover: (1) current economic dispatch procedures; (2) possible changes to improve the ability of nonutility generation "to offer their output for sale for the purpose of inclusion in economic dispatch;" and (3) the benefits to consumers that such changes would bring.[1]

[1] A scrivener's error has resulted in this section appearing twice. It appears as Section 1234 in the Electricity title. It also appears in Title XVIII, the Studies title, as Section 1832. The provisions are identical.

ANALYSIS

Unregulated Transmitting Utilities. The Commission formerly lacked jurisdiction to require governmental entities to file open access transmission tariffs, although FERC did have authority to compel such entities to provide wheeling under FPA Section 211. Now, compliance with Order No. 888 open access is no longer voluntary, as FERC will have the authority to require government and cooperative owned utilities to file open access tariffs. Even the statutory exemption for certain smaller entities is subject to termination if FERC finds in a given case that it "unreasonably impairs the continued reliability of an interconnected transmission system."

FERC also obtains jurisdiction to review the rates charged by such non-jurisdictional entities for transmission services. Such rates must be comparable to the rates that a non-jurisdictional entity charges itself (its bundled retail customers) for transmission services. However, many non-jurisdictional utilities do not unbundle their rates and determining what bundled retail customers are charged for transmission may be complicated and controversial.

Federal Utilities. Although there was never a prohibition on Federal Utilities joining Transmission Organizations, the issues resolved by the Act correspond to several of the issues raised in various FERC proceedings involving restructuring initiatives by BPA and others. Ensuring that Federal Utility participation in a Transmission Organization will not give FERC jurisdiction over the generation assets, electric capacity or energy, or power sales activities of the Federal Utility appear designed to eliminate concerns previously raised by these utilities in connection with their consideration of joining Transmission Organizations.

Native Load Priority. There has been significant tension on the native load priority issue between FERC and state regulators and utilities, particularly in areas where utilities remain vertically integrated. On the other hand, merchant generators and marketers have claimed that Order No. 888's native load protection provisions are anti-competitive and need to be watered down or eliminated. Order No. 888 permitted transmission providers to retain the necessary firm transmission capacity to serve native load needs, and gave native load and other network customers priority access to non-firm transmission to economically integrate power supply resources. The Act limits FERC's ability to reduce these native load protections, but the relevant provisions are sufficiently vague that they will be open to interpretation by FERC. The Act makes it less likely that FERC, upon its promised reconsideration of Order No. 888, will make significant changes to the existing native load protections. Among the beneficiaries of these native load provisions are non-jurisdictional utilities in existing Transmission Organization regions that hold grandfathered contract rights to transmission that FERC may not upset.

Economic Dispatch. The Act gives a nod to merchant generators that have claimed their facilities are not being dispatched on an equivalent economic basis with

utility-owned generation. Advocates for the merchant generation industry argued for inclusion of a provision that would have required FERC to order utilities to include merchants in their dispatch plans. The Act, however, requires only that DOE perform annual studies of economic dispatch and make proposals for additional legislation. It will be interesting to see whether FERC chooses to play an active role in the DOE studies and whether these statutory provisions calling for DOE to look into the matter will cause FERC to back away from ongoing investigations into this same issue.

SUBTITLE D: TRANSMISSION INFRASTRUCTURE INVESTMENT (Sections 1241-1242)

OVERVIEW OF ACT

- The Act requires FERC to issue rules to establish incentive-based rates for transmission facilities, with the goal of increasing reliability and reducing congestion costs. The incentive measures are to include, among other things, a return on equity that attracts new investment in transmission facilities, but subject to the just and reasonable rate standard of FPA Section 205.

- The Act provides that FERC may approve participant funding of transmission or interconnection upgrades regardless of whether the applicant is a member of an RTO.

ANALYSIS

Incentive Ratemaking for All Transmission Providers -- Not Just RTO Participants and ITCs. Through a series of orders and proposed policy statements, FERC has signaled its support for incentive ratemaking for transmission providers that join RTOs or are Independent Transmission Companies (ITCs). In a recent order, FERC stated that incentive proposals for ITCs included:

> enhanced returns on equity, within the zone of reasonableness; hypothetical or imputed capital structures; recovery of deferred income tax liabilities; cost deferrals; Construction Work in Progress (CWIP) in rate base; accelerated book depreciation; and expensing of pre-certification costs associated with new transmission. In addition, the Commission is willing to consider further incentives for independent transmission companies, among which are 100 percent recovery of CWIP, 100 percent recovery of abandoned plant costs, and accelerated depreciation.

111 FERC 61,473 (2005). As recently as this spring, FERC was prepared to formalize its incentive policies on a generic basis, but backed off when it became clear that energy legislation might be passed that addressed this same subject. The Act returns FERC to the drafting table with a mandate to issue a final rule providing for incentive based rates within one year of the enactment of the statute.

The legislation is broader in scope than FERC's existing and proposed policies, in that subsections (a) and (b) apply to all utilities, not just those that are ITCs or members of RTOs. It also contains an additional section, subsection (c), that explicitly provides for the establishment of incentives to each transmitting utility that joins a Transmission

Organization. The Commission should respond to the Act by offering rate incentives applicable to all transmission owners that build new transmission. However, FERC will also likely continue to promote independent ownership and operation of transmission by offering the largest incentives to ITCs and transmission owners that become RTO members.

Participant Funding for New Interconnections and Transmission Upgrades. Through a series of rules and orders, FERC has sought to minimize interconnecting generators' responsibility for the costs of upgrades to the transmission network that are required due to the interconnection of new generators, favoring the spreading of such costs to loads. Recently, some RTOs have provided for participant (*i.e.*, generator) funding of such upgrades, departing from FERC's general policies. FERC has approved these alternative regimes, but only when implemented by a Transmission Organization.

The Act gives FERC the authority to approve a participant funding plan to allocate the costs of transmission upgrades associated with a new generator interconnection to the entities that benefit therefrom, without regard to whether they are members of a Transmission Organization. However, the Act does not require participant funding of transmission upgrades or new generator interconnections -- the decision is left with FERC. Thus, the Act does not compel FERC to change its current policies. It may well be that the D.C. Circuit's review of FERC Order No. 2003 (FERC's interconnection rule) will be more influential than the Act in determining the policies applicable to cost recovery for new transmission facilities associated with the interconnection of generators.

SUBTITLE E: AMENDMENTS TO PURPA (THE PUBLIC UTILITY REGULATORY POLICIES ACT OF 1978) (Sections 1251-1254)

OVERVIEW OF ACT

- New Electric Utility Standards to Encourage Efficiency. The amendments to PURPA expand the standards for electric utilities to include net metering, smart metering, and other goals. State PUCs (and nonregulated electric utilities) must consider several new standards:

  – Net Metering -- utilities shall provide net metering service under which electric energy generated by a consumer from an eligible on-site generating facility and delivered to the local distribution facilities may be used to offset energy provided by the utility.

  – Fuel Sources -- each utility shall develop a plan to minimize dependence on one fuel source and ensure diverse generating sources.

  – Fossil Fuel Generation Efficiency -- each utility shall develop a ten-year plan to increase the efficiency of fossil fuel generation.

  – Smart Metering -- utilities shall offer customers, upon request, a time-based rate schedule (with rates varying during different time periods to reflect the varying costs of electricity) and a time-based meter.

  – Interconnection Services -- utilities shall offer interconnection service to consumers with on-site generating facilities (distributed generation) under standards developed by IEEE.

- Demand Response. The PURPA amendments seek to encourage time-based pricing and to encourage states to coordinate demand response services. DOE will provide technical assistance to the States and regional organizations, and FERC will prepare a report on advanced metering, time-based rate programs, and demand response.

- Qualifying Facilities. The Act requires changes to PURPA's Qualifying Facility (QF) Requirements and Rules.

  – No Impact on Existing QF Contracts. The PURPA amendments do not affect any QF contract that exists or is pending state PUC approval on the date of enactment.

  – New Rule: No More "PURPA Machines." FERC is directed to issue a rule revising the criteria for cogeneration QFs so that the thermal energy output is used in a productive and beneficial manner and the electrical, thermal and chemical

output is used fundamentally for industrial or commercial purposes and not simply for sale to an electric utility.

- Mandatory Purchase Continues for Existing Cogen QFs and Those Meeting the Requirements of the New Rule. Utilities are not required to enter into a new contract with a cogeneration facility that is not an "existing" QF unless it meets certain standards that FERC is required develop. Existing QFs are those QFs in operation on the date of enactment or QFs that file for certification prior to the date FERC issues its new QF rules.

- Partial Repeal of the Must-Buy Requirement. The PURPA requirement that utilities purchase power from QFs will not apply if FERC determines that the QF has nondiscriminatory access to competitive wholesale markets. Utilities may file with FERC for service area-wide relief from the mandatory purchase obligation.

- Utility QF Ownership Allowed. The Act amends the FPA to eliminate the limitation on utility ownership of QFs.

ANALYSIS

The new PURPA standards for electric utilities -- like those first set forth in the 1978 version of PURPA -- provide only a gentle push toward the stated goals, currently: net metering, smart metering, distributed generation, and fuel efficiency. Under PURPA, the States are required only to consider the standards, and are off the hook entirely if they previously considered something similar. The Act did not adopt proposals for a renewable portfolio standard.

One of the new standards, "smart metering," is intended to promote time-of-use billing and allows considerable flexibility in the type of time-based rate schedules that may be offered. Like the other standards, the States need only consider it. The standard requires that customers, on-request, receive time-based meters, but does not indicate how the investment in the new meters will be funded. Thus, the progress of time-of-use billing may be slowed by requirements that individual customers pay the costs of the new meters. Ultimately, the Act's attempt to address this issue seems somewhat toothless.

Smart metering and other demand response initiatives will be supported by DOE, which is charged with providing technical assistance to the States and regional organizations. Within six months, DOE is to report to Congress with recommendations on how to achieve demand response benefits by January 2007. FERC has a year to begin publishing an annual report on regional demand response resources. Time will tell whether these provisions herald new initiatives to increase demand response resources.

The amendments that address PURPA's QF program involve major changes affecting QF ownership and qualifying requirements. The Act repeals the statutory

provisions underlying FERC's rule that a utility (and its affiliates) could hold no more than 50% of equity interest in a QF. In the past, PURPA resulted in complex QF ownership arrangements and creative legal theories (*e.g.,* "stream of benefits") that were designed to allow utilities to participate as substantial owners in QF projects. Under the Act, utilities and their affiliated companies should be able to acquire additional, controlling interests in QFs without jeopardizing the QF status of the facility. Notably, the Act does not preclude a utility (or its affiliate) from owning a QF that sells power to that same utility. However, this opportunity for increased utility ownership of QF generating facilities may raise concerns about potential affiliate abuse.

The Act directs FERC to issue new rules to assure that future cogeneration projects are legitimate, commercially useful, and efficient. Existing QFs and QFs that apply for certification before FERC issues its new rule implementing these provisions will not be subject to the new rules. Thus, certification activity may increase in the short term as developers seek to avoid future compliance issues.

The number of QFs that are able to take advantage of PURPA's mandatory purchase requirement will shrink under the Act. The Act terminates the mandatory purchase obligation for a utility once FERC determines that the QF has nondiscriminatory access to competitive wholesale markets, which is defined to include independently-administered, auction based, daily and real-time wholesale energy markets along with wholesale markets for long-term sales of capacity and energy; competitive markets that present a "meaningful" opportunity to sell, through transmission and interconnection services provided by a "regional transmission entity" (an undefined term); *or* markets of comparable competitive quality. This provision appears intended to provide an incentive for utilities to participate in entities with formal, centralized energy markets in order to avoid the obligation to purchase power from new QFs. Electric utilities may file an application with FERC for relief from the mandatory purchase obligation, and the Act directs FERC to make a final determination on such application within 90 days.

SUBTITLE F: Repeal of PUHCA (Sections 1261-1277)

OVERVIEW OF ACT

- The Act repeals PUHCA, effective six months from the enactment date.

- FERC must issue regulations no later than four months after enactment addressing certain impacts associated with the repeal of PUHCA. Such regulations will address matters such as FERC access to books and records, affiliate transactions, and cost allocation.

- The Act requires FERC to adopt, by rule, procedures for expeditious consideration of mergers and acquisitions that clearly meet its merger standards.

- In addition, Section 1289 of the Act (found in Subtitle G) amends FPA Section 203 to require FERC to act on all applications for approval of mergers and acquisitions within 180 days, unless FERC finds, based on good cause, that further time is required. In such event, FERC must rule upon the transaction within another 180 days.

- The Act confers upon FERC jurisdiction to approve acquisitions or leases of generation facilities, even if no transmission facilities are involved.

- The Act grants FERC jurisdiction over mergers of utility holding companies, providing that no holding company whose system includes an electric utility or a transmitting utility may acquire, merge with, or purchase the securities of an electric utility, a transmitting utility, or a holding company system that includes an electric utility or a transmitting utility, without FERC approval.

- The Act adds another criterion to FERC's merger review. It provides that the Commission cannot approve a proposed merger or change in control if it finds that the transaction results in cross-subsidization of a non-utility associate company, or the encumbrance of utility assets for the benefit of an associate company, unless it finds such cross-subsidization or encumbrance to be in the public interest.

- FERC obtains the authority to review and authorize the allocation of costs of non-power goods and administrative management services provided to a public utility by an affiliate in a holding company system, at the election of the pertinent state commission.

ANALYSIS

The repeal of PUHCA creates the prospect for the creation of much larger and geographically diverse utilities than has heretofore been possible, and it opens the door

for acquisitions of utility companies by foreign companies and by companies not in the electric sector of the economy. PUHCA precluded mergers among firms that could not show that they operated as a single integrated electric system and in a single region of the country. Thus, mergers among geographically distant electric companies were problematical. Moreover, PUHCA's severe limitation on ownership of non-utility businesses by a registered holding company, to say nothing of the statute's many layers of regulation, chilled U.S. companies not in the power sector and diversified foreign companies from engaging in merger and acquisition activity with utilities. Now such activities are legally feasible at the federal level.

However, state regulatory approval requirements still exist and complicate the achievement of such transactions, as state commissions can be expected to carefully scrutinize efforts by out-of-state and potentially non-power sector entities to acquire utilities.

The new provisions streamlining FERC's merger review process make it more unlikely that FERC will set even major mergers for a live evidentiary hearing. More likely is that FERC will expedite review of mergers that clearly satisfy its Appendix A competition criteria, and for mergers like Exelon/PSEG, which exceed the Appendix A screening criteria, will focus on the adequacy of proposed mitigation via requiring paper filings (in that case the parties engaged in essentially de facto paper hearings). Moreover, mergers that involve geographically distant utilities, as the repeal of PUHCA now permits, are unlikely to raise complicated competitive issues. However, there is a potential for FERC to decide to take a harder look at ratepayer benefits, especially in transactions involving distant utilities or acquirers with no previous utility experience.

It remains to be seen how FERC implements its new authority regarding the review of books and records, which appears to be aimed at providing transparency in affiliate relationships and ensuring that transactions among holding company affiliates do not harm customers. FERC has for a long time already required codes of conduct governing certain kinds of affiliate dealing affecting wholesale markets, and states generally have in place similar rules governing conduct that may affect retail consumers. FERC will now issue expanded rules that require utilities to make available cost and other data on relationships between utilities and their affiliates that will permit regulators and third parties to monitor these relationships.

SUBTITLE G: MARKET TRANSPARENCY, ENFORCEMENT, AND CONSUMER PROTECTION (Sections 1281-1290)

OVERVIEW OF ACT

- FERC may establish rules providing for the timely dissemination of information about the availability and prices of wholesale energy and transmission service. Any disclosure rules adopted by FERC must not be "detrimental to the operation of an effective market" or "jeopardize system security."
  - FERC may exempt entities with "de minimis market presence" from any reporting requirements.
  - FERC's rules may not apply to energy or transmission service transactions within ERCOT.
  - FERC may obtain such information from any "market participant" and rely on others (index price publishers) to publicly disseminate the information. FERC may establish a new electronic information system if it determines that existing publications are not providing adequate "price discovery" or "market transparency."
- Entities (including municipal electric utilities) are prohibited from "willfully and knowingly" reporting false sales price or transmission availability information "with intent to fraudulently affect the data" compiled by FERC or other agencies.
- Entities (including municipal electric utilities) are prohibited from using any "manipulative or deceptive devise or contrivance" in connection with the purchase or sale of energy or the purchase or sale of transmission services subject to FERC's jurisdiction.
- The criminal punishment for willful and knowing violations of the FPA have been increased from $5,000 to $1,000,000, and from imprisonment of up to 2 years to imprisonment of up to 5 years. The criminal punishment for willful and knowing violations of FERC rules or orders has been increased from $500 per day to $25,000 per day.
- FERC may impose civil penalties for any violation of Part II of the FPA or any FERC rule or order thereunder, of up to $1,000,000 per day.
- Refunds resulting from Section 206 proceedings may be assessed back to the date of the filing (or the date FERC initiated the proceeding), eliminating the prior 60-day lag.

- Refunds resulting from a municipal entity's "short-term sale" (31 days or less) through "organized markets" in which rates are established by FERC-approved tariffs (rather than by contract) are available, but only if (i) the municipal entity's sale "violates the terms of the tariff or applicable FERC rules," (ii) and the municipal entity sells at least 8,000,000 megawatt hours per year.

  – Electric cooperatives are exempt from these new refunds provisions.

  – BPA's sales are subject to refund only if the sales are at an "unjust and unreasonable rate," defined to be "higher than the highest just and reasonable rate charge by any other entity for a short-term sale…in the same geographic market for the same, or most nearly comparable, period" as the BPA sale.

  – FERC may not assert jurisdiction over TVA and other Federal power marketing agencies except to order refunds for short-term sales as necessary "to achieve a just and reasonable rate."

- The Act requires the Federal Trade Commission to adopt consumer privacy and protection rules.

- The District Court may, on petition by FERC, prohibit (permanently or temporarily) any person found to have engaged in the filing of false information from acting as an officer or director of an electric utility or from engaging in the business of purchasing or selling electric energy or jurisdictional transmission services.

- The amendments to FPA Section 203 in this subtitle, in addition to providing for more expeditious merger review as already discussed, alter the threshold for FERC review from $50,000 to $10,000,000.

- The Act provides specific measures for Northwest utilities by providing FERC exclusive jurisdiction over the issue of the reasonableness of contract termination payments for power never delivered by a seller found to have engaged in market manipulation.

ANALYSIS

The market transparency and enforcement provisions of the Act represent the culmination of FERC's efforts over the past several years to increase its statutory authority to oversee markets and to impose sanctions for market manipulations and deceptive practices, such as those that occurred during the Western power crisis. In particular, FERC has argued that it needed the ability to better monitor the marketplace so as to foster greater price transparency and the authority to levy civil penalties to deter conduct that violates the Federal Power Act and FERC orders or FERC-approved tariffs.

In large part, the provisions of Subtitle G were designed to address sales within organized regional markets, such as those in place in PJM, New England, New York, and California, where a seller or group of sellers could implement various strategies designed to drive up prices across the region. In the past, FERC felt that its ability to address such behavior was constrained because FERC first had to identify specific tariff provisions or market rules that were violated and even then FERC could require only the "disgorgement" of profits resulting from the transactions at issue, which often required FERC to determine the otherwise just and reasonable benchmark price. The Act largely addresses these limitations by significantly enhancing the tools available in FERC's enforcement arsenal.

Although the increased scope and size of the civil penalty authority is eye-catching, the key will be how FERC devises and implements the standards for market manipulation. The Act requires FERC to prescribe rules to define "any manipulative or deceptive device or contrivance," which provides FERC and the industry the opportunity to fashion straightforward rules with specific examples of manipulative actions, which could minimize the potential for the after-the-fact imposition of stiff sanctions based on unspecified and ambiguous standards. Implementing the Act in this fashion should enhance confidence in the markets, which could stimulate (or at least not further depress) investment in new generation, as well as encourage the entry of new market participants, which would increase alternatives in the marketplace and reduce concerns about the potential exercise of market power.

The enhanced civil penalty authority will place heightened importance on compliance with all of FERC's basic regulatory programs, such as filing requirements and code of conduct and standards of conduct obligations, which generally can be accomplished through renewed emphasis on existing compliance programs. Companies that actively participate in organized regional markets, however, will need to establish comprehensive internal controls and protocols, including, where necessary, legal review, to ensure that their transactions will not run afoul of FERC rules prohibiting "manipulative and deceptive" practices. The challenge will be to put in place compliance programs that are sufficiently rigorous to screen for potentially unlawful practices but not so restrictive so as to hamstring the traders' ability to pursue legitimate business opportunities. It may be beneficial, in the subsequent rulemaking proceedings, to urge FERC to institute a formal "no-action" procedure under which sellers could obtain from FERC a determination that a particular trading or marketing strategy will not be deemed inconsistent with the market manipulation rules.

While the new refund provisions included in Section 206 will affect all sellers, they may also have significant ramifications for buyers that transact in organized energy markets. Because the Act significantly hampers FERC authority to order refunds for municipal and cooperative entities' short-term sales – even when such sales violate the terms of FERC-approved tariffs – buyers may find themselves unable to recover all the

refunds they are owed as a result exempt entities' sales. The solution may well be to contractually obligate *all* market participants to be subject fully to all applicable market rules, including the obligation to make any refunds ordered by FERC. The courts have ruled that otherwise non-jurisdictional entities may contractually bind themselves to adhere to the terms of FERC-approved tariffs, which necessarily would include the obligation to make any refunds imposed by FERC resulting from transactions entered into under such tariffs.

The impact of the Act on Northwest utilities' goal of seeking relief from Enron's claims to termination payments has already been felt in that some purchasers already filed at FERC under the auspices of the Act for such relief.

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