

THE FALL OF PUHCA AND THE RISE OF FERC

Transfer of Authority Over Mergers and Inter-Affiliate Transactions

The Energy Policy Act Of 2005:
A Restructured World for Electric Utilities
EXNET/Bruder, Gentile & Marcoux, L.L.P.
September 28, 2005

Carmen L. Gentile, Esquire
Bruder, Gentile & Marcoux, L.L.P.
1701 Pennsylvania Avenue, N.W.
Suite 900
Washington, D.C. 20006-5805
Telephone: 202/296-1500
Facsimile: 202/296-0627
E-mail: clgentile@brudergentile.com

PUHCA'S FALL AND FERC'S RISE

MAJOR TOPICS

- Federal Merger Authority
 - ◆ SEC authority eliminated
 - ◆ FERC merger authority expanded
- Jurisdiction Over Inter-Affiliate Transactions
 - ◆ FERC acquires authority over holding company inter-affiliate transactions and holding company books and records
- FERC's September 16, 2005 NOPR

PUHCA REPEAL

- PUHCA repeal achieved after years of effort by SEC, utilities and financial institutions
- PUHCA, a Roosevelt New Deal centerpiece
- PUHCA merger requirement was electric integration, if not geographic contiguity; intended to break up national utility trusts

PUHCA REPEAL, cont'd

- PUHCA also intended to
 - ◆ Prevent abusive transactions among affiliates
 - ◆ Facilitate state cost-of-service regulation
- PUHCA created for industry that was characterized by
 - ◆ Cost-based rates
 - ◆ Vertical integration
 - ◆ Localized monopolies
 - ◆ Limited entry by new market participants

PUHCA'S PARTIAL OBSOLESCENCE

- PUHCA importance as anti-trust device diminished due to
 - ◆ Shift to competitive power production markets
 - ◆ Need to attract new participants and new capital sources to the production and transmission markets
 - ◆ Less concern over and perceived advantages of national power companies
 - ◆ Changed conditions, *e.g.*, technology, power pools and RTOs, since PUHCA enactment

INTEGRATION NO LONGER REQUIRED

- PUHCA repeal and FPA expansion does not include retention of integration requirement
- Door reopened to national electric companies with non-integrated operations in non-continuous states
- New national electric companies
 - ◆ can be predominately in electric production, but
 - ◆ may also include vertically integrated subsidiaries

INTEGRATION NO LONGER REQUIRED, cont'd

- FERC merger standard continues to be consistent with public interest
- FERC probably lacks authority to prevent merger of companies that are
 - ◆ Geographically dispersed
 - ◆ Separately operated, and
 - ◆ Vertically integrated

INTEGRATION NO LONGER REQUIRED, cont'd

- End result could be merger avalanche that changes the face of the electric utility industry
- New industry structure could integrate competition and national ownership
- New industry structure could also combine national ownership with reversion to cost-based rate making
- In either case, repeal of PUHCA geographic/operating merger requirement could be most far-reaching EPACT change

NEW FERC MERGER AUTHORITY

- Prior to EPACT, FERC jurisdiction over mergers based on transmission facilities including generator step-ups
- EPACT eliminates transmission limitation and extends FERC merger authority to include merger of generation facilities
- EPACT increases merger jurisdictional minimum from \$50,000 to \$10 million
- Net effect of adding generation facilities and increasing jurisdictional minimum is substantial increase in FERC merger authority

NEW FERC MERGER AUTHORITY, cont'd

- Traditional “consistency with public interest” standard of FERC merger authority retained by EPACT
 - ◆ Requires only that merger not harm public interest
 - ◆ A merger need not promote the public interest
- However, FERC must now find that a merger will not result in cross-subsidization of a non-utility member of a holding company system or that any cross-subsidy is not contrary to the public interest

STREAMLINED FERC MERGER PROCEDURES

- EPACT requires streamlining of FERC merger procedures including
 - ◆ Classifying transactions warranting expedited review and acting on all other merger applications within six months unless FERC
 - ◆ Specifically finds additional time needed for good cause
 - ◆ Issues an order delaying its action for no more than an additional 180 days
 - ◆ Grants or denies the application within the additional 180 day period

REVISED FERC MERGER AUTHORITY – OVERALL IMPACT

- FERC will continue to assess merger public interest issue chiefly based on impact on competition and also on any impacts on customer rates
- FERC will no longer consider merger impact on its own regulation since FERC has inherited SEC authority over inter-affiliate transactions
- Under EPACT 2005, FERC will also consider affiliate cross-subsidies

REVISED FERC MERGER AUTHORITY – OVERALL IMPACT, cont'd

- Federal utility merger policy takes brand new direction -- now favors merger of companies that lack integrated operations and are geographically remote from each other
 - ◆ No statutory prohibition against merger of companies with non-integrated operations
 - ◆ Competitive issues often present if utilities in same market
 - ◆ By contrast, no competitive issues when merging utilities
 - ◆ Are geographically remote from each other
 - ◆ Operate in different markets
 - ◆ Engage in non-integrated operations

FERC AUTHORITY OVER INTER-AFFILIATE TRANSACTIONS -- PUHCA 1935

- EPACT replaces “PUHCA 1935”, the Public Utility Holding Company Act of 1935, with “PUHCA 2005”
- Under PUHCA 1935, SEC had regulatory authority over transactions between registered holding company affiliates
- Under *Ohio Power*, FERC in wholesale rate cases could not revise SEC-determined prices for goods and services provided by non-regulated holding company subsidiaries to their regulated affiliates

FERC AUTHORITY OVER INTER-AFFILIATE TRANSACTIONS -- PUHCA 1935, cont'd

- FERC resisted SEC control over inter-affiliate pricing by requiring "*Ohio Power*" waiver as a standard merger approval condition
- Pursuant to waiver, merger applicants agreed to FERC authority to adjust inter-affiliate prices for wholesale ratemaking purposes
- Waiver a blatant regulatory blackmail; if no waiver, then no merger approval

FERC AUTHORITY OVER INTER-AFFILIATE TRANSACTIONS -- PUHCA 1935, cont'd

- FERC affiliate abuse concerns also reflected in market-based rate Code of Conduct that requires pricing for goods and services
 - ◆ At no higher than market when provided by unregulated company to regulated affiliate
 - ◆ At higher of cost or market when provided by regulated utility to unregulated affiliate

PUHCA 2005

■ PUHCA 2005 highlights

- ◆ Terminates SEC non-financial jurisdiction over public utility holding company systems
- ◆ Provides for FERC and state access to holding company books and records
- ◆ Transfers to FERC jurisdiction to determine cost allocations among holding company affiliates with respect to provision of goods and services to regulated affiliates provided request is made by a holding company or state commission
- ◆ Vests FERC and state commissions with authority to determine treatment of inter-affiliate transactions in wholesale and retail rate cases

PUHCA 2005 APPLICATION

- FERC PUHCA 2005 jurisdiction applies to public utility holding companies except financial institutions
- PUHCA 2005 appears to end distinction between registered and unregistered holding companies except FERC by regulation must exempt from the PUHCA 2005
 - ◆ Books and records requirements for holding companies that own only QFs, EWGs, or foreign utility companies

PUHCA 2005 APPLICATION, cont'd

- ◆ Cost allocation requirements for holding companies that engage in
 - ◆ public utility operations substantially in a single state
 - ◆ other transactions not relevant to a public utility's jurisdictional rates

PUHCA 2005 SPECIFIC RESPONSIBILITIES

- PUHCA 2005 gives FERC two major areas of responsibility affecting holding company subsidiaries
 - ◆ Upon the request of the affected holding company or state commission, FERC is to review and determine the allocation of costs related to the provision to a regulated utility by its non-regulated affiliate of non-power goods or administrative or management services
 - ◆ FERC has the authority to examine the books and records of any holding company and any holding company subsidiary if FERC determines that such records are relevant to wholesale ratemaking

PUHCA 2005 STATE ACCESS TO BOOKS AND RECORDS

- PUHCA 2005 gives state commissions without FERC review the right to examine the books and records of a holding company system provided
 - ◆ The state has jurisdiction to regulate a public utility member of the affected holding company system
 - ◆ The books and records are identified in reasonable detail in a proceeding before a state proceeding
 - ◆ The books and records are relevant to the discharge of the state commission's duties

FERC'S SEPTEMBER 16, 2005 NOPR

- In compliance with PUHCA 2005, FERC has issued a NOPR seeking comments on several areas of PUHCA 2005 implementation, including
 - ◆ FERC access to holding company books and records
 - ◆ Extent FERC should adopt SEC accounting, cost allocation, recordkeeping, reporting requirements and related rules developed under PUHCA 1935
 - ◆ Extent FERC should broaden application of SEC PUHCA 1935 rules to new companies
 - ◆ Whether to exclude transactions involving passive investors from new FERC rules regarding books and records

FERC'S SEPTEMBER 16, 2005 NOPR, cont'd

- ◆ Exercise of FERC authority to allocate among holding company members the costs of non-power goods or administrative or management services provided to a regulated public utility
- ◆ Whether PUHCA 1935 registered holding companies should be required to file cost allocation agreements with FERC
- ◆ Whether FERC in cost allocation among holding company subsidiaries should apply the SEC "cost" standard or the "lower of cost or market" standard

FERC'S SEPTEMBER 16, 2005 NOPR, cont'd

- ◆ How FERC should define the “confined substantially to a single state” standard for determining whether a holding company should be exempt from FERC cost allocation authority
- ◆ Whether FERC should remove from its regulations the filing requirements and procedures for obtaining exempt wholesale generator status
- ◆ Whether FERC needs to adopt additional rules or policies to protect against inappropriate cross-subsidization of non-regulated companies in holding company systems, including whether restrictions should be adopted regarding diversification into non-utility businesses

PUHCA 2005 RESIDUARY RATEMAKING RIGHTS

- PUHCA 2005 specifically reserves FERC and state commission rights to allow only just and reasonable affiliate costs in developing cost-regulated rates for public utilities that are subsidiaries of holding company systems
- In other words, FERC and states have the statutory right in rate cases to disallow non-regulated affiliate costs to the extent a determination is made that the inclusion of such costs in regulated rates would be unjust and unreasonable

CONCLUSIONS

- EPACT 2005 substantially increases FERC merger authority and eliminates SEC authority over the non-financial aspects of a merger. The major loss in Federal oversight of electric utility mergers is the PUHCA 1935 prohibition against the merger of electric utility companies that did not conduct integrated operations within the same general region. The likely effect of EPACT 2005 is to significantly increase merger activity among companies that are geographically remote from each other and do not operate in the same markets.

CONCLUSIONS, cont'd

- Except for authority over books and records, the chief PUHCA 2005 enhancement of FERC authority is to oust the SEC of jurisdiction and make FERC “the only game in town” with respect to the pricing of inter-affiliate transactions for wholesale ratemaking purposes. FERC also has the responsibility to determine cost allocations among holding company members but only upon the request of the affected holding company or affected state commission. Nevertheless, it is likely that the net effect of PUHCA 2005 will be to greatly increase FERC activity against inter-affiliate pricing abuse with respect to goods and services provided by holding company members to their regulated affiliates.