THE ENERGY POLICY ACT OF 2005: REDEFINING THE FEDERAL-STATE RELATIONSHIP

ROBERT W. GEE
PRESIDENT
GEE STRATEGIES GROUP LLC

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Overview

- How the Energy Policy Act of 2005 significantly addresses three areas (the three "Rs") :
  - Reliability under a mandated federal scheme
  - Revival of transmission infrastructure investment through incentives
  - Risk management through PUHCA repeal
- How the Act alters the federal/state balance
- Issues ahead -- where are the flashpoints?

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A Preface

Congressional action in these three areas is grounded on the following premises:

- The utility sector has been in dire need of significant capital investment to maintain affordable, reliable electric service for the future
- This investment requirement could be met only by making the sector more competitive from a capital-attraction standpoint
- Regulatory reform was required to spawn greater capital attractiveness
- This reform required significant alteration of the federal role, with consequential impacts on the states

Reliability Responsibility: Now Federalized

- Pre-Energy Policy Act Enactment
  - Reliability responsibility rested primarily with states at local distribution level (regulating outage frequency, continuity of service)
  - Industry reliability requirements for planning and operation of bulk power system were voluntary
- Northeast-Midwest power outage was a watershed
- Energy Policy Act Federalizes Reliability
  - Congress directed development of mandatory, federally (FERC) approved, enforceable reliability standards
  - FERC will certify a single Electric Reliability Organization (ERO) to oversee reliability of US portion of interconnected North American Bulk-Power System, subject to FERC oversight
  - The ERO may delegate enforcement responsibilities to a Regional Entity, but only after the FERC approval of delegation agreement
  - Either ERO or Regional Entity may propose reliability standards, monitor compliance, or impose a penalty on user, owner or operator for standard violation, subject to review by, and appeal to, FERC

FERC's Reliability Standards : Balancing National Vs. Regional Interests

- FERC seeks standards uniformity "as much as possible" across interconnected North American bulk power system
- Will permit regional differences to extent more stringent than continent-wide or necessitated by physical system
- Will **not** defer to ERO or Regional Entity with respect to the effect on competition of proposed reliability standard

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The States' Authority : No Preemption, But FERC Resolves Alleged Conflicts

- Energy Policy Act savings clause: State action to ensure the safety, adequacy, and reliability of electric service within that state not preempted as long as such action is not inconsistent with any [federal] reliability standard

- FERC rule: sets out procedure for resolving before FERC all federal/state conflicts upon petition by ERO, Regional Entity, or other affected person

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State Authority to Form Regional Advisory Bodies

- Upon petition of at least two-thirds of the states within region with more than one-half of their electric load served within the region
  - Requires member from each participating state in the region, appointed by governor of each state
  - May include representatives of agencies, states and provinces outside of US
- Regional Advisory Body may provide advice to ERO, Regional Entity, or FERC concerning:
  - Governance of an existing or proposed Regional Entity within the same region;
  - Whether reliability standard proposed to apply within the region is just, reasonable, not unduly discriminatory or preferential, and in the public interest;
  - Whether fees for all activities proposed to be assessed within the region are just, reasonable, not unduly discriminatory or preferential, and in the public interest; and
  - Any other responsibilities requested by the FERC
- FERC may give deference to Regional Advisory Body that is organized on an Interconnection-wide basis

Incentives For Increased Transmission Investment

- Energy Policy Act Section 219 : "[FERC]. . . shall establish, by rule, incentive-based (including performance-based) rate treatments for . . . transmission by public utilities [to benefit] consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion."

- "The rule shall:
  - Encourage deployment of transmission technologies. . . To increase the capacity and efficiency of existing transmission facilities. .
  - Allow recovery of . . . all prudently incurred costs necessary to comply with mandatory reliability standards. . ."

- Premised on fact that transmission investment declined in real dollar terms for 23 years from 1975 to 1998, while load has more than doubled

- Estimated 25 percent increase in transmission investment necessary to meet anticipated growth in customer demand over next two decades

- FERC Notice of Proposed Rulemaking issued in November 2005 and comments received in January 2006

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Proposed Rate Incentives

- Providing rates of return on equity sufficient to attract new investment
- Recovering in rate base of 100 percent of prudent transmission-related construction work in progress to increase cash flow
- Expensing prudent pre-commercial operation costs instead of capitalizing them, allowing for immediate cash flow for the utility
- Allowing hypothetical capital structures to provide the flexibility needed to maintain the viability of new capacity projects
- Accelerating recovery of depreciation expense
- Recovering all prudent development costs in cases where construction of facilities may be abandoned or canceled due to circumstances beyond the control of the utility
- Allowing deferred cost recovery upon expiration of retail rate moratoria
- FERC will not require cost-benefit study as basis for requested incentives
- All incentives still subject to Federal Power Act Sections 205, 206, and 219 requirements that rates be just and reasonable and not unduly discriminatory or preferential

Inducements for Specific Conduct

- Incentive for Transco (stand-alone transmission companies) formation
  - Authorizing a higher return on equity (ROE) to facilitate new investment in transmission more quickly than under integrated utility business model
  - Providing “hold harmless” measure on capital gains income tax exposure for seller of transmission assets to new Transco

- Incentive equity returns for transmitting and electric utilities to join a Regional Transmission Organization or Independent System Operator

Selected State Concerns

- Rate incentives not the only tool to induce more transmission, citing need for more regional planning (NARUC)
- Incentives for transmission should be narrowly crafted and balanced with range of other alternatives, such as generation and demand side management (NY, NJ)
- Deferred cost recovery of transmission facilities following expiration of retail rate moratorium tramples on states' prerogatives (PA, KY, NM)
- Recovery of cost of abandoned projects antithetical to market (NY)
- Equity return incentives should not be extended to those utilities already members of RTOs or ISOs (NY)
- (Unstated) Encouragement of Transco formation through incentive returns removes assets from state retail rate jurisdiction

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Selected Opinions of Others

Proposal generally supported by many, but. . .

- FERC's favoring of Transco model opposed by some (EEI, PacifiCorp, Consumers Power Alliance), but strongly favored by others (EPSA)
- Benefits must be shown to outweigh costs prior to incentives adoption (ELCON, E On)
- Incentives should be limited to instances where utilities provide opportunities for load-serving entities (munis and coops) to participate and when regional planning involved (APPA)
- Premise that current transmission capacity is insufficient and that future needs not met except through higher-cost enhancements is not valid (E On)
- States may not cooperate in allowing FERC incentives to be reflected when setting rates for bundled transmission service in retail rates (E On)

Background of Public Utility Holding Company Act of 1935

- No significant utility state regulation existed
- PUHCA enacted to address financial abuses facilitated by complex holding company structures and interlocking directorates resulting in numerous utility insolvencies and little accountability
- Required simplified, limited holding company system
- Utility activities limited to a single, geographically integrated public utility system and to such other businesses as are "reasonably incidental, or economically necessary or appropriate" to the operations of the integrated system
- Imposed significant recordkeeping and filing requirements before the Securities and Exchange Commission

The Case for PUHCA Repeal

- Over time, PUHCA's restrictions were deemed as not reflecting either the market structure or regulatory policy priorities affecting the modern electric power industry
  - Geographic integration requirement counterintuitive to blunt growth of market power
  - States had assumed greater ratepayer protection role
- Over 2 decades, SEC favored its repeal
- Perception grew that repeal was necessary to eliminate arcane, duplicative, and unduly burdensome regulations that disserved the interest of the consuming public by hindering needed investment
- FERC and states would be better equipped to protect ratepayers, and not the SEC which is focused on investor protection

“PUHCA of 2005”

- [Under Energy Policy Act, FERC given expanded Section 203 authority to oversee mergers & acquisitions of electric and gas companies to include holding companies, and to prevent cross-subsidization by utility of non-utility affiliates]
- FERC given access to books and records of utility holding companies “relevant to costs incurred” by the public utility affiliated with a holding company and “necessary or appropriate” to protect utility customers
- FERC authorized to determine certain non-power goods and services cost allocations among holding company members upon request
- State commissions given a federally enforceable right to request access to utility holding company books and records, wherever located, with certain provisos
- Act does not preempt states from exercising jurisdiction under otherwise applicable law to protect utility customers

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FERC's Response to Repeal

- FERC's final rule takes cautious approach to exercising new authority
- Filing requirements streamlined in contrast to SEC requirements
- Declined to mandate blanket filing of cost allocation agreements addressing costs of non-power goods and services purchased by jurisdictional utilities from affiliated companies
- Declined to impose additional rules regarding cross subsidization, encumbrances of utility assets, or diversification into non-utility businesses
- Preferred to rely on existing ratemaking authority under Federal Power Act and Natural Gas Act and enhanced merger & acquisition authority
- Will revisit need for expanded action in technical conference next year

What's Next?

- Some states uneasy about prospect of increased merger & acquisition activity, introducing greater complexity in discerning utility's cross-subsidization of its affiliates, and in addressing diversification risks
- Some utilities uneasy about prospect of state overreaction to PUHCA repeal, and possible enactment of multiple "mini-PUHCAs", allegedly thwarting Congressional intent to attract capital into the sector
- Some state commissions have opened dockets to consider whether PUHCA repeal merits adoption of *ex ante* safeguards in anticipation of utility holding company diversification and greater cross-subsidization
  - Examining limits on degree and character of holding company diversification
  - Requiring structural separation of utility and holding company, accompanied by ringfencing" safeguards
- Financial community is attentive and watching from the sidelines

Post-PUHCA Observations

- PUHCA repeal represents rare instance of Congress curtailing federal regulation of energy sector and deferring to states to occupy the field
- How states respond to Congress' invitation to "fill the gap" could strongly influence pace and degree of future mergers and acquisitions
- How FERC exercises its new M & A authority in tandem with PUHCA authority could influence character of state response
- Verdict is still out regarding ultimate effect of PUHCA repeal
- Will likely see more M & As, but investments will continue to be strategic

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Parting Thoughts

- Reliability requires development of strong federal mandatory standards with state advice & counsel
- Rate incentives for additional transmission investments -- particularly for reliability -- are required by new law, notwithstanding concerns of some states
- Although capital infusion for such new investment required repeal of certain requirements imposed by PUHCA of 1935, FERC still armed with new oversight authority in conjunction with state authority
- Whether they like it or not, Federal and state authorities are “joined at the hip” in implementing this legislation
- Federal-state relationship will continue to evolve upon new law’s application and as courts review it

Gee Strategies Group, LLC

Robert W. Gee
President
Gee Strategies Group LLC
7609 Brittany Parc Court
Falls Church, VA 22304
U.S.A.
703.593.0116
703.698.2033 (fax)
rwgee@geestrategies.com
www.geestrategies.com

Gee Strategies Group, LLC