ENERGY UPDATE PANEL

ENERGY POLICY ACT OF 2005-
PUHCA REPEAL AND PURPA AMENDMENTS

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I. REPEAL OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Of all the major changes to electricity law contained in the Energy Policy Act of 2005 (EPA 2005), perhaps the most far-reaching was Congress's decision to repeal the Public Utility Holding Company Act of 1935 (PUHCA 1935). PUHCA 1935 provided the Securities and Exchange Commission (SEC) with the authority to break up the large interstate utility companies once controlled by Samuel Insull and others. The current ownership structure of the investor-owned utility industry remains largely a reflection of the SEC's handiwork. With PUHCA 1935 no longer in place, the ownership structure of the utility industry could undergo significant changes in the coming years.

Congress began chipping away at PUHCA 1935 in 1978 as part of the Public Utility Regulatory Policies Act (PURPA). PURPA was the first step toward creating the independent power industry, and as part of that effort, certain qualifying cogeneration and renewable power plants (QFs) were necessarily exempted from the strictures of PUHCA 1935. Congress took a bigger step towards limiting the reach of PUHCA 1935 in the Energy Policy Act of 1992, which created a new class of generators known as "exempt wholesale generators" or "EWGs." As a result, independent generation serving the wholesale electricity market was not subject to PUHCA 1935, even if it was not a cogeneration or renewable facility.

Nevertheless, PUHCA 1935's fundamental regulatory scheme, including geographic restrictions on ownership of utility assets and limitations on the ability of utilities to invest in unrelated businesses, remained in place for seventy years, until enactment of EPA 2005 last month.

Impacts of PUHCA 1935

PUHCA 1935 restricted investments in the utility sector in a wide variety of ways, primarily because most entities avoided any investment, merger or other business arrangement that would lead to being deemed a public utility holding company subject to registration and pervasive regulation under PUHCA 1935.

Actions that could trigger public utility holding company status included:

- Purchase of 10% or more of the voting securities of an electric utility company.
- Exercising a controlling interest over the management or policies of a public utility company or a holding company.

If an entity was deemed a public utility holding company under PUHCA 1935, the following consequences could occur:

- SEC registration with and pervasive regulation.
- Mandatory divestiture of non-utility businesses that are not functionally related.
- Public utility operations limited to a single integrated system within one region.

In response, many potential investors in the U.S. utility industry, such as private equity funds, financial institutions, and companies that were not in the utility sector, were effectively barred from investing in the utility business (except to the extent permitted as EWGs or QFs).

Effective Date of Repeal of PUHCA 1935

Title XII, Subtitle F of EPA 2005, known as the Public Utility Holding Company Act of 2005 (PUHCA 2005), repeals PUHCA 1935 in its entirety effective six months after EPA 2005's enactment (i.e., February 8, 2006).

Enactment of PUHCA 2005

PUHCA 2005 includes several new authorities for FERC to safeguard utility customers in the absence of the restrictions of PUHCA 1935. FERC must promulgate regulations implementing the PUHCA 2005 provisions by December 8, 2005 (unless otherwise noted). On September 16, 2005, the Commission issued a notice of proposed rulemaking to seek public comment on proposed regulations to implement the repeal of PUHCA 1935 and PUHCA 2005 (PUHCA NOPR).

- Federal Access to Books and Records

A holding company and each associate company thereof must allow the Federal Energy Regulatory Commission (FERC) to have access to those companies' books, accounts, memoranda, and other records that FERC determines are relevant to the costs incurred by a public utility or natural gas company that is an associate company of such holding company and are necessary or appropriate for the protection of utility customers with respect to FERC-jurisdictional rates. A "holding company" in EPA 2005 is defined as the company that directly or indirectly owns, controls, or holds, with power to vote, 10 percent or more of the outstanding voting securities of a company that owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale. An associate company of a company is any company in the same holding company as such company.

Affiliates of a holding company or of any subsidiary company of a holding company must also allow FERC to have access to books and records, which involve any transaction with another affiliate, that FERC determines are relevant to the costs incurred by a public utility or natural gas company that is an associate company of such holding company and are necessary or appropriate for the protection of utility customers with respect to FERC-jurisdictional rates. An affiliate of a company is defined in EPA 2005 as any company, 5 percent or more of the outstanding voting securities of which are owned, controlled, or held, directly or indirectly, with the power to vote, by such company.

The EPA 2005 also authorizes FERC to examine the books, accounts, memoranda, and other records of any company in a holding company system, or any affiliate thereof, as the Commission determines are relevant to costs incurred by a public utility or natural gas company within such holding company system and necessary or appropriate for the protection of utility customers with respect to FERC-jurisdictional rates.

In the PUHCA NOPR, the Commission proposes to amend its regulations by adding the statutory language of PUHCA 2005 regarding federal access to books and records. FERC also proposes to adopt certain accounting, cost-allocation, recordkeeping, and related rules promulgated by the SEC for holding companies and their service companies, as they existed on the date of enactment of EPA 2005 (August 8, 2005).

- State Access to Books and Records

EPA 2005 also provides state utility commissions that regulate a public-utility company in a holding company system the authority to inspect books, accounts, memoranda, and other records of the holding company or any associate company or affiliate thereof, other than such public-utility company, wherever located, that:

(1) have been identified in reasonable detail in a proceeding before the state commission;
(2) the state commission determines are relevant to costs incurred by such public-utility company; and
(3) are necessary for the effective discharge of the responsibilities of the state commission with respect to such proceeding.

- Exemption Authority

PURPA, as implemented by FERC's regulations, exempts QFs from PUHCA 1935 and state rate, organizational, and financial regulation. While EPA 2005 repeals PUHCA 1935, it does not affect a QF's exemption from state rate, organizational, and financial regulation under PURPA. Furthermore, EPA 2005 expressly exempts from the state access to books and records requirement of EPA 2005 any person that is a holding company solely by reason of ownership of one or more QFs.

EPA 2005 exempts from FERC's access to books and records authority under EPA 2005 any person that is a holding company, solely with respect to one or more QFs, EWGs, or foreign utility companies. In the PUHCA NOPR, FERC proposes to adopt such an exemption for holding companies with respect to persons granted EWG status prior to the repeal of PUHCA 1935. Thus, companies that currently are EWGs may maintain their EWG status and, by doing so, such EWGs and their parent holding companies would remain exempt from providing FERC with access to their books and records under this provision of EPA 2005.

Because PUHCA 2005 repeals PUHCA 1935, including section 32 regarding EWGs, FERC proposes to remove the EWG provisions from its regulations. As a result, new entities would not be able to seek EWG status, and current EWGs that lose their EWG status would not be able to re-attain it. However, FERC's proposal to do away with providing approvals of EWG status in the future may not be consistent with the intent of the statute, which provides that EWG has "the same meanings as…existed on the day before the effective date" of PUHCA 2005. This indicates that Congress intended to preserve the availability of EWG status going forward.

EPA 2005 also exempts a person or transaction from the federal books and records access if, upon application or upon a motion by FERC: (1) the Commission finds that the books and records of a person are not relevant to the jurisdictional rates of a public utility or natural gas company; or (2) the Commission finds that a class of transactions is not relevant to the jurisdictional rates of a public utility or natural gas company. FERC proposes in the PUHCA NOPR to exempt persons or transactions under this authority on a case-by-case basis.

The Commission also notes in the PUHCA NOPR that while a company that is a holding company solely with respect to QFs or EWGs is exempt from FERC's access to the holding company's books

and records, EWGs and QFs could still be public utilities under the Federal Power Act (FPA) and remain subject to the Commission's authority regarding books and records under section 301 of the FPA: "An exemption from the requirements of [the federal access to books and records provision] is not an exemption from FPA section 301, [Natural Gas Act] section 8, or any other requirements of the FPA and the NGA."

FERC must promulgate regulations implementing the exemption from the FERC books and records access requirement by May 9, 2006.

- Non-Power Goods and Services Cost Allocation

The repeal of PUHCA 1935 eliminated certain oversight activities of the SEC, and PUHCA 2005 transfers one of these authorities to FERC: the review and authorization of the cost allocation of non-power goods and services. In the case of non-power goods or administrative or management services provided by an associate company organized specifically for the purpose of providing such goods or services to any public utility in the same holding company system, at the election of the system or a state commission having jurisdiction over the public utility, the Commission will review and authorize the allocation of the costs for such goods or services to the extent relevant to that associate company.

PUHCA 2005 provides an exemption from FERC review and authorization of costs of non-power goods or services for any holding company whose public utility operations are confined to a single state and any other class of transactions the Commission finds not relevant to jurisdictional public utility rates.

The PUHCA NOPR proposes to amend its regulations to reflect the legislative language of PUHCA 2005 regarding FERC's review of the cost allocation of non-power goods and services and the exemptions therefrom. In the PUHCA NOPR, FERC requests suggestions on how the Commission should define "confined substantially to a single state."

- Affiliate Transactions

PUHCA 2005 does not limit the authority of the Commission under the FPA to require that jurisdictional rates are just and reasonable. Such authority includes the ability to deny or approve the pass through of costs, the prevention of cross-subsidization, and the issuance of such rules and regulations as are necessary or appropriate for the protection of utility consumers.

EPA 2005 does not preclude the Commission or a state commission from exercising its jurisdiction under otherwise applicable law to determine whether a public-utility company, public utility, or natural gas company may recover in its rates any costs of an activity performed by an associate company, or any costs of goods or services acquired by such public utility company from an associate company.

- Enforcement

EPA 2005 provides that FERC will have the same powers to enforce PUHCA 2005 that it currently has under sections 306-317 of the FPA. These powers include the authority to:

- Issue any rules, regulations or orders FERC finds necessary to carry out the FPA;
- Order investigations of potential violations of the FPA or FERC's regulations or orders;
- Seek injunctions and writs of mandamus;
- Impose criminal penalties for statutory violations of not more than $1 million and up to 5 years imprisonment
- Criminal penalties for violations of rules and regulations of not more than $25,000 each day.
- Civil penalties of up to $1 million per day.

Conclusion

The repeal of PUHCA 1935 and its restrictions on utility ownership could accelerate consolidation in the U.S. utility industry. We have already seen companies take advantage of the repeal. Prior to the enactment of EPA 2005 and the repeal of PUHCA 1935, a holding company that owned 10% or more of the voting shares of a public utility was required to register with the SEC and provide detailed reports of its financial transactions and holdings. Shortly after Congress passed the EPA 2005, Berkshire Hathaway Inc. requested FERC approval of the conversion of Berkshire Hathaway's preferred non-voting shares of MidAmerican Energy Holdings Co. (MEHC) stock to common voting shares, thereby giving Berkshire Hathaway indirect control over the MidAmerican Energy Co. with more than 80% of the voting shares. Liberated from the shackles of PUHCA 1935, Berkshire Hathaway was free to exercise its right to convert its stock into an indirect but controlling interest over a public utility.

In a separate but related FERC filing, MEHC and PacifiCorp amended their FERC application concerning MEHC's acquisition of PacifiCorp by withdrawing their proposal to establish a 50-megawatt transmission path connecting the MidAmerican and PacifiCorp control areas. The parties had proposed the transmission line to address the PUHCA 1935 requirement that a merger or acquisition involving public utilities create an integrated utility system operating in a "single area or region." As a result of PUHCA 1935's repeal, the transmission path was not required or necessary.

Until FERC promulgates final rules implementing the PUHCA 2005 provisions, affected companies will have several issues to ponder, including:

- Should a public utility company apply for an EWG determination prior to the effective date of the repeal of PUHCA 1935?
    - Based solely on the language of the PUHCA NOPR, the answer would be "yes" if that company wants to be exempt from FERC access to its books and records as provided in PUHCA 2005; or
    - "No" if it does not want its activities to be limited by EWG status.

II. AMENDMENTS TO SECTION 210 OF PUBLIC UTIILTY REGULATORY POLICIES ACT

Section 210 of the Public Utilities Regulatory Polices Act (PURPA) requires electric utilities to purchase power from certain qualifying cogeneration and "small power production facilities" ("QFs") at the utility's "avoided cost." Enacted in 1978 as part of President Carter's response to the Arab oil embargo, a key purpose of PURPA was to encourage the development of cogeneration and renewable energy facilities.

In the mid to late 1990s many electricity policy makers believed that Section 210 was becoming outmoded due to the onset of open access transmission and wholesale competition emerging after passage of the Energy Policy Act of 1992. In response, a number of bills were introduced in Congress to repeal Section 210 of PURPA. However, over time it became apparent that the road to a vigorous competitive electricity market was more bumpy than expected. In light of this, Congress adopted compromise amendments to Section 210 as part of EPA 2005. These amendments provide for a gradual phasing out of Section 210 to the extent the Federal Energy Regulatory Commission (FERC) determines that QFs have access to a competitive wholesale electricity market (Section 1253).

Section 210 Phase-Out

EPA 2005 has no affect on PURPA must-buy contracts in effect or pending approval on the date of enactment. It does, however, authorize FERC to relieve an electric utility of the mandatory purchase requirement of PURPA on a *prospective* basis in instances which the QFs have nondiscriminatory access to:

(1) independently-administered, auction-based day-ahead and real-time wholesale markets and to wholesale markets for long-term sales of capacity and electric energy, or
(2) nondiscriminatory transmission and interconnection services provided by a FERC-approved RTO or ISO and competitive wholesale markets that provide a meaningful opportunity to sell capacity and electric energy to buyers other than the utility to which the QF is interconnected.
(3) Alternatively, the mandatory purchase obligation may be eliminated where a QF has nondiscriminatory access to wholesale markets that are comparable to the markets described above.

In addition an electric utility would be relieved of its existing Section 210 obligation to sell power to a QF if the Commission finds that there are competing retail suppliers that are able to do so and the electric utility is not required by law to sell electric energy in its service territory.

FERC Determines if Must Buy Obligation is Relieved or Reinstated

- A utility must apply to the FERC for relief from the PURPA must-buy obligation. FERC must make a final determination within 90-days, with notice and comment
- FERC may reinstate the PURPA must-buy obligation in response to a request from a QF, State or any other affected person, if FERC finds that relief is no longer justified.

Cost Recovery Rule

- A federal right for utilities to recover PURPA Section 210 costs is created.
- FERC rulemaking shall be initiated to assure recovery of "all prudently incurred costs associated with the purchase."

FERC Rule Revising Criteria for New Qualifying Cogeneration Facilities

- QF requirements for new cogeneration facilities to be made more stringent.
- Within 180 days of enactment FERC to issue new rule to ensure:

    1. thermal energy output of a new cogen QF is "used in a productive and beneficial manner";
    2. output of new cogen facility is "used fundamentally for industrial, commercial or institutional purposes and is not intended fundamentally for sale to an electric utility"; and
    3. "continuing progress in the development of efficient electric energy generating technology."

- New rule only applies to must purchase obligation, not other rights under PURPA, such as interconnection.

- Notwithstanding the new QF rule, Commission's prior QF criteria apply to any "existing" cogeneration facility that was a QF on date of enactment or files for certification prior to the date of issuance of final rule.

Ownership Limitations Repealed

- Requirement that facilities not be owned by a person primarily engaged in the generation or sale of power is eliminated. In other words, electric utilities can own QFs.

Conclusion

For now, PURPA Section 210 lives and could potentially be a significant factor in the regulatory battles regarding utility power supplies in some areas of the country. The key variable for the future is the nature of FERC's implementation of the revisions to Section 210. In regions of the country served by independently-administered, auction-based day ahead and real-time markets and Regional Transmission Organizations, there is a relatively high likelihood that FERC will relieve most electric utilities of their must-buy obligation. However, in other regions where no "FERC-organized" wholesale electricity market exists, it is more difficult to gauge how FERC will respond to requests for relief from the must-buy obligation.