On August 8, 2005, President Bush signed into law the Energy Policy Act of 2005 (the Act). The Act adopts a number of important changes in federal law governing the US energy industry. Indeed, in describing the Act's impact on federal energy regulation, the Chairman of the Federal Energy Regulatory Commission (FERC), Joseph Kelliher, remarked that the Act's provisions represent the most significant changes to FERC's responsibilities in over 70 years. This Client Alert focuses primarily on those changes contained in the Electricity provisions of Title XII of the Act and certain provisions affecting the gas industry.

Of particular significance to the electric power industry, the Act repeals the Public Utility Holding Company Act of 1935 (PUHCA) effective February 8, 2006 (i.e., six months after enactment of the Act), opening the door to new utility mergers and acquisitions by entities—and across geographic regions—that previously would have been all but impossible under PUHCA. The Act also amends the Public Utility Regulatory Policies Act of 1978 (PURPA) by, among other things, allowing FERC to relieve a utility of the requirement to undertake new QF purchase obligations if FERC determines that the utility's service territory is sufficiently competitive so that a QF will be able to sell power on a nondiscriminatory, competitive basis.

In addition, the Act modifies the Federal Power Act (FPA) in a number of important respects: (i) giving FERC authority to ensure the reliability of the electric transmission grid; (ii) conferring on FERC “backstop” siting authority where transmission projects are deemed to be in the national interest; (iii) clarifying in an expansive manner the scope of FERC’s merger authority to extend to transfers of generating facilities, while also imposing time limits for FERC action on merger applications; (iv) increasing penalties for violations of the FPA; (v) establishing express prohibitions against market manipulation; and (vi) granting FERC discretionary authority to implement regulations intended to promote market transparency.

The Act also extends certain tax incentives for renewable energy until December 31, 2007 and expands the scope of such incentives to include certain hydro power facilities. There are also new tax credits for clean coal technology.
In the gas industry, the Act grants FERC exclusive jurisdiction over the siting and construction of LNG terminals and authorizes FERC to permit market-based charges for natural gas storage-related services from new facilities.

**PUHCA Repeal**

Effective February 8, 2006, the Act repeals PUHCA. For decades, PUHCA imposed significant restrictions on ownership of traditional electric and natural gas utilities. PUHCA required non-exempt holding companies to register with the Securities and Exchange Commission (SEC), thereby subjecting themselves and their subsidiaries to extensive regulation of various activities including securities issuances, acquisitions and affiliate transactions. PUHCA also limited the scope of businesses that could be owned by registered holding company systems to those deemed necessary or appropriate to the operation of an integrated public utility system. Most traditional utilities structured their operations to avoid this burdensome regulation, either by ensuring that they would be eligible for one of a limited number of exemptions (the most commonly-used of which requires that utility operations be primarily located in a single state) or by avoiding a holding company structure altogether. The result has been that most traditional utilities have restricted their operations to a single geographic region, typically within a single state or in contiguous states.

The repeal of PUHCA eliminates these restrictions on the industry. It will allow utility mergers or acquisitions without triggering the extensive SEC regulation formerly imposed on non-exempt, registered holding companies. Moreover, certain mergers and acquisitions that would have been barred altogether under PUHCA’s “integration” requirement will now be permissible.

PUHCA repeal will also increase opportunities for acquisitions by entities that are not primarily engaged in the business of owning and operating electric and gas utilities in the United States, including foreign companies and those with substantial foreign government ownership, as well as investment/commercial banks and hedge funds.

- **New Federal and State Oversight Authority.** In partial mitigation of the loss of SEC oversight over holding company systems associated with PUHCA repeal, the Act vests new oversight responsibility and authority in FERC and in the states. The Act replaces PUHCA with provisions that will give FERC and state regulators access to “such books, accounts, memoranda and other records” of holding companies, associate companies and their affiliates as are “necessary or appropriate for the protection of utility customers with respect to jurisdictional rates.”

- **Exemption for EWGs, QFs and Foreign Utility Companies.** The Act contemplates, however, that certain categories of independent power producers would be exempt from these federal access requirements, namely, any entity that is a holding company solely due to its ownership of (1) PURPA QFs, (2) exempt wholesale generators (EWGs), or (3) foreign utility companies (FUCOs). The Act requires FERC to issue a final rule on or before May 9, 2006 to exempt such facilities from federal disclosure requirements. Thus, even following PUHCA repeal, project companies may want to maintain their existing regulatory status as EWGs, QFs or FUCOs if they wish to ensure that they will qualify for exemption from the new federal disclosure requirements. Such entities, however, may still be subject to state disclosure requirements.
**PURPA Amendments**

The Act significantly alters the criteria for attaining QF status, as well as the potential benefits associated with such status.

- **Ownership Rules.** The Act repeals the existing ownership restriction, which limited to 50 percent the ownership interest in a QF that could be held by affiliates of traditional electric utilities. This repeal provision took effect immediately, and can be expected to create a more robust market for the purchase and sale of ownership interests in QFs to utility affiliates.

- **Utility Purchase Obligation.** The Act eliminates, on a prospective basis, mandatory utility purchase requirements where QFs have access to competitive power markets. Specifically, a utility is entitled to relief from the mandatory purchase requirement if FERC finds that a QF has nondiscriminatory access to one of the following: (1) independently administered, auction-based day ahead and real time energy markets and wholesale markets for long-term capacity sales, (2) open access transmission and interconnection services provided by a FERC-approved regional transmission organization and competitive wholesale markets that provide a “meaningful opportunity” to sell capacity and electric energy, or (3) wholesale markets for the sale of energy and capacity that FERC finds are of “comparable competitive quality” to the markets described in either (1) or (2) above. Individual utilities may petition FERC for relief from the obligation to purchase from and sell electricity to QFs on a service territory-wide basis by attempting to show that the requirement for competitive conditions has been met. Conversely, QFs, state agencies and other affected persons may petition FERC to reinstate such a purchase obligation.

- **Existing QF Contracts Grandfathered.** Importantly, the Act explicitly states that none of the aforementioned PURPA amendments will affect the rights of any party under any contract in effect or pending approval on August 8, 2005.

- **Modified Rules for New Cogeneration QFs.** Within 180 days of enactment of the Act (i.e., on or before February 4, 2006), FERC is required to issue a rule revising the criteria applicable to new cogeneration facilities seeking to sell power pursuant to Section 210 of PURPA. FERC’s new rule must ensure (1) that the thermal output of a new cogeneration QF “is used in a productive and beneficial manner,” (2) that the “electrical, thermal, and chemical output” of the cogeneration facility is used fundamentally for industrial, commercial or institutional purposes, and (3) the continuing progress in the development of efficient generation technology. These new criteria are not applicable to existing QFs—including QFs that file self-certifications before FERC issues its new rule. Moreover, the new criteria are applicable only to entities seeking to sell power pursuant to Section 210 of PURPA. The Act appears intended to tighten the operating and efficiency criteria for qualifying cogeneration facilities, and it will presumably be more difficult for new cogeneration facilities to meet the modified requirements (e.g., to show that their thermal output is used in a “productive and beneficial manner”) once the revised rule is adopted.

**FERC Merger Authority**

Effective February 8, 2006, the Act makes a number of amendments to Section 203 of the FPA, which confers upon FERC the authority to review utility mergers and acquisitions and other dispositions involving jurisdictional assets.
• **Expanded Section 203 Authority.** The Act gives FERC express authority to review any transaction involving the purchase, lease or other acquisition of an existing generating facility used to make FERC-jurisdictional sales with a value in excess of $10 million. FERC previously had authority to review such transactions only if a transfer of interconnecting transmission facilities and/or jurisdictional contracts or rate schedules were also involved.

• **Holding Company Review.** The Act adds a provision clarifying that holding companies in a holding company system that includes a public utility must obtain FERC authorization prior to (1) the acquisition of any security of a public utility company, or a holding company that owns a public utility, with a value in excess of $10 million, or (2) the merger or consolidation with a public utility company, or a holding company that owns a public utility, with a value in excess of $10 million.

• **Standard of Review.** The Act establishes a slightly modified standard of review under FPA Section 203, requiring FERC to find not only that a disposition is in the public interest but also that the disposition will not result in cross-subsidization to an associate company unless FERC specifically finds that such cross-subsidization is also consistent with the public interest.

• **Expedited Merger Review.** The Act requires FERC to develop rules for expedited Section 203 review, identifying classes of transactions that will normally meet the applicable public interest standard for approval. For all other transactions, FERC is required to approve or disapprove any applications under Section 203 of the FPA within 180 days. Any application not acted on within such time will be deemed approved unless FERC finds that further consideration is required and issues a tolling order.

• **Monetary Threshold.** The Act increases the monetary threshold for Section 203 review to dispositions of jurisdictional facilities with a value in excess of $10 million (formerly $50,000).

### FERC’s FPA Enforcement Authority and Market Rules

The Act increases FERC’s enforcement authority under the FPA, including new refund authority and additional civil and criminal penalties for violation of the FPA.

• **Market Manipulation Penalties.** The new law establishes an express prohibition on the use of any manipulative or deceptive device in the wholesale sale or transmission of electric energy. The Act also increases both criminal and civil penalties for certain FPA violations. Criminal penalties for market manipulation and other willful violations of the FPA are raised to a maximum fine of $1 million (formerly $5,000), or maximum imprisonment of five years (formerly two years). Civil penalties are extended to all of Part II of the FPA and fines are increased from $10,000 to a maximum of $1 million per day.

• **Refund Authority.** The Act increases FERC’s refund authority under Section 206 of the FPA to include short-term sales into an organized market under a FERC-approved tariff rather than by contract, to the extent that such sales are made in violation of the applicable tariff. Additionally, the Act amends the refund effective date provision under Section 206 to allow for refunds beginning on the filing date of any complaint or FERC notice initiating a Section 206 proceeding, rather than 60 days after the filing of a complaint or notice under existing law.

• **Market Transparency.** Pursuant to the Act, FERC is permitted, but not required, to create rules regarding the dissemination of “information about the availability and prices of wholesale electric energy and transmission service.” Specifically,
FERC is encouraged to examine pricing information that is currently available to the market and is encouraged to take action only if FERC determines that “existing price publications are not adequately providing price discovery or market transparency.”

- **Certain Western Power Contracts.** The Act grants FERC exclusive jurisdiction under the FPA to determine whether certain power purchase agreements are unjust, unreasonable or contrary to the public interests. By its terms, this provision covers only certain power purchase agreements under which Enron was the seller.

- **LICAP.** The Act also includes a “Sense of Congress” statement regarding a proposed Locational Installed Capacity (LICAP) mechanism for New England that encourages FERC to “carefully consider the States’ objections” to the proposed mechanism.

**Reliability and Transmission Infrastructure**

The Act makes important modifications to the regulation of electricity transmission, giving FERC greater direct authority to address reliability and infrastructure concerns, removing barriers to access to the transmission systems of non-jurisdictional utilities, and providing incentives for transmission owners to build necessary facilities.

- **Reliability.** The Act grants FERC the authority to certify electric reliability organizations (EROs) to establish and enforce reliability standards for bulk power systems. EROs will have the authority to impose penalties for violation of FERC-approved reliability standards, which penalties will be appealable to FERC.

- **Transmission Siting.** The new law directs the Secretary of Energy to perform a study of electric transmission congestion and issue a report within one year, and every three years thereafter, in which the Secretary may designate “national interest electric transmission corridors.” The Act confers new federal “backstop” authority on FERC over transmission facility siting for such national interest transmission corridors. This authority can be invoked where, for example, a state siting commission has withheld approval for a transmission siting application for more than one year, and the facilities are to be used for interstate transmission. In such a case, permit applications are to be filed with FERC (and states shall have an opportunity to comment). The new law further provides for certain eminent domain authority associated with such transmission siting if the applicant is unable to acquire by contract the necessary rights-of-way for the proposed facility.

- **Non-Jurisdictional Transmission Owners.** The Act gives FERC greater authority to order certain “unregulated transmission owners” (primarily municipal utilities and Federal Power Marketing Agencies) to provide transmission services at comparable, nondiscriminatory rates, and ensures that Federal Power Marketing Agencies can cede control of their facilities to a regional transmission organization without being subject to additional regulation by FERC.

- **Transmission Rate Reform.** The Act directs FERC to establish, by rule within one year, an incentive-based rate structure for the transmission of electric energy in interstate commerce. Specifically, the incentive rate structures must provide a return on equity that attracts investment and allows recovery of all costs prudently incurred in complying with new reliability standards. While the Act has retained language that allows FERC to approve “participant funding” of transmission upgrades, it does not require that such an approach be adopted and merely
states that such an approach should not be tied to a given transmission owner’s participation in a regional transmission organization.

- **Protection for Native Load.** Finally, the Act directs FERC to ensure that public utilities in certain markets are entitled to use their transmission facilities or firm transmission rights to serve native load obligations and provides that such reservation of transmission capacity will not be considered discriminatory under the FPA.

**Tax Incentives**

The Act amends the Internal Revenue Code to extend and modify the Renewable Electricity Production Credit, and provides certain other new or modified tax credits and incentives.

- **Extension of Credit.** The production tax credit is extended for two years to cover certain renewable energy facilities (e.g., windpower, geothermal) that achieve commercial operation by December 31, 2007.
- **Period of Credit Extended to 10 Years for All Renewables.** The credit period for electricity produced from “open loop” biomass, geothermal, solar, small irrigation, landfill gas and trash combustion facilities is extended from five years to ten years (consistent with the existing 10-year credit period for windpower).
- **Certain Hydropower Facilities Qualify.** The Act also modifies the covered categories of renewable generation to include certain hydro facilities that achieve new efficiencies or increased capacity between the time of enactment of the Act and December 31, 2007.
- **New Clean Coal Tax Credits.** The Act establishes a new investment tax credit that will apply to investments in domestic projects that use integrated gasification combined cycle and other advanced coal-based generation technology to power a new generation facility or repower an existing one (including an existing natural gas-fired combined cycle unit) and that satisfy certain enumerated criteria. The Act also establishes the “Clean Coal Power Initiative” to fund projects that advance the efficiency, environmental performance and cost competitiveness of coal-based power generation technologies, adds a new Clean Air Coal Program that offers financial assistance to projects utilizing clean coal generating equipment, and offers financial support for certain individual clean coal projects.

**Natural Gas Regulation**

The Act also confers new or clarified federal authority over natural gas regulation in the following areas:

- **LNG Terminals.** The Act grants FERC exclusive jurisdiction over applications for the “siting, construction, expansion or operation of an LNG terminal,” thus removing uncertainty about whether state commissions might have such jurisdiction in some instances. Moreover, the Act effectively codifies, through at least December 31, 2014, FERC’s Hackberry policies by allowing LNG terminalling services to be provided at market-based rates, and not be subject to the open access requirements applicable to natural gas pipelines, nor subject to any tariff or contract filing requirements related to rates and charges. FERC also may not deny an application solely on the basis that the applicant proposes to use the LNG terminal “exclusively or partially for gas that the applicant or an affiliate of the applicant will supply to the facility.” The Act provides for FERC to coordinate and consult with the Secretary of Defense regarding any siting, construction, expansion or operation of LNG facilities that “may affect” an active military installation. The Act further directs FERC to promulgate (within 60 days of August 8, 2005) new regulations on the National Environmental Policy Act (NEPA)
pre-filing process, requiring that the pre-filing process commence at least six months prior to the filing of an application to construct an LNG terminal. State governors are directed to designate the appropriate state agency for purposes of consulting with FERC during the NEPA review process concerning state and local safety considerations, and FERC is directed to review and respond specifically to any issues raised by the state agency during the consulting process and prior to issuing an order granting an application to site, construct, expand or operate an LNG terminal.

- **Natural Gas Storage.** The Act allows FERC to authorize the provision of storage and storage-related services from new storage facilities at market-based rates even where an applicant is unable to demonstrate that it lacks market power if FERC determines that market-based rates for such services are in the public interest and customers are adequately protected, thereby promoting the development of natural gas storage facilities.

**Endnotes**

1. Because PUHCA did not exempt foreign sovereigns from holding company regulation, it effectively prohibited investment by such companies in US utilities.
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