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To: Our Clients and Friends

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Changes in the Ownership of Energy Assets May Require Federal and State Regulatory Approvals

Section 203 of the Federal Power Act ("FPA") requires Federal Energy Regulatory Commission ("FERC") approval of mergers, acquisitions, and certain other changes in ownership of electric energy assets valued at more than $10 million. Although section 203, by its terms, applies to transactions involving a "public utility," or a holding company that includes a "transmitting utility or an electric utility," FERC has asserted jurisdiction under section 203 over entities that own no electric generation plants, or transmission and distribution lines. Such an entity, for example, could have an authorization from FERC to resell, at unregulated wholesale market rates, electric energy that it purchases, and that is produced and distributed by facilities owned and operated by other, unaffiliated entities. Failure by such a reseller of electric energy to obtain FERC's approval for a transfer of its wholesale market rate authorization to an acquiring entity could lead to FERC's assessment of civil penalties. FERC has authority to assess penalties of up to $1 million for each violation of its rules. Accordingly, proposed acquisitions and sales involving energy-related businesses need to be examined carefully to determine whether FERC approval is necessary before the deal is closed.

In addition to FERC approval, it may be necessary or prudent to seek approval of changes in the ownership of energy assets from public utility commissions ("PUCs") in States where the assets are located. PUCs may require energy suppliers and even energy brokers within their jurisdictions, that own no energy supply or transmission or distribution facilities, to have a license from or at least register with the PUC. The PUCs may also have authority to impose civil penalties for violation of their rules.

A recent case illustrates the approval process. EDF Development Inc., ("EDF") a subsidiary of Electricitie de France, SA (the French electric utility holding company that is 84.8 percent owned by the French government) proposed to acquire a 49.99 percent interest in Constellation Energy Nuclear Group, LLC ("Constellation Nuclear"), a subsidiary of Constellation Energy Group, Inc., and an affiliate of the Maryland utility, Baltimore Gas & Electric Company ("BG&E"). The applicants sought approval from the New York Public Service Commission ("NYPSC"), because Constellation Nuclear subsidiaries own three nuclear power plants in New York, as well as from FERC. After FERC conditionally approved

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the transaction by Order issued February 19, 2009 (“Order”), the NYPSC issued a declaratory ruling regarding the transaction on April 23, 2009 (“Ruling”).

FERC’s Order is based on its standard approach to merger analysis under section 203 of the FPA. If FERC finds that the transaction “will be consistent with the public interest,” the statute requires FERC to approve the transaction. FERC generally analyzes the public interest issue by considering the effect of the transaction on electric power competition, rates and regulation in the relevant geographic and product markets. The Energy Policy Act of 2005 amended section 203 to expressly require FERC to find also that the transaction “will not result in cross subsidization of a non-utility associate company or the pledge or encumbrance of utility assets for the benefit of an associate company,” unless the Commission determines that such a result of the transaction “will be consistent with the public interest.”

FERC’s analysis of the effect on competition includes an examination of both horizontal and vertical market power issues. In this case, the applicants own electric energy assets in several different markets and would merge assets within only one wholesale electricity market: the California Independent System Operator (“CAISO”) market area. FERC found that Constellation Nuclear’s parent controls only 0.2 percent of the installed generating capacity in CAISO. EDF, through its affiliate enXco, has an interest in 402 MW of wind-powered electric generation in CAISO, which amounts to only 0.7 percent of that market. In light of these facts, FERC held that the merger would not “materially” increase concentration in the CAISO market. As to vertical market power, FERC found that the merger would not increase the incentive or ability of the applicants to deny competitors access to inputs necessary to generate power, or to raise their input prices for the purpose of impeding or foreclosing competition. Because the rate-regulated electric transmission facilities involved in the merger are operated by an independent entity – PJM Interconnection – FERC observed that there is “no ability to use” the “transmission to disadvantage competitors” of the merged entity.

FERC also found no adverse impact from the transaction on wholesale electricity rates or regulation. As to rates, FERC observed that the merging entities “sell electricity at market-based rates” in competitive markets. FERC has long held that a merger of such entities “is unlikely to have an adverse impact on rates.” In regard to regulation, FERC found that the jurisdictional status of the merging entities would not change as a result of the transaction, and that the facilities involved would remain subject to regulation to the same extent as they were before the merger. Accordingly, FERC found no adverse impact on federal or state regulation resulting from the merger.

As to the issue of cross-subsidization, FERC held that, contrary to the applicants’ claim, the transaction was not entitled to the “safe harbor” analysis afforded to mergers of non-traditional utilities, even though the merging entities themselves are not traditional regulated utilities. Because Constellation Nuclear is affiliated with BG&E, which is a regulated utility, FERC reasoned that there was a “possibility” of a “transfer of benefits from a public utility’s captive customers . . . to shareholders of the public utility’s holding company due to an intra-system transaction . . . .” Nevertheless, FERC held that the applicants had satisfied FERC’s four-factor test applicable to the transaction by a separate showing that cross subsidization would not in fact result from the merger. FERC, however, conditioned its approval on the applicants’ agreement to afford FERC access to the books and records of EDF’s

ultimate parent company, because that company is a foreign entity over which FERC has no statutory jurisdiction. Without such access FERC's ability to protect against cross-subsidy "may be impaired."

In contrast to FERC, the NYPSC in its Ruling found that the transaction qualified for its own version of "safe harbor" treatment. The NYPSC's "safe harbor" includes "transactions involving parent entities upstream from the entities owning wholesale electric generation facilities located in New York" where there is no "potential for the exercise of market power or other harm to the interests of captive New York ratepayers." In this case, Constellation Nuclear is the upstream parent of two entities that own wholesale nuclear power plants in the New York market area, where EDF owns no facilities. Moreover, while FERC raised the possibility of cross-subsidy resulting from the transaction, that danger stems from potential exploitation of captive customers of BG&E in Maryland. No such captive customers in New York are affected by the transaction because their public utilities are unaffiliated with the merger applicants. FERC would likely afford "safe harbor" treatment of the cross-subsidy issue to mergers of purely competitive electric energy wholesalers who do not own or control essential, rate-regulated electric energy facilities. Qualifying for such "safe harbor" treatment of the cross-subsidy issue facilitates but does not obviate compliance with the statutory requirement that FERC approve the transaction before it closes.

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