

**UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION**

In the Matter of

**American Electric Power
Company, Inc.**

)
)
) **Administrative Proceeding**
) **File No. 3-11616**
)
)
)

**DIVISION OF INVESTMENT MANAGEMENT'S BRIEF IN SUPPORT
OF ITS PETITION FOR REVIEW OF INITIAL DECISION**

David B. Smith, Jr.
Catherine A. Fisher
Martha Cathey Baker
Ronald E. Alper
Lore C. Steinhauser
Andrew P. Mosier, Jr.
Catherine P. Black
Arthur S. Lowry

Attorneys for
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-0503

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I. Introduction

This matter arises from an application-declaration (“Application”) filed jointly in 1999 by the American Electric Power Company, Inc. (“AEP”) and the Central and South West Corporation (“CSW”).¹ The Application sought the Commission’s authorization under the Public Utility Holding Company Act of 1935, as amended (“Act”), for AEP to acquire CSW. At the time, AEP was a registered public-utility holding company with utility operations in Ohio, Michigan, Indiana, Kentucky, Tennessee, Virginia and West Virginia. CSW was a registered public-utility holding company with utility operations in Arkansas, Louisiana, Oklahoma and Texas.

Among other things, the Application stated that the utility system that would result from the acquisition (“Combined AEP System”) would be “integrated,” as required by sections 10 and 11 of the Act. More specifically, the Application asserted that, in the terms of section 2(a)(29)(A), the Combined AEP System (i) would be “physically interconnected or capable of interconnection,” (ii) would be capable of economic operation “as a single interconnected and coordinated system,” (iii) would be “confined to a single area or region,” and (iv) would be “not ... so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.”

The Commission agreed, and on June 14, 2000, it issued a lengthy order (“Order”) granting the Application and denying the hearing requests it had received with respect to the Application.² The companies merged shortly thereafter.

¹ S.E.C. File No. 70-9381.

² 54 S.E.C. 697, Holding Co. Act Release No. 27186 (June 14, 2000).

The National Rural Electric Cooperative Association (“NRECA”) and the American Public Power Association (“APPA,” and with NRECA, “APPA/NRECA”) subsequently sought review of the Order in the United States Court of Appeals for the District of Columbia Circuit (“Court of Appeals”). Although the Court of Appeals affirmed many of the Commission’s findings and conclusions in the Order, it ultimately vacated the Order and remanded the matter for further explanation from the Commission for its conclusions that the Combined AEP System met tests (i) and (iii) enumerated above -- the “interconnection” and the “single area or region” requirements.³

On August 30, 2004, the Commission set this matter down for an evidentiary hearing.⁴

The Commission’s Notice and Order for a Hearing directed that a hearing be held in this matter:

for the purpose of determining whether the AEP and CSW systems are interconnected, through a unidirectional contract path or otherwise, and whether the resulting combined system operates in a single area or region, and hence satisfy the requirements of sections 10(c)(1) and 11(b)(1) of the [Public Utility Holding Company] Act....

Administrative Law Judge Robert Mahony conducted the evidentiary hearing on January 10, 2005, held oral argument on March 7, 2005, and issued an initial decision (“Initial Decision”)⁵ on May 3, 2005. The Division of Investment Management (“Division”) argued, as did AEP, that the record evidence supported a finding that both of these statutory requirements were met. APPA/NRECA, joined by intervenor and limited participant Public Citizen, argued that neither the interconnection nor the single area or region requirement was met.

In his Initial Decision, the Law Judge concluded that, based on the record

³ *National Rural Elec. Coop. Ass’n v. S.E.C.*, 276 F.3d 609 (D.C. Cir. 2002) (“Remand Order”).

⁴ *American Electric Power Company Inc.*, Holding Co. Act Release No. 27886 (Aug. 30, 2004) (“Notice and Order for a Hearing”).

⁵ *American Electric Power Company Inc.*, Initial Decision, Release No. 293 (May 3, 2005).

evidence, the combined system satisfied the interconnection requirement.⁶ The Division agrees with this conclusion.⁷ However, the Initial Decision also held that the single area or region requirement was not met.⁸ The Division disagrees with this conclusion. As discussed below, the Law Judge’s analysis of the Act’s single area or region requirement in terms of a so-called “geographic test”⁹ is reductionist and incorrect.

The Division and AEP filed Petitions for Review with the Commission on May 24, 2005.¹⁰ The Commission issued an Order Granting the Petitions for Review on June 6, 2005, as amended on June 7, 2005, directing that opening briefs be filed by July 7, 2005. Accordingly, the Division respectfully submits this brief in support of its Petition for Review.

II. Summary of the Facts Relevant to the Single Area or Region Requirement

A. Relevant Regulation and Structure of the Electric Power Industry

When Congress passed the Act in 1935, electric utilities were typically regulated, vertical monopolies. Generally, the state awarded a utility a set territory (service territory) within which it had an exclusive franchise, and, in return, the utility was obligated to serve all the customers in that territory. These discrete service territories were usually not connected in any meaningful

⁶ Initial Decision at 12.

⁷ APPA/NRECA, joined by Public Citizen, successfully cross-petitioned the Commission to review the Law Judge’s conclusion that the Combined AEP System is interconnected. The Division intends to file a brief responding to the arguments raised by APPA/NRECA and Public Citizen in their cross-petition opening briefs in accordance with the Commission’s schedule for briefing.

⁸ Initial Decision at 23. Based on that conclusion, the Law Judge also denied the Application. *Id.* The Division believes that in so ruling on the underlying Application, the Law Judge exceeded the scope of the Commission’s Notice and Order for Hearing, which set the matter down only for an evidentiary hearing in order to supplement the record to allow “us to address the issues identified in the Court’s opinion” Notice and Order for a Hearing (emphasis added).

⁹ *Id.* at 21.

¹⁰ APPA/NRECA filed a Cross-Petition for Review on June 3, 2005, which was granted by the Commission in its order of June 7, 2005. Around the same time, limited participant Public Citizen filed a Cross-Petition for Review. On June 13, 2005, the Commission issued an order denying Public Citizen’s petition for review and granting leave to participate on a limited basis.

way, if at all. Consequently, a single utility company was responsible for generating, distributing, and transmitting all electric power within a local area.

Today, the electric utility industry structure is radically different from the discrete, isolated, service territories that made up the industry in 1935. The North American system of electricity generation, transmission and distribution is physically and administratively subdivided into three large networks or “interconnections” – the Eastern Interconnection (east of the Rocky Mountains), the Western Interconnection (west of the Rocky Mountains) and the ERCOT Interconnection in Texas. Electric power utilities within each regional Interconnection are physically connected to and a part of that interconnection and transmit power in sync. The Interconnections are also connected with each other.

The Interconnections developed as electric power generation and transmission technology evolved and allowed electricity to be transmitted farther from its generation point than was either possible or economical in the 1930s. Potential transmission voltage also has increased with the construction of transmission lines that can handle increasing voltages: from the 1920s (132 kilovolt (“kV”) lines) through the 1950s (345 kV lines) and the 1970s (765 kV transmission lines). In tandem with this increase in transmission voltages has been an increase in generation capacity. Today, electricity is regularly transmitted over distances of many hundreds of miles, and, in some cases, over one thousand miles.¹¹

The contemporary electric power industry has also been affected by regulatory changes, particularly regulatory changes designed to enhance competition in the electricity markets that began in earnest in the 1990s. In the mid-1990s, the Federal Energy Regulatory Commission

¹¹ AEP Exhibit 2 (Prepared Direct Testimony of Paul B. Johnson) at 11:12-12:1-2; 12:18-13:6; Testimony of Paul B. Johnson (“Johnson”) at 51:25-52:12, 53:13-54:6; 55:11-20; 57:1-58:4.

(“FERC”) issued Orders 888 and 889, the first steps in an effort to eliminate the ability of individual transmission owners to restrict and control access to their transmission systems. These FERC orders effectively inaugurated the present Open Access Transmission Tariff (“OATT”) regime.¹² Open access to transmission facilities has brought new industry participants, such as independent power producers (who often are solely in the business of generating power for sale but not transmitting it), to an industry that was formerly limited primarily to vertically integrated electric power utilities.¹³

The goal of this restructuring of the electric utility industry is to use the expanded and interconnected transmission system to provide access to more sources of generation supplies and, thereby, lower the cost of electricity. States have also altered their regulatory structures, in some cases, permitting retail customers to choose from a number of electricity suppliers. In response to restructuring initiatives, some utilities have unbundled their electric generation assets and transmission assets from their distribution assets. The generation facilities have often been placed in a separate corporation within the utility’s holding company system or sold to a third

¹² AEP Exhibit 2 at 11. The FERC mandated open access transmission is described by the Commission in *CP&L Energy, Inc.*, 54 S.E.C. 996 at 1012-13, Holding Co. Act Release No. 27284 (Nov. 27, 2000) (“CP&L Energy”), as:

the requirement that all utilities subject to FERC jurisdiction open their transmission systems and allow any qualified entity to use their system to deliver electricity at a fair and non-discriminatory rate. Open access transmission makes it possible now for the Eastern and Western areas [of the CP&L system] to coordinate their operations[O]pen access transmission offers a better, more flexible and more economical way to achieve significant interchange capability than the more traditional firm contract path [R]eliance on numerous transmission service reservations increases the number of potential interconnection options and allows utilities to use less expensive non-firm products where appropriate while providing a high level of assurance that transmission capacity will be available when needed. Utilities can obtain a portfolio of transmission capacity over multiple paths, with various degrees of firmness, providing for various amounts of capacity that can be selected to achieve optimal integrated operations. Today, interchange capacity can be achieved via a portfolio of short-term firm and non-firm transmission at a lower comprehensive cost than the more limited rigid, single firm contract path.

¹³ *Id.* at 24.

party. The transmission assets have often been pooled with those of other utility systems to form regional transmission organizations (“RTOs”) stretching over many states.

Just as open access enables new industry entrants and old industry participants to use the interconnected electric grid to pursue competitive opportunities, vertically integrated utilities can also use open access and RTOs for transactions within, between and among their own service territories.¹⁴ Thus, the OATT regime and the evolution of the electricity industry to include RTOs have greatly enlarged both the practical limits of electric power transmission and the geographic scope of the markets for electric power.¹⁵ These developments, which were well under way when the Commission approved the AEP/CSW merger, have begun transforming the industry from one primarily focused on the provision of local utility service to one of expanding interstate markets.¹⁶

B. Relevant Facts Regarding the Combined AEP System

The operations of the Combined AEP System take place within the industry as shaped by the technological and regulatory developments and advances described above. The Commission previously determined that the old CSW operations, which are located in the ERCOT Interconnection and the Eastern Interconnection, constitute an integrated electric system.¹⁷ The old AEP operations, which, considered independently, also constituted an integrated system, are located in the Eastern Interconnection. The Combined AEP System is thus directly

¹⁴ AEP Exhibit 2 at 23.

¹⁵ AEP Exhibit 5 (Prepared Direct Testimony of J. Craig Baker) at 25:5-31:16 and 35: 9-16.

¹⁶ *Id.* and Amendment No. 5 to Form U-1 Application in File No. 70-9381 (restated and amended Form U-1 Application-Declaration (“AEP Amendment 5”) at 76.

¹⁷ *Central and South West Corp.*, 47 S.E.C. 754, Holding Co. Act Release No. 22439 (April 11, 1982). Texas Central Company and most of AEP Texas North Company are located in the ERCOT (Texas) Interconnection. AEP Exhibit 2 at 6:7-12; AEP Exhibit 5 at 21:20-22:4.

interconnected with and embedded in a system of interconnected utility companies,¹⁸ and it utilizes contract rights with other utilities, the OATTs regime and RTOs to move electric power as needed.¹⁹ Operations of the Combined AEP System are situated within a single wholesale electric power market.²⁰ Further, the record evidence shows that the operations are within a number of broad regions that are defined in terms of manufacturing types²¹ and that the operations are within several functional regions, including those characterized by natural gas production, transportation and consumption; petroleum products, transportation and consumption; and rail, waterway and highway transportation networks.²²

III. Applicable Law

A. Section 11(b)(1) of the Act

This section requires the Commission, in pertinent part, “to limit the operations of [a] holding company system” to “a single integrated public-utility system.”²³

B. Section 2(a)(29)(A) of the Act

This section defines an integrated electric public-utility system as:

a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or

¹⁸ AEP Exhibit 5 at 37:5-16; AEP Exhibit 11.

¹⁹ AEP Exhibit 5 at 9:11-17, 10:18-11:2, 11:3-12-12:20; 20:1-9; AEP Exhibits 6, 7, 8, 11; Baker at 95:8-96:23; 102:8-16; 105:16-108:7; 145:12-25.

²⁰ AEP Exhibit 5 at 33:1-10.

²¹ AEP Exhibit 1 (Prepared Direct Testimony of David Harrison, Jr., Ph.D.) at 3:25-7:5; Testimony of David Harrison, Jr. (“Harrison”) at 17:18-18:19 (the Combined AEP System falls within certain homogenous regions, *i.e.*, regions demarcated on the basis of internal uniformity).

²² AEP Exhibit 5 at 41:19-42:5; Harrison at 19:4-21:4; 22:17-23:9; 25:19-23; 33:16-34:2 (the Combined AEP System falls within functional regions, *i.e.*, regions characterized by economic interdependence). *See* later discussion of *American Gas & Electric Co.*, 21 S.E.C. 575 (December 26, 1945) (“American Gas”).

²³ This section was described in a 1935 Senate Report as the “very heart” of the Act. *See S. Rep. No. 621*, 74th Cong., 1st Sess. (1935) at 11.

region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operations, and the effectiveness of regulation.

As both the Court of Appeals' decision and prior Commission decisions have recognized, the integration requirement has four parts. The "single area or region" requirement is one of these parts.

C. Sections 9 and 10 of the Act

Congress did not eliminate the use of the holding company in the electric and gas industries. Instead, it gave the Commission "the additional responsibility, under sections 9 and 10, of 'supervision over the future development of utility-holding company systems'"²⁴ so that the abuses that had led to enactment would not be recreated. Section 10(c)(1) of the Act prohibits approval of an acquisition that, among other things, would be "detrimental to the carrying out of the provisions of section 11." Section 10(c)(2) requires the Commission to find that a proposed acquisition will "serve the public interest by tending towards the economical and efficient development of an integrated public-utility system." The Commission and the courts have interpreted section 10 to incorporate the general requirement of section 11(b)(1) that the utility operations of a holding company be limited to a single integrated public-utility system.²⁵

²⁴ *Southern Co.*, 50 S.E.C. 1328, 1337 and n. 38, Holding Co. Act Release No. 25639 (Sept. 23, 1992) ("*Southern Co.*"), citing *S. Rep. No. 621* at 30 ("In this way there will be secured complete Commission supervision of the securities and capital plants that are to be brought into holding-company systems, making impossible the mad scramble for utility properties that has characterized the mushroom growth of holding companies . . ."); see also *H.R. Rep. No. 1318* at 15.

Section 9(a)(1) of the Act requires a registered holding company to seek prior Commission approval under section 10 for a direct or indirect acquisition of any "securities or utility assets." Section 9(a)(2) requires approval for the acquisition of any security of any public-utility company by "any person" who is, or will by virtue of an acquisition become, an affiliate of two or more public-utility companies." For purposes of section 9(a)(2), an "affiliate" is any person that directly or indirectly owns 5% or more of the outstanding voting securities of a public-utility company. See section 2(a)(11)(A) of the Act.

²⁵ *Southern Co.* at 1334 n. 22.

IV. The Initial Decision Erroneously Interpreted “Geography” in Terms of Conventional Labels Instead of Giving it Content Based on the Act’s Goals of Economy and Efficiency

As we noted above, Judge Mahony concluded in his Initial Decision that AEP failed to demonstrate that the operations of the Combined AEP System are in a “single area or region.” He, therefore, denied the Application. The Division took the position that in determining whether a holding company system is within a single area or region, the Commission typically has defined an acceptable region in terms of an area which could be economically and efficiently served by a system. Given the current state of the electricity market – a state determined by economic, technological and regulatory factors – the Division argued that the single area or region inquiry should focus on whether the combined operations were located within a single, identifiable market for electricity. A positive determination would strongly indicate that the system met the single area or region requirement.

Judge Mahony rejected this argument, instead adopting an approach that focused almost exclusively on what he termed “geography.” Indeed, Judge Mahony’s conclusion that the combined system was not within a single area or region is solely rooted in his view that:

[The traditional considerations by which the Commission applies the region requirement of Section 2(a)(29)(A) to be predominantly based on geography, with other factors such as socioeconomics and geology also contributing. To now apply the region requirement based on broad-based economic considerations, effectively ignoring geography, would be contrary to the Commission’s traditional method of analysis.²⁶

We agree that the “single area or region” requirement is effectively a geographic limitation on the extent of a holding company system. The task, of course, is how to decide what space or features constitute a “single area or region.” The Initial Decision provides very little content for what the term “geography” means. The Initial Decision does try to provide some meaning to the

²⁶ Initial Decision at 21.

term by focusing on the Commission's decision in *CP&L Energy, Inc.*,²⁷ a matter decided shortly after the AEP matter was decided. Quoting the Commission's conclusion in that order that "[t]he retail service area of the [combined] CP&L Energy Electric System will be confined to three states, North Carolina, South Carolina, and Florida, in the *Southeastern* United States," (emphasis supplied by the Initial Decision), the Initial Decision points to the Commission's supposed use of "strictly geographical terminology" to support its approach to this matter.

There are a number of problems with a geographical test. First, although the Initial Decision suggests that *CP&L Energy* is typical of the Commission's current approach to the single area or region requirement, this is incorrect. The Initial Decision fails to discuss other decisions prior to and contemporaneous with both the original AEP Order and *CP&L Energy* that found large and wide-ranging systems satisfied the requirement.²⁸ Thus, *CP&L Energy* is simply not typical of the Commission's interpretation of the single area or region requirement.

More importantly, the mere fact that the three states noted in the *CP&L Energy* decision are, in common parlance, within the "southeastern United States," explains little about either the appropriate geographic extent of a public utility holding company's operations or the fundamental meaning of the "single area or region" requirement. After all, "a continent" and "an island" are both geographic terms, but neither is of obvious help in interpreting the "single area or region" requirement. An approach that does little more than apply convenient geographic

²⁷ 54 S.E.C. 996, Holding Co. Act Release No. 27284 (Nov. 27, 2000) ("CP&L Energy").

²⁸ See *New Century Energies, Inc.*, Holding Co. Act Release No. 27212 (Aug. 16, 2000) (authorizing New Century Energies, Inc. and Northern States Power Company to merge and form Xcel Energy Inc. This merger brought together under one corporate umbrella electric utility operations in eleven states -- Texas, Oklahoma, Kansas, New Mexico, Colorado, Wyoming, South Dakota, North Dakota, Minnesota, Wisconsin and Michigan) and *Energy East Corp.*, Holding Co. Act Release No. 27224 (Aug. 31, 2000) (authorizing Energy East Corp. to acquire CMP Group Inc., CTG Resources, Inc. and Berkshire Energy Resources. The resulting company had electric and gas utilities operating in New Jersey, New York, Massachusetts, Connecticut and Maine. See also *American Gas*, which dealt with the predecessor system of the old AEP system. The Commission approved a system that included utility operations in Virginia, Tennessee, Michigan and Ohio. See also *New Century Energies, Inc.*, Holding Co. Act

labels like “southeastern” may be sufficient for certain simple cases – systems, such as that described in *CP&L Energy*, that involve a small number of states very close together. But that approach does little to give meaningful content to the term “single area or region” as that term operates in the Act, and hence does not provide a substantive basis for deciding cases involving utility systems that cover a broader area. The Commission’s approach to a requirement as important as the single area or region requirement needs to be rooted in something more substantive than semantics.

Thus, the fact that a label like “southeastern” cannot easily be applied to the AEP system is not dispositive. Instead of focusing on geographic labels like “southeastern,” the requirement should instead be interpreted in light of the statute’s structure, the purposes of the Act, the Commission’s historical approach to interpreting the “single area or region” requirement, and ultimately, notions of good policy. As the Division argued below, we believe that, in light of the language, structure and history of the Act as well as the Commission’s historical administration of the Act, the only sensible way to interpret the “single area or region” requirement is in terms of economic considerations. The Act is broadly concerned with the ability of a utility system to operate efficiently, and each of the provisions of the Act that serves to limit the size and scope of utility company systems reflects this concern. The “single area or region” requirement is no different. As we demonstrate below, the Initial Decision’s “geographic” test is both incorrect and bad policy.

Release No. 26748 (Aug. 1, 1997) (dealing with predecessor systems of Xcel) and *Exelon Corp.*, Holding Co. Act Release No. 27904 (Oct. 28, 2004).

A. An Analysis that Includes Economic Factors is Consistent with the Structure of the Act

Section 1 of the Act, which articulates the reasons for enactment, is directed toward economy and efficiency, not geographic concerns. Section 1(b)(4) states that the interest of consumers and investors may be adversely affected “when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties.” Section 1(b)(5) continues the emphasis on economy and efficiency, stating that consumers and investors may be adversely affected “when in any other respect there is lack of economy of management and operation of public-utility companies or lack of efficiency and adequacy of service rendered by such companies, or lack of effective public regulation, or lack of economies in the raising of capital.” Nowhere in section 1 is a concern raised about the geographic size or geographic relationship of utilities.

Section 10(c)(2) of the Act directs the Commission to approve a merger only if it “will serve the public interest by tending towards the economic and efficient development of an integrated public-utility system.” Again, this language demonstrates that Congress was not concerned with the size and scope of a utility system *per se*, but rather was concerned about those factors that would limit the ability of a system to operate economically and efficiently.

Furthermore, neither section 11(b)(1), which calls for “integrated public-utility systems,” nor section 2(a)(29)(A), which defines these systems, uses the word “geographic.” Efficiency and economy are, however, emphasized. Section 2(a)(29)(A) does not refer to a “single geographic area or region.” Nor does it refer to a “single demographic area or region.” It states only a “single area or region.” Therefore, although the single area or region requirement is a limit on the scope of utility systems, it is a limit that should be defined in terms of the broader goals of the integration requirement and of the Act generally. The Act simply does not require –

or even suggest – that the question of whether a utility system operates in a single area or region be answered by pointing to the physical distance between its parts, the geological features of the places in which its assets and customers are located, or, more broadly, the shifting agreed-upon conventions defining what constitutes a distinct “region.” Significantly, the phrase “single area or region” in the Act is not preceded by any language confining the definition. Had Congress intended the requirement to be interpreted in any of these limited ways, it surely could have drafted the statute to reflect that intent.

Instead, given the emphasis on economies and efficiencies in so many other parts of the Act that deal with the scope of holding company systems, the Division believes that it is appropriate to interpret the single area or region requirement in light of these goals. Moreover, as we show below, this approach is consistent with the Act’s legislative history as well as the Commission’s historical practice in applying the single area or region requirement.

B. An Analysis that Includes Economic Factors is Consistent with the Legislative History of the Act

The legislative history of the Act similarly does not compel the conclusion that a single area or region is equated with a geographic area. In particular, much of the Act’s legislative history is concerned with the inefficiencies that arise from the ownership of scattered, unregulated utility properties. For example, at one point during hearings leading to enactment of the Act, Congressman Sam Rayburn, one of the Act’s primary proponents, was asked what he meant by the term “regional.” He stated:

There are systems which have been shown here, that I call integrated systems, covering parts of four or five States. I do not think that would be objectionable at all, but I do object to these sprawling systems that cover 36 States, or 20 States, that are wholly disconnected, being under common control.²⁹

²⁹ Hearings before the Committee on Interstate And Foreign Commerce, House of Representatives, 74th Cong., 1st Sess. on H.R. 5423, Part I at 369.

In making this comment, the primary focus of his statement is not on the number of states a system covered (and, implicitly, how many of those states could be within a single region), but rather on the “wholly disconnected” nature of the systems he saw as objectionable. This is reinforced by a statement Congressman Rayburn had given earlier the same day, in which he stated:

All too often considerations of business need and sound economy have been neglected, and utility properties have been gerrymandered for private advantage and pride, not integrated for the public good.³⁰

Congressman Rayburn’s concepts of “business need” and “sound economy” are very helpful to understanding what Congress meant by the “single area or region” requirement.

Similarly, the Report of the National Power Policy Committee had found that:

Whole strings of companies with no particular relation to, and often essentially unconnected with, units in an existing system have been absorbed [by holding companies] from time to time Because this growth has been actuated primarily by a desire for size and the power inherent in size, the controlling groups have in many instances done no more than pay lip service to the principle of building up a system as an integrated and economic whole, which might bring actual benefits to its component parts from related operations and unified management. Instead, they have too frequently given us massive, over capitalized organizations of ever-increasing complexity and steadily diminishing coordination and efficiency.³¹

These and other passages in the legislative history show the manner in which Congress was attempting to protect investors and ratepayers by requiring an efficient and economic electric industry.

³⁰ *Id.* at 343.

³¹ *Report of the National Power Policy Committee on Public-Utility Holding Companies*, S. Doc. No. 137, 74th Cong., 1st Sess.

C. The Commission Has Historically Considered Efficiency and Other Economic Factors in Interpreting the Single Area or Region Requirement

The Commission has likewise historically emphasized the need to take the economics of the utility industry into account when interpreting the integration requirements of section 2(a)(29)(A), including the single area or region part of that requirement. Many of the Commission's orders, particularly the early ones, do not definitively discuss the single area or region requirement at all. These cases instead seem to assume that a system that is interconnected and coordinated and that can be operated efficiently must, as a matter of course, fall within a single area or region.³² A few cases do, however, consider the single area or region requirement separately. In those matters, the Commission's conclusion that a system is within a single area or region focuses less on what makes the specific region distinct in terms of geographic features than on why the underlying economics of the utility operations and the nature of the underlying market for electricity leads to the conclusion that the single area or region requirement is satisfied.

Consider, for example, the Commission's 1945 decision in *American Gas*. In that opinion, the Commission found that a system that stretched from Michigan to Ohio to Tennessee to Virginia and that covered approximately 90,000 square miles constituted a single integrated system. In reaching this result, the Commission distinguished between the various prongs of section 2(a)(29), but considered them together as a group:

The central system ... has a long historical record of having been planned, developed and operated as a highly coordinated system.... Moreover, it does not appear to be so large in any of the States in which it operates as to impair the effectiveness of regulation.... In the instant case, the relatively high degree of coordination of the system's utility facilities and their relatively economical operation ... have led us to conclude that the system, as

³² See, e.g., *Centerior Energy Corp.*, 49 S.E.C. 472, Holding Co. Act Release No. 24073 (April 29, 1986); *General Public Utilities Corporation*, 32 S.E.C. 807, Holding Co. Act Release No. 10982 (Dec. 28, 1951); *American Water Works and Electric Company Inc.*, 2 S.E.C. 972, Holding Co. Act Release No. 949 (Dec. 30, 1937).

presently constituted, constitutes a single integrated system within the meaning of Section 2(a)(29)(A) of the Act.³³

While this passage deals with all four of the integration requirements together, one of its component premises must be that because the system is operated economically, it is within a single area or region. The *American Gas* decision contains virtually no discussion at all about what geographic features of this region make it distinct unto itself, distinguish it from other geographic regions or demonstrate why it is a single region rather than multiple regions. Instead, the approach is essentially economic – the ability of the system to be operated as an efficient whole shows that it is in a single area or region. The system operates in such a way that it is in a single market for electricity, and hence the statutory requirement is satisfied.

This economic, market-oriented approach shows even more clearly in other Commission decisions from the same time period. For example, in its 1944 decision in *Middle West Corp.*,³⁴ the Commission did note the geographical homogeneity of an otherwise large geographical region and the region’s uniform reliance on “oil and other minerals, agriculture, and relatively light industry for its subsistence.”³⁵ However, the Commission ultimately came to its conclusion that the utility system in question was in a single area or region not as a direct result of those homogenous factors, but because of the way in which those factors determined the economics of building and operating an electric utility system:

The rendition of satisfactory service in arid and sparsely-settled areas frequently requires the stretching of lines over long distances to connect small population centers with generating facilities strategically placed near water and fuel supplies. In view of these facts, we believe that the properties in question lie within a single area or region.³⁶

³³ *American Gas* at 595-96. See also *American Gas & Electric Company*, 22 S.E.C. 808 (May 17, 1946).

³⁴ *Middle West Corp.*, 15 S.E.C. 309, Holding Co. Act Release No. 4846 (Jan. 24, 1944) (“Middle West”).

³⁵ *Id.* at 336.

³⁶ *Id.*

Thus, the Commission in *Middle West* is reaching a conclusion about the economics of a particular electricity market. Specifically, the Commission is effectively saying that the region is not a single area or region solely because it is sparsely populated but rather because the sparsely populated nature of the region gives rise to a particularly appropriate and efficient type of utility system – one that covers the entire region so that it can be centrally and efficiently planned. Once again, the Commission’s analysis of the single area or region requirement is rooted in the economics of the electricity industry, not just in an abstract analysis of the characteristics of the region in question.

These decisions make sense. As we have argued above, while each of the requirements in section 2(a)(29)(A) is distinct, those requirements nonetheless work together to ensure that the public-utility systems that are permissible under the Act are those that are efficient, can be centrally planned and operated and can be effectively regulated. Because those are the fundamental goals of the integration requirement, it is unsurprising that the Commission’s early approach to the single area or region requirement was rooted in how the electricity industry of that day operated. As the record evidence regarding the historical development of the industry shows, in the 1940s, the United States electric system was not a broad-based system, covering large parts of the country, but rather consisted of a number of distinct electric systems (and sometimes nothing more than distinct utilities) that operated for the most part independently of one another, each in a form relatively efficient for the area in which it operated. The Commission’s administration of the single area or region requirement served to ensure that a holding company could own only one of these distinct systems.

As the economics of the electric utility industry changed, the Commission’s fundamental approach to the single area or region requirement did not change. However, as a result of the

changing economics of the industry, the results of the application of this approach did change. A perfect example of this is how the Commission dealt with jointly-owned nuclear power plants in the 1960s.

Nuclear plants were highly expensive to construct. As a result, nuclear plants were often jointly constructed by a number of utilities. Although the plant would be in the service territory of a single utility, the Act required each registered system that held an interest in it to demonstrate that its ownership of its interest satisfied the statutory integration requirements of the Act, including the single area or region requirement.

In *Connecticut Yankee Atomic Power Co.*³⁷ and *Vermont Yankee Nuclear Power Corp.*,³⁸ the Commission concluded that these types of projects satisfied the integration requirements. For example, in *Connecticut Yankee*, the Commission stated that:

As noted, Conn. Yankee will function only as a generating and wholesale company selling power to its sponsors in the same proportion as they have stock ownership. The large size and proven design of the plant are expected to result in production costs which compare favorably with present production costs of conventional steam generation plants in the New England area. The sponsor companies are already interconnected and coordinated in their operations through the New England transmission grid.... *It further appears that in view of the existing state of the arts of generating and transmission and the demonstrated economic advantages of the proposed arrangement, each sponsor may be considered to operate in the same area or region as Conn. Yankee....*³⁹

Again, the Commission's reliance on economic factors rather than on geographic features or labels specific to the region was notable. The key facts in the Commission's analysis were the existence of a transmission grid and the ability of the sponsoring utilities to obtain and use

³⁷ 41 S.E.C. 705 (Nov. 15, 1963) ("Connecticut Yankee").

³⁸ 43 S.E.C. 693 (Feb. 6, 1968) ("Vermont Yankee").

³⁹ *Connecticut Yankee* at 710 (*emphasis added*). By the time it decided *Vermont Yankee*, the Commission barely considered the issue, doing little more than citing the language of section 2(a)(29)(A) in a footnote. See *Vermont Yankee* at 693 n.4.

efficiently the power generated by the jointly-owned nuclear generating plants. While geographic proximity undoubtedly played a role in permitting the Commission to find these facts, the Commission's approach significantly does not rely on proximity in the abstract, but rather proximity considered in the context of the underlying realities and economics of a relevant market for electricity. Here, application of the Commission's approach to different economics and different market structures – that is, the economics of ownership structures dictated by the expense of building nuclear power plants and the existence of a transmission grid – led to a result that, while factually different from the 1940s cases, is nonetheless based on the same legal principles and analysis.

The current case requires that the Commission take the same approach – that it determine, in light of the utility industry as it exists today, whether the AEP system is within a single region within which it can be operated economically and efficiently, or whether its operations are too scattered for this to occur. As described in the record documentary evidence and testimony, as technology has advanced and the nature of regulation has changed, the economics of the utility industry have also changed. These changes necessarily impact the results of the single area or region inquiry. But, the fundamental principles of the underlying analysis remain constant.

D. Alternatively, Revisiting the Single Area or Region Requirement to Interpret the Requirement Explicitly in Light of Efficiency and Other Economic Factors Would Be Appropriate and Good Policy

In the Remand Order, the Court of Appeals observed that the Commission can alter its analysis with regard to an integrated electric utility company as long as it states its intentions to do so and its reasons.⁴⁰ As the Division has shown above, the Combined AEP System is within a single area or region, a conclusion consistent with the evidence, established precedent, the statutory language and the statutory intent of the Act. Nonetheless, cognizant that the Commission may, alternatively, decide to adopt a new approach to the single region requirement than it has used in previous decisions, the Division respectfully submits the following recommendations in the event the Commission decides to revisit its single region precedent.

Although the facts in this case do not compel revisiting or revising precedent, to the extent that any prior cases may appear to allow a reductionist, semantics-oriented interpretation, the Division urges the Commission to clarify that traditional concepts of geography have not been and are not a stand-alone determining factor in deciding whether a system is within a single area or region and is “integrated” under the Act. The standard announced should clearly state that economic factors as well as any other significant evidence tending to further the purpose and goals of the Act are relevant and should be considered together and in combination with the relevant facts and circumstances in determining whether a system is within a single area or region and whether it is an integrated public-utility system. Such a standard would emphasize that

⁴⁰ Remand Order at 615 (“[A]n agency changing its course must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored,” citing *Greater Boston Tel. Corp. v. F.C.C.*, 444 F. 2d 841, 852 (D.C. Cir. 1970)).

the Commission has in the past and will continue to consider the four requirements for an integrated electric utility system in conjunction with each other and in light of the overall goals of the Act. The Commission should make clear that it is not and has never read “single” out of the single area or region requirement but rather has adopted in the past and intends to continue using a flexible approach in determining whether a system meets this criterion by examining each system on a case-by-case basis and the facts and circumstances relating to that system’s operation, including markets and geography, that bear on whether the system is in a single area or region – whether it is located in an area which can be economically and efficiently served by a single utility system.

V. Under a Proper Interpretation, the Combined AEP System Satisfies the Single Area or Region Requirement

Commission orders dealing with “integrated public-utility systems” demonstrate that the realities of the underlying transmission and marketing of electricity at the time the matter was decided play a critical role in the Commission’s analysis. The witnesses, as well as other evidence in the record, describe an electricity market today that is much different than the market when the Act was created and for much of the time since then.⁴¹ The testimony and evidence provide substantial and un rebutted evidence of the presence of various forces at work in the contemporary electricity industry, including Congress, the FERC, and the States, which have been and are promoting competition in the U.S. retail and wholesale electricity markets. Since

⁴¹ As noted earlier in the summary of facts, the electric industry has changed greatly since 1935. Then it was an industry made up of locally oriented, vertical utilities that provided generation, transmission and distribution of power in a given geographic area (service territory) under an exclusive franchise. Today the industry is interconnected throughout the country through three large Interconnections and has been shaped by restructuring, open access to utility transmission lines and the creation of RTOs, which bring all of the transmission lines within a region together for more efficient transmission.

the 1990s and the enactment of the Energy Policy Act, these forces have been transforming what was until then a monopolistic market.⁴²

AEP and CSW undertook the merger, in part, to position themselves for efficient participation in the emerging competitive market. For example, in AEP's original U-1 Application at 10-11, the company, noted, among other things, that the "Combined Company will operate more efficiently and be better equipped to keep rates low in an increasingly competitive electric utility industry." This evidence is clearly relevant to demonstrating that the combined system operates within a single region for the purchase, sale and transmission of electricity.

Specifically, the testimony and other evidence show that:

- AEP's public-utility system functions largely within a single wholesale electricity market, defined generally as a system in which "all of the generating resources and load commitments ... are situated in a common transmission infrastructure."⁴³

⁴² As noted by AEP:

Federal deregulation [of transmission and prices] and state restructuring [separating or "unbundling" generation from transmission and distribution] have materially altered [the traditional paradigm in the electric industry]. Today there is a vibrant market for electricity. A utility sells electricity not only to the customers located in its service area, but also to wholesale customers. (Amendment No. 5 to Form U-1 Application in File No. 70-9381 (restated and amended Form U-1 Application-Declaration ("AEP Amendment 5") at 76.

AEP/CSW further notes the relationship between generation resources and trading activities in the current industry:

Today, a utility creates value by selling as much electricity as it profitably can, after meeting the requirements of its native load. . . . if the price of electricity is such that a utility can sell electricity profitably, the trading group will direct that utility's generating units to generate electricity to full capacity. If, on the other hand, the price of electricity is so low that it is cheaper to purchase electricity to meet native load instead of incurring production costs, then the trading group will direct its generating units to curtail operations. *Id.* at 75

The Application noted that the maturation of power trading, together with information technology, would allow the combined company (and the industry as a whole) to respond quickly to the needs of the combined system and the marketplace. In other words, "*integration*" [*i.e.*, coordination of operations] would be accomplished through the surrounding markets as well as the specific interconnection between AEP and CSW. *Id.* at 71.

⁴³ AEP Exhibit 5 at 33.

- The Combined AEP System is directly interconnected with a number of surrounding systems – systems that are also interconnected with one another – in a way that creates one cohesive whole.⁴⁴
- The predominance of OATTs generally permits AEP, as well as other market participants, to transmit and trade electricity efficiently across the geographic area covered by the Combined AEP System.⁴⁵
- The development of RTOs and the establishment of practices and procedures that permit the seamless transmission of power across multiple RTOs similarly permit AEP, as well as other market participants, to transmit and trade electricity efficiently across the geographic area covered by the Combined AEP System.⁴⁶
- The growth in the number of other electricity market participants, including independent power producers and power marketers, as well as the development of trading hubs devoted to the purchase and sale of electricity has led to the development of electricity markets that are deeper, more liquid and more geographically expansive than those that existed prior to the 1990s.⁴⁷
- AEP is able to dispatch and transmit power from one part of its system to another and is able to do so on a daily, hourly and emergency basis from a central location. Moreover, AEP participates in a single electric market that overlays its system and permits it to purchase power as cheaply as possible wherever it is available and to transmit it to those parts of its system where it can be used most economically.⁴⁸
- A number of different homogenous and functional regions broadly overlay the Combined AEP System. For example, the natural gas pipeline system was built in such a way that the Combined AEP System falls within a single region for the marketing of natural gas. Similar showings can be made with respect to a number of additional indicia of regions, including other types of pipelines, waterways, trade flows, and transportation-oriented infrastructure systems.⁴⁹

Each of these facts demonstrates that the post-merger AEP system sits within a single market for the purchase, sale and transmission of electricity and that the existence of this market facilitates AEP's ability to operate its system as a single system. Moreover, the existence of this

⁴⁴ See, e.g., AEP Exhibit 5 at 37; AEP Exhibit 11.

⁴⁵ See, e.g., AEP Exhibit 5 at 25-26.

⁴⁶ See, e.g., AEP Exhibit 5 at 26-31, 35; AEP Amendment No. 5 at 36.

⁴⁷ See, e.g., AEP Exhibit 5 at 24-25, 33.

⁴⁸ See, e.g., AEP Exhibit 5 at 14, 32.

market, and the economic impact it has on the way in which AEP is able to operate the system, permits the Commission to find that the combined system is within a single area or region. In suggesting that the Commission should make this finding, we are not arguing that the Commission should abandon, expand or otherwise alter existing Commission precedent regarding the single area or region requirement. As noted above, the Commission has in the past determined the extent of a single area or region by looking at the existence of identifiable and efficiently operating electricity markets. In this context, the record evidence demonstrates that the scope and geographic extent of electricity markets has grown in recent years. It also shows more specifically that the Combined AEP System is within a single electricity market. Application of Commission precedent, therefore, dictates the conclusion that AEP system is within a single area or region.

Finally, as we have suggested above, we believe this result is consistent with other mergers involving large systems that were approved around the same time as the AEP decision. We believe that the Commission's original Order in this matter, as well as the orders in these other cases, was motivated by its understanding of the changing economics of the utility industry. As the Court of Appeals remand suggests, the Commission may have failed adequately to explain this result. The present case, therefore, presents the Commission with a clear opportunity to apply the single area or region requirement using the same principles that underlay its earlier decisions but in the context of a changed utility industry.

⁴⁹ See, e.g., AEP Exhibit 1.

VI. Conclusion

The Commission's goal in analyzing the Act's statutory single area or region requirement has been to ensure that a proposed system has the ability to operate as an efficient whole in its setting. In performing that analysis, the Commission has in the past looked to geographic data to illuminate the scope of the electric market efficiently served by the system. In some cases, this data may be helpful in informing the Commission's decision. However, the Division believes that geographic data has become less helpful in identifying markets efficiently served by electric utilities as a result of the technological advances and regulatory changes discussed above. By giving predominant importance to a so-called "geographic test," the Initial Decision effectively placed the analysis on its head, making the Act's statutory goals subordinate to conventional geographic labels.

The Combined System satisfies the single area or region requirement as that requirement is properly understood and analyzed. In addition, the Initial Decision properly concluded that the AEP system is interconnected or capable of interconnection – the only other requirement subject to the Court of Appeals Remand Order. Because the Commission has previously found that the Combined System satisfies all the other requirements applicable to it, the Commission should issue an order reaffirming its earlier approval of the Application.

Respectfully submitted,

David B. Smith, Jr.
Catherine A. Fisher
Martha Cathey Baker
Ronald E. Alper
Andrew P. Mosier, Jr.
Lore C. Steinhauser
Catherine P. Black
Arthur S. Lowry

Attorneys for
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-0503