UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	)	
	)	**Administrative Proceeding**
American Electric Power Company Inc.	)	**File No. 3-11616**

POST-HEARING BRIEF AND STATEMENT OF POSITION OF THE DIVISION OF INVESTMENT MANAGEMENT (CORRECTED)

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I. INTRODUCTION

On August 30, 2004, the Securities and Exchange Commission ("Commission") ordered this hearing[1] on a remand from the United States Court of Appeals for the District of Columbia[2] to supplement the existing administrative record concerning American Electric Power Company's ("AEP's") application under the Public Utility Holding Company Act of 1935 ("Act") to acquire Central and South West Corporation ("CSW"). The Commission's order directs that the hearing be held:

> 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….

This hearing occurs in the context of AEP's and CSW's ("Applicants'") joint application for an appropriate order from the Commission approving AEP's acquisition of CSW. The Commission initially issued an order approving the proposed transaction on June 14, 2000 ("Approval Order"),[3] and AEP subsequently acquired CSW on June 15, 2000.

The Commission's Approval Order dealt with numerous issues arising under the Act. Most notably, the Commission approved the consideration being paid for CSW,

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1 *Notice and Order for a Hearing*, Holding Company Act Release No. 27886 (Aug. 30, 2004) ("Hearing Order").

2 *National Rural Electric Cooperative Association v. SEC*, 276 F.3d 609 (D.C. Cir. 2002) ("*NRECA v. SEC")*

3 *Order Authorizing Acquisition of Registered Holding Company and Related Transactions*, Holding Co. Act Release No. 27186 (June 14, 2000).

determined that the merger would produce "economies and efficiencies," and found that the resulting utility system would be integrated according to the terms of section 2(a)(29)(A) of the Act. In reaching this final conclusion, the Commission determined that the Applicants' combined system satisfied each of the four requirements that make up the integration requirement: that the system's utility assets were "physically interconnected or capable of interconnection," that "under normal conditions, [the system] may be economically operated as a single interconnected and coordinated system," that the system was "confined in its operations to a single area or region," and that the system was "not so large as to impair … the advantages of localized management, efficient operation, and the effectiveness of regulation."

In its opinion, the D.C. Circuit held that the Commission had failed to explain adequately its conclusions that the combined system would be "physically interconnected or capable of interconnection" and that the system was within a "single area or region." Those two requirements are the subject of this hearing. In this context, the issues upon which this hearing is focused are remarkably narrow. All of the other findings that the Commission made in connection with the AEP/CSW merger – including findings that the AEP/CSW system is "not so large as to impair the advantages of localized management," that "under normal conditions [the AEP/CSW system] can be operated as a single coordinated system" and that the merger will create economies and efficiencies – were either not challenged in the D.C. Circuit proceeding or were affirmed by that court.

While the two requirements at issue clearly involve legal and interpretive issues, they are fundamentally factual in nature. The burden is on the Applicants – AEP and

CSW[4] – to demonstrate that, as a factual matter, their combined system meets these two requirements. In an attempt to accomplish this, AEP and CSW have introduced significant evidence into the record, both prior to the issuance of the Approval Order and as a part of this proceeding.

Up until this point, the Division of Investment Management has not stated a conclusion as to whether we believe that the Applicants have satisfied their burden.[5] We have now carefully reviewed the complete record in this matter. As we outline below, we believe that AEP and CSW have met their burden of proof. AEP and CSW have introduced substantial amounts of largely uncontroverted evidence that demonstrates, consistent with Commission precedent, that their combined system meets these two requirements. We, therefore, urge the Court to find that the combined system is "interconnected or capable of interconnection" and that it is within a "single area or region."

II. BACKGROUND OF THE ACT, THE INDUSTRY AND THE INTEGRATION REQUIREMENT

A. The Statutory Background

Before turning to the two specific statutory requirements that are at issue in this proceeding, it is helpful to place those requirements in the context of the Act itself and of the abuses that the Act is intended to address. The Public Utility Holding Company Act of 1935 was directed against certain financial and other abuses that had come to

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[4] The original applicants were AEP and CSW. Now, the combined entities are known as AEP. In this brief, they may be referred to as either "AEP" or "AEP and CSW."

[5] *Division of Investment Management's Statement of Position and Summary of the Case*, Administrative Proceeding 3-11616 (November 30, 2004).

characterize the U.S. gas and electric industry through the misuse of the holding company structure. One such abuse was the detriment to the national public interest and to investors and consumers "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."[6]

Section 11(b)(1), described in the Senate Report as the "very heart" of the Act, requires the Commission in pertinent part "to limit the operations of [a] holding company system" to "a single integrated public-utility system." Section 2(a)(29)(A) of the Act defines an electric integrated public-utility system to mean:

> 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 region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected)

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[6] Section 1(b)(4) of the Act . 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.

Report of the National Power Policy Committee on Public-Utility Holding Companies, S. Doc. No. 137, 74th Cong., 1st Sess. The Act was passed as companion legislation to the Federal Power Act ("FPA"). The FPA gave the Federal Power Commission (now the Federal Energy Regulatory Commission ("FERC")) jurisdiction over the sale of electricity at wholesale in interstate commerce and the transmission of electricity in interstate commerce.

the advantages of localized management, efficient operations, and the effectiveness of regulation.

Section 11 was the mechanism "to create conditions under which effective Federal and State regulation will be possible."[7] In section 11, Congress directed the Commission to reorganize the U.S. gas and electric industries according to the statutory integration requirements.

By 1952, the Commission reported that the task of bringing about compliance with section 11 "is rapidly nearing completion."[8] In a 1951 report to the Congress, the Commission stated that, "Perhaps the most dramatic achievement of Section 11(b)(1) is the elimination from the national scene of the giant utility holding company empires, stretching in some instances from coast to coast and from the Canadian border to the Gulf, to be replaced by functionally interconnected, integrated utility systems, operating in a single state or region."[9]

Congress did not eliminate the use of the holding company in the electric and gas industries. Instead, "Congress gave the Commission the additional responsibility, under sections 9 and 10, of 'supervision over the future development of utility-holding

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7 *S. Rep. No. 621*, 74th Cong., 1st Sess. 11 (1935) (Report of Senator Wheeler from the Committee on Interstate Commerce). Likewise, many of the provisions of the FPA were designed to supplement state jurisdiction and to ensure the effectiveness of state regulation. See *The Regulation of Public-Utility Holding Companies*, Division of Investment Management, United States Securities and Exchange Commission, June 1995 ("*1995 Report*") at 11-14.

8 Eighteenth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1952, at 82.

9 *Report for the SEC Subcommittee of the House Committee on Interstate and Foreign Commerce on the Public Utility Holding Company Act of 1935*, Securities and Exchange Commission, Oct. 15, 1951, at 14.

company systems.'"[10] 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 a requirement that utility acquisitions tend toward a single integrated public-utility system.[11]

The challenges of the post-reorganization period required the Commission to develop parameters for the future structure of the electric industry, particularly in light of the continuing evolution of the industry. The Commission's application of the statutory integration requirements generally recognized these changes. The Commission noted that holding companies hoping to expand their systems would have to do more than

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[10] *Southern Co.*, 50 SEC 1328, 1337 and n. 38 (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.

[11] *Southern Co.* at 1334 n. 22.

simply establish physical interconnections among their subsidiary companies, rather they would need to show that economies and efficiencies resulted from a combination. [12]

B. The Electric Utility Industry

When the Act was passed, local electric utilities were regulated, vertical monopolies. Usually, the state gave a utility a set territory (service territory) within which it had an exclusive franchise. In return, the utility was obligated to serve all the customers in that territory. A single company controlled electricity generation, transmission and distribution in the given geographical area.

Today, the industry is structured very differently. The North American system of electricity generation, transmission and distribution is physically and administratively subdivided into three large networks or "interconnections."[13] The Eastern Interconnection virtually covers the United States east of the Rocky Mountains, excluding the Texas Interconnection. The Texas or ERCOT Interconnection consists of the utilities in the region of the Electric Reliability Council of Texas, most of the state of Texas. The Western Interconnection includes the utilities in the western third of the United States. The three Interconnections are electrically independent from one another, except for a few small direct current (DC) ties that link them.

The contemporary electric industry has also been shaped significantly by a restructuring that began in earnest in the mid-1990s. FERC Order 888, issued in 1996, was the first step in an attempt by the FERC to eliminate the ability of individual

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[12] SEC Annual Report of 1951 at 92. Annual Report of the SEC to the United States Congress ("Annual Report of 1951").

[13] AEP Exhibit 2 (Prepared Direct Testimony of Paul B. Johnson) ("AEP Exhibit 2") at 6; AEP Exhibit 3 at 1.

transmission owners to control who used their systems and, instead, create a system of open-access.[14] The Energy Policy Act of 1992 created a new industry entrant, the exempt wholesale generator ("EWG"). EWGs are limited to the generation business and were intended to compete as merchant generators with traditional utilities, thus lowering costs to consumers. They are exempt from many of the regulations applicable to traditional utilities.[15] Other new industry entrants are power marketers (in some cases, affiliates of vertically integrated utilities; in other cases, entities without utility affiliates and without physical utility assets). The utilities themselves have been restructuring in many states according to state initiated programs. Frequently, these restructurings have resulted in the generation assets being separated from the distribution and transmission assets and placed in a separate corporation within the holding company system or sold to a third

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[14] *Id*. at 11. The FERC mandated open access transmission is described by the Commission in *CP&L Energy, Inc.*, 54 SEC 996 at 1012-13 (November 27, 2000), Holding Co. Act Release No. 27284, 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 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 expansive 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.

[15] *Id.* at 24.

party. In some jurisdictions, retail customers were given the opportunity to choose their electric suppliers. Those customers began to use the transmission system to access generation supplies outside of the franchised utility's control area to lower their energy costs.

Just as open access enables the new industry entrants (which were sometimes affiliates of vertically integrated utilities) to use the interconnected electric grid to pursue competitive opportunities, vertically integrated utilities began to use transmission networks for economic transactions within, between and among their own service territories.[16] These developments, which were well under way when the Commission approved the AEP/CSW merger and are reflected in the Approval Order, have greatly expanded the geographic scope of electricity interaction, institutions and markets, transforming the industry from one primarily focused on the provision of local utility service to one of expanding interstate markets and associated institutions.[17] As noted by AEP/CSW:

> 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.[18]

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

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[16] AEP Exhibit 2 at 23.

[17] *Id*.

[18] 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.

> 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.[19]

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 Applicants.[20]

III. PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Findings of Fact

1. Interconnection

1. The combined AEP-CSW system has been operated under unified control since 2000.[21]

2. The combined AEP-CSW system operates on a coordinated basis in a manner intended to serve its load, in general, with lowest-cost available power. Consistent with this goal, the combined AEP-CSW system transmits significant quantities of electric

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[19] *Id.* at 75.

[20] *Id.* at 71.

[21] AEP Exhibit 5 (Prepared Direct Testimony of J. Craig Baker) ("AEP Exhibit 5") at 20-21.

power between the components that previously formed the separate AEP and CSW systems (referred to as "AEP East" and "AEP West"). The majority of the power transfers take place from AEP East to AEP West, as AEP generally transfers less expensive coal-fired generation electric power to AEP West, which has a predominance of more-expensive gas-fired generation facilities. However, when economical to do so, AEP does transfer power from west to east. Testimony of J. Craig Baker ("Baker") at 101:3-102:7; 103:4-105:8; AEP Exhibit 5 at 15-17, Exhibit 6 and Exhibit 7.

3. Technological progress in the electrical industry, and in particular, the development of higher transmission voltages, has allowed electricity to be transmitted farther from its generation point than was possible or economical in the 1930s. Potential transmission voltage has increased with the construction of transmission lines able to handle increasing voltages: from the 1920s (132 kV lines) through the 1950s (345 kV lines) and the 1970s (765 kV transmission lines). As transmission voltage increases, the corresponding electrical impedance over distances decreases. In tandem with this increase in transmission voltages has been an increase in generation capacity. Long distance transmission of electricity regularly occurs over distances of many hundreds of miles, and, in some cases, over a thousand miles. AEP Exhibit 2 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.

4. AEP East has a substantial amount of high voltage transmission lines, including approximately 2,000 miles of 765 kV lines, and about 4,000 miles of 345 kV lines. AEP East also has larger power generation capacity than does AEP West. This infrastructure facilitates efficient transmission of AEP East power generation to satisfy

the AEP customer load in AEP West. Johnson at 54:15-55:10 and 61:12-25; Baker at 124:4-12; AEP Exhibit 5 at 15:8-10 and 16:21-23.

5. AEP has employed a contract with Ameren by which it may transmit electricity in both directions between AEP East and AEP West. This connection is known as the "Contract Path" or "Ameren Path." Under this contract, power transfers between AEP East and AEP West occur in two ways. First, AEP has, under the contract, secured a firm 250 megawatt transmission path for power from AEP East to AEP West. Secondly, AEP has, under the contract, secured certain non-firm rights to use the Contract Path to transfer power from AEP West to AEP East. Consequently, AEP has contract rights to use the Ameren transmission path in either direction, from east to west and west to east. The Ameren Path is approximately 250 miles long, running from AEP's service territory in Oklahoma to the city of St. Louis, Missouri. AEP Exhibit 5 at 9:11-17, 10:18-11:2, 11:3-12-12:20; AEP Exhibits 6, 7, 11; Baker at 95:8-96:23.

6. The Ameren Path has been in place since the merger of AEP with CSW. AEP has renewed the contract after the initial three-year period and intends to renew it again. Presently, AEP's Contract Path utilizes the Midwest ISO ("MISO"), which is a regional transmission organization ("RTO") in which Ameren is a member and which provides for a much broader transmission capability than the original Ameren path. Baker at 95:8-23; 102:8-16; 145:12-25

7. AEP also has contracts in place with other parties for non-firm transmissions that it can use to transfer power from AEP West to AEP East. Power is also transferred from AEP West to AEP East through these other parties' transmission paths by these non-firm contracts. All transfers from AEP West to AEP East occur via non-firm

contracts under the Open Access Transmission Tariffs ("OATTs") implemented by FERC Order No. 888, which requires intermediate utilities to offer both firm and non-firm point-to-point transmission service and transmission access to all eligible parties (including AEP). All transfers from AEP West to AEP East occur via non-firm contracts under the OATTs rules, as AEP does not have a firm contractual path for west to east power transfers. Power is capable of being transmitted rapidly between AEP East and AEP West as needed. AEP Exhibit 5 at 9:11-17, 11:3-12:4; 16:1-17:5; AEP Exhibit 6, 7, 8 and 11 at 1-2; Baker at 129:4-130:5.

8. Non-firm capacity for power transfers from AEP West to AEP East has been sufficient for AEP's needs and will be sufficient for AEP's needs through January 1, 2007. AEP Exhibit 5 at 17:6-13.

9. AEP also has the ability to contract with parties other than Ameren to transfer power in either direction by making contracts for firm or non-firm transmission. These transfers occur by transmitting the power through intermediate utilities, and this ability to contract for transmission rights and obtain transmission access has been assured to, and is open to, all eligible parties (including AEP) under OATTs implemented by FERC Order No. 888, which requires intermediate utilities to offer both firm and non-firm point-to-point transmission service and access. These other potential methods of interconnecting AEP East with AEP West have been enhanced by the development of RTOs. Although AEP has not used these connections due to cost considerations, these alternative paths are available to AEP in the event that the availability or economics of its Contract Path should change. AEP Exhibit 5 at 20:1-9; AEP Exhibit 8; Baker at 105:16-108:7.

2. Single Area or Region

11. The combined AEP-CSW system is located within a single wholesale power market. AEP Exhibit 5 at 33:1-10.

12. The combined AEP-CSW system is directly interconnected with and embedded in a system of interconnected operating and utility companies. AEP Exhibit 5 at 37:5-16; AEP Exhibit 11.

13. The OATTs regime, and the evolution of the electricity industry to include RTOs, has greatly expanded the practical scope of electricity transmission and the geographic scope of markets for electric power. AEP Exhibit 5 at 25:5-31:16 and 35: 9-16.

14. The combined AEP system, with the exception of those portions of the former CSW system located in Texas (Texas Central Company and most of AEP Texas North Company), is located within the larger Eastern Interconnection, a large-scale power grid that permits all the utilities in the eastern and mid-western United States to operate at the exact same frequency. AEP Exhibit 2 at 2:2-7:17; AEP Exhibit 3; AEP Exhibit 5 at 20:20-22:4.

15. Those portions of the former CSW system located in Texas are situated in the ERCOT (Texas) Interconnection. AEP Exhibit 2 at 6:7-12; AEP Exhibit 5 at 21:20-22:4.

16. The Commission has previously held that those portions of the former CSW system situated in ERCOT were interconnected and within a single area or region with the rest of CSW. *Central and South West Corp*., 47 SEC 754 (April 11, 1982), Holding Co. Act Release No. 22439 ("Central and South West").

17. In terms of homogenous regions, that is, regions demarcated on the basis of internal uniformity, the combined AEP system falls within a number of broad regions

defined in terms of manufacturing types. 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.

18. In terms of functional regions, that is, regions characterized by economic interdependence, the combined AEP system falls within a broader region as characterized by natural gas production, transportation and consumption, petroleum products transportation and consumption, and rail, waterway and highway transportation networks. 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.

19. Any findings of fact contained in the following Conclusions of Law are incorporated herein by this reference.

B. Conclusions of Law

1. In this proceeding, AEP was required to prove, by a preponderance of the evidence, that it is entitled to the order for which it applied. 5 U.S.C. § 556(d); *Steadman v. Securities and Exchange Commission*, 450 U.S. 91, 101-102 (1981).

2. The issues for determination in this hearing are: 1) "whether the AEP and CSW systems are interconnected, through a unidirectional contract path or otherwise;" and 2) whether the combined AEP-CSW system "operates in a single area or region." Hearing Order.

3. AEP has demonstrated by a preponderance of the evidence that the former AEP and CSW systems are capable of interconnection (and are in fact interconnected), through the firm-contract Ameren Path and otherwise, via non-firm contract transmission. The evidence submitted by AEP shows that the interconnection is bi-directional with large east to west transfers made possible, in part, by AEP's large scale electricity

generation and transmission capacity. West to east power transfers also occur on a regular basis in smaller amounts. The mechanisms for this transfer – firm contracts with a third party for east to west transfers through the Ameren Path and non-firm contracts with third parties through the Ameren Path and intermediate RTOs under OATTs – more than satisfy Commission precedent for interconnection. *See Exelon Corp.*, Holding Co. Act Release No. 27904 (October 28, 2004) ("Exelon 2004") (availability of open access transmission market structure alone sufficient for interconnection between utility properties located in Chicago and Philadelphia); *CP&L* (OATTs access sufficient to constitute interconnection between discontinguous utility properties located in North and South Carolina); *Conectiv, Inc.* Holding Co. Act Release No. 26832 (February 25, 1998) ("Conectiv") ("direct interconnection [is] not required in circumstances that would have resulted in an uneconomic duplication of transmission facilities"); *Unitil Corporation*, 50 SEC 961 (April 24, 1992), Holding Co. Act Release No. 25524 ("Unitil"). Moreover, the distance between the eastern and western zones for AEP – 250 miles – is smaller than the distances for other utility mergers that have been approved by the Commission. *See New Century Energies, Inc.*, 53 SEC 54 (August 1, 1997), Holding Co. Release No. 26748 ("New Century Energies")(approving merger where utility properties separated by 300 miles).

4. AEP has demonstrated by a preponderance of the evidence that the combined AEP-CSW system satisfies the "single area or region" requirement. The evidence adduced shows that AEP is an integrated whole that operates economically utilizing more than one power grid. The evidence also shows that AEP operates within (and participates in) a larger underlying market for electricity generation and transmission, a market that

has resulted from technological advances in power generation and transmission and from regulatory developments encouraging interdependence among adjacent systems, transparency in pricing for transmission of power, and reliability of the interconnected whole. *See Connecticut Yankee Atomic Power Co.*, 41 SEC 705, 710 (November 15, 1963), Holding Co. Act Release No. 14968 ("in view of the existing state of the arts of generating and transmission … each sponsor [within the New England transmission grid] may be considered to be in the same area or region as Conn. Yankee…."); *see also Vermont Yankee Nuclear Power Co.*, 43 S.E.C. 693 (February 6, 1968), Holding Co. Act Release No. 15958; *Middle West Corp.*, 15 SEC 309, 336 (January 24, 1944), Holding Co. Act Release No. 4846 ("Middle West") (looking at the nature of the underlying market for electricity). The fact that AEP also falls into a larger region when broadly defined by factors such as manufacturing and economic interdependence further supports the conclusion that the system is located within a single area or region.

5. Any conclusions of law contained in the above Findings of Facts are incorporated herein by this reference.

IV. THE COMBINED AEP/CSW SYSTEM IS INTERCONNECTED OR CAPABLE OF INTERCONNECTION

A. Introduction

The first of the two issues remanded to the Commission for reconsideration was the question of whether the Applicants' combined system satisfies the interconnection requirement. Section 2(a)(29)(A) requires that, as part of showing that a utility system is integrated, it be shown that it is "interconnected or capable of interconnection."

Interconnection, as the word itself clearly implies, is fundamentally about whether transmission capacity exists that will permit a holding company system to transmit power or cause power to be transmitted between various parts of its system. This ability is critical, for without it, low cost generation (or low cost power) that is available in one part of the system cannot be used in other areas of the system. In the ordinary merger case, the burden is on the applicant to show how its system will be operated following the merger. This is based on forward-looking opinions, estimates and studies and can be difficult to decide.

Because of the procedural posture of this case, however, this Court has an advantage in assessing the interconnection requirement since the AEP/CSW system has been operated under common control for the past four years. And, as the evidence in the record demonstrates, significant quantities of power are transmitted in multiple directions between various parts of the system in a way that permits load to be served with the lowest cost power available and in a way that makes the combined operation work in a coordinated way.[22] Because this could not be done if the system were not interconnected,

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[22] As described in the Approval Order (at 41-42), the System Integration Agreement requires both the East Zone (AEP East) and the West Zone (AEP West) of the Combined Company to have enough generating capacity to meet its firm load obligations. When one zone has surplus capacity available for sale and the other has insufficient capacity, the surplus zone will make its surplus capacity available. Applicants generally expected that the East Zone would have surplus capacity. If neither zone has surplus capacity after meeting its firm load obligations, or if third party capacity is cheaper than that available from the surplus zone, capacity will be purchased from third parties for the zone(s) with insufficient capacity. The System Integration Agreement also contemplates that economic energy will be transferred from one zone to the other to minimize the total production cost of the combined AEP System.

As explained in the Approval Order also (at 44-45), Applicants contemplated that, from time to time, there would be opportunity to transfer energy economically from the West

the mere fact that these transactions occurred is likely a sufficient basis upon which to determine that the various parts of the system are, in fact, interconnected in a way that permits power to flow in all directions.[23]

In this regard, it is helpful to consider the interconnection of the combined company in the context of Commission precedent regarding the interconnection requirement. The D.C. Circuit faulted what it perceived as the Commission's reliance on the existence of a unidirectional contract path as its sole basis for its finding of interconnection. However, as the evidence shows, although there is not a single bi-directional path upon which AEP can rely, it can rely on the availability of transmission to move power in all directions through its system. And, as we outline below, Commission precedent demonstrates that systems can be shown to be interconnected in a number of ways – not only through a firm contract path but also through a combination of firm paths, non-firm paths, and the existence of various market structures, such as power

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Zone to the East Zone. In these circumstances, Applicants would make use of their rights under their transmission service agreements with Western Resources and Ameren.

AEP Exhibit No. 6 lists by month, from July 2001 to October 2004, the megawatt hours shipped east to west over the Ameren Contract Path and west to east. Large east-to-west transfers were made every month. Smaller west-to-east transfers were made in 43 of the 51 months covered by the exhibit. AEP Exhibit No. 7 is a bar graph based on the same data. These actual transfers confirm the production cost simulation projections made prior to the merger, which indicated that power flows from west to east would constitute only a small fraction of the total power flows. AEP Exhibit 5. This evidence of actual transmissions of electricity on a regular and frequent basis both from east to west and west to east is uncontroverted. Further, Mr. Baker testified that there are transmission alternatives as a result of the RTOs (at 19) and that there are other alternatives that AEP has not pursued at this time for cost reasons (at 20 and AEP Exhibit 8).

[23] After all, as the D.C. Circuit itself indicated, without adequate interconnection between the noncontiguous operations of old AEP and old CSW, it is hard to "understand how a system restricted to a unidirectional flow of power from one half to the other can be operated in [a coordinated] manner."

pools and the product of regulatory change[24] that provide an available and predictable ability to transmit power throughout the system. As we argue below, the Applicants have submitted substantial and uncontroverted evidence into the record that demonstrates that this ability to transmit power throughout the combined system does exist. We, therefore, believe that the Court should find that the interconnection requirement is satisfied.

B. Commission Precedent Regarding the Interconnection Requirement

1. Direct Interconnection

The Commission's earliest decisions under the Act typically find interconnection to exist with respect to contiguous utility systems that were interconnected with one another through transmission lines or, in other cases, discrete but commonly-owned utility companies interconnected through a transmission line owned by one or both utilities. These cases represent a logical but very simple approach to the interconnection requirement. The Commission's earliest cases, as noted above, typically involved the dismantling of the far-flung properties of registered holding companies. In these cases, the Commission scrutinized the operations of utility companies, both individually and in combination with other utility companies, for compliance with section 2(a)(29)(A). For example, the Commission determined in cases involving a registered holding company, Engineers Public Service Company ("Engineers"), that a utility subsidiary operating in Virginia and North Carolina (Virginia Electric and Power Company) had an integrated

[24] In making their argument, we are not urging the Court to conclude that FERC Order 888 by itself demonstrates that the AEP system is interconnected. However, Order 888 has resulted in changes, whether specifically intended by the FERC or not, in how the transmission system operates. Those factual changes are relevant to the question of whether the AEP system is interconnected.

electric system whose operations were interconnected by its 5,130 pole miles of transmission lines and 80 miles of underground conduits.[25]

However, another subsidiary, Savannah Electric & Power Company, while also owning an integrated electric system, was not interconnected with Virginia Electric and Power Company; indeed, there was no operating relationship between the two companies.[26] As another example, the Commission determined that the properties contained in an electric system owned by another subsidiary, El Paso Electric Company, were entirely interconnected, with the exception of properties serving the two cities of Sierra Blanca and Van Horn, Texas. However, the properties located at Sierra Blanca were being interconnected with the main El Paso system, and so could be retained as part of that system.[27] Again, the Commission determined that many of the properties of Gulf States Utilities Company, another subsidiary of Engineers with operations in southwestern Louisiana and southeastern Texas constituted an integrated electric system

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[25] *Engineers Public Service Company*, 12 SEC 41, 61-62 (September 16, 1942), Holding Co. Act Release No. 3796 ("*1942 Engineers Public Service* "); *Engineers Public Service Company*, 9 SEC 764 (March 11, 1941), Holding Co. Act Release No. 2607 ("*1941 Engineers Public Service*").

[26] *1942 Engineers Public Service* at 67. Further, common ownership was not permissible under section 11(b)(1)(A)-(C). The ABC clauses create an exception to the general requirement that a holding company is confined to ownership of a single integrated system. Under these clauses, the Commission shall permit a registered holding company to retain an additional system if the additional system cannot be operated as an independent system without the loss of substantial economies, the additional system is located in one state or in adjoining states or in a contiguous country, and the combination of the systems under the control of a single holding company is not so large as to impair the advantages of localized management. Clause C, in particular, is an almost identical counterpart to section 2(a)(29)(A). See *North American Co.*, 11 S.E.C. 194, 214 (April 14, 1942), Holding Co. Act Release No. 3405 ("*North American*"), *aff'd*, 133 F.2d 148 (2d Cir. 1943), *aff'd on constitutional issues*, 327 U.S. 686 (1946).

[27] *1942 Engineers Public Service* at 85-86.

within the meaning of section 2(a)(29)(A).[28] However, because these two systems were not interconnected with each other, the Commission concluded that they could not be owned by a single holding company.[29]

2. Rights to Use Third Party Transmission

By the 1940s, the Commission was already beginning to recognize that two discrete but commonly-owned utility systems could be found to be interconnected when the utilities had the right to use a third party transmission line running between them. For example, in 1943, the Commission found that the Cheyenne Light Fuel & Power Company and the Public Service Company of Colorado were interconnected on the basis of their right to use a 30-mile transmission line between the two systems that was owned by the United States Bureau of Reclamation.[30]

This approach of identifying a particular line or lines characterized many other interconnection decisions during the next 40-odd years. In 1986, for example, the Commission's approach had begun to change. The Commission found that the Cleveland Electric Illuminating Company and the Toledo Edison Company were interconnected, in spite of the fact that their service territories were separated by 50 miles. Specifically, the Commission identified a particular line, owned by a third party that interconnected the

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28 *Id.* at 71-72.

29 *Id.* at 88.

30 *See Cities Service Power & Light Co*., 14 SEC 28 (August 17, 1943), Holding Co. Act Release No. 4489 at 53 and n. 44 ("*Cities Services*").

two non-contiguous utilities and based its decision upon the companies' rights to use that third-party transmission line that ran between the two systems.[31]

During the 1990s, the Commission continued to find that the interconnection requirement was satisfied based on the existence of a contract path. However, as the technology that underlay the country's transmission system became more sophisticated and larger amounts of power could be transmitted over longer distances, the Commission began to find that the combinations of more distant utility properties could satisfy the statutory standards in several ways.

For example, in 1997, the Commission approved the combination of Southwestern Public Service Company with Public Service Company of Colorado and Cheyenne Light, Fuel and Power Company.[32] Southwestern served southwestern Kansas, the Oklahoma Panhandle, the Panhandle and south plains of Texas and eastern and southeastern New Mexico. Public Service of Colorado served primarily the Denver and Front Range metropolitan areas. Cheyenne served Cheyenne, Wyoming. Southwestern and Public Service of Colorado were not contiguous and proposed to interconnect through a transmission line to be built within five years of the merger. In the meantime the companies stated that they intended to rely on a third party for interconnection.

At the time the Commission was considering the application, the actual routing of the proposed line had not been finally determined, but the parties estimated that a 300

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31 *See Centerior Energy Corp.*, 49 SEC 472 at 478-79 (April 29, 1986), Holding Co. Act Release No. 24073 at 7 ("*Centerior*").

32 *New Century Energies,* 53 SEC 54 (August 1, 1997), Holding Co. Act Release No. 26748.

mile, 345kV line from Amarillo, Texas, to southeastern Colorado would be required.[33] The proposed 300-mile line was also far longer than any previously relied upon by the Commission to support a finding of interconnection (and, indeed, was longer than the 250 mile line at issue in this matter).[34]

The case shows that the length of a contracted transmission line is not, in itself, determinative of whether the interconnection requirement is or can be satisfied.[35] It also shows that the Commission was receptive to alternatives to a contract that relied on changes in the organizational structure of the industry and on regulatory changes. While accepting these, the Commission continued to focus on the ability to transmit significant amounts of power economically and efficiently between the various parts of a utility system in order to satisfy the interconnection requirement.

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[33] *Id.* at 59. In addition to the significant length of the transmission line that would interconnect the two, arguably distant, utilities this case is also noteworthy for the fact that the 300-mile line was planned to cross from the eastern United States electrical grid to the western United States electrical grid. See n. 13. Spanning the two grids was an explicit condition of approval of the proposed merger by the FERC, which was attempting to facilitate trade between the two grids. *Id.* at 59-60 and n. 16.

[34] Until the time that the 300-mile line was built, Southwestern and Public Service of Colorado relied on the use of a transmission line owned by the Public Service Company of New Mexico to satisfy the interconnection requirement. *New Century* at 58 and n. 12. The two utilities, together with Public Service of New Mexico, were members of the Western Systems Power Pool and, as such, had rights to use the transmission assets under the pool agreement. According to the Commission, this agreement was amended and refiled, apparently before the Commission's order in that case was issued, to comport with the open access and nondiscriminatory requirements of Order No. 888, issued by FERC in 1996. *Id.* n. 12. While the Commission approved the combination of the utilities on a finding that they were capable of physical interconnection in light of the proposed 300-mile line, it was satisfied to allow third party contract rights and the provisions of Order No. 888 to carry power over approximately 300 miles in order to meet the interconnection requirements at least for a period of five years.

[35] *See also Electric Energy, Inc.*, 38 SEC 658 (November 28, 1958), Holding Co. Act Release No. 13871 ("*Electric Energy*").

3. Interconnection Through Market Structures and the Availability of Transmission

The Commission implicitly recognized in these cases that interconnection was less about having an actual property right to transmit electricity over a specific transmission path or whether obtained through a contract with a third party to transmit power between the two utilities over the third party's transmission lines, than about the predictable ability to move power between the various utilities.

In recent years, this recognition has led the Commission to focus on market structures, such as power pools and open access transmission tariffs, as a central part of its interconnection analysis. This approach may well find its origins in the 1986 decision regarding the Cleveland Electric Utility Company and the Toledo Edison Company. Although, as discussed above, the Commission focused on the two utilities' right to use a third party transmission line between their two systems, the Commission's opinion did note that the two utilities, the owner of the transmission line and three other utilities all belonged to the Central Area Power Coordination Group and that the two systems' right to use the third party transmission line did not arise through a direct agreement with the third party, but rather through their common membership in the group.[36]

In recent years, the Commission has begun to rely on these types of arrangements in appropriate cases. For example, in 1992, the Commission departed from its historical practice of identifying a particular transmission line and instead focused on a contractual right, arising out of membership in a group, to use a system of interconnecting

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[36] The Commission may have placed some reliance on the structure of the transmission systems owned by multiple companies as early as 1958; however, in that case, it appears to at least principally, be concerned with individual lines connecting the respective utilities. *See Electric Energy*.

transmission lines. Specifically, the Commission approved the combination of three closely related but non-contiguous electric distribution companies to form Unitil Corporation based on the fact that all three were members of a tight power pool.[37] Notably, the pool coordinated the operation of the power resources and transmission facilities owned by the participants in the pool, including centralized dispatch of the electric generation assets of the members and, thereby, economically operated as a coordinated system.[38] In concluding that the interconnection requirement was satisfied, the Commission noted that "[t]his matter differs from prior orders in that there will be no particular line through which transfers of power will be made among the Companies. Instead, power will be delivered through a nonaffiliated system and a transmission charge will be paid to the owner of the facilities."[39]

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[37] *Unitil* at 965-67, Holding Co. Act Release No. 25524 at 9-10 and 12. In this order, the Commission took the important step of enlarging the acceptable solutions for meeting the interconnection requirement. This order is also discussed because it is the second in the three cases identified by the D.C. Circuit Court in accepting the argument on contract rights and integration of distant utilities. In *Unitil*, the Commission cited to *Northeast Utilities*, 50 S.E.C. 427, Holding Company Act Release No. 25221 (December 21, 1990) ("Northeast Utilities"). *Northeast Utilities* is the earliest of the cases identified by the Court in accepting the argument that the Commission had an express policy that "contract rights cannot be relied upon to integrate two distant utilities." *See, NRECA v. SEC*. The Commission did state, at footnote 75 of the *Northeast Utilities* order, that " use of a third party cannot be relied upon to integrate two distant utilities" and cited the single area or region element of section 2(a)(29)(A). The Commission provided no rationale for the statement, including any explanation of what it intended by "distant," nor did the Commission cite to any previous application of the statement.

[38] *Id.* at 965-966.

[39] *Id.* at 966. As it sometimes had in the past, the Commission also stated it had "considered advances in technology and particular operating circumstances in applying the integration standards." *Id.* at 967 and n. 35.

Similarly, in 1998, the Commission again concluded that interconnection could be established on the basis of the availability of transmission rather than on the existence of a committed transmission path. Specifically, in approving the merger of Delmarva Power & Light Company and Atlantic Energy, Inc., the Commission was once again dealing with two non-contiguous utilities that were not directly interconnected.[40] In concluding that the combined system of these two utilities satisfied the interconnection requirement, the Commission explicitly relied upon the ability of Delmarva and Atlantic to obtain transmission between their respective systems as a result of their membership in PJM Interconnection, LLC,[41] but noted the central operating transmission and generation control center operated by Conectiv in Newark, Delaware.[42] In this context, the Commission declined to require Delmarva and Atlantic to build a line that would directly interconnect the two. While noting that it would be possible to construct such a line, the Commission accepted the assertion that it was unnecessary because the then present transmission arrangements provided adequate service.[43] The Commission observed importantly that "direct interconnection [is] not required in circumstances that would have resulted in an uneconomic duplication of transmission facilities."[44]

More recently, the Commission has recognized that the two utilities that comprise the utility system of the Exelon Corporation – Commonwealth Edison, which is located

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40 *Conectiv* at 5.

41 *Id.* at 4 and 13.

42 *Id.* at 13.

43 *Id.* at 12.

44 *Id.* at n. 27. (Citing, *Unitil*, citing *Electric Energy* at 669.)

in the Chicago area, and the Philadelphia Electric Company, which is located in the Philadelphia area – could satisfy the interconnection requirements based on the existence of underlying market structures and open access transmission requirements that make transmission available to them on a predictable basis.[45] In approving the merger of these two utilities in 2000, the Commission has initially noted the existence of a 100MW firm east to west path between the two utilities, in addition to open access transmission tariffs mandated by FERC by which power could move back and forth between the various parts of the Exelon system. By 2004, however, the Commission permitted the two utilities to abandon the contract path, and rely solely on the availability of transmission between the two systems.[46]

In the four years since the original order, Commonwealth Edison joined PJM and PJM otherwise expanded its area of control. The Commission noted that, in December 2002, the FERC had designated PJM as a RTO.[47] The Commission also noted that the AEP operating companies that were within the PJM footprint had recently joined PJM.[48] Based on these changes the Commission concluded that Exelon could abandon the contract path and rely on PJM, administering the open access transmission tariffs of its member utilities, to meet the interconnection and economic coordination requirements since PJM engaged in the economic and central dispatch of the generating resources

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45 *Exelon Corp.*, Holding Co. Act Release No. 27256 (October 19, 2000) ("Exelon").

46 *Exelon 2004*.

47 *Id.* at 2. Commission cites *PJM Interconnection, L.L.C.*, 101 FERC par. 61345 (2002).

48 *Id.* at n. 3.

within the PJM area and since PJM controlled the transmission systems of its member companies.[49]

The fourth case, CP&L Energy, Inc., involves the acquisition by CP&L of Florida Progress Corporation.[50] CP&L operated two non-contiguous electric systems: one located in North and South Carolina, principally around Raleigh and Wilmington ("Eastern Area"), and the other in Asheville, North Carolina ("Western Area"). The two were interconnected through the use of a firm contract path over the system owned by a non-affiliated, third party, Duke Power Company, until shortly before the filing of the merger application. Interconnection was also possible over lines owned by AEP. The Commission's order does not mention a firm contract, but rather notes that relatively large amounts of monthly firm and non-firm east-to-west transmission capacity were available over the AEP system.[51] CP&L did not renew the firm contract with Duke when it expired in June 1999 because, according to the Commission, "CP&L determined that the transmission requirements between the Eastern and Western Areas could be met under the open access tariffs ("OATTs") of Duke Power and/or AEP."[52]

In reaching this conclusion, the Commission observed that it had found interconnection in recent mergers largely on the basis of contractual arrangements with one or more third parties "although the companies also planned to achieve

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49 *Id.* at 3.

50 *See CP&L.*

51 *Id.* at 998.

52 *Id.* at 1012. Florida Progress operated in the central and northern parts of Florida. *Id.* at 999-1000. No parts of CP&L and Florida Progress were contiguous.

interconnection by utilizing non-firm shorter-term transmission."[53] The Commission concluded the "absence of this contract path, however, does not preclude a finding that the Eastern and Western Areas are physically interconnected, because CP&L can obtain adequate transmission service through open access under the OATTs of Duke Power and other transmission arrangements with Duke Power and AEP to establish physical interconnection of the two areas."[54] Based on open access transmission and additional interconnections with other third parties, the Commission ultimately found that the two portions of CP&L met the interconnection requirement.[55]

C. The Record in this Matter Demonstrates that the AEP System is Interconnected

The testimony of Mr. Johnson and of Mr. Baker on behalf of AEP establishes that the East and West portions of the AEP system are, in fact, interconnected under the meaning of section 2(a)(29)(A) of the Act.[56] The testimony of Mr. Casazza and Ms.

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53 *Id.* at 1012 and n. 19, *citing Energy East Corp.*, Holding Co. Act Release No. 27224 (August 31, 2000) and *Exelon*.

54 *Id* at 1012.

55 *Id.* at 1016.

56 The fundamental question in this proceeding is whether the old AEP system is interconnected with the old CSW system. Some parties in this matter may choose instead to argue that the combined system is not interconnected because the ERCOT portion of the former CSW system is not interconnected to the remainder of the system. This issue is simply irrelevant – the question of whether the CSW-owned ERCOT utilities are interconnected with the non-ERCOT parts of CSW was resolved by the Commission long before this matter. Specifically, the Commission addressed and concluded in *Central and South West Corp.* that the portions of the Central and South West Corporation within ERCOT and the portions outside ERCOT were interconnected and within a single area or region. With respect to interconnection, that order approved a FERC-approved settlement under which two asynchronous high-voltage direct current lines were installed between SPP and ERCOT, specifically, a 220 MW line owned by CSW and a 600 MW line of which CSW owns half. The Commission found that those lines interconnected

Hargis do not contest any of the facts underlying the conclusion that the two portions are interconnected. AEP's testimony satisfies the interconnection standard in several ways. First, it established actual physical interconnection as a result of the Contract Path. Mr. Baker testified that AEP had secured a firm, 250 MW path from east to west connecting the two portions of the AEP system.[57] That the Contract Path is used to transfer power between the east and west and vice-versa is established in Mr. Baker's testimony and through AEP Exhibit No. 6 and 7.[58] This portion of AEP's testimony and exhibits alone satisfy the interconnection standard under the guidance of the Commission's decisions relying on a distinct contract path as in the *Cities Service* and *New Century Energies* orders discussed above.[59]

The testimony goes beyond that, however. Mr. Baker also testified that the eastern and western portions of AEP's system are interconnected by transmission service contracts based on the OATTs required under FERC Order No. 888.[60] Mr. Johnson supported this testimony with his own, explaining that the Eastern Interconnect operates as a single, electrically interconnected entity[61] and that within the Eastern Interconnect

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CSW's ERCOT and non-ERCOT operating companies and permitted CSW to operate its system in a coordinated fashion.

57 AEP Exhibit No. 5 at 10, lines 21-24. *See also*, AEP Exhibit No. 11 and Baker at 86, line 8 – 87, line 23.

58 *Id.* at 16, line 14-21.

59 *See also, Electric Energy; Northeast Utilities*, Holding Co. Act Release No. 25221 (December 21, 1990); *WPL Holdings Inc*., Holding Co. Act Release No. 26856 (April 14, 1998).

60 AEP Exhibit No. 5 at 9, lines 13-15.

61 AEP Exhibit No. 2 at 6, lines 13-18; at 7, lines 6-8; at 19, line 13; at 20, line 2.

are several RTOs that provide independent operational oversight of the electric facilities, reliability assurance and facilitation of a competitive generation electric market.[62] Mr. Baker expanded on the explanation of RTOs, testifying that two such organizations have formed on both sides of the Contract Path, the Midwest Independent System Operator ("MISO") and the Southwest Power Pool ("SPP").[63] He further testified that these organizations offer transmission service over the combined transmission facilities of a number of utilities that are its transmission–owning members and thereby improves the usefulness of the Contract Path.[64] Finally, he testified that the PJM Interconnection L.L.C., a RTO, and the Midwest Operator had entered into a Joint Operating Agreement ("JOA"), approved by the FERC, that offered "a higher level of operational coordination and cooperation than had ever existed between or among RTOs, utilities or control areas."[65] He said also that the FERC has directed the SPP to enter into a JOA with MISO.[66] Under the guidance of the Commission's decision in the *Unitil* and *New Century Energies* cases discussed above, a right to use an unidentified transmission line or lines, which use was coordinated by a third party, satisfied the interconnection requirement.

In addition to the means provided above in the testimony of Mr. Baker for meeting the interconnection requirements, his testimony provides a third. Mr. Baker

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62 *Id.* at 15, lines 6-9.

63 AEP Exhibit No. 5 at 18, lines 6-8.

64 *Id.* at 18, lines 10-11 and 19, lines 4-13.

65 *Id.* at 30, lines 6-9.

66 *Id.* at 30, line 19 – p. 31, line 10.

testified that there are other potential means to interconnect the east and west portions of the system. He testified that there are alternative paths that AEP has not pursued because they were viewed as more expensive than the Contract Path but that they were available as backup.[67] This satisfies the interconnection requirement because, as the Commission has noted in several cases, the Act states at section 2(a)29(A) that the "companies are physically interconnected or *capable of physical interconnection*…."

These facts demonstrate that the combined AEP/CSW system is, in fact, interconnected in numerous ways. The Court should, therefore, find that the system satisfies the interconnection requirement.

V. THE COMBINED AEP/CSW SYSTEM IS WITHIN A SINGLE AREA OR REGION

A. Introduction

As we have noted above, showing that a public-utility system is integrated also requires a demonstration that it is "confined in its operations to a single area or region." Considered from the perspective of geography, there appears to be a simple, common sense answer to the question of whether the AEP system is in a single area or region. The AEP system extends from Virginia to Michigan to Texas. There is simply no way that those three states are in a single area or region. Hence, it seems "obvious" that the AEP system fails that test.

However, the determination of whether a utility system is in a single area or region is not, in reality, nearly that simple. The analysis must start from the statutory language: notably, section 2(a)(29)(A) does not refer to a "single geographic area or

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[67] *Id.* at 20, lines 4-9. *See also* AEP Exhibit No. 8.

region." Nor does it refer to a "single demographic area or region." It states only a "single area or region." Therefore, the question of whether a utility system operates in a single area or region cannot be answered merely by pointing to the physical distance between its parts, to the geologic features of the places in which its assets and customers are located, or, more broadly, our common sense and culturally-determined notions of what constitutes a distinct region. Instead, as evidenced by Commission precedent, a utility system must be evaluated in terms of the characteristics of the electric market in which it operates as well as in terms of the broader economic markets in which it is situated. And, as the Commission has demonstrated over and over since its initial administration of the Act in the 1930s, these factors do not delineate static "areas" or "regions" fixed in size or fixed in place for all time. Rather, the Commission has traditionally approached the "single area or region requirement" flexibly – as, indeed, it has approached each of the components of integration analysis – taking into account facts as they exist now, rather than as they existed years or decades ago.

As we argue below, we believe AEP has introduced facts into the record that demonstrate the AEP system operates in a single area or region. In particular, the evidence that has been introduced into this proceeding shows that the AEP system operates within a number of unified markets including, most notably, an economically unified market for electricity. Given this evidence, we believe that the Court can conclude that the AEP system is in a single area or region. Indeed, the Court need not stretch precedent to do so. The Commission has always interpreted this requirement in the context of changing technology, changing market structures and the changing nature

of the utility business.[68] Thus, in our view, a conclusion that AEP operates in a single area or region is not only appropriate but is firmly rooted in Commission precedent governing this issue.

B. The Commission's Historical Approach to the Single Area or Region Requirement

Evidence regarding geology, topography, demographics and economics has sometimes played a role in the Commission's approach to the single area or region requirement. More fundamentally, however, the orders demonstrate that the realities of the underlying market for electricity at the time the matter was decided play a critical role in the Commission's analysis.[69]

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[68] The Act clearly states that "the state of the art" should be considered in determining a single area or region. Section 2(a)29(A). Therefore, the Commission has taken a flexible approach in its interpretation of the phrase. *See, e.g.*, *Unitil*; *Yankee Atomic Electric Co.*, 36 SEC 552 (November 25, 1955), Holding Co. Act Release No. 13048.

[69] Our analysis below focuses primarily on Commission precedent. We note, however, that this approach is also consistent with the Act's legislative history. For example, at one point in the hearings on the Act, Congressman Sam Rayburn, one of the Act's primary proponents, was asked what he meant by the term "regional." He stated that:

> 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.

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 does not appear to be 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:

In spite of the Commission's early recognition that the integration requirement in section 2(a)(29)(A) consists of four separate requirements, many of the cases, particularly the early cases, do not definitively discuss the single area or region requirement at all. These cases instead seemingly assume that a system that is coordinated, interconnected and that can be operated efficiently must, as a matter of course, fall within a single area or region.[70] 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 than on why the underlying nature of the 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 & Electric Co*.[71] 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

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> 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.
> *Id*. at 343.

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.

[70] *See, e.g.*, *Centerior*; *General Public Utilities Corporation*, 32 SEC 807 (December 28, 1951), Holding Co. Act Release No. 10982 ("*General Public*"); *American Water Works and Electric Company Inc.*, 2 SEC 972 (December 30, 1937), Holding Co. Act Release No. 949 ("*American Water Works*").

[71] *American Gas & Electric Co.*, 21 SEC 575 (1945). Interestingly, this case dealt with the predecessor system of the pre-merger AEP system.

distinguished between the various prongs of section 2(a)(29), but considered them 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 presently constituted, constitutes a single integrated system within the meaning of Section 2(a)(29)(A) of the Act.[72]

While this passage deals with a number of the integration requirements, one of its fundamental premises is 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 features of this region make it distinct unto itself, distinguish it from other 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 is designed in such a way that it is a market for electricity, and hence the statutory requirement is satisfied.

This economic, market-based approach shows even more clearly in other Commission decisions from the same time period. For example, in its 1944 decision in *Middle West Corp.*,[73] 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."[74] Even in light of

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72 *Id.* at 595-96.

73 *Middle West*.

74 *Id.* at 336.

these factors, however, the Commission ultimately came to its conclusion that the utility system in question was in a single area or region by looking to the nature of the underlying market for electricity:

> 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.[75]

Here, the Commission 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 AEP's evidence regarding the historical development of the industry shows, in the 1940s, the

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[75] *Id.*

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 only own 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, a number of nuclear plants were 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.*[76] and *Vermont Yankee Nuclear Power Corp.*,[77] the Commission concluded that these types of projects satisfied the integration requirements. For example, in *Connecticut Yankee*, the Commission stated that:

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[76] *Connecticut Yankee*, 41 SEC 705 (November 15, 1963).

[77] *Vermont Yankee*, 43 SEC 693 (February 6, 1968).

> 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*….[78]

Again, the Commission's reliance on economic factors rather than on facts 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 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 again does not rely on proximity in the abstract, but rather proximity considered in the context of the underlying realities and economics of the 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.

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[78] *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.

C. Under Established Commission Precedent, the AEP/CSW System is in a Single Area or Region

The same approach that the Commission has historically applied should be applied to the AEP/CSW system. In applying that approach, there is no need to specifically examine and attempt to interpret the various FERC orders that attempt generally to reshape the U.S. electricity industry – and, specifically, the bulk transmission segment of that industry and industry pricing mechanisms. Rather, the central question should focus on what is actually happening in the underlying electricity market in which AEP operates.

The Applicants presented significant evidence, almost wholly unrefuted by the other parties in this matter, that is relevant to this determination. Notably, the Applicants presented evidence which shows that:

- The Applicants' public-utility system functions largely within a single wholesale electricity market, defined generally in terms of a utility infrastructure in which "all of the generating resources and load commitments … are situated in a common transmission infrastructure."[79]

- The AEP and CSW systems are directly interconnected with a number of surrounding systems – systems that are also interconnected with one another – in a way that creates one cohesive whole.[80]

- The predominance of OATTs generally permits the Applicants, as well as other market participants, to transmit and trade electricity efficiently across the geographic area covered by the Applicants' public-utility system.[81]

- The development of RTOs and the establishment of practices and procedures that permit the seamless transmission of power across multiple RTOs similarly

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79 AEP Exhibit 5 at 33.

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

81 *See, e.g.*, AEP Exhibit 5 at 25-26

permits the Applicants, as well as other market participants, to transmit and trade electricity efficiently across the geographic area covered by the Applicants' public-utility system.[82]

- The growth in the number of independent power producers 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.[83]

- The Applicants generally are able to transmit power from one part of their utility system to another. Moreover, the Applicants participate in a single electric market that overlays their system and permits them 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.[84]

Each of these facts tends to demonstrate 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 the Applicants' ability to operate their system as a single system.

Moreover, the existence of this market, and the economic impact it has on the way in which the Applicants are able to operate their system, permits the Commission to find that the combined system is within a single area or region. In suggesting that the Court can (and therefore should) make this finding, we are not arguing that the Court 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 Applicants' evidence does demonstrate that the scope and geographic extent of electricity markets has grown in

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

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

84 *See, e.g.*, AEP Exhibit 5 at 14, 32.

recent years. It also shows more specifically that the Applicants' public-utility system is within a single electricity market. Application of Commission precedent, therefore, dictates the conclusion that Applicants' system is within a single area or region.

Nothing in the other parties' evidence or in the cross-examination of the Applicants' witnesses seriously undercuts these conclusions. Public Citizens' evidence appears focused on two goals: an attempt to demonstrate that the FERC's current approach to regulating the electric utility industry is misguided and an attempt to demonstrate that the Commission has improperly administered a wide variety of provisions of the Act.

None of those issues, however, are relevant to the question of whether the Applicants' public-utility system is in a single area or region. Whether the FERC's approach to regulating electric utilities has been or is likely to be effective or good public policy – or indeed any discussion at all of what FERC policy is or seeks to accomplish – has nothing to do with the essentially factual question of whether the Applicants' system is within a single market for electricity and hence whether it can be found to be in a single area or region. Similarly, Public Citizen's attack on the Commission's overall administration of the Act in recent years similarly has nothing to do with the scope and nature of the area or region in which the AEP/CSW system is situated. Rather, these lines of argument have the potential of doing little more than confusing the issue by putting irrelevant facts and arguments before the Court.

The cross-examination conducted by APPA/NRECA likewise did little to undercut the credibility of the factual evidence that the Applicants have submitted in this matter. Indeed, to the extent that their cross-examination sought to undermine the

Applicants' case, it did so not by seeking to question the factual accuracy of the evidence, but rather by attempting to show that seemingly absurd legal results could be drawn from the evidence. However, seeking answers to legal questions from witnesses who offer factual evidence does nothing to undermine the credibility of the testimony and, thus, is irrelevant to the factual question of the scope of the area or region in which the Applicants' utility operate.

Finally, Dr. Harrison's testimony, underscores the conclusion that Applicants' system is within a single area or region. In particular, Dr. Harrison's testimony describes a number of homogenous and functional regions that broadly overlay the Applicants' system. For example, Dr. Harrison's testimony shows that, as a result of the manner in which the natural gas pipeline system was built, the Applicants' public-utility system is within a single natural gas market.[85] His testimony makes similar showings with respect to a number of additional indicia of regions, including other types of pipelines, waterways, trade flows, and transportation-oriented infrastructure systems. Moreover, many aspects of the functional region in which he places the merged system (for example, natural gas is used by some of the system's generating plants and some of the infrastructure he describes is used to move the raw materials needed to generate electricity).

VI. CONCLUSION

As discussed above, based on the evidence in the record and the Commission's well established precedent, it is the staff's position that AEP has met the

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[85] *See, e.g.*, AEP Exhibit 1 at 8-14.

"interconnection" and "single area or region" requirements. Accordingly, this Court should enter an order holding that the AEP and CSW systems satisfy the requirements of sections 10(c)(1) and 11(b)(1) of the Act, and, thereby, permitting the Commission to reaffirm its earlier approval of AEP's and CSW's joint application seeking authority for AEP's acquisition of CSW.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that on February 15, 2005, I caused true and correct copies of the foregoing document, captioned Post-Hearing Brief And Statement Of Position Of The Division of Investment Management, to be sent by Federal Express, overnight delivery, to counsel at the addresses indicated below.

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