Federal Energy Regulatory Commission

FERC

Annual Report **2006**

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2006

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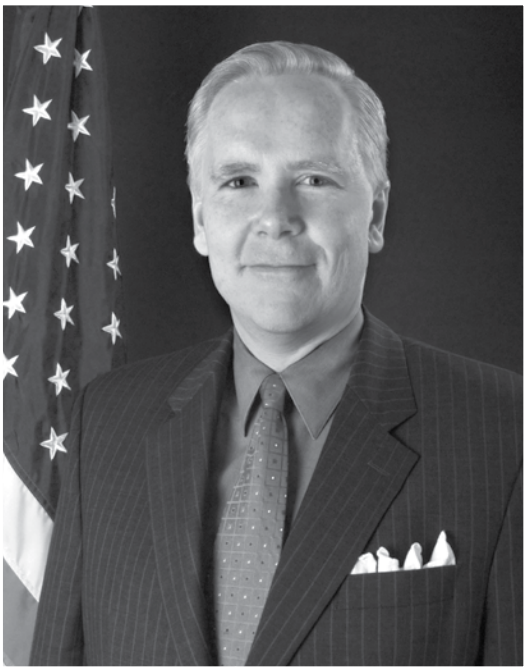
Chairman's Message



To the Senate and House of Representatives:

I am pleased to submit to the Congress the Federal Energy Regulatory Commission's annual report, covering the fiscal year from October 1, 2005, through September 30, 2006. For fiscal year 2006, Congress appropriated $220,400,000 to support Commission activities. Under the authority of the Omnibus Budget Reconciliation Act of 1986 and other laws, the Commission recovers all of its costs from regulated industries through fees and annual charges. Revenues generated from these sources completely offset congressional appropriations and results in a net cost of zero dollars to the treasury. Thus, the users and beneficiaries of the Commission's services pay its operating costs—not the general taxpayers.

This is the 86th Annual Report issued by the Commission and its predecessor, the Federal Power Commission. The report demonstrates that the Commission's overall duties remain the same: guarding electric and gas consumers from market power abuse, and promoting development of a robust energy infrastructure. Those have been the same duties that have guided the Commission since 1935 and 1938, when the Federal Power Act and Natural Gas Act were enacted.

On August 8, 2005, the Energy Policy Act of 2005 (EPAct 2005) was enacted. EPAct 2005 marked the most significant increase in Commission regulatory authority in 70 years. Among the most important of these tools is new authority to establish rules to prevent manipulation of electric and gas markets, with significant new penalty authority. These new regulatory tools also include authority to establish and enforce electric reliability standards and discretionary authority to provide greater price transparency in electric and gas markets.

In FY 2006, the Commission worked diligently and met all of the deadlines set by Congress. During the first year since EPAct 2005 was signed into law, the Commission promulgated nine final rules, issued three additional notices of proposed rulemaking, authored and submitted seven reports to Congress, and entered into a memorandum of understanding with the Commodity Futures Trading Commission. With these new duties in place, we now have more authority to prevent unjust and unreasonable rates in wholesale power sales, to prevent undue discrimination or preference in wholesale power sales and transmission service, and to encourage the development of a stronger energy infrastructure.

Sincerely,

Joseph T. Kelliher
Chairman

FERC

Mission

Regulate and oversee energy industries in the economic, environmental, and safety interests of the American public.

Guiding Principles that Strengthen the Commission's Overall Performance

To fulfill its Mission, the Federal Energy Regulatory Commission commits to…

Organizational Excellence

Use resources efficiently and effectively to achieve strategic priorities

Due Process and Transparency

Complete regulatory proceedings in an open and fair manner, consistent with established regulations

Regulatory Certainty

Provide regulatory certainty through consistent Commission approaches and actions

Stakeholder Involvement

Ensure that interested parties are informed and provided an appropriate opportunity to participate in Commission proceedings

Timeliness

Act on regulatory matters in an expeditious manner

Vision

Abundant, reliable energy in a fair competitive market.

Goal 1: Energy Infrastructure

Promote the Development of a Strong Energy Infrastructure

Objective A: Stimulate Appropriate Infrastructure Development

- Resolve regulatory and other challenges to needed development
- Encourage investment and effect timely cost recovery

Objective B: Maintain a Reliable and Safe Infrastructure

- Assure reliability of interstate transmission grid
- Protect safety at LNG and hydropower facilities
- Incorporate environmental considerations into Commission decisions

Goal 2: Competitive Markets

Support Competitive Markets

Objective A: Develop Rules that Encourage Fair and Efficient Competitive Markets

- Employ best practices in market rules
- Reduce barriers to trade between markets and among regions

Objective B: Prevent Accumulation and Exercise of Market Power

- Assure proposed mergers and acquisitions are in the public interest
- Address market power in jurisdictional wholesale markets

Goal 3: Enforcement

Prevent Market Manipulation

Objective A: Provide Vigilant Oversight

- Identify and remedy problems with structure and operations in energy markets

Objective B: Provide Firm but Fair Enforcement

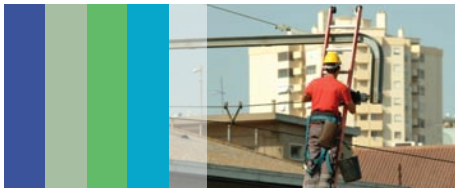
- Establish clear and fair processes
- Conduct investigations promptly and impose penalties where appropriate
- Encourage self-policing and/or self-reporting of violations

Acronyms and Abbreviations

ATC	Available Transmission Capability
Bcf	Billion cubic feet
CAISO	California Independent System Operator Inc.
CFTC	Commodity Futures Trading Commission
Commission	Federal Energy Regulatory Commission
DOE	U.S. Department of Energy
Dth	dekatherm
EA	Environmental Assessment
EIS	Environmental Impact Statement
Entergy	Entergy Services Inc.
EPAct 2005	Energy Policy Act of 2005
EQR	Electric Quarterly Report
ERO	Electric Reliability Organization
FERC	Federal Energy Regulatory Commission
FPA	Federal Power Act
FPC	Federal Power Commission
ILP	Integrated Licensing Process
ISO	Independent Transmission System Operator

kV	kilovolt
LG&E	Louisville Gas & Electric Company
LNG	Liquefied Natural Gas
MAPP	Mid-Continent Area Power Pool
Midwest ISO	Midwest Independent Transmission System Operator Inc.
MMC	Market Monitoring Center
MOU	Memorandum of Understanding
MW	megawatts
NAESB	North American Energy Standards Board
NERC	North American Electric Reliability Corp.
NEPA	National Environmental Policy Act of 1969
NGA	Natural Gas Act
NGPA	Natural Gas Policy Act of 1978
NRC	Nuclear Regulatory Commission
OASIS	Open Access Same Time Information System
OATT	Open Access Transmission Tariff
PJM	PJM Interconnection
PUHCA 1935	Public Utility Holding Company Act of 1935
PUHCA 2005	Public Utility Holding Company Act of 2005
PURPA	Public Utility Regulatory Policies Act of 1978
RPM	reliability pricing model
RTO	regional transmission organization
SPP	Southwest Power Pool Inc.

Section 1



Management's Discussion and Analysis

Commission Overview

The Federal Energy Regulatory Commission (hereafter "FERC" or the "Commission") is an independent agency that regulates the electric, natural gas and oil pipeline industries. FERC also reviews proposals to build liquefied natural gas (LNG) terminals, certificates interstate natural gas pipelines and licenses hydroelectric power projects. The Energy Policy Act of 2005 (EPAct 2005) gave FERC additional responsibilities. The Commission:

- Regulates the transmission and sale of natural gas for resale in interstate commerce;
- Regulates the transportation services of interstate oil pipelines;
- Regulates the transmission and wholesale sales of electricity in interstate commerce;
- Reviews mergers, acquisitions, asset sales and certain security transactions in the electric industry;
- Licenses and inspects private, municipal and state hydroelectric projects;
- Approves the siting of and abandonment of interstate natural gas facilities, including pipelines, storage facilities and liquefied natural gas facilities;
- Approves the siting of electric transmission facilities in national interest electric transmission corridors if certain conditions are met;
- Oversees the establishment and enforcement of reliability standards for the bulk power transmission system;
- Monitors wholesale energy markets and investigates violations of Commission orders, rules, and regulations;
- Enforces compliance with FERC rules, through audits, the use of civil penalties, and other means;
- Oversees environmental matters related to natural gas and hydroelectric projects;
- Administers accounting and financial reporting regulations and conduct of regulated companies; and
- Assures the safety of licensed hydroelectric projects and liquefied natural gas facilities.

The combination of the Commission's vision, mission, organizational structure, resources, and goals, as described in this section, will help achieve its regulatory responsibilities, including those added by EPAct 2005.

Regulatory Authority

The Commission is an independent regulatory agency within the U.S. Department of Energy (DOE) that oversees major aspects of the Nation's electric, natural gas, hydroelectric and oil pipeline industries.

The Commission was created through the Department of Energy Organization Act on October 1, 1977. At that time, the Federal Power Commission (FPC), the Commission's predecessor established in 1920, was abolished, and the Commission inherited most of the FPC's regulatory mission.

The Commission has five members who are appointed by the President of the United States, with the advice and consent of the Senate, to five-year staggered terms. Each Commissioner has an equal vote on regulatory matters and no more than three Commissioners may belong to the same political party. One member is designated by the President to serve as Chair and is the Commission's administrative head.

Hydropower regulation, the oldest area of the Commission's jurisdiction, began with the FPC's regulation of non-federal hydroelectric generation in 1920, and includes authorizing the construction of projects in interstate commerce and overseeing their operation and safety.

Since 1935, the Commission regulated certain electric industry activities under the Federal Power Act (FPA). Under FPA sections 205 and 206, the Commission ensures that the rates, terms and conditions of sales for resale of electric energy and transmission service in interstate commerce by public utilities are just, reasonable, and not unduly discriminatory or preferential. Under FPA section 203, as amended by EPAct 2005, the Commission reviews mergers and certain corporate transactions involving public utilities and public utility holding companies. Under FPA sections 203, 205 and 206 the Commission primarily regulates investor-owned utilities. Government-owned utilities (e.g., Tennessee Valley Authority, federal power marketing agencies, and municipal utilities) and most cooperatively owned utilities are not, in large part, subject to Commission regulation (with certain exceptions).

Regulation of retail sales and local distribution of electricity are matters left to the states. In addition, the Commission has no role in authorizing the construction of new generation facilities (other than non-federal hydroelectric facilities), as regulation of such construction is the responsibility of state and local governments. EPAct 2005 authorized the Commission to permit the construction or modification of transmission facilities in national interest electric transmission corridors designated by the Secretary of Energy, if certain conditions are met.

A major new area of Commission regulation as a result of EPAct 2005 is oversight of the Electric Reliability Organization (ERO). This organization will develop and enforce mandatory reliability standards for the Nation's bulk power system, subject to Commission approval. On July 20, 2006, the Commission conditionally certified the North American Electric Reliability Corp. (NERC) as the ERO. All owners, users and operators of the bulk power system will be subject to mandatory reliability standards approved by the Commission.

The Commission's role in regulating the natural gas industry is largely defined by the Natural Gas Act (NGA). Under sections 3 and 7 of the NGA, the Commission regulates the construction of new on-shore liquefied natural gas (LNG) import terminals and natural gas pipelines and related facilities. Under sections 4 and 5 of the NGA, FERC oversees the rates, terms and conditions of sales for resale and transportation of natural gas in interstate commerce. The Commission's jurisdiction over wholesale sales of natural gas, however, is limited

by the Natural Gas Policy Act of 1978 (NGPA) and the Wellhead Decontrol Act of 1989.

Pipeline siting and construction is authorized by the Commission if found required by public convenience and necessity. As with hydropower licensing, the Commission's actions on LNG and pipeline projects typically require consideration of factors under the National Environmental Policy Act of 1969 (NEPA), the Endangered Species Act, the Coastal Zone Management Act and other statutes. Regulation of the production and gathering of natural gas, as well as retail sales and local distribution of natural gas, are matters left to the states.

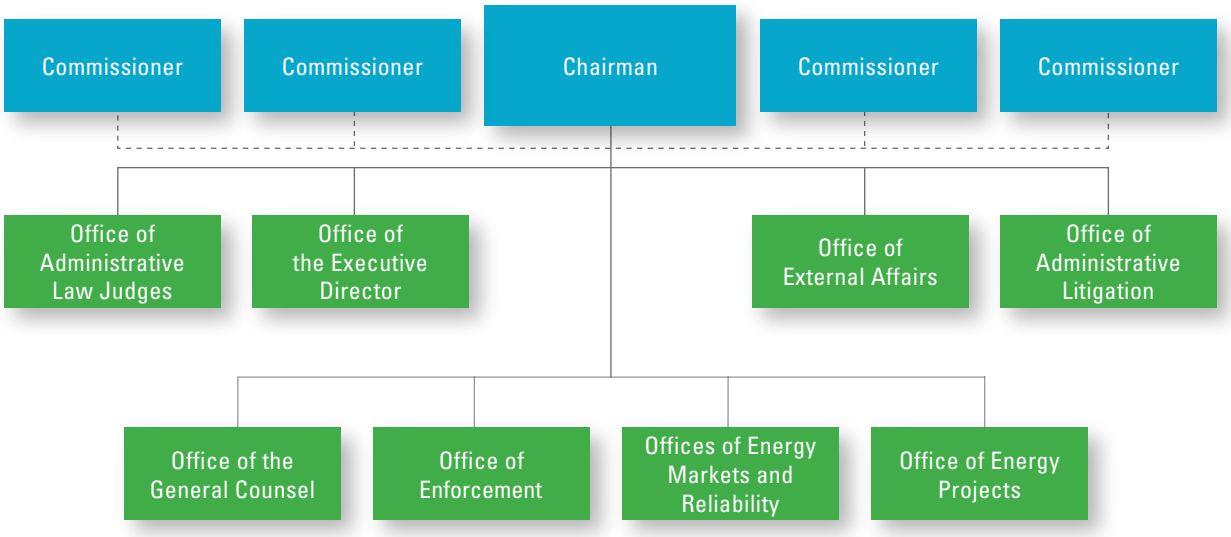
Finally, the Interstate Commerce Act gives the Commission jurisdiction over the rates, terms and conditions of transportation services provided by interstate oil pipelines. The Commission has no authority over the construction of new oil pipelines, or over other aspects of the industry such as production, refining, or wholesale or retail sales of oil.

Organizational Structure and Resources

The Commission is an independent regulatory agency within DOE that oversees the Nation's electric, natural gas, hydroelectric, and oil pipeline industries. It is comprised of a bi-partisan, five-member Commission, headed by the Chairman and four Commissioners who are appointed by the President and confirmed by the Senate. The Chairman serves as the chief executive officer. In FY 2006, FERC was organized by eight functional offices (see table). The Commission's headquarters are in Washington, D.C., and it has five regional offices throughout the country.

In FY 2006, Congress appropriated $220,400,000 to support Commission activities. As of September 30, 2006, the Commission employed 1,337 staff, including 1,306 permanent staff and 31 temporary staff.

Federal Energy Regulatory Commission



Offices/Organizations	Descriptions
Office of Administrative Law Judges	Resolves contested cases as directed by the Commission effectively, efficiently and expeditiously, either through impartial hearing and decision or through negotiated settlement, ensuring that the rights of all parties are preserved.
Office of Administrative Litigation	Represents the public interest and seeks to litigate or settle cases set for hearing in a timely, efficient and equitable manner while ensuring the outcomes are consistent with Commission policy.
Office of External Affairs	Handles all external communications with the public, press, Congress, and the states for the Commission.
Office of the Executive Director	Provides administrative support services to the Commission including human resources, procurement, information technology, organizational management, financial, logistics and others.
Office of Energy Projects	Strengthens our energy infrastructure through the approval and oversight of hydroelectric and natural gas energy projects that are in the public interest and assures the safety of hydroelectric and LNG facilities.
Office of the General Counsel	Provides legal services to the Commission. OGC represents the Commission before the courts and Congress, and is responsible for the legal phases of the Commission's activities.
Office of Enforcement	Ensures effective regulation and protection of consumers by monitoring the operation of energy markets, identifying and remedying market problems in a timely manner, and enforcing Commission orders, rules, and regulation.
Office of Energy Markets and Reliability	Establishes and maintains rules for fair and competitive wholesale energy markets and prevents the exercise of market power and undue discrimination and preference. This includes establishing the rates, terms and conditions for open access to electric transmission and gas transportation facilities in interstate commerce. In addition, the office oversees the development and enforcement of reliability standards for the Nation's bulk electric power system.

Guiding Principles that Strengthen the Commission's Overall Performance

Five principles guide the Commission as it exercises its jurisdiction under its governing statutes. Whether the Commission is adjudicating a rate filing, ruling on a permit application, or developing a new policy, it strives to meet these criteria as a means of ensuring that each of its actions is consistent with the public interest.

- ***Organizational Excellence.*** Above all, the Commission strives to use its resources efficiently and effectively to achieve its strategic priorities. This includes its human resources. The Commission performs targeted recruiting and hiring and has developed a markets-oriented training curriculum for entry-level as well as experienced staff. The Commission also makes efficient use of its information technology to receive filings, produce reports and orders, and maintain data repositories. The Commission tracks the activities of its staff to ensure that they are directed at meeting the Commission's strategic goals and objectives.
- ***Due Process and Transparency.*** Paramount in all proceedings is the Commission's determination to be open and fair to all participants.

All significant initial filings submitted to the Commission are announced by public notice published in the *Federal Register*. Material issues of fact are litigated in public hearings governed by due-process rules. Finally, many of the Commission's major decisions are discussed and announced at open meetings that are webcast at no charge on its website.

- ***Regulatory Certainty.*** In each of the thousands of orders, opinions and reports issued by the Commission each year, the Commission strives to provide regulatory certainty through consistent approaches and actions. Without an assurance that the Commission's policies will be internally consistent and applied reliably, investors may be unwilling to bear the risks associated with investing in critical energy infrastructure. Where it is appropriate, the Commission provides generic direction to industry participants in the form of guidance orders, policy statements or rulemakings to avoid uncertainty. The Commission also has adopted market-power rules designed to prevent the exercise of market-power and market abuse, to provide a more stable marketplace and to create an environment that will attract needed investment capital.
- ***Stakeholder Involvement.*** The Commission conducts outreach on a regular basis to ensure that interested parties have an appropriate opportunity to contribute to the performance of the Commission's responsibilities. The Commission also organizes technical conferences and workshops designed to explain and explore issues related to the development and implementation of its policies. Throughout FY 2006, the Commission met with state and federal regulators, industry officials and the public to discuss electric market and reliability issues. For example, the outreach resulted in collaboration on issues concerning security constrained economic dispatch, demand response and advanced metering, reliability, electronic tariff and rate-case filing, proposed cost allocation policies in the markets of Midwest Independent Transmission System Operator, Inc., PUHCA 2005 reporting requirements, Open Access Transmission Tariff (OATT) reform and market transparency issues. The outreach further informed the Commission on the effects of railroad delivery matters on reliability in electric markets and explored opportunities for coordination with the Nuclear Regulatory Commission (NRC). The Commission also held regional conferences to identify infrastructure conditions, needs and investment, as well as environmental and landowner concerns. Finally, in processing hydropower and gas-related permit applications, the Commission conducts extensive collaborative pre-filing processes, during which input is received from a multitude of stakeholders, including citizen groups, environmental organizations, tribal interests, and local, state and federal resource agencies. The Commission has proposed to use the same pre-filing process for resolution of transmission siting applications.
- ***Timeliness.*** The Commission's goal is to reach an appropriate resolution of each proceeding in an expeditious manner. The Commission has steadily decreased the time it takes to act on projects, such as LNG import terminals, gas storage facilities, and interstate natural gas pipelines. It has done so without compromising environmental protection and public participation responsibilities. The Commission sets and tracks compliance for timely resolution of filings for cost recovery, new services or changes to existing services, as well as on opinions resolving initial decisions, complaints and FPA section 203 applications.

Section 2

Goal 1: Energy Infrastructure: Serving the Nation's Needs

A strong energy infrastructure is critical to the health of the U.S. economy. Competitive and reliable energy markets also require a strong infrastructure. A strong infrastructure helps make competitive markets work by:

- improving reliability;
- improving customer access to low-cost resources; and
- allowing customers to choose between multiple supply sources.

The Commission has an important role in the development of a strong energy infrastructure that operates effectively and reliably. The Commission authorizes development of LNG facilities, certificates natural gas pipeline, natural gas and storage projects, and can issue permits for electric transmission facilities in certain instances, as well as license hydropower projects. FERC directly affects the reliability of the interstate bulk power transmission grid through approval and enforcement of reliability standards. In addition, the Commission provides opportunity for the recovery of infrastructure costs, including pipelines, by which nearly two-thirds of the energy consumed by the United States is transported and regulated by the Commission.

Effective Commission regulation can help ensure the development of a strong energy infrastructure. Commission rules on pricing and operations influence the level of infrastructure investment. They affect the amount and efficiency of infrastructure siting and the smoothness of the decisional process.

Objective A: Stimulate Appropriate Infrastructure Development

The Commission's timely identification and resolution of regulatory and other challenges stimulate appropriate infrastructure development. As mentioned above, the Commission is responsible for authorizing LNG facilities, certificating interstate natural gas pipelines and storage projects, permitting electric transmission facilities in interstate commerce (under certain circumstances) and licensing non-federal hydropower projects. Throughout all of these application processes, the Commission's goal is to reduce the time it takes to act on projects without compromising environmental protection and public participation responsibilities. The Commission also promotes, and sometimes requires, the use of the pre-filing process, which involves completing a substantial portion of the environmental review and identifying significant non-environmental issues prior to the filing of an application. The pre-filing process addresses issues early in the application process and involves stakeholders from the beginning. This process has been validated by Congress in the EPAct 2005, and the Commission continues to pursue this method as a way to stimulate infrastructure development.

The Commission promotes infrastructure development by applying pricing policies encouraging investment, and establishing and consistently applying policies that permit timely cost recovery. The Commission's rate policies, consistently applied to infrastructure projects, give investors confidence that they have an opportunity to recover their investments. Without such assurances, investors will face greater risks, jurisdictional facilities will face difficulty when obtaining financing and fewer energy projects will be constructed than the Nation needs. That in turn will undermine the provision of adequate and reliable energy service.

The Commission promotes rate designs that support competitive wholesale markets for electric power and natural gas and gives companies incentives to build and efficiently operate key new projects. The Commission has undertaken measures to provide timely cost recovery for infrastructure investors and reasonable rates and greater rate certainty for customers. Wholesale electric utility customers and gas and oil pipeline ratepayers need reasonable assurance: (1) of the transportation costs they can expect to face, (2) that these costs will be fair, and (3) that they will continue to have nondiscriminatory access to transportation services.

The Commission works to ensure that terms and conditions of service provide reliable open access service for all customers.

Long-Term Transmission Rights

In July 2006, the Commission finalized guidelines for regional transmission organizations (RTOs) operating organized electric markets to develop proposals providing long-term firm transmission rights. These guidelines will increase long-term transmission price certainty in the organized electricity markets and encourage new investments and other long-term power supply arrangements. Specifically, these guidelines provide increased certainty about the congestion cost risks of long-term service in organized electricity markets, and assist load-serving entities and other market participants in supporting new investments and other long-term power supply arrangements.

LNG Facilities

LNG is key to offsetting declining domestic natural gas production and reducing energy price volatility during peak demand periods. The demand for natural gas in the United States has been exceeding domestic supply for most of the decade. In fact, natural gas usage is increasing while United States production is falling. LNG is considered a supplemental supply source to offset near-term demand for natural gas. LNG is economically viable at today's market price. In October 2005, the Commission took an important step to facilitate the development of LNG facilities by adopting a final rule requiring potential developers of new LNG terminals to initiate pre-filing procedures at least six months prior to filing a formal application with the Commission. The rule also encourages prospective applicants to cooperate and coordinate with state and local government officials to address safety and security considerations.

In FY 2006, following a thorough safety review, the Commission authorized with conditions the construction and operation of the following three new LNG import terminals:

- Creole Trail LNG to site, construct and operate a new LNG import terminal in Cameron Parish, Louisiana. The terminal would include four LNG storage tanks that would have the capability to store up to 13 billion cubic feet

(Bcf) of natural gas and have a send-out capability of an average of 3.3 Bcf per day;

- Port Arthur LNG to site, construct and operate a new terminal and related facilities near Port Arthur, Texas. The facilities include six LNG storage tanks with a nominal capacity of 3.3 Bcf each. The project would ultimately provide an average of 3 Bcf per day to existing interstate pipeline systems in Texas and Louisiana, connecting to markets in the Midwest and Northeast; and
- Crown Landing LLC to construct and operate a new onshore LNG import terminal in Logan Township, New Jersey. The proposed terminal would store up to the LNG equivalent of 9.2 Bcf of gas, vaporize LNG and send it out through a connecting pipeline at a base load rate of 1.2 Bcf per day.

In FY 2006, the Commission also conditionally authorized several expansions, including the following three major expansions at previously authorized LNG facilities:

- Sabine Pass LNG project, which was authorized in December 2004 to be constructed and operated in Cameron Parish, Louisiana. The expansion included three additional 3.3 Bcf storage tanks and related facilities that would provide an average send-out capacity ranging from 2.6 Bcf per day to 4 Bcf per day;
- Cove Point LNG import facility near Lusby, Calvert County, Maryland. The Commission authorized the company to expand its LNG terminal facilities by adding two new storage tanks, each capable of storing 3.3 Bcf along with other related facilities. The expansion will enable it to increase the send-out capability by 0.8 Bcf per day and increase storage capacity by approximately 6.8 Bcf per day; and
- Freeport LNG import terminal which is under construction on Quintana Island, Brazoria County, Texas. The approved facilities constitute Phase II of the original Freeport LNG Project which was authorized on June 18, 2004. The expansion will increase the terminal's send-out capacity from 1.5 Bcf per day to 4.0 Bcf per day.

Natural Gas Pipelines

To meet the growing demand for natural gas, the Commission must continue to respond quickly when companies propose to expand and construct needed pipelines and related facilities. In October 2005, the Commission held a technical conference on issues related to the development of natural gas pipeline infrastructure. The discussions included changes in the industry that affect infrastructure development, regulatory impediments, financial risks involved, and suggestions for regulatory improvements.

In FY 2006, the Commission took several steps to expedite the certification of natural gas pipelines. For example, Commission staff actively participated in over 30 projects that were using the pre-filing process to engage stakeholders in the identification and resolution of stakeholder concerns prior to the filing of a certificate application with the Commission. The staff's participation and initiative in these efforts will allow for the filing of better certificate applications, enabling more efficient and expeditious licensing actions by the Commission.

In August 2006, the Commission issued a newly updated brochure, *An Interstate Natural Gas Facility on My Land; What Do I Need to Know?* This brochure assists the public in understanding the natural gas pipeline pre-filing, application and construction processes, as well as citizens' rights and responsibilities.

In FY 2006, the Commission took the following four industry-wide actions to facilitate the expansion and construction of needed pipelines and related facilities:

- In May 2006, the Commission issued proposed rules to implement EPAct 2005 provisions that granted the Commission authority to coordinate the processing of

interstate natural gas infrastructure proposals among federal and state authorities and to maintain a consolidated record of decisions for judicial review;

- In June 2006, the Commission adopted a policy statement on natural gas quality and interchangeability that delineates five principles the Commission will use as it continues to address disputes over gas quality and interchangeability on a case-by-case basis. This policy statement should provide guidance for the timely resolution of disputes over gas quality and interchangeability;
- In June 2006, the Commission proposed to extend blanket certificate authority to interstate natural gas facilities previously ineligible for such consideration. The Commission also proposed raising project cost limits for a self-implementing project to $9.6 million and for a prior-notice project to $27.4 million; and
- In August 2006, the Commission revised its rules to better monitor and assess the physical state of the interstate natural gas pipeline grid and gas storage infrastructure when service is disrupted due to damage caused by a hurricane, other natural disasters or acts of terrorism.

Overall in FY 2006, the Commission approved 772 miles of new natural gas pipelines in the United States. Specifically, the Commission authorized the following major natural gas pipeline projects:

- In December 2005, the Commission authorized ANR Pipeline Co. to construct and operate various pipeline and compression facilities in Wisconsin as part of its Wisconsin 2006 Expansion Project. The proposed facilities, together with an agreement with Great Lakes Transmission Co. will enable ANR to ensure delivery of an additional 168,241 dekatherms (Dth) per day of natural gas to meet increased demand by local distribution companies and other customers in Wisconsin;
- In March 2006, the Commission authorized Midwestern Gas Transmission Co. to construct and operate approximately 30 miles of pipeline and related facilities, known as the Eastern Extension Project, in Sumner and Trousdale Counties, Tennessee to transport 120,000 Dth per day of natural gas to Piedmont Natural Gas;
- In May 2006, the Commission issued a certificate to Transcontinental Gas Pipe Line Corp. to construct and operate its Leidy to Long Island Expansion Project. The Long Island Expansion Project is an expansion of Transco's existing pipeline system, under which Transco will provide 100,000 Dth per day of incremental firm transportation service to KeySpan Gas East Corp;
- In June 2006, the Commission conditionally authorized the construction and operation of approximately 177 miles of 24-inch and 30-inch diameter pipe, 31,050 horsepower of compression, and appurtenant facilities as part of Southern Natural Gas Co.'s proposed Cypress Pipeline; and
- In September 2006, the Commission authorized Questar Overthrust Pipeline Co. to construct 27.1 miles of 36-inch diameter pipeline in Wyoming from its interconnect with Wyoming Interstate Co.'s system to an interconnection with Kern River Gas Transmission Co.'s system.

Natural Gas Storage Projects

The Commission is committed to the timely review of natural gas storage filings to support the need for additional storage capacity. The damage and disruption to energy infrastructure caused by hurricanes in the Gulf Coast region in 2005, underscored the price ramifications of insufficient supply. Underground natural gas storage can be used to balance a variable market with a nearly constant supply of natural gas provided by the pipeline system. Storage fields are the warehouses

that give a ready supply of natural gas that can serve a market with high peak demands in warm or cold weather. In FY 2006, the Commission continued to issue certificates to projects in order to increase the storage capacity in the United States. Specifically the Commission issued certificates to the following major storage projects:

- In December 2005, the Commission authorized the construction and operation of the Liberty Gas Storage Project, a salt dome natural gas storage facility, and other associated pipeline facilities, in Calcasieu and Beauregard Parishes, Louisiana. Upon completion, the storage facility will be capable of delivering natural gas at the rate of approximately 1.0 Bcf per day, and receiving injection gas at a rate of approximately 0.5 Bcf per day;
- In May 2006, the Commission authorized Unocal Windy Hill Gas Storage to construct and operate a salt bed natural gas storage facility near the City of Brush, Morgan County, Colorado. Maximum withdrawal capability will initially be 0.2 Bcf per day upon completion of the first two caverns in Phase 1, and will then increase to 0.4 Bcf per day after completion of Phase 2; and
- In July 2006, the Commission authorized Bobcat Storage to construct and operate a new salt dome natural gas storage facility and related pipelines, a compression station and other facilities in St. Landry Parish, La., near the town of Port Barre. Upon completion, the storage facility will be capable of delivering natural gas at the rate of approximately 1.2 Bcf per day, and receiving injection gas at a rate of approximately 0.9 Bcf per day.

Natural Gas Storage Pricing

In June 2006, the Commission issued a final rule intended to mitigate natural gas price volatility by encouraging the development of new natural gas storage capacity. The rule provides further incentives for the development of new natural gas storage capacity and ensures access to storage services at just and reasonable rates, while at the same time ensuring that adequate storage capacity will be available to meet anticipated market demand. The rule set up two ways for developers of natural gas storage facilities to seek authorization to charge market-based rates. The first approach includes a broadened definition of the relevant product market for storage. The second approach implements EPAct 2005 provisions which would allow an applicant to request authority to charge market-based rates even if a lack of market power has not been demonstrated, under certain circumstances where market-based rates are in the public interest and necessary to encourage the construction of storage capacity in the area needing storage service, and customers are adequately protected.

The rule allows storage service providers to apply for market-based rates by filing appropriate supporting data when they submit a certificate application, or as part of a request for rate authorization under section 311 of the NGPA, or in a request for a declaratory order for authority to charge market-based rates. The Commission also established a process to ensure that reasonable terms and conditions are in place to protect customers.

Hydropower Projects

Hydropower remains an important component of the Nation's energy portfolio and supports efficient, competitive electric markets by providing low-cost energy reserves and ancillary services. In December 2005, the Commission held a workshop to focus on several pending license applications filed at the Commission. The goals of the workshop were to: (1) review and discuss the pending license applications; (2) identify unresolved issues; (3) determine next steps; (4) agree on who will take the next steps; and (5) focus on solutions. The workshop concentrated on identifying the unresolved issues associated with each project, and determining the best course of action to resolve or remove obstacles to final action on each pending license application.

In FY 2006, the Commission authorized 287.7 megawatts (MW) of additional capacity at existing licensed hydropower projects. The Commission also granted an increasingly large number of preliminary permits authorizing feasibility studies for 2,900 MW of capacity for new projects, including Tidal Energy Projects.

Tidal Energy involves the harnessing of tidal movements using new technology to generate electricity without the construction of a dam or water retaining device at the mouth of rivers, bays,

or other natural channels. The new technology can generate electricity with the incoming tide and the outgoing tide. These new technologies may or may not be anchored to the river/channel bottom with cables or shafts and the tidal water can flow through them unimpeded to generate power. In FY 2006, the Commission issued three preliminary permits for sites in California, Washington, and New York to study the feasibility of harnessing ocean waves, tidal or current energy potential.

The purpose of a preliminary permit is to maintain priority of application for a license for three years while the permit holder conducts investigations and secures data necessary to determine the feasibility of a new project and prepares an application to develop it.

During FY 2006, the Commission acted on a total of 29 hydropower applications, which included a total of 20 applications to relicense, five original license applications and three, 5 MW exemption applications. These applications represented an installed capacity of over 51 MW. The Commission also initiated the processing of nine proposals to relicense, four of which have an installed capacity in excess of 100 MW. Meanwhile, the Commission reduced the average processing time for hydropower relicensing by 4.3 percent.

Several new hydropower projects were licensed or issued 5 MW exemptions, contributing to an increase in overcall capacity. Specifically the following actions took place in FY 2006:

- In February 2006, the Commission issued an original license to SAF Hydroelectric LLC for the construction and operation of the 8.98 MW Lower St. Anthony Falls Project. The project would be located at the existing U.S. Army Corps of Engineers' Lower St. Anthony Lock and Dam on the Mississippi River, in the city of Minneapolis, Hennepin County, Minnesota;
- In July 2006, the Commission issued an original license to Birch Power Company for the construction and operation of the 5 MW Lower Turnbull Drop Project. The project would be located on the Spring Valley Canal in Teton County, Montana; and
- In July 2006, the Commission issued an original license to Wade Jacobsen for the construction and operation of the 1.05 MW Mill Coulee Drops Hydroelectric Project. The project would be located on the Mill Coulee Canal in Cascade County, Montana.

The Commission also issued the following new licenses:

- In December 2005, the Commission issued a new license to the Portland General Electric Co. and Blue Heron Paper Co. for continued operation of the Willamette Falls Project, a 16.68 MW project located on the Willamette

River near the cities of West Linn and Oregon City, Oregon;

- In January 2006, the Commission issued a new license to the New York State Electric & Gas Corp. to continue operation and maintenance of the 40.26 MW Saranac River Hydroelectric Project located on the Saranac River in Clinton County, New York;
- In May 2006, the Commission issued a new license to Southern California Edison Co. to continue operation and maintenance of the Borel Hydroelectric Project, a 12 MW project located on the North Fork of the Kern River and the main stem of the Kern River in Kern County, California;
- In June 2006, the Commission issued a new license to Alabama Electric Cooperative Inc. to continue operation and maintenance of the Conecuh River Project, an 8.25 MW project located on the Conecuh River, in Covington County, Alabama;
- In August 2006, the Commission issued a new license to the Grand River Dam Authority to continue operation and maintenance of the 108 MW Markham Ferry Hydroelectric Project located on the Grand River in Mayes County, Oklahoma; and
- In August 2006, the Commission issued a new license to Central Maine Power Co. for the continued operation and maintenance of the existing 31.54 MW Gulf Island-Deer Rips Hydroelectric Project located on the Androscoggin River in Androscoggin County, Maine.

Headwater Benefits

The additional electric generation that results at a downstream project from regulation of the flow of the river by an upstream headwater project is referred to as headwater benefits. These benefits are usually attributable to increasing or decreasing the release of water from a storage reservoir. Pursuant to section 10(f) of the FPA, in FY 2006 the Commission assessed $8,357,000 in headwater benefits in 22 river basins covering 103 hydroelectric projects for energy benefits provided by federal headwater storage facilities. Headwater benefit assessments are returned to the U.S. Treasury to offset headwater project construction costs.

Integrated Licensing Process

In an effort to increase the efficiency of the licensing process, which involves a multitude of stakeholders, including citizen groups, environmental organizations, tribal interests, and local, state and federal resource agencies, the Commission developed the Integrated Licensing Process (ILP). The ILP's ultimate goal is to establish an efficient, predictable and timely licensing process that develops a record sufficient for the Commission to take final action.

In FY 2006, the number of hydropower projects using the ILP doubled from eight to 17. The Commission expanded the use of the ILP which, among other things, merges prefiling consultation with the development of the environmental analysis document under NEPA. Throughout FY 2006, the Commission undertook numerous outreach efforts to educate the industry, resource agencies, tribes, nongovernmental organizations, citizen groups and other stakeholder groups on the ILP. Staff made presentations and led discussions on the ILP at several national hydropower meetings. In addition, regional conferences and intensive project-specific meetings with multiple stakeholder groups were held to educate participants on the ILP. Specifically, the Commission took the following steps in FY 2006 to improve the ILP:

- In February 2006, the Commission prepared a document on ideas for implementing and participating in the ILP, which provided tools for industries, agencies, tribes, non-governmental organizations and citizens; and
- In February 2006, the Commission evaluated the effectiveness of the ILP by summarizing comments from interviews, teleconferences, and regional outreach meetings.

Electric Transmission Pricing Reform

EPAct 2005 directed the Commission to develop incentive-based rate treatments for transmission of electric energy in interstate commerce and added a new section 219 to the FPA. In response, the Commission issued a pricing reform rule in July 2006. With it, the Commission seeks to bolster investment in the Nation's transmission infrastructure, and to promote electric power reliability and lower costs for consumers by reducing transmission congestion. The rule identified specific incentives the Commission would allow based on a case-by-case analysis of individual transmission proposals. The rule does not grant utilities all of the incentives the Commission listed, but rather allows utilities on a case-by-case basis to select and justify the package of incentives needed to support new investment. Additionally, the rule provides expedited procedures for the approval of incentives to provide utilities regulatory certainty and facilitate the financing of projects.

At the same time, the Commission conditionally approved rate incentives for the following two projects:

- American Electric Power Corp.'s 765-kilovolt (kV), 550-mile proposed transmission line that would extend from West Virginia to New Jersey; and
- Allegheny Energy Inc.'s proposed 500-kV transmission line, which would extend from southwestern Pennsylvania to Virginia.

Transmission Upgrade Cost Allocation

With the need for more transmission, in some areas significantly more, the Commission faces the issue of who will pay for needed electric transmission expansion and upgrades. In FY 2006, the Commission reviewed proposed cost allocation plans to ensure they result in rates that are just and reasonable, not unduly discriminatory or preferential. For example, the Commission took the following actions in FY 2006:

- In January 2006, the Commission accepted Southwest Power Pool Inc.'s (SPP) compliance filing, which modified provisions of SPP's OATT relating to allocation of costs of new and/or upgraded transmission facilities and, in particular, provisions regarding credits to be paid to customers to whom such costs were originally allocated;
- In February 2006, the Commission conditionally accepted the Midwest ISO's transmission expansion cost allocation policy that will allocate and recover costs associated with new transmission projects and system upgrades within the Midwest ISO Transmission System;
- In April 2006, the Commission convened a technical conference to discuss the Midwest ISO's proposed cost allocation policy. Specifically, the conference focused on the degree of regional cost sharing for reliability projects at 345-kV and above, pursuant to a prior Commission order.

Merchant Transmission

Merchant transmission projects are transmission projects in which the builder typically assumes the risk of the project, and seeks market-based rates approved by the Commission. Merchant transmission projects play a useful role in expanding competitive generation alternatives for customers and meeting reliability needs, as demonstrated by the success of the 330 MW Cross-Sound Cable project that connects Long Island to Connecticut. The 660 MW Neptune project, which is expected to be in service by the end of 2007, will connect New Jersey with Long Island. The Commission continues to work to facilitate merchant transmission projects. For example, in FY 2006, the Commission approved negotiated rates for the Montana-Alberta Tie's proposal that will provide up to 600 MW of transmission capacity between Alberta, Canada, and Great Falls, Montana. The project will allow resources, including renewable

resources that are being developed in Montana, to get to markets throughout the West. It also further integrates the United States and Canadian transmission grids and serves to increase electric system reliability in both countries.

Emergency Cost Recovery

The measures the Commission has undertaken to provide timely cost recovery for infrastructure investors also provide reasonable rates and greater rate certainty for customers. The Commission has also used its declaratory order process to provide clear cost recovery processes to energy industry stakeholders.

In FY 2006, the Commission continued taking action to ensure that security-related costs are recovered. In accordance with its policy statement regarding *Extraordinary Expenditures Necessary to Safeguard National Energy Supplies*, issued three days after the September 11th terrorist attacks, the Commission continues to give the highest priority to deciding any requests made for the recovery of extraordinary expenditures to safeguard the reliability and security of the Nation's energy transportation systems and energy supply infrastructure.

The damage done by Hurricanes Katrina and Rita in the Gulf Coast area in late summer 2005 was widespread and severe. Offshore energy production was shut in; pipelines, power lines, and other means of energy transportation were seriously damaged; and other important parts of the energy infrastructure system, such as natural gas processing plants, were off line. In order to encourage rapid restoration of service, the Commission took a number of actions, including temporarily raising cost limits and including mainline facilities within the definition of eligible facilities that may be constructed by natural gas companies under blanket certificates; granting waivers on a case-by-case basis of the 120-day limit on emergency natural gas transactions, including the construction and operation of necessary facilities; and granting waivers of tariff provisions to allow delivery of gas at alternative points when the usual delivery points were out of service from hurricane damage. In the February 2006 report, *The Federal Response to Hurricane Katrina: Lessons Learned,* the Commission was recognized as having taken immediate steps to reconstruct the natural gas infrastructure of the region as well as reduce the disruption in natural gas supply.

In August 2006, the Commission revised its regulations to better monitor and assess the physical state of the interstate natural gas pipeline grid and gas storage infrastructure when service is disrupted, due to damage caused by a hurricane, other natural disasters or acts of terrorism. The final rule requires jurisdictional natural gas companies to report to the Commission damage to their facilities and report service disruptions that occur when a natural disaster or other cause results in a reduction in pipeline throughput or storage deliverability.

Objective B: Maintain a Reliable and Safe Infrastructure

The Nation's energy infrastructure must be reliable and safe for customers to enjoy the benefits of competitive energy markets. Given the economy's dependence on a reliable supply of electricity, it is critical for the industry to have clear, unambiguous, mandatory and enforceable reliability standards and secure communications and control technology. The Commission also needs a highly trained staff that understands the complexities of the bulk power system.

The Commission is responsible for the safety of on-shore LNG and non-federal hydropower facilities throughout the entire life cycle of a project: design review, construction, and operation.

The Commission reviews and approves the final engineering design of authorized LNG projects, inspects these facilities during construction to ensure compliance with the safety and reliability requirements of Commission orders, and conducts the annual and biennial safety and reliability inspections of the existing jurisdictional LNG peak shaving and marine import terminals for the life of these

facilities. The Commission will take steps to ensure the review of new facilities does not conflict with the ongoing obligation of the Commission to ensure the safe and reliable operation of existing facilities.

Natural gas projects and hydropower projects have environmental impacts that can be mitigated with appropriate measures. The Commission is committed to satisfying environmental concerns through cost-effective mitigation of environmental impacts, while also seeking to avoid construction delays. Commission licenses include terms and conditions that are designed to mitigate possible environmental impacts of project construction and operation, and to provide opportunities to enhance the public's use of the available resources. The Commission monitors these terms and conditions for compliance throughout the term of the license.

Reliability of Interstate Transmission Grid

Historically, while the Commission regulated access to the transmission grid, it had no role in the approval or enforceability of reliability standards. Prior to 1965, reliability of the interconnected electric grid was managed by individual electric utilities, or groups of interconnected utilities, which were, to varying degrees, accountable to state and local regulators. Following the Northeast Blackout of 1965, regional reliability organizations and, later, NERC, were formed to develop voluntary reliability rules and to encourage reliable operating practices.

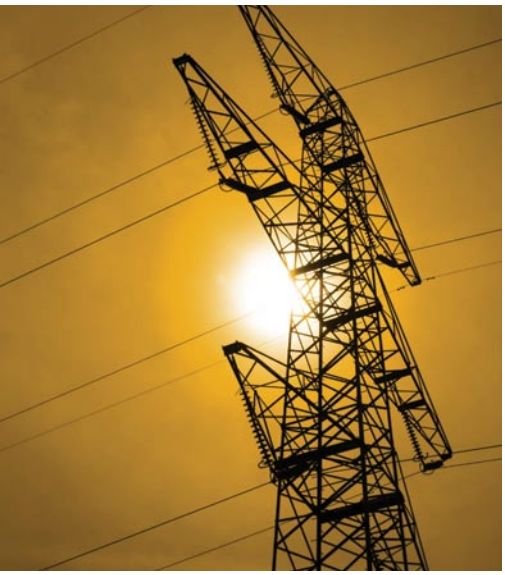
In August 2005, EPAct 2005 added to the FPA a new section 215 on reliability. It directed the Commission to promulgate new rules addressing establishment of an ERO and development of mandatory electric reliability standards and enforcement procedures. During FY 2006, the Commission took the following steps to implement section 215:

- In February 2006, the Commission finalized new rules on the certification of an ERO and the procedures for the establishment, approval and enforcement of mandatory electric reliability standards. This followed technical conferences in November and December 2005 which addressed: the process that the ERO will use in proposing the new mandatory reliability standards; the role of regional entities in the ERO's standards development process; how existing reliability standards can be improved over time by the regional entities; how to establish new electric reliability standards; the roles states play with respect to reliability; and issues related to compliance and enforcement of standards;
- In April 2006, the Commission established a rulemaking proceeding to address proposed mandatory and enforceable reliability standards developed by NERC;
- In May 2006, the Commission completed a staff preliminary assessment of NERC's proposed mandatory and enforceable reliability standards and asked for public comments on the assessment to help it prepare a Notice of Proposed Rulemaking; and
- In July 2006, the Commission certified NERC as the Nation's ERO and accepted, with some modifications and clarifications, NERC's proposed governance structure, funding, reliability standards development process, enforcement program and *pro forma* Regional Entity delegation agreement, through which NERC would delegate certain of its compliance and enforcement responsibilities to regional entities.

The Commission has also begun to analyze and facilitate the industry's work in cyber and physical security and information exchange within the industry. Additionally, the Commission took other significant steps to ensure the reliability of the interstate transmission grid:

- In January 2006, the Commission directed the PJM Interconnection (PJM) and Potomac Electric Power Co. to develop and implement a comprehensive plan to preserve reliability in the Washington, D.C., region. The Commis-

sion concluded that reliability standards are not being met during certain conditions, and that the long-term reliability of the regional power grid in the Washington, D.C., area is compromised. In July 2006, the 69-kV portion of the Potomac River Project was completed (i.e., two feeders were energized). Additionally, PJM and Potomac Electric Co. anticipate an in-service date of June 21, 2007 for the 230-kV portion of the Potomac River Project;



- In May 2006, the Commission and the NRC met to discuss and promote interactions between the two agencies on matters relating to the Nation's electric power grid reliability and the operation of United States commercial nuclear power plants; and
- In September 2006, the Commission approved an innovative agreement among electric utilities put forth by the Edison Electric Institute establishing a Spare Transformer Equipment Program designed to increase the industry's inventory and availability of spare electric transformers. The Commission concluded that this agreement will help to maintain the integrity of the Nation's transmission system in the event of a terrorist attack by providing participating utilities immediate access to a pool of spare transformers and, thus, dramatically reducing the length of an outage resulting from an attack. The Commission has encouraged the participating utilities to expand the scope of the program to include such emergency situations as natural disasters, under which the transfer of spare transformers will be required under the Agreement.

Safety at LNG Facilities

The Commission works with the Department of Transportation, the U.S. Coast Guard and other agencies to ensure the safe siting, operations, and reliability of facilities. This process ensures that approved LNG terminals and associated LNG vessel traffic meet safety and environmental requirements during construction and operation. The Commission can also impose safety requirements to ensure or enhance operational reliability of the LNG terminals.

In FY 2006, the Commission staff completed the process of producing guidelines on the content and level of engineering detail required for LNG applications. Specifically, in December 2005, the Commission issued Draft Guidance for Filing Resource Reports 11 & 13 for LNG Facility Applications to assist applicants by identifying the specific information and level of detail required for filing these resource reports as specified by Title 18 of the Code of Federal Regulations, Sections 380.12 (m) and (o).

To get industry feedback on this guidance, in May 2006, the Commission convened a technical conference to discuss the engineering and safety information required in applications for LNG facilities. In FY 2006, the Commission also performed detailed reviews of safety and security issues, in coordination with the U.S. Coast Guard and the U.S. Department of Transportation.

In May 2006, the Commission established a new LNG Compliance Branch within the Office of Energy Projects to further the Commission's mission to ensure safe and environmentally responsible construction and operation of LNG facilities. The LNG Compliance Branch is responsible for the Commission's continued safety inspections and oversight of operating LNG facilities. The staff, including LNG engineers, civil and mechanical engineers, and other experts, reviews final facility design and engineering to ensure compliance with Commission orders.

Safety at Hydropower Facilities

The Commission administers the largest dam safety program in the United States. The Commission cooperates with a large number of federal and state agencies to ensure and promote dam safety and homeland security. More than 2,500 FERC-licensed dams are in the program. Two-thirds of these dams are more than 50 years old. As dams age, concern over their safety and integrity grows, and oversight and regular inspection programs are extremely important.

Dam safety is a critical part of the Commission's hydropower program. Before projects are constructed, the Commission staff reviews and approves the designs, plans and specifications of dams, powerhouses and other structures. During construction, Commission staff engineers frequently inspect a project, and once construction is complete, Commission engineers continue to inspect the dam on a regular basis. Commission staff inspect projects on an unscheduled basis to investigate potential dam safety problems; complaints about constructing and operating a project; safety concerns related to natural disasters; and issues concerning compliance with terms and conditions of a license. In FY 2006, the Commission held a series of workshops to improve the Commission's safety program at hydro facilities. Specifically, the Commission held the following workshops:

- In February 2006, the Commission organized a workshop for Pacific Northwest dam owners, operations personnel, and regulatory staff to discuss and explore collaborative opportunities on topics related to seismic issues and extreme hydrologic events;
- In April 2006, the Commission held a workshop with the Department of Homeland Security to discuss dam security, dam safety, and emergency preparedness issues;
- In April 2006, the Commission hosted an Emergency Action Plan Exercise Design Course to discuss exercise emergency requirements and the design process; and
- In May 2006, the Commission hosted a Dam Safety Surveillance and Monitoring Workshop for dam owners, operators, consultants, instrumentation equipment manufacturers and Commission staff, which focused on the appropriate design, installation and data interpretation of instrumentation and monitoring systems at dams and appurtenant structures.

In response to a December 2005 reservoir breach at the Taum Sauk Pumped Storage Project, the Commission sent teams of engineers to investigate at the facility near Lesterville, Missouri. In May 2006, the Commission released for public comment a report by an Independent Panel of Consultants on the technical reasons for the breach of the Taum Sauk Pumped Storage Project upper reservoir.

Immediately following the breach, the Commission initiated a review of all Commission-regulated pumped storage projects to assure project safety and determine the need for and development of guidelines for the safe operation of pumped storage projects. This ongoing effort includes a review of the effectiveness of the instrumentation and monitoring systems, operating procedures, operator training programs and Emergency Action Plans. In addition, the Commission requested each operator to conduct a fault-tree analysis of possible failure mechanisms addressing the project structures, all instrumentation and monitoring systems, backup alarms and computer controls; and to begin planning for a meeting of operators, managers, and consultants from the 21 pumped storage projects under the Commission's regulation.

On May 5, 2005, a sinkhole was discovered in the crest of the Swinging Bridge Dam on the Mongaup River in Sullivan County, New York. The Commission commenced an investigative program to assess the condition of the dam, to determine the cause of the sinkhole, and to determine what actions may be necessary to correct the problem.

Throughout FY 2006, the Commission took steps towards the rehabilitation of the Swinging Bridge Dam. Commission staff oversaw the

construction activities designed to ensure the safety of the dam to handle the spring flood season, which was completed in May 2006, and continued working toward the completion of all remedial activities at the site.

Environmental Considerations – Natural Gas

In FY 2006, the Commission promoted the use of the third-party compliance monitoring program for environmental compliance in natural gas projects. The program established a full-time on-site presence during the construction and restoration of major projects, giving the Commission staff immediate access to information regarding field conditions and the ability to respond quickly to requests from landowners and construction contractors. This gives the industry more flexibility to react to changing or unanticipated construction conditions.

During FY 2006, the Commission staff completed the environmental review of 452 gas pipeline and LNG filings, including 54 environmental assessments (EAs) and 8 Environmental Impact Statements (EISs). Concurrently, the Commission staff continued work on 33 additional EAs and 14 additional EISs, primarily for new LNG import terminals. Because of the effective use of the Commission's pre-filing process, the average time for the staff's completion of the EISs was about 14.8 months.

Environmental Conditions – Hydropower Projects

Hydropower licenses include requirements that are designed to protect, mitigate and enhance the environmental resources of project areas. The Commission safeguards the environment by requiring all hydropower applicants to communicate with affected federal and state natural resources agencies, tribes and state water quality agencies prior to submitting an application to the Commission.

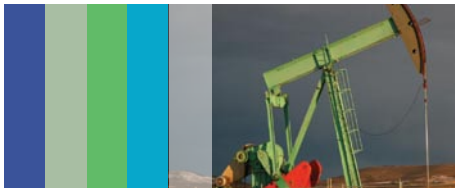
In many cases, environmental measures are proposed in settlement agreements filed with the Commission. The Commission will encourage parties to develop settlements consistent with the Commission's responsibilities under the FPA so the Commission can include agreed-upon provisions in licenses. To facilitate this process, in September 2006 the Commission issued a policy statement in the form of a guidance document for participants in settlement agreements associated with hydroelectric licensing cases. This document aims to help parties determine which conditions are appropriate for inclusion in these settlement agreements.

The Commission continues to receive an increasing number of land–and water–use development applications that involve contested, complex issues related to water quality, navigation hazards, aesthetics and erosion around licensed lakes and reservoirs. The Commission expects the same trend to continue, as public leisure demands continue to grow on lakes and reservoirs. The Commission has issued a guidance manual for shoreline management, and will hold land resources management and development workshops in the affected regions of the country.

In FY 2006, Commission staff completed the environmental review of 34 hydroelectric license and exemption applications, including 20 EAs and four EISs. Concurrently, the Commission staff continued work on three draft EAs and seven draft EISs.

In FY 2006, the Commission continued to monitor compliance through its environmental inspection program to ensure that resource protection measures designed to maintain environmental quality at hydropower projects are constructed and implemented according to license requirements. The Commission's compliance assistance program, comprising environmental inspections, building partnerships, engaging in collaborative problem solving and delivering guidance will ensure effective license compliance and resource protection.

Section 3



Goal 2: Competitive Markets: Benefiting the Customer

The Commission continues to develop rules that encourage fair and effective competitive markets and prevent the accumulation and exercise of market power.

The Commission is charged by statute with ensuring that prices in jurisdictional energy markets remain just and reasonable and are not unduly discriminatory or preferential. One way the Commission does this is by preserving and expanding the transparency of information and operations in energy markets. This in turn relies on Commission rules being effective at encouraging fair and efficient competitive markets. The Commission accomplishes this primarily through:

- its rate and corporate jurisdiction under sections 205, 206 and 203 of the FPA;
- its rate jurisdiction under sections 4 and 5 of the NGA; and
- EPAct 2005 amendments to the FPA and NGA related to market operations, including new transparency provisions and anti-manipulation provisions.

To help reach these goals, the Commission reorganized the staff and structure from the Office of Markets, Tariffs and Rates into the Office of Energy Markets and Reliability in early FY 2006. Changes were also made to the Office of Market Oversight and Investigations which resulted in the new Office of Enforcement. These realignments match the Commission's work in the areas of competitive markets and enforcement.

Objective A: Develop Rules that Encourage Fair and Efficient Competitive Markets

In exercising its jurisdiction over wholesale markets and transportation in interstate commerce, the Commission strives to reduce barriers in gas and electric intra- and inter-market trade. The operations of jurisdictional energy providers in the United States must work together as seamlessly as possible to reduce transaction costs and help ensure that rates are reasonable. Furthermore, the Commission seeks to adopt approaches that are complementary to those of the states in their regulation of retail markets.

Rule Changes

In FY 2006, the Commission continued to look for areas in which to improve upon Commission policies in furtherance of wholesale competitive markets.

- In May 2006, the Commission issued a Notice of Proposed Rulemaking containing proposals to amend the Commission's regulations adopted in Order Nos. 888 and 889 and its pro forma OATT. The proposed changes were designed to ensure that transmission services are provided on a basis that is just, reasonable and not unduly discriminatory or preferential. The proposed rulemaking is intended to strengthen the pro forma OATT to ensure that it achieves its original

purpose —remedying undue discrimination—not to create new market structures. The Commission took this action to strengthen the OATT and address deficiencies that have become apparent over the decade since its adoption, particularly in the areas of available transmission capability (ATC) calculation and transmission planning

- In May 2006, the Commission issued a Notice of Proposed Rulemaking to reform its four-prong analysis for determining whether a wholesale seller of electric energy, capacity or ancillary services is qualified for market-based rate authority. The four-prong analysis examines generation market power, transmission market power, other barriers to entry and affiliate abuse/reciprocal dealing. Under the proposed rule, the Commission's review would be reformed into a more traditional horizontal and vertical market power analysis
- In April 2006, the Commission, after finding that PJM's existing capacity obligation rules unjust and unreasonable, determined that certain elements of the proposed alternative, the reliability pricing model (RPM), may form the basis for a just and reasonable capacity market. Guidance was provided on the features of RPM that must be further analyzed before the Commission can determine whether RPM is a just and reasonable capacity market, and established procedures – including a technical conference – to resolve the issues. Concurrently, the parties entered into settlement talks
- In March 2006, and in subsequent orders in FY 2006, the Commission provided guidance and approvals for SPP's proposed tariff revisions intended to implement a real-time, offer-based, energy imbalance market that will be used to calculate the price of imbalance energy, and establish a market monitoring and market power mitigation plan
- In June 2006, the Commission approved a settlement agreement addressing problems in New England's generation capacity market. The settlement attempted to resolve protracted litigation and bring a needed measure of stability to the region. The Commission found that the settlement agreement was a just and reasonable outcome consistent with the public interest and should resolve the deficiencies in New England's existing capacity market. The agreement was the product of a series of more than 30 formal settlement conferences over a four-month period overseen by a Commission administrative law judge
- In September 2006, the Commission conditionally accepted the California Independent System Operator Inc.'s (CAISO's) Market Redesign and Technology Upgrade proposal, concluding that the tariff reforms will bring important corrections and improvements to the CAISO markets necessary to enhance reliability of the grid, protect customers from market manipulation and promote infrastructure development. The same month, the Commission approved Midwest ISO's phased approach to implementing a long-term resource adequacy plan and offered guidance on Midwest ISO's future plans to implement ancillary service markets and an energy-only market.

The Commission has also encouraged the development of business rules and practices that maximize market efficiency, ease market entry and reduce transaction costs, relying in the first instance on organizations such as the North American Energy Standards Board (NAESB), RTOs and independent transmission system operators (ISOs), where appropriate. For example, in FY 2006, the Commission finalized the first set of standards governing business practices and electronic communications for public utilities, which were developed through consensus by the Wholesale Electric Quadrant of NAESB. The business standards developed by NAESB included Open Access Same

Time Information System (OASIS) Business Practice Standards, OASIS Standards and Communications Protocols, and an OASIS Data Dictionary. These standards replace the Commission's business practice standards for OASIS transactions and OASIS Standards and Communication Protocols and Data Dictionary requirements.

Reduce Barriers to Entry

Barriers to entry can be caused by differences between federal and state rules or by differences in approach by individual service providers within a market. In FY 2006, the Commission supported efforts by industry groups, such as NAESB, to address these types of differences in operating and business practices by standardizing business practices in both gas and electric markets. In wholesale electric markets, the Commission's OATT reform proceeding seeks to increase the consistency and transparency of the rules governing jurisdictional transmission service.

In FY 2006, the Commission took steps toward increasing transparency. For example, in December 2005 the Commission revised its Uniform System of Accounts and financial reporting requirements to provide greater transparency and uniformity regarding costs incurred by public utilities, including RTOs and ISOs. The accounting changes provide additional information on transmission service, market-related services and generator interconnection studies. They will enhance the transparency and consistency of accounting and financial reporting for the costs of RTO assets, expenses and revenues.

Also, in December 2005, the Commission enhanced transparency when it issued rules to implement the Public Utility Holding Company Act of 2005 (PUHCA 2005). Among other things, these rules established requirements for holding companies and service companies to maintain and make available to the Commission their books and records, and established annual reporting requirements for service companies.

Later in FY 2006, the Commission issued proposed rules to establish a Uniform System of Accounts for centralized service companies, to revise the annual reporting requirements for centralized service companies on a basis consistent with the proposed accounting rules, and to establish records retention requirements for holding companies and service companies under PUHCA 2005. These proposed rules would provide transparency on centralized service company activities and operations and give the Commission the necessary oversight tools to carry out its responsibilities under PUHCA 2005. In July 2006, the staff held a technical conference to discuss and get further comments on these proposed rules.

A lack of real-time pricing can be a barrier to increased use of demand response in both wholesale and retail markets. In January 2006, the Commission held a technical conference on demand response and advanced metering issues. In August 2006, the Commission issued a report

that assesses demand response resources, by appropriate region, including those available from all customer classes.

Inter-market barriers, such as seams, are an important focus of Commission work. Seams refer to the differences in market rules and designs, operating and scheduling protocols, and other control-area practices that inhibit or preclude the

ability to execute transactions that cross regional boundaries and create inefficiencies. Significant differences in power products and pricing and market rules between markets can reduce competition between suppliers across the regions. Thus, resolving seams differences could lower the transaction costs of power sales, permit dispatch of lower cost power and ultimately lower costs to customers.

The Commission has facilitated discussions between industry and states to address and resolve the seams issues that occur at boundaries between organized markets. For example, when the Commission conditionally accepted the CAISO's Market Redesign and Technology Upgrade proposal, in September 2006, the Commission established a technical conference to discuss seams issues between California and other Western states.

In addition, during FY 2006, as part of the Commission's directive that Midwest ISO and PJM consider a joint and common market to resolve seams, Midwest ISO and PJM developed broader price transparency between markets and common reporting to facilitate trading between markets. Midwest ISO and PJM also began the alignment of reliability agreements and practices to cover emergency energy needs and joint expansion planning to increase the reliability of the grid. To meet Commission directives for reliability, Midwest ISO and PJM intend to align their black start restoration practices to further strengthen reliability of the grid in 2007. Additionally, the Commission acted on a proposal to revise the existing joint operating agreement between the Midwest ISO and PJM and their respective transmission owners to allocate to customers in each RTO the cost of new transmission facilities that are built in one RTO but provide benefits to customers in the other RTO.

Finally, in order to create a more seamless administration between the tariffs of the Midwest ISO's energy markets and other utilities and regional transmission operators bordering the Midwest ISO, the Commission has acted on several seams agreements, or revisions to such agreements during FY 2006. Specifically, to reduce seams issues between the Midwest ISO and the non-market operations of Mid-Continent Area Power Pool's (MAPP) members that do not belong to the Midwest ISO, the Commission approved MAPP's proposal to conform its ATC calculation methodologies to provisions of the seams operating agreement between MAPP and the Midwest ISO. The Commission also approved revisions to an existing seams agreement between the Midwest ISO and SPP to align the agreement more closely with the existing joint operating agreement between the Midwest ISO and PJM.

Objective B: Prevent Accumulation and Exercise of Market Power

Commission rules encourage fair and efficient competitive markets by preventing the accumulation and exercise of market power and promoting transparency of competitive electric and gas markets.

Most industries that transition to increased competition witness considerable restructuring, including consolidations of companies within individual segments of the industry. Mergers and other dispositions or acquisitions can bring efficiencies from economies of scale and also can represent the result of successful competition when more effective business models grow. However, they can also eliminate competitors and can lead to markets that are too concentrated and not fully competitive.

The Commission safeguards the customer from consolidations of energy assets that decrease competition and ensures the rates customers pay for electricity and transmission services in wholesale markets are just and reasonable.

The FPA and the NGA enable the Commission to detect and disallow imprudently incurred, unjust or unreasonable or unduly discriminatory or preferential costs from affiliate transactions between companies in the same holding company system.

Merger and Acquisition Review

In December 2005, the Commission issued a final rule to implement the electric company merger and acquisition provisions of EPAct 2005. The rule provided blanket authorizations for certain transactions while ensuring that captive utility customers are protected. The goals of the revised rule are to ensure that all jurisdictional transactions subject to FPA section 203 are consistent with the public interest and at the same time ensure that our rules do not impede day-to-day business transactions or stifle timely investment in transmission and generation infrastructure. Also in December 2005, to ensure protection of customers, the Commission issued a final rule to implement its enhanced access to holding company books and records under the PUHCA 2005.

The Commission approved the following significant mergers and acquisitions in FY 2006:

- The Commission authorized Duke Energy and Cinergy to combine to create a company with more than $70 billion in assets and operations in two-thirds of the United States and parts of Canada. The merged companies will have retail electric and gas customers in Kentucky, Indiana, North Carolina, Ohio, South Carolina and Canada, and own more than 45,000 MW of electric generation and 17,500 miles of natural gas transmission pipeline;
- The Commission approved MidAmerican Energy Holdings Co.'s $5.1 billion acquisition of Portland, Oregon-based PacifiCorp, a subsidiary of Scottish Power. MidAmerican provides electric service to over 698,000 customers in Illinois, Iowa and South Dakota, while PacifiCorp serves electric customers in parts of California, Idaho, Oregon, Utah, Washington, and Wyoming; and
- In September 2006, the Commission conditionally approved the acquisition of Michigan Transco Holdings LP by ITC Holdings Corp., marking the first time the Commission has authorized the acquisition of a standalone transmission company, or "transco," by another transco.

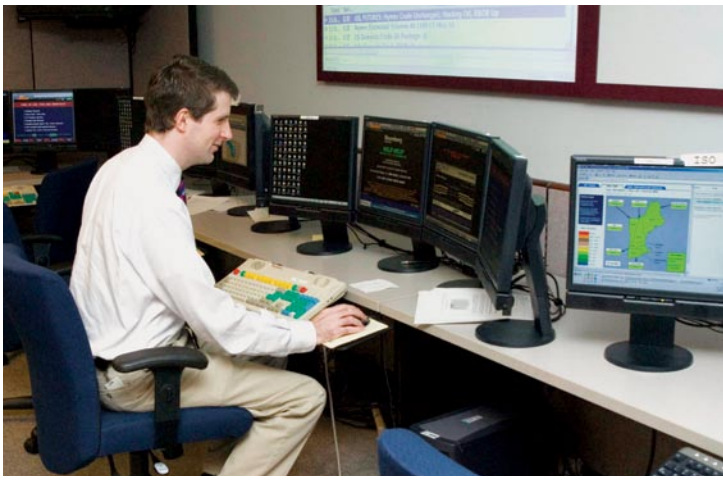
Open Access Transmission Tariff

In May 2006, the Commission issued a Notice of Proposed Rulemaking containing proposals to amend the Commission's regulations adopted in Order Nos. 888 and 889 and its pro forma OATT. The proposed changes were designed to ensure that transmission services are provided on a basis that is just, reasonable and not unduly discriminatory or preferential. The proposed rulemaking is intended to strengthen the pro forma OATT to ensure that it achieves its original purpose—remedying undue discrimination—and not to create new market

structures. The Commission took this action to strengthen the OATT and address deficiencies that have become apparent over the decade since its adoption, particularly in the areas of ATC calculation and transmission planning.

In FY 2006, the Commission approved proposals by four vertically integrated utilities to contract with an independent entity to serve as the independent coordinator of transmission. The independent entities oversee these utilities' transmission systems, including authority to administer each utilities' OATT. In approving these proposals, the Commission found the companies demonstrated the proposals were consistent with or superior to the OATT:

- In December 2005, the Commission accepted Duke Power's proposal to have the Midwest ISO serve as its Independent Entity responsible for certain transmission functions. The Independent Entity will evaluate and approve transmission service requests, calculate Total Transfer Capacity and ATC, operate the OASIS, dispose of interconnection requests and coordinate transmission planning;
- In December 2005, the Commission approved MidAmerican Energy Co.'s Transmission Service Coordinator proposal. In June 2006, the Commission conditionally approved MidAmerican Energy Co.'s proposed agreement with TranServ International Inc. to serve as the utility company's Transmission Service Coordinator;
- In March 2006, the Commission conditionally approved Louisville Gas and Electric Co.'s (LG&E's) proposal to withdraw its transmission facilities from the transmission system operated by the Midwest ISO, and in place of its existing arrangements with the Midwest ISO, the Commission approved a proposal to designate SPP as administrator of LG&E's transmission tariff; and
- In April 2006, and by subsequent orders issued in FY 2006, the Commission conditionally approved Entergy Services' proposal for an Independent Coordinator of Transmission finding that "substantial benefits" can be brought to market participants and to Entergy's native-load customers from the adoption of this proposal. The Commission subsequently approved SPP to serve as Entergy's Independent Coordinator of Transmission.



Market Power in Wholesale Power Sales

To address market power in jurisdictional wholesale markets, in FY 2006 the Commission reviewed applications for market-based rates for power sales to make sure that applicants do not have the ability to exercise market power. The Commission also reviewed tariff filings made by natural gas pipelines and public utilities providing electric transmission service to ensure they do not permit undue discrimination or preference.

In May 2006, the Commission proposed reforms to its current four-prong analysis for determining whether a wholesale seller of electric energy, capacity or ancillary services is qualified for market-based rate authority. The proposed regula-

tions, for the most part, would adopt the Commission's current standards for granting market-based rates, but would refine and codify the standards to help ensure that customers are protected from the exercise of market power. The proposal also will provide greater certainty to sellers seeking market-based rate authority. Under the proposed rule the four-prong analysis would be reformed into a more traditional horizontal and vertical market power analysis. In addition, the Commission proposed to modify and streamline its process by: (1) adopting a standardized market-based rate tariff of general applicability; (2) adopting a regional approach to triennial reviews; and, (3) allowing small sellers to file only change-in-status filings (i.e., relieve them of the requirement to file a triennial review).

Regarding affiliate abuse/reciprocal dealing, the Commission proposed to retain its policy that sales of power between a utility and any of its non-franchise power sales affiliates must be pre-authorized by the Commission prior to transacting and that requires a code-of-conduct governing the relationship between the affiliates. The Commission also proposed to codify code-of-conduct restrictions in its regulations.

Further, the Commission proposed to prevent the exercise of market power through bolstered reporting requirements for those found to have market power, a modified generation market power analysis and a revised and clarified change-of-status reporting requirement.

In FY 2006, the Commission took several other significant actions to protect consumers from the exercise of market power. For example:

- In November 2005, the Commission followed up on its May 2005 order directing companies that were delinquent in filing an updated market power analysis to file their analyses within 60 days or have their market-based rate authority revoked. The Commission revoked the market-based rate authority of more than 100 companies that failed to comply with its May 2005 order. In addition, the Commission revoked the market-based rate authority of two companies for "patently deficient" filings.
- In February 2006, the Commission revoked the market-based rate authority of eight companies for failure to comply with regulations requiring electric quarterly reports.

Industry Compliance through Audits

Audits are a crucial part of the Commission's strategy to prevent the accumulation and exercise of market power. The Commission staff conducts audits on a regular but unscheduled basis to ensure jurisdictional companies do not exercise market power in four major program areas: OATT; market-based rates; market-based rates for natural gas storage; and price transparency. Audits in these major program areas are performed to ensure jurisdictional companies are following the appropriate Commission precedent when providing and obtaining transmission service, making power sales in wholesale power markets, pricing storage and storage services at market prices, and reporting trade data to price index publishers. In FY 2006, the Commission completed major audits in these program areas to improve jurisdictional companies' compliance with Commission precedent. Corrective actions resulting from these audits included structural, process, and procedural changes, as well remedies to improve market transparency.

Market Power in Gas Storage Operations

EPAct 2005 amended NGA section 4 to authorize the Commission to allow market-based rates for providing storage and storage-related services at natural gas storage facilities even if the seller cannot demonstrate that it lacks market power. The Commission began establishing the framework to evaluate market-based rate applications filed under these new rules to ensure that customers are adequately protected.

Section 4

Goal 3: Enforcement: Guarding the Customer

Competitive energy markets can succeed only when competition is tempered by effective regulation. The Commission has adjusted its regulatory policies to meet the dramatic changes that have occurred in both the natural gas and electricity industries. While the core legal duties of the Commission have not changed—that is, to guard the consumer from market power abuse—the means of discharging this duty have evolved over time.

The Commission permits market-based rates and increasingly sets rules of general applicability that govern market participants and, where applicable, an entire market. As a result of this regulatory approach, it is even more important for the Commission to promote compliance with, and enforce, the statutes it is responsible for implementing and the regulations it issues under those statutes.

The Commission seeks to detect violations quickly, to penalize those who violate orders, rules and regulations, to seek disgorgement of unjust profits or other remedies, to publicize misconduct where appropriate and to take prompt action to prevent future misconduct.

It is critical that the Commission understand market dynamics, detect problems or issues in energy markets early, prevent violations of its rules and enforce compliance with the laws under its jurisdiction. Perhaps most important, the Commission needs to ensure that utilities subject to its jurisdiction have effective internal monitoring and compliance programs in place to help assure they are following established Commission rules and regulations. Commission oversight must then provide an independent and external check to ensure the compliance programs of each jurisdictional utility are adequate, and to periodically audit utility compliance with Commission's rules, regulations and statutory requirements.

The Commission's enforcement tools were greatly reinforced when EPAct 2005 conferred expanded authority, which provided for the first time penalty authority for violations of the NGA and all of Part II of the FPA. This expanded penalty authority also applies to any entity (not just companies traditionally subject to the Commission's jurisdiction) that manipulates wholesale gas or electric markets by engaging in fraud or deceit in connection with jurisdictional transactions. Armed with this expanded authority, the Commission will create an even stronger and more effective compliance and enforcement program to protect the public interest.

To better meet the changing needs of the marketplace, the Commission reorganized and established the Office of Enforcement. Within this new Office, the Division of Energy Market Oversight now includes a Market Monitor Relations branch to better define the Office's and Division's focus on working with the market monitors in the Commission-approved RTOs and ISOs. This Branch holds monthly calls with each of the market monitors, and convenes two-day, semi-annual meetings to discuss objectives, progress and impediments to achieving mutual goals. The reorganization created the Division of Investigations to conduct non-public investigations of violations

of Commission orders, rules, or regulations, and the Division of Audits to conduct operating and financial audits of regulated entities practices.

Objective A: Provide Vigilant Oversight

Energy markets are complex and change rapidly. A key part of the Commission's market-oriented approach to the natural gas and electric power industries is to identify potential problems quickly and to address them before they become severe.

Identify and Remedy Potential Market Problems

To accomplish this objective, in FY 2006, the Commission enhanced its comprehensive energy market oversight program. The energy market oversight program reviews all key markets daily to detect both anomalous behavior by individual market participants and problems with market rules or operations that significantly affect outcomes. The program uses a real-time information capability to address rapidly developing situations and emergencies. The Commission's Market Monitoring Center (MMC) provides analysts with such data from numerous sources of market information. The information includes data on prices from sources such as RTOs and the trade press on physical flows on the pipeline and electric transmission systems (largely from data aggregators), on the operating status of some generating units (for example, from the NRC) and on some aspects of individual transactions from some trading platforms. It acts as a nerve center where analysts can quickly examine market conditions, exchange insights, and develop shared understanding of the information observed. Through daily fact-finding meetings attended by Commission staff followed by briefings if warranted, the market oversight program helps keep key decision makers updated on market activities.

The MMC, where Commission staff can access most of the real-time and other data subscribed to from information providers, is a hub of data-collecting and analysis for Commission research staff and a "must-visit" for foreign and domestic visitors engaged in or contemplating monitoring their energy markets. In FY 2006 more than 75 groups were briefed on MMC functions and operations by Commission staff; these groups included 685 individuals from 19 foreign country delegations. Staff from the U.S. Congress, state commissions, federal agencies, and other energy-related agencies and organizations also received tours of the MMC in conjunction with appropriate briefings.

The market oversight program focuses on wholesale physical markets for natural gas and electric power and associated transmission markets. The Commission's market oversight program examines detailed interactions between the two industries to detect any possible problems as soon as possible after their occurrence.

Because many other markets affect the operation of the physical electric power and natural gas markets, the market oversight program also reviews related markets every day, including financial markets for electric power and natural gas (overseen by the Commodity Futures Trading Commission or CFTC), generation fuels and emissions credits, long-term financial markets, and international markets.

In connection with the availability of data, the Division of Energy Market Oversight held 34 outreach meetings on data transparency, from June through August 2006, with groups representing the natural gas and electricity industry as well as information providers. Subsequently, the Commission held a price transparency technical conference at which the Commissioners and senior FERC staff had the opportunity to ask panelists from all facets of the industry about transparency issues of interest to them.

In FY 2006, the Commission made available to state energy agencies information on energy markets including natural gas supplies and prices,

electric power, LNG facilities planned and under construction, coal market fundamentals, weather implications and an analysis of observed changes over the month. The program provides for a monthly phone discussion with state representatives of the information sent and other energy issues the agencies may wish to discuss. This outreach program started out modestly and has now grown to more than 35 participating state energy agencies.

Complementing the new market oversight program is the long-established Enforcement Hotline program. The Hotline provides a way for market participants and the public to contact the Commission's enforcement staff on a confidential basis by telephone or email on matters affecting prices and wholesale utility service, including bidding anomalies, price spikes, inappropriate use of financial instruments, changes in available capacity on electric transmission systems or natural gas pipelines, undue discrimination in access to interstate transmission or transportation services, or violations of the Commission's Standards of Conduct or other improper affiliate transactions. The Hotline is also available to landowners to raise concerns regarding pipeline construction and remediation that affects their property. Matters brought to the attention of the Hotline may result in investigations by the Commission's enforcement staff.

During FY 2006, Commission staff continuously examined the seasonal events affecting natural gas and electricity prices. The goal was to provide information for Commission staff and to help Congress, state officials, and citizens to understand the factors affecting energy supply and demand, and natural gas and electricity prices. Starting at the Commission's October 12, 2005, conference on the State of Natural Gas Infrastructure and at every regularly scheduled Open Commission Meeting in FY 2006, staff presented the Commission and the public detailed information relating to current market prices and analyses explaining those prices and their effect on supply and demand in the various regions of the Nation.

In FY 2006, the Commission also made available to the public information on natural gas prices, in particular, by posting on the Commission's web page and making hard copies available of a pamphlet entitled: "Gas Basics." This pamphlet was developed to give the general public a better understanding of wholesale natural gas markets and factors that affect the level of natural gas prices. Throughout the remainder of the fiscal year, the Commission continued to provide information on what has driven these prices and what the Commission is doing to monitor them to be certain that they are not the result of manipulation or the exercise of market power.

Objective B: Provide Firm but Fair Enforcement

In EPAct 2005, Congress amended the NGA and FPA to prohibit the use of manipulative or deceptive devices or contrivances by any entity in connection with the purchase or sale of electric energy, natural gas or transmission or transportation services subject to the jurisdiction of the Commission.

In light of the new authorities granted the Commission by EPAct 2005, the Commission has taken a number of steps to craft a cohesive approach to enforcement, built around the central theme that Commission enforcement actions will be firm but fair. The Commission uses the full range of remedies available—civil penalties, disgorgement of unjust profits, or conditioning, revocation, or suspension of authorizations—but exercises discretion to apply such penalties and remedies in a fair, reasonable and appropriate manner.

Establish Clear and Fair Processes

In FY 2006, the Commission took several major steps to establish clear and fair processes to protect energy customers. Together, the Commission's newly enhanced civil penalty authority and adoption of a new rule prohibiting market manipulation

opened a new chapter in the Commission's enforcement activity. With the policy statement outlining how the civil penalty authority will be applied and the industry's ability to request "no action" letters from staff, the Commission has strived to provide regulatory certainty.

- In October 2005, the Commission issued the Policy Statement on Enforcement, outlining factors the Commission will consider when assessing civil penalties or developing remedies for violations of the statutes, orders, rules, and regulations the Commission administers. The policy statement identified factors to be weighed in determining the seriousness of the violation, and indicated what consideration will be given for mitigating factors, such as adopting strong internal compliance programs, voluntarily reporting violations, and cooperating with staff investigations
- Also in October 2005, the Commission entered into a memorandum of understanding (MOU) with the CFTC regarding the sharing of information and the confidential treatment of proprietary energy trading data. The MOU ensures that information requests to markets within the respective jurisdiction of each agency are properly coordinated to minimize duplicative information requests and that the agencies consult and coordinate their enforcement activities
- In November 2005, the Commission approved a process whereby Commission staff will provide informal advice as to whether a proposed transaction, practice or situation may raise compliance issues under the Commission's regulations. The No-Action Letter process assists regulated entities in seeking guidance on real-world applications of the Commission's regulations and orders. It makes available informal, advance advice by staff on specific proposed transactions on whether staff would recommend that the Commission take enforcement action based on the facts presented
- In January 2006, the Commission adopted rules prohibiting market manipulation. Under these rules, which implement the EPAct 2005 statutory prohibition of manipulative or deceptive devices or contrivances, it is unlawful for any entity, directly or indirectly, in connection with the purchase or sale of electric energy or natural gas, or in providing transmission or transportation services subject to the Commission's jurisdiction: (1) to use any device, scheme or artifice to defraud; (2) to make any untrue statement of material fact or to omit a material fact; or (3) to engage in any act, practice or course of business that operates or would operate as a fraud or deceit. The new rules provide guidance to industry as well as important protections for market participants
- In February 2006, the Commission issued revised rules modifying the 2003 Market Behavior Rules to reflect adoption of the new anti-manipulation rules. Market Behavior Rule 2 and 6 were rescinded, and remaining Market Behavior Rules were codified. This provides certainty for industry as to the rules applicable to market activity, while retaining important customer protections
- In May 2006, the Commission established rules that expand the procedural rights of persons subject to all conducted audits by the Commission under the FPA, the NGA, the NGPA and the Interstate Commerce Act, except audits pertaining to reliability that the Commission authorized in Order No. 672. The order expands this protection beyond financial audits to non-financial audits and establishes the procedures and timeframes required to dispute audit findings and recommendations contained in draft audit reports.

Investigations and Enforcement

In competitive markets, participants constantly seek new profit opportunities, but some participants may violate rules or manipulate markets to

reap unjust profits. In FY 2006, the Commission actively monitored natural gas markets to determine whether price movements are the result of market manipulation or market fundamentals. The Commission's market oversight and investigations staff continually reviewed market activity for any possible manipulation of prices. In close coordination with investigations staff, market oversight staff performs a detailed review of natural gas prices and market activity on a daily basis with the intent of identifying areas of possible manipulation. If Commission staff identifies price anomalies that are not explained by market fundamentals, the Commission's investigations staff will investigate the matter.

The Commission's enforcement investigations in FY 2006 have focused on possible market manipulation, undue discrimination or affiliate abuses, violations of Standards of Conduct requirements, compliance with hydropower requirements, violations of the terms and conditions of tariffs, referrals of behavior in organized markets, and violations related to Commission rules and regulations. Enforcement investigations arise from a variety of sources: including referrals from the Commission, Enforcement Hotline calls, direct contact with enforcement staff, observation of markets, market monitors in RTOs and ISOs, as well as anonymous tips.

In FY 2006, the Commission completed 88 audits of energy companies, including natural gas pipelines and electric utilities. The audits focused on transmission market power, index of customers, electric and gas tariff compliance, affiliate abuse, Standards of Conduct and code of conduct compliance, EQR, filing requirements, cash management and interlocking directorate rules for officers and directors of electric companies. The audits resulted in stringent compliance plans requiring the creation of robust compliance programs, organizational, procedural and process remedies. Moreover, the Commission ordered refunds of $6 million to energy customers and directed a public utility to invest $23 million in construction to alleviate congestion on the transmission system as a result of these audits.

The Commission's 22 completed investigations focused on possible instances of market power and manipulation, undue discrimination or affiliate abuses, violations of rules and tariffs, hydropower requirements, and license or certificate conditions.

In FY 2006, the Commission continued to use the Enforcement Hotline, a mechanism whereby industry participants provide information to the Commission, to identify other potential investigations. In addition to identifying possible investigations, the Enforcement Hotline was used by the Commission to encourage self-policing and reporting of violations. In FY 2006, the Enforcement Hotline marked its 20th year of operation.

Where the Commission identified violations, it applied remedies to mitigate the effects of market power, required disgorgement of unjust profits where appropriate, imposed civil penalties or other sanctions when available under existing laws, and required compliance plans to prevent future violations.

Internal Compliance

It is incumbent upon the Commission to ensure that its market, reliability and other regulatory rules are clear, enforceable and fully understood by the jurisdictional entities that we regulate. However, the obligation to comply with those regulations, rules and standards lies with the regulated entity. Therefore, it is important that regulated entities have a rigorous internal compliance program that provides them with the tools, processes and high-level management support to identify problems or areas of non-compliance and to report such problems to the Commission. In FY 2006, the Commission worked with its regulated entities to help them develop and maintain good compliance procedures such that any necessary enforcement actions by the Commission (including penalties or sanctions) are a regulatory tool of last resort—invoked only when the compliance process has failed.

Section 5

Energy Policy Act of 2005 (EPAct 2005) Implementation

EPAct 2005 is the first major energy law enacted in over a decade, and makes the most significant changes in Commission authority since the FPA and NGA. By passing EPAct 2005, Congress signaled a strong vote of confidence in the Commission. In FY 2006, the Commission took on the new duties and authorities conveyed to it under EPAct with a sense of purpose, mindful of the public trust they entail. Moreover, FY 2006 demonstrated the Commission's commitment to meeting these obligations within the time allotted by Congress.

EPAct 2005 had three general policy goals in the areas of concern to the Commission. First, it reaffirmed a commitment to competition in wholesale power markets as national policy, the third major federal law in the last 30 years to do so. Second, it strengthened the Commission's regulatory tools, recognizing that effective regulation is necessary to protect the consumer from exploitation and assure fair competition. Third, it provided for development of a stronger energy infrastructure.

EPAct 2005 gave the Commission significant new responsibilities and granted significant new authority to discharge these responsibilities by modifying the FPA, the NGA, and the Public Utility Regulatory Policies Act of 1978 (PURPA). In addition, EPAct 2005 repealed the Public Utility Holding Company Act of 1935 (PUHCA 1935), and in its place created a new PUHCA 2005, which emphasizes access to books and records.

New Responsibilities

The Commission's significant new responsibilities include:

- overseeing the establishment and enforcement of reliability standards for the Nation's electric transmission grid;
- implementing new tools, including penalty authority, to prevent market manipulation;
- providing rate incentives to promote electric transmission investment;
- supplementing state transmission siting efforts in national interest electric transmission corridors; and
- reviewing certain holding company mergers and acquisitions involving electric utility facilities, a well as certain public utility acquisitions of generating facilities.

EPAct 2005 also specified a number of actions to be taken by the Commission. In fulfilling these requirements during the first year since EPAct 2005 was signed into law on August 8, 2005, the Commission has promulgated nine final rules, issued three additional notices of proposed rulemaking, authored and submitted seven reports to Congress, and entered into a memorandum of understanding with the CFTC. The Commission has taken these actions in a timely manner – meeting every deadline set for the Commission in EPAct 2005.

Some of these deadlines were challenging, particularly the task of implementing the repeal of PUHCA 1935 and promulgating a new rule to implement PUHCA 2005, as well as implementing rules to address the Commission's expanded corporate transaction review authority under the FPA.

Market Manipulation

EPAct 2005 gave the Commission the authority to issue rules to prevent market manipulation in jurisdictional wholesale power and gas markets, and in jurisdictional transmission and transportation services. For the Commission, this is one of the most important and challenging provisions of the Act. Congress granted this authority out of recognition that wholesale power and gas markets had changed dramatically since the 1930s. While the Commission's legal duty remains the same – protecting the wholesale power and gas customer – it needed additional regulatory tools to discharge this duty.

EPAct 2005 gives the Commission civil penalty authority, which the Commission has indicated it will exercise carefully by assuring that its market manipulation rules are clear. That will more strongly influence regulated entities to assure compliance, and make it easier for the Commission to identify violations.

Electric Reliability and Infrastructure

EPAct 2005 significantly expanded the Commission's electric authorities. Perhaps the most important of these are the provisions governing reliability of the bulk power system. For the first time, the Commission was granted authority to oversee mandatory reliability standards governing the Nation's electric grid. The Commission finalized rules on the certification of an ERO and on procedures for the establishment, approval and enforcement of mandatory electric reliability standards. The Commission has certified the ERO and issued a Notice of Proposed Rulemaking proposing to approve 83 of 107 reliability standards filed by the ERO for Commission approval.

EPAct 2005 also contained a number of provisions directed to expanding and modernizing the Nation's electric grid. The Commission issued a rule in July 2006 on electric transmission pricing reforms designed to promote needed investment in electric energy infrastructure and benefit energy customers. The goal of this rule is to bolster power grid reliability and lower costs for delivered power by reducing transmission congestion. That same month, the Commission issued a rule to require transmission organizations with organized electricity markets to make available to load-serving entities long-term firm transmission rights that satisfy certain guidelines. This will help customers who want to make long-term supply arrangements. These customers want to be able to enter into long-term transmission service arrangements without being exposed to unhedged congestion cost risk. The final rule goes far to reduce the risk exposure to transmission customers, and is important to development of the grid.

EPAct 2005 addressed the difficulties of siting major new transmission facilities by authorizing the Secretary of Energy to designate "national interest electric transmission corridors" to alleviate major transmission congestion. EPAct 2005 also allows applicants seeking to build transmission within these corridors to seek construction permits from the Commission under certain conditions. While most transmission projects will continue to be sited by states under state law, EPAct 2005 granted the Commission this important siting authority. FERC has issued proposed rules on transmission siting that will govern the issuance of construction permits by the Commission for projects that meet the statutory criteria.

In addition to the provisions relating to transmission grid improvements, EPAct 2005 addressed a significant generation issue within the jurisdiction of the Commission. Pursuant to directives in EPAct 2005, the Commission tightened the thermal efficiency

requirements for qualifying cogeneration facilities under PURPA in February 2006. The Commission's new rules should limit the potential for abuse under PURPA, curtail sham transactions, and prevent new PURPA "machines." At the same time, the rules support the development of new cogeneration facilities that truly conserve energy by ensuring new qualifying cogeneration facilities use thermal output in a productive and beneficial manner, and that the electrical, thermal, chemical and mechanical output of new qualifying cogeneration facilities is used fundamentally for industrial, commercial and institutional purposes. Pursuant to EPAct 2005 amendments to the FPA, the Commission also eliminated ownership restrictions on qualifying cogeneration and small power production facilities with the same rule.

The Commission also proposed new regulations implementing EPAct 2005 amendments to add PURPA section 210(m), which provides among other things for termination of the requirement that an electric utility enter into a new contract or obligation to purchase electric energy from qualifying facilities if the Commission finds the qualifying facility has nondiscriminatory access to one of three categories of markets.

Only minor changes to the Commission's hydroelectric regulations were enacted with the passage of EPAct 2005. For example, the first action the Commission took upon enactment of the law was to extend the Flint Creek Project preliminary permit for three years. Pursuant to section 241 of EPAct 2005, the Commission has worked with other resource agencies to develop mandatory license conditions that are fairer and more balanced. The Commission also has issued a guidance document to help hydropower licensees seeking renewable tax credit certification for incremental energy gains from efficiency improvements.

Natural Gas Infrastructure

Pursuant to EPAct 2005, the Commission has moved to encourage more investment in the Nation's natural gas infrastructure. In order to promote the expansion of natural gas storage capacity and mitigate natural gas price volatility, the Commission has issued new rules for allowing market-based rates for interstate natural gas storage.

To decrease the time needed for creating a complete application for new LNG terminals, the Commission also adopted a rule requiring potential developers to initiate pre-filing procedures at least six months prior to filing a formal application with the Commission. The Commission also has proposed rules to implement provisions that grant authority to coordinate the processing of Federal and state authorizations, required under Federal law for natural gas projects, as well as to maintain a consolidated record of decisions for judicial review.

Mergers and Acquisitions

Further, in response to EPAct 2005 the Commission implemented the repeal of PUHCA 1935 and the provisions of a new PUHCA 2005. PUHCA 2005 permits Commission access to books and records of holding companies and their members if relevant to jurisdictional rates. The Commission implemented PUHCA rules governing accounting, record retention and reporting, including certain blanket waivers and exemptions, within the deadlines in EPAct 2005.

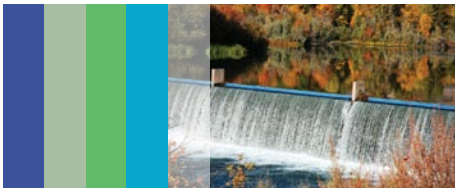
Along with the repeal of PUHCA 1935, EPAct 2005 expanded the Commission's corporate review authority to include authority over certain holding company mergers and acquisitions, as well as certain public utility acquisitions of generating facilities. It also imposed statutory deadlines for acting on mergers and other jurisdictional corporate transactions. The Commission implemented these new provisions of EPAct 2005 by providing blanket authorizations for certain transactions while ensuring that captive utility customers are protected. The Commission acted quickly, so that new rules would be in effect before the effective dates of the new corporate review authority and PUHCA 2005, and before the repeal of PUHCA 1935. All these changes took effect February 8, 2006.

Studies and Reports

The Commission has issued seven reports as mandated by EPAct 2005. In December 2005, the Commission issued a report on investigation of charges during the California electricity crisis detailing the actions the Commission has taken and the timetable for future action to resolve outstanding refund claims from this time period. Also in December, the Commission submitted to Congress a report on whether any PUHCA technical and conforming changes were needed as a result of the repeal of the PUHCA 1935. In February 2006, the Commission together with the Department of Energy issued a report on steps to establish a system to make available to all transmission owners and regional transmission organizations in the Eastern and Western interconnections real-time information on the functional status of all transmission lines within the interconnections. Also in February, the Commission issued its initial report on the progress made in licensing and constructing the Alaska natural gas pipeline, and a subsequent progress report was issued in July 2006 as required by EPAct 2005.

The Commission issued two additional reports before August 8, 2006 as required by EPAct 2005. First was a report assessing, by region, demand response resources and the use of advanced metering resources. The second was a report detailing the recommendations of regional joint boards to study the issue of security-constrained economic dispatch for the various market regions, what constitutes security-constrained economic dispatch and how it affects or enhances the reliability and affordability of electric service.

Appendix A



Hydroelectric Power Table

Projects For Which Licenses Will Expire Between January 1, 2006 and December 31, 2011

Licensee	FERC Project No.	State	County	River	Installation (KW)	Facilities Under License
Duke Power, A Div Of Duke Energy	02686	Nc	Jackson	West Fork Tuckasegee River	24600	Dm Ph
Duke Power, A Div Of Duke Energy	02698	Nc	Jackson	Wolf Creek	26175	Dm Ph
Union Electric Co (Mo)	00459	Mo	Benton	Osage	176200	Dm Ph
Pacificorp (Or)	02082	Or	Siskiyou	Klamath River	161338	Dm Ph
Duke Power, A Div Of Duke Energy	02692	Nc	Macon	White Oak Creek	43200	Dm Ph
South Carolina Pub Serv Auth (Sc)	00199	Sc	Clarendon	Santee River	134520	Dm Ph
Pacificorp (Or)	00935	Wa	Cowlitz	Lewis River	136000	Dm Ph
Pacificorp (Or)	02111	Wa	Cowlitz	Lewis River	240000	Dm Ph
Puget Sound Energy, Inc.(Wa)	02150	Wa	Whatcom	Baker River	170030	Dm Ph
Pud No 1 Of Cowlitz County (Wa)	02213	Wa	Skamania	Lewis River	70000	Dm Ph
Pud No 1 Of Chelan County (Wa)	02145	Wa	Douglas	Columbia River	1237400	Dm Ph
Portland General Electric Co (Or)	02195	Or	Clackamas	Oak Grove Fork of Clackamas River	136600	Dm Ph
California Dept-wtr Resources (Ca)	02100	Ca	Butte	Feather River	762850	Dm Ph
Pacific Gas And Electric Co (C	00606	Ca	Shasta	South Cow Creek	4440	Dm Ph
Chugach Electric Assn Inc (Ak)	02170	Ak	Kenai Peninsula Borough	Kenai Lake	15000	Dm Ph
Garkane Energy Cooperative, Inc.	02219	Ut	Garfield	West Fork Boulder Creek	4300	Dm Ph
Alabama Power Co (Al)	00082	Al	Coosa	Coosa River	170000	Dm Ph
Alabama Power Co (Al)	00618	Al	Elmore, Chilton	Coosa River	100000	Dm Ph
Sacramento Municipal Util Dist (Ca)	02101	Ca	El Dorado	South Fork American R	640950	Dm Ph
Alabama Power Co (Al)	02146	Ga	Floyd	Coosa River	690900	Dm Ph
Pacific Gas And Electric Co (C	02155	Ca	El Dorado	South Fork American River	7000	Dm Ph
Avista Corporation	02545	Wa	Spokane	Spokane River	136600	Dm Ph
Alaska Power & Telephone Co (Wa)	01051	Ak	Skagway-yak	Dewey Creek	943	Dm Ph
Alabama Power Co (Al)	02165	Al	Winston, Tuscaloosa	Sipsey Fork	203250	Dm Ph
New York Power Authority	02216	Ny	Niagara	Niagara River	2755500	Dm Ph
Southern California Edison Co (Ca)	02085	Ca	Madera	San Joaquin River	150938	Dm Ph
Synex Michigan, Llc.	02785	Mi	Midland	Tittabawassee	3300	Dm Ph
Sitka City Of & Borough Of (Ak)	02230	Ak	Sitka Division	Sawmill Cr	7540	Dm Ph
Ottumwa City Of (Ia)	00925	Ia	Wapello	Des Moines River	3250	Dm Ph
Hyrum City Corp (Ut)	00946	Ut	Cache	Blacksmith Fork River	400	Dm Ph
Alcoa Power Generating Inc.	02197	Nc	Stanly	Yadkin River	216380	Dm Ph
Progress Energy Carolinas,inc.	02206	Nc	Stanly, Montgomery	Pee Dee R	108600	Dm Ph

Licensee	FERC Project No.	State	County	River	Installation (KW)	Facilities Under License
Virginia Electric & Power Co (Va)	00906	Va	Amherst	James River	7500	Dm Ph
Crisp County Power Comm (Ga)	00659	Ga	Worth	Flint River	15200	Dm Ph
Duke Power, A Div Of Duke Energy	02232	Sc	Lancaster,york,fairfield	Wateree River	804940	Dm Ph
Pud No 1 Of Pend Oreille Cnty (Wa)	02225	Wa	Pend Oreille	Sullivan Creek	0	Dm Ph
City Of Eugene	02242	Or	Linn	Mckenzie River	120500	Dm Ph
Southern California Edison Co (Ca)	00067	Ca	Fresno	South Fork San Joaquin River	373320	Dm Ph
Southern California Edison Co (Ca)	00120	Ca	Tulare	San Joaquin River	165375	Dm Ph
Southern California Edison Co (Ca)	02175	Ca	Tulare	San Joaquin River	150150	Dm Ph
Georgia Power Co (Ga)	02237	Ga	Fulton	Chattahoochee River	16800	Dm Ph
Eagle & Phenix Hydro Co Inc (Sc)	02655	Ga	Russell	Chattahoochee River	27660	Dm Ph
South Feather Water And Power Agenc	02088	Ca	Yuba	South Fork Feather River	104100	Dm Ph
Augusta Canal Authority	09988	Ga	Richmond	Savanah River	2050	Dm Ph
Public Service Co Of Nh (Nh)	07528	Vt	Essex	Deubert	1100	Dm Ph
Boulder City Of (Co)	01005	Co	Boulder	Middle Boulder Creek	20000	Dm Ph
Pacific Gas And Electric Co (C	00803	Ca	Butte	West Branch Feather River	26650	Dm Ph
Littleville Power Co Inc (Ma)	02801	Ma	Berkshire	Sum	1140	Dm Ph
Pp&I Montana, Llc	02301	Mt	Stillwater	West Rosebud Creek	10000	Dm Ph
Moss Richard	06885	Ca	Mono	Middle Creek	175	Dm Ph
Clark Fork And Blackfoot, Llc.	02543	Mt	Missoula	Clark Fork	3200	Dm Ph
Energy Northwest	02244	Wa	Lewis	Lake Creek	26125	Dm Ph
Appalachian Power Co (Va)	02210	Va	Roanoke	Roanoke(Staunton) R	636000	Dm Ph
Consumers Energy Co (Mi)	00785	Mi	Allegan	Kalamazoo River	2550	Dm Ph
Jacobson Eric R	00733	Co	Ouray	Uncompahgre River	700	Dm Ph
Willis Ken	01992	Ca	Tehama	Fern Springs Creek	15	Dm Ph
Public Service Co Of Colorado (Co)	00400	Co	San Miguel	San Miguel River	11500	Dm Ph
Idaho Power Co (Id)	00503	Id	Owyhee	Snake River	25000	Dm Ph
Union Electric Co (Mo)	02277	Mo	Washington	East Fork Black River	408000	Dm Ph
Kaukauna City Of (Wi)	02677	Wi	Outagamie	Fox River	8000	Ph
South Carolina Electric&gas Co (Sc)	00516	Sc	Saluda	Saluda River	207300	Dm Ph
Mackay Bar Corp (Id)	03041	Id	Idaho	Smith Creek	12	Dm Ph
Green Island Power Authority	00013	Ny	Albany	Hudson R	6000	Dm Ph
Duke Energy Indiana, Inc.	02211	In	Switzerland	Ohio River	64800	Dm Ph
Mead Paper Corp (Ma)	02985	Ma	Berkshire	Zavesky	100	Dm Ph
Everett, City Of (Wa)	02157	Wa	Snohomish	Sultan River	111800	Dm Ph
Appalachian Power Co (Va)	00739	Va	Pulaski	New River	75000	Dm Ph
Pacific Gas And Electric Co (C	02106	Ca	Shasta	Pit River	340500	Dm Ph
Seattle City Of (Wa)	02144	Wa	Pend Oreille	Pend Oreille River	1024000	Dm Ph
Northern Lights Inc (Id)	02594	Mt	Lincoln	Lake Creek	4500	Dm Ph

Federal Energy Regulatory Commission

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