

**REGULATION OF THE ELECTRIC
UTILITY INDUSTRY**

HEARING
BEFORE THE
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
ONE HUNDRED TENTH CONGRESS
SECOND SESSION

TO

EXAMINE THE ADEQUACY OF STATE AND FEDERAL REGULATORY STRUCTURES FOR GOVERNING ELECTRIC UTILITY HOLDING COMPANIES IN LIGHT OF THE REPEAL OF THE PUBLIC UTILITY HOLDING COMPANY ACT IN THE ENERGY POLICY ACT OF 2005, WITH PARTICULAR ATTENTION TO THE REPORT ISSUED BY THE GOVERNMENT ACCOUNTABILITY OFFICE—GAO-08-289, UTILITY OVERSIGHT: RECENT CHANGES IN LAW CALL FOR IMPROVED VIGILANCE BY FERC

MAY 1, 2008



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REGULATION OF THE ELECTRIC UTILITY INDUSTRY

THURSDAY, MAY 1, 2008

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-366, Dirksen Senate Office Building, Hon. Jeff Bingaman, chairman, presiding.

OPENING STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR FROM NEW MEXICO

The CHAIRMAN. Alright. Good morning. Thanks to all of you for coming. I have a short statement to give. I know Senator Domenici does as well.

But, Senator Feingold is our first witness today and is a Senator who is largely responsible for us having this hearing. He was very focused on this issue back when we were enacting the 2005 Energy bill. We appreciate him being here.

So why don't we just go right to him and hear his testimony at this point. After that, I'll give my statement and Senator Domenici will give his.

Senator DOMENICI. Welcome.

STATEMENT OF HON. RUSSELL D. FEINGOLD, U.S. SENATOR FROM WISCONSIN

Senator FEINGOLD. Thank you so much, Mr. Chairman. I thank Senator Domenici, the Ranking Member. It's tremendously courteous of you to allow me to go at all and certainly to go at the beginning.

Thank you very, very much. Thank you for holding this hearing. I'm here today to express my strong concerns about the lack of consumer and small business protections against harmful transactions or cross subsidization between companies and their affiliate companies.

The Energy Policy Act of 2005 significantly altered the Federal regulation of utilities by repealing the Public Utility Holding Company Act or PUHCA of 1935. In response Chairman Bingaman, Senator Brownback and I requested a report from the General Accounting Office to examine the effect of PUHCA's repeal on the oversight of electric utility holding companies and the ability to prevent harmful cross subsidization. I'm pleased that the committee is examining the GAO's recent findings and recommenda-

tions that are identified in the report entitled, *Utility Oversight: Recent Changes in Law Call for Improved Vigilance by FERC*.*

The report is disturbing. It reveals that “the Federal Energy Regulatory Commission has made few substantive changes to either its merger review process or its post merger oversight since the EPA Act and as a result does not have a strong basis for ensuring the harmful cross subsidization does not occur.” Chairman, harmful cross subsidization results in very real and serious impacts on consumers, small businesses and our economy as a whole.

Unfair practices between utility companies and their affiliates force electricity and natural gas consumers to foot the bill for another company’s expenses and allows the utilities to unfairly compete against small businesses. Now previously, PUHCA, as you well know, had stood as a barrier to harmful cross subsidization and other abusive affiliate transactions for decades. Given its repeal it is essential that Congress ensure their effective authorities for oversight and regulation of electric utility holding companies.

Under the current law established in 2005 to encourage investment in the utility sector there is little doubt that utilities will become larger, more complex and located in geographically diverse areas. The size and complexity of these companies also will make it more difficult to identify abuses. Unfortunately all too often utilities have succumb to temptation and have relied on the more stable regulated utilities within the company to shore up balance sheets and offset risky non-utility investments while customers, ratepayers and investors pay the bill.

To ensure adequate protections, Senator Brownback and I have championed efforts to require FERC to establish ring fencing rules to help ensure that the financial integrity of public utilities is not harmed by the repeal of PUHCA. Ring fencing is the legal walling off or encircling of a regulated utility from its unregulated affiliates. Insulating utilities in this way is intended to protect regulating the utility itself and its investors, the electricity and natural gas consumers as well as to prevent unfair, illegally subsidized competition with small businesses.

Our legislative proposal has the support of trade associations, unions, small business representatives, public interest groups and utility associations, such as the American Public Power Association, the American Sub Contractors Association, Associated Builders and Contractors, Association of Financial Guarantee Insurers, International Brotherhood of Electrical Workers, National Electrical Contractors Association, Plumbing, Heating, Cooling Contractors, public citizens, public interest research groups, Small Business Legislative Council and the Sheet Metal and Air Conditioning Contractors National Association.

So, Mr. Chairman, I look forward to continue to work with you, this committee, Senator Brownback and our colleagues to ensure that there are strong safeguards against harmful cross subsidization. Thanks so much to both of you.

The CHAIRMAN. Thank you very much for your testimony and your interest in this issue and continued focus on it. I think it’s useful to us. We are going to try at today’s hearing to get good tes-

* Report has been retained in committee files

timony about what, if any, additional action we should consider here in the Congress. But thank you very much.

Senator DOMENICI. Thank you, Senator.

The CHAIRMAN. Let me go ahead and make a statement, and then Senator Domenici. Then we'll call the first panel forward. I believe this is an important hearing. I look forward to hearing from the witnesses, and appreciate the thoughtful testimony we've already received in written form.

In 2005 when we passed the Energy Policy Act, we did a number of things related to the electric utility industry. Among the most important, Senator Feingold mentioned was the repeal of PUHCA. PUHCA had stood as an important consumer protection statutes since 1935. In the 1930s when PUHCA was passed, the country had just been through a great deal of turmoil in the electric utility industry.

In the 1920s the industry had expanded rapidly. The financing of that expansion was through some highly questionable corporate practices. Large complicated holding company structures were developed and sprawled across the country.

Regulation by the States was almost impossible, and there was no Federal regulation at that point. Many observers credit the Pondsey schemes developed to finance electricity expansion with being one of the main causes of the stock market crash in 1929.

Congress and the Roosevelt Administration passed PUHCA to get control of the corporate structure of the electricity industry. It did that in two ways. First, ownership of utilities by other kinds of businesses or ownership of other businesses by utilities was discouraged or outright banned.

Second, large multi-State holding companies were required to file all affiliate transactions. All transactions with utility affiliates had to be at cost. The intent was to keep our corporate structure simple enough that State regulators could keep track of it or to subject multi-State systems to stringent regulation of inter-affiliate relationships at the Federal level.

So as we began to move toward a more competitive industry many viewed PUHCA as being outmoded. Its strict ownership requirements discourage potential investors. Its geographic and structural requirements discourage new interest into markets.

I agreed with that point of view. I still do. However, I also felt that the consumer protections of the Holding Company Act should not be entirely lost. We insisted that part of the legislation we would enact would strengthen FERC's merger authority to require clearer protection against cross subsidization and pledges of debt by a utility for the benefit of its affiliate companies.

Many in Congress believe that this was not enough. The consumers would not be protected without broader consumer safeguards. We had just been through another era when utilities were getting into financial trouble because of their relationships with corporate affiliates and Members of Congress were concerned.

Some of these protections were accepted, such as the merger authority language. Senator Cantwell proposed market manipulation provisions that were included. Other proposals were not accepted. Specifically, Senator Feingold and Senator Brownback's proposal for affiliate transactions was not accepted.

At that time, they asked for a report to be done by the GAO and that we have a hearing. I supported that request and this hearing is the result of that request.

GAO has issued its report. GAO is here today to testify on its conclusions. They were highly critical, as Senator Feingold pointed out, of FERC's application of its new authority, its new merger authority and of its cross subsidization regime in general. FERC is here, primarily to argue that the rules they have put in place are sufficiently protective in their view.

If GAO is correct and FERC's rules are insufficient, that's a serious issue that we need to try to correct. If Chairman Kelliher is correct and FERC is adequately protecting consumers than obviously we have nothing to worry about. So we're here today to look at that exact question. I very much appreciate all the witnesses being here.

Senator Domenici.

**STATEMENT OF HON. PETE V. DOMENICI, U.S. SENATOR FROM
NEW MEXICO**

Senator DOMENICI. Thank you very much, Mr. Chairman. Thanks to all of the Commissioners for joining us here today. I was one of those who for years thought PUHCA, years before its repeal, thought that it should be repealed. I remember that you, Mr. Chairman, went along with that as you've indicated in your statement. We did provide some safeguards that you wanted in the energy legislation that included that PUHCA repeal.

I want to, here and now, complement the Commission under the leadership of its chairman. I believe from everything I have ascertained that the disagreement of Chairman Kelliher with the GAO findings is quite appropriate. I believe the chairman is correct. I believe GAO is not correct. Maybe they can convince me today.

But from what I see all the ominous predictions, when we passed the repeal about merger mania would occur. We would see all kinds of the things happening that were protected against. None of those have happened.

There's been no merger mania. Just been about average merger effectiveness as the years prior to the repeal. I want to, by day's end, hope that I can say to the Commission that they should continue with what they're doing and do it in a very strong and forceful way.

I'm willing to listen to what those who are here to say that you ought to do more. But I frankly do not believe any harm to anyone has occurred during the time that we've had the repeal, during which the Commission has exercised its authority and has brought in the States where they can be helpers and make the thing work better. All in all, I think, in a very admirable job. Thank you very much, Mr. Chairman. I look forward to the witnesses.

[The prepared statement of Senator Domenici follows:]

PREPARED STATEMENT OF HON. PETE V. DOMENICI, U.S. SENATOR FROM
NEW MEXICO

Welcome. Thank you all for being here this morning. I very much appreciate the witnesses taking time out of their busy schedules—particularly all five FERC Com-

missioners—to appear before us today as we examine the repeal of “PUHCA,” the Public Utility Holding Company Act of 1935.

After years of debate, Congress repealed this 70-year-old law in the Energy Policy Act of 2005. The rigid geographic and ownership limitations—while important protections in the wake of the 1929 stock market crash—became outdated. PUHCA’s restrictions served as a barrier to much needed investment in the utility industry and denied customers potential merger-related benefits.

Those opposed to PUHCA repeal argued that consumers would not be protected because affordable and reliable utility services could not be ensured. But everyone shared the common goal of consumer protection.

In order to close any regulatory gaps left from PUHCA’s repeal, Congress moved to protect consumers from affiliate abuse by:

- strengthening the merger review authority of both FERC and the state commissions;
- enacting “PUHCA 2005”—a provision granting federal and state regulators access to holding company books and records for audit and oversight purposes; and
- amending the Federal Power Act to require FERC, in its merger review process, to protect consumers from improper cross-subsidizations.

Additionally, to address any remaining concerns of our colleagues who supported federal “ring-fencing” measures, the Energy Committee agreed to ask GAO to study the implications of PUHCA repeal and committed to conduct a hearing on the results. Of course that completed GAO report is now before this Committee—it’s why we’re all here today.

Despite some of the doomsday predictions we heard during the energy debate, there has not been an explosion of merger proposals in the industry. FERC has reviewed only 17 merger proposals since passage of EPAct. Importantly, GAO has not found any instances of cross-subsidization since PUHCA repeal.

However, GAO does find fault with the oversight provided by both FERC and the states and concludes that the Commission lacks a strong basis for ensuring that harmful cross-subsidization does not occur.

Mr. Chairman, I appreciate you holding this hearing today. I know FERC has worked very hard to implement its new Energy Policy Act responsibilities and that Chairman Kelliher disagrees strongly with the GAO’s findings. While PUHCA may no longer be the front-burner issue it was back during the energy bill debate in 2005, it is important that we understand the implications of that repeal and its impact on consumers. I also want to thank GAO for undertaking this review and thank the other witnesses before us—representing state, consumer, and utility interests—in assessing today’s post-PUHCA regulatory scheme.

The CHAIRMAN. Thank you very much. Why don’t we go ahead and call the first panel forward. Chairman Kelliher, Commissioner Moeller, Commissioner Wellinghoff, Commissioner Kelly and Commissioner Spitzer, please. Thank you all for being here. We very much appreciate it.

Why don’t we start with you, Chairman Kelliher? Why don’t you go ahead with your statement? We’ll include all the statements, of course, in the record as if read. But any points you would like to make to us orally, we’re glad to hear those as well. So, go right ahead.

STATEMENT OF JOSEPH T. KELLIHER, CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

Mr. KELLIHER. Thank you, Mr. Chairman. Let me begin first of all by thanking you for your efforts on the Farm bill. There were provisions in the Farm bill that could have fractured FERC jurisdiction over wholesale power markets, could have impaired our ability to assure just and reasonable wholesale power prices and actually invited manipulation. I want to thank you for your leadership in working on those provisions and the hard work of your staff. So I’m grateful for that.

My written statement does emphasize what FERC has done since Congress expanded our merger authority in 2005. But what I'd like to do in my oral remarks is really answer, emphasize, a slightly different point. Why we have taken the course that we have and why we have not pursued certain alternatives. So really answer the why question rather than the what question.

Now let me begin first of all by thanking Chairman Bingaman, Senator Domenici and other members of the committee for the strong merger provisions of the Energy Policy Act of 2005. The expanded scope of that provision included generation facilities and holding company review and those changes I personally believe were necessary. I personally advocated in favor of those for close to 10 years.

But Congress, in the expanded merger provisions, the expanded 203 provisions of the Energy Policy Act did largely ratify the merger test that FERC had used for a number of years. FERC—the Congress also added the cross subsidization provisions in section 203. I really think that's the core of the question here today is have we properly exercised, have we properly utilized the provisions regarding cross subsidies the Congress added to our merger and corporate review authority.

I want to emphasize though that cross subsidization, by no means, is a new duty for the Commission. It's something that we've been doing since the 1930s. It's really at the heart of ratemaking, preventing improper cross subsidization.

So addressing it in the context of merger review is not new. It's different. We have normally policed cross subsidies when we set rates rather than review a merger. But it's not altogether a new proposition for us.

Now the Commission has been very active in implementing the expanded section 203 provisions. As detailed in my written testimony, we began within weeks of enactment of the new law. We continued through February of this year, so altogether the Commission has spent about two and a half years on the expanded section 203 provisions. But I welcome the interest of the committee in this area. I think we have acted in a manner consistent with the statutory language and congressional intent.

But really to understand how the Commission has proceeded, it's important to understand the nature of section 203. This is a very highly complex area. It is frequently short handed as our merger provision. But it actually goes far beyond mergers. It also applies to more than traditional utilities.

I think there might be a perception that section 203 is a merger provision, only affects utilities. It does not. The range of entities that are subject to 203 is very broad.

It includes independent power producers who have no cost based rates. It includes marketers and traders who own no generation, but own contracts. It includes utilities that truly are not vertically integrated. They don't own generation. They don't make wholesale power sales.

It also applies to a very wide range of transactions. Securities transactions, utility purchases of power plants, internal transfers where there actually is no sale, merger or acquisition, the sale of power plants between two unaffiliated power producers. So it ap-

plies to a very wide range of transactions. Some of which actually do not entail a risk of cross subsidization.

Now another factor that governed our review is what should the proper relationship of FERC be to State regulators as we address cross subsidization. To me that's governed our decisions. Given there's a broad range of transactions.

Another complexity is that there's more than one way to guard against cross subsidization. Even ring fencing, which is a popular and a proven means. It is a category. There's actually a variety of ring fencing measures. So some transactions raise risk of cross subsidization, some do not. There are a range of equally effective ways to guard against cross subsidization.

So then that led us to a threshold question of how should we use this in a new authority given our relationship with the States. The way electricity is governed in this country, we have a very Federalist scheme. FERC has strong authority. States have strong authorities.

The kinds of transactions that do entail some risk of cross subsidization typically involve a vertically integrated utility. Vertically integrated utilities are typically governed by both FERC and State regulation. The kind of transactions that arguably raise the greatest risk of cross subsidization are typically subject to both FERC and State merger review.

Now we had two paths that we could go down as we use our new 203 authority. One is a preemptive approach where we would establish a single Federal rule to guard against cross subsidization at the point of a merger or we could take a cooperative approach. To me the rationale for the preemption approach would be a view, a prediction or actually almost an assumption of comprehensive failure by the part of State regulators to guard against cross subsidies. I'm not prepared to make that assumption. I don't think the Commission is either.

The rationale for cooperation is a view that Federal and State regulators actually have a concert of interest. We both want to avoid cross subsidies. We both have a duty to prevent cross subsidies. We're charged with protecting different consumers, retail consumers or wholesale consumers.

But we actually have a concert of interest. We believe that we recognize there's more than one equally effective way to guard against cross subsidies. There's actually no need to preempt the States. To me, need alone should dictate whether we preempt the States. I think it's actually unnecessary to preempt the States in this area.

So FERC has taken a cooperative approach with the States. The approach that we've taken, we will review. We allow States to address cross subsidies. We will review the conditions they establish. If we find them inadequate we will add to them. But we will have a cooperative approach.

That is reflected in the recent order the Commission approved with regard to Puget Sound in Washington State. Washington State has very strong ring fencing protections. We will look to the provisions, the protections that the State ultimately decides on. If necessary, we'll add to them.

With that I just wanted to emphasize the kind of approach that we took and the considerations that we bore in mind as we developed our policy toward implementing section 203. I thank you for inviting the Commission today.

[The prepared statement of Mr. Kelliher follows:]

PREPARED STATEMENT OF JOSEPH T. KELLIHER, CHAIRMAN, FEDERAL ENERGY
REGULATORY COMMISSION

INTRODUCTION AND SUMMARY

Mr. Chairman and members of the Committee, thank you for the opportunity to speak here today. My testimony addresses the efforts of the Federal Energy Regulatory Commission (FERC or the Commission) to implement the aspects of the Energy Policy Act of 2005 (EPAcT 2005) concerning electric utility holding companies in the context of mergers and elsewhere. Supplies and prices of energy play a critical role in our economy and in the welfare of our Nation's citizens. EPAcT 2005 sought, in various ways, to allow and encourage greater investment in the energy industry while at the same time protecting customers from cross-subsidization and other improper activities. I welcome the Committee's review of these important issues.

At heart, the Commission is a consumer protection agency. Our primary task since the 1930s has been to guard the consumer from exploitation. The Commission has extensive ratemaking authority under the Federal Power Act (1935) and the Natural Gas Act (1938), and the Commission has used that authority vigorously to prevent cross-subsidization. Our most powerful tool for preventing cross-subsidization is the disallowance of recovery in rates of costs found unjust and unreasonable as improper cross-subsidies. The states have similar tools to prevent rate recovery of unjust and unreasonable costs. And, these tools apply to all utilities, not just the few involved in a merger at any given time.

EPAcT 2005 expanded FERC's merger and corporate review authority under section 203 of the Federal Power Act (FPA). Specifically, EPAcT 2005 clarified our jurisdiction over public utility holding company mergers, and granted FERC authority over acquisitions of generation facilities used for wholesale sales and certain holding company securities acquisitions. With respect to these changes, I thank Chairman Bingaman in particular for his leadership in filling statutory gaps regarding holding company mergers and generation facility acquisitions. EPAcT 2005 also largely codified the merger test used by FERC for some years but, significantly, added to the public interest determination a required finding that a transaction will not result in cross subsidization of a non-utility associate company or the pledge or encumbrance of utility assets for the benefit of an associate company, unless such cross-subsidization, pledge or encumbrance is in the public interest. Finally, EPAcT 2005 amended FPA section 203 to hold that a merger or other corporate transaction requiring section 203 approval will be deemed granted if the Commission does not act within 180 days of filing, with the opportunity for the Commission to grant itself one 180-day extension for good cause. This time limitation signaled Congressional intent that the Commission act expeditiously in making its public interest determinations for corporate transactions.

EPAcT 2005 also repealed the Public Utility Holding Company Act of 1935 (PUHCA 1935) and enacted PUHCA 2005. Under PUHCA 1935, the Securities and Exchange Commission (SEC) regulated certain utility holding companies extensively. In the decades after PUHCA 1935's enactment, federal and state regulation of utilities increased significantly enough that PUHCA 1935 was thought to be an unnecessary impediment to investment in the energy industry. Therefore, PUHCA 2005 does not require or allow the Commission to regulate holding companies in the same way as the SEC did under PUHCA 1935. This is because the Commission and states have very powerful regulatory tools to protect customers against holding company abuses, particularly their corporate and ratemaking authorities. To assist them in using their ratemaking tools, PUHCA 2005 authorizes the Commission and state regulators to obtain the books and records of holding companies and their members if relevant to jurisdictional rates. State regulators have independent authority under PUHCA 2005, and do not need FERC's approval to obtain information. The only provision of PUHCA 2005 that touches on the Commission's substantive authority is a procedural provision that allows multi-state holding companies and state commissions to obtain a determination regarding centralized service company cost allocations for such multi-state holding companies, although the Commission al-

ready has substantive authority to do this under the FPA now that PUHCA 1935 has been repealed.

The Commission implemented its responsibilities under EAct 2005 within the tight deadlines set by Congress, and has subsequently issued additional rules to improve its implementation of PUHCA 2005, its new corporate authorities under FPA section 203 and its rate oversight with respect to potential cross-subsidies. The Commission's new rules address, e.g., accounting for centralized service companies in holding companies, pricing for affiliate trades of non-power goods and services, and cross-subsidy filing requirements for applicants in FPA section 203 cases. On the latter issue, our policy is to accept state cross-subsidization protections absent evidence that additional measures are needed to protect wholesale customers or where states lack authority in this area.

In addition, the Commission staff conducts targeted audits to detect and protect against cross-subsidization. The Commission considers a range of factors in selecting companies for audits, including a variety of methods for assessing risk. The Commission has never relied on self-reports as its primary enforcement mechanism to prevent inappropriate cross-subsidization. While the Government Accountability Office (GAO) has criticized our efforts, I do not believe its report reflects a full understanding of the factors considered by the Commission in selecting companies for audits or in conducting the audits, as discussed in more detail below.

IMPLEMENTATION OF EACT 2005'S MERGER AND PUHCA PROVISIONS

Upon enactment of EAct 2005, the Commission took a series of actions addressing FPA section 203 and PUHCA 2005, all within the statutory deadlines:

- (1) adopted regulations to implement PUHCA 2005, including detailed reporting and record retention requirements for utility holding companies and their service companies, and accounting requirements for centralized service companies, codified at 18 C.F.R. Part 366 (December 2005);
- (2) revised the accounting requirements for centralized service companies, to provide greater accounting transparency (proposed rule, April 2006; final rule, October 2006);
- (3) amended the Commission's regulations for FPA section 203 to require explicit consideration of whether a proposed merger or other corporate transaction "will result in cross-subsidization"; required applicants to provide the Commission with a record that would allow it to address cross-subsidization; and required applicants to demonstrate that proposed mergers would not result in cross-subsidization or the pledge or encumbrance of utility assets, or explain how the cross-subsidization or pledge or encumbrance would be in the public interest (December 2005); and
- (4) amended the Commission's regulations under FPA section 203 to grant "blanket authorizations" (a regulatory pre-approval) for certain transactions that would accommodate greater investment in utilities, including certain holding company acquisitions of utility securities under new FPA section 203(a)(2), where there was no adverse impact on competition or harm to captive customers (December 2005).

As a foundation for a second round of initiatives, the Commission held public conferences on December 7, 2006, and March 8, 2007. Industry participants and state commissioners provided input on key issues including the protection of utility customers from cross-subsidization. In particular, the Commission sought input on overlaps in state-federal jurisdiction with respect to mergers and various cross-subsidization protections such as "ring-fencing" and other techniques to protect the assets of regulated utilities. One important purpose of these conferences was to solicit the views of state regulators on the best way to prevent cross-subsidization, and how to coordinate federal and state merger review to that end.

In response to the input received in those conferences and written comments following the conferences, the Commission took the following actions in July 2007:

- (1) The Commission issued a Supplemental Merger Policy Statement, which provided clarification and guidance on the types of commitments applicants could make and the ring-fencing measures applicants could offer to address cross-subsidization concerns. In response to recommendations by the states, the Commission said that it would accept state ring-fencing measures absent evidence that additional measures were needed to protect wholesale customers or where there was a regulatory gap because states lacked such authority. The Commission also adopted certain "safe harbors," for example, for transactions not involving a franchised public utility with captive customers, since these are unlikely to present cross-subsidization concerns.

(2) The Commission proposed rules to codify restrictions on the pricing of power and non-power goods and services in affiliate transactions between franchised public utilities with captive customers, on the one hand, and their market-regulated power sales affiliates and their non-utility affiliates, on the other hand.

(3) The Commission proposed rules to grant additional limited “blanket authorizations” for certain jurisdictional corporate transactions that would not harm either competition or captive customers.

In February of this year, the Commission adopted final rules on the pricing of non-power goods and services. The rules require that any such sales to a franchised public utility with captive customers by a market-regulated power sales affiliate or non-utility affiliate will not be at a price above market price, and any such sales by a franchised utility with captive customers to a market-regulated power sales affiliate or non-utility affiliate will be at the higher of cost or market price, unless otherwise authorized by the Commission. The Commission also codified a requirement it had previously imposed case-by-case, requiring its prior approval under FPA section 205 of any power sales between a franchised public utility with captive customers and any market-regulated power sales affiliates. These restrictions apply to all public utilities, not just those proposing a merger. These rules strengthen FERC’s ability to protect customers against affiliate abuse.

Also in February, the Commission adopted final rules allowing additional limited blanket authorizations to facilitate investment in the electric utility industry and, at the same time, ensure that public utility customers are adequately protected from any adverse effects of such transactions.

All of the above rules and the Commission’s Supplemental Merger Policy Statement have focused first and foremost on ensuring customer protection (including protection against inappropriate cross-subsidization) and precluding harm to competition, but also on removing unnecessary transaction burdens and limitations on much-needed investment in the utility industry. Also, consistent with Congress’ specific directive in the section 203 amendments, the Commission in its rules has identified classes of transactions that meet the statutory standards for approval and thus can be expeditiously considered for approval.

CROSS-SUBSIDIZATION ISSUES UNDER FPA SECTION 203

In exercising our new responsibility to police cross subsidies in evaluating merger applications, we could have imposed a uniform and preemptive federal rule on ring-fencing provisions. That approach, however, could have preempted state merger conditions even if those conditions guarded against improper cross subsidization just as effectively as the federal rule. Given the common interest of FERC and state regulators in policing improper cross subsidization, that approach would have produced unnecessary conflict between federal and state regulators.

Under FERC’s more flexible approach, we will review merger conditions imposed by a state commission to protect consumers from improper cross subsidization or encumbrance, such as ring fencing or other measures. If these conditions are sufficient to guard against improper cross subsidization, FERC will not impose additional conditions. If we determine state safeguards are inadequate, we will impose additional conditions. If states have no authority to act, we likewise will step in to ensure that adequate protections are in place.

Our approach reflects the reality that a wide variety of transactions are subject to FPA section 203, many of which are not mergers of regulated utilities. Some of these transactions entail some risk of improper cross-subsidization, but others do not. Our approach also reflects the reality that there is more than one mechanism to effectively guard against improper cross-subsidization. Ring fencing is only one such means.

In most cases, a transaction subject to section 203 that entails some risk of cross-subsidization would also be subject to review by state commissions. A preemptive federal approach would limit the ability of state commissions to craft cross-subsidization safeguards, and force state commissions to accept the federal rule. A preemptive approach could be warranted in circumstances such as when uniform regulation would provide a particular benefit or when widespread evidence suggests a regulatory failure on the part of state commissions. I do not believe that protecting against improper cross-subsidization presents such a situation. I believe my state colleagues have been vigilant in guarding against cross-subsidization in the course of state merger review. Under our approach, FERC properly exercises its new duty to guard against improper cross-subsidization, and we can and will take action where state protections are inadequate. But we view preemption as a last resort, not a first resort.

Earlier this month, the Commission applied this approach in conditionally approving the merger of Puget Energy, the holding company that owns Puget Sound Energy and other public utilities, and a number of investor firms, led by Macquarie Group. We found the transaction will not harm competition or rates, adversely affect regulation or result in improper cross subsidization. The Washington Utilities and Transportation Commission has strong ring fencing requirements, and the applicants' filing with the state commission proposed ring fencing commitments and other measures to insulate Puget Sound from any risk related to the financial activities of its affiliates as a result of the transaction. Consistent with our Supplemental Merger Policy Statement, we stated that we would accept the cross-subsidization conditions ultimately adopted by the Washington commission unless they are inadequate to police improper cross subsidization. We reserved our authority to issue supplemental orders as appropriate after the ring fencing provisions adopted by the Washington commission are filed with the Commission.

In every case under FPA section 203, the Commission bases its decision on the record developed in that case—a record created not only by the applicant but also by others, including customers and state consumer advocates, competitors, state commissions and attorneys general. If this record is not adequate, the Commission can find that the applicant's filing is "deficient" and direct the applicant to submit additional record evidence. Other parties can review and challenge any of the evidence. The Commission also can institute so-called "paper hearing" procedures or even trial-type evidentiary hearing procedures. Once there is sufficient record evidence, the Commission's decision must be based on this record evidence. A Commission decision based on non-record evidence will be overturned by a reviewing court.

The Commission carefully analyzes the record evidence submitted by a section 203 applicant. However, the Commission is not bound to follow the analysis of the applicants, and it often does not. Rather, the Commission analyzes the entire record, determines the appropriate result based on the entire record, and provides its analysis of the record in its public order.

While the Commission in some cases relies on commitments by merger applicants, and these commitments are important tools, they are far from the only tools used by the Commission. The Commission has many means by which it can prevent cross-subsidization, including its traditional ratemaking authority. However, applicant commitments usually reflect a careful review of Commission policy by the applicants, and applicants often anticipate merger conditions that would otherwise be imposed by the Commission to prevent cross-subsidization. Further, adherence to those commitments is a condition of the Commission's approval and if public utilities do not adhere to the commitments they are subject to sanctions, including possible civil penalties. For every transaction approved under section 203, the Commission also retains authority under section 203(b) to issue such supplemental orders as it may find necessary or appropriate with respect to the transaction.

CROSS-SUBSIDIZATION ISSUES IN OTHER CONTEXTS

The Commission's rules implementing PUHCA 2005 will enhance the ability of the Commission and others to police cross-subsidization. As noted above, the Commission adopted new accounting regulations in October 2006, adding a new Uniform System of Accounts for centralized service companies, in order to provide greater transparency to protect ratepayers from paying improper service company costs. In addition, the Commission's December 2005 rules required holding companies and service companies to retain records consistent with the retention periods for public utilities and natural gas companies, and required centralized service companies to file on an annual basis financial information and information related to non-power goods and services provided to affiliates. Information collected in that form is available electronically to market participants and the public for use in detecting cross-subsidization, affiliate abuse, or other improper activities.

As further protection, the Commission staff conducts targeted audits as proactive measures to detect and protect against cross-subsidization. Even before PUHCA 1935 was repealed, the Commission had a longstanding practice dating back at least to the 1970s of auditing affiliated transactions as part of its financial audit program. More recently, in November 2003, the Commission began auditing affiliated transactions as part of its multi-scope audits covering its market-based rate program. See, e.g., *Progress Energy*, 111 FERC ¶ 61,243 (2005); *Public Service Company of Colorado*, Docket No. PA05-1-000 (November 28, 2005).

In anticipation of the repeal of PUHCA 1935, the Commission developed and implemented a comprehensive audit program to conduct audits of affiliated transactions to detect and deter cross-subsidization. The audit program reflects the de-

tailed auditing procedures and techniques used to guide the audit team in conducting the audits.

The Commission considers a number of factors including the size and complexity of holding companies in determining how many holding company audits the Commission will conduct in a given year. PUHCA 2005 did not go in effect until February 2006. Until the Commission obtains sufficient experience conducting holding company audits pursuant to PUHCA 2005, the Commission cannot estimate precisely how many of these audits will be needed in the future. Three PUHCA 2005 audits are scheduled for FY08 and these are the initial audits focused on compliance with these requirements. These three audits include some of the largest utility holding companies. These audits are not definitive indicators of the number of audits that the Commission will perform in subsequent years.

The Commission uses a variety of methods to assess risk in selecting audit candidates. These methods include internally developed screens and models, past compliance history, information gleaned from on-going and completed audits, investigations, complaints, Commission financial forms, SEC filings, websites, and rate information gathered from Commission and state rate filings. Further, unlike other agencies that do not have ratemaking responsibilities, the Commission has available a variety of legal and technical experts very familiar with the details of public utilities and the holding companies of which they are a part, and the particular regulatory and other issues facing those public utilities. We therefore bring all our expertise to bear in determining which companies should be audited.

Contrary to the implications in the recent GAO Report,¹ the Commission has never relied on self-reports as its primary enforcement mechanism to prevent inappropriate cross-subsidization. Cross-subsidization, by its very nature, does not lend itself to being self-reported. Ratemaking is a complicated process which relies on the development of an extensive record on costs and revenues, and determination of the proper allocation of costs between jurisdictional and non-jurisdictional operations, the appropriate distribution of costs between and among the various jurisdictional services, and the selection of an appropriate rate of return. Under these circumstances, self-reports would not be an effective method to monitor cross-subsidization. In any event, prior to passing through costs in cost-based rates, a public utility must request authority to do so and therefore the Commission, at the time of such a request, can determine whether the proposed rate or rate formula permits inappropriate cross-subsidization to occur and, if so, to disallow rate recovery. Further, as described above, the Commission has adopted specific, prophylactic restrictions regarding the pricing standard that will be applied in determining whether transactions will be considered to have resulted in inappropriate cross-subsidization (in shorthand, whether an "at cost" or a "market" standard will be applied).

In its report, the GAO makes four recommendations that purportedly would enhance the Commission's ability to detect and prevent harmful cross-subsidization involving public utilities. These recommendations focus primarily on post-merger oversight, in particular with respect to the audit process. While I appreciate the GAO's concern that audit candidates be chosen appropriately and that the Commission should take into account the financial risks facing a company, and I have asked Commission staff to look into the recommendations made by GAO, I do not believe the report reflects a full understanding of the factors considered by the Commission in selecting companies to be audited, or all of the factors in addition to risk that should be considered in selecting such companies.

The GAO Report's first recommendation is that the Commission "[d]evelop a comprehensive, risk-based approach to planning audits of affiliate transactions in holding companies and other corporations that it oversees to more efficiently target its resources to highest priority needs and to address the risk that affiliate transactions pose for utility customers, shareholders, bondholders, and other stakeholders." Contrary to the premise of this recommendation, the Commission followed a risk-based approach in selecting the FY08 PUHCA audit candidates and will continue to follow a similar approach in the future. The risk-based approach entailed a comprehensive review of audit materials obtained from the SEC; discussions with the SEC; examination of financial information contained in FERC Form No. 60, FERC Form No. 1, and SEC filings; rate information gathered from Commission filings; and discussions with the Commission's legal and technical experts. In addition to the above methods, the Commission audit staff searched through 155 boxes of audit materials received from the SEC covering 28 holding companies, participated in several conference calls with the SEC staff responsible for the implementation of PUHCA 1935 and discussed audit practices, processes and procedures, as well as outstanding

¹GAO Report, Recent Changes in Law Call for Improved Vigilance by FERC, GAO-08-289(February 2008) at 8,10 and 14-15.

issues for certain holding companies. Finally, shortly after the audits started, the Commission held discussions with state commission officials in the states of Georgia, Alabama, Mississippi, Florida, Maryland, Virginia, West Virginia, and Pennsylvania.

The second recommendation suggests that the Commission should develop a better understanding of the risks posed by each company, by monitoring the financial condition of utilities and developing a better means of collaborating with state regulators. Contrary to the GAO Report's assumptions, the Commission audit staff frequently interacts with state regulators during an audit. For example, the Commission's audit staff recently either met or had telephone conversations with eight state regulators regarding the three current FY08 PUHCA 2005 audits. These actions demonstrate the Commission's recognition that maintaining contact with state regulators is mutually beneficial to the states and the Commission.

However, the suggestion that the Commission should monitor the financial condition of utilities fails to appreciate that a company's stock price and bond ratings are typically driven by the company's overall business risks and prospects. Thus, the fact that a company's stocks or bonds are doing well or poorly says little or nothing, standing alone, about whether cross-subsidization is occurring. That is why the Commission's existing method of assessing risk is comprehensive and takes into account both financial and non-financial information rather than solely relying on a utility's stock prices and bond ratings as indicators of potential cross-subsidization.

The third recommendation is that the Commission "[d]evelop an audit reporting approach to clearly identify the objectives, scope and methodology, and the specific findings of the audit, irrespective of whether FERC takes an enforcement action, in order to improve public confidence in FERC's enforcement functions and the usefulness of audit reports on affiliate transactions for FERC, state regulators, affected utilities, and others." The Commission has always strived to clearly identify its objectives and methodologies for all areas of its jurisdictional responsibilities. The Commission is currently implementing this recommendation in the audit context. For example, in November 2007, the Commission's audit staff began the process of including an enhanced audit methodology section in all of its public audit reports. See, e.g., Kansas City Power & Light Co., Docket No. PA06-6-000 (Nov. 27, 2007). Also, the Commission's public audit reports have always included audit objectives and scope, as well as audit findings, where applicable. In contrast, the SEC previously issued non-public audit reports at the completion of its holding company audits. Thus, the Commission's enhanced audit methodology and practice of publicly publishing audit reports have increased the transparency of the process.

Finally, the GAO Report recommends that the Commission, "[a]fter developing a more formal risk-based approach, reassess whether it has sufficient audit resources to perform these audits" and request additional funds, if necessary. The Commission continuously reassesses its audit and other resources to achieve its strategic goals. To that end, for each audit cycle, the Commission prepares an annual audit plan that is vetted with senior Commission officials, and reviewed and approved by me as Chairman. Needless to say, the Commission will continue to seek additional funds from Congress if it believes it needs more resources to carry out its auditing responsibilities, including PUHCA 2005 and cross-subsidization audits, just as the Commission recently did when requesting additional funds for transmission system reliability audits. To summarize, the Commission's auditors already follow a risk-based approach for selecting holding company audit candidates for examination of their affiliated transactions, and the Commission constantly assesses and reassesses its audit resources to carry out the audit priorities in the annual audit plan. Similarly, the Commission continues to collaborate with state regulators to capitalize on their unique knowledge. Interacting with state regulators during the course of an audit is a practice the Commission auditors have followed for a long time. Finally, the Commission continually strives to maintain and improve existing staff practices to ensure that the audit reports include clear audit objectives, scope, and methodologies.

CONCLUSION

In conclusion, let me emphasize that, just as the Commission has done since 1935, it will continue to be vigilant to protect customers from inappropriate cross-subsidization through its ratemaking and other authorities, and to also protect them against mergers or other jurisdictional corporate transactions that are not consistent with the public interest. The rules and policies the Commission has adopted since enactment of EPAct 2005, and the strengthening of its enforcement function, have given the Commission an even stronger foundation to protect against inappropriate cross-subsidization on an ongoing basis irrespective of whether a merger is

involved. Our existing cross-office approach to regulating utilities allows us to bring to bear all agency expertise necessary to detect potential problems and protect customers. Further, with respect to protecting customers against inappropriate cross-subsidization or realignment at the time of a request for merger or other corporate approval under section 203 of the FPA, the Commission has in place a sound program for ensuring such protection—an approach that provides appropriate deference to state regulatory protections and that fills any regulatory gaps.

I note that it has now been two years since the repeal of PUHCA 1935, the enactment of the PUHCA 2005 books and records provisions, and the amendments to our FPA section 203 corporate authority took effect (February 2006). Since that time, the predicted “rush” of major utility mergers and realignments has not occurred, and in fact the annual number of merger applications filed with the Commission has not increased compared to the prior period. Whatever the future may hold with respect to increased utility merger or investment activity, I believe the Commission has laid a solid foundation to adequately protect customers and we will continue to adapt our policies and our auditing approach as necessary to meet our core customer protection mission.

I would be happy to answer any questions the Committee members may have, after my colleagues have had an opportunity to express their views.

The CHAIRMAN. Thank you very much for your testimony. Commissioner Kelly, go right ahead.

**STATEMENT OF SUEDEEN G. KELLY, COMMISSIONER,
FEDERAL ENERGY REGULATORY COMMISSION**

Ms. KELLY. Thank you, Mr. Chairman. Thank you, Chairman Bingaman, Ranking Member Domenici and members of the committee for your leadership and for the opportunity today to update you on the status of the Energy Policy Act of 2005 and PUHCA of 2005 and their implementation.

As Chairman Kelliher noted in his written testimony, at heart, the Commission is a consumer protection agency. The Commission must continue to work closely with this committee, and more broadly, the Senate and the House to make certain that FERC is protecting the American consumer. This has never been more the case than today.

With the repeal of PUHCA 1935, EPACT has correctly taken the SEC out of the enforcement business and given the role to FERC. That has expanded FERC’s role considerably. I’m very proud of the work that this Commission has done and notably our tremendous staff to breathe life into our new and evolving role.

Today I’d like to discuss four issues:

First, the impact of this legislation on investment in the energy market.

Second the need to build more process into FERC’s enforcement authority.

Third, the issues of cross subsidization and encumbrances of utility assets.

Fourth, the case for compliance.

To understand the States and the Commission’s regulatory and enforcement roles under this relatively new legislation, it’s essential to discuss the very positive impact that EPACT has had on the energy market itself. EPACT has helped the American consumer and the economy by broadening the field of investors in the energy market, which of course, is one of the best ways to spur the improvements and innovations in the market that we are eager to see. The proponents of this legislation saw new opportunities for

new investors with new money and new ideas to enter the energy market giving the impetus to push ahead into the 21st century.

As noted in the GAO report, this objective has been met. New investors have entered the energy marketplace since EPACT was enacted and specifically because it was enacted. This is good news for the American consumer.

What this also means is that the energy market has welcomed a host of new members and investors who may be and in some cases are, unfamiliar with regulation. It would be irresponsible for all of us to purposefully attract new investors to the energy market and not educate them about the rules that govern it. Therefore the Commission must at a minimum develop an enforcement strategy and be transparent in communicating that strategy to market participants.

There's a distinct difference between including objectives and scope in an individual audit and setting forth the Commission's objective, scope, vision and strategy for enforcement more broadly. The GAO's paper raises issues that this committee and my fellow Commissioners have taken seriously and must take seriously. Whether we build risk based assessments into the Commission's enforcement mandate as the GAO recommends or some other methodology that is clear, predictable, fair and sufficiently straight forward that market participants can understand it and know what rules to follow. It's imperative that the Commission adopt and communicate a clear vision for its enforcement strategy.

A risk based assessment has considerable merit on the micro level for individual companies.

First, risk is a metric readily identifiable in the business community. Market participants and holding companies make decisions everyday on the basis of their own risk calculations in a variety of circumstances.

Second, risk assessments can lay down clear metrics that will give market participants sufficient predictability concerning what is expected of them.

Third, risk also provides the flexibility to not be so prescriptive, that the metrics rule out unforeseen or variable circumstances. One size does not fit all. Risk assessments take that reality into account.

The key in all of this is to continue to foster Congress' successful intent behind EPACT and the repeal of PUHCA 1935, bringing new investment and new investors into the marketplace while avoiding another ENRON from occurring. With the clearly thought out and communicated enforcement strategy that marketplace predictability and enhanced certainty will attract even greater investment and further protect the American consumer from any exploitation.

It's no mystery that the provisions on cross subsidization were central to the passage and enactment of EPACT 2005 and the repeal of PUHCA of 1935. Cross subsidization is to be avoided at all costs. Through cross subsidization a utility could increase rates to the American consumer, not to benefit the consumer, but to benefit some business entity held by the consumer or its holding company. Or through cross subsidization a utility could allow some unregulated entity held by it or its holding company to use the utilities

assets to provide it an unfair competitive advantage. Or it could also be used to harm the financial integrity of the utility itself.

That is why the Commission took the steps that it has as laid out in the chairman's written testimony. However, we can and we must do more. The chairman cautions against adopting a uniform and preemptive Federal rule on cross subsidization in the absence of widespread evidence of State regulatory failure.

I agree with him that many State Regulatory Commissions have succeeded. But they have not succeeded across the board. Not all States have comprehensive corporate structuring statutes in place.

PUHCA provided that protection for the American consumer. PUHCA did it in a very blunt and, as we came to see, a very inefficient way. So, Congress has rightfully repealed that Act. But in its absence it requires us to be vigilant that corporate structures not be adopted which provide the possibility of harmful cross subsidization or inappropriate encumbrances of utility investment of utility assets to the detriment of utility investors and consumers.

I agree that there is no one silver bullet for preventing cross subsidization. Some States have found ring fencing to be very successful. Other States find that it presents problems and have chosen not to accept it. That does not mean the Federal Government cannot provide more leadership in the area of cross subsidization.

We could, for example, insist that at least one of the suite of mechanisms to prevent cross subsidization be adopted. Not every one of the 50 States needs to adopt ring fencing. But they should all be looking at some proven mechanism to ensure that where cross subsidization is a possibility the corporate structure will be done in such a way as to prevent that from occurring. FERC could and should help States pilot a course for the adoption of productive corporate structure policies.

I would also like to talk about the future—what I hope to see the role—

The CHAIRMAN. Could you sort of summarize because we're going to run out of time?

Ms. KELLY. Thank you, Mr. Chairman.

The CHAIRMAN. Thanks.

Ms. KELLY. I just wanted to say briefly that as the enforcement role of the Commission and the States continue to evolve, regulators should be working with market participants to ensure that they understand how to comply with the rules. I would like to see the Commission embark on a serious program of compliance and not just enforcement. Thank you.

[The prepared statement of Ms. Kelly follows:]

PREPARED STATEMENT OF SUEDEEN G. KELLY, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

INTRODUCTION

Thank you, Chairman Bingaman, Ranking Member Domenici, and members of the Committee for your leadership and for the opportunity to update you on the status of the Energy Policy Act of 2005 (EPAAct 2005) and the Public Utility Holding Company Act of 2005 (PUHCA 2005) and their implementation.

I also want to extend my gratitude to Senators Feingold and Brownback who, along with Chairman Bingaman, asked the Government Accountability Office (GAO) to look into the progress made on the implementation of EPAAct 2005. More specifically, I applaud them all for demanding a close look at what the Commission is doing to prevent cross-subsidization. Cross-subsidization was central to this legisla-

tion's enactment, and we—as a Commission—can and must go farther than we have on this most serious issue. As Federal Energy Regulatory Commission (FERC) Chairman Kelliher noted in his testimony, “At heart, the Commission is a consumer protection agency,” and the Commission must continue to work closely with this Committee and, more broadly, the Senate and the House to make sure that FERC is protecting the American consumer.

This has never been more the case than today. With the repeal of PUHCA 1935, EAct 2005 has correctly taken the Securities and Exchange Commission (SEC) out of the enforcement-picture and has expanded FERC's role considerably. I am proud of the work that the Commission and—notably—our tremendous staff have done to breathe life into this new and evolving role.

Congress was correct to repeal PUHCA 1935, entrusting the regulatory and enforcement roles to the states and to FERC, when it comes to the holding companies that have acquired or seek to acquire public utilities. FERC is equipped to regulate and take enforcement action to enforce that regulation. Under PUHCA 2005, FERC and the states have access to the holding companies' books and records, so that regulators can make fully informed decisions. Congress has also correctly given the Commission the authority it needs to “blow the whistle”, as necessary, and assess appropriate penalties.

Permit me to discuss four issues: first, the impact of this new legislation on investment in the energy market; second, the need to build more process into FERC's enforcement authority; third, cross-subsidization; and fourth, the case for compliance.

IMPACT OF EACT 2005 ON THE ENERGY MARKET—NEW INVESTORS

To understand the states' and the Commission's regulatory and enforcement roles under this relatively new legislation, it is essential to discuss the very positive impact EAct 2005 has on the energy market itself.

Born in this Committee, EAct 2005 has helped the American consumer and the economy by broadening the field of investors in the energy market, which is one of the best ways to spur the improvements and innovations in the market that we are all so eager to see. The proponents of this legislation saw new opportunities for new investors with new money and new ideas to enter the energy market, giving the impetus to push ahead through the beginning of the 21st century. As noted in the GAO report, this objective has been met: new investors have entered the energy marketplace since EAct 2005 was enacted and specifically because it was enacted. That is good news for the American consumer.

BUILDING A BETTER ENFORCEMENT PROCESS

What this also means is that the energy market has welcomed a host of new members and investors who may be, and—in some cases—are, unfamiliar with regulation. It would be irresponsible for all of us to purposefully attract new investors to the energy market and not educate them about the rules that govern it. Therefore, the Commission must—at a minimum—develop an enforcement strategy and be transparent in communicating that strategy to market participants. There is a distinct difference between including objectives and scope in an individual audit and setting forth the Commission's objectives, scope, vision, and strategy for enforcement more broadly.

The GAO's thoughtful paper raises issues that this Committee and my fellow Commissioners have and must take seriously. Whether we build strategy risk-based assessments into the Commission's enforcement mandate, as the GAO recommends, or some other methodology that is clear, predictable, fair, and sufficiently straightforward such that market participants can understand it and know what rules they must follow, it is imperative that the Commission adopt and communicate a clear vision for its enforcement strategy.

A risk-based assessment has considerable merit on the micro-level for individual companies. First, risk is a metric readily identifiable in the business community; market participants and holding companies make decisions each day on the basis of their own risk calculations in a variety of circumstances. Second, risk assessments can lay down clear metrics that will give market participants sufficient predictability concerning what is expected of them. Third, risk also provides the flexibility to not be so prescriptive that the metrics rule out unforeseen or variable circumstances. One size does not fit all, and risk assessments take that reality into account.

For nearly all of the same reasons, a risk-based approach to enforcement also has merit, on the macro-level, of assessing which companies, regions, or problems should cause the Commission the greatest concern, as it develops its enforcement strategy.

The key in all of this is to continue to foster Congress' successful intent behind EAct 2005 and PUHCA 2005: bringing new investment and new investors into the marketplace, while avoiding another Enron from occurring. With a clearly thought out and communicated enforcement strategy, that marketplace predictability and enhanced certainty will attract even greater investment and further protect the American consumer from exploitation.

CROSS-SUBSIDIZATION

It is no mystery that the provisions on cross-subsidization were central to the passage and enactment of EAct 2005. Nor was it a mystery in 2005. Cross-subsidization is to be avoided at all costs. Through cross-subsidization, a utility could increase rates to the American consumer not to benefit the consumer but to benefit some business entity held by the utility or its holding company. Or, through cross-subsidization, a utility could allow some unregulated entity held by it or its holding company to use the utility's assets to provide it an unfair competitive advantage and, possibly, harm the utility's financial integrity. That is why the Commission took the steps it did, as laid out in testimony by Chairman Kelliher. However, we can and must do more.

Chairman Kelliher cautions against adopting a uniform and preemptive federal rule on cross-subsidization in the absence of widespread evidence of state regulatory failure. I agree with him that many state regulatory commissions have succeeded, but they have not succeeded across the board. I also agree that there is no one silver bullet for preventing cross-subsidization, and that—to use the example Chairman Kelliher invoked—some states have found ring-fencing to be very successful, even though it can cause problems for other states which have chosen not to accept it. That does not mean the federal government cannot insist that at least one of a suite of mechanisms to prevent cross-subsidization be adopted. Not every one of the 50 states needs to adopt ring-fencing specifically, but they should all adopt some proven mechanism to help them better regulate these holding companies and guard the American consumer from cross-subsidization.

As a practical matter, the Commission currently relies primarily on self-reported assurances from the market participants it regulates to learn about their cross-subsidization practices and the likelihood of those practices occurring. No amount of conferences, rules, or policy statements will help the Commission obtain better information about cross-subsidization until the Commission's auditing and enforcement arms are given more resources and a clearer mandate to obtain the same information on their own—independent of the information provided directly by the market participants. Enhanced resources would also permit the Commission to obtain better information from state regulators and to meet more frequently with them. Finally, enhanced audit and enforcement resources would build the Commission's capacity to analyze this information so that it can better fulfill its mission to protect the public interest.

Now is not the time to rule out options, but to explore them and adopt one or more of them soon, whether it is through independent risk-based assessments, as GAO recommends; ring-fencing; or some other method. We must make sure we are doing all we can to guard the American consumer from cross-subsidization and other forms of exploitation.

THE CASE FOR COMPLIANCE

As the enforcement role of the Commission and the states continues to evolve, regulators must work with market participants to ensure that they understand how to comply with the rules—especially insofar as new investors who are unfamiliar with FERC, state regulators, and the regulated energy marketplace generally are concerned. The Commission has not used its authority to play “gotcha” with holding companies and other market participants. That was not the intent of Congress and this Committee. Still, we must make that abundantly clear to all market participants and, in particular, to the new investors that EAct 2005 was intended to attract.

With the 2005 enactment, the Commission has entered the enforcement business and has room to grow in this endeavor. The Commission may want to examine the enforcement practices of other government agencies entrusted with similar authority, such as the Federal Trade Commission. There are always ways to improve, and so why not look down the street to agencies that have experience in this business? What are their practices? What are their strategies? How are they staffed? What do their budgets look like?

We may learn from these other agencies that it would be prudent for the Commission to enter the “compliance” business as well. By assisting regulated companies

with their compliance on a more consistent basis, they will gain a much better sense of what the rules are, how to comply with them, and what the Commission values. The Commission, in turn, will learn from its regulated companies which rules are clear and effective and which are not. A strong compliance program presumably would provide market participants with greater assurance that the Commission is not out to play "gotcha." To the contrary, a more productive relationship should emerge. At the end of the day, the American consumer would benefit from a Commission working regularly with market participants to make sure they understand the rules and are playing by them.

CONCLUSION

This Committee's efforts, under the leadership of Chairman Bingaman and Ranking Member Domenici, cannot go for naught. These new laws can be a boon not only to the energy market and the American economy, but also to the American consumer. This legislation has sent FERC into a new world of enforcement with the authority to impose million dollar per day penalties. With that great power comes great responsibility. We not only need to know where to look, but also what we are looking for. To that end, we must develop a comprehensive enforcement strategy and be clear about it. We must also enlist market participants and the states as allies to protect the American consumer from exploitation. The heavy stick of enforcement cannot—by itself—get the job done. We must require that public utilities have the necessary structures in place to prevent cross-subsidization, and we must work together to make sure everyone plays by the rules. Thank you.

The CHAIRMAN. Thank you very much.
Commissioner Moeller.

STATEMENT OF PHILIP D. MOELLER, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. MOELLER. Thank you, Mr. Chairman, Senator Domenici, Senator Craig, Senator Cantwell. It's my pleasure to be here before you today. My statement largely supports the written testimony submitted by Chairman Kelliher concerning our ability to detect and prevent any improper cross subsidization between regulated utilities and their affiliates.

The Commission has had a long standing responsibility to prevent utility consumers from paying rates that reflect inappropriate cross subsidies. In my opinion the best opportunity for the Commission to discover cross subsidization is in the rate making process. That is before any cost can be recovered from wholesale customers served under cost based rates.

The Commission reviews those costs to determine if their recovery would be just and reasonable. Costs that result from inappropriate cross subsidies are not recoverable in rates. While our auditing enforcement and merger authority is significant these measures complement rather than substitute for the rate review that FERC conducts. In addition the States have responsibility over retail rates providing them with authority to deny the recovery of amounts representing inappropriate cost for subsidies and other unjust and unreasonable costs.

As far as I have seen the repeal of PUHCA 1935 has not led to an increase in cross subsidization. Notwithstanding, our Commission must exercise and is exercising vigilance in our rate making, our merger review, our enforcement processes and our auditing functions. I also believe that as competitive energy markets mature, cross subsidization will become less of an issue.

In purely competitive markets where there are no captive customers and energy is sold at market based rates, utilities will not have an incentive to add costs that result in non-competitive prices.

However the markets regulated by the Commission are not purely competitive at this time and thus, not immune from inappropriate cross subsidization between affiliates. As such the Commission is and must exercise its authority to guard against inappropriate cross subsidization.

With regard to the report issued by the Government Accountability Office, I appreciate their efforts to examine this issue. As explained in the chairman's statement, to some extent we are considering or have already implemented or adopted their recommendations. But in our efforts to continually improve our oversight responsibilities and to provide a more transparent enforcement process, I encourage any comments, suggestions or criticisms as full compliance with our rules and regulations is my policy goal.

Our job is to protect the consumers. One of the major enforcement powers we have are the new authorities that you gave us as a Commission in the 2005 Act. I've, at times over the last year felt like a little bit of a lone voice asking that our enforcement process be more open and transparent and give more context to those who regulate so that it is fair.

Again, ultimately, consumers are protected through that. So I'm quite heartened by the fact that I think that our Commission has a growing recognition that that process needs to be more open, particularly heartened by Commissioner Kelly's comments to that effect. At the appropriate time I'd be happy to answer any questions.

[The prepared statement of Mr. Moeller follows:]

PREPARED STATEMENT OF PHILIP D. MOELLER, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you today. My statement largely supports the written testimony submitted by Chairman Kelliher concerning our ability to detect and prevent any improper cross-subsidization between regulated utilities and their affiliates.

The Commission has had a long-standing responsibility to prevent utility consumers from paying rates that reflect inappropriate cross-subsidies. In my opinion, the best opportunity for the Commission to discover cross-subsidization is in the ratemaking process. That is, before any costs can be recovered from wholesale customers served under cost-based rates, the Commission reviews those costs to determine if their recovery would be just and reasonable. Costs that result from inappropriate cross-subsidies are not recoverable in rates. While our auditing, enforcement, and merger authority is significant, these measures complement rather than substitute for the rate review that FERC conducts. In addition, the states have responsibility over retail rates, providing them with authority to deny the recovery of amounts representing inappropriate cross-subsidies and other unjust and unreasonable costs.

As far as I have seen, the repeal of PUHCA 1935 has not led to an increase in cross-subsidization. Notwithstanding, our Commission must exercise and is exercising vigilance in our ratemaking, our merger review, our enforcement processes, and our auditing functions. I also believe that as competitive energy markets mature, cross-subsidization will become less of an issue. In purely competitive markets where there are no captive customers and energy is sold at market-based rates, utilities will not have an incentive to add costs that result in non-competitive prices. However, the markets regulated by the Commission are not purely competitive at this time and thus, not immune from inappropriate cross-subsidization between affiliates. As such, the Commission is, and must, exercise its authority to guard against inappropriate cross-subsidization.

Finally, with regard to the report issued by the Government Accountability Office, I appreciate their efforts to examine this issue. As explained in the Chairman's statement, to some extent we are considering or have already adopted their recommendations. However, in our efforts to continually improve our oversight responsibilities and to provide a more transparent enforcement process, I encourage any

comments, suggestions, or criticisms as full compliance with our rules and regulations is my policy goal.

I would be happy to respond to any questions.

The CHAIRMAN. Thank you very much.
Commissioner Spitzer.

**STATEMENT OF MARC SPITZER, COMMISSIONER, FEDERAL
ENERGY REGULATORY COMMISSION**

Mr. SPITZER. Thank you, Mr. Chairman, members. We've got very learned colleagues here and sort of feel an old statement by an Arizona hero, Morris Udall, is relevant. Everything's been said, but not by everybody.

So I'll try to expedite my comments and particularly refer to my having spent about 9 months of my life on a ring fencing case in Arizona involving an acquisition in 2004 that informs me as to the——

The CHAIRMAN. Which side of the case were you on?

[Laughter.]

Mr. SPITZER. I was representing the State of Arizona as the commissioner at the time.

The CHAIRMAN. Ok.

Mr. SPITZER. Mr. Chairman, and I believe the FERC policies that have arisen from the regulatory environment from EPACT 2005 correctly balance the competing considerations, specifically fulfilling the congressional mandate to protect rate payers with respectful consideration of State commissions and their orders. Ensuring that an applicant demonstrate a proposed transaction will not result in inappropriate cross subsidization. FERC has deferred and I believe should defer to State Utility Commission's findings regarding ring fencing.

FERC will impose protections regarding cross subsidization or asset impairment if prophylactic authority does not exist under State law or if specific State Regulatory protections are insufficient to protect customers. FERC's imposition of additional ring fencing measures is best exercised as a backstop authority rather than a mechanism to preempt State action. State Utility Commissions have long employed tools to protect their retail customers from asset impairment and cross subsidization in various contexts, including proceedings regarding mergers and acquisitions. Thus, where States are willing and able to address cross subsidization, FERC should generally defer to lawful and effective State Utility Commission orders.

As chair of the Arizona Corporation Commission I presided over an application to acquire Unisource Energy Corporation, the parent corporation of Tucson Electric Power Company. In that case the Arizona Commission borrowed liberally from the 1997 decision of the Public Utility Commission of Oregon approving the acquisition of Portland General Electric Company by ENRON Corporation. In approving the 1997 acquisition the Oregon Commission adopted several ring fencing provisions that have been described as the gold standard for the protection of retail ratepayers from asset impairment and cross subsidization in the context of utility merger.

The proof in the pudding, so to speak is that due to ten ring fencing conditions that the Oregon Commission imposed on that merg-

er transaction, the bankruptcy of ENRON Corporation resulted in no negative impacts upon the regulated Oregon utility. I cite to you the testimony in our technical conference on this matter of Commissioner Ray Baum from the Public Utility Commission of Oregon. The Arizona case also raised potential asset impairment and cross subsidization concerns.

Consequently the Arizona Commission examined at great length all of the potential adverse ratepayer impacts of the acquisition of an Arizona utility by out of State interests. This review resulted in the parties to the proceeding, including the Arizona Commission staff, to stipulate to the Oregon Commission's ring fencing language with modest revisions arising from and consistent with Arizona law. FERC should not presume States are unwilling to protect their retail ratepayers from asset impairment or from cross subsidization.

The cases decided by State Utility Commissions, including my own experience on the Arizona Commission, suggest the contrary is true. Therefore, FERC has properly adopted a backstop for those circumstances where the States are without statutory authority, unwilling or unable to impose cross subsidization protections. In fact, since the passage of EPACT 2005, FERC has not preempted a State Utility Commission's ring fencing determination, nor has it imposed views potentially inconsistent with State rules.

It is incorrect, however, to contend that FERC has failed to fulfill its statutory obligations. For example, in the Puget Energy case, FERC recently approved a Federal Power Act, section 203 acquisition conditioned on the Washington Utilities and Transportation Commission's approval of proposed ring fencing provisions. If the Washington Commission's cross subsidization requirements are not adequate to protect customers, the Commission will consider requiring additional ring fencing provisions. But I must note, being familiar with the Washington Commission, I think it would be incorrect for FERC to presume that the Washington Commission's protections will be inadequate.

State Utility Commissions are generally best suited to craft effective ring fencing conditions to protect utility assets and more importantly, their own ratepayers. Therefore, where State Utility Commissions are willing and able to impose adequate ring fencing rules that protect customers, the FERC should not preempt or require additional and potentially conflicting measures. Mr. Chairman, thank you very much.

[The prepared statement of Mr. Spitzer follows:]

PREPARED STATEMENT OF MARC SPITZER, COMMISSIONER, FEDERAL ENERGY
REGULATORY COMMISSION

The first and noblest mission of utility regulation is the protection of the rate-paying public. The Federal Energy Regulatory Commission (FERC) and state utility commissions share this important mission through a matrix of federal and state rules. The primary obligation of FERC is to ensure reliable wholesale energy supplies at just and reasonable rates. As described in Chairman Kelliher's testimony, FERC has adopted a number of mechanisms to fulfill its statutory obligations.

In the Energy Policy Act of 2005 (EPAct 2005), Congress expanded those obligations by amending Section 203 of the Federal Power Act (FPA) to require FERC to consider, among other things, whether a proposed merger or other corporate transaction will result in the improper impairment of utility assets or subsidization of non-utility affiliates. EPAct 2005, section 1289.

In response to EAct 2005, FERC undertook several rulemaking proceedings to establish regulations and policies governing cross-subsidization and asset impairment attendant to review of transactions under FPA Section 203. A primary objective of these proceedings, particularly in light of the repeal of the Public Utility Holding Company Act of 1935 (PUHCA 1935), was to address potential harm to captive ratepayers.

Among the interests balanced in the FERC rulemakings were how to faithfully discharge the Congressionally-mandated obligation without unnecessarily or counter-productively interfering in the long-standing tradition of “ring-fencing” decisions by state utility commissions. I believe the FERC’s policies achieve the correct balance. In ensuring compliance with the requirement that an applicant demonstrate that a proposed transaction will not result in inappropriate cross-subsidization, FERC has deferred, and I believe should defer, to state utility commissions’ findings regarding ring-fencing. FERC will impose protections regarding cross-subsidization or asset impairment only if prophylactic authority does not exist under state law or if specific state regulatory protections are insufficient to protect captive customers.

FERC’s imposition of additional ring-fencing measures is best exercised as a “backstop” authority rather than as a mechanism to preempt state action. State utility commissions have long employed tools to protect their retail customers from asset impairment and cross-subsidization in various contexts, including proceedings regarding mergers and acquisitions. Thus, where states are willing and able to address cross-subsidization, FERC generally should defer to lawful and effective state utility commission orders.

As Chair of the Arizona Corporation Commission (Arizona Commission), I presided over an application to acquire UniSource Energy Corporation, the parent corporation of Tucson Electric Power Company. In the Matter of the Reorganization of UniSource Energy Corporation, Decision No. 67454, ACC Docket No. E-04230A-03-0933 (Jan. 4, 2005). In that case, the Arizona Commission borrowed liberally from the 1997 decision of the Public Utility Commission of Oregon (Oregon Commission) approving the acquisition of Portland General Electric Company by Enron Corp. In approving the 1997 acquisition, the Oregon Commission adopted several ring-fencing provisions that have been described as the “gold standard” for the protection of retail ratepayers from asset impairment and cross-subsidization in the context of a utility merger. The “proof in the pudding,” so to speak, is that, due to the ten ring-fencing conditions that the Oregon Commission imposed on that merger transaction, the bankruptcy of Enron Corp. resulted in no negative impacts upon the regulated Oregon utility. Testimony of Commissioner Ray Baum of the Public Utility Commission of Oregon, Technical Conference on Public Utility Holding Company Act of 2005 and Federal Power Act Section 203 Issues, FERC Docket No. AD07-2-000, at 24 (Dec. 7, 2006).

The Arizona case raised potential asset impairment and cross-subsidization concerns. Consequently, the Arizona Commission examined, at great length, all of the potential adverse ratepayer impacts of the acquisition of an Arizona utility by out-of-state interests. This review resulted in the parties to the proceeding, including the Arizona Commission staff, stipulating to the Oregon Commission’s ring-fencing language with modest revisions arising from and consistent with Arizona law.

FERC should not presume states are unwilling to protect their retail ratepayers from asset impairment or cross-subsidization. The cases decided by state utility commissions, including my own experience on the Arizona Commission, suggest the contrary is true. Therefore, FERC properly has adopted a “backstop” for those circumstances where the states are without statutory authority, or are unwilling, to impose cross-subsidization protections.

In fact, since the passage of EAct 2005, FERC has not preempted a state utility commission’s ring-fencing determination nor has it imposed views potentially inconsistent with state rules. It is incorrect, however, to contend FERC has failed to fulfill its statutory obligations. For example, in *Puget Energy, Inc.*, 123 FERC ¶ 61,050 (2008), FERC recently approved an FPA Section 203 acquisition conditioned on the Washington Utilities and Transportation Commission (Washington Commission) approval of proposed ring-fencing provisions. If, however, the Washington Commission’s cross-subsidization requirements are not adequate to protect customers, the Commission will consider requiring additional ring-fencing protections.

State utility commissions are generally best situated to craft effective ring-fencing conditions to protect utility assets, and most importantly, their own ratepayers. Therefore, where state utility commissions are willing and able to impose adequate ring-fencing rules that protect consumers, the FERC should not preempt or require additional, potentially conflicting, measures.

The CHAIRMAN. Thank you very much.
Commissioner Wellinghoff.

**STATEMENT OF JON WELLINGHOFF, COMMISSIONER,
FEDERAL ENERGY REGULATORY COMMISSION**

Mr. WELLINGHOFF. Thank you, Chairman Bingaman, Ranking Member Domenici and members of the committee. Thank you for the opportunity to appear here today to discuss these issues with you. I endorse Chairman Kelliher's testimony concerning the role of the Federal Energy Regulatory Commission in protecting consumers against improper cross subsidization from mergers that involve an electric utility holding company.

I would like to highlight three related issues though. First, I strongly support Chairman Kelliher's statement that FERC is a consumer protection agency. I also agree that FERC and State regulators have a common interest in policing cross subsidization.

I believe that FERC's approach to that issue appropriately reflects both these important principles. Specifically, FERC's approach recognizes that States have an important role to play in protecting consumers against improper cross subsidization in the context of corporate transactions. As Chairman Kelliher described in evaluating merger applications pursuant to section 203, the Federal Power Act, as amended, FERC reviews ring fencing measures and other merger conditions that a State commission imposes to safe guard customers against cross subsidization. If that examination convinces FERC that such state imposed conditions are sufficient we will not impose additional conditions.

However, our approach also recognizes that Congress assigned new authority to FERC in EPACT 2005. Where we determined that state imposed conditions are inadequate or that relevant State commissions lack authority to act, FERC can and will use our new authority under the 2005 EPACT to protect consumers against improper cross subsidization. I believe that such initial deference to State regulatory review where appropriate both promotes an efficient use of resources and fosters greater State/Federal coordination.

By contrast, I am concerned that a less flexible preemptive approach would unnecessarily undermine such coordination and would limit the ability of State commissions to craft cross subsidization safeguards. In this regard I agree with the comments made at FERC's December 2006 Technical Conference on these issues by Oregon Commissioner Ray Baum and former Wisconsin Commissioner Robert Garvin, who observed that many State commissions are effectively and independently carrying out the statutory responsibilities to protect retail customers from adverse effects of subsidization by public utility affiliates within a holding company organization.

Second, it's worth emphasizing that in every case under section 203 of the FPA the Commission bases its decision on the record developed in that case by the applicant and other parties. In addition to submissions from customers, competitors, State Commissioners and Attorney Generals, I'd like to highlight the contribution that FERC receives from State consumer advocates. I was honored to serve as Nevada's first State Consumer Advocate for customers of

public utilities and I believe that State Consumer Advocates can and do play an important role of building the case records that supports FERC's actions to protect customers against improper cross subsidization.

Finally while it is essential to have well designed rules in place at the Federal and State levels to protect against improper cross subsidization, it is equally important to ensure that those rules are being followed. This is a place for auditing. Because FERC has great resources for auditing than the States in many instances this is an area in which Federal/State collaboration can be particularly instructive.

As Chairman Kelliher stated in his testimony FERC's audit staff interacts frequently with State regulators during an audit reflecting our recognition that maintaining contact with State regulators is mutually beneficial to FERC and the States. I would like to reiterate Chairman Kelliher's comments that FERC will continue to seek additional funds from Congress if we believe that more resources are necessary to carry out essential auditing responsibilities including cross subsidization audits just as FERC currently did when requesting additional funds for transmission system reliability audits.

Thank you very much again, Mr. Chairman for inviting me.
[The prepared statement of Mr. Wellinghoff follows:]

PREPARED STATEMENT OF JON WELLINGHOFF, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Chairman Bingaman, Ranking Member Domenici, and members of the Committee, thank you for the opportunity to appear before you today.

I endorse Chairman Kelliher's testimony concerning the role of the Federal Energy Regulatory Commission (FERC) in protecting consumers against improper cross-subsidization from mergers that involve an electric utility holding company. I would like to highlight three related issues.

First, I strongly support Chairman Kelliher's statement that FERC is a consumer protection agency. I also agree that FERC and state regulators have a common interest in policing cross-subsidization. I believe that FERC's approach to this issue appropriately reflects both of those important principles.

Specifically, FERC's approach recognizes that states have an important role to play in protecting customers against improper cross-subsidization in the context of corporate transactions. As Chairman Kelliher described, in evaluating a merger application pursuant to section 203 of the Federal Power Act (FPA) as amended by the Energy Policy Act of 2005 (EPAAct 2005), FERC reviews ring fencing measures and other merger conditions that a state commission imposes to safeguard customers against cross-subsidization. If that examination convinces us that such state-imposed conditions are sufficient, then we will not impose additional conditions.

However, our approach also recognizes that the Congress assigned new authority to FERC in EPAAct 2005. Where we determine that state-imposed conditions are inadequate, or that a relevant state commission lacks the authority to act, FERC can and will use our new authority under EPAAct 2005 to protect customers and ultimate consumers against improper cross-subsidization.

I believe that such initial deference to state regulatory review, where appropriate, both promotes an efficient use of resources and fosters greater federal-state coordination. By contrast, I am concerned that a less flexible, pre-emptive approach would unnecessarily undermine such coordination and would limit the ability of state commissions to craft cross-subsidization safeguards. In this regard, I agree with comments made at FERC's December 2006 technical conference on these issues by Oregon Commissioner Ray Baum and former Wisconsin Commissioner Robert Garvin, who observed that many state commissions are effectively and independently carrying out their statutory responsibilities to protect retail customers from the adverse effects of subsidization by public utility affiliates within a holding company organization.

Second, it is worth emphasizing that in every case under section 203 of the FPA, the Commission bases its decision on the record developed in that case by the applicant and other parties. In addition to submissions from customers, competitors, state commissioners, and attorneys general, I would like to highlight the contributions that FERC receives from state consumer advocates. I was honored to serve as Nevada's first consumer advocate for customers of public utilities, and I believe that state consumer advocates can and do play an important role in building the case records that support FERC's actions to protect customers against improper cross-subsidization.

Finally, while it is essential to have well-designed rules in place at the federal and state levels to protect against improper cross-subsidization, it is equally important to ensure that those rules are being followed. This is the place for auditing. Because FERC has greater resources for auditing than the states in many instances, this is an area in which federal-state collaboration can be particularly constructive. As Chairman Kelliher stated in his testimony, FERC's audit staff interacts frequently with state regulators during an audit, reflecting our recognition that maintaining contact with state regulators is mutually beneficial to FERC and the states. I would like to reiterate Chairman Kelliher's commitment that FERC will continue to seek additional funds from the Congress if we believe that more resources are needed to carry out our essential auditing responsibilities, including cross-subsidization audits, just as FERC recently did when requesting additional funds for transmission system reliability audits.

Thank you again for inviting me to speak here today.

The CHAIRMAN. Thank you very much. Thank you all for your excellent testimony. Let me ask a few questions and then defer to Senator Domenici for his questions.

It seems like just hearing your various statements, I think, at least from my perspective, we're all in agreement on some basic things. FERC should not be preempting the States. I agree with that. I think everybody has said that.

It's best for FERC to exercise backstop authority. That's what I think we intended with the law. I guess my concern is that I don't know that there, I believe Commissioner Kelly, you said that I think the words you used were that FERC needs to have a clearly thought out and communicated enforcement strategy. I'm not sure that that is currently in place.

I guess I'm not sure that State regulators or corporations that may consider mergers have a clear idea of when FERC will step in and exercise backstop authority. That's a concern that occurs to me. Let me also just refer, I believe your testimony, Commissioner Spitzer, of where you talk about here at the end of your statement, where State Utility Commissions are willing and able to impose adequate ring fencing rules that protect consumers, FERC should not preempt or require additional, potentially conflicting measures. I agree with that.

The obvious question though is what are adequate ring fencing rules at the State level? What has FERC told States and told potential companies, with the idea of entering into mergers, about what adequate ring fencing rules are. I guess that's my concern.

Chairman Kelliher, do you have some reaction to that?

Mr. KELLIHER. Yes, sir. First of all, I agree that section 203, a point I tried to make in my oral testimony, that section 203 the Federal Power Act is highly complex and the transactions are complex. I would not be surprised if there's some level of uncertainty in the regulated community as well as in the public as to how does FERC go about these reviews.

But also the reviews are very fact intensive because look at two different scenarios. Look at two companies, utilities, that are dis-

tribution only companies. They own no generation. They own no transmission. They engage in no sales at market based rates. All they do is provide distribution service at a rate set by State regulators. Let's say they merge.

Then look at another scenario of two independent power producers merge. They make no cost based sales. Everything is a market based rate sale. Let's say they're arguably in two totally different regions of the country.

The kind of conditions that FERC might impose, I would expect would vary in those two circumstances. In the second there might be an argument that there's actually no risk of cross subsidization. If there's no rate set by government. There's no cost base rate. There's no regulated rate. You can argue there's actually no risk of cross subsidization. So we don't impose any protections on cross subsidization. In the first, you might also argue there's not a risk of cross subsidization because there's no non-regulated—there's no sale of a service or a product that's not regulated.

But the third scenario would be a complicated merger, a holding company, two holding companies that engage in market based rate sales, cost based rate sales. Let's argue they're even adjacent. In that case we might see a significant risk of cross subsidization, the need to guard against it. We would look at how the State, in this case, there might be multiple States. What conditions are imposed by the States in their review of those mergers and then what conditions do we need to perhaps add to that.

That's part of the difficulty is that some mergers involve multiple States. Some involve one State. The recent action we took on Puget. It involved an acquisition of a utility in a single State. Washington State has very strong ring fencing provisions. They have some of the best regulators in the State including North Carolina.

North Carolina and Washington have excellent regulators.

[Laughter.]

Mr. KELLIHER. We are not going to blindly trust them. But we're going to rely on the commitments the applicant made and the State regulators. Then we'll look at those commitments. We might add to them.

The CHAIRMAN. Ok. Let me just ask Commissioner Kelly if you have a thought about this. I gather, as I understand the chairman's position is that there are so many varieties of mergers involved here, so many circumstances, it's really not possible to give more specific direction as to what the Commission would expect States to do by way of dealing with this problem.

Do you have a point of view?

Ms. KELLY. Mr. Chairman, I believe that we can exercise more leadership in this area of ensuring sensible and appropriate corporate structures. Many of the States are sophisticated in this area, but others are not. We have mostly deferred to the States.

We could do more without preempting the States than we have done. For example, we could take a more active role in explaining for the States, where the problems lie in explaining the importance of preventing the possibility of cross subsidization instead of just taking care of it through the rate making process after it has occurred. Considering the productive verses the non-productive or

any productive corporate structures that are possible and keeping an eye out for interstate conflicts because when you defer to States that have different rules, there is the potential of interstate conflicts and of putting undue burdens on entities that do business in multiple States.

It's possible that we could come up with principles to guide States without preempting. I think we should also consider the possibility of adopting the State's structural requirements as our own because currently if we defer to the States, it's just a State requirement. If we adopted them as our own, it would give us the ability to use our enforcement assets and resources in the event that the States don't have adequate ones, should some transgression occur.

The CHAIRMAN. Thank you very much.

Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman. Commissioner Kelly, let me ask this—first make an observation. It seems to me that I was listening to each Commissioner and it seems like that they all agree that basically with Chairman Kelliher's statement, with the exception of you, Commissioner Kelly. I'm not sure how much you're differing.

First I would like to ask, so that I would understand that, have you raised with the Commission or the chairman the facts that you are raising here today? Ask that the Commission do something that's preparatory that they aren't currently doing?

Ms. KELLY. Senator Domenici, our role in implementing this provision of EPACT has evolved. It's evolved since the law was passed in 2005. When we initially—

Senator DOMENICI. That has nothing to do with my question. My question is have you recommended to the Commission that they do something they're not doing with reference to implementation of the provisions that we've put in the law?

Ms. KELLY. As we have gone along, I have worked with the chairman and the other Commissioners to evolve our thinking on this issue.

Senator DOMENICI. Right.

Ms. KELLY. Initially we didn't, when we implemented rules, when we proposed rules and adopted rules to implement PUHCA 2005, we did not deal with the issue of looking in advance at corporate structures and that was acceptable to me because we didn't have the knowledge. However, the chairman agreed to have a technical conference on the subject, which we did in 2006.

A result of that technical conference we accumulated more knowledge on the issue. Then at the end of 2006, we issued a policy statement which evolved our thinking on this issue and showed that we did have a concern about pre-merger review of corporate statements. In that policy statement we have we talked about ring fencing and other structures. We announced our policy of looking at the States. Then in subsequent decisions we have continued to evolve our thinking.

So I feel that the relationship that I've had with the chairman and the other Commissioners has been very productive and has resulted in an evolution of thinking about the importance of this. I anticipate that it will continue.

Senator DOMENICI. That was a very long answer to a very easy question. It's not difficult. I mean I really think I was asking you whether you shared these views with the Commission or did you come share them with us today for the first time?

Ms. KELLY. Oh, thank you, Senator.

Senator DOMENICI. I asked the question like that. You didn't answer it. But that's alright. I guess you don't want to.

Chairman Kelliher, would you tell me with reference to the GAO report, they find that FERC does not have a strong basis for ensuring that cross subsidization does not occur. Do you agree with the report? How is the Commission protecting consumers in that regard?

Mr. KELLIHER. I would have to say I strongly disagree with the report and continue to disagree respectfully. But I think our primary means—I think in part it's just a disagreement on how—what is the best means for FERC to guard against improper cross subsidization? FERC, we have done that historically through rate making.

When we set a rate, we prevent cross subsidy from being recovered when we set a rate, when we set a regulated rate. We did that in the 1930s. We do that today.

To me, rate making is the principal means at FERC to guard against improper cross subsidization. Our rate making authority was not affected by any extent by the 2005 Act. It wasn't decreased and i.e., rate making is our principal means of guarding against cross subsidies.

The 203 merger provisions are a supplement to that because in part they only apply under certain kinds of transactions and by certain kinds of entities. Whereas rate making has a broader reach and a continuous reach. A merger view is a single point in time. Whereas rate making is, well, I don't want to say that rate making is forever. It sounds obnoxious. It suggests that there will always be a FERC. But rate making is more permanent, let's say.

Senator DOMENICI. Ok. I just want to know, I'm sure that all the Commissioners are aware of the GAO study and the GAO report. First let me start with you, Commissioner Moeller, do you agree or disagree with the GAO report? Are you all doing your job right or do they make suggestions that indicate you should change your ways?

Mr. MOELLER. Senator Domenici, I think what the GAO report respectfully may have missed is the point that the chairman made and I tried to make in my testimony, the role of rate making in protecting consumers from inappropriate cross subsidies. That said, I thought the recommendations were, really several of them, reasonable. I think we've actually worked at implementing some of them, particularly being a little more open in terms of how our auditing process goes.

So in that sense, I think maybe they missed the larger point. But I appreciated their recommendations.

Senator DOMENICI. What about you, Mr. Spitzer?

Mr. SPITZER. Thank you, Mr. Chairman, Senator. Certainly the FERC and all of us are willing to consider anything to further protect the interest of the ratepayers of this country. With regard to

the specifics, I think I'd associate my views with those of Commissioner Moeller.

In terms of information sharing, I think we maybe could do a better job and that could be very valuable to State regulators, particularly with new types of corporate structures. Just as an example, in Arizona we had to modify the Oregon ring fencing provisions because Oregon involved an acquisition by a SEC corporation of the operating utility. In Arizona you had a leveraged buy out transaction which was structured as a general partnership.

So the ring fencing rules had to be different to accommodate different structures. Now we have infrastructure funds that are structured even differently than leveraged partnerships. They're not based on debt. They're based on equity. To the degree to which FERC will share information and share audit reports with our State colleagues, I think would be very valuable.

That being said, my experience in transactions prior to PUHCA and then since I came to FERC in 2006, I don't see any harm that's occurred by virtue of the FERC rulemaking. So I don't believe our rulemaking is inadequate. But certainly anything we can do in terms of further sharing information and audits might be very beneficial.

Senator DOMENICI. Commissioner.

Mr. WELLINGHOFF. Mr. Chairman, Senator Domenici, I disagree with the fundamental premise of the GAO report. That is, that it indicates that we're not protecting the interests of consumers. However I think I certainly would agree with Commissioner Moeller and I think some of the points that Commissioner Kelly made that there's always room for improvement.

I think there are suggestions in the GAO report that certainly are worth considering and worth incorporating into our practices. I would have no problem with considering that.

Senator DOMENICI. Thank you very much. Ms. Kelly?

Ms. KELLY. Senator Domenici, I agree that the GAO provides us with some good ideas for improving our enforcement process.

Senator DOMENICI. I thank you all very much. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Cantwell.

Senator CANTWELL. Thank you, Mr. Chairman. Commissioner Kelliher, when you have cross subsidization it results in utilities paying either inflated or above cost for goods and services provided by that non-utility, right?

Mr. KELLIHER. It could work two ways. A utility could sell something below cost to an affiliate that makes sales or a utility could buy something from an affiliate at above cost. So it could work both. The utility customer loses either way, I think.

Senator CANTWELL. Right.

Mr. KELLIHER. Yes.

Senator CANTWELL. Exactly. To know if a utility paid above market prices for an affiliate you would have to look and review the cost and do a comparative, right, to really understand that?

Mr. KELLIHER. Yes, when there's an attempt to recover those costs through a rate because if a utility seeks to change a rate or set a rate, they would need FERC approval for jurisdictional transactions. They would need State approval for other transactions.

Senator CANTWELL. But I mean, you would have to review all those costs to really understand that. FERC, you know, under their market based rates, doesn't look at individual cost components.

Mr. KELLIHER. We're—

Senator CANTWELL. For a utility rate. You don't look at that.

Mr. KELLIHER. Typically cross subsidy can occur when you have a vertically integrated utility. This is a general rule. Vertically integrated utility engages in both cost based transactions as well as market based transactions.

Some company, corporate systems have affiliates and you have the mix of both cost based and market based transactions.

Senator CANTWELL. But I'm saying under FERC what you look at. You look at market based rates and so the Commission doesn't review those individual component costs in looking at the utility rate.

Mr. KELLIHER. We set both market based rates and cost based rates. We set cost based rates for transmission. For wholesale power sales we set cost based rates as well as market based rates.

Market based rates are a privilege, not a right. To get market based rates the company has to demonstrate the absence of market power or mitigate any market power. We have been revoking market based rates where we find that a company cannot demonstrate the absence of market power.

Senator CANTWELL. I feel like we're tiptoeing around this issue as it relates to ring fencing and that is that somehow it's this State should have the first attempt. I mean I look at the GAO report and it says that FERC has made few substantive changes to either its merger review process or its post merger oversight since EPACT. As a result does not have a strong basis for ensuring that harmful cross subsidization does not occur.

Maybe Commissioner Kelly is in a different position than the rest of you on the panel. But it seems to me that FERC should implement a ring fencing provision to have more effective tools in looking at these mergers. It should be part of the process. Because I think where you are with your market based rate authority it creates an enormous opportunity for utilities and these decisions to move away, basically, from protecting the consumers.

You're the cop on the beat. You can't leave it up to the great State of Washington, ok. Yes, they have a great utility. That utility commission did its job, but what about the other States? What about these issues that are across States?

So you're basically saying, yes, it really worked effectively in Washington State because they did their job. But the bottom line is you don't have effective tools unless you adopt something, like ring fencing, to really say that consumers are going to be protected. I think the bottom line here is that the public needs to understand because I don't know of anybody out there who really is following the cross subsidization, ring fencing, all of that dialog.

I mean the bottom line here is on mergers. Is the cop on the beat going to do their job and protect consumers when a merger happens from allowing a partnership, profit margin sharing to basically drive up the rates, eventually, from consumers? Because if you would have had a savings and instead they are used. If you would have had profits and they were used instead to subsidize

this other company instead of helping to protect the consumers on their rates. Eventually the consumer's rates are going to go up.

So, I'm, Mr. Chairman, a fan of having a stronger statute at the Federal level. We can't just leave it up to whether some States want to do this job in policing the markets. That's what FERC's job is, policing the markets.

I thank the Chair.

Mr. KELLIHER. Could I respond, Mr. Chairman or I'm sorry.

The CHAIRMAN. If you'd like to respond, go ahead. If not, we'll go to the next questioner. Go ahead.

Mr. KELLIHER. At your discretion, sir.

The CHAIRMAN. You go ahead.

Mr. KELLIHER. Ok, thank you. I would like to say, emphasize that we do not blindly trust the States. Look at the hypothetical—look at Washington State. Washington State has strong ring fencing provisions. We approved the Puget Sound acquisition, but we retained the authority to impose—issue additional orders, impose additional conditions.

Look at a hypothetical. Let's assume failure by the Washington State regulators, I don't think it's likely, but I suppose it's not a zero percent scenario. Let's assume they just set aside the requirements and say, we're not going to ring fence. We're not going to do anything. We'll impose no cross subsidization provisions.

In that scenario I think there's a good chance the Commission would issue a future order imposing its own cross subsidization provisions. It might be ring fencing. It might be something else. But there is a possibility of preemption as we use of cross subsidization authority in section 203. But it is a last resort, not a first resort. I think that's the distinction.

Should it be a first resort? Should it be reflexive? Should we have something on the shelf that we impose in every 203 transaction? I don't think that would be wise given the nature of the transactions.

The Commission recently had to approve the acquisition of Bear Sterns by J.P. Morgan. Ring fencing frequently improves cash management. If we had a uniform Federal approach on cross subsidization I suppose we would have taken it and imposed it in the J.P. Morgan acquisition of Bear Sterns. FERC would be policing the cash activities of that entity. That doesn't seem to be—we decided that really wasn't the right approach.

So there is a scenario of preemption if we're convinced there's failure by the States. So that seemed to be your concern. I just wanted to reassure you that we will act in the event that a State fails, does not have to prevent cross subsidies. We will attach our own provisions.

Senator CANTWELL. If I could, Mr. Chairman, for 15 seconds.

The CHAIRMAN. Sure.

Senator CANTWELL. I would just say with all that's happened in the marketplace, having a very bright line on something like ring fencing. That it's in your tool box would help in stopping these problems. I certainly, you know, Bear Sterns owning, you know, 10 percent of a utility.

I would hate to see what would happen to Bear Stern to own 10 percent of all utilities. We'd all be in a lot of trouble. So, thank you.

The CHAIRMAN. Senator Craig.

Senator CRAIG. Thank you very much, Mr. Chairman. I say to all of you I helped lead the repeal of PUHCA. I'm glad it's gone. So, I'm always curious when those who opposed it ask the GAO to examine because in repealing it we saw multiple roles.

We saw the role of the State as it related to cross subsidization. I think you've all spoken to that. It sounds like whether some agree or disagree that there's a variance of ability or desire out there. But where it appears to be necessary there seems to be action. It also appears to me that at least, Mr. Chairman, you're telling us that where there is inaction, the FERC is very willing to take action.

I've always felt in the marketplace in your role of protecting consumers that rates went a lot further in protecting the consumer than bureaucracies, often times or systems. Now systems can lead to rates. I understand that.

But at the same time I'm glad you see a State role. I think that's extremely important in all of this. As our markets change, obviously the oversight and the responsibility of FERC is critically important. I would much prefer that this committee and the GAO focus on other things that I think are tremendously more important today to consumers than this business.

How about market manipulation, reliability, competitive markets, I mean, to me, today, in the changing face of where we are, those become extremely more valuable as roles for FERC to play. I would hope that the business that you're in as it relates to this particular activity and transitioning out of PUHCA is not overpowering your ability to do all of these other things. Because I think there are considerably more important to the consumer in the marketplace.

I also want to thank you for, you know, implementing hydro relicensing. Those are the kinds of things that we have to get done out there in the market that is important. You deserve kudos for that. I'm willing to offer those up because I think it's important.

So I guess if there is a question in my comment it would be are you spending the right amount of time and the right amount of energy and the right amount of resource in reliability, market manipulation, competitive markets? Mr. Chairman?

Mr. KELLIHER. I think those are exactly the top priorities in the areas of enforcement. These are new responsibilities Congress gave us just two and a half years ago and to me the top priorities in the area of enforcement are preventing market manipulation, preventing market power exercise and upholding reliability standards. That's where we have to dedicate our resources.

If they're top priorities they should get top priority of our resources. So we are conducting audits. We are conducting PUHCA audits. We conduct other financial audits. But I think we have to focus on the high priorities.

Senator CRAIG. Anyone else wish to respond?

Ms. KELLY. Senator, I would just like to take this opportunity to say how much I've appreciated Chairman Kelliher's leadership in the implementation of EPACT 2005. As this committee well knows, we were given many new tasks and many new responsibilities. I believe that, if I recall correctly, the initial list was 35 new efforts

we were to undertake within a year and a half and we did all of those.

I think that with our newest responsibilities the way we are approaching them is continuing to evolve and continuing to improve which is not surprising that it works that way as we get more familiar with our responsibilities. If I could make one more pitch that I put in my written testimony for more resources for enforcement. Thank you.

Senator CRAIG. Thank you, Commissioner Kelly. It's certainly in those priorities that we've laid out in EPACT 2005, we want to make sure you have the resources to do that. I think the American consumer, more today than ever before, is focused on the price of their energy. They want to know that it's being reasonably priced in relation to its costs of production. Thank you. Thank you all.

The CHAIRMAN. Senator Salazar.

Senator SALAZAR. Thank you.

Senator DOMENICI. Senator Salazar, would you yield for one, 30 seconds?

Senator SALAZAR. Absolutely, Senator.

Senator DOMENICI. I wanted to make an observation, Senator Bingaman. I have to leave for a while. I just wanted to congratulate the Commission. I think that you have properly, Commissioner Kelly, summarized the great task that we gave you. I don't think there's a better Commission than this one, nor do I think looking at the law which had abundant new provisions for a lot of agencies. A great law, I think.

You all were given about as many changes to administer as any and you did it admirably. So I commend you. I hope that we can get you the right resources. You're not the only one that tells us they need them, but I'm glad you reminded us. As you should be adequately—you should have adequate resources for powerful people that are smart, that know their business, helping you. So thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Salazar.

Senator SALAZAR. Thank you, Chairman Bingaman. Thank you for the Commissioners and your testimony here this morning. You know, I looked at the GAO report last night and as I was reading it, it seems to be simply in many ways a suggestion for how we improve regulation.

I mean, if you look at the title of the report itself. It says Utility Regulation opportunities exist to improve oversight. Looking at the summary of what the GAO has found here. It says that all the comprehensive risk based approach to planning audits. It says monitor financial conditions of utilities and has other recommendations there.

Yet I sense from the testimony presented both in written form as well as here this morning that the Commission is being very defensive of these GAO findings. If you recall in the 2005 bill which we were all involved in getting through. The legislation that was proposed or the amendment I think on the floor by Senator Brownback and Senator Feingold resulted in our agreeing that what we would do is to have GAO conduct a review after we had the chance to implement the law for a couple of years.

So my question to each of you starting with you, Chairman Kelliher, is whether there are things in this GAO report that you find useful in terms of the ultimate objective here which is making sure that we are protecting consumers in this new day of post PUHCA which had been in place for what, 70 years before we got to the 2005 EPACT Act. Are there things within the recommendations that the GAO has provided to this committee that you would find helpful. What would be the top two or three if, or maybe you don't find any helpful? Give me a response to that.

Mr. KELLIHER. I would say that I would disagree with some of the assertions and conclusions in the report. I just think they're simply incorrect. But I don't reject the recommendations out of hand. I think it is something we should bear in mind whether we should conduct more audits. I think that's, you know, in a perfect world we would do more across the board in the area of enforcement. Perhaps we would do more audits.

I think in some cases it's just a difference in interpretation. I think we actually do risk based audits currently. But we just view risk in a different manner than GAO. But I think, as my colleagues have said, we are taking therecommendations in the spirit in which they are offered.

I would have preferred that the report say that FERC is doing a good job and it could do an even better job if it considered these recommendations. But we're considering the recommendations nonetheless.

Senator SALAZAR. Is the ability to do a better job dependent on the resources currently that FERC has? For example, doing additional audits or what are the barriers for the Commission of being able to implement an improvement strategy along the lines that GAO has indicated?

Mr. KELLIHER. Resources are certainly an issue because we have asked Congress for additional enforcement resources and Congress has been supportive. But whatever we have is finite. Then we have to allocate it.

To me the highest priority areas are preventing market manipulation, preventing market power exercise, upholding reliability standards. Then the other enforcement priorities have to, to some extent, fight for the remainder of our enforcement budget. This, I don't think, I think the financial audits, the PUHCA audits simply aren't the same priority as preventing market manipulation.

So if we do get more enforcement resources we might be able to conduct more audits.

Senator SALAZAR. Let me ask the other Commissioners if you'd comment quickly on this.

Commissioner Kelly.

Ms. KELLY. Senator Salazar, I agree with the GAO's recommendation that we engage in some sort of open, transparent, comprehensive risk based or some other similar approach to undertake our enforcement activities. I think that would be helpful to us. I think it would be helpful to the regulated community.

So I think they have a lot to offer there. I do believe that we need more resources in our enforcement area.

Senator SALAZAR. Commissioner Moeller.

Mr. MOELLER. Senator Salazar, a little context, having been a Senate staffer for several years when PUHCA repeal was being considered, I think there was a big concern that there would be merger mania after it was repealed. I think the perspective is that there hasn't been, that we have been vigilant, but we need to continue to be vigilant in examining inappropriate cross subsidization in the case of a merger.

In talking to our audit folks, I think they feel that they could be a little more open. But they also focus on things where they see improvements. They don't go through the litany of where they think a company is doing something well.

So that could be just a basic disagreement as to an approach as to how we do audits. But again, I'm amenable to any recommendations on how we can be more open and more transparent in every part of our enforcement program.

Senator SALAZAR. Commissioner Spitzer.

Mr. SPITZER. Thank you, Senator. There were a number of mergers arising prior to 2005 repeal of 1935 PUHCA. A number of them turned out very badly including the Kansas transaction that I know concerned Senator Brownback and 1935 PUHCA did not serve ratepayers well. My judgment is that, due to the efforts of this Congress, in 2005 ratepayer protections were actually enhanced over the status quo ante.

The second observation would be that had FERC promulgated a rule of a one size fits all preemptive ring fencing, for example, Oregon, that would not have worked in the Arizona transaction and might not have worked in other transactions involving different types of investment vehicles.

That would segue into my third observation which would be perhaps more outreach by FERC to State commissions. Making the States aware, which have limited resources, that FERC has perhaps certain observations or views regarding some of the new investment vehicles in the utility space might assist the States. That is the information and collaborative outreach that I look forward to working with my State colleagues in the future.

Senator SALAZAR. If I could ask one more question of you? Is there a great variance in terms of the State capacity from PUC to PUC? I would imagine that you have some States that have significant resources and can provide the oversight function that allows for them to play the backstop function. But do you have? I would imagine the Commission has a good sense that some States are, you might give them a ten in an eight plus rating in terms of their oversight. Other States probably don't have the resources really to provide that kind of oversight.

Mr. SPITZER. Senator in the second panel you're going to hear from NARUC and Mr. Kerr, Commission Kerr, could certainly discuss some of the efforts that the States have done in collaborating amongst themselves. I would agree absolutely that the States have different levels of resources and both within the NARUC as well with FERC, there is collaboration with the States. One of our missions should be to assist those States where resource constraints cause them to ask for additional advice.

Senator SALAZAR. Thank you.

Commissioner Wellinghoff.

Mr. WELLINGHOFF. Thank you, Mr. Chairman, Senator Salazar. I believe that there are a number of things in the GAO report that we do need to consider. We look at the issue of risk ranking of audits, for example.

I would agree with the chairman that I think in some degree we do that already. Certainly with risk ranking, looking at market manipulation is the highest risk. The highest potential harm to consumers I think we have to really put our audit enforcement forces in that area first.

However, with respect to within analysis of potential cross subsidization, perhaps there is some room for more structured ranking of those audits as GAO suggests. But perhaps GAO also needs to investigate more detail exactly how we are currently structuring those audits. As the chairman indicates we do have some measure of a risk ranking that we already use, although it may not be something that's published and transparently available.

If we did provide that information I think it could help clarify that. In addition to the chairman's point on making it more transparent as to what our backstop really is. Let's make it clear. There certainly is a backstop to the extent that the States are not providing for a vigorous and effective ring fencing.

It certainly would be my policy and my position that FERC would and should step in. But there is an issue of what is actually that line. I think Senator Cantwell was concerned about what is that line as well. Perhaps we could have a workshop with the States and with the industry to explore that line a little more.

I think we're defining the line as we get more cases. Certainly I think the Puget case gives us one point on that line. But perhaps we need to get more points on that line. Thank you.

Senator SALAZAR. Thank you, Commissioner. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Let me thank all the Commissioners. You've been very generous with your time and very excellent testimony. We appreciate it.

Why don't we go ahead with the second panel? We have four additional witnesses on the second panel.

Mark Gaffigan, who's the Director with the Energy Project Division of Natural Resources and Environment with the GAO.

David Owens, Executive Vice President with Edison Electric Institute.

The Honorable James Kerr who is the Commissioner with the North Carolina Utilities Commission and representing NARUC here today.

Scott Hempling is Executive Director with the National Regulatory Research Institute.

Thank you all for being here.

Commissioner Kerr, I mispronounced your name. I apologize.

Let me just alert folks that about 11 o'clock, I'm going to have to go to a meeting that Senator Reid has called. Senator Salazar has agreed to remain and preside at that point. So, why don't we go ahead with testimony? Then after each of you has summarized your testimony I'm sure there will be questions.

Mr. Gaffigan, why don't you go right ahead?

STATEMENT OF MARK GAFFIGAN, DIRECTOR, NATURAL RESOURCES AND ENVIRONMENT, GOVERNMENT ACCOUNTABILITY OFFICE

Mr. GAFFIGAN. Thank you, Mr. Chairman. Mr. Chairman, Senator Salazar, members of the committee, Good morning. I'm pleased to be here to discuss Federal and State oversight of electric utility holding companies in light of the 2005 repeal of PUHCA.

Since the repeal of PUHCA there has been considerable interest about harmful cross subsidization—that is the passing of inappropriate costs to utility consumers from transactions between utilities and affiliated companies that are part of larger utility holding companies. Regarding Federal oversight of cross subsidization PUHCA's repeal impacted the Federal Energy Regulatory Commission in two ways.

First, FERC's merger review responsibilities were expanded to ensure at the time of merger that mergers between companies would not result in cross subsidization.

Second, it made FERC the principle Federal agency responsible for post merger oversight of utility holding companies, eliminating the role of the Securities and Exchange Commission.

States continue to share in utility oversight and are very much interested in and impacted by Federal efforts. My testimony today will be based on GAO's February 2008 report that addressed the extent to which FERC has changed its merger and post merger oversight processes to protect against cross subsidization and second, the views of States about their oversight capacity.

Regarding FERC, as has been stated, we found that FERC had made few substantive changes to either its merger review process or its post merger oversight and thus did not have a strong basis for ensuring that harmful cross subsidization does not occur. In the merger review process, FERC will rely on its existing policy that requires merging companies to disclose existing or planned cross subsidization. To certify in writing that they will not engage in cross subsidization.

After mergers take place, FERC will rely on its existing enforcement mechanisms, which include company self reporting of violations. Two, a limited number of compliance audits. Our primary concern and the focus of our report recommendations is our view that FERC is over reliant on self reporting and under reliant on cost and compliance audits.

Specifically FERC believes that the threat of large fines will encourage companies to investigate and self report any cross subsidization. However, to date, no companies have self reported any such violations. Some key stakeholders who we spoke to have raised concerns about this approach.

For example, could large fines chill a company's willingness to self report? Others were concerned that companies may not be fully aware of the broad cross subsidization rules. Given the concerns about self reporting and its inherent limitations, FERC's other primary enforcement mechanism, compliance audits, is an important tool.

However, since the repeal of PUHCA, FERC has not completed any holding company audits for cross subsidization. In 2008, FERC plans to audit three of the 36 holding companies it has determined

are subject to its oversight. While this rate of review and the number of holding companies may change, at this pace, it would take 12 years for FERC to review each company.

Most important, while FERC's audit plans for 2008 reflects insights of key staff. We did not find that FERC had a risk based approach that formally considers the risk posed by individual companies in determining where to focus its audit resources. For example, the use of company financial information and input from knowledgeable people in the financial community and States could be used to help plan FERC's audits.

Without a risk based approach, FERC may not be effectively allocating its limited audit resources. Currently FERC's division of audits has 34 full time staff. With a magnitude of companies it oversees and a range of rules it enforces that go well beyond holding company cross subsidization.

Making the most of limited resources is a theme that is not exclusive to the Federal role. It is an excellent segue to the State's views on their oversight capacity. While State views vary, a common theme that we identified in our survey of the States was the need for additional resources to respond to changes in oversight after repeal of PUHCA.

For example, the majority of States reported auditing 1 percent or less of transactions between affiliated companies over the last 5 years. States expressed their concerns about Federal over reliance on self reporting and the need for regular audits in light of their limited resources. Since oversight is a shared mission, and there is a common resource limitation, it makes even more sense for FERC to consider our recommendations to develop a risk based audit approach that includes collaboration with the States, consideration of company's financial status and clear audit reporting. After development of such an approach, FERC would also be in the best position to assess the need for its resources to perform its audits.

This concludes my opening statement. I have submitted a written statement for the record. I welcome any questions you might have. Thank you.

[The prepared statement of Mr. Gaffigan follows:]

PREPARED STATEMENT OF MARK GAFFIGAN, DIRECTOR, NATURAL RESOURCES AND ENVIRONMENT, GOVERNMENT ACCOUNTABILITY OFFICE

UTILITY REGULATION: OPPORTUNITIES EXIST TO IMPROVE OVERSIGHT

WHY GAO DID THIS STUDY

Under the Public Utility Holding Company Act of 1935 (PUHCA 1935) and other laws, federal agencies and state commissions have traditionally regulated utilities to protect consumers from supply disruptions and unfair pricing. The Energy Policy Act of 2005 (EPAAct) repealed PUHCA 1935, removing some limitations on the companies that could merge with or invest in utilities, and leaving the Federal Energy Regulatory Commission (FERC), which already regulated utilities, with primary federal responsibility for regulating them. Because of the potential for new mergers or acquisitions between utilities and companies previously restricted from investing in utilities, there has been considerable interest in whether cross-subsidization—unfairly passing on to consumers the cost of transactions between utility companies and their “affiliates”—could occur.

GAO was asked to testify on its February 2008 report, *Utility Oversight: Recent Changes in Law Call for Improved Vigilance by FERC* (GAO-08-289), which (1) examined the extent to which FERC changed its merger review and post merger oversight since EPAAct to protect against cross-subsidization and (2) surveyed state util-

ity commissions about their oversight. In this report, GAO recommended that FERC adopt a risk-based approach to auditing and improve its audit reports, among other things. The FERC Chairman disagreed with the need for our recommendations, but GAO maintains that implementing them would improve oversight.

WHAT GAO FOUND

In its February 2008 report, GAO reported that FERC had made few substantive changes to either its merger review process or its post merger oversight since EAct and, as a result, does not have a strong basis for ensuring that harmful cross-subsidization does not occur. FERC officials told GAO that they plan to require merging companies to disclose any cross-subsidization and to certify in writing that they will not engage in unapproved cross-subsidization. After mergers have taken place, FERC intends to rely on its existing enforcement mechanisms—primarily companies' self-reporting noncompliance and a limited number of compliance audits—to detect potential cross-subsidization. FERC officials told us that they believe the threat of the large fines allowed under EAct will encourage companies to investigate and self-report noncompliance. To augment self-reporting, FERC officials told us that, in 2008, they are using an informal plan to reallocate their limited audit staff to audit the affiliate transactions of 3 of the 36 holding companies it regulates. In planning these compliance audits, FERC officials told us that they do not formally consider companies' risk for noncompliance—a factor that financial auditors and other experts told us is an important consideration in allocating audit resources. Rather, they rely on informal discussions between senior FERC managers and staff. Moreover, we found that FERC's audit reporting approach results in audit reports that often lack a clear description of the audit objectives, scope, methodology, and findings—inhibiting their use to stakeholders.

GAO's survey of state utility commissions found that states' views varied on their current regulatory capacities to review utility mergers and acquisitions and oversee affiliate transactions; however many states reported a need for additional resources, such as staff and funding, to respond to changes in oversight after the repeal of PUHCA 1935. All but a few states have the authority to approve mergers, but many states expressed concern about their ability to regulate the resulting companies. In recent years, two state commissions denied mergers, in part because of these concerns. Most states also have some type of authority to approve, review, and audit affiliate transactions, but many states review or audit only a small percentage of the transactions; 28 of the 49 states that responded to our survey question about auditing said they audited 1 percent or fewer transactions over the last five years. In addition, although almost all states reported that they had access to financial books and records from utilities to review affiliate transactions, many states reported they do not have such direct access to the books and records of holding companies or their affiliated companies. While EAct provides state regulators the ability to obtain such information, some states expressed concern that this access could require them to be extremely specific in identifying needed information, thus potentially limiting their audit access. Finally, 22 of the 50 states that responded to our survey question about resources said that they need additional staffing or funding, or both, to respond to changes that resulted from EAct, and 8 states have proposed or actually increased staffing since EAct was enacted.

Mr. Chairman and Members of the Committee: Thank you for the opportunity to discuss our work on federal and state efforts to protect against potential cross-subsidization in the utility industry after the repeal of the Public Utility Holding Company Act of 1935 (PUHCA 1935). Public utilities sell about \$325 billion worth of electricity and natural gas to more than 140 million customers in U.S. homes and businesses each year. These utilities may face the need to invest potentially hundreds of billions of dollars to expand and upgrade the utility infrastructure over the next 10 years. Oversight of utilities is carried out by the federal government and state commissions—with the federal role focused on regulation of interstate transmission and wholesale markets and the states' role focused on regulating retail markets. These federal and state regulators seek to balance efforts to protect utility consumers from potential supply disruptions and unfair pricing practices while ensuring that utilities are profitable enough to attract private investment. Traditionally, this regulation took place within the framework of PUHCA 1935 and other federal laws. In 2005, the Energy Policy Act (EAct) repealed PUHCA 1935, removing some limitations on the companies that could merge with or invest in utilities and opening the sector to new investment. The repeal of PUHCA 1935 has raised concerns about whether the remaining laws and regulations strike an appropriate balance between encouraging investment in the utility sector and protecting consumers.

PUHCA 1935 was a response to the rapid expansion, consolidation, and subsequent bankruptcies in the utility sector during the early part of the 20th century. Prior to its enactment, utilities were regulated by state commissions. As utilities grew, they began to span across multiple states that often had different rules and jurisdictional authority, making it difficult for state utility commissions to effectively regulate them. By the 1920s, as a result of mergers and acquisitions, utilities were largely controlled by a handful of complex corporations—called holding companies—many of which owned several utilities as well as other companies. In many cases, the companies within these holding companies—called affiliates—sold a wide range of goods and services to utilities, such as fuel for power plants. Since the rates utility customers pay generally include the cost of all the goods and services bought to serve them, some transactions between these affiliates allowed the utilities to take advantage of economies of scale to the benefit of utility customers, such as when utilities effectively shared the cost of legal and other administrative services with affiliates instead of each company maintaining staff and other resources to provide these services separately.

However, affiliate transactions that were priced unfairly could inflate customers' rates to subsidize operations outside the utility—called cross-subsidization. Compounding this complex web of corporate ownership and affiliate transactions, poor disclosure of financial information and limited access to financial records made it difficult for investors to accurately assess the utilities' financial health. Many of these holding companies were involved in risky business ventures outside the utility industry and had pledged utility assets to support those investments. Partly as a result of the poor financial disclosure and the complex web of corporate ownership and affiliate transactions, many utilities went into bankruptcy during the financial collapse followed by the Great Depression.

To restore public confidence after the Depression, the federal government undertook three efforts that influenced the regulation of utilities. First, to protect investors, including utility investors, the federal government created the Securities and Exchange Commission (SEC) in 1934. SEC established rules—including improved financial reporting—for the financial markets and publicly traded companies participating in those markets, as well as a means to regulate them. Second, to protect utility customers, the federal government enacted the Federal Power Act of 1935 which served, and continues to serve today, as the foundation of federal regulatory authority related to regulation of public utilities, and empowered the Federal Energy Regulatory Commission (FERC) to serve as the primary federal regulator of utilities.¹ As such, FERC became responsible for overseeing interstate transmission of electricity, wholesale sales of electricity to resellers (e.g., sales by utilities to other utilities), and reviewing proposed mergers or acquisitions involving companies it regulates. In its role of regulating interstate transmission and wholesale sales, FERC has been responsible for approving prices (i.e., rates) for the use of transmission lines and the sales of electricity in wholesale markets—also commonly called “rate setting.” As part of that process, FERC has determined which costs, including affiliate transaction costs, may be lawfully included in rates. Third, the federal government enacted PUHCA 1935 to regulate investment in the utility industry and protect investors and consumers from potential abuses such as cross-subsidization by holding companies. SEC was responsible for administering PUHCA, including reviewing mergers or acquisitions involving holding companies. To that end, SEC was given primary responsibility for examining and determining how to allocate affiliate transaction costs for holding companies it regulates. Among other things, PUHCA limited the formation of new holding companies that were not physically connected by electric power lines, and prohibited existing holding companies from acquiring more than one utility, unless the utilities were physically connected by power lines. Over time, other statutory and regulatory changes reduced some of the strict limitations PUHCA 1935 initially imposed.

Over the past two decades, some interested parties in the utility industry sought repeal of PUHCA 1935, arguing that it was a roadblock to the private investment that could reduce the cost of improvements to the utility infrastructure, and noting that several federal antitrust laws that apply to utility companies have been passed since PUHCA was enacted. Opponents of PUHCA 1935's repeal, including some business and consumer representatives, expressed concern that its repeal would encourage utilities to return to the kinds of risky business ventures that spawned it, and that utilities would again become too complex to effectively regulate, potentially raising prices for consumers. Business groups outside the utility industry were also

¹The Federal Power Act of 1935 empowered the Federal Power Commission, the predecessor to FERC.

concerned that utilities could use their monopolies to cross-subsidize investments into other kinds of businesses and harm competition in those industries.

In 2005, EPAct repealed PUHCA 1935—thereby opening the sector to new investment—and replaced it with PUHCA 2005. The repeal of EPAct 1935 eliminated SEC’s oversight role in regulating utility holding companies or preventing cross-subsidies, giving FERC new authorities to regulate corporate structures and transactions.² FERC’s expanded authorities fall into two broad areas: 1) FERC was required to ensure at the point of the merger review that the proposed merger would not result in harmful cross-subsidization, and 2) FERC became the principal federal agency responsible for determining how costs for affiliate transactions should be allocated for all utility holding companies. To help FERC better oversee these transactions, EPAct provided FERC specific postmerger access to the books, accounts, memos, and financial records of utility owners and their affiliates and subsidiaries, and granted state utility commissions similar access. Furthermore, EPAct expanded FERC’s civil penalty authority to help it enforce its new requirements, providing the commission the ability to levy penalties of up to \$1 million per day per violation. After EPAct, states continue to play key roles overseeing utilities and reviewing mergers, including conducting some audits of affiliate transactions.

My testimony today will focus on our February 2008 report, *Utility Oversight: Recent Changes in Law Call for Improved Vigilance by FERC* (GAO-08-289), which examined: (1) the extent to which FERC, since EPAct’s enactment, has changed its merger or acquisition review process and postmerger or acquisition oversight to ensure that potential harmful cross-subsidization by utilities does not occur; and (2) the views of state utility commissions regarding their current capacity, in terms of regulations and resources, to oversee utilities. For that report, we reviewed relevant reports and data, interviewed key officials, visited four states—California, New Jersey, Oregon, and Wisconsin—that had or were considering implementing strong protections for overseeing holding and related affiliate companies, and surveyed state utility regulators in all 50 states and the District of Columbia. We performed our review from May 2006 through February 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In summary, we found:

- FERC has made few substantive changes to either its merger review process or its postmerger oversight since EPAct and, as a result, does not have a strong basis for ensuring that harmful cross-subsidization does not occur. FERC officials told us that they plan to require merging companies to disclose existing or planned cross-subsidization and to certify in writing that they will not engage in unapproved cross-subsidization. Once mergers have taken place, FERC intends to rely on its existing enforcement mechanisms—primarily companies’ self-reporting noncompliance and a limited number of compliance audits—to detect potential cross-subsidization. FERC officials told us that they believe the threat of large fines, as allowed by EPAct, will encourage companies to investigate and self-report noncompliance. To augment self-reporting, FERC officials told us that they are using an informal plan to reallocate their limited audit staff to conduct affiliate transaction audits of 3 of the 36 holding companies it regulates in 2008. In planning these compliance audits, FERC officials told us that they do not formally consider companies’ risk for noncompliance—a factor that financial auditors and other experts told us is an important consideration in allocating audit resources—relying instead on informal discussions between senior FERC managers and staff. Moreover, we found that FERC’s audit reporting approach results in audit reports that often lack a clear description of the audit objectives, scope, methodology, and findings—inhibiting their use to stakeholders.
- Although states’ views varied on their current regulatory capacities to review utility mergers and acquisitions and oversee affiliate transactions, many states reported a need for additional resources, such as staff and funding, to respond to changes in oversight after the repeal of PUHCA 1935. All but a few states have merger approval authority, but many states expressed concern about their

²The SEC will continue enforcing laws and regulations governing the issuance of securities and regular financial reporting by public companies. The Department of Justice and the Federal Trade Commission will continue their long-standing enforcement of antitrust laws. These include the premerger provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and Section 7 of the Clayton Act.

ability to regulate the resulting companies after merger approval. In recent years, two state commissions denied mergers, in part because of these concerns. Most states also have some type of authority to approve, review, and audit affiliate transactions, but many states review or audit only a small percentage of the transactions, with 28 of the 49 reporting states auditing 1 percent or less over the last five years. In addition, although almost all states reported that they had access to financial books and records from utilities to review affiliate transactions, many states reported they do not have such direct access to the books and records of holding companies or their affiliated companies. While EAct provides state regulators the ability to obtain such information, some states expressed concern that this access could require them to be extremely specific in identifying needed information, thus potentially limiting their audit access. Finally, 22 of the 50 states that responded to our survey question about resources said that they need additional staffing or funding, or both, to respond to changes that resulted from EAct, and 8 states have proposed or actually increased staffing since EAct was enacted.

FERC'S MERGER AND ACQUISITION REVIEW AND POSTMERGER OVERSIGHT TO PREVENT CROSS-SUBSIDIZATION IN UTILITY HOLDING COMPANY SYSTEMS ARE LIMITED

In February 2008, we reported that FERC had made few substantive changes to either its merger and acquisition review process or its postmerger oversight as a consequence of its new responsibilities and, as a result, does not have a strong basis for ensuring that harmful cross-subsidization does not occur. Specifically:

Reviewing mergers and acquisitions.—FERC's merger and acquisition review relies primarily on company disclosures and commitments not to cross-subsidize. FERC-regulated companies that are proposing to merge with or acquire a regulated company must submit a public application for FERC to review and approve. If cross-subsidies already exist or are planned, companies are required to describe how these are in the public interest by, for example identifying how the planned cross-subsidy benefits utility ratepayers and does not harm others. FERC also requires company officials to attest that they will not engage in unapproved cross-subsidies in the future. This information becomes part of a public record that stakeholders or other interested parties, such as state regulators, consumer advocates, or others may review and comment on, and FERC may hold a public hearing on the merger. FERC officials told us that they evaluate the information in the public record for the application and do not collect evidence or conduct separate analyses of a proposed merger. On the basis of this information, FERC officials told us that they determine which, if any, existing or planned cross-subsidies to allow, then include this information in detail in the final merger or acquisition order. Between the time EAct was enacted in 2005 and July 10, 2007—when FERC provided detailed information to us—FERC had reviewed or was in the process of reviewing 15 mergers, acquisitions, or sales of assets. FERC had approved 12 mergers, although it approved three of these with conditions—for example, requiring the merging parties to provide further evidence of provisions to protect customers. Of the remaining three applications, one application was withdrawn by the merging parties prior to FERC's decision and the other two were still pending.

Postmerger oversight.—FERC's postmerger oversight relies on its existing enforcement mechanisms—primarily self-reporting and a limited number of compliance audits.³ FERC indicates that it places great importance on self-reporting because it believes companies can actively police their own behavior through internal and external audits, and that the companies are in the best position to detect and correct both inadvertent and intentional noncompliance. FERC officials told us that they expect companies to become more vigilant in monitoring their behavior because FERC can now levy much larger fines—up to \$1 million per day per violation—and that

³ FERC officials also told us that in addition to self-reporting and audits of some companies, they also may initiate investigations based on internal and external reports of potential violations. Officials told us that they are able to initiate internal investigations based on referrals from FERC staff such as those monitoring natural gas and electricity trading and markets in the market monitoring center. In addition, FERC officials noted that companies and individuals may report potential violators. Such reports may be made, they said, through their "hotline" reporting system, which allows individuals to anonymously report suspected violations of FERC rules. In addition, individuals knowledgeable of FERC's processes and rules may also report violations as formal or informal complaints that companies are violating the terms and conditions of the detailed FERC-approved tariffs or rates. FERC officials did not tell us how many such reports have been made related to cross-subsidies or how many of such reports resulted in cross-subsidy violations. However, officials noted that all complaints are investigated to determine whether they have merit.

a violating company's actions in following this self-reporting policy, along with the seriousness of a potential violation, help inform FERC's decision on the appropriate penalty.⁴ Key stakeholders have raised concerns that internal company audits tend to focus on areas of highest risk to the company profits and, as a result, may not focus specifically on affiliate transactions. One company official noted that the threat of large fines may "chill" companies' willingness to self-report violations. Between the enactment of EAct—when Congress formally highlighted its concern about cross-subsidization—and our February 2008 report, no companies had self-reported any of these types of violations. To augment self-reporting, FERC plans to conduct a limited number of compliance audits of holding companies each year, although at the time of our February 2008 report, it had not completed any audits to detect whether cross-subsidization is occurring. In 2008, FERC's plans to audit 3 of the 36 companies it regulates—Exelon Corporation, Allegheny, Inc., and the Southern Company. If this rate continues, it would take FERC 12 years to audit each of these companies once, although FERC officials noted that they plan audits one year at a time and that the number of audits may change in future years.

We found that FERC does not use a formal risk-based approach to plan its compliance audits—a factor that financial auditors and other experts told us is an important consideration in allocating audit resources. Instead, FERC officials plan audits based on informal discussions between FERC's Office of Enforcement, including its Division of Audits, and relevant FERC offices with related expertise. To obtain a more complete picture of risk, FERC could more actively monitor company-specific data—something it currently does not do. In addition, we found that FERC's postmerger audit reports on affiliate transactions often lack clear information—that they may not always fully reflect key elements such as objectives, scope, methodology, and the specific audit findings, and sometimes lacked key information, such as the type, number, and value of affiliate transactions at the company involved, the percentage of all affiliate transactions tested, and the test results. Without this information, these audit reports are of limited use in assessing the risk that affiliate transactions pose for utility customers, shareholders, bondholders, and other stakeholders.

In our February 2008 report, we recommended that the Chairman of the Federal Energy Regulatory Commission (FERC) develop a comprehensive, risk-based approach to planning audits of affiliate transactions to better target FERC's audit resources to highest priority needs. Specifically, we recommended that FERC monitor the financial condition of utilities, as some state regulators have found useful, by leveraging analyses done by the financial market and developing a standard set of performance indicators. In addition, we recommended that FERC develop a better means of collaborating with state regulators to leverage audit resources states have already applied to enforcement efforts and to capitalize on state regulators' unique knowledge. We also recommended that FERC develop an audit reporting approach to clearly identify the objectives, scope and methodology, and the specific findings of the audit to improve public confidence in FERC's enforcement functions and the usefulness of its audit reports. The Chairman strongly disagreed with our overall findings and the need for our recommendations; nonetheless, we maintain that implementing our recommendations would enhance the effectiveness of FERC's oversight.

STATES VARY IN THEIR CAPACITIES TO OVERSEE UTILITIES

States utility commissions' views of their oversight capacities vary, but many states foresee a need for additional resources to respond to changes from EAct. The survey we conducted for our February 2008 report highlighted the following concerns:

- Almost all states have merger approval authority, but many states expressed concern about their ability to regulate the resulting companies. All but 3 states⁵ (out of 50 responses) have authority to review and either approve or disapprove mergers, but their authorities varied. For example, one state could only disapprove a merger and, as such, allows a merger by taking no action to disapprove it. State regulators reported being mostly concerned about the impact of mergers on customer rates, but 25 of 45 reporting states also noted concerns that the resulting, potentially more complex company could be more difficult to regulate. In recent years, the difficulty of regulating merged companies has

⁴FERC generally plans to retain its flexibility and discretion to decide remedies on a case-by-case basis rather than to prescribe penalties or develop formulas for different violations.

⁵After completion of our survey, one state subsequently obtained approval from its legislature to review and approve future electric utility mergers.

been cited by two state commissions—one in Montana and one in Oregon—that denied proposed mergers in their states. For example, a state commission official in Montana told us the commission denied a FERC-approved merger in July 2007 that involved a Montana regulated utility, whose headquarters was in South Dakota, which would have been bought by an Australian holding company.

- Most states have authorities over affiliate transactions, but many states report auditing few transactions. Nationally, 49 states noted they have some type of affiliate transaction authority, and while some states reported that they require periodic, specialized audits of affiliate transactions, 28 of the 49 reporting states reported auditing 1 percent or fewer over the last five years. Audit authorities vary from prohibitions against certain types of transactions to less restrictive requirements such as allowance of a transaction without prior review, but authority to disallow the transaction at a later time if it was deemed inappropriate. Only 3 states reported that affiliate transactions always needed prior commission approval. One attorney in a state utility commission noted that holding company and affiliate transactions can be very complex and time-consuming to review, and had concerns about having enough resources to do this.
- Some states report not having access to holding company books and records. Although almost all states report they have access to financial books and records from utilities to review affiliate transactions, many states reported they do not have such direct access to the books and records of holding companies or their affiliated companies. While EPart provides state regulators the ability to obtain such information, some states expressed concern that this access could require them to be extremely specific in identifying needed information, which may be difficult. Lack of direct access, experts noted, may limit the effectiveness of state commission oversight and result in harmful cross-subsidization because the states cannot link financial risks associated with affiliated companies to their regulated utility customers. All of the 49 states that responded to this survey question noted that they require utilities to provide financial reports, and 8 of these states require reports that also include the holding company or both the holding company and the affiliated companies.
- States foresee needing additional resources to respond to the changes from EPart. Specifically, 22 of the 50 states that responded to our survey said that they need additional staffing or funding, or both, to respond to the changes that resulted from EPart. Further, 6 out of 30 states raised staffing as a key challenge in overseeing utilities since the passage of EPart, and 8 states have proposed or actually increased staffing.

In conclusion, the repeal of PUHCA 1935 opened the door for needed investment in the utility industry; however, it comes at the potential cost of complicating regulation of the industry. Further, the introduction of new types of investors and different corporate combinations—including the ownership of utilities by complex international companies, equity firms, or other investors with different incentives than providing traditional utility company services—could change the utility industry into something quite different than the industry that FERC and the states have overseen for decades. In light of these changes, we believe FERC should err on the side of a “vigilance first” approach to preventing potential cross-subsidization. As FERC and states approve mergers, the responsibility for ensuring that cross-subsidization will not occur shifts to FERC’s Office of Enforcement and state commission staffs. Without a risk-based approach to guide its audit planning—the active portion of its postmerger oversight—FERC may be missing opportunities to demonstrate its commitment to ensuring that companies are not engaged in cross-subsidization at the expense of consumers and may not be using its audit resources in the most efficient and effective manner. Without reassessing its merger review and postmerger oversight, FERC may approve the formation of companies that are difficult and costly for it and states to oversee and potentially risky for consumers and the broader market. In addition, the lack of clear information in audit reports not only limits their value to stakeholders, but may undermine regulated companies’ efforts to understand the nature of FERC’s oversight concerns and to conduct internal audits to identify potential violations that are consistent with those conducted by FERC—key elements in improving their self-reporting. We continue to encourage the FERC Chairman to consider our recommendations.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

The CHAIRMAN. Thank you very much.

Commissioner Kerr.

STATEMENT OF JAMES Y. KERR II, COMMISSIONER, NORTH CAROLINA UTILITIES COMMISSION REPRESENTING NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. KERR. Thank you, Mr. Chairman. On behalf of my colleagues at NARUC I appreciate the opportunity to be here today and thank you and the members of this committee. I suspect I ought to also thank Chairman Kelliher for his insightful assessment of the relative regulatory bodies across the country. My colleagues in Washington State and I believe he's absolutely correct in that regard.

I want to thank you, Mr. Chairman, Senator Brownback and Senator Feingold for requesting this report and especially thank GAO for the quality work product. NARUC had the opportunity to work closely with GAO in conducting the survey and producing the report. Since the report was issued GAO has presented on the report to our staffs of committee on accounting.

We believe the report provides both States and our Federal colleagues at FERC a valuable tool to continue to do what you've asked us to do with the adoption of EPACT 2005 which is to work together to ensure that we effectively carry out our shared responsibility to consumers. I believe that the report reveals no actual regulatory failures. It reveals no actual regulatory gaps.

It does however identify areas for potential improvements for regulation at both the State and Federal level. Given the awesome responsibility we share with our Federal colleagues to protect consumers, I believe that the GAO report is both timely and helpful.

I want to briefly summarize four points from the perspective of State regulators.

First of all and this cannot be underestimated is the capital needs facing these vital industries are tremendous and they are growing everyday. The growing concern about various environmental issues, interest in efficiency, demand response, alternative generation as well as advanced technologies for more traditional forms of generation are causing significant increases in the capital demands in these industries and that is coupled unfortunately at a time when both commodity and construction costs are escalating.

We cannot perceptively and prescriptively determine how or where the capital will or should come from to meet these needs. We can and do care greatly about who owns and operates these vital businesses. How they are owned and operated. But we cannot afford to discriminate or foreclose the various approaches the needs are simply too great.

These, as Chairman Kelliher said, and I agree are very fact specific inquiries. To meet the challenges we will need the opportunity to consider a variety of approaches, transactions and sources of capital both internal and external. We need to be able to benefit from the creativity and variety that the—with the adoption of EPACT 2005 and the repeal of PUHCA 1935, we now have a greater opportunity to take advantage of.

But you, as you are doing today, should ask yourselves do we have an adequate and effective regulatory structure to perform this

inquiry and to protect consumers. You've heard a lot from the first panel about the Federal approach. I won't cover that again.

I will say that I think when you read the record in this case including the GAO report the answer is yes, we do have an effective regulatory structure. From the State level and I'll anticipate the question of do we disagree with the GAO report in any regard. I don't think this is a disagreement. But I would say that I think the GAO report probably underestimates the pervasive, positive role that rate making authority plays.

I don't mean to be trite. But I do believe that the old expression that if you have them by the rates, their hearts and minds will follow is in fact, an accurate assessment of the importance of rate making authority as it affects the totality of the relationship. We have the power, as demonstrated by the record to approve mergers and acquisitions and other transfers.

But also importantly and I think this was slightly underemphasized is the ability to condition merger approvals, rate making orders to address areas where actual statutory authority may not exist. I have attached to my testimony an extensive appendix from our Duke Synergy merger review that I think makes that point almost too clear with its length and the detail. Then once you've done that. You have the ability to regulate, verify and enforce the various relationships that exist. I think that from a State perspective we believe that we do.

So what are we doing since the repeal of PUHCA and where do we find ourselves? My last point would be that we are working cooperatively with our Federal colleagues. We are, as the GAO suggests, we might want to, willing to do more in this regard.

Some States are expanding the regulatory tools where they determine necessary. They are either getting statutory authority or relying more on orders and conditions. We are working through to leverage resources. To Senator Salazar, to your earlier question, we are trying to leverage resources across States and commissions through NARUC, through the National Regulatory Research Institute, through our extensive interaction with the financial community and if resources are a problem we can work with our State legislatures on funding for resources if additional resources are necessary.

I'd be happy to answer questions at the appropriate time. Thank you.

[The prepared statement of Mr. Kerr follows:]

PREPARED STATEMENT OF JAMES Y. KERR II, COMMISSIONER, NORTH CAROLINA UTILITIES COMMISSION REPRESENTING NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Good morning Chairman Bingaman, Ranking Member Domenici, Members of this Committee, and distinguished panelists.

My name is Jim Kerr. I am a member of the North Carolina Utilities Commission ("NCUC"). I am also the immediate past President of the National Association of Regulatory Utility Commissioners ("NARUC"), and I am testifying today on behalf of that organization. In addition, my testimony reflects the views of the NCUC and provides some detailed information concerning our approach to issues raised in this hearing and the GAO Report. On behalf of NARUC and the NCUC, I very much appreciate the opportunity to appear before you this morning.

I ask that my testimony be made a part of the record and I will summarize our views.

NARUC is a quasi-governmental, non-profit organization founded in 1889. Our membership includes the State public utility commissions serving all States and territories. NARUC's mission is to serve the public interest by improving the quality and effectiveness of public utility regulation. Our members regulate the retail rates and services of electric, gas, water, and telephone utilities. We are obligated under the laws of our respective States to ensure the establishment and maintenance of such utility services as may be required by the public convenience and necessity and to ensure that such services are provided under rates and subject to terms and conditions of service that are just, reasonable, and non-discriminatory.

INTRODUCTION

The Energy Policy Act of 2005 ("EPAct 2005") repealed the Public Utility Holding Company Act of 1935 ("PUHCA 1935") and enacted the Public Utility Holding Company Act of 2005 ("PUHCA 2005"). EPAct 2005 also expanded the Federal Energy Regulatory Commission's ("FERC" or the "Commission") merger and corporate review authority under Federal Power Act ("FPA") Section 203.

PUHCA 1935 repeal opened the door for new and different corporate combinations, including the ownership of utilities by complex international holding companies or private equity firms. At the same time, the repeal did not fundamentally alter the manner in which State commissions regulate.

State regulatory commissions have traditionally had jurisdiction over the regulation of utilities in various areas, including mergers and acquisitions, affiliate transactions, audits, and financial reporting. The repeal of PUHCA 1935 did not change the States' authority in these areas. In fact, EPAct 2005 explicitly gave State Commissions authority to obtain the books and records of a public utility in a holding company system, the holding company or any associate company or affiliate.

State commissions have the obligation under State law to ensure the establishment and maintenance of such energy utility services as may be required by the public convenience and necessity. We have to ensure that such services are provided at rates and conditions that are just, reasonable and nondiscriminatory for all consumers.

State commissions have powerful regulatory tools to protect customers. Each State has extensive ratemaking authority, and in the exercise of the same, has the right to disallow recovery in rates of inappropriate or improper costs, including those deemed to represent cross-subsidies. The exercise of State merger review authority provides a means to protect consumer interests by imposing conditions on any proposed transaction. In fact, the broad statutory mandates to uphold the public interest and ensure reliable service at just and reasonable rates have allowed State commissions to establish specific consumer protections not directly spelled out under their broad statutory authority.

COORDINATION WITH FERC

The Report by the Government Accountability Office ("GAO"), Recent Changes In Law Call for Improved Vigilance by FERC, GAO-08-289 (February 2008) ("GAO Report" or "Report") concluded with a number of recommendations to the FERC Chairman.¹ One of the recommendations stated that the Chairman should develop "a better means of collaborating with [S]tate regulators to leverage resources already applied to enforcement efforts and to capitalize on [S]tate regulators' unique knowledge. As part of this effort, FERC may want to consider identifying a liaison, or liaisons, for [S]tate regulators to contact and to serve as a focal point(s)."²

NARUC has had an extensive and constructive working relationship with FERC, and welcomes the recommendation of the GAO Report in this regard. Currently, we have three State/FERC Collaboratives that cover cross jurisdictional areas: demand response, competitive procurement and smart grid. These initiatives have involved all members of the FERC and Senior Staff and a broad cross-section of State Commissioners and Staff. These efforts have been collegial, informative and productive. In short, the relationship and precedent exists to explore to continue working together in this particular case.

FERC's implementing regulations under EPAct 2005 have been respectful of State authority. FERC has said that where there is State authority in the area of merger review and cross-subsidization protections, that authority should be recognized. For example, as to reviews under FPA Section 203, the FERC policy is to accept State cross-subsidization protections unless there is evidence that additional measures are

¹GAO Report, Recent Changes In Law Call for Improved Vigilance by FERC, GAO-08-289 (February 2008) at 31-32.

²Id.

needed to protect wholesale customers or if there is a regulatory gap because the State lacks authority in the area. This approach properly coordinates federal and State merger review to avoid unnecessary conflict and potential claim of federal preemption.

RESPONSES TO THE GAO REPORT

The following sections will focus on responding to the issues covered in the GAO Report's survey of State commissions. The issues covered in the State survey are (1) State Review of Mergers, (2) State Regulation of Affiliate Transactions and Cross-Subsidies, (3) Financial Protections or Ring-Fencing (4) Audits, Access to Books and Records, and Financial Reporting; and (5) Status of State Resources. The GAO recognized that most of the State commissions have authority which they exercise in these areas.

We note that the detail of the State responses to specific questions depended on the respondent. Further research into State Commission practices were conducted with GAO Staff's visits to four States only.³ In addition, responses and observations were provided from non-State commission entities, such as officials from the financial community,⁴ an "expert" with "extensive experience with FERC and several [S]tate public utility commissions",⁵ a "consultant whose firm does numerous affiliate transaction audits in many [S]tates",⁶ "utility experts",⁷ a "president of an audit company",⁸ and "representatives from two consumer groups".⁹ These points were not made to be critical of the GAO Report, but to recognize the difficulty in responding with precision to the Survey responses.

(1) State Review of Mergers

Almost all States have specific authority to review mergers and similar corporate transactions. The GAO Report recognized that even for the two States that do not have direct merger review authority, these States were able to use other State Commission authority to conduct such reviews.¹⁰ Each State will apply its merger authority to the facts and circumstances of the merger transaction at hand.

The merger statute in my home State of North Carolina is fairly typical: It prohibits any transfer affecting a public utility without approval from the NCUC.¹¹ Such approval will be given "if justified by the public convenience and necessity". The "public convenience and necessity" standard has been described by the North Carolina courts as "a relative or elastic theory rather than an abstract or absolute rule".¹²

According to the leading North Carolina case construing our transfer statute, the NCUC is required to "inquire into all aspects of anticipated service and rates occasioned and engendered by the proposed transfer" in deciding the issues raised by a merger application.¹³ The ultimate decision must be made by analyzing "the facts of each case". This amounts to a requirement that we utilize a "totality of the circumstances" or an ad hoc balancing test in review merger applications.

While the repeal of PUHCA 1935 has not fundamentally altered our authority or ability to review merger applications, our merger analysis has been affected in a limited number of ways:

- (1) We have not had to impose conditions that attempted to preclude PUHCA 1935-related preemption under the Ohio Power decision;
- (2) We have had to beef up our accounting-related conditions to account for the absence of certain accounting practices that would have otherwise been required by PUHCA 1935; and

³Id. at 26.

⁴Id. at 24.

⁵Id. at 26.

⁶Id.

⁷Id. at 28.

⁸Id.

⁹Id. at 27.

¹⁰The GAO Report survey concluded that only 3 States (Florida, Indiana, Texas) out of the responding 50 States lack authority to review mergers. GAO Report, Recent Changes In Law Call for Improved Vigilance by FERC, GAO-08-289 (February 2008) at 22. The Report notes that after completion of the survey, one State (Texas) subsequently obtained approval from its legislature to review and approve future electric utility mergers.

¹¹N.C. Gen. Stat. 62-111.

¹²State ex. rel. North Carolina Utilities Commission v. Casey, 245 N.C. 297, 96 S.E.2d 8 (N.C. 1957).

¹³State ex. rel. Utilities Commission v. Village of Pinehurst, 115 P.U.R.4th 558, 393 S.E.2d 111 (N.C.App. 1996).

(3) We have had to impose financial protection conditions to account for the absence of various limitations and protections that had been provided for by PUHCA 1935.

Other than the above and a widening scope of the types of transactions that can be presented to the NCUC for review and approval, PUHCA 1935 repeal has had little impact on the manner to which we handle merger-related proceedings.

To be sure, the NCUC tries to provide applicants with some idea of the nature of our concerns in preparation for filing an application for a merger or similar business combination transaction. As a matter of decisional law, we have attempted to put some further meat on the statutory test in our decisions. Several of our prior orders provide that a merger should be approved, whether as proposed or as conditioned, as long as:

- (1) The proposed transfer has no known adverse impact on the rates and service of the utility;
- (2) Customers are protected from potential harm as much as possible; and
- (3) Customers are provided with sufficient benefits as a result of the transfer to offset any potential costs, risks and harms.

We have required applicants to file cost/benefit and market power studies. The obvious purpose of this request is to ensure that a particular proposal will not have a harmful anticompetitive effect on North Carolina retail ratepayers and to provide us some idea of the extent of any cost savings from a particular merger.

As a general proposition, we have tended to ascertain if a proposed transaction makes broad business sense. If it does, we determine what, if anything, needs to be done through the adoption of conditions to ensure that customers are not harmed and that the benefits are commensurate with the potential costs, risks, and harms. Because of the fact that the broad business justification for most of the transactions before us is relatively apparent, most of our Orders tend to focus on the development of appropriate conditions.

For your review and information I have attached an Appendix* which illustrates in greater detail how the NCUC reviewed the Duke Energy Corporation/Cinergy Corporation merger ("Duke/Cinergy merger") after the repeal of PUHCA 1935. For example, the NCUC adopted: (1) certain conditions relating to accounting rules and affiliate transactions; (2) conditions intended to preserve the utility's access to capital and to ensure that the utility is not utilized solely as a source of funding for unrelated holding company activities; and (3) certain rate-related transactions intended to require the utility to share the cost savings predicted to result from the transaction. All these conditions had the simple purpose of preserving the ability of the NCUC to regulate the utility in the same way that it always had.

(2) State Regulation of Affiliate Transactions and Cross-Subsidies

With regard to affiliate transactions and authority to prevent potential cross-subsidies, the GAO reported that almost all the State commissions regulate affiliate transactions or regular reporting of such transactions, or both.¹⁴ In fact, the Report said that 49 of the reporting 50 States have some type of authority to approve, review and audit transactions between utilities and their affiliated companies.¹⁵

In North Carolina, we have specific statutory authority to review affiliate transactions. The majority of potential affiliate contracts are subject to being reviewed and declared void if found to be unjust or unreasonable and made for the purpose or with the effect of concealing, transferring or dissipating the earnings of the utility. In addition, prior to paying any kind of compensation to the listed types of affiliated companies for services, the utility must obtain the Commission's approval to pay the compensation. All affiliated costs and expenses are subject to being audited and disallowed within the context of a general rate case.

In our most recent merger proceeding we required that an independent audit be conducted no less than every two years of the affiliate transactions undertaken pursuant to the affiliate agreements associated with the merger. The audit includes both the holding company's and the utility's compliance with all conditions imposed by the Commission concerning affiliate company transactions, including the pro-

*Document has been retained in committee files.

¹⁴GAO Report, Recent Changes In Law Call for Improved Vigilance by FERC, GAO-08-289 (February 2008) at 25.

¹⁵Id. at 9, 25. The Report noted that 27 States reported that under their authority, affiliate transactions did not require prior State commission approval, but could be reviewed and disallowed later. Id. at 25. The findings were that 41 States require utilities to report affiliate transactions at least annually, or more frequently. Id.

priety of the transfer pricing of goods and services between and/or among the utility and its affiliates.

In addition, a number of State Commissions—Arkansas, California,¹⁶ Kansas,¹⁷ Maryland¹⁸ and New Jersey—have opened proceedings to address measures for ratepayer protection post-PUHCA 1935 repeal.

For example, the New Jersey Board of Public Utilities (“BPU”) approved new regulations with the goal of providing additional protection for the State’s electric and natural gas customers.¹⁹ The New Jersey BPU developed the regulations after analyzing what changes should be made to offset the protections lost at the federal level with the repeal of PUHCA 1935.²⁰

As these examples show, each State commission must address for itself how it wishes to balance allowing additional investment while also ensuring consumer protections. Each State must be allowed to structure the scope of ratepayer protections that will fulfill its statutory duty and public interest charge.

(3) *Financial Protections or Ring-Fencing*

PUHCA 1935 provided protection to ratepayers against a variety of financial risks caused by the creation of a holding company, such as draining the utility of cash and using it for collateral and diversification into non-core, risky businesses. With the repeal of PUHCA 1935, none of these federal limitations and protections remains in effect.

Even before the repeal of PUHCA 1935, many States sought to protect ratepayers from risks associated with utilities being acquired by holding companies, including diversification into non-utility businesses. Although it has become common practice for electric utilities to diversify into non-utility and foreign businesses, this diversification carries an increased risk. NARUC believes that this risk should not be borne or shifted to the customers of the regulated utility, since the beneficiaries of these investments are the shareholders.

States use a variety of mechanisms to effectively guard against improper cross-subsidization. One approach is to craft “ring-fencing” protections. The goal of ring-fencing is to build structural and financial protections around utility subsidiaries within a holding company system in order to insulate these subsidiaries from potential risks and negative impacts created by affiliates.²¹ Rating agencies have looked favorably on ring-fencing provisions established through State regulatory policies.

Perhaps the most well-known instance of a State using ring-fencing to protect a utility from potential holding company risks occurred when the Public Utility Commission of Oregon saved Portland General Electric Company (“PGE”) from the adverse effects of the Enron bankruptcy. Despite Enron’s historic collapse, PGE was able to maintain its financial integrity because of the actions taken by the State to “ring-fence” or protect the utility from Enron’s other business ventures.

Another State approach is a “mini-PUHCA”—a tool that attempts to recreate PUHCA 1935 at the State level. The Wisconsin Utilities Holding Company Act (“WUHCA”)²² is a well-known example of statutory ring-fencing. In implementing the State law, the Wisconsin Public Service Commission (“PSCW”) has adopted a three-pronged approach to address cross-subsidization: (1) imposing restrictions, (2) implementing reporting requirements, and (3) conducting compliance audits of holding company transactions and operations.

¹⁶ Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities and Their Holding Companies and Non-Regulated Affiliates, Docket No. R. 05-10-030, October 27, 2005. The GAO Report cited to California’s work to increase its authority to oversee affiliate transactions. GAO Report, Recent Changes In Law Call for Improved Vigilance by FERC, GAO-08-289 (February 2008) at 25.

¹⁷ In the Matter of the Investigation of Affiliate and Ring-Fencing Rules Applicable to all Kansas Electric and Gas Public Utilities, Docket No. 06-GMIX-181 -GIV, May 14, 2007.

¹⁸ Commission Staff Analysis of Ringfencing Measures for Investor-Owned Electric and Gas Utilities, Maryland Public Service Commission, February 18, 2005.

¹⁹ Affiliate Relations, Fair Competition and Accounting Standards, Public Utility Holding Company Standards and Related Reporting Requirements, Docket Number AX05070641 (September 18, 2006).

²⁰ Id.

²¹ Some examples of ring-fencing provisions are: (1) requirement that regulated utilities maintain a separate corporate entity; (2) utility to have its own Board of Directors and management; (3) utility’s accounts and records kept separately from those of affiliates; (4) independent cash management and debt for utilities; (5) State commission approval before securities can be issued; (6) limits on dividends (7) minimum equity requirements; (8) periodic ring-fencing reports.

²² Wis. Stat. § 196.795.

(4) Audits, Access to Books and Records, and Financial Reporting

As the GAO Report notes, each State Commission's audit process is unique.²³ The Report recognized that for the 4 States GAO Staff visited, those States put "special emphasis on auditing affiliate transactions".²⁴

FERC and State regulators already collaborate on audit review. We will continue to work with our federal colleagues on improving audits of affiliated transactions and cross-subsidies.

The GAO concluded that all States regularly require financial reports from utilities and are able to obtain access to the financial books and records of these utilities.²⁵ The Report said that all 49 responding States require utilities to at least provide financial reports.²⁶ GAO added that States have access to utility companies' financial books and records in order to review affiliate transactions.²⁷

NARUC advocated the explicit EAct 2005 authority for State access to needed books and records. Access to the books and records to verify transactions directly affecting a company's regulated utility operations is of vital importance to State commissions. Requests for such access by a State commission, its staff, or its authorized agents are presumably valid, material, and relevant, with the burden falling to the company to prove otherwise.

The GAO concludes, however, that some States do not have such direct access to books and records of holding companies or affiliated nonutility companies.²⁸ The reasons vary.²⁹ State Commissions will continue to work on ways to improve their access to this information. FERC's detailed accounting and increased transparency in its record retention policies for holding companies and centralized service companies assists in improving States access to needed information from utility companies and their affiliates.

(5) Status of State Resources

GAO reported that some States reported that they needed additional staffing and funding to respond to changes in their oversight responsibility.³⁰ At the same time, the Report recognized that States have gained over 2 years of experience since EAct 2005 was passed.³¹

States have been and will continue to collaborate and expand on their knowledge base. NARUC's Meetings, which occur three times a year, have featured various PUHCA and utility merger panels. NARUC's Staff Subcommittee on Accounting and Finance has also produced publications³² and sponsored meeting panels on these topics. This Staff Subcommittee collaborated with GAO Staff on the State survey. The National Regulatory Research Institute ("NRRRI") has published various briefing documents to educate State Commissioners on key issues arising from PUHCA 1935 repeal and the changing utility merger landscape.³³

States can better coordinate with their State colleagues on a regional basis, as well as with FERC, in regulating these increasingly complex multi-State utility companies. State commissions can work with their respective legislatures to improve the status of State resources.

CONCLUSION

In our view, NARUC's members have performed admirably in their oversight responsibilities in the short time since passage of EAct 2005. In light of the challenges identified by GAO, there will be more work ahead to insure continued oversight of mergers in the utility sector, particularly given the vastly different resources available to the various States. We are confident that with FERC's contin-

²³ GAO Report, Recent Changes In Law Call for Improved Vigilance by FERC, GAO-08-289 (February 2008) at 9, 25-26.

²⁴ Id. at 27.

²⁵ Id. 27.

²⁶ Id. at 9, 27.

²⁷ Id. at 9.

²⁸ Id. at 9, 27-28.

²⁹ Id.

³⁰ Id. at 9, 29-30.

³¹ Id. at 29.

³² See, e.g., Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System, NARUC Staff Subcommittee on Accounting and Finance, July 27, 2003.

³³ See e.g., Implications of EAct 2005 for State Commissions, The National Regulatory Research Institute, October 2005; Repeal of the Public Utility Holding Company Act of 1935: Implications and Options for State Commissions, The National Regulatory Research Institute, August 2006; Private Equity Buyouts of Public Utilities: Preparation for Regulators, The National Regulatory Research Institute, December 2007.

ued cooperation and collaboration, as well as the academic resources NARUC's members have with NRRI the States will be ready for the challenge.

Senator SALAZAR [presiding]. Thank you, Mr. Kerr.
Mr. Owens.

STATEMENT OF DAVID K. OWENS, EXECUTIVE VICE PRESIDENT, BUSINESS OPERATIONS, EDISON ELECTRIC INSTITUTE

Mr. OWENS. Thank you, Senator. I certainly do appreciate this opportunity.

My name is David K. Owens. I'm the Executive Vice President of the Business Operations at the Edison Electric Institute. As you well know EEI is a trade association of U.S. shareholder owned electric companies and has international affiliates and associate members worldwide.

I certainly do appreciate the leadership that this committee has provided with the implementation of EPACT 2005 to encourage investment in electric utility infrastructure. We believe that EPACT has been successful in encouraging significant new investments. We applaud the leadership of this committee.

We also believe that FERC has done a really good job of implementing its new responsibilities under EPACT 2005. FERC has undertaken a completed series of major rulemaking, as the Chair mentioned earlier. Those have lead as an example to the adoption of new requirements for holding companies and their service companies. FERC has adopted new accounting standards as an example for centralized service companies. They've developed clear rules for pricing affiliate transactions. They've developed new auditing and enforcement initiatives. So they've done a whole set of major new initiatives in order to deal with this evolving area.

They've done all of this while working very closely with the States. As you all know our country needs significant new investment in electric infrastructure in the coming years. To provide the enormous investment which we estimate to be over a trillion dollars by 2030, it requires us to employ a flexibility and a variety of organizational structures and organizational arrangements. This is in order to finance, construct, to operate and maintain facilities needed to provide our country with the electricity it demands. In addition some of our companies need the option to merge in some instances or consolidate with other companies with the appropriate regulatory reviews in order to achieve additional efficiency benefits which benefit our customers.

Now under existing Federal laws we believe that FERC is well equipped to ensure that mergers and acquisitions are in the public interest and that consumers are well protected. We think that FERC has done a fairly adequate job in that area. EPACT 2005, as we all know, Congress replaced a 70-year-old PUHCA 1935 with updated PUHCA 2005. It also updated and expanded section 203 of the Federal Power Act to give FERC new authorities regarding mergers.

As a result FERC has strengthened its regulation of utility mergers and acquisitions and has incorporated new oversight of affiliate transactions in particular to prevent cross subsidization, an encumbrance of utility assets except when in the public interest. Contrary

to projections or predictions by many that EPACT would lead to this vast array of mergers, that really has not happened. We've had a modest increase in mergers.

In my written testimony I've outlined the many steps FERC has taken to put in place advanced merger, acquisition, accounting, financial and reporting regulations policies and practices. The significant actions have involved a tremendous commitment by FERC with substantial input from State regulators and other key stakeholders. We believe the States play an important role in regulating utilities, in approving mergers, in protecting retail consumers and Federal laws should continue to accommodate this role without duplicative or conflicting requirements.

States clearly play a very active role as Commissioner Kerr has just indicated. They oversee utility mergers. They oversee retail rates. They look at the just and reasonable transactions. They oversee a whole range of activities relating to affiliate transactions. Most State commissions have considerable authority to ensure the financial integrity of utilities they regulate and to insulate and protect consumers of public utilities from potential adverse consequences of non-utility related investment or activities.

Congress and FERC have recognized that States play such a vital role in regulating electric utility mergers and activities and have sought to accommodate the State role in Federal statutes and regulations. Thus the Federal Power Act provides a clear sharing of responsibilities between States and FERC and oversee utility activities and similarly FERC regulation reflect the complementary Federal and State roles.

Now I realize I'm running out of time. Let me make a point. That point is that I disagree substantially with some of the recommendations of the GAO report. Specifically with regard with whether FERC is doing a good job and whether there are regulatory gaps.

We disagree, as I indicated, FERC has issued a broad range of rulemakings. They have comprehensive authority over all aspects of rate making. They've adopted new accounting rules. They've adopted pricing rules for affiliates. So they've done an awful lot. They have very broad based auditing responsibility. So I don't believe that the comments or the suggestions by GAO are well founded.

I do believe that there are some recommendations that the Commission should look at carefully and that relates to transparency and working more closely with the States. Thank you.

[The prepared statement of Mr. Owens follows:]

PREPARED STATEMENT OF DAVID K. OWENS, EXECUTIVE VICE PRESIDENT, BUSINESS OPERATIONS, EDISON ELECTRIC INSTITUTE

My name is David K. Owens, and I am Executive Vice President in charge of the Business Operations Group at the Edison Electric Institute (EEI). EEI is the trade association of U.S. shareholder-owned electric companies and has international affiliate and industry associate members worldwide. Our U.S. members serve 95% of the ultimate customers in the shareholder-owned segment of the industry and represent about 70% of the U.S. electric power industry.

EEI appreciates the steps forward that Congress took in the Energy Policy Act of 2005 (EPAct 2005) to encourage new investment in and by the electric utility industry. Our country needs new investment in electric infrastructure to ensure continued availability of reliable, affordable electricity. The steps Congress took in EPAct 2005 to modernize regulation of the industry, while ensuring that ample consumer protections remain in place, were appropriate and are producing positive re-

sults. Contrary to predictions that were made before EAct 2005 was enacted, merger activity since enactment has actually been relatively modest. At the same time, the provisions of EAct 2005 have encouraged significant new investment in energy infrastructure.

Moreover, the Federal Energy Regulatory Commission (FERC) has done an exemplary job in implementing its new responsibilities under EAct 2005. FERC has undertaken and completed a series of major rulemakings and new auditing and enforcement initiatives in a very short time, meeting tight deadlines set in EAct 2005. In the process, FERC has strengthened its regulation of utility mergers and acquisitions, managed the complicated transition from the Public Utility Holding Company Act of 1935 (PUHCA 1935) to its successor the Public Utility Holding Company Act of 2005 (PUHCA 2005), and incorporated new oversight of affiliate transactions, in particular to prevent cross-subsidization and encumbrance of utility assets except when in the public interest. And FERC has done all this while working closely with and respecting the authority of the states that also regulate utilities in these areas.

OUR COUNTRY NEEDS SIGNIFICANT NEW INVESTMENT IN ELECTRICITY INFRASTRUCTURE
IN COMING YEARS TO MEET INCREASING DEMAND AND TO ENSURE CONTINUED RELIABILITY

As this Committee knows well, electricity is a vital service to our nation. EEI and its member companies take pride in providing reliable, affordable supplies of electricity, even as our country's population and demand for electricity have grown dramatically in recent years and continue to grow. Electricity is essential to powering our homes, businesses, and industries with cooling, refrigeration, heating, lighting, computers, telecommunications equipment, medical equipment, and the host of other day-to-day necessities on which we all rely. Because electricity is provided and used on an instantaneous basis and cannot practicably be stored, the provision of affordable, reliable electricity requires a careful balancing of generation, transmission, and distribution facilities. In turn, constructing, operating, and maintaining these facilities require an enormous investment.

In coming years, the United States will need significant additional electricity generation and delivery resources. The Energy Information Administration (EIA) is projecting that electricity demand will increase by 30% by 2030. Already, as the North American Electric Reliability Corporation (NERC) has indicated in its most recent 10-year assessment of the nation's electricity system, many areas of the country are operating on thin demand-supply and delivery-capacity margins.¹ This need for new facilities will only increase in future years, as a result of continued population growth, increasing electrification of our nation's homes and businesses, increasing demand for renewable energy resources, and compliance with enhanced environmental standards—even with a major commitment to energy efficiency.

To put these issues in perspective, I would like to provide some numbers:

Overall Capital Expenditures (Capex)

- Capex for U.S. shareholder-owned electric utilities rose by 15.5% in 2007, from \$59.9 billion in 2006 to \$69.1 billion in 2007, and is projected to reach approximately \$75 billion in 2008 and \$75.5 billion in 2009.²
- Total capital spending in 2007 was projected to be allocated as follows: Generation 31%; Distribution 30%; Environmental 14%; Transmission 12%; Natural Gas-related 6%; and General/ Other 7%.³
- Companies are boosting spending on environmental compliance and transmission and distribution upgrades, and are beginning to announce new generation projects in many power markets to ensure adequate reserve margins over the long term. Already, 657 projects that would provide more than 130,000 MW of capacity either have applications pending, have been approved, or already are under construction.⁴
- According to a recent study conducted by the Brattle Group, dramatically increased raw materials prices (e.g., steel, cement) have increased construction costs directly and indirectly through the higher cost of manufactured components common in utility infrastructure projects. These cost increases have pri-

¹NERC 2007 Long-Term Reliability Assessment 2007-2016 (October 2007), www.nerc.com.

²The 2008 and 2009 projections and the 2007 category allocation are based on EEI's spring 2007 study of industry capital spending based on SEC Form 10-K data, company presentations, and discussions with companies.

³Id. The "General/ Other" category includes investments that do not fit into the other categories listed, such as construction, materials, fuel processing, and mining activities.

⁴These numbers are based on recent analyses by Ventex, Inc., an EEI consultant.

marily been due to high global demand for commodities and manufactured goods, higher production and transportation costs (in part owing to high fuel prices), and a weakening U.S. dollar.

- Preliminary findings released by the Brattle Group estimate that, without taking into account utility energy efficiency programs, close to \$1.5 trillion in investment in new generation (\$559 billion) and transmission and distribution (\$900 billion) will be required by 2030 to meet electricity demand. Brattle further estimates that required generation investment can be reduced from \$559 billion to \$457 billion if more aggressive utility energy efficiency programs are implemented.

Transmission Capital Expenditures⁵

- In 2006, both shareholder-owned electric utilities and stand-alone transmission companies invested an historic \$6.9 billion in the nation's transmission grid. This represents a 51% increase over 2000 levels.
- Since the beginning of 2000, the industry has invested more than \$37.8 billion in the nation's transmission system.
- Over the 2007-2010 time period, the industry is planning to invest \$37 billion in the transmission system.
- This amount represents a 55% increase over the amount invested from the 2003-2006 period.

Distribution Capital Expenditures

- In 2006, shareholder-owned electric utility investment in the distribution system surpassed \$17 billion for the first time. This level of investment (\$17.3 billion) represents a 6.5% increase over the inflation-adjusted \$16.2 billion (\$14.5 billion prior to inflation adjustment) invested in 2005.
- 2006 industry distribution investment represents an 18% increase over 2000 levels.
- Since the beginning of 2000, the industry has invested almost \$109 billion in the nation's distribution system.

TO PROVIDE THE INVESTMENT RESOURCES FOR ELECTRICITY INFRASTRUCTURE, ELECTRIC UTILITIES NEED TO BE ABLE TO EMPLOY A VARIETY OF ORGANIZATIONAL STRUCTURES, MERGE, CONSOLIDATE, FORM PARTNERSHIPS, AND ACQUIRE ASSETS

EEI members include vertically integrated electric utilities that provide electricity generation, transmission, distribution, and related services to families and businesses throughout the country. Our members also include generation-only and transmission-only "stand alone" companies. Many of these utilities and companies are owned by parent companies that may also own other electric utilities, energy, and non-energy businesses. Many of the energy companies are affiliated with others, either through parent-subsidiary or partnership models.

Thus, there are a variety of organizational structures and affiliations within the electric utility industry. This variety of structures and affiliations has enabled the electricity industry to finance, construct, operate, and maintain facilities needed to provide our country with the electricity it needs. Indeed, the sheer cost of electricity facilities, and the risks involved in siting, financing, and earning a reasonable rate of return on them—especially in times of increasing wholesale competition and fuel and materials charges—often require the ability to use a variety of organizational structures and affiliations to share costs and risks.

In addition, utilities need the option to merge or consolidate with other companies. For electric utilities and their customers, mergers and acquisitions offer many potential benefits including:

- Potential cost efficiencies
- Increased economies of scale
- Greater optimization of generation, transmission, and distribution assets
- The ability of a larger utility to offer new and innovative products and services to consumers
- Acquisition of superior technology capability
- Scale necessary for significant capex, to maintain credit quality, to lower cost of capital, and to enhance access to capital markets and new investors.

Indeed, severely limiting utilities' ability to take advantage of economies of scale and experience in competitive markets could deny electric customers the benefits of

⁵These transmission and distribution investment data are provided in real terms (2006\$) and have been adjusted for inflation using the Handy-Whitman Index®. Planned transmission investment was adjusted for inflation using the GDP Deflator.

such economic efficiencies. These efficiencies enable companies to supply products and services at lower costs to consumers.

This said, the pace of mergers and acquisitions in recent years has been relatively modest. In 2007, there were four announced deals, six completed transactions, and one withdrawn deal. In 2006, there were seven announced deals. This represents a small step up in overall activity from the quiet three-year period from 2003 through 2005, when most companies were implementing back-to-basics strategies by exiting non-core businesses, investing in core utility and competitive generation operations, and strengthening their balance sheets. Nevertheless, the number of whole company merger and acquisition deals in 2006 and in 2007 remained well below the higher pace that marked the late 1990s, when 10 to 20 announcements per year were the norm. An emerging trend of recent utility merger and acquisition activity has been the increasing participation of private equity investors and international buyers, including infrastructure funds and international utilities.

UNDER EXISTING FEDERAL LAWS, FERC IS WELL EQUIPPED TO ENSURE THAT MERGERS AND ACQUISITIONS ARE IN THE PUBLIC INTEREST, AND THAT CONSUMERS ARE WELL PROTECTED—AND FERC IS FULLY ON THE JOB

Recognizing the need for new infrastructure, and the need to accommodate new investment in and by the electricity industry, in the past two decades, Congress has taken steps to update and modernize the laws governing the structure and operation of the industry. These steps have helped to ensure that companies have sufficient flexibility to provide the resources needed to get the job done, while also ensuring that consumers and markets are well protected. In particular, Congress, states, and the FERC have taken steps to encourage competition in fuel supply and electricity generation, while also ensuring open access to electric and natural gas transmission facilities. In addition, organized markets for electricity sales and delivery have evolved, including regional transmission organizations (RTOs) and independent system operators (ISOs), providing the ability to call on a wide array of generation and transmission resources to serve load centers within different regions of the country.

Recognizing that these legal and policy changes have spurred changes in the electric utility industry, in EPAct 2005, Congress replaced the 70-year old PUHCA 1935 with an updated PUHCA 2005. In addition, Congress updated section 203 of the Federal Power Act (FPA) to require FERC, in reviewing proposed mergers and financial transactions, to ensure that these activities will not result in cross-subsidization of non-utilities by utilities or encumbrance of utility assets, unless in the public interest.

In making these changes, Congress recognized that the FPA and other laws governing the electric utility industry have evolved substantially since 1935. Furthermore, FERC, states, and Wall Street have developed increasingly sophisticated regulations and other measures to ensure that companies that provide electricity services make ample information about their finances and activities available to regulators and the public, and the companies do not engage in inappropriate behavior that can harm customers.

In particular, FERC has put in place advanced merger, acquisition, accounting, financial, and reporting regulations, policies, and practices. Under its merger provisions, FERC examines a wide array of factors, such as: the ability of companies in a proposed merger to exercise market power; the relative concentration that would result from the merger; benefits of the merger to wholesale and retail consumers; and measures necessary to protect consumers. FERC also has detailed accounting and financial disclosure requirements to ensure that public utility, wholesale, and transmission activities are open to regulators and the public. FERC actively oversees utility financial transactions under section 203 of the Federal Power Act, and FERC oversees rates to ensure that they remain just and reasonable under sections 205 and 206 of the Act.

In addition, FERC has moved aggressively under its existing authority to prevent abuse of financial relationships between regulated utilities and their unregulated affiliates, issuing strict new rules that prohibit utilities from using debt linked to utility assets for non-utility businesses. FERC has imposed rules to regulate cash management practices, including limits on the amount of funds that can be transferred from a regulated subsidiary to a non-regulated parent company. FERC also has adopted detailed standards of conduct to ensure that transmission providers do not use their unique access to information to provide unfair advantages to their wholesale merchant functions and their marketing affiliates. FERC vigorously audits and enforces compliance with these standards. FERC closely scrutinizes all transactions where a utility seeks to purchase power from an affiliate by contract or purchase

a power plant owned by an affiliate, to ensure that the price does not exceed the market price and the utility does not unduly favor its affiliate over other competitors in the wholesale market.

Since passage of EAct 2005 alone, FERC has issued a number of complex, stringent regulations aimed at implementing PUHCA 2005 and revised FPA section 203. These regulations ensure that companies will keep detailed records and make them available as needed to FERC and to state regulators. They ensure that FERC approval is required for mergers, acquisitions, and major financial transactions, subject to strict guidelines and certain blanket authorizations to help streamline the review process. They also protect against inappropriate cross-subsidization of non-utilities by utilities, in particular when captive customers could be harmed. To list just a few of the more significant FERC developments in these areas since EAct 2005:

- PUHCA 2005 regulations
 - December 8, 2005—Final rule and report to Congress
 - April 24, 2006—Rehearing order
 - July 20, 2006—Rehearing order
 - December 7, 2006—Technical conference
 - February 26, 2007—Rehearing order
- PUHCA 2005 accounting and reporting regulations
 - January 11, 2006—Guidelines for notification of holding company status
 - January 13, 2006—New dockets prefix notice
 - February 9, 2006—Additional guidelines for filings under PUHCA 2005
 - March 6, 2006—Filing guidelines for self certification notices
 - April 7, 2006—Electronic filing guidelines
 - July 18, 2006—Technical conference
 - October 19, 2006—Final rule
 - October 19, 2006—Form 60 electronic filing final rule
 - December 14, 2006—Form 60 software notice
- FPA section 203, merger, and cross-subsidy regulations
 - December 23, 2005—Final rule
 - January 10, 2006—Errata to the rule
 - April 24, 2006—Rehearing order
 - July 20, 2006—Rehearing order
 - August 1, 2006—Errata to the rehearing order
 - December 7, 2006—Technical conference
 - March 8, 2007—Technical conference
 - July 20, 2007—Policy statement
 - February 21, 2008—Final rules and supplemental policy statement

These activities have involved thousands of hours of work by FERC, with input by the public, to ensure that the Commission has developed careful, protective measures. In each of the technical conferences, FERC Commissioners and staff heard in person from representatives of all stakeholders, particularly representatives of state commissions and consumers addressing the respective role of FERC and the states. The Commission has had to take a large array of factors into account, balancing the need for information and to impose appropriate constraints, against the cost and impacts on companies and markets. We believe, on balance, the Commission has sought to implement its statutory responsibilities fairly and effectively, in the public interest.

STATES PLAY AN IMPORTANT ROLE IN REGULATING UTILITIES, APPROVING UTILITY MERGERS, AND PROTECTING RETAIL CUSTOMERS. FEDERAL LAW SHOULD CONTINUE TO ACCOMMODATE THIS ROLE WITHOUT DUPLICATIVE OR CONFLICTING REQUIREMENTS

As the General Accounting Office (GAO) has recognized at page 9 of its report to Congress on “Utility Oversight” in the wake of EAct 2005, “state regulators in all but a few states reported [that] utilities must seek state approval” for mergers, and “most states have some type of authority to approve, review, and audit affiliate transactions.” In fact, as the record before FERC and in its technical conferences demonstrates, states play a prominent role in these areas.

States clearly play a very active role in reviewing proposed mergers. State utility commissions look closely to ensure that mergers will be in the public interest and will fully protect retail customers. Often governors and even legislatures weigh in as well. States also are not shy about denying approval of a proposed merger if they believe that the proposal does not meet these tests or provide adequate benefits to

utility customers. In addition, states actively oversee utility activities, including affiliate transactions, with a substantial focus on protecting retail customers. States oversee retail rates to ensure that the rates are reasonable given the costs needed to provide electricity. States also ensure that rate-regulated utility resources are not inappropriately used for non-utility activities, and states ensure that utility affiliates fairly reimburse regulated utilities for any shared resources. States ensure compliance with these rules through their careful scrutiny of company books and records, to which PUHCA 2005 assures access. A February 2004 Fitch Ratings report highlights the “increasingly proactive” efforts of state commissions in these areas, especially through their authority to approve rates:

[State regulatory commissions] generally have broad statutory mandates to do whatever is necessary to uphold the public interest and ensure that reliable service is provided at just and reasonable rates. This broad authority can be used to disallow from customer rates any financing, affiliate transaction or other operating costs viewed as inconsistent with the public interest.⁶

Last year, EEI conducted a survey of existing state laws and voluntary utility practices. We found that under their original enabling state legislation, most state commissions have considerable authority to assure the financial integrity of the utilities they regulate and to insulate and protect customers of public utilities from potential adverse consequences of non-utility related investments or activities. These authorities allow state commissions to address transactions involving affiliates of a public utility and to insulate the jurisdictional utility and its consumers from the actions of other affiliates when appropriate. While each state commission may implement its authority in its own manner, most state commissions have the authority:

- To approve the issuance of securities by the jurisdictional utility (or utility subsidiaries), including common stock, preferred stock, long-term debt, short-term debt above a certain “materiality” threshold, and guarantees of obligations of others.
- To regulate the capital structure of the jurisdictional utility (e.g. debt to equity ratios).
- To assure that payment of dividends by a jurisdictional utility is derived from retained earnings or does not lead to a deviation from the utility’s approved capital structure range.
- To regulate or review intercompany loans involving a holding company or utility affiliates.
- To establish appropriate pricing for the sale of goods and services between a jurisdictional utility and affiliated companies.
- To regulate services, transactions or contracts between a jurisdictional utility and its holding company or other affiliates companies above a material amount. Some states exercise this oversight through an audit or prudence-review process; others through a prior contract review.
- To approve the sale or pledge of jurisdictional assets of the public utility.
- To approve the acquisition of utility assets (above a material amount) by a public utility that would be put into rate base within the commission’s jurisdiction.
- To approve a sale or merger of a jurisdictional utility, including approval of the transfer of equity rights which provide a controlling interest in a jurisdictional utility.
- To obtain needed information from the jurisdictional utility to ensure compliance with these other authorities through annual or periodic reporting, certification of status, an audit process, rate case filing or other methods.

Furthermore, states are continually refining and expanding the authority of state public utility commissions over utility activities.

Congress and FERC have recognized that states play an important role in regulating electric utility mergers and activities, and have sought to accommodate the state role carefully in federal statutes and regulations. Thus, the FPA provides a clear sharing of responsibilities between states and FERC in overseeing utility activities. And similarly, FERC regulations reflect the complementary federal and state roles.

For example, in adopting new regulations for implementing FPA section 203, FERC has been appropriately careful not to preempt effective state regulations, but instead to review state-imposed requirements to see if additional requirements are

⁶“Utility Regulatory Survey of State Public Service Commissions,” Fitch Ratings Ltd., February 25, 2004, p. 2.

warranted under federal law. Applying these regulations, FERC recently approved a proposed merger involving Puget Energy, conditioned in part on the Washington Utilities and Transportation Commission adopting conditions that the merging companies proposed to have the state commission adopt to protect against inappropriate cross-subsidization. FERC concluded that, if adopted, those measures would fully protect against cross-subsidization without the need for additional federal constraints. FERC therefore approved the merger contingent on those conditions being adopted at the state level. This is cooperative federalism in the public interest in action.

FERC IS ACTIVELY AND APPROPRIATELY IMPLEMENTING ITS PUHCA 2005, FPA SECTION 203, MERGER, AND CROSS SUBSIDY RESPONSIBILITIES, AND DOES NOT NEED ADDITIONAL AUTHORITY THAT COULD CREATE UNNECESSARY BURDENS AND UNCERTAINTY, THUS DISCOURAGING INVESTMENT

Taking all the developments just discussed into account, EEI fundamentally disagrees with the GAO report's conclusion that FERC is not doing an active enough job at overseeing utility mergers, acquisitions, affiliate transaction, and cross-subsidy issues. FERC actively oversees utility mergers and acquisitions, and the Commission has instituted a very aggressive array of regulations, accounting and reporting requirements, and auditing and enforcement measures to protect captive customers, promote effective markets, ensure fair competition, prevent inappropriate cross subsidies and encumbrance of utility assets, and provide open access to transmission. Congress has put an array of such statutory requirements in place, and we believe these requirements are more than sufficient and are being effectively implemented by FERC.

In addition, the Securities and Exchange Commission (SEC) oversees company accounting, auditing, finances, and participation in financial markets, including through implementation of the Sarbanes-Oxley Act of 2002. States oversee utility retail rates and activities, as discussed above. And companies have voluntarily and as part of binding commitments adopted an array of positive measures to protect customers. Taken together, these measures provide robust assurances that the electric utility industry operates for the public benefit, and these measures amply protect consumers.

Requiring FERC to take additional steps toward rigid rules for corporate and financial separation of shareholder-owned electric utilities and their non-utility affiliate companies is unnecessary in light of the fact that FERC and the states already have the authority to protect, and do protect, regulated utilities and their customers from any potential risks of affiliate businesses.

Increased federal oversight over non-utility corporate activities and structure could create substantial barriers to investment and competition in electricity markets, and could create unreasonable restrictions and delays on the day-to-day business operations of companies, contrary to what Congress intended when it modernized utility regulation in EPAct 2005. It also could encroach upon authority currently exercised by state utility commissions, and it would unnecessarily duplicate, and possibly contradict, consumer protections and corporate governance standards already in place at the federal and state levels, including tough SEC corporate governance and accounting standards imposed on all publicly-traded companies, not just utilities, by the Sarbanes-Oxley Act. Furthermore, issues of affiliate transactions and corporate financing are already addressed by state and federal regulators, who have the flexibility to consider individual circumstances and transactions.

Given the array of federal and state laws now in place, there is abundant federal statutory and regulatory oversight of mergers and acquisitions and protections against inappropriate cross subsidization and encumbrance of utility assets. Congress does not need to add any additional new requirements and constraints at this time.

Senator SALAZAR. Thank you, Mr. Owens.
Mr. Hempling.

**STATEMENT OF SCOTT HEMPLING, EXECUTIVE DIRECTOR,
NATIONAL REGULATORY RESEARCH INSTITUTE**

Mr. HEMPLING. Thank you, Senators for the opportunity to appear. I'm Scott Hempling, Executive Director of the National Regulatory Research Institute. I'm here as an expert, not as a representative of any entity. My expertise derives from years in private prac-

tice where I've been on the inside of dozens of State commissions and know the facts associated with their efforts.

Senators, over the past century our citizens have paid trillions to support the infrastructure of our Nation's electric utilities. We must ensure that the recipients of those trillions remain accountable to the public. For 70 years the Public Utility Holding Company Act of 1935 provided that accountability.

Its central technique was corporate simplification. Each utility holding company had to limit its assets and activities to those necessary to vital electric service. The Act thus aligned corporate form with public interest obligation.

The GAO/FERC dialog focuses on cross subsidies. Specifically, to FERC's practices and policies protect ratepayers from bearing the cost of business activities unrelated to the provision of essential electric service. But that question is only a subset of the much larger questions forced upon regulators by Congress' repeal of the 1935 Act.

The larger question is what is our vision for corporate structure? Is that vision consistent across States and between States and FERC? If there is no such vision do we have a process for creating one?

When it repealed the 1935 Act, Congress left these questions unanswered. At the same time, repeal increased the likelihood of structural complexity. Gone are the geographic limits. Gone are the type of business limits on utility mergers and acquisitions. Gone are the prohibitions on leverage financing. Gone is the at cost requirement for all inter-affiliate transactions. The corporate structure options are now nearly unlimited.

State commissions and FERC thus face questions they have not had to address, systematically at least, for 70 years. Should they limit the types of companies and corporate structures that furnish essential service? Should they welcome new structural options without limit? Should they proceed ad hoc? Are leveraged private equity firms when owned by investors with short term interests an appropriate substitute for traditional conservative buy and hold investors?

On these questions, Senators, there is no expert consensus, no political consensus and no systematic process for arriving at either. Some argue that protection against cross subsidies and other structural risks lies in rate making. This view is not fact based.

Ratemaking depends on auditing. Auditing is not like a trip to the dentist who checks every tooth. Auditing is sampling. It cannot promise 100 percent coverage, especially with limited or what FERC calls, targeted regulatory resources allowing structures that invite cross subsidies or complicate auditing increases the probability of problems.

Ratemaking is also after the fact. But after the fact regulation invites too big to fail results. In the business world poor decision-makers fail, but not always.

We all are familiar with situations, some very recent, in which a company size or significance pressures regulators to prop them up. State commissions dependent on the incumbent utility will tend to save the company rather than revoke its right to serve. Given the inherent uncertainty of back end rate review, front end struc-

ture review makes more sense. The regulatory community needs to address this reality.

The GAO study cited State commission concerns about availability of resources to deal with cross subsidies. Those concerns are the real, empirical world that I know about, that I practiced law in, that I presently serve. In fact the resource problem is larger. After several dozen mergers and acquisitions in the electric and gas industries since 1985, no one has systematically studied the economic, engineering, finance and managerial implications of these transactions.

In conclusion my testimony today urges alertness and anticipation. We need to identify the types of utility corporate transactions that trigger regulatory concern and we need to create policies to address them. Some say that to articulate a vision for accountable corporate structures is to “reconstruct” the 1935 Act in violation of Congress’ 2005 intent.

This argument is deficient in logic and law. Section 203, the Power Act, requires the Commission to judge mergers by a public interest standard. The public interest requires accountability. The 2005 Congress did not dilute this language. It subjected more transactions to it.

It remains regulators continuous obligation to align corporate structures with the public interest. With the repeal of the 1935 Act that obligation becomes more difficult to fulfill. The acquisition of remote utility properties, the mixing of utility and non-utility businesses, the use of unconventional ownership structures and financing structures, these all call for new resources and new expertise. The dialog created here by GAO and FERC is a worthy beginning, but it is only beginning.

Mr. Chairman, I hope during the questions we can address the issue of preemption because I believe there’s some significant misunderstandings about the nature of that term and how it should apply in this context. In the meantime, let me thank you and the members of the committee for this opportunity to testify. I look forward to your questions.

[The prepared statement of Mr. Hempling follows:]

PREPARED STATEMENT OF SCOTT HEMPLING, EXECUTIVE DIRECTOR, NATIONAL REGULATORY RESEARCH INSTITUTE

Mr. Chairman and Members of the Committee: My name is Scott Hempling. I am the Executive Director of the National Regulatory Research Institute (NRRI). NRRI is an independent, Section 501(c)(3) corporation, funded largely by voluntary state commission payments. Its mission is to carry out the research activities that enable utility regulators to make public interest decisions of the highest possible quality. My testimony today reflects my own views, and not those of NRRI, any state commission or any past client of mine or of NRRI.

As an attorney in private practice, I advised public and private sector clients involved in regulated industries, particularly state regulatory commissions and organizations of consumers or consumer representatives. I have represented clients in many cases under the Public Utility Holding Company Act of 1935 (PUHCA), before the Securities and Exchange Commission (SEC) and the U. S. Court of Appeals. I have testified before this and other Congressional committees many times on PUHCA and other electric industry matters.

The stated purpose of this hearing is to “examine the adequacy of state and federal regulatory structures for governing electric utility holding company structures in light of the repeal of the Public Utility Holding Company Act” of 1935, and in particular to discuss the concerns raised by the report of the United States Government Accountability Office (GAO), Recent Changes in the Law Call for Improved

Vigilance by FERC, GAO 08-289 (February 2008). These “recent changes” are the 2005 repeal of the Public Utility Holding Company Act of 1935, and the new FERC authorities established by the Public Utility Holding Company Act of 2005. The GAO report has produced some useful dialogue between FERC and the GAO on FERC’s regulatory policies. My testimony seeks to extend this dialogue so that we address the gamut of regulatory issues raised by the Committee and by the 2005 amendments.

My testimony has five parts.

Part I places the current debate between FERC and GAO in the larger context of corporate structure regulation. Effective corporate structure regulation should encourage transactions that serve the public interest and discourage ones that do not.

Part II explains that the 2005 repeal of the Public Utility Holding Company Act of 1935 created gaps in corporate structure regulation.

Part III argues that to restore public accountability in corporate structure transactions we must (a) identify and promote sensible corporate structures and (b) apply cost-benefit standards.

Part IV explains that regulatory preparedness for the new structural transactions made possible by the repeal of PUHCA 1935 requires multidisciplinary expertise and a shared multijurisdictional purpose.

Part V, the conclusion, argues for alertness on the part of all regulators.

I. CROSS SUBSIDIES IN CONTEXT: EFFECTIVE CORPORATE STRUCTURE REGULATION SHOULD ENCOURAGE TRANSACTIONS THAT SERVE THE PUBLIC INTEREST AND DISCOURAGE INEFFICIENT ONES THAT DO NOT

Over a century, our citizens have paid trillions of dollars to support the infrastructure of our nation’s electric and gas industries. Corporate structure regulation seeks to make the recipients of those trillions—owners, financiers and operators of that infrastructure—accountable to the public. To that end, legislators and regulators have asked five questions:

1. Who can acquire and own electric and gas utilities?
2. What business activities may exist within the utility’s corporate family?
3. What corporate structures may these corporate families have?
4. What financial structures may these corporate families have?
5. What interactions may occur among the members of the corporate family?

These five questions share a common purpose: to encourage transactions in the public interest, and discourage transactions that are not.

The detailed dialogue between the General Accounting Office and the Federal Energy Regulatory Commission on cross subsidies addresses one subset of these questions: Do FERC’s practices and policies prevent infrastructure owners from forcing ratepayers to bear, through excessive electricity and gas rates, the cost of business activities unrelated to the provision of essential electric and gas service?

The five major questions make clear that cross subsidy regulation is only one part of a corporate structure accountability mechanism. The GAO-FERC debate is part of a larger conversation: What is our vision for corporate structure? Does anyone have one? If so, is that vision consistent across states, and between states and FERC? If there is such a vision, do the regulators work consistently toward that goal? If there is no such vision, is there a process for creating one?

When Congress in 2005 repealed the Public Utility Holding Company Act of 1935, it left these questions unanswered. The result is multiple gaps in corporate structure regulation, in our ability to screen inefficient from efficient transactions, and in the accountability of infrastructure owners to consumers, investors and the public. Ensuring accountability requires that regulators identify and promote sensible corporate structures that satisfy rigorous cost-benefit standards. To prepare for this task—to put standards in place before receiving proposals for the many structural transactions made possible by the 2005 repeal—requires new multidisciplinary expertise and a common purpose shared by the multiple regulatory jurisdictions.

II. THE REPEAL OF PUHCA 1935 CREATED GAPS IN CORPORATE STRUCTURE REGULATION

A. *PUHCA 1935 created accountability to investors, consumers and the public through four types of regulation*

For 70 years, the federal Public Utility Holding Company Act of 1935 (“PUHCA 1935”) defined and limited the structural options for electric utilities.¹ PUHCA 1935’s central policy goal was utility accountability—to customers, investors, regulators and legislators. Its central technique was corporate simplification—the alignment of corporate form with public service obligation.

The alignment mechanism was the “integrated public-utility system”. each utility holding company had to limit its assets and activities to those necessary to provide electric or gas service to the public. PUHCA 1935 applied this principle by running corporate structure proposals through a series of tests, restrictions and reviews in four major areas: mergers and acquisitions, mixing of utility and non-utility businesses, issuances of debt or equity, and interaffiliate transactions. An understanding of these tests assists the analysis of how deeply the regulatory infrastructure has changed.

1. *Mergers and acquisitions*

Under Section 10 of PUHCA 1935, the acquisition of a public utility, through the holding company form, had to satisfy six tests. Specifically, the acquisition:

1. Must not “tend towards interlocking relations or the concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors, or consumers,” Section 10(b)(1);
2. Must bear a “fair relation to the sums invested in or the earning capacity of” the property acquired, Section 10(b)(2);
3. Must not “unduly complicate the capital structure of the holding company system,” Section 10(b)(3);
4. Must not be “detrimental to the public interest or the interest of investors or consumers or the proper functioning of” the holding company system, Section 10(b)(3);
5. Must not be “detrimental to the carrying out of the provisions of” Section 11 (relating to simplification of holding company systems, Section 10(c)(1); and
6. Must “serve the public interest by tending towards the economical and efficient development of an integrated public-utility system,” Section 10(c)(2).

2. *Mixing of utility and non-utility businesses*

For “registered” holding companies (usually the multi-state systems), the Act limited operations to “a single integrated public-utility system.” The only exception was for “such other businesses [i.e., other than the business of a public-utility company] as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system....” Section 1 1(b)(1). Example: If a utility owned coal burning plants, its holding company could own a coal mine to service those plants; but it could not own hotels and restaurants to house and feed coal miners.

For all “exempt” holding companies (usually the intrastate systems), the Act allowed ownership of nonutility businesses, but only to the extent not “detrimental to the public interest, or the interest of investors or consumers.” Section 3(a).

3. *Issuances of debt or equity*

For the registered holding companies, Section 7(d)(1) prohibited an issuance of securities if the issuance triggered one or more of six negative findings:

1. “The security is not reasonably adapted to the security structure of the declarant and other companies in the same holding-company system”.
2. “The security is not reasonably adapted to the earning power of the declarant”.
3. “Financing by the issue and sale of the particular security is not necessary or appropriate to the economical and efficient operation of a business in which the applicant lawfully is engaged or has an interest”.

¹I use the term “PUHCA 1935” to distinguish that statute from the Public Utility Holding Company Act of 2005, which includes the language repealing the PUHCA 1935, plus some provisions relating to regulators’ access to books and records, and procedures for allocating certain costs among holding company affiliates. PUHCA 1935 was codified at 15 U.S.C. sec. 79 et seq. Practitioners customarily referred to PUHCA 1935 provisions by section number rather than by U.S. Code cite; therefore Section 1 of PUHCA is 15 U.S.C. sec. 79a, Section 2 is 15 U.S.C. sec. 79b, etc.

4. "The fees, commissions, or other remuneration, to whomsoever paid, directly or indirectly, in connection with the issue, sale, or distribution of the security are not reasonable".

5. "In the case of a security that is a guaranty of, or assumption of liability on, a security of another company, the circumstances are such as to constitute the making of such guaranty or the assumption of such liability an improper risk for the declarant"; or

6. "The terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers."

4. *Interaffiliate transactions*

Sections 12 and 13 of PUHCA 1935 applied to registered holding companies a set of prohibitions and conditions relating to interaffiliate transactions in two major categories: financial transactions (e.g., loans, guarantees of indebtedness, extension of collateral), and sales of goods and services (other than electricity or gas).

Prohibited transactions included any loaning of money, or guaranteeing of indebtedness, by a utility subsidiary in favor of its holding company or any affiliate. See Section 12(a). Other interaffiliate transactions had to heed SEC rules, which generally required interaffiliate pricing to be "at cost," to prevent utility subsidiaries from being forced to subsidize nonutility businesses. See, e.g., Section 13(d).

B. *The repeal of PUHCA 1935 eliminated key accountability measures, increasing the likelihood of corporate complexity and abuse of interaffiliate relations*

By eliminating the 1935 Act's restrictions and reviews, the 2005 statute increased the likelihood of structural complexity, including self-dealing between regulated and unregulated holding company affiliates. Gone are the geographic and type-of-business limits on utility mergers and acquisitions, along with reviews of and limits on leveraged financing and interaffiliate transactions.

These changes make utility regulation more challenging. Because PUHCA 1935 induced conservatism in corporate restructuring, states and FERC had less need to create their own policies. Of the dozens of mergers between 1985 and 2005, most involved the joining of adjacent utilities. In these cases, the main challenges were to test the claims of cost savings from the combination (claims based on the assumption that the combination would produce greater economies of scale and scope); then allocate the risks, costs and benefits associated with those claims among customer groups and investors. Additional challenges included identifying and protecting against horizontal and vertical market power; and ensuring that the larger, post-merger entity devoted sufficient attention to local quality of service. These mergers, for the most part, did not involve the joining of remote electric facilities, or the mixing of utility and nonutility businesses, or leveraged private equity financing that increased debt while decreasing public information.

By removing limits on geographical, type-of business or financial arrangements, the repeal of PUHCA 1935 changed the market for corporate restructuring. Regulators at state commissions and at FERC thus face questions they had not had to address, systematically at least, for 70 years: Should they impose limits on the types of companies and corporate structures that provide retail monopoly service to electricity and gas customers? Or should they welcome new structural options without limit? With respect to these questions, there is no expert consensus, no political consensus, and no systematic process for arriving at one.

III. TO ENSURE PUBLIC ACCOUNTABILITY IN CORPORATE STRUCTURE TRANSACTIONS, WE MUST (A) IDENTIFY AND PROMOTE SENSIBLE CORPORATE STRUCTURES AND (B) APPLY COST-BENEFIT STANDARDS

A. *What types of corporate structures promote the public interest?*

In repealing PUHCA 1935, the 2005 Congress expressed no particular vision for corporate structures. There are no federal statutory limits on geographic remoteness, the mixing of utility and nonutility business, leveraging, private buyouts, interaffiliate transactions. Anyone can try anything.

Regulators thus face corporate structure transactions not permitted, or not permitted without review, for 70 years. This circumstance requires us to revisit regulatory policy on corporate structures. The purpose of such revisiting is not to replicate every aspect of the prior federal regime, but to inquire systematically into the nature of the new transactions and to determine the appropriate regulatory response, if any.

The table on the following page, "Corporate Restructuring by Public Utilities: How Should Regulators Prepare and Respond?," displays the necessary analysis. Listed on the left are corporate structure events which attempt to describe all major types of transactions: 7 categories and 21 subcategories. Listed across the top are the 3

categories of regulatory options—prohibition; permission without review; and permission subject to reviews, limits and conditions. By completing this table, the regulator determines, systematically, the types of companies and corporate structures permitted to provide utility service. For each of these 63 cells, PUHCA 1935 gave an answer. With PUHCA 1935's detail eliminated, the answers now must come from state law, and state and federal regulatory discretion.

This Part III of my testimony introduces the type of analysis applicable to four of these subjects: expansion of utility business, mixing of utility and nonutility businesses, interaffiliate transactions and issuance of debt or equity. First, the regulator must define the types of transactions that trigger regulatory concern. Then the regulator must determine the response: prohibition, permission without review, or permission subject to standards and review. The concepts below are examples for consideration. Some overlap. There is no intent that all should be promulgated. Rather, regulators and legislators should consider the full array and select those that suit their preferences.

Caution: Advocates of regulatory forbearance may misinterpret this table as a recommendation for regulatory conditions in every cell. The table does not prescribe a result; rather, it ensures alertness—to those corporate structure actions that warrant regulatory attention, and to the types of regulatory intervention (including no intervention). The purpose is to alert regulators to a statutory fact: the 1935 Act addressed every cell, in some way; the 2005 Act addresses only some.

1. Utility acquisitions of more utility businesses

The regulatory concern here relates to diseconomies of scale, management distraction and business risk: Will a utility become part of a system so large that quality and efficiency of local service will suffer, or local concerns be ignored, in setting terms and conditions of service? These transactions warrant attention whether structured as an acquisition, pooling of interests, transfer of assets or other form of restructuring; or whether the certificate to serve is transferred or remains in the original hands.

As with all the subject areas discussed here, the options for regulatory action on utility requests for permission to acquire other utility businesses include prohibitions, permission without review, and permissions subject to conditions and reviews. In cases where the statute or regulator does not prohibit the acquisition, regulators should submit it to economic tests, such as requirements of new efficiencies, non-recovery of any acquisition premium except to the extent the premium is matched by demonstrated cost reductions, and limits on the utility debt used for the acquisition. There also are structural conditions, such as placing the in-state utility business in a corporation separate from nonutility business, requiring that the utility maintain its own bond ratings, and requiring that the in-state utility obtain, file, maintain and update annually a third party's nonconsolidation opinion, i.e., an opinion that regulatory provisions are sufficient to prevent utility from being forced into bankruptcy should the holding company or other affiliate fail. Operational conditions include requirements that the merged entities be operationally integrated, commit to specified operational cost reductions (otherwise, there would not be cost justification for the merger), use best practices in all areas, satisfy quality of service standards, and bring no new cost or risk unless exceeded by measurable benefits.

A risk associated with any of these conditions is that they may not provide a level of protections comparable to what existed before the transaction.

2. Mixing of utility and nonutility businesses

The mixing of utility and nonutility business, including the control of a utility business by a nonutility owner, was long prohibited or discouraged by PUHCA 1935. The concerns here are management distractions, use of utility ratepayers to finance or guarantee debt associated with the nonutility business, and unearned competitive advantages for utilities entering nonutility markets.

Regulatory options, along with prohibition, and permission without review, include: (a) limits on the percentage of total holding company assets, revenues or net income that can be attributable to nonutility businesses; (b) limits on holding company or utility financing of any acquisition of nonutility businesses; (c) limits on the utility's ability to file for bankruptcy based on affiliate difficulties; and (d) forms of separation between utility and nonutility businesses, such as separate affiliates, accounting, financing and financial statements.

3. Interaffiliate transactions

Affiliate transactions fall into four major categories: sales of utility services, sales of nonutility goods and services, sales of utility assets, and financial transactions (e.g., loans and guarantees of indebtedness). Affiliate transactions move in both directions: to and from the utility, from and to the holding company or other affiliates.

There are multiple risks. “Cross subsidy” is a term frequently used in this context but infrequently defined. Where the corporate family has both utility and nonutility businesses, a cross subsidy occurs when a utility ratepayer bears costs caused by nonutility activities; i.e., when the ratepayer pays a price for utility service higher than she would have paid in the absence of the nonutility activities. When a utility holding company buys a hotel and shifts acquisition costs to the ratepayers, a cross subsidy occurs. When a utility enters a risky nonutility business, and the utility covers the higher cost of capital through utility rates, a cross subsidy occurs.

Cross subsidies are only part of the adverse effects of inappropriate interaffiliate relations. When utility customers have historically borne the economic cost of an asset, they should receive the full market value associated with that asset’s use by others. But a common practice is for the nonutility affiliate to obtain rights to the asset at cost rather than at market value. The result is not a cross subsidy, technically, because the ratepayers’ rates do not rise as a result of nonutility affiliate’s use. But there is a mismatch of risk and reward. The utility ratepayers bear all the costs but receive only part of the benefits.

The regulatory options for addressing these challenges again range from prohibition to conditional permissions to unconditional permissions. Examples: (a) prohibition on a public utility providing to an affiliate any financial loan, guarantee or other benefit other than the normal payment of dividends; (b) requirement that any goods or services sold by a utility to an affiliate be priced at the higher of book or market; (c) requirement that any goods or services sold to a utility by an affiliate be priced at the lower of book or market; (d) advance review of dividend payments to protect financial integrity of the holding company system and the working capital of in-state utility affiliate; and (e) advance approval for interaffiliate cost allocation practices and contracts above a minimum dollar level.

4. Issuance of debt or equity

With the electric and gas industries now free of any federal prohibitions on the types of corporate acquisition, utilities, their holding companies or their affiliates may attempt securities transactions that could trigger regulatory concern over leveraging, and over acquisition prices in excess of underlying value (with the expectation that captive ratepayers will fund the excess). The types of transactions warranting attention include issuance of debt or equity, and guarantees or assumptions of liabilities, (a) at the holding company level, for utility or nonutility purposes; (b) at the utility level, for utility purposes or nonutility purposes; and (c) at the non-utility level, for utility purposes or nonutility purposes.

The regulatory options include, besides prohibiting, or permitting without review, these transactions, the following: (a) the terms and conditions of the security issuance must be consistent with the sound and economical financing of the public utility businesses, i.e., that there is neither excess nor insufficient debt, and that the debt be reasonably adapted to the security structure of the utility and all companies in the holding company system; (b) the fees associated with the securities issuance must be reasonable and there may be no conflicts of interest among the transacting parties and their advisers, and (c) debt incurred by or guaranteed by a public utility must be used for public utility purposes only.

B. In assessing corporate couplings, how do we ensure that benefits justify the costs?

After dozens of utility mergers, the fundamental economic analysis of whether a merger is, from the consumers’ perspective “worth it,” remains unsettled. This “merger equation” involves four main questions:

1. What should be the relationship of costs to benefits?
2. How should we measure costs?
3. How should we measure benefits?
4. If actual costs and benefits deviate from projections, who is accountable?

There is no commonly held answer to these questions. In many mergers, the questions never arise, let alone receive answers.

What should be the relationship of costs to benefits? The most frequent answer is either (a) “benefits must not be less than costs” (sometimes called the “no harm” test), or (b) benefits must exceed cost, but not necessarily by much (sometimes called the “positive benefits” test). Another test, applied uniformly in prudence review, and in standard financial analysis, but rarely in merger review, is “Does the cost produce benefits at least equal to alternative, feasible uses of the money?” The roots of this third test are in the common sense view of economic efficiency, that the “public interest” is harmed when a merger consumes resources that would allow a lower-cost means of achieving benefits. In the regulatory community there has been no

systematic examination of these alternative equations, or of the implications of allowing dozens of mergers to proceed without such examination.

How should we measure costs and benefits? Savings asserted by merger applicants have included: administrative/general savings, labor savings, fuel savings, O&M savings, savings from coordination efficiencies, savings from construction deferral and savings from bulk purchases and other economies of scale.

As with the benefit-cost relationship, there is no common regulatory treatment of costs. Some states require merger applicants to quantify savings with the degree of specificity required in a rate proceeding, or to accept rate reductions based on their assertions of savings. Sometimes, however, applicants' assertions of savings are so general that there is insufficient information on which to base a credible cost-benefit judgment. Regulators also differ over the period of time over which they must quantify savings. Nancy Brockway, NRR's Director of Multi-Utility Research and Policy, points out that there is no industry standard for estimating likely merger synergies, and typically no track record of proven synergies from other mergers by which to assess forecast results from the proposal under review.

If actual costs and benefits deviate from projections, who is accountable? A continuing difficulty is determining whether an asserted merger benefit would have occurred without the merger. Otherwise merger cost recovery from ratepayers would negate cost reductions that would have occurred without the merger.

After-the-fact rate review is not enough. Some argue that protection against cross subsidies and other risks lies in ratemaking. The implication is that structural complexity poses no risk because ratemaking will catch problems. This view is not fact-based. Ratemaking depends on auditing. Auditing is not like a trip to the dentist, who checks every tooth. Auditing is sampling. It cannot promise 100% coverage—especially with limited regulatory resources. Allowing structures that invite cross subsidies or complicate auditing increases the probability of problems.

Reliance on after-the-fact disallowance also invites too-big-to-fail situations. In the competitive world, poor decisionmakers fail. But not always. We all are familiar with situations in which a company's size or national importance pressures regulators to prop them up. State commissions whose residents depend on the incumbent will tend to save the company rather than exact the ultimate penalty—especially since bankruptcy law addresses creditor rights, not consumer protection. Given the inherent uncertainty of “back-end” accountability in the form of rate review, “front-end” accountability in the form of advance review of financial risks becomes even more critical.

IV. REGULATORY PREPAREDNESS FOR NEW STRUCTURAL TRANSACTIONS REQUIRES MULTIDISCIPLINARY EXPERTISE AND A SHARED MULTI-JURISDICTIONAL PURPOSE

A. Multidisciplinary analysis calls for a new array of regulatory resources and skills

The GAO study cited state commission concerns about availability of resources to deal with cross subsidies. That concern applies as well to the larger set of questions throughout this testimony. Analysis of corporate structure events requires expertise and resources in the area of economics, engineering, finance and accounting, and business management. In this subpart I give examples of the types of question demanding new skills and resources.

1. Economics: What are the economies and diseconomies of scale for the various components of utility service—production, transmission, distribution, customer relations? What are the economies and diseconomies of scope among various utility and nonutility activities potentially coexisting within the same corporate family? How can regulators gather this information in the context of reviewing merger and acquisition proposals?

2. Engineering: For each of the major physical functions involved in utility service, what are the geographic and size limits beyond which reliability, quality and responsiveness of service are affected?

3. Finance and accounting: What are appropriate financial structures for the various businesses within a utility holding company structure? Do some structures pose the risk of corporate managers channeling utility cash flow to nonutility businesses, in amounts detrimental to the utility's optimal functioning? For example, can there be “safe harbors” for various types of nonutility investments by utility holding companies, such that should business failures occur, no damage to the utility will result? Are there true benefits to utility shareholders to having a utility holding company diversified into other business, as compared to the shareholders diversifying their portfolios individually?

In corporate acquisitions occurring within noncompetitive markets, there is a risk of financial circularity: the acquiring company pays a premium for a utility knowing that the premium can be recovered from monopoly ratepayers. (Competitive mar-

kets, in contrast, cap premium payments because the acquired entity cannot raise product prices above market prices.) Given the circularity risk, what methods exist for determining the appropriate size of acquisition premia? What regulatory policies best line up the acquirer's desire to pay a premium, the acquiree's insistence on a premium, and the ratepayer's legal right to protection from rate increases associated with the premium? (Such policies should encourage efficient mergers—meaning mergers that lower costs—and discourage inefficient mergers.)

4. Business management: What are implications for efficient and effective management when utility operations are geographically dispersed, i.e., not operationally integrated? How do managers, and regulators, determine these limits? What are the incentives, for various management positions, which result from a mix of utility and nonutility businesses in the same corporate family? Are these incentives aligned with the public interest? What are the skill sets necessary to manage, simultaneously and successfully, monopoly and competitive businesses within the same corporate family? After several dozen mergers and acquisitions in the electric and gas industries since 1985, what data are available to study these questions?

B. Multiple regulators of the corporate structure market need a shared purpose

While eliminating federal statutory restrictions, Congress left pre-existing state and FERC roles undiminished. The responsibility for making those judgments necessary to prevent adverse effects on consumers, markets (for power, gas and finance) and the general public thus shifts to the regulators, federal and state, who must try to use their existing jurisdictional tools to address the new challenges. This situation creates opportunities for regulatory experimentation and creativity, but it raises a fair question: Will the separate actions, or inactions, of multiple jurisdictions produce a rational regulatory policy on corporate restructuring in multistate markets?

I suggest that the current conversation on cross subsidies grow into a discussion of this larger question: Do we need consistent regulatory policies across jurisdictional lines to encourage utility corporate structures that serve the public interest, and discourage ones that do not? Can we achieve that consistency while still leaving flexibility for individual jurisdictions?

This question need not trigger a federal-state dispute over a jurisdictional zero-sum equation. There is opportunity for a jurisdictional policy that allows for federal and state roles, and for variation among the states on a number of issues. A rational policy would distinguish between (a) the need for an efficient multistate market for utility asset acquisitions, and (b) the need for responsible state-level regulation to ensure efficient and reliable local service. Without a concerted effort on the part of federal and state policy makers to address the whole set of issues raised by utility mergers and acquisitions, from cross-subsidies to federal/state jurisdiction, however, we will dilute our ability to address the gaps left by the repeal of PUHCA 1935. I hope this Commission, and the participants in today's testimonial panels, can address this question.

V. CONCLUSION: THE REPEAL OF PUHCA 1935 DOES NOT RELIEVE REGULATORS OF THEIR DUTY TO ADVANCE THE PUBLIC INTEREST THROUGH CORPORATE STRUCTURE REGULATION

This testimony has focused on alertness, in the form of four types of anticipatory actions: (a) identifying the types of utility corporate structure transactions that trigger regulatory concern; (b) establishing principles to guide market participants who fashion such transactions; (c) recognizing the multidisciplinary ingredients to effective regulatory review; and (d) revisiting the federal-state relationship to ensure consistency in vision and implementation. The present focus on cross subsidies is too narrow to accommodate these larger, more far reaching questions.

Some have argued that to articulate and encourage a vision for accountable corporate structures is to "reconstruct" PUHCA 1935, in violation of Congress's 2005 intent. This argument is deficient in logic, law and thoughtfulness. Section 203 of the Federal Power Act requires the Commission to judge mergers by a "public interest standards. The 2005 Congress did not dilute this language, but rather subjected more transactions to it. State merger statutes create similar duties.

It remains regulators' continuous obligation to align corporate structures with the public interest. With the repeal of PUHCA 1935, that obligation becomes more difficult to fulfill. The acquisition of remote utility properties, the mixing of utility and nonutility businesses, and the use of unconventional ownership structures and financing structures, all call for new resources and new expertise. The dialogue created here by GAO and FERC is a worthy beginning, but it is only a beginning.

Thank you for the opportunity to present this testimony. I look forward to any questions from the Committee.

Senator SALAZAR. Thank you, Mr. Hempling. Let me start out with you, Mr. Gaffigan. You, in your testimony talked about the few substantive changes in FERC after the 2005 Act. You talk about how we essentially have a system in place that's self certification system. I think your conclusion is that FERC is too over reliant on self reporting. That they don't have a risk based approach to targeted auditing that the resources that FERC has with only 34 auditors isn't sufficient for them to do the job that we assigned to them under the 2005 EPACT.

Would the remedy there essentially be to give more resources to FERC so that they could actually do the job that was assigned to them by the Congress back in 2005? How big is that deficiency?

Mr. GAFFIGAN. Right. I think the first step is to have them sit down and do a real risk based approach, in other words, understanding what's the portfolio of companies that they're going to look at.

For example, if it is the 36 utility holding companies, which ones are the highest risk? How involved are they? If we have more mergers become involved what's the make up of the companies? I mean, really complex types of issues.

That's going to really dictate and put them in a position to say, alright, here's how many resources we need to cover this. We're short. So I wouldn't go off and just say, look, just throw a bunch of auditors at it. I would have them do the risk based approach as our recommendation outlines. Then I think, then they'll be in a position to give a good assessment of what their resource needs might be.

Senator SALAZAR. Based on what you know, based on having done the GAO report, how short do you think they are on resources? Or do you think you can't answer that until you go through the risk based analysis.

Mr. GAFFIGAN. I think to give you a good answer, you can't answer that. I expect it to change over time. You know, we could have more mergers than is expected and that would dictate how much staff they're going to have.

I think they're in a position where, you know, when the SEC went away, they used to do these audits. They were a group of about 25 auditors. So they have gone away. The Division of Audits has pretty much stayed the same within FERC.

Senator SALAZAR. Commissioner Kerr, on behalf of the States. The concept here is that the States through their PUCs do a lot of this work and so FERC essentially acts as a backstop. Do the States have, I mean, your testimony is the States don't have the resources. You're resource deficient.

What I'd like you to do is to talk about that a little bit and also talk about the variance between the States because knowing the reality of States some legislatures and Governors will put more money into their commissions than others. And so do we have a patchwork of regulation here for when deferring to the State levels that is not workable.

Mr. KERR. Senator, I would be fired I think if I said we have all the resources at the State level we need and by my colleagues. They wouldn't like that. I mean, obviously resources are always scarce.

I think certainly the question is yes, that there is variety from State to State or commission to commission when you think about financial or human resources. I would say the good human resources aren't always in the bigger States. I mean, we're just variable, like any group of 50.

But I don't think, and I think that GAO's report bore this out, I don't think there is tremendous variation in terms of legal authority. I mean the report is pretty clear. There is consistent authority found in statute or rules to look at mergers, to audit, to have access to books and records.

Certainly in EPACT 2005 Congress expanded for all States access to books and records of holding companies and affiliates. So I think that the legal. There's not as much legal variety or variation across the States. I think that the report bears that out.

Now I will say that they did identify some discrepancies or some variety, fairly minimal. I think that's why we're glad that they've come and reported to us. It gives us a tool to fill in some of those gaps. Certainly since the repeal of PUHCA some States have gone in and asked for certain authorities from their legislatures that they felt like they needed.

So, yes, as to financial and human. I don't think so from a legal standpoint. In other words we have the authority to do the job.

I think the answer for how do we handle that variability from a resource standpoint is largely found in organizations like NARUC, like the National Regulatory Research Institute, which Mr. Hempling heads up for us. In fact we went looking at the future and our responsibilities. We went out and found someone like Mr. Hempling to come in and assist us.

At footnote 32 and 33 of my testimony I've listed some of the work that we've done with the prospect and the reality of PUHCA repeal to help prepare States. Academic reports, substantive work to try to make sure that that variability we can leverage the resources of the national organization and the various States to try to even out and fill in and provide for that variability.

Senator SALAZAR. Thank you.

Mr. KERR. I would make one other just quick point too and that is the level at which we are doing a better job in the last two or 3 years of working with the financial community. I think they know where we are now and we know where they are. So I think the way, the manner and the level at which we understand the private equity community, the fixed income side of these issues.

We're much more sophisticated. I think we needed to be. I think that is helpful. I do think that's across the board. I mean that's at the national level and at the regional level and we're doing a better job there.

Senator SALAZAR. Thank you, Commissioner Kerr.

Senator Murkowski.

Senator MURKOWSKI. Thank you, Mr. Chairman. I apologize that I was not here for the first half of this hearing. Obviously a very important issue and one that I'm pleased that has been brought before the committee.

I was over in the Indian Affairs Committee where we were talking about the Indian Energy Act and the fact that we may have put in place some good provisions, but we have lacked in certain

areas when it comes to providing things like loan guarantees and the financial assistance. So it was an important hearing over there too this morning. Busy morning.

Let me ask you, Mr. Gaffigan, well I wasn't here for Mr. Kelliher's testimony. I did have an opportunity to review it. You're arguing that the principle means for identifying the cross subsidies is through the financial audits, the periodic financial audits.

But the Commission highlights its rate making authority as the most powerful and perhaps the most effective tool for to prevent the cross subsidies. Do you agree that this rate making authority can be an effective tool both at the State and Federal level or is that a basic area of disagreement here?

Mr. GAFFIGAN. You know, rate making is part of it. I mean our focus was on the compliance audit which formerly SEC did. What I would say about rate making, you know, it occurs infrequently. They could be many years apart. The audits can be many years apart and in sort of a prospective look.

So what I would say it's a different tool. I think what the compliance audits we're talking about offer a retrospective look and a particular look at affiliate transactions and the whole range of cost. FERC is looking at, you know, transmission costs and the wholesale sale of electricity. So it doesn't cover necessarily all the costs that ultimately a consumer can pay.

So I would say they are complementary and what I would say is that the compliance audits we're talking about are just as important. That was the focus of our concern.

Senator MURKOWSKI. I see. So it's not an either/or. You're saying that it's a complementary process then.

Mr. GAFFIGAN. Absolutely.

Senator MURKOWSKI. Mr. Owens, you've testified that this increased Federal oversight over non-utility corporate activities could actually create barriers to investment and competition in the electricity markets. Which is exactly what we were intending to do, to eliminate when we repealed PUHCA. Can you elaborate a little bit more on this line?

Mr. OWENS. If the rules aren't clear. If the rules appear to be preemptive of activities that the States have underway where they also review a range of activities that companies are engaged in, it could create tremendous confusion and delay in getting a range of financing approvals. It could also potentially could create tension between the State commissions as well as the Federal Energy Regulatory Commission if the rules are not clear and the rules are not collaborative.

Ratemaking is a very comprehensive responsibility that both the States and FERC have. I do agree with the earlier comments that it's just not an audit. It's the looking of all aspects of a company's operations.

But the rules have to be clear. The rules have to be understandable. The rules have to be implemented in a way that it does not create confusion and uncertainty.

Senator MURKOWSKI. Mr. Hempling, you have left the door open. You invited the question from Senator Salazar and myself on the issue of preemption. Your testimony provides for revisiting the Fed-

eral/State relationship to achieve consistent regulatory policies across jurisdiction lines with respect to cross subsidies.

Are these the code words for Federal preemption? Talk a little bit about where you were going when you kind of left that question hanging there.

Mr. HEMPLING. Thank you very much, Senator. I in fact meant the opposite. But first let me address the issue of preemption, deference and backstop, three words that have been used frequently this morning.

There is absolutely no, in my opinion, congressional intent in the 2005 statute to authorize FERC to make decisions that are preemptive of States. I'm concerned that that word has departed from the way I learned it in law school. I went to law school a long time ago. But I think somewhat more recently than some of the other panelists.

Preemption, technically, simply means that the State law becomes invalid and inoperative under State law. I don't think anything in the 2005 statute could have that effect. There is the possibility that the FERC could find that the range of conditions imposed at the State level are insufficient as a matter of Federal law. Therefore the Federal Energy Regulatory Commission could add to them.

But there is no authority in FERC to declare that somehow the State law conditions are inoperative or unlawful. To the extent the prior panelists meant preemption in that way, there's no legal basis for it. I think perhaps they were using it in a non-legal way.

But I think it has caused confusion because the issue here is not a matter of deference to States. The FERC has independent legal authority. By the way in the context of section 203, that authority is not confined to the protection of wholesale customers. I'm sure the chairman and his lawyers know that.

The only wholesale notion in the Federal Power Act has to do with rates. But in the context of mergers and acquisitions and restructurings under section 203, the public interest includes all customers both wholesale and retail. There is no legal authority in FERC to create in some party a burden to prove to FERC that somehow State conditions are inadequate.

The FERC has an independent obligation to ensure that all customers are protected. The fact that FERC might come in to say we like the Washington State conditions, but we think more are necessary. That's not called preemption the way I learned it in law school. That's called exercising independent authority to strengthen.

I know of many States who would be very pleased to have FERC play that role because the States either lack the resources or the political support to impose as many conditions as they would like. So when we talk about cooperation and complementing each other. It is in the exercise of independent authority at the State and the Federal level.

My concern about consistency actually is consistent with what Mr. Owens and others have said is that I want to see clear signals sent to the marketplace. Some mergers and acquisitions are going to be good. We've got corporate boundaries that were drawn almost 100 years ago.

Some of them are old and need to be replaced with larger companies that have better economies of scale. Other mergers are going to be inefficient because they are motivated by the wrong desires. We need this concept of consistent rules that are clear so that the marketplace knows how to react.

That's where I think collaboration can occur. Thank you for the opportunity.

Senator MURKOWSKI. I appreciate your statement there. Thank you, Mr. Chairman. I've gone over my time.

Senator SALAZAR. Thank you very much, Senator Murkowski. Let me ask a question of you, Mr. Owens for EEI. One of the things that was predicted back in 2005 when we working on EPACT and the repeal of PUHCA was that we were going to see merger mania, 70 years of regulation under PUHCA ended in 2005 and everybody said we were going to see major merger mania. It hasn't happened.

Looking ahead, what do you see? Do you see the possibility of merger mania in the utility world?

Mr. OWENS. If I knew that answer I wouldn't be here. I'd be a rich man. Let me stop being a—I would say it really depends on market conditions and whether companies can see benefits that will accrue to customers as well as benefits that would accrue from technology improvements.

You can't predict whether a merger is going to occur or not. As all the panelists have indicated there are a range of issues that are presented when a company considers merging with another company or acquire another company. The bottom line of all those considerations are savings to consumers, technological advancements, economies of scale, economies of scope.

Senator SALAZAR. Let me try to pinpoint my question a little bit more.

Mr. OWENS. Yes.

Senator SALAZAR. We see what's happening in the airline industry today where there are a number of conversations about mergers and the airline industry. We have seen it over the last ten, fifteen years with respect to what happens in the financial industry and the banking industry with respect to mergers.

Mr. OWENS. Yes.

Senator SALAZAR. We have not seen a merger mania.

Mr. OWENS. That's right.

Senator SALAZAR. A significant movement in that way in last several years with respect to regulated utilities. Do you, in terms of the way that EEI sees the world, is that something that you are thinking might happen? Do you think it's not going to happen? I mean what are your economists—

Mr. OWENS. Wall Street would love to see it happen. They indicate that there are too many companies. I mentioned earlier that many of our companies are undergoing tremendous investment in infrastructure. Based upon the major investment in infrastructure it is likely that some companies will not be able to have the finance ability to build a major new facility. They may find that they have a stronger balance sheet if they combine with other companies. So that's one condition that could lead to greater mergers.

There's uncertainty with respect to what happens under the concerns about climate change. Companies have different levels of re-

sources. Companies that are not heavily coal based may see an opportunity or an advantage in combining with a company that has a broader array of resources.

Again all of these are pretty speculative. They really depend upon changing conditions. But I don't think they're so far fetched.

There are international companies that are looking at the U.S. market and the dropping of the value of the dollar and the strong balance sheets that some of the international companies have. They may view that they can see opportunities in acquiring a U.S. company and providing economies to that U.S. company. I think we're in an environment where that can occur.

We look at all of that and say we don't see a tremendous rise in mergers potentially occurring. But we think the factors that could lead to mergers, many of those factors are presented today.

Senator SALAZAR. So it could, in fact, happen, which in the sense makes the importance of this hearing and having a FERC that has the adequate oversight work well.

Mr. Hempling, I'll come back to you, Mr. Gaffigan. On this question of preemption, I think I understand what you were saying that this is not really a preemption in the legal sense. You have independent authority at FERC. You have independent authority with the State Regulatory Commissions. So those independent authorities need to be exercised in the public interest.

The question I would have for you then is how do we make sure that these independent authorities get exercise in a way where they're essentially part of the same team of protecting the public interest as opposed to having, you know, one big cop at the Federal level and another cop at the State level. How do you create that kind of collaboration so there is consistency with respect to the regulation?

Mr. HEMPLING. I was afraid somebody would ask such a thoughtful question and not that the other questions haven't been thoughtful. It's a difficult way to answer it without getting stuck in the canard that I'm proposing a "one size fits all" which is a phrase people often use to describe a solution they don't like.

I want to first emphasize that I'm not talking about the need to have a single approach to every transaction. I think the prior panel made clear that depending on whether it's a partnership, a SCEcorp or other sorts of arrangements, there need to be different types of tools. I think what has to happen is much more difficult than what we're addressing. That is there has to be some consensus about the nature of the corporations that we want serving the company.

There's something episodic and opportunistic about the way it's working right now. I was never among the ones who predicted merger mania. I don't think the concern is the speed at which these transactions or the rate at which they occur.

I think the question is what is the nature of the companies. Are we indifferent when a Warren Buffet acquires a Washington or an Oregon utility? Are we indifferent when a private equity firm acquires a utility? Do we care whether the long term shareholders have been replaced by short term shareholders?

My concern is that there is lacking a dialog among regulators at the State and Federal level and together as to what it is we're try-

ing to achieve here. Because if one were to infer from the present regulatory stance the inference would be that whatever the “market” produces in terms of couplings is what is right. I’m concerned that the market is not sufficiently competitive or disciplined or overseen for us to have that type of trust in it.

So I’ll simply concede that I have no direct answer to your question, yet. But I believe it’s the main one we have to address, sir.

Senator SALAZAR. Ok. Why don’t we keep—my time is up. So, Commissioner Kerr and Mr. Gaffigan, if you’ll quickly respond and then we’ll turn it over to Senator Murkowski.

Mr. KERR. I think I agree with Mr. Hempling. I think the trouble is it is so difficult. Things are moving so fast. It’s hard to make that distinction. You know, Mr. Buffet’s involvement in the utility industry has been, I think, successful and welcome. Certainly if you look at the disaster that became ENRON, you know, that basically evolved off a utility platform. It began as a typical utility platform that evolved.

I think my basic point is we can’t know prescriptively, prospectively what we are going to need or where these investments are going to come from. I absolutely agree with Mr. Hempling that we know the type of investor, the longer term horizon, the folks who understand the unique public service obligation of these entities. It’s more difficult to sort through and figure out who is Warren Buffet and who is Gordon Gecko. I can see that. I don’t see how you’re going to do that in advance.

Senator SALAZAR. Do you think, Commissioner Kerr, that Mr. Hempling suggestion on the need for the dialog between FERC and the States is adequate?

Mr. KERR. I think absolutely. I think we have that. I mean, I think one of the points that I want to make clear that might have slipped by during the first panel is the policy statement that FERC has adopted was based on a technical conference that had representatives of two State commissions including Oregon which is really the preeminent case of ring fencing and the effectiveness of protecting the underlying utility from the ENRON debacle.

So I think that dialog is ongoing. I mean, can we do more as the GAO suggests? Yes, certainly, we might be able to. I think both FERC and the State and NARUC have indicated, an absolutely, a willingness to do more if that’s what we need to do.

Senator SALAZAR. If you take about 20 seconds, Mr. Gaffigan.

Mr. GAFFIGAN. I can. I just want to add to Mr. Hempling, the merger mania concerns we heard were not the numbers and the rate. It was: what are things going to look like? That’s the concern we had. We don’t have a concern about regulatory gaps, as Mr. Owens implies.

We have a concern about how are these States going to deal with this issue of more complex companies coming in and potentially putting themselves in the situation of having to approve a merger. They could face things that are more daunting than what was faced in the 1930s and the whole reason for PUHCA in the first place.

Senator SALAZAR. Senator Murkowski.

Senator MURKOWSKI. Just very quickly to finish up my questions. This should be a, you know, 30-second answer from each of you.

With FERC do we have in place sufficient customer protections in light of PUHCA repeal? Now Mr. Gaffigan you mentioned you're not concerned that there have been any regulatory gaps that have resulted as a consequence of the repeal.

But do we have sufficient customer protections, consumer protections in place?

Mr. GAFFIGAN. Our concern was not with the rules. It's with enforcement of the rules. That's our main concern. I think that, you know, FERC has an opportunity to do some things in the recommendations that I think will provide that assurance.

That's all our recommendations were saying. I think we heard even from all the Commissioners, some element of, yes, there might be some value there. Some stronger than others, but even Commissioner Kelliher, Chairman Kelliher was talking about it. In his comments he says well, I'm going to have the staff consider the GAO recommendations, carefully consider.

That's all we're saying, that the rules are there. It's the enforcement of the rules that we're concerned about.

Senator MURKOWSKI. Commissioner Kerr.

Mr. KERR. I think the rules and the authorities are there, but at the State and Federal level I think there's an awareness of the issues and the potential concerns with respect to consumer protection at both the State and Federal level. I think there's a working relationship that gives us the opportunity to make sure that consumers are protected. I think with the GAO report we've got a critique from an independent agency that's made some suggestions that will further benefit the points we already have.

So I don't think I could ever answer you absolutely, are we perfect. But I think we are where you should expect us to be when you adopted EPACT 2005.

Senator MURKOWSKI. Good.

Mr. Owens.

Mr. OWENS. I also think the rules are there. I think the elements to make sure that the rules are carried out are there. I do believe that I will agree here with the GAO that there could be continuing collaboration with the States.

FERC has and the States have several collaboratives that undertaking today. I would encourage that they seek to fill any resource gaps by working more closely together. More clearly identifying, as Mr. Hempling said, if there are concerns about the evolution of different organizational structures then I think the States and the FERC need to collaborate.

I think it is appropriate if they believe that those structures are structures that are creating adversity with respect to looking at affiliated arrangements. There should be a dialog about that rather than adopting rules that would lead to uncertainty and raise the overall cost of capital and frustrate utility investment infrastructure.

So I would be in support of greater collaboration, greater clarity and having FERC and the States work together.

Senator MURKOWSKI. Mr. Hempling, you get the final word.

Mr. HEMPLING. Thank you, Senator. A comment on substance and then a comment on attitude. Concerning substance, I think FERC has to be more hip to the possibility that the motivations be-

hind certain transactions are not long term and may deviate from the public interest. There needs to be more skepticism there.

They need to start subjecting the mergers and acquisitions to at-test showings of economies and efficiencies restrictions of leveraging. They need to examine empirically the sufficiency of resources at the Federal and the State level.

A word on attitude. The Federal Power Act is not a backstop. The Federal Power Act is not a statute that defers. The Federal Power Act is a command to the Federal Energy Regulatory Commission to protect the consumer. It takes nothing away from Federal/State relations for the Federal Energy Regulatory Commission to say we must play a lead role here with the resources that we have.

So I'm looking for a modification of their attitude in that respect. Thank you very much.

Senator MURKOWSKI. Thank you.

Thank you, Mr. Chairman.

Senator SALAZAR. Thank you very much, Senator Murkowski. Mr. Gaffigan, Chairman Kelliher argued in his testimony that the financial health of the holding company is not evidence as to whether cross subsidization is occurring. From your point of view in your review, are there other threats to the well being of a utility and its rate payers, of the financial health of the parent company might be a good indicator of?

Mr. GAFFIGAN. I think our point in our report was there are a lot of financial indicators that FERC could look at to assess its risk, not just financial statements. There's a whole range of things. We, in our recommendation, indicated that they look at that portfolio and come up with some good measures of financial risk. So we think there's a lot of opportunities for them to look at the risk of financial companies by looking at a lot of different types of financial information.

Senator SALAZAR. Mr. Hempling, in EPACT 2005 we gave FERC new authorities and obligations to review mergers. Specifically we required the middle law to find that there would be no cross subsidization or encumbrance of assets for the benefit of the affiliate as a result of the merger. In your view have FERC's modification of their merger rules adequately implemented this requirement?

Mr. HEMPLING. There's one difference I would have with FERC is to their rules and that concerns the measurement for the appropriateness of inter-affiliate relations. If I'm not mistaken the rule is that there is a sale by an affiliate to the utility the price cannot exceed market.

That's a deviation from the Holding Company Act rule which is an at cost rule. The notion had always been that the sale from an affiliate to the utility should be at the lower of cost or market. The reason for that is to avoid a situation that has occurred in a number of States where an asset like generation, which had been charged for to ratepayers at an embedded cost, depreciated over time, that that generation migrates to an affiliate and then the output is sold back to the utility at a higher market price thereby depriving the utilities ratepayers of the bargain for which they many years before had paid.

So I would recommend that FERC, if I'm not mistaken on that rule, modify it so that the sale from the affiliate to the utility is the lower cost or market. Other than that, sir, I would say that the rules themselves given their purpose are reasonable in light of the congressional intent. I did make the statement earlier that I think there's more here than just those issues.

Senator SALAZAR. So your view is then that there ought to be a modification of that rule on the part of FERC. Are there statutory changes that you would make a recommendation to this committee that we ought to look at?

Mr. HEMPLING. That's a good question. It deserves a long answer, but I'll give you a short one. I would like to see FERC apply to mergers and acquisitions a better defined test than the test that presently exists which is merely, "consistent with the public interest." That's a generic phrase seen often in regulatory statutes.

I like the notion of the FERC requiring that mergers demonstrate that life will be better off in the industry with the merger than without. That the purpose of the merger is to create economies and efficiencies associated with the coupling which could not be achieved by lower cost means. That's not the standard that exists in the new statute. It was the standard that exists in the old statute.

Let me warn people who are about to run to their cell phones. I'm not suggesting that we bring back the Holding Company Act with all its prohibitions. I am suggesting there's a middle ground where we screen mergers and insist that the ones that occur are the ones that do serve the public interest by adding efficiencies.

Senator SALAZAR. Now is that something to be accomplished by change in the law or is it something that can be accomplished through modifications of the rules by FERC?

Mr. HEMPLING. FERC could do it under its present authority. It could define the phrase consistent with the public interest to require the creation of efficiencies and economies. They could do it under present authority. If they do not then there's reason to talk about modifying the statute in that regard.

Mr. KERR. You've succeeded in getting a Commissioner to argue with the head of our research institute. I'm sure that wasn't your intent. But just let me say this I think I agree with Mr. Hempling as we sit here today.

I do think though when we start thinking about our future, our sense of the public interest in this arena is evolving. We're probably moving away from the concept of pure economic efficiency or lowest cost. We are confronting environmental challenges that are going to have us view the role of the utilities, perhaps, somewhat differently.

We may want the lower cost of capital that is available to the typical utility applied to, for instance, renewable generation opportunities. They are not the most economically, efficiently currently as you all know wrestling with the tax credit issues. So what we're going to want tomorrow in the public interest may not be what we have traditionally viewed as purely economically efficient investments or structures.

That was the key point that I wanted to make is we know it's changing rapidly. We're not sure where we're going to be with re-

spect to how we serve the public interest in this vital segment of our economy and so my personal view is that more flexibility at the current time. As long as you all are comfortable that we and our Federal colleagues know what we're doing, I think more flexibility at the current time is what we need to meet the challenges we confront because our concept of how this segment of our society is going to be dealt with is evolving rapidly. It's not purely a matter of economic efficiency anymore.

Mr. HEMPLING. I consider Commissioner Kerr's statement as an enhancement to my suggestion. I fully agree with it.

Senator SALAZAR. Thank you very much.

There are a number of other questions which I know Chairman Bingaman and other Senators on the committee have and so those will be sent to you. We would ask that you respond to those questions.

We thank you for your testimony here this morning. We have learned a lot. It will guide us as we will move forward. Thank you very much. The meeting is adjourned.

[Whereupon, at 11:44 a.m. the hearing was adjourned.]

[The following statement was received for the record.]

STATEMENT OF MICHAEL E. BOYD, PRESIDENT, CARE, SUNNYVALE, CA

I watched the May 1st Committee Hearing on the adequacy of FERC's consumer protection with much dismay. After waiting seven years for refunds for California's energy consumers for the seventy one billion dollars of energy overcharges imposed on California's consumers during the 2000—2001 energy crisis I am frankly not surprised that FERC Chairman Kelliher hears and sees no evil in the energy markets. This is because Chairman Kelliher is part of the problem. The Senate need look no farther than to where Mr. Kelliher came from before he became Chairman, working heading up VP Dick Cheney's 2001 Energy Task Force to know why FERC's consumer protection program is an oxymoron. Mr. Cheney's Energy Task Force likely was the architect of the program set up to transfer a huge amount money from energy consumers in the West to the very power generators and energy marketers FERC is supposed to regulate. This plan to privatize the profit for a few energy insiders, has resulted in a huge socialization of the costs of deregulation on the backs of energy consumers nationwide. Our group CALifornians for Renewable Energy, Inc. (CARE) has brought a law suit before the US 9th Circuit Court of Appeals challenging the FERC's Decisions regarding the crisis (attached).*

The FERC decisions addressing the 2000-1 western energy crisis did not hold hearings or other proceedings including the affected ratepayers. CARE's efforts were the only direct ratepayer participation. All the other parties to the proceedings were regulated utility companies, energy commodity traders, governmental "non-public utilities" and state and federal government agencies that implemented the policies and practices leading to the energy crisis. Those harmed include CARE members, specifically those members who are low-income and people of color, who had their utility service turned-off because of the exorbitant rates charged. By denying the affected plaintiffs the opportunity for a fair hearing before the FERC it has deprived plaintiffs of their constitutional rights. Yet CARE's concerns and injuries were not considered during the proceedings in question. This is a violation CARE's due process rights.

I would like an opportunity for energy consumers to be given the opportunity that FERC was unwilling to provide us to be heard by the U.S. Senate Committee on Energy and Natural Resources on the adequacy of FERC's consumer protection or the lack thereof.

*Document has been retained in committee files.

APPENDIX

RESPONSES TO ADDITIONAL QUESTIONS

RESPONSES OF MARK GAFFIGAN TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Your report recommends that FERC adopt a risk-based analysis in selecting candidates for audits of affiliate transactions. Chairman Kelliher indicates that FERC already this [sic]. Is there a difference between what you are suggesting and what the Commission already does?

Answer. We believe there is a difference between what GAO suggests and the Commission's current practice. During the course of our year-long engagement, key senior FERC officials described the process for selecting companies to audit as informal; they did not mention the mechanisms the Chairman described in his testimony as a risk-based approach. When we asked FERC staff for a record of a risk-based analysis, or the criteria FERC would have used to conduct such an analysis, they were unable to provide them and consistently told us audit selections were based on informal discussions with knowledgeable senior FERC staff.

While FERC officials may consider risk in these discussions and, as we noted in our February 2008 report, may believe their judgments provide a reasonable picture of risk, we believe a risk-based audit planning approach should be more systematic. A more systematic approach would more reliably guide FERC in assessing individual company risks and the overall risks posed by the companies collectively, and would ensure that its audit selection process remained consistent when staff in key positions change.

As we noted in our report, some federal agencies develop their own statistical measures of risk using quantitative models. This method may be appropriate for FERC, but there are others. FERC's approach will need to be flexible enough to meet its current and expected future auditing demands now that it is solely responsible for detecting potential cross-subsidization. In our recommendations, we did not prescribe a method for developing and implementing a more formal, risk-based approach; our intent was to give the Chairman flexibility to identify the most appropriate method. In any case, designing a formal risk-based approach will take time and effort, and FERC may want to consider consulting with outside experts.

Question 2. Chairman Kelliher argues that the financial health of a holding company is not evidence as to whether cross-subsidization is occurring. Are there other threats to the well-being of a utility and its ratepayers that the financial health of the parent company might be a good indicator of?

Answer. It is not our view that the health of the parent company is an indicator of cross-subsidization, but rather that FERC should develop appropriate financial metrics to identify companies' risks and the potential pressures that could lead to unauthorized cross-subsidization. FERC could incorporate these metrics into its audit selection process.

RESPONSES OF MARK GAFFIGAN TO QUESTIONS FROM SENATOR DOMENICI

Question 1. Does FERC have in place sufficient customer protections in light of PUHCA repeal? Has the repeal of the Holding Company Act resulted in any regulatory gaps?

Answer. We did not analyze all federal and state regulations to determine whether the repeal of PUHCA 1935 resulted in any regulatory gaps; however, as we noted in our report, we are concerned that while FERC has taken significant steps to enact its new authorities, it has not yet made sufficient changes to its processes to protect consumers from harmful cross-subsidies. As we note in our report, while FERC has many rules prohibiting cross-subsidies, it has taken few formal steps to detect violations of these rules. We believe that implementing our recommendations would improve FERC's oversight and help it better protect consumers.

Question 2. You argue that the principal means of identifying cross-subsidies is through periodic financial audits. However, the Commission has highlighted its ratemaking authority as a powerful tool to prevent cross-subsidies.

Do you agree that ratemaking can be an effective tool at both the state and federal level? If not, why don't you believe that improper cross-subsidies can be prevented through ratemaking?

Answer. In our report, we recognized that FERC retains a limited ratemaking role and, as such, may have opportunities to examine costs incurred by utilities and decide which costs may be lawfully included in rates charged to customers. However, we also noted that rate reviews are infrequent and are generally prospective—they do not always include the retrospective analysis of costs incurred and compliance with FERC's ratemaking rules that would be necessary to detect cross-subsidies.

Question 3. GAO notes that since PUCHA's repeal, through last July, FERC reviewed 15 proposed mergers—about the same number as the same period prior to the Act's repeal. Do you believe any of these mergers hurt consumers and resulted in accumulation of market power?

Answer. We did not examine the positive or negative implications for consumers of the mergers that have occurred since EPAAct 2005 was enacted, nor the market power implications of these mergers.

Question 4. You advocate for the Commission to adopt a more risk-based audit approach. Isn't FERC already doing a risk-based audit approach? Doesn't the Commission need the flexibility to address their high-priority areas of policing market manipulation, market power exercise, and reliability?

Answer. We believe there is a difference between what GAO suggests and the Commission's current practice. During the course of our year-long engagement, key senior FERC officials described the process for selecting companies to audit as informal; they did not mention the mechanisms the Chairman described in his testimony as a risk-based approach. When we asked FERC staff for a record of a risk-based analysis, or the criteria FERC would have used to conduct such an analysis, they were unable to provide them and consistently told us audit selections were based on informal discussions with knowledgeable senior FERC staff.

While FERC officials may consider risk in these discussions and, as we noted in our February 2008 report, may believe their judgments provide a reasonable picture of risk, we believe a risk-based audit planning approach should be more systematic. A more systematic approach would more reliably guide FERC in assessing individual company risks and the overall risks posed by the companies collectively, and would ensure that its audit selection process remained consistent when staff in key positions change. Furthermore, such an approach should be flexible enough to meet FERC's current and expanded future auditing demands now that it is solely responsible for detecting potential cross-subsidization.

It is clear that, as a result of statutory and regulatory changes, FERC has many additional and important responsibilities beyond those related to cross-subsidization and FERC needs flexibility to determine how best to address its high priority areas. However, it is equally clear that FERC is the sole federal agency responsible for ensuring that harmful cross-subsidization does not occur and may be the only regulatory agency with sufficient scope and access to effectively detect cross-subsidies. Given that Congress has entrusted FERC to "ensure" that unauthorized cross-subsidies do not occur, we are encouraging FERC to develop a formal, comprehensive, risk-based, audit approach to detect when such subsidies may be occurring and to seek additional resources, if needed.

RESPONSES OF SUEDEEN G. KELLY TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Do you believe that FERC has acted to fulfill sufficiently the statutory obligation to ensure that no cross-subsidization or encumbrance of assets will occur as a result of a merger?

Answer. I believe FERC can, and should, exercise more leadership to ensure that no cross-subsidization or encumbrance of assets will occur as a result of a merger. To date, we have deferred to the states to require sensible and appropriate corporate structures to protect against cross-subsidization or encumbrance of assets. We should do more than we have done—without preempting the states. For example, we could take a more active role in explaining, for the states, (1) where the problems lie with corporate structures; (2) the importance of preventing the possibility of cross-subsidization instead of merely taking care of it through the ratemaking process after it has occurred; and (3) potential corporate structures that are productive, versus non-productive. We need to be vigilant regarding the possibility of interstate conflicts because, when we defer to states that have different rules, there is

the potential for interstate conflicts and for the imposition of undue burdens on entities that do business in multiple states.

We should also establish principles related to how corporations should be structured that could guide the states without preempting them.

We should also consider the possibility of adopting states' corporate structure requirements as our own. When we merely defer to the states, their structural requirements remain theirs alone. If we adopted these requirements as ours, it would give FERC the ability to use our audit and enforcement assets to ensure compliance in the event the states do not have adequate audit and enforcement resources.

Question 2. Do you believe that FERC's cross-subsidization protection is adequate to protect ratepayers?

Answer. I believe FERC's reliance on the ratemaking process is not adequate to protect ratepayers from cross-subsidization. Ratepayers are better protected when appropriate requirements for how corporations should be structured are in place to prevent cross-subsidization or encumbrances of assets from occurring. As I explained in my answer to Question 1, above, FERC could do more, without preempting the states, to ensure appropriate corporate structure requirements are in place and are complied with.

Question 3. Is there anything that we need to change in the law to give you sufficient authority to protect consumers adequately or to be sure that you do so?

Answer. I believe EAct 2005 gives the Commission sufficient authority to protect consumers adequately. I believe the Commission could use enhanced auditing and enforcement resources to better ensure compliance with the law.

RESPONSES OF SUEDEEN G. KELLY TO QUESTIONS FROM SENATOR DOMENICI

Question 1. GAO's Report finds that FERC relies primarily on self-reports to detect inappropriate cross-subsidization. Is this correct? If not, what does FERC rely on to police cross-subsidization?

Answer. If inappropriate cross-subsidization were to occur, FERC would rely on its usual enforcement tools to detect it. These are self-reports, hotline calls and audits.

Question 2. Is the Commission doing enough follow-up to ensure that companies are complying with merger conditions and that improper cross-subsidizations are not occurring? Why isn't FERC using a risk-based audit approach as GAO suggests? GAO also notes that FERC has only 3 ongoing audits on cross-subsidization. Why isn't FERC taking a more proactive approach to auditing?

Answer. FERC does not use a formal, risk-based approach like that described in the GAO Report to plan its audits. Instead, FERC uses, and has always used, an informal, but reasoned, approach in allocating audit resources. The GAO's Report makes suggestions that FERC should consider to improve its approach to audit planning. Whether FERC builds risk-based assessments into its enforcement mandate, as the GAO recommends, or some other methodology that is clear, predictable, fair and sufficiently straightforward such that market participants can understand it and know what rules they must follow, it is imperative that the Commission adopt and communicate its objectives, scope and vision for its enforcement strategy. Enhanced audit and enforcement resources would enable the Commission to take a more proactive approach to auditing for inappropriate cross-subsidization.

Question 3. Do you all agree with Chairman Kelliher that ratemaking is a powerful enforcement tool for detecting cross-subsidization? Please elaborate on how the Commission uses its ratemaking authority to protect consumers.

Answer. The Commission's ratemaking tool with respect to cross-subsidization prevents the flow-through into rates of costs deemed to represent cross-subsidies. Thus, the ability of this tool to detect a cross-subsidy is limited to the following situation: (1) the utility applies to FERC for a rate increase; (2) the utility seeks a rate increase based on an historic test year; (3) the chosen historic test year includes a cross-subsidization event and resulting cost; and (4) the utility seeks to recover that cross-subsidization cost in its new rates.

Question 4. Your colleagues appear to be in agreement that FERC should take a flexible approach in order to collaborate with state regulators and not preempt state authority. Do you disagree with the Commission's policy to accept state cross-subsidization protections absent evidence that additional measures are needed to protect wholesale customers or where states lack authority in this area?

Answer. I agree with my colleagues that FERC should not preempt state cross-subsidization protections. However, I believe FERC should exercise more leadership in determining whether additional measures are needed to protect wholesale customers. Instead of relying on some third party to alert us to the need for additional measures, we could, for example, expand our merger policy to establish principles

regarding corporate structure requirements that we believe would be appropriate and productive. This would likely also be helpful to merger applicants who would have more certainty around the issue of appropriate structural requirements. We should also consider the possibility of adopting the corporate structure requirements imposed by a state in a particular merger as our own.

Question 5. You conclude your testimony by stating that we must “make sure we are doing all we can to guard the American consumer from cross-subsidization and other forms of exploitation.” Are you proposing a legislative fix? If so, what and at what level? The federal or the state?

Answer. I believe EPAct 2005 gives the Commission sufficient authority to protect consumers adequately from cross-subsidization and encumbrances of assets. I believe the Commission could use enhanced auditing and enforcement resources to better ensure compliance with the law.

RESPONSES OF DAVID K. OWENS TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Do you believe that FERC’s merger review adequately implements the new authority given them in EPAct?

Answer. The Edison Electric Institute (EEI) believes that the Federal Energy Regulatory Commission’s (FERC’s or the Commission’s) merger regulations and merger review process fully implement the Commission’s new authority under the Energy Policy Act of 2005 (EPAct 2005). These regulations and review process also maintain the Commission’s tradition of ensuring that mergers are in the public interest, will not adversely affect markets, and will protect and benefit consumers as a condition of approving the mergers.

As I noted in my prepared testimony, the Commission has put in place a number of new regulations specifically aimed at implementing the new authority relating to mergers and acquisitions that FERC received in EPAct 2005, both under the Public Utility Holding Act of 2005 (PUHCA 2005) and revised section 203 of the Federal Power Act (FPA). Those new regulations track the provisions of EPAct 2005 very carefully in order to implement Congress’s intent.

FERC’s section 203 regulations specifically incorporate provisions aimed at preventing inappropriate cross-subsidization by utilities of their affiliates and inappropriate encumbrance of utility assets for non-utility purposes. Companies proposing mergers or acquisitions subject to section 203 must ensure that such cross-subsidies will not occur, in accordance with the provisions of the statute and regulations. Moreover, the Commission has gone further and imposed similar constraints under FPA sections 205 and 206, requiring that all companies subject to FERC’s rate jurisdiction ensure that utility-affiliate transactions are priced according to strict rules aimed at protecting utility customers.

Under FERC’s PUHCA 2005 regulations, if a utility is part of a holding company that has a centralized service company (which typically consolidates services such as accounting, construction, legal, operations, maintenance, real estate, and risk management services as a means to reduce costs to consumers), the Commission has required service companies to keep detailed records in a new section of the Uniform System of Accounts, and to file detailed information with the Commission in a lengthy new FERC Form 60 that will ensure transparency. These recordkeeping and reporting requirements complement the detailed requirements that already apply to utilities themselves under the FPA and FERC regulations. The PUHCA 2005 regulations also mandate FERC and state commission access to holding company records, in keeping with the new statute.

These new regulations complement the Commission’s existing merger policy and regulations at 18 C.F.R. Part 33. Under that existing policy and regulations, the Commission also examines the market effects of a proposed merger including the degree of concentration of companies in the affected markets, the anticipated benefits to consumers, and measures to prevent market power or other potential negative consequences of a merger.

In addition, the Commission requires public utilities that participate in holding company cash management programs to file participation agreements explaining how the programs manage utility and affiliate cash and borrowing. The companies also must maintain detailed records of utility participation in the programs, and must notify the Commission if proprietary capital ratios fall below 30 percent within any given quarter year. The Commission has recognized that cash management programs help to reduce the cost of borrowing and increase liquidity within holding companies, while thus ensuring that the programs are subject to Commission review.

In sum, EEI believes that the Commission is taking its merger responsibility and authority very seriously, including the new merger and cross subsidy provisions of EPAct 2005. FERC is carefully implementing its responsibility and authority to ensure that mergers and other transactions subject to FPA section 203 are fully in the public interest and are carefully structured to protect consumers.

Question 2. Do you believe that FERC's cross-subsidization protection is adequate?

Answer. As mentioned in the answer to Question 1, FERC has put in place strict regulations applicable to utility-affiliate transactions under FPA sections 203, 205, and 206 to protect against inappropriate cross-subsidization and encumbrance of utility assets.

Under these regulations, the Commission must approve any wholesale power sales between a franchised public utility with captive customers and its market-regulated power sales affiliates. In addition, sales of non-power goods and services by a utility with captive customers to a market-regulated power sales affiliate or a non-utility affiliate must be priced at the higher of cost or market, and purchases by such a utility from such an affiliate must be priced no higher than market, unless authorized by the Commission. The Commission also may impose additional cross-subsidization restrictions on affiliate transactions, as appropriate, on a case-by-case basis.

Further, the Commission examines the potential for cross-subsidies and encumbrances of utility assets in the context of mergers and other transactions subject to its review authority under FPA section 203, as required by amendments to that section in EPAct 2005. The Commission also has imposed constraints on sharing of staff and information and brokering of power between franchised public utilities with captive customers and market regulated power sales affiliates.

In addition, the Commission's regulations reflect that most state utility commissions also oversee utility-affiliate transactions and have rules protecting regulated retail customers against inappropriate cross-subsidy. The Commission has signaled that it will review such measures and seeks to complement rather than preempt them as needed to ensure adequate customer protection. The Commission has also shown its willingness to step in if state safeguards are inadequate or states do not have authority to impose conditions to protect consumers from improper cross-subsidization or encumbrance of utility assets.

Together, these regulations effectively prohibit cross-subsidy or encumbrance of utility assets for non-utility purposes absent Commission approval based on a public interest determination. They also ensure that a utility's regulated customers are well protected against inappropriate cost-shifts in transactions between a utility and an affiliate. In summary, the Commission has significant means to prevent cross-subsidization, including its broad ratemaking and merger review authorities under the FPA, and it is exercising that authority actively to protect electricity consumers.

RESPONSES OF DAVID K. OWENS TO QUESTIONS FROM SENATOR DOMENICI

Question 1. Does FERC have in place sufficient customer protections in light of PUHCA repeal? Has the repeal of the Holding Company Act resulted in any regulatory gaps?

Answer. In EEI's view, FERC has robust, effective, and complete customer protections in place. The Commission has built a comprehensive framework of regulations and enforcement to ensure that:

- electricity generators have transmission access to wholesale customers, so the generators can compete to offer the services customers need at competitive prices;
- transmission providers provide fair, equal, and open access to the transmission grid while also ensuring reliability;
- integrated utilities maintain very strict separation of generation and transmission functions;
- utility-affiliate transactions are carefully scrutinized to prevent inappropriate cross-subsidization and encumbrance of utility assets to the benefit of an affiliate unless in the public interest;
- utility mergers and acquisitions are carefully scrutinized to ensure that they are in the public interest;
- utility wholesale and transmission rates are just and reasonable;
- competitors in markets cannot exercise market power or manipulate markets; and
- utilities and service companies keep detailed records and file detailed reports that enable the Commission and the public to review and understand utility assets, finances, and operations.

These protections complement equally effective measures by state utility commissions, the Securities and Exchange Commission (SEC), and the Federal Trade Commission (FTC). State utility commissions oversee the full range of utility activities, in particular as those activities may affect retail customers. Most states have counterpart regulations and oversight to complement the FERC provisions just described. In addition, the states actively oversee resource planning and siting activities. The SEC regulates stock issuances and transactions by shareholder-owned utilities, holding companies, and affiliates. The SEC regulations ensure that companies provide accurate financial information through its reporting requirements such as the annual Form 10-K, through regulations implementing the Sarbanes-Oxley Act of 2002, which ensures that companies maintain robust internal and external accounting controls and auditing oversight to ensure accuracy of their financial records and reports, and in oversight of company prospectuses associated with stock transactions and the stock exchanges. The FTC has regulations and guidelines that govern the accuracy of consumer advertising and claims, including by participants in electricity markets. Along with state consumer advocates, the FTC also participates in FERC rulemakings to provide its views on consumer protection issues.

Repeal of the Public Utility Holding Company Act of 1935 (PUHCA 1935 or the 1935 Act), and its replacement by PUHCA 2005 and revised FPA section 203, has not created regulatory gaps. Instead, repeal of the 1935 Act appropriately recognized that an array of other fully effective consumer protection measures are now in place, and the 1935 Act was imposing unnecessary additional constraints that were impeding investment in needed new utility facilities.

Question 2. You testified that increased federal oversight over non-utility corporate activities could create substantial barriers to investment and competition in electricity markets—the reason PUHCA was repealed. Please elaborate.

Answer. As Congress was considering legislation that ultimately evolved into EPAct 2005, EEI and a wide array of others encouraged Congress to repeal PUHCA 1935 because that Act was viewed as layering unnecessary federal statutory and regulatory constraints on the utility industry, thereby impeding investment in the industry. The 1935 Act, for example, imposed geographic constraints on utility holding companies that prevented holding companies from engaging in utility activities in non-contiguous states. This discouraged consolidation of companies that could otherwise have provided economies of scale to the benefit of utility customers and the development of companies that could specialize in certain aspects of the utility business (nuclear generation, transmission, etc.) on a national basis. In addition, the 1935 Act effectively prohibited investment in the utility industry by investors in other industries. It also failed to recognize the host of protections that have been put in place in the decades since the 1935 Act was enacted, so that FERC, the SEC, the FTC, and states now robustly regulate utility, holding company, and affiliate activities, without the need for the PUHCA 1935 constraints.

In addition, Congress, FERC, and state commissions have put very effective cross-subsidy and utility asset protections in place, to ensure that utility assets are not inappropriately used for the benefit of affiliate or other companies to the detriment of utility consumers. With these significant protections in place, there is no regulatory gap and simply no need for additional federal regulation of non-utility activities.

The investment community recognizes that with repeal of PUHCA 1935, Congress removed unnecessary impediments to investment in energy infrastructure, and granted new authorities to FERC and the states to protect consumers. As stated earlier, FERC is working closely with the states to address any gaps in their regulatory authority to protect consumers from improper cross-subsidizations or encumbrance of utility assets.

Increased federal oversight is unnecessary and would be inappropriate because it would intrude into areas of investor activities that are unrelated to utility activities. Additional federal oversight also would add confusion and raise uncertainty within the investment community. At a time when the energy industry's capital investment is expected to be at its highest level in recent decades to address growing demand, aging infrastructure, and environmental concerns, unnecessary additional mandates or restrictions would be a major step backwards. Instead, we should be striving to provide simplicity, clarity, and stability in the rules to stimulate major new investment, especially given that existing federal and state laws already amply protect utility consumers.

RESPONSES OF JOSEPH T. KELLIHER TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. We gave the Commission new authority and obligations in the review of mergers as a partial compensation for repeal of PUHCA. GAO reports that you have not changed the review of mergers sufficiently to fulfill the obligation to be sure that no cross-subsidization or encumbrance of assets will result from a merger. You disagree. What has the Commission done to ensure that no harmful cross-subsidization or encumbrance of assets will occur as a result of a merger?

Answer. In December 2005, the Commission revised its regulations specifically to address possible cross-subsidization or encumbrance of assets resulting from a merger or other FPA section 203 transaction. Merger applicants must make what is called an "Exhibit M" filing, which is a detailed showing (based on facts and circumstances known or reasonably foreseeable) that the merger will not result (at the time of the transaction or in the future) in the following activities by a traditional public utility that has captive customers or that operates Commission jurisdictional transmission facilities, in each case for the benefit of an associate company: (a) the transfer of facilities, (b) the issuance of securities, (c) the pledge or encumbrance of assets, and (d) the execution of contracts other than approved contracts for non-power goods and services. Also, the applicants must disclose any pledges or encumbrances of utility assets existing at the time of the application. If the applicants cannot provide adequate assurances against such activities, they must demonstrate that the activities are consistent with the public interest.

Following two technical conferences, which sought input from state commissioners and others on what additional measures (including ring-fencing) the Commission should take to protect customers against inappropriate cross-subsidization, in July 2007 the Commission also issued an FPA section 203 Supplemental Policy Statement. This policy statement provided clarification and guidance on the types of section 203 transactions that do not raise cross-subsidy concerns and guidance on the types of commitments applicants could make and the ring-fencing measures applicants could offer to address potential cross-subsidy concerns. First, the Commission adopted a policy to defer to state commissions where the state adopts or has in place ring-fencing measures to protect customers unless those measures are inadequate to protect wholesale customers. If, based on the record of the transaction before the Commission, however, the state measures are inadequate to protect customers in a given case, the Commission will adopt supplemental measures as appropriate. Or, if the state does not have authority to act on a section 203 transaction, the Commission will fill any regulatory gap by imposing ring fencing protections where appropriate. It is important to note that where the Commission does defer to ring-fencing protections adopted by the state, the Commission's approval of the proposed section 203 transaction is premised on compliance with those ring-fencing protections and the Commission may audit and enforce compliance with those protections just as it enforces any additional protections it may accept or impose for a particular transaction; failure to abide by the restrictions constitutes a violation of the Commission's order approving the transaction. In addition, the Commission made clear in the Supplemental Policy Statement that, if it approves a transaction under section 203 (with or without ring-fencing measures), the Commission retains authority under FPA section 203(b) to later impose additional cross-subsidy protections or modify any previously-approved measures.

Second, the Supplemental Policy Statement also provided specific guidance on the types of protections companies might adopt to make the demonstration required by Exhibit M, referred to above, where a state has not required or does not have authority to require ring-fencing provisions. For example, the Commission stated that a ring-fencing structure related to internal corporate financings, i.e., money pool or cash management transactions, could include some or all of the following elements, depending on the circumstances of the proposed transaction:

- (1) the holding company participates in the money pool as a lender only and it does not borrow from the subsidiaries with captive customers;
- (2) where the holding company system includes more than one public utility, the money pool for subsidiaries with captive customers is separate from the money pool for all other subsidiaries;
- (3) all money pool transactions are short-term (one year or less), and payable on demand to the public utility;
- (4) the interest rate formula is set according to a known index and recognizes that internal and external funds may be loaned into the money pool;
- (5) loan transactions are made pro rata from those offering funds on the date of the transactions;
- (6) the formula for distributing interest income realized from the money pool to money pool members is publicly disclosed; and,

(7) the money pool administrator is required to maintain records of daily money pool transactions for examination by the Commission by transaction date, lender, borrower, amount and interest rate(s).

Thus, while not adopting a set of mandatory one-size-fits-all federal ring-fencing protections in the Supplemental Policy Statement, the Commission gave detailed guidance regarding the types of restrictions that, from the federal viewpoint, might be appropriate depending upon the particular facts presented. It made clear that the forms of ring-fencing protections listed were examples of protections the Commission would consider in evaluating proposed ring-fencing measures and stated that appropriate ring-fencing measures would depend on the facts presented and the specifics of an applicant's corporate structure, to be evaluated on a case-by-case basis. It also noted that the listed measures were among those typically approved by the Securities and Exchange Commission (SEC) and/or adopted by state commissions.

In addition to the adoption of the new FPA section 203 requirement for an Exhibit M filing and the policies and guidance set forth in the Supplemental Policy Statement, the Commission announced in one of the first mergers following the effective date of the new section 203 provisions, National Grid plc, 117 FERC ¶ 61,080 (2006), that it would impose on all section 203 transactions involving a holding company a condition that members of the holding company adhere to specific pricing restrictions on non-power goods and services transactions between "unregulated" companies and their public utility affiliates with captive customers. Further, because cross-subsidy concerns regarding both power and non-power goods and services transactions can arise not only at the time of a proposed merger, but rather on an ongoing basis, the Commission in July 2007 also adopted in its regulations non-power goods and services pricing restrictions on all transactions between unregulated companies and their public utility affiliates with captive customers. Similar restrictions were adopted with respect to affiliate power sales in June 2007. The Commission also adopted recordkeeping and reporting requirements for utility holding companies and their service companies, and detailed accounting requirements for centralized service companies. These requirements will enhance the ability of the Commission and the public to monitor for cross-subsidization.

Also, in response to PUHCA 2005, the Commission's Office of Enforcement is auditing affiliated transactions to detect and deter cross-subsidization. Three such audits are scheduled for FY08. These three audits include some of the largest utility holding companies. If information gained from these audits or elsewhere indicates a need for increased auditing, I will either shift resources to such audits or, if necessary, seek additional resources from the Congress.

Importantly, all of these new requirements are in addition to the Commission's traditional and broad ratemaking authority to disallow rate recovery of costs found unjust and unreasonable as improper cross-subsidies. This authority applies to all utilities, whether or not they engage in cross-subsidies resulting from a merger.

Question 2. GAO reports that your cross-subsidization protection is largely dependent on self-reporting by violators. You indicate that your enforcement authority gives you assurance that such self-reporting will be protective. Does not the possibility of large fines or penalties discourage self-reporting? Why would utilities report violations if they expect to be faced with a stiff fine?

Answer. The Commission does not rely on self-reporting to prevent improper cross-subsidization. In the context of cross-subsidization, the Commission does not assume utilities will self-report violations. As stated in my testimony, cross-subsidization by its very nature does not lend itself to being self-reported. Ratemaking is a complicated process which relies on the development of an extensive record on costs and revenues, and determination of the proper allocation of costs between jurisdictional and non jurisdictional operations, the appropriate distribution of costs between and among the various jurisdictional services, and the selection of an appropriate rate of return. Under these circumstances, self-reports would not be an effective method to monitor cross-subsidization. Further, with respect to the Commission's pricing standards imposed on non-power goods and services transactions between regulated and non-regulated affiliates to prevent inappropriate cross-subsidization (i.e., pricing at cost or at market), while it is possible that an accounting or similar type of error resulting in inappropriate pricing or an inappropriate allocation of costs might be self-reported, for the most part a violation of the pricing standards also would not lend itself to self-reporting. Rather, violations of these standards would be detected in a rate case or through audit.

In contexts other than cross-subsidization, however, self-reports are an important part of the Commission's enforcement efforts. The Commission first announced its views on self-reports in the October 2005 Enforcement Policy Statement. We stated there that we place great importance on self-reporting, as companies are in the best

position to detect and correct violations of our orders, rules, and regulations, both inadvertent and intentional, and should be proactive in doing so. Moreover, as we pointed out, when companies self-report violations to the Commission it facilitates remedies to affected parties. Accordingly, the Commission decided to give credit to companies that self-report, and indicated that such credit could eliminate or reduce the otherwise applicable penalty for the violation.

The Commission's experience since the issuance of the Enforcement Policy Statement confirms that self-reports reinforce the agency's enforcement program. Even though a majority of the investigations settled under the guidelines of the Enforcement Policy Statement have involved penalties for self-reported violations, the number of self-reports has actually increased during the relevant period. Thus, for example, so far in FY08, we have received 33 self-reports, whereas at this time a year ago, we had received only 16 self-reports.

Utilities consider reporting violations even if they face stiff fines because of the credit that the Commission gives to companies for self-reporting. Since issuing the Enforcement Policy Statement, the Commission has approved twelve settlements totaling \$42.2 million where the investigations were initiated after a company self-reported a violation. In each of these settlements, the penalty amount would have been higher if the particular company had not self-reported the violations.

Again, however, self-reports are not relied upon and have never been relied upon as an effective means of monitoring inappropriate cross-subsidization.

Question 3. You point to the recent order conditioning the Puget Sound acquisition on your review of Washington state's ring-fencing requirements. Your merger policy statement indicates that you will follow this pattern in all merger reviews, i.e., that you will determine if the state's protection is sufficient and if it is not will impose conditions of your own. Washington is acknowledged by many to have a vigorous ring-fencing requirement. How will you determine if a state's requirements are sufficient in this and other cases since there does not appear to be a set of specific criteria for making this determination in the merger policy statement, nor a minimum set of actions that you would take if the state's protections were found to be insufficient?

Answer. The Commission will review the adequacy of a state's ring-fencing requirements on a case-by-case basis. The diversity of transactions addressed by FPA section 203 cautions against adoption of one-size-fits-all criteria or a minimum set of ring-fencing restrictions, at least at this early stage of the Commission's experience with its broader authority under FPA section 203. For example, the acquisition of a franchised public utility with captive customers by a holding company with unregulated subsidiaries may raise very different issues than the acquisition by such a utility of a similar, neighboring utility with captive customers. As the Commission gains experience analyzing cross-subsidization issues under its expanded section 203 authority, its case-by-case analysis may lead to adoption of generic policies or minimum actions applicable to certain types of cases. Finally, as noted in the response to Question 1, the Commission's recent Supplemental Policy Statement already identifies seven specific ring-fencing protections a merger applicant might propose where a state has not required or does not have authority to require ring fencing provisions.

RESPONSES OF JOSEPH T. KELLIHER TO QUESTIONS FROM SENATOR DOMENICI

Question 1. GAO's Report finds that FERC relies primarily on self-reports to detect inappropriate cross-subsidization. Is this correct? If not, what does FERC rely on to police cross-subsidization?

Answer. The GAO Report is not correct. As I pointed out in my response to GAO, the Commission has never relied on self-reports as its primary enforcement mechanism to prevent inappropriate cross-subsidization. Cross-subsidization, by its very nature, does not lend itself to being self-reported.

The Commission relies on other tools to police cross-subsidization. The Commission has in place affiliate pricing restrictions—applicable to all public utilities, not just those involved in mergers—addressing both power and non-power sales between affiliates. The Commission also has specific and detailed record retention rules for holding companies and their affiliates, as well as a new standardized Uniform System of Accounts (adopted in October 2006) that must be followed by all centralized service companies, thus providing greater transparency to protect ratepayers from paying improper service company costs. Centralized service companies must also file an annual report (Form No. 60) containing financial information and information related to non-power goods and services provided to affiliates. Information collected in this form is available electronically to market participants and the public for use in detecting potential cross-subsidization. Other types of service companies (e.g., a

special purpose service company) also have an annual reporting requirement containing a narrative description of the service company's functions during the prior calendar year. These measures coupled with our ratemaking authority, compliance measures, auditing, and the penalty authority under EPCA 2005 provide adequate customer protection and policing over regulated entities' transactions.

Question 2. Is the Commission doing enough follow-up to ensure that companies are complying with merger conditions and that improper cross-subsidizations are not occurring? Why isn't FERC using a risk-based audit approach as GAO suggests? GAO also notes that FERC has only 3 ongoing audits on cross-subsidization. Why isn't FERC taking a more proactive approach to auditing?

Answer. Given the Commission's other responsibilities, especially with respect to its new authority to oversee reliability of the nation's bulk power system and to police against market manipulation, we believe that we are taking appropriate steps to ensure that companies are complying with merger conditions and that inappropriate cross-subsidization is not occurring.

With respect to audits, we have already performed an audit involving merger conditions (NSTAR, Docket No. FA07-1) and are in the process of conducting audits of several holding and service companies' books and records. Also, as part of our annual audit planning cycle, the Commission will take additional audits into consideration with our other priorities and the number of available resources.

Contrary to GAO's understanding, the Commission does and will follow a risk-based approach in selecting the merger and PUHCA audit candidates. Our risk-based approach entails a comprehensive review of audit materials obtained from the SEC; examination of financial information contained in FERC Form No. 60, FERC Form No. 1, and SEC filings; rate information gathered from Commission filings; and discussions with the Commission's legal and technical experts. The risk-based approach described above results in a preliminary risk assessment that takes into account, for example, the amount and type of costs reported in the FERC Form No. 60 and FERC Form No. 1; compliance problems gleaned from the non-public audit reports previously issued by the SEC; information on affiliated transactions included in SEC filings as well as other pertinent financial information affecting stock and bond prices; a review of the federal and state commissions' actions regarding affiliated transactions; and discussions with Commission legal and technical experts. Finally, shortly after the audit commences, the Commission audit staff discusses the audit scope, objectives and any other matters with state commission officials.

Moreover, it is important to note that the Commission commenced the three audits shortly after PUHCA 2005 went into effect in February 2006. The companies selected for the FY08 audit cycle were initial audits and included some of the largest utility holding companies in the nation.

RESPONSES OF JOSEPH T. KELLIHER TO QUESTIONS FROM SENATOR MENENDEZ

THE GAO REPORT

Question 1. My home state of New Jersey has a strong Board of Public Utilities, one which has implemented strong regulations which protect electricity consumers. But consumers in other states are not so lucky, and rely on the Federal Energy Regulatory Commission. This GAO report comes at a time when consumers are paying high and rapidly rising prices for electricity. Consumers are being hit by rising prices for food, fuel, and electricity, and their trust in government is at an all time low. This is a dangerous combination, and even the appearance of weak oversight is simply unacceptable. It is not enough to rely on self-reporting, and your audits need to be more transparent. I am concerned that the FERC does consider the rising electricity prices to be a priority. I would like you to explain how you determine which companies to audit. What evidence leads you to investigate one company or another? What are the tell-tale signs of cross subsidization?

Answer. The Commission uses a risk-based approach in selecting the merger and PUHCA audit candidates. This risk-based approach entails a comprehensive review of audit materials obtained from the SEC; examination of financial information contained in FERC Form No. 60, FERC Form No. 1, and SEC filings; rate information gathered from Commission filings; and discussions with the Commission's legal and technical experts. The risk-based approach described above results in a preliminary risk assessment that takes into account, for example, the amount and type of costs reported in the FERC Form No. 60 and FERC Form No. 1; compliance problems gleaned from the non-public audit reports previously issued by the SEC; information on affiliated transactions included in SEC filings as well as other pertinent financial information affecting stock and bond prices; a review of the federal and state commissions' actions regarding affiliated transactions; and discussions with Commission

legal and technical experts. Finally, shortly after the audit commences, the Commission audit staff discusses the audit scope, objectives and any other matters with state commission officials.

Question 2. Surely, after a report like this, you must see the need to improve the transparency of your audits and oversight if nothing else. What opportunities do you see to improve how you protect consumers?

Answer. The Commission audit process provides transparency to the public when an audit is initiated and completed. Companies that are the subject of an audit from the Commission receive an audit commencement letter that is available to the public. The commencement letter alerts the public to the audit scope areas, the time period to be covered by the audit, and the legal basis for conducting the audit. Further, contact information is included in the commencement letter for the audit team members and management in the Division of Audits in the Commission's Office of Enforcement.

The Commission's audit reports are also public and provide the users of our public audit reports the opportunity to get information about the audit objectives and scope, audit methodology, background information, as well as audit findings and recommendations, where applicable. As a result of the GAO report, the Commission has improved its audit reporting by including an enhanced audit methodology section in all of its public audit reports. In contrast, the SEC previously issued non-public audit reports at the completion of its holding company audits. Thus, the Commission's enhanced audit methodology and practice of publishing audit reports provide the public and the regulated community with greater transparency than was previously provided by the SEC.

MERGERS

Question 3. The concerns raised by the GAO report ring true for me because I watched the FERC review the proposed merger between PSEG and Exelon a few years ago. This proposed merger would have created the largest utility in the country. At that time, the New Jersey Board of Public Utilities raised a host of concerns, ranging from market power to reliability of service to increased consumer costs. At the time, it appeared to me that the FERC approved this merger without addressing these questions. Obviously, the Energy Policy Act of 2005 has increased the FERC's responsibilities. If the FERC was reviewing this merger today, would the process be different? What steps would the FERC now take to investigate the impact of this proposal on consumer prices? After such a merger, could New Jersey still enforce its own strong consumer protections?

Answer. In the order authorizing the merger of Exelon and PSEG, the Commission addressed the issues of the merger's effect on market power and consumer rates and imposed conditions to mitigate market power. First, in order to address any market power concerns, the Commission required the merger applicants to abide by a commitment they had made to divest 6,600 megawatts of generation, consisting of 2,600 megawatts of "virtual divestiture" of nuclear generation (in the form of required long-term energy sales from nuclear generating units) as well as the divestiture of 4,000 megawatts of fossil-fired capacity. This was the largest divestiture ever ordered by this agency. Moreover, the divestiture was applied to both baseload and peaking units, in order to more completely address the merged firm's ability and incentive to withhold output and potentially drive up the price of power in the relevant markets. In addition, as a further condition of the Commission's authorization, Exelon was required to make a subsequent demonstration, based on the plants that were ultimately divested and the buyers of those plants, that actual market concentration would be sufficiently reduced to mitigate any merger-related harm to competition.

Second, while the Commission does not have jurisdiction over retail rates, it does protect consumers from cost increases by looking at the merger's effect on wholesale rates, which in turn can affect retail rates. In the Exelon case, and consistent with Commission policy, the merger applicants were required to hold customers harmless from any and all merger-related costs. Specifically, the Commission accepted applicants' commitment not to seek to recover any merger-related costs in wholesale rates without showing quantifiable offsetting savings. In this way, the Commission ensured that wholesale customers were fully protected from any merger-related costs.

Regarding concerns about reliability, only two claims about reliability were raised in the FERC proceeding. One was found to be unrelated to the merger, but it was considered in another case where the Commission found that a joint operating agreement between Midwest Independent Transmission System Operator, Inc. and PJM Interconnection, L.L.C. (PJM) addressed the concern. The Commission found

that the other concern was fully addressed by an applicant study of the PJM-East capacity market in the merger proceeding. In fact, the applicants argued that, given Exelon's record in operating nuclear power plants, the merger would enhance reliability by combining Exelon's expertise in running nuclear plants with PSEG's existing fleet of nuclear plants. No party questioned Exelon's claims that its expertise in operating nuclear plants could enhance reliability.

After EPAAct 2005, as part of its merger analysis, the Commission specifically considers whether a merger will result in inappropriate cross-subsidization of a non-utility associate company or pledge or encumbrance of utility assets for the benefit of an associate company. Merger applicants must file evidence demonstrating that the merger will not result in inappropriate cross-subsidization at the time of the merger or in the future. We impose additional ring-fencing protections as needed on a case-by-case basis, giving deference to state regulatory ring-fencing requirements unless we find those requirements insufficient or the state does not have authority.

In addition, in the Commission's order on the merger of National Grid and KeySpan Corporation,¹ the Commission announced a new policy to require all merging parties to abide by a code of conduct regarding power and non-power goods and services transactions between the utility subsidiaries and their affiliates. The code of conduct: (1) requires our approval of all power sales by a utility to an affiliate, (2) requires a utility with captive customers to provide non-power goods or services to a non-utility or "non-regulated utility" affiliate at a price that is the higher of cost or market, (3) prohibits a non-utility or non-regulated utility affiliate from providing non-power goods or services to a utility affiliate with captive customers at a price above market price, and (4) prohibits a centralized service company from providing non-power services to a utility affiliate with captive customers at a price above cost. These requirements offer further protection of a utility's captive customers against inappropriate cross-subsidization.

In EPAAct 2005, Congress largely ratified the merger test the Commission used to render the proposed Exelon/PSEG merger. For that reason, if the FERC were reviewing the Exelon/PSEG proposed merger today, the process would not be different except that the Commission would address the new requirement to make specific findings that the proposed merger will not result in inappropriate cross-subsidization or encumbrance of utility assets. Applicants would be required to file an "Exhibit M" making this demonstration and the Commission would determine whether the record supported a finding that the new statutory requirement was met. The authority of the New Jersey Commission to protect its retail customers would not be affected by a Commission decision to approve the merger.

RELIABILITY PRICING MODEL

Question 4. Chairman Kelliher, I would also like to discuss a regional consumer protection issue. As you know, our nation faces an urgent need for increased investment in transmission and generation infrastructure. To provide the market signal needed to build this infrastructure, you have approved the so-called "Reliability Pricing Model", or RPM, for the RTO which included New Jersey. I hear many different things about RPM. Some people tell me that it's working, paying for upgrades to old plants, and that new generation is in the queue. Others disagree. But I know two things for certain: The RPM is costing New Jersey consumers billions of dollars, and we are seeing very few new entrants bringing generation online. In PJM as a whole, consumers have made \$26 billion in forward capacity payments, but only 2,500 megawatts of new generation have come on-line. This is about 10 times what 2,500 megawatts of new generation should cost. Do you see anything wrong with this picture? Is the RPM system working? What steps is the FERC taking to ensure that these vast sums of money will result in new generation? Does FERC have any plans on how to change RPM if the new capacity they have projected does not come online? When considering changes to the RPM system, how can FERC reduce its costs to consumers?

Answer. The principal goal of RPM is to address the long-term reliability needs of all electricity customers within the PJM footprint, including New Jersey customers. During the past several years, reliability concerns arose within several areas within PJM due to: (1) a surge in planned generator retirements, (2) steadily growing demand, and (3) a slowdown of new generation entry.

RPM was proposed to the Commission as the solution to these problems. The RPM proposal was submitted to the Commission following extensive, multiyear, stakeholder discussions and was supported by the vast majority of PJM stake-

¹National Grid plc, 117 FERC ¶ 61,080 (2006).

holders, including generators, load serving entities, municipalities, state commissions and consumer groups.

In the RPM market design, all existing as well as new capacity resources—generation, demand-side resources (including energy efficiency resources), and transmission enhancements—that meet specified criteria are eligible to offer capacity into the auction and receive capacity payments. This provision, the uniform price auction method, and various other features and provisions of the RPM were agreed to by the parties to the RPM Settlement Agreement. Furthermore, to increase the opportunities for competition from new generation entry, suppliers enter into forward contracts for delivery three years in advance to ensure that reliability goals are met and that existing as well as new capacity resources are assured of sufficient revenues to either retain their current investment in PJM, or invest in new capacity resources.

Over the four auctions completed through January 2008, approximately 4,375 MW of new, upgraded, or reactivated generation capacity was offered and accepted. In addition, 7,443 MW of demand-side resources, imports, and withdrawn or cancelled retirements were also offered and accepted into the RPM auctions. The breakdown is as follows:

| | |
|-----------------------------------|-----------------|
| New Generation | 1,036.1 |
| Generation Upgrades | 2,989.9 |
| Generation Reactivation | 348.7 |
| Forward Demand Resources | 1,373.0 |
| Withdrawn or Canceled Retirements | 3,082.0 |
| Net Increase in Capacity Imports | 2,987.5 |
| Total Impact (MW) | 11,817.2 |

These initial results appear promising, particularly compared to the capacity market construct that was in place prior to RPM. That earlier capacity market failed to produce market-clearing prices sufficient to induce new generation or forestall planned generation retirements in PJM. However, at this early stage in the RPM process, it is too early to draw conclusions on the success of the RPM. The RPM has only been in place for less than one year, and its first four auctions have been transitional in nature, and were undertaken at relatively short intervals in rapid succession with forward periods of less than three years.

Nevertheless, the Commission is already undertaking several initiatives to ensure the proper functioning of markets operated by PJM, including RPM. These include a thorough assessment of the performance of RPM and determination of the changes that may be necessary in order to ensure better performance in terms of market efficiency and costs to consumers.

The Commission recently issued a Notice of Proposed Rulemaking on Wholesale Competition in Regions with Organized Electric Markets,² which proposes changes that will improve the operation of organized wholesale electric markets in the areas of: (1) demand response and market pricing during a period of operating reserves shortage; (2) long-term power contracting; (3) market-monitoring policies; and (4) the responsiveness of regional transmission organizations (RTOs) and independent system operators (ISOs) to stakeholders and customers, and ultimately to the consumers who benefit from and pay for electricity services. In comments to that proceeding, stakeholder groups such as the American Forest and Paper Association and the Portland Cement Association put forth specific proposals to modify existing capacity markets.

The Commission held a technical conference on May 7, 2008, to discuss such proposals and more generally the operation of forward capacity markets in the PJM and ISO New England regions. The conference featured, for example, different perspectives on the markets from a broad cross-section of stakeholders, including RTOs, independent experts, and customer representatives.

²Wholesale Competition in Regions with Organized Electric Markets, Notice of Proposed Rulemaking, 73 Fed. Reg. 12,576 (March 7, 2008), FERC Stats. & Regs. ¶ 32,628 (2008).

Also, in a recent order on a motion filed by RPM Buyers³ requesting a technical conference to examine the performance of RPM,⁴ the Commission directed PJM to expand the scope of an independent assessment of RPM that is currently being undertaken by an outside consultant, the Brattle Group, to include the concerns raised by RPM Buyers. The consultant's report is expected to be completed by the end of June 2008. The assessment will be presented to PJM stakeholders shortly thereafter and it is expected that any necessary changes to RPM will be fully considered at that time. The Commission directed PJM to submit a summary of the proceedings of the stakeholder deliberations on the report within 15 days of the conclusion of those proceedings.

Based on the outcome of these and related initiatives, the Commission will determine whether changes to the RPM capacity market are required and take appropriate steps to implement any necessary reforms. Among other things, the Commission is evaluating the merits and demerits of alternative capacity market designs and resource adequacy approaches. It is also actively working to foster much greater participation of demand-side resources in RTO capacity markets, which will reduce the overall need for investment in new generation facilities. The significant impact and greater potential of these resources are already evident from the results of both PJM's and ISO New England's Forward Capacity Market auctions thus far.

RGGI, TRANSMISSION, PLANNING

Question 5. Chairman Kelliher, my home state of New Jersey is one of several states which are leading the nation in the fight against global warming. New Jersey has joined the Regional Green House Gas initiative. To meet its goals, New Jersey has embarked on an ambitious program which aims to get 20% of its energy from renewable sources by 2020. In order to do this, they use revenues from a cap and trade system to fund investments in renewables and energy efficiency. However, some neighboring states are not members of RGGI but are part of PJM regional transmission organization. What will the FERC do to help New Jersey meet its clean energy goals?

Answer. The Commission has been working to remove regulatory barriers to development of renewables and to ensure that demand-side resources, including energy efficiency, have access to wholesale power markets and the transmission grid comparable to that of supply-side resources. For example, the Commission recently modified its policy concerning the allocation of some of the costs of interconnecting certain generators to the grid. The Commission recognized that the original policy, which was developed when most generators had considerable flexibility on where they located, had become a barrier to many generation projects under development now, particularly renewable projects. See California Independent System Operator Corp., 119 FERC ¶ 61,061, reh'g denied, 120 FERC ¶ 61,244 (2007). The Commission is also acting to improve the speed with which proposed generation projects, many of which are renewable projects, are interconnected with the grid. The Commission held a December 11, 2007 technical conference to explore the current backlog in the interconnection request "queues" of ISOs and RTOs, including PJM, and recently followed up with a March 20, 2008, order providing guidance on possible reforms and directing the ISOs and RTOs to report on the status of their reform efforts. See Interconnection Queuing Practices, 122 FERC ¶ 61,252 (2008).

Question 6. The FERC has designated a broad swath of the mid-Atlantic as a "National Interest Electrical Transmission Corridor". While building some new transmission is certainly necessary, new power lines could also be used to deliver coal-fired electricity from older, less efficient plants into RGGI states, completely undermining the initiative. How will the FERC regulate PJM in order to prevent this from happening?

Answer. The Secretary of Energy, rather than the Commission, is responsible for designating National Interest Electric Transmission Corridors under section 216(a) of the Federal Power Act. Nevertheless, I share your view that transmission upgrades are needed in the PJM footprint. Such upgrades are critically important to ensuring access to new renewable generation. Precisely which transmission lines might be the subject of an application for a Commission construction permit under FPA section 216, or which transmission lines will ultimately be constructed in the Mid-Atlantic Area National Interest Electric Transmission Corridor, let alone the

³RPM Buyers include: state regulatory commissions, municipal electric utilities, joint power agencies, a rural electric cooperative, end-use customers, state consumer advocate offices, and load serving entities (LSEs) in the PJM region.

⁴PJM Interconnection, L.L.C., 123 FERC ¶ 61,037 (2008).

sources of power that those lines would access (coal, natural gas, nuclear, or renewable), is speculative at this time.

RESPONSES OF PHILIP D. MOELLER TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Do you believe that FERC has acted to fulfill sufficiently the statutory obligation to ensure that no cross-subsidization or encumbrance of assets will occur as a result of a merger?

Answer. Yes, I believe the Commission has acted to sufficiently fulfill its statutory obligation to ensure that no inappropriate cross-subsidization or encumbrance of assets will occur as a result of a merger. I endorse Chairman Kelliher's comprehensive response to this question, and I wish to emphasize several points. Notably, it should be recognized that our most significant and long-standing authority relates to our ratemaking review and FERC's ability to find and prevent inappropriate cross subsidization prospectively through the ratemaking process.

Recent actions taken by the Commission include the a new regulation that requires the filing of a statement demonstrating that a proposed merger will not result in cross-subsides, and imposition of pricing restrictions on all non-power goods and services transactions between a holding company's affiliates and any of its other affiliates with captive utility customers. In July 2007, a Supplemental Policy Statement was issued to clarify Section 203 of the Federal Power Act. That statement adopted a policy that included deference to state commissions on ring fencing measures and provides guidance when a state has not implemented ring fencing measures.

Additionally, since the enactment of Energy Policy Act of 2005 (EPAAct 2005), merger applicants must pledge, under penalty of law, that they will not engage in inappropriate cross-subsidies as the result of a merger.

Question 2. Do you believe that FERC's cross-subsidization protection is adequate to protect ratepayers?

Answer. Yes. In light of my answer above, I believe the Commission's cross-subsidization protections are currently adequate 1 to protect ratepayers. If the circumstances were to change, I would act quickly and forcefully to ensure that cross-subsidies will not occur.

Question 3. Is there anything that we need to change in the law to give you sufficient authority to protect consumers adequately, or to be sure that you do so?

Answer. No, at this time I do not believe that a change in the law is necessary to enhance the Commission's authority to protect consumers. However, I remain open to supporting a statutory change if it can be demonstrated that such a change is warranted to better protect consumers.

RESPONSES OF PHILIP D. MOELLER TO QUESTIONS FROM SENATOR DOMENICI

Question 1. GAO's Report finds that FERC relies primarily on self-reports to detect inappropriate cross-subsidization. Is this correct? If not, what does FERC rely on to police cross-subsidization?

Answer. No, the GAO report is not correct. While self-reports are an important mechanism for public utilities to self-identify prohibited conduct, the Commission primarily relies on audits and the ratemaking review process to detect inappropriate cross-subsidization.

Question 2. Is the Commission doing enough follow-up to ensure that companies are complying with merger conditions and that improper cross-subsidizations are not occurring? Why isn't FERC using a risk-based audit approach as GAO suggests? GAO also notes that FERC has only 3 ongoing audits on cross-subsidization. Why isn't FERC taking a more proactive approach to auditing?

Answer. I believe the Commission is conducting adequate follow-up to ensure that companies are both complying with merger conditions and that inappropriate cross-subsidization is not occurring. After conferring with our Audit staff, I have been assured that the Commission employs a risk-based audit approach, but this approach is not formalized; allowing sufficient flexibility in a case-by-case application.

With respect to the question of why the Commission does not conduct more cross-subsidization audits, the Commission made a conscious decision to allocate its audit resources to concentrate on other more serious matters, such as market manipulation, that have a more significant impact on customers' rates. Ultimately, I believe that our allocation of audit resources reflects the agency's priorities and yields the highest return; that is, the maximum protection for the nation's ratepayers.

Question 3. Do you all agree with Chairman Kelliher that ratemaking is a powerful enforcement tool for detecting cross-subsidization? Please elaborate on how the Commission uses its ratemaking authority to protect consumers.

Answer. Yes, I completely agree with Chairman Kelliher that our ratemaking authority is a powerful enforcement tool for detecting inappropriate cross-subsidies. The ratemaking process requires extensive documentation of relevant costs corresponding to the function these costs are assigned to for accounting purposes. During our review of public utility rates, inappropriate cross-subsidies can be detected and removed.

The states have similar tools to prevent the recovery of inappropriate costs in their ratemaking processes. Moreover, the ratemaking function applies to all utilities, not just the few that may be involved in mergers at any given time.

RESPONSES OF PHILIP D. MOELLER TO QUESTIONS FROM SENATOR MENENDEZ

THE GAO REPORT

My home state of New Jersey has strong Board of Public Utilities, one which has implemented strong regulations which protect electricity consumers. But consumers in other states are not so lucky, and rely on the Federal Energy Regulatory Commission.

This GAO report comes at a time when consumers are paying high and rapidly rising prices for electricity. Consumers are being hit by rising prices for food, fuel, and electricity, and their trust in government is at an all time low. This is a dangerous combination, and even the appearance of weak oversight is simply unacceptable. It is not enough to rely on self-reporting, and your audits need to be more transparent.

I am concerned that the FERC does consider the rising electricity prices to be a priority.

Question 1. I would like you to explain how you determine which companies to audit. What evidence leads you to investigate one company or another? What are the tell-tale signs of cross subsidization?

Surely, after a report like this, you must see the need to improve the transparency of your audits and oversight if nothing else. What opportunities do you see to improve how you protect consumers?

Answer. I endorse the answers given by Chairman Kelliher but as I noted in my testimony before the Committee, the Commission should always be open to suggestions on improving the transparency of all of its functions, including the audit function. I welcome any specific suggestions on improving the transparency of our audit function. Moreover, my experience here at the Commission has proven that its staff is highly sensitive to rising prices, and is doing all that it can ensure rates are just and reasonable.

MERGERS

Question 2. The concerns raised by the GAO report ring true for me because I watched the FERC review the proposed merger between PSEG and Exelon a few years ago. This proposed merger would have created the largest utility in the country. At that time, the New Jersey Board of Public Utilities raised a host concerns, ranging from market power to reliability of service to increased consumer costs. At the time, it appeared to me that the FERC approved this merger without addressing these questions.

Obviously, the Energy Policy Act of 2005 has increased the FERC's responsibilities. If the FERC was reviewing this merger today, would the process be different? What steps would the FERC now take to investigate the impact of this proposal on consumer prices? After such a merger, could New Jersey still enforce its own strong consumer protections?

Answer. Chairman Kelliher thoroughly describes the Commission's actions pertaining to the proposed merger between PSEG and Exelon, which occurred prior to my arrival at the Commission. However, as a result of changes to our regulations in December 2005, the Commission now requires that merger applicants file an "Exhibit M" to demonstrate that a merger will not result in inappropriate cross-subsidies to (or from) an affiliate.

RELIABILITY PRICING MODEL

Question 3. Chairman Kelliher, I would also like to discuss a regional consumer protection issue. As you know, our nation faces an urgent need for increased investment in transmission and generation infrastructure. To provide the market signal need to build this infrastructure, you have approved the so-called "Reliability Pricing Model", or RPM, for the RTO which included New Jersey.

I hear many different things about RPM. Some people tell me that it's working, paying for upgrades to old plants, and that new generation is in the queue. Others

disagree. But I know two things for certain: The RPM is costing New Jersey consumers billions of dollars, and we are seeing very few new entrants bringing generation on-line.

In PJM as a whole, consumers have made \$26 billion in forward capacity payments, but only 2,500 megawatts of new generation have come on-line. This is about 10 times what 2,500 megawatts of new generation should cost. Do you see anything wrong with this picture? Is the RPM system working?

What steps is the FERC taking to ensure that these vast sums of money will result in new generation?

Does FERC have any plans on how to change RPM if the new capacity they have projected does not come online?

When considering changes to the RPM system, how can FERC reduce its costs to consumers?

Answer. I again endorse the answer given by Chairman Kelliher relating to your questions on the Reliability Pricing Model (RPM). I am closely monitoring the status of the RPM design, including the promising results of the most recent forward capacity auction (held in May 2008). These results, reflecting a downward movement in capacity prices, are trending in the right direction for ratepayers.

RGGI, TRANSMISSION, PLANNING

Question 4. Chairman Kelliher, my home state of New Jersey is one of several states which are leading the nation in the fight against global warming. New Jersey has joined the Regional Green House Gas initiative. To meet its goals, New Jersey has embarked on an ambitious program which aims to get 20% of its energy from renewable sources by 2020. In order to do this, they use revenues from a cap and trade system to fund investments in renewables and energy efficiency. However, some neighboring states are not members of RGGI but are part of PJM regional transmission organization.

What will the FERC do to help New Jersey meet its clean energy goals?

Answer. From my perspective, the Commission can best help New Jersey meet its clean energy goals by promoting policies that allow the needed transmission lines to be constructed. Although New Jersey certainly has some renewable resources that can be developed within its state, other regions have better access to lower cost and more reliable renewable resources. As a percentage of a consumer's electricity bill, transmission lines are a relatively inexpensive way to move the best renewable energy resources to the markets that require (and demand) them.

One of my efforts has focused on the development of hydrokinetic technologies for in-river, wave and tidal power that has the potential to produce significant amounts of renewable energy. FERC has promoted changes in its hydropower licensing process to develop such renewable resources.

Question 5. The FERC has designated a broad swath of the mid-Atlantic as a "National Interest Electrical Transmission Corridor". While building some new transmission is certainly necessary, new power lines could also be used to deliver coal-fired electricity from older, less efficient plants into RGGI states, completely undermining the initiative.

How will the FERC regulate PM in order to prevent this from happening?

Answer. I concur with the response provided by Chairman Kelliher. The Secretary of Energy, rather than our Commission, is responsible for designating National Interest Electric Transmission Corridors under section 216(a) of the Federal Power Act.

RESPONSES OF MARC SPITZER TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Do you believe that FERC has acted to fulfill sufficiently the statutory obligation to ensure that no cross-subsidization or encumbrance of assets will occur as a result of a merger?

Answer. Yes. As I stated in my testimony before the Committee, I believe that FERC has fulfilled its statutory obligation to ensure a proposed merger or other transaction will not result in the improper impairment of utility assets or subsidization of non-utility affiliates.

Since the enactment of the Energy Policy Act of 2005, FERC has undertaken several initiatives to establish regulations and policies governing cross-subsidization and asset impairment attendant to review of transactions under section 203 of the Federal Power Act. While FERC initiated several rulemakings after the enactment of the Energy Policy Act of 2005 to implement the new authorities granted by Congress, FERC knew that it needed to revisit these issues as it gained additional experience under the new regulations. Accordingly, FERC held two technical conferences

that specifically addressed how FERC should supplement the protections against cross-subsidization that were implemented in the original rules and whether the Commission's existing competition analysis is sufficiently rigorous to analyze mergers. As described in Chairman Kelliher's response, the result of these technical conferences was a Supplemental Merger Policy Statement which provides, among other things, guidance to the industry regarding the types of measures applicants could offer to demonstrate that their proposed transaction does not raise cross-subsidization concerns. The technical conferences also led to the adoption of restrictions on affiliate transactions between franchised public utilities that have captive customers or that own or provide transmission service over jurisdictional transmission facilities, and their market-regulated power sales affiliates or non-utility affiliates.

These measures, in addition to our ratemaking authority, compliance measures, auditing, and the penalty authority under the Energy Policy Act of 2005, provide adequate consumer protection and discipline over regulated entities' transactions. They ensure that when FERC examines any proposed merger—a review that is based on the specific facts developed in the record—no improper impairment of utility assets or subsidization of non-utility affiliates will take place.

All of FERC's activities in this regard have focused on fulfilling Congress's objective for the repeal of the Public Utility Holding Company Act of 1935—encouragement of greater investment in the utility industry and removal of unnecessary burdens while at the same time ensuring that there is no harm to competition and no harm to ratepayers.

Question 2. Do you believe that FERC's cross-subsidization protection is adequate to protect ratepayers?

Answer. Yes. After the enactment of the Energy Policy Act of 2005, FERC adopted supplementary measures to focus on the potential for improper cross-subsidization in addition to the ongoing scrutiny and consumer protections through FERC's traditional ratemaking authority. These measures include, but are not limited to: specific pricing standards for non-power goods and services transactions between affiliates if one of the affiliates has captive customers or transmission customers; specific and detailed record retention rules for holding companies and their affiliates; a new standardized Uniform System of Accounts that must be followed by all centralized service companies; and annual reporting requirements for various forms of service companies. Each of these measures is detailed in Chairman Kelliher's response. Notably, the application of these protections is not limited to mergers and other corporate transactions. Rather, these protections facilitate FERC's statutory mandate to ensure that no entity receives or grants an undue preference with respect to any transmission or sale subject to FERC's jurisdiction.

Question 3. Is there anything that we need to change in the law to give you sufficient authority to protect consumers adequately, or to be sure that you do so?

Answer. I do not believe statutory change is required. FERC has implemented and continues to implement the beneficial authority granted by Congress in 2005 to ensure reliable and plentiful wholesale energy supplies at just and reasonable rates. At this time, I believe FERC has sufficient resources to implement its responsibilities. However, FERC's efforts to protect ratepayers are evolving. Therefore, I concur with Chairman Kelliher that FERC will seek additional authority or funds from the Congress if we believe that more resources are necessary to ensure FERC's continued vigilance to protect ratepayers.

RESPONSES OF MARC SPITZER TO QUESTIONS FROM SENATOR DOMENICI

Question 1. GAO's Report finds that FERC relies primarily on self-reports to detect inappropriate cross-subsidization. Is this correct? If not, what does FERC rely on to police cross-subsidization?

Answer. GAO's finding that FERC relies primarily on self-reports to detect inappropriate cross-subsidization is not correct. As detailed in Chairman Kelliher's response, cross-subsidization does not lend itself to self-reporting. While self-reports are an important part of FERC's overall enforcement efforts, they are not the primary way by which FERC detects inappropriate cross-subsidization. As discussed above, FERC has adopted supplementary measures after the enactment of the Energy Policy Act of 2005 to focus on potential cross-subsidization. However, one of FERC's most effective policing mechanisms is the continued use of its traditional ratemaking authority to protect ratepayers.

Question 2. Is the Commission doing enough follow-up to ensure that companies are complying with merger conditions and that improper cross-subsidizations are not occurring? Why isn't FERC using a risk-based audit approach as GAO suggests? GAO also notes that FERC has only 3 ongoing audits on cross-subsidization. Why isn't FERC taking a more proactive approach to auditing?

Answer. FERC is taking the necessary measures to ensure that regulated entities are complying with merger conditions and that improper cross-subsidization is not occurring. FERC does and will follow a risk-based approach in selecting audit candidates. As Chairman Kelliher describes in his response, FERC's risk-based approach is part of a comprehensive review that considers various issues including, but not limited to, financial information.

Further, I concur with Chairman Kelliher's assessment that, given FERC's other responsibilities, FERC has been diligent to ensure utilities are complying with merger conditions and that inappropriate cross-subsidization does not occur. The number and scope of audits on cross-subsidization will be determined in consideration of all FERC's priorities and the number of available resources as FERC maintains its oversight over cross-subsidization and other matters required by statute or rule.

Question 3. Do you all agree with Chairman Kelliher that ratemaking is a powerful enforcement tool for detecting cross-subsidization? Please elaborate on how the Commission uses its ratemaking authority to protect consumers.

Answer. I agree with Chairman Kelliher that ratemaking is a powerful enforcement tool for detecting cross-subsidization. As Commissioner Kerr testified on behalf of the National Association of Regulatory Utility Commissioners, ". . . the GAO report probably underestimates the pervasive, positive role that rate making authority plays. I don't mean to be trite. But I do believe that the old expression that if you have them by the rates, their hearts and minds will follow is in fact, an accurate assessment of the importance of rate making authority as it affects the totality of the relationship."¹ The same is true for federal ratemaking. Having adjudicated both Federal and State rate cases, I can assure the Committee such proceedings are an effective means of both discerning financial chicanery and absolving the innocent.

Before any costs can be recovered from wholesale customers served under cost-based rates, FERC reviews those costs to determine if their recovery would be just and reasonable. A public utility may not charge rates subject to FERC's jurisdiction (wholesale sales in interstate commerce) without notice to the public and approval by FERC under section 205 of the Federal Power Act. A public utility may not recover costs that are imprudently incurred. If a utility in a section 205 rate proceeding seeks to flow through to wholesale customers costs of non-power goods or services purchased from an affiliate, FERC will disallow those costs if they are determined to be unreasonable or imprudently incurred. Moreover, for any cost-based rate that is filed for approval with FERC, FERC may institute a proceeding on its own motion or in response to matters raised by others, including claims of potential cross-subsidization. Additionally, an entity may file a section 206 complaint for FERC review to challenge allegedly improper cost recovery.

RESPONSES OF MARC SPITZER TO QUESTIONS FROM SENATOR MENENDEZ

THE GAO REPORT

Question 1. My home state of New Jersey has [a] strong Board of Public Utilities, one which has implemented strong regulations which protect electricity consumers. But consumers in other states are not so lucky, and rely on the Federal Energy Regulatory Commission. This GAO report comes at a time when consumers are paying high and rapidly rising prices for electricity. Consumers are being hit by rising prices for food, fuel, and electricity, and their trust in government is at an all time low. This is a dangerous combination, and even the appearance of weak oversight is simply unacceptable. It is not enough to rely on self-reporting, and your audits need to be more transparent. I am concerned that the FERC does consider the rising electricity prices to be a priority. I would like you to explain how you determine which companies to audit. What evidence leads you to investigate one company or another? What are the tell-tale signs of cross subsidization? Surely, after a report like this, you must see the need to improve the transparency of your audits and oversight if nothing else. What opportunities do you see to improve how you protect consumers?

Answer. With respect to audits, I concur with Chairman Kelliher that FERC uses a risk-based approach in selecting audit candidates. However, as I stated in my testimony, the GAO Report does provide some lessons for FERC. There is always room for improvement in our programs. FERC continues to take steps to improve the transparency of its audit and oversight functions. For example, as Chairman Kelliher notes in his response, as a result of the GAO Report, FERC has improved

¹ Tr.79:17-24.

its audit reporting by including an enhanced audit methodology section in all of its public audit reports.

Furthermore, FERC has recently taken actions to improve transparency as to all of its enforcement activities. On May 15, 2008, FERC issued a series of orders that provide further guidance regarding our enforcement policies and regulations. FERC's Revised Policy Statement on Enforcement provides guidance as to FERC's approach to audits and investigations; the factors FERC's Enforcement Staff will consider and processes they will follow in conducting audits and investigations; and considerations that FERC will evaluate when choosing an appropriate remedy for enforcement violations. I believe that vigorous enforcement is critical to ensuring fair, open, and transparent competitive markets. However, I also recognize that clarity in our regulations and policies is essential to compliance by market participants. Our existing enforcement program is new and will continue to evolve as the Congress' objectives change. These orders demonstrate FERC's commitment to responsiveness and to ongoing improvements in our program.

MERGERS

Question 2. The concerns raised by the GAO report ring true for me because I watched the FERC review the proposed merger between PSEG and [Exelon] a few years ago. This proposed merger would have created the largest utility in the country. At that time, the New Jersey Board of Public Utilities raised a host [of] concerns, ranging from market power to reliability of service to increased consumer costs. At the time, it appeared to me that the FERC approved this merger without addressing these questions. Obviously, the Energy Policy Act of 2005 has increased the FERC's responsibilities. If the FERC was reviewing this merger today, would the process be different? What steps would the FERC now take to investigate the impact of this proposal on consumer prices? After such a merger, could New Jersey still enforce its own strong consumer protections?

Answer. Under the statutory requirements both before and after the Energy Policy Act of 2005, FERC carefully reviews all merger applications on a fact-specific basis to ensure any proposed transaction is consistent with the public interest. I did not assume my position on FERC until July 2006. However, as observed by Chairman Kelliher in his response, FERC's review of the proposed Exelon/PSEG merger after the Energy Policy Act of 2005 would address the new requirement to make specific findings that the proposed merger would not result in inappropriate cross-subsidization or encumbrance of utility assets.

I agree with Chairman Kelliher that FERC's current merger test is sufficient to analyze the effect a proposed merger may have on competition, rates and regulation. FERC specifically sought comment on this issue and carefully considered the matter in a technical conference prior to issuance of FERC's 2007 Supplemental Merger Policy Statement. If FERC finds that a proposed merger will have adverse effects, it has the option to deny the merger, to condition merger approval on measures to mitigate any resulting market power, or to impose additional structural changes necessary to protect consumers. In addition, FERC not only makes the finding that a proposed merger will not result in inappropriate cross-subsidization of non-utility affiliates or the encumbrance of utility assets for the benefit of an affiliate, as required under the Energy Policy Act of 2005, but it has in place affiliate pricing restrictions—applicable to all public utilities not only those involved in mergers—to address both power and non-power sales between affiliates.

RELIABILITY PRICING MODEL

Question 3. Chairman Kelliher, I would also like to discuss a regional consumer protection issue. As you know, our nation faces an urgent need for increased investment in transmission and generation infrastructure. To provide the market signal need to build this infrastructure, you have approved the so-called "Reliability Pricing Model", or RPM, for the RTO which included New Jersey. I hear many different things about RPM. Some people tell me that it's working, paying for upgrades to old plants, and that new generation is in the queue. Others disagree. But I know two things for certain: The RPM is costing New Jersey consumers billions of dollars, and we are seeing very few new entrants bringing generation on-line. In PJM as a whole, consumers have made \$26 billion in forward capacity payments, but only 2,500 megawatts of new generation have come on-line. This is about 10 times what 2,500 megawatts of new generation should cost. Do you see anything wrong with this picture? Is the RPM system working? What steps is the FERC taking to ensure that these vast sums of money will result in new generation? Does FERC have any plans on how to change RPM if the new capacity they have projected does not come

online? When considering changes to the RPM system, how can FERC reduce its costs to consumers?

Answer. There are numerous proceedings through which FERC is examining the effectiveness of the PJM markets, including RPM. These proceedings are the appropriate forum for parties to raise concerns about the functioning of the markets and have the opportunity to be heard. FERC's task in these docketed proceedings is to ensure adequate new generation at just and reasonable rates.

On May 7, 2008 the Commission held a technical conference to discuss the operation of forward capacity markets, specifically focusing on RPM and its equivalent in the New England region. This technical conference raised a number of issues, including those posed by your question. FERC is considering the comments from that conference as well as related filings in connection with bringing new, clean generation into constrained load pockets.

RGGI, TRANSMISSION, PLANNING

Question 4. Chairman Kelliher, my home state of New Jersey is one of several states which are leading the nation in the fight against global warming. New Jersey has joined the Regional Green House Gas initiative. To meet its goals, New Jersey has embarked on an ambitious program which aims to get 20% of its energy from renewable sources by 2020. In order to do this, they use revenues from a cap and trade system to fund investments in renewables and energy efficiency. However, some neighboring states are not members of RGGI but are part of PJM regional transmission organization. What will the FERC do to help New Jersey meet its clean energy goals?

Answer. I am personally committed to ensuring FERC does what it can to support states' efforts to implement renewable portfolio standards. As a member of the Arizona Corporation Commission I supported a state renewable portfolio standard of 15% by 2025. As someone who designed two renewable portfolio standards at the state level (in 2001 and 2006), I am deeply respectful of state efforts in this regard.

I agree with Chairman Kelliher's description of FERC's efforts to remove regulatory barriers to renewables and energy efficiency. FERC has taken steps to support regulated entities' efforts to comply with state renewable portfolio standards and the states' efforts to require reductions in greenhouse gas emissions. For example, FERC supported the proposal of the California Independent System Operator to finance facilities to interconnect location-constrained renewable resources such as wind, geothermal and solar generation to its transmission grid.² In this order FERC approved a mechanism that would remove barriers to increased development of renewable energy.

Question 5. The FERC has designated a broad swath of the mid-Atlantic as a "National Interest Electrical Transmission Corridor". While building some new transmission is certainly necessary, new power lines could also be used to deliver coal-fired electricity from older, less efficient plants into RGGI states, completely undermining the initiative. How will the FERC regulate PJM in order to prevent this from happening?

Answer. The U.S. Department of Energy designated the National Interest Electric Transmission Corridors in 2007. That designation underscores the systemic underinvestment in transmission across the country, which Congress acknowledged in enacting section 219 of the Federal Power Act (section 1241 of the Energy Policy Act of 2005). Transmission congestion imposes reliability and economic burdens upon consumers and requires greater transmission investment. Moreover, I believe investment in the transmission grid will also support investment in renewable generation and energy efficiency. However, denial of an application for transmission or interconnection based upon the fuel source of the generator could raise serious legal concerns. The matter is perhaps better addressed as part of the consideration of carbon policy pending in the Congress.

I concur with Chairman Kelliher's response. Until there is a specific application related to the U.S. Department of Energy's designation of a Mid-Atlantic Area National Interest Electric Transmission Corridor, it is difficult to anticipate what actions FERC should take in response.

²California Independent System Operator Corporation, 119 FERC ¶ 61,061, order on reh'g, 120 FERC ¶ 61,244 (2007).

RESPONSES OF JON WELLINGHOFF TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Do you believe that FERC has acted to fulfill sufficiently the statutory obligation to ensure that no cross-subsidization or encumbrance of assets will occur as a result of a merger?

Answer. I take seriously the Commission's statutory obligation to review applications filed pursuant to section 203 of the Federal Power Act to ensure that a proposed transaction will be consistent with the public interest, and will not result in cross-subsidization of a non-utility associate company or the pledge or encumbrance of utility assets for the benefit of an associate company, unless the Commission determines that the cross-subsidization, pledge, or encumbrance will be consistent with the public interest. I believe that the Commission has acted appropriately to fulfill this statutory obligation by taking the steps described in the response to your first post-hearing question to Chairman Kelliher. I would particularly like to highlight the Commission's commitment to adopt supplemental measures to protect consumers against improper cross-subsidization where the record before the Commission indicates either that a regulatory gap exists because a state lacks the authority to act or that the measures adopted by a relevant state commission are inadequate.

Question 2. Do you believe that FERC's cross-subsidization protection is adequate to protect ratepayers?

Answer. Yes, for the reasons stated in my response to Question # 1 above. I also agree with Chairman Kelliher's statement that the Commission's actions taken in the context of reviewing applications filed pursuant to section 203 of the Federal Power Act are in addition to the Commission's traditional and broad ratemaking authority to disallow rate recovery of costs found unjust and unreasonable as improper cross-subsidies.

Question 3. Is there anything that we need to change in the law to give you sufficient authority to protect consumers adequately, or to be sure that you do so?

Answer. No. I believe that the Commission has sufficient authority to prevent improper cross-subsidization, and that the Commission exercises that authority to provide adequate protection for consumers.

RESPONSES OF JON WELLINGHOFF TO QUESTIONS FROM SENATOR DOMENICI

Question 1. GAO's Report finds that FERC relies primarily on self-reports to detect inappropriate cross-subsidization. Is this correct? If not, what does FERC rely on to police cross-subsidization?

Answer. As Chairman Kelliher states in response to your first post-hearing question, the Commission does not rely on self-reports as its primary enforcement mechanism to prevent improper cross-subsidization. I also agree with Chairman Kelliher's identification of several other tools on which the Commission does rely for that purpose.

Question 2. Is the Commission doing enough follow-up to ensure that companies are complying with merger conditions and that improper cross-subsidizations are not occurring? Why isn't FERC using a risk-based audit approach as GAO suggests? GAO also notes that FERC has only 3 ongoing audits on cross-subsidization. Why isn't FERC taking a more proactive approach to auditing?

Answer. Chairman Kelliher states in response to your second post-hearing question that in light of the Commission's other responsibilities, especially with respect to the Commission's new authority to oversee reliability of the bulk power system and to police against market manipulation, the Commission is taking appropriate steps to ensure that improper cross-subsidization is not occurring and that companies are complying with merger conditions. Chairman Kelliher further states that the Commission does and will follow a risk-based approach in selecting companies for audits that address cross-subsidization, and that the companies selected for the FY08 audit cycle include some of the country's largest utility holding companies. I agree with these statements. I would add that the Commission will seek additional funds from the Congress if we determine that more resources are needed to carry out our essential auditing responsibilities, including cross-subsidization audits.

Question 3. Do you all agree with Chairman Kelliher that ratemaking is a powerful enforcement tool for detecting cross-subsidization? Please elaborate on how the Commission uses its ratemaking authority to protect consumers.

Answer. The Commission has broad ratemaking authority to disallow recovery in rates of costs found unjust and unreasonable as improper cross-subsidies. I agree with Chairman Kelliher that exercising this traditional authority is an important part of the Commission's commitment to protecting consumers against improper cross-subsidization.

RESPONSES OF JON WELLINGHOFF TO QUESTIONS FROM SENATOR MENENDEZ

THE GAO REPORT

Question 1. My home state of New Jersey has strong Board of Public Utilities, one which has implemented strong regulations which protect electricity consumers. But consumers in other states are not so lucky, and rely on the Federal Energy Regulatory Commission.

This GAO report comes at a time when consumers are paying high and rapidly rising prices for electricity. Consumers are being hit by rising prices for food, fuel, and electricity, and their trust in government is at an all time low. This is a dangerous combination, and even the appearance of weak oversight is simply unacceptable. It is not enough to rely on self-reporting, and your audits need to be more transparent.

I am concerned that the FERC does consider the rising electricity prices to be a priority.

I would like you to explain how you determine which companies to audit. What evidence leads you to investigate one company or another? What are the tell-tale signs of cross subsidization?

Surely, after a report like this, you must see the need to improve the transparency of your audits and oversight if nothing else. What opportunities do you see to improve how you protect consumers?

Answer. I served as the State of Nevada's first consumer advocate for customers of public utilities, and I recognize the importance of ensuring that consumers' electricity rates are just and reasonable. I agree that even the appearance of weak oversight can undermine public trust in government.

The need for effective oversight extends to preventing improper cross-subsidization. In responding to this question, Chairman Kelliher states that the Commission does and will follow a risk-based approach in selecting companies for audits that address cross-subsidization. I agree with that statement, as well as with Chairman Kelliher's description of sources that are relevant to that risk-based approach. It is also noteworthy that the companies selected for the FY08 audit cycle include some of the country's largest utility holding companies. I would add that the Commission will seek additional funds from the Congress if we determine that more resources are needed to carry out our essential auditing responsibilities, including cross-subsidization audits.

More generally, I agree with you that it is important to improve the transparency of the Commission's audits. Both the GAO Report and comments at a conference that the Commission held in November 2007 demonstrated that some aspects of the Commission's enforcement policies are not well understood. Such confusion does not help consumers who are the ultimate beneficiaries of those policies. To address this problem, the Commission last week issued a package of orders that provide greater transparency in our enforcement process. As the Commission gains further experience in implementing our expanded enforcement authority under EAct 2005, we will continue to review our enforcement policies and will make further changes as appropriate to improve protection of consumers.

MERGERS

Question 2. The concerns raised by the GAO report ring true for me because I watched the FERC review the proposed merger between PSEG and Exelon a few years ago. This proposed merger would have created the largest utility in the country. At that time, the New Jersey Board of Public Utilities raised a host concerns, ranging from market power to reliability of service to increased consumer costs. At the time, it appeared to me that the FERC approved this merger without addressing these questions.

Obviously, the Energy Policy Act of 2005 has increased the FERC's responsibilities. If the FERC was reviewing this merger today, would the process be different? What steps would the FERC now take to investigate the impact of this proposal on consumer prices? After such a merger, could New Jersey still enforce its own strong consumer protections?

Answer. In EAct 2005, the Congress largely ratified the Commission's test for reviewing applications filed pursuant to section 203 of the Federal Power Act. With regard to such applications, however, the Congress also directed the Commission to ensure that a proposed transaction will not result in cross-subsidization of a non-utility associate company or the pledge or encumbrance of utility assets for the benefit of an associate company, unless the Commission determines that the cross-subsidization, pledge, or encumbrance will be consistent with the public interest. The Commission has taken a number of steps since the enactment of EAct 2005 to im-

plement this new statutory obligation, as Chairman Kelliher described in his prepared testimony.

If a merger affecting the State arose today, New Jersey could still enforce its own consumer protections. Indeed, the Commission would consider the State's actions in determining whether to adopt supplemental measures to protect consumers against improper cross-subsidization.

RGGI, TRANSMISSION, PLANNING

Question 3. My home state of New Jersey is one of several states which are leading the nation in the fight against global warming. New Jersey has joined the Regional Green House Gas initiative. To meet its goals, New Jersey has embarked on an ambitious program which aims to get 20% of its energy from renewable sources by 2020. In order to do this, they use revenues from a cap and trade system to fund investments in renewables and energy efficiency. However, some neighboring states are not members of RGGI but are part of PJM regional transmission organization.

What will the FERC do to help New Jersey meet its clean energy goals?

The FERC has designated a broad swath of the mid-Atlantic as a "National Interest Electrical Transmission Corridor". While building some new transmission is certainly necessary, new power lines could also be used to deliver coal-fired electricity from older, less efficient plants into RGGI states, completely undermining the initiative.

How will the FERC regulate PJM in order to prevent this from happening?

Answer. I believe that climate change is one of the most serious problems now facing our country. I commend the State of New Jersey for its leadership on this issue, including its focus on increased investment in renewable generation and energy efficiency. I agree that renewables and demand resources, including energy efficiency and demand response, are among our vital tools in combating climate change.

The Commission is taking important steps to remove regulatory barriers to development of renewables and to ensure that demand resources have appropriate access to wholesale power markets. For example, the Commission has required transmission providers, including PJM, to develop an open, transparent regional transmission planning process. I believe that these planning processes will facilitate the development of demand resources, in part because the Commission has determined that demand resources capable of performing needed functions should be permitted to participate in the planning process on a basis comparable to other resources. Moreover, these planning processes can account for regional and state energy initiatives such as New Jersey's participation in the Regional Greenhouse Gas Initiative (RGGI). These planning processes will ultimately reduce costs to consumers and increase the competitiveness of utilities.

Chairman Kelliher's response to this question identifies other examples of the Commission's efforts in these areas. I strongly support the Commission's recent orders that modified our policy for allocating some costs associated with transmission lines that are needed to connect renewable generation to the grid. It is also noteworthy that the Commission is seeking to dislodge the backlog in interconnection request queues of independent system operators and regional transmission organizations, including PJM.

In addition, it is worth noting that if a PJM market participant were to incur increased costs of complying with environmental requirements—including climate change legislation that may be enacted at the federal level—that change would likely be reflected in bids that the market participant submits into PJM's wholesale markets subject to the Commission's jurisdiction. Based on PJM's economic dispatch, market participants submitting higher bids generally would be selected less frequently to serve consumers in PJM, including those in New Jersey. Therefore, the plants owned by such market participants would remain idle more often and would produce fewer greenhouse gases.

Finally, Chairman Kelliher correctly states that the Secretary of Energy, rather than the Commission, is responsible for the designation of any National Interest Electric Transmission Corridors (NIETC). The Commission, however, may be presented with applications to site transmission lines within a NIETC. The Commission has adopted regulations that would apply in that situation. Those regulations make clear that in reviewing a proposed project, the Commission will consider all relevant factors on a case-by-case basis. As part of that review, the Commission will look at alternatives, including—where appropriate—alternatives other than new transmission lines. Such alternatives may include demand resources, as well as upgrades to existing facilities. This review will promote efficiency and environmentally-sound solutions.

RESPONSE OF JAMES Y. KERR II TO QUESTION FROM SENATOR BINGAMAN

Question 1. Would it be appropriate for FERC to establish specific criteria for when it would consider state protections inadequate to protect consumers, and to issue rules that would specify what kinds of protections they would institute in those cases?

Answer. If FERC were to establish specific criteria for when it would consider State protections inadequate to protect consumers or issue rules that would specify what kinds of protections it would institute in those cases, this approach might produce unnecessary conflict between federal and State regulators. A prescriptive “one size fits all” federal approach would limit the ability of State commissions to craft appropriate safeguards. The underlying regulatory relationships and transactions are unique and are best dealt with on a case by case, fact specific basis. The appendix attached to NARUC’s written statement addressing the North Carolina Utility Commission’s decision in the Duke merger case describes the nature and scope of this case by case approach.

The Commission sought input from State commissions before finalizing its regulations under Federal Power Act (“FPA”) Section 203. FERC asked for the State views on the best way to prevent cross-subsidization and how to coordinate federal/State merger review. The current FERC policy on merger applications is to defer to State cross-subsidization protections, unless there is evidence that additional measures are needed to protect wholesale customers, or where States lack authority to provide sufficient protections. This flexible approach properly manages the jurisdictional overlap in this area. It also reflects the reality that a wide variety of transactions are subject to FPA Section 203 review and that there is more than one mechanism to guard against improper cross-subsidization. NARUC appreciates that FERC declined to impose a uniform federal rule on cross-subsidization protections. A generic approach could have displaced State merger conditions even if those conditions guarded against improper cross-subsidization as effectively as the federal rule. A potentially conflicting approach assumes a “regulatory failure” on the part of State commissions. Federal and State regulators have the common interest in policing improper cross-subsidization. To that end, States have been vigilant in guarding against cross-subsidies in the course of State merger review and in other contexts.

RESPONSES OF JAMES Y. KERR II TO QUESTIONS FROM SENATOR DOMENICI

Question 1. Does FERC have in place sufficient customer protections in light of PUHCA repeal? Has the repeal of the Holding Company Act resulted in any regulatory gaps?

Answer. The Commission has sufficient customer protections in place. The exercise of complementary federal and State authority results in comprehensive regulation. FERC has powerful regulatory tools to prevent cross-subsidization, including the disallowance of the recovery in rates for those costs found to reflect improper cross-subsidies. As described in detail in the FERC Commissioners’ testimony, the Commission has adopted numerous implementing regulations and policies under the Energy Policy Act of 2005 (“EPAct 2005”) to enhance its ability to police cross-subsidization. In addition, FERC has further strengthened its enforcement function to better protect consumers.

The repeal of PUHCA has not resulted in any regulatory gaps. In fact, EPAct 2005 filled in statutory gaps regarding holding company mergers and generation facility acquisitions. For example, the Statute added to the public interest determination for FPA Section 203 reviews. The determination now requires a finding that a transaction will not result in cross-subsidization of a non-utility associate company or the pledge or encumbrance of utility assets for the benefit of an associate company, unless such cross-subsidization, pledge or encumbrance is in the public interest. Also, for every transaction approved under FPA Section 203, FERC retains the authority to issue supplemental orders as it may find necessary or appropriate with respect to that transaction.

State commissions have the obligation under State law to ensure the establishment and maintenance of such energy utility services as may be required by the public convenience and necessity. We have to ensure that such services are provided at rates and conditions that are just, reasonable and nondiscriminatory for all consumers. State commissions have powerful regulatory tools to protect customers. Each State has extensive ratemaking authority, which includes the right to disallow recovery in rates of inappropriate or improper costs, including those deemed to represent cross-subsidies. The exercise of State merger review authority provides a means to protect consumer interests by imposing conditions on any proposed transaction. In fact, the broad statutory mandates to uphold the public interest and ensure reliable service at just and reasonable rates have allowed State commissions

to establish detailed consumer protections not directly spelled out under their broad statutory authority. State regulatory commissions have traditionally had jurisdiction over the regulation of utilities in various areas, including mergers and acquisitions, affiliate transactions, audits and financial reporting. The repeal of PUHCA did not change the States' authority in these areas.

Question 2. Do you believe any supplemental federal authority is needed to police cross-subsidizations such as a federal ring-fencing provision?

Answer. Supplemental statutory authority, such as a federal ring-fencing provision, added to the FPA is not needed to police cross-subsidizations. As per our response to Domenici Question 1, the Commission already possesses extensive federal authority. And, FERC effectively exercises its broad statutory authority to protect against improper cross-subsidization. In fact, increased federal oversight over non-utility corporate activities and structure could create substantial barriers to investment in electricity markets, which would be contrary to the intent of PUHCA repeal. Supplemental federal authority could unnecessarily duplicate, and possibly contradict, consumer protections already in place at the State level.

Question 3. What are your thoughts on Mr. Hempling's argument that we should revisit the federal-state relationship to achieve consistent regulatory policies across jurisdictional lines?

Answer. There is no need to revisit the federal-State relationship to achieve consistent regulatory policies across jurisdictional lines, given the absence of evidence of consumer harm caused by a regulatory failure. The Commission and the States exercise their complementary authority to result in consistent and comprehensive regulation. The current approach properly balances the federal-State interests in this area. It also promotes an efficient use of resources and fosters greater federal-State coordination. For example, FERC collaborates with the States on audits, recognizing that maintaining contact with State regulators is mutually beneficial. NARUC has had an extensive and constructive working relationship with FERC. The three NARUC/FERC Collaboratives that cover cross jurisdictional areas—demand response, competitive procurement and smart grid—demonstrate that the precedent exists to continue working together.

RESPONSES OF SCOTT HEMPLING TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. In EPAAct 05 we gave FERC new authorities and obligations to review mergers, specifically, we required them to find that there would be no cross-subsidization or encumbrance of assets for the benefit of an affiliate as the result of a merger. Have FERC's modifications of their merger rules adequately implemented this requirement?

Answer. A rule prohibiting cross-subsidies, by itself, does not prevent cross-subsidies, any more than a speed limit prevents speeding. The risk of cross subsidies arises from corporate structures which make cross subsidies (a) possible, and (b) desirable to the companies involved. Given possibility and desirability, the rational actor's decision to engage in cross subsidies is a product of the probability of detection and the magnitude of the penalty.

The gap in cross subsidy prevention exists because FERC has not identified, and discouraged, the types of corporate structures that create the possibility and desirability of cross subsidies. Prior to repeal, PUHCA 1935 limited the possibility of cross subsidies by prohibiting, limiting or requiring advance review of structures that mixed, within the same corporate family, utility and nonutility businesses, or competitive and non-competitive businesses. FERC has statutory authority, under the "consistent with the public interest" phrase in Section 203 of the Federal Power Act, to identify and limit corporate structures and affiliations. FERC's decision not to do so means that the risks of cross subsidies are higher now than prior to 2005, regardless of FERC's rules.

Given the increase in corporate complexity allowed by the combination of PUHCA 1935 repeal and the absence of new FERC limits on corporate structure, one would expect the resources devoted to cross subsidy detection, and the frequency of detection efforts, to match the greater risk. There is no evidence of such matching. Rational corporate planners therefore can assume that if the rewards of cross subsidies are high enough, the risk is worth taking.

Question 2. Some have argued that you can't prove a negative, i.e., that it is impossible to establish that there will be no cross-subsidization. Would not a structural barrier between the holding company and its utility affiliate provide the insurance that we were seeking?

Answer. Please see response to Bingaman Question 1. The phrase "structural barrier" deserves some elaboration. FERC and state regulators should insist that atten-

tion to the core utility business be the focus of a utility corporation. Any distraction from that business is inherently inconsistent with the core function. Regulators therefore should define the types of businesses which may co-exist in a utility corporate family without causing risks to customers. Such limits cause shareholders no loss in legitimate value, because shareholders on their own face no barriers in investing, separately, in whatever mix of businesses best serves their portfolio.

Question 3. Is there something else that needs to be done in either statute or rule to fulfill this obligation or to protect adequately against cross-subsidization.

Answer. Should FERC adhere to its decision not to address cross subsidy risk through structural limits, then it should identify with more precision the detection procedures and resources. The GAO's thoughts on the allocation of audit resources according to risk principles are worth considering. Moreover, those who through their structural choices increase the risk of cross subsidies should pay the freight for audit detection, just as any public corporation pays for its own audit. FERC therefore should consider a schedule of audit fees that vary with a corporate family's structural complexity. Otherwise a cross subsidy occurs at the outset, as all rate-payers or all taxpayers must pay for higher audit costs necessitated by the structural choices of a discrete set of companies.

RESPONSES OF SCOTT HEMPLING TO QUESTIONS FROM SENATOR DOMENICI

Question 1. 1. Does FERC have in place sufficient customer protections in light of PUHCA repeal? Has the repeal of the Holding Company Act resulted in any regulatory gaps?

Answer. Based on my career of advising over 20 state commissions while I was in private practice, and on my current responsibilities which involve ascertaining and fulfilling the research needs for all state commissions, I conclude that there are gaps in consumer protections due to the repeal of PUHCA 1935. As explained in my submitted written testimony, the following factors combine to create uncertainty and insufficiency in the area of consumer protection: (a) the elimination of all federal limits on utility corporate structure, which elimination allows structures that create a direct conflict between the utility's public service obligation and its opportunities to seek profit outside of its utility service business; (b) FERC's over-reliance on rate cases, as distinct from structural limits, to identify and correct cross subsidies; (c) insufficient information about the frequency, quality and consequences of regulatory efforts to detect and eliminate cross subsidies; and (d) the gap between regulatory resources (both human and statutory) and the new opportunities to engage in conflict-causing structures and behaviors.

Question 2. I understand you opposed PUHCA repeal. Do you think Congress made a mistake when it repealed the Holding Company Act? Do you think the 1935 Act should be reenacted?

Answer. Throughout the long debate about the future of PUHCA 1935, in which I was active as early as 1989, I avoided the bipolarity of statements such as "I oppose PUHCA repeal" and "I support PUHCA repeal." The bipolarity of the debate moved to the margin the correct question, which is: "How do we modernize federal structural regulation so as to promote the diversity and competitiveness of electricity markets while ensuring that customers receive the best possible service at reasonable cost?" This more complex question requires one to ask: "Is it wise to permit corporate structures that place utility executives in a conflicted position, where they have the choice of actions which are profitable but which undermine customer interests?" My position throughout the debate was that stark repeal caused such conflicts, whereas leaving the statute unchanged impeded the injection of diversity and competitiveness.

Given this statement of the issue, I believe Congress erred in not replacing PUHCA 1935 with a modern statute that accommodated the concerns set forth elsewhere in my comments. Re-enactment of PUHCA 1935 would not be the answer; creating a statute that allowed those corporate structures that promote diversity and competitiveness but precluded structures that embodied conflicts of interest would be the answer.

As explained in my written testimony, my views set forth here are my own; not those of NRRRI or of any state commission.