FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

OFFICE OF THE COMMISSIONER

February 7, 2005

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Dingell:

I am writing in response to your letter of January 24, 2005. Enclosed are my responses to the questions you posed in your letter.

I look forward to working with you and your staff on energy legislation.

Sincerely,

Joseph T. Kelliher

Enclosure

cc: The Honorable Joe Barton, Chairman
Committee on Energy and Commerce

RESPONSE OF COMMISSIONER KELLIHER

Question 1:

Chairman Wood's response accurately describes developments on market information, civil and criminal penalties, and the Alaska natural gas pipeline since his testimony before the Subcommittee on Energy and Air Quality on March 5, 2003.

I believe the Commission needs additional legal authority in two of the three areas raised in your question, namely market information and civil and criminal penalties. Under current law, the Commission can only obtain information from market participants other than public utilities in the course of a specific enforcement investigation, or in the preparation of a report to Congress. There is a need to strengthen the Commission's ability to collect market information on a routine basis from all market participants, not just public utilities. Improved access to information from all sellers or other entities that have market price information would strengthen our ability to monitor and understand market developments, and take appropriate action to prevent market power abuse.

I also believe the Commission's civil and criminal penalty authority must be strengthened and support section 1283(d) and (e). Civil penalties should apply to any violation of Part III of Federal Power Act, in addition to Part II violations, and legislation should provide for comparable civil penalties for violations of the Natural Gas Act and Natural Gas Policy Act of 1978. I particularly commend Chairman Barton for his foresight in this area. The electricity legislation he authored in 1999—well before the electricity crisis in California and the West—included tough civil and criminal penalties for Federal Power Act violations. If that legislation had been enacted, the strong penalty authority may have discouraged the manipulative practices that ensued.

With respect to other proposed legislative changes, see my response to question 4.

Question 2:

Chairman Wood's response accurately describes steps the Commission has taken to improve grid reliability, encourage regional transmission organization (RTO) formation, and encourage transmission investment.

I believe current law provides the Commission adequate authority to encourage transmission investment. Under current law, the Commission has a legal duty to set transmission rates at a level that attracts investment. The Commission has broad discretion with respect to transmission pricing, and is not bound to any particular ratemaking methodology. Further, the Commission has shown a willingness to consider innovative transmission pricing proposals.

With one exception, I believe current law is adequate to promote RTO formation. That exception is clarifying that Federal utilities such as the power marketing administrations and Tennessee Valley Authority can join RTOs. The conference report on H.R. 6 includes provisions that adequately address this issue.

I believe current law is inadequate to assure grid reliability and site transmission facilities, and there is a need to legislate in these areas.

Reliability

In most respects, section 1211 of the conference report on H.R. 6 provides an adequate process for establishment of reliability standards. The legislation should clarify that the Commission can suspend approved reliability standards if it finds they are unjust, unreasonable, unduly discriminatory or preferential, or not in the public interest, and establish an interim reliability standard pending development of a standard on remand to the electric reliability organization. The enforcement provisions could also be improved. The legislation currently authorizes the electric reliability organization to impose penalties of unstated magnitude for violations of reliability standards approved by the Commission. The legislation should specify a maximum penalty. In addition, penalties should be imposed by the Commission, rather than the electric reliability organization. In my view, enforcement is an inherently governmental function. The electric reliability organization provisions in H.R. 6 are based on the self-regulatory organization model in securities law. Recent experience with respect to these self-regulatory organizations suggests that a Federal agency is better suited to performance of this enforcement role.

Transmission Siting

I recommend the Committee consider adopting the statutory approach used to site interstate natural gas pipelines, as codified in section 7 of the Natural Gas Act. I have come to believe Federal siting is essential to development of a robust transmission grid.

It may be of note that when Congress enacted the Natural Gas Act in 1938, it did not provide for Federal siting of interstate natural gas pipelines. That was added nine years later, after Congress became convinced that state siting was an obstacle to development of a strong interstate pipeline network. Interestingly, this Committee led the effort to grant the Commission authority to site interstate natural gas pipelines in 1947. The legislative history explains why Congress provided for Federal siting:

> Many of the eminent domain laws of the States are inadequate. Some States confer the right only upon corporations incorporated under the laws of such States. Other States grant the right only to public utilities and pipe lines which are serving the people of those States .... The principal reason that a natural gas pipeline company cannot rely upon the eminent domain laws of the States is that a State only has the constitutional authority to confer this right on utilities and pipeline companies serving the people of that State.

In addition, many state laws provided that property may be taken for "public use", but construed "public use" to mean for the use of the public of the particular state conferring the right of eminent domain.

These same factors currently impede siting of electric transmission facilities.

There is little doubt the interstate pipeline network would not be as robust as it is today without Federal siting authority. For the same reasons the Congress concluded Federal siting was necessary for development of a strong interstate natural gas pipeline network, I urge the Committee to provide for Federal siting of transmission facilities.

I believe the best means of siting transmission facilities would be an approach modeled on section 7 of the Natural Gas Act. However, the "Federal backstop" provisions of the conference report on H.R. 6 are an improvement over current law. The provision may work better if Federal decisionmaking were not bifurcated between two Federal agencies, but consolidated at the Commission.

Question 3:

I do not believe legislation is needed in the four named areas. With respect to how enactment of the provisions in question would affect Commission policy, I agree with the comments submitted by Chairman Wood regarding sections 1235, 1236, and 1242. With respect to section 1286, it is difficult to evaluate the impact of the provision on current Commission policy. The Commission has applied the *Mobile-Sierra* public interest standard to interpret power sales contracts that do not adopt a different standard of review, so the impact of the provision may be negligible. However, the outcome of litigation regarding long-term power sales contracts may require Congressional action.

Question 4:

I think there is an urgent need for legislation action to: (1) reform the Federal Power Act to strengthen the ability of the Commission to prevent unjust and unreasonable rates and undue discrimination and preference in wholesale power sales and transmission service, and (2) strengthen our energy infrastructure.

Federal Power Act Reform

The Federal Power Act was enacted 70 years ago this year. It is a well-crafted law that has withstood the passage of time. However, any law reflects the circumstances in which it was enacted. The Federal Power Act reflects certain unspoken assumptions by Congress. One of these assumptions was that there is a natural monopoly in electricity generation. Another was that electricity markets would remain neatly confined within state boundaries. We now know those assumptions are no longer valid as the natural monopoly theory was disproved over 25 years ago and electricity markets in the United States are now regional in nature. In 1935, there was little interstate commerce in electricity, and the transmission grid was largely local in nature. Today, interstate commerce has expanded dramatically, and the transmission grid is not only interstate, but international, extending into Canada and part of Mexico.

While electricity markets and the industry have changed dramatically since 1935, the Federal Power Act remains largely the same. There is a need for some fundamental reforms to Federal electricity law, in the same manner that changes in the telecommunications industry and financial services industry led Congress to make reforms to the Federal laws that govern these industries. Significantly, this Committee led the effort to reform our telecommunications and financial services laws.

The central charge of the Commission today is the same as provided by Congress 70 years ago: prevent unjust and unreasonable rates and undue discrimination and preference in wholesale power sales and transmission service. However, I believe we need different tools to discharge that responsibility, given market and industry changes.

Following is an outline of some specific reforms I believe merit consideration:

- **Market Manipulation**: There is no express prohibition of market manipulation in Federal electricity law—there should be. Securities and commodities law expressly proscribe market manipulation, and authorize Federal agencies to define manipulation by rule or order. In addition, securities and commodities law include tough penalties for market manipulation violations, penalties far greater than provided in the Federal Power Act. I see no reason why manipulation in electricity markets should be subject to a lesser penalty than manipulation in securities and commodities markets. The Federal Power Act should expressly

proscribe market manipulation, authorize the Commission to define market manipulation by rule or order, and provide for civil penalties comparable to those for market manipulation in securities and commodities markets.

- **Enforcement**: The civil and criminal penalty provisions in the Federal Power Act should be strengthened, as discussed in my response to question 1.

- **Market Power**: Under current law, the Commission lacks authority to review dispositions of generation-only facilities. That creates the prospect a significant accumulation of generation market power could escape Federal review altogether, since antitrust agencies do not review acquisitions of generation facilities. State review cannot adequately address generation market power in markets that are regional in nature, extending far beyond state boundaries. In a cost-based regulatory regime, the accumulation of generation market power is arguably less important, since cost-based rates can prevent exercise of generation market power. However, the accumulation of generation market power poses a threat in a regulatory regime where sellers can charge market-based rates. Section 203 of the Federal Power Act should be amended to grant the Commission authority to review generation-only dispositions. The legislation should also clarify the Commission's authority over public utility holding company mergers. The conference report on H.R. 6 includes this latter provision.

- **Market Rules**: Over the years, the Commission's role has evolved from setting rates for individual sellers to setting rules of general application that govern electricity markets. Sometimes, these rules are incorporated into RTO tariffs. There may be a need to revise these rules in an expeditious manner, to ensure reliability or prevent market power abuse. Legislation could authorize the Commission to temporarily suspend or modify tariff provisions.

- **Market Information**: The Commission's authority to collect market information should be strengthened, as discussed in my response to question 1.

- **Transmission Siting**: The Federal Power Act should provide for Federal transmission siting, as discussed in my response to question 2.

- **Open Access to Unregulated Transmission Systems**: Currently, one-third of the transmission grid is owned by transmission owners that for most purposes are not subject to the Commission's jurisdiction. Open access to this part of the grid would make wholesale power markets more competitive. The conference report on H.R. 6 includes provisions that address this need (section 1231).

- **TVA Title**: The Tennessee Valley is the only region of the U.S. where wholesale competition is barred by Federal law. The Tennessee Valley Authority Act of 1933 should be amended to allow wholesale customers in the Valley to purchase from suppliers other than the Tennessee Valley Authority (TVA). In turn, TVA should be authorized to sell excess wholesale power outside the Valley, subject to Commission review. Legislation should also address TVA stranded costs.

- **Reliability**: The Federal Power Act should provide for enforcement of reliability standards, as discussed in my response to question 2.

Strengthen our Energy Infrastructure

- **LNG Import Facilities**: Legislation should clarify the Commission's authority to license liquefied natural gas (LNG) import facilities. The implications of a legal challenge to the Commission's authority are greater than generally understood. If the Commission loses this litigation, the result will extend far beyond the disputed project in California. The question being considered by the court is whether the Commission has authority to license any LNG import facilities, not whether it can license import facilities that interconnect to an intrastate natural gas pipeline. Development of LNG import facilities could be delayed indefinitely if subject to siting decisions by a dozen different states. States have no expertise in this area, and it would take some time for them to develop sufficient expertise to review the complicated safety and siting issues. There is a need for uniform national standards for matters of foreign commerce, such as siting LNG import facilities.

- **Offshore Gathering Facilities**: Under the Natural Gas Act, the Commission regulates natural gas pipelines, and states regulate gathering and local distribution facilities. However, the Act makes no provision for regulation of offshore gathering facilities. That creates the prospect that owners of offshore gathering facilities can charge monopoly rents, which in turn may result in a shut-in of offshore natural gas production. The Commission has tried to act within its current legal authority to prevent unjust and unreasonable gathering rates, but has been repeatedly rebuffed by the courts. Legislation could grant the Commission authority to regulate offshore gathering facilities. Doing so would not curtail state authority, since states lack authority over offshore gathering facilities.