SPEECH OF
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"FERC POLICY ON UTILITY MERGERS"

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Thank you for inviting me to speak with you today. I appreciate the opportunity to discuss Federal Energy Regulatory Commission (FERC) policy. My remarks will focus on development of FERC merger policy since enactment of the Energy Policy Act of 2005, but I invite you to raise other issues in questions at the end.

It has been more than two years since enactment of the Energy Policy Act of 2005, which significantly expanded the Commission's merger and corporate review authority. It did so by amending section 203 of the Federal Power Act to clarify our jurisdiction over holding company mergers, by granting FERC authority over certain holding company securities acquisitions, and by granting the Commission authority to review disposition of generation facilities.

The Energy Policy Act largely codified the merger test used by the Commission, with one significant change, namely adding 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 pledge or encumbrance is in the public interest.

I would like to take the opportunity to review FERC's implementation of its expanded merger authority, address some of the major policy issues that have arisen over the past two years, and comment on FERC policy toward utility mergers.

FERC acted quickly to implement its expanded merger authority, and the past two years have been very active. While we acted quickly, we have also been careful in how we exercised our expanded regulatory authority. Throughout this period, we have sought to facilitate transactions in a capital intensive industry, while discharging our statutory duty to prevent the accumulation and exercise of market power.

Following is a brief review of all the actions the Commission has taken over the past two and half years to implement the Energy Policy Act provisions that revised section 203 of

the Federal Power Act (FPA) and repealed the Public Utility Holding Company Act of 1935:

- Adopted regulations to implement the Public Utility Holding Company Act of 2005 (PUHCA 2005)
- Adopted detailed accounting, reporting, and record retention requirements for utility holding companies and their service companies
- Amended FERC regulations governing corporate transactions subject to FPA section 203 to require explicit consideration of whether a proposed merger or other corporate transaction will result in cross subsidization
- Adopted section FPA 203 filing requirements to provide the Commission with a record that will allow it to address cross subsidization
- Required FPA section 203 applicants to demonstrate that proposed mergers would not result in cross subsidization or the pledge or encumbrance of utility assets, or explain how cross subsidization, pledge, or encumbrance is in the public interest

Last July, the Commission proposed a package of orders that would further implement FPA section 203 as amended by the Energy Policy Act and also use the Commission's FPA section 206 authority to further protect against cross-subsidization:

- Approved a Supplemental Merger Policy Statement that provided additional clarification and guidance on how the Commission would prevent inappropriate cross subsidization, as well as clarifying other aspects of FERC merger policy
- Issued a proposed rule to codify restrictions on affiliate transactions applicable to power and non-power goods and services transactions between utilities with captive customers and affiliates
- Issued a proposed rule that would grant limited blanket authorizations for certain jurisdictional corporate transactions

These orders – once final – would complete our initial implementation of the rules governing future Commission action on section 203 transactions. As you can see, the Commission has been active on merger policy since enactment of the Energy Policy Act. At the same time, we have continued to review and act on proposed utility mergers.

I would now like to turn to some of the merger policy issues that have arisen in the course of FERC implementation of the relevant Energy Policy Act provisions.

<u>Cross Subsidization</u>

Preventing cross subsidization is certainly not a new responsibility for the Commission; it has been a core duty for the agency since 1935. However, normally we police cross subsidies when we review rates, rather than at the point of a merger. So, to that extent

the cross subsidization provisions of the Energy Policy Act were new – charging us with assuring mergers will not result in inappropriate cross subsidization.
We have taken a number of steps to strengthen our protections against cross subsidization. In our rulemaking implementing the revisions to section 203, we required merger applicants to demonstrate that a proposed merger would not result in inappropriate cross subsidization. We followed that action with a package of orders issued last July to strengthen our protections against cross subsidization.

Cross subsidization is a matter of concern to both federal and state regulators, since as a general matter the beneficiaries of cross subsidization protections are both retail consumers and wholesale captive customers. Knowing that, we have been careful in how we exercise our authority to avoid conflict with our state colleagues. Most state commissions have authority to review mergers of state regulated utilities, and most state commissions can impose so-called ring fencing or other conditions designed to protect retail consumers.

Our central focus is the potential for cross subsidization by wholesale customers as a result of a proposed merger. While our primary means of protecting customers at the wholesale level is through rate mechanisms, we must also review whether additional protections are needed in the context of a proposed merger. If the answer is yes, FERC policy is that we will defer to state-imposed protections if they are sufficient to protect wholesale customers. If state commissions do not have authority to impose necessary protections or if state-imposed protections are not sufficient, we will act to fill any regulatory gap. If FERC were to take an expansive approach towards implementation of the new cross subsidization provisions in section 203, and adopt inflexible, mandatory federal standards, the result could be direct conflict with our state colleagues.

Last July, we proposed to codify restrictions on affiliate transactions applicable to power and non-power goods and services transactions between utilities with captive customers and affiliates. We also proposed clarifying the types of mergers that raise legitimate cross subsidization issues and are therefore subject to cross subsidization protections. The reality is that not all transactions subject to section 203 raise legitimate cross subsidization issues. We also provided guidance on what kinds of cross subsidization protections are appropriate, including ring fencing. These actions provide greater regulatory certainty on how the Commission will police cross subsidization.

These orders recognize that cross subsidization is a common concern to both federal and state regulators, seek to avoid regulatory conflict, respect state authority, and attempt to harmonize federal and state regulation in this area.

Repeal of the Public Utility Holding Company Act of 1935

At the same time that Congress expanded FERC's merger authority, it also repealed the

Holding Company Act. The dire predictions about the effects of repealing the Holding Company Act have proven to be greatly overstated. When the Energy Policy Act was enacted, some declared that repealing the Holding Company Act somehow would eliminate state merger review. The course of utility mergers over the past two years has obviously proven that view wrong. In my view, the state role in merger review was not diminished by repeal of the 1935 Act.

Others predicted that there would be a wave of consolidation, that repeal of the Holding Company Act would open the door to mergers. The reality has been that the level of merger activity has not changed dramatically. The Holding Company Act was not a bulwark against mergers, and its repeal did not breach any defenses.

Some predicted that repeal of the Holding Company Act would open the door to financial sector entry into the electricity business and foreign acquisitions of U.S. utilities. This view seemed to ignore the fact that financial sector entry and foreign acquisitions of U.S. utilities began before repeal of the Holding Company Act.

Nonetheless, some observers believe that in its implementation of its expanded merger authority, the Commission should somehow try to resurrect the Holding Company Act. This view may have been encouraged by an accident of statutory drafting. At the same time that Congress repealed the Public Utility Holding Company Act of 1935, it enacted the Public Utility Holding Company Act of 2005.

While the two statutes share a similar title, they otherwise have very little kinship. PUHCA 2005 is a modest law that contains none of the sweeping authority of the Holding Company Act. PUHCA 2005 is a books and records provision, it supplements FERC's pre-existing authority to access the books and records of holding companies and their affiliates and provides for state access to books and records.

FERC has not sought to resurrect the 1935 Act on the thin bones of PUHCA 2005 for the simple reason that PUHCA 2005 has none of the substantial authority of the Holding Company Act, as well as that attempting to do so would be totally inconsistent with Congressional intent in repealing the Holding Company Act.

Conditional Approval

Under the Federal Power Act, FERC is required to approve a proposed merger if it meets our statutory test. Moreover, the Act now includes a time limit for FERC approval. If the Commission does not act on a proposed merger within 180 days, the merger will be deemed granted under the statute unless the Commission finds, based on good cause, that one additional 180 days is needed to rule on the merger.

The Commission exercises its conditioning authority to assure that proposed mergers are

consistent with the public interest. In my view, we have properly exercised that authority. The Commission's major concern in reviewing a proposed merger is the accumulation and exercise of market power, and we exercise our conditioning authority to prevent market power exercise. Where a proposed merger presents market power issues, we will likely exercise our conditioning authority. Where a merger does not present market power issues, we may well approve it without conditions.

Our merger test is clear and well understood. A merger applicant may offer mitigation in anticipation of conditions, in order to expedite Commission review. In that circumstance, Commission approval without further conditions speaks to the clarity of the FERC merger test and our fidelity to making decisions based on the law and the facts, rather than other considerations.

There is some criticism of the Commission for its past merger approvals. However, when we have asked critics to identify completed mergers approved by the Commission that have resulted in harm to consumers or competitive markets, the answer has been silence.

Financial Sector Entry

One development in recent years has been the increased role of the financial sector in the electricity business, as an owner and operator of assets. In general, I view this as a positive development. The electricity industry is one of the most capital intensive industries in the country, and financial sector entry can result in increased investment in generation, transmission, and distribution at a time when the U.S. is confronting the need for significant investment. Indeed, one of the reasons Congress repealed PUHCA 1935 was to remove some of the restrictions on such investments.

As a case in point, consider the acquisition of PacifiCorp by MidAmerican. The result was a much stronger company in financial terms, one that is now poised to make large investments in its transmission system, investments that will benefit a broad region.

The financial sector entered the generation business a number of years ago, but private equity has demonstrated increased interest in the regulated sectors of transmission and distribution. Some of the early efforts by private equity to acquire utilities were unsuccessful, namely the failed acquisitions of Unisource and Portland General Electric. More recent transactions have been successful.

The Commission has no bias against financial sector entry into the electricity business. From one perspective, if these transactions involve a new entrant, they do not present difficult market power issues. The attitude of state regulators towards financial sector entry has been more unpredictable, and some states have rejected financial sector acquisitions approved by FERC. Whether investments are made by the financial sector of other types of investors, the Commission is vigilant to protect captive customers.

Conclusion

Implementation of our expanded merger and corporate review authority has been a major priority of mine over the past two and a half years. The Commission has spent a great deal of time and resources implementing this new authority. Our overall approach towards mergers is to guard against the accumulation and exercise of market power, while facilitating transactions in a capital intensive industry. I believe we have struck the appropriate balance. Once the agency takes final action on the package of orders issued last July, we will have completed our initial implementation of the expanded merger and corporate review authority of the Energy Policy Act of 2005. We will have established the framework for future Commission consideration of section 203 transactions.