



Federal Energy Regulatory Commission
January 18, 2007
Open Commission Meeting
Statement of
Chairman Joseph T. Kelliher

Item M-2: Standards of Conduct for Transmission Providers (RM07-1-000)

"Today, the Commission considers a proposed Standards of Conduct rule that has several important elements. First, we propose to make permanent the revisions to the rule reflected in last week's interim rule with respect to natural gas pipelines. In this regard, we are not suggesting a new factual or theoretical basis for the application of the Standards of Conduct to the non-marketing affiliates of natural gas pipelines. Second, we seek comment on scope of application of the rule to electric utilities. Finally, we propose changes to facilitate state-mandated integrated resource planning and competitive solicitations.

This action comes on the heels of the interim rule we issued last week that directly responded to the decision of U.S. Court of Appeals for the District of Columbia Circuit in *National Fuel* vacating and remanding the Standard of Conduct rule as it relates to natural gas pipelines. The interim rule repromulgated the Standards of Conduct that were not challenged before the court on an interim basis as the Commission considers how to respond to the court's decision on a permanent basis.

Scope of Application of the Standards of Conduct Rule

In *National Fuel* the D.C. Circuit concluded the Commission's promulgation of the Standards of Conduct rule in Order No. 2004 "[did] not reflect reasoned decision making" and was "arbitrary and capricious" as applied to natural gas pipelines.

Order No. 2004 expanded the scope of the rule beyond marketing affiliates to all energy affiliates of both natural gas pipelines and electric utilities. The justification for this expansion to nonmarketing affiliates was both an asserted theoretical threat of undue preference and a claimed record of abuse. However, the court found "FERC here has provided no evidence of a real problem" and "Order 2004 does not include a single example of abuse by nonmarketing affiliates." Instead, the court found the record of abuse appeared to be limited to marketing affiliates. The court also found the Commission advanced no strong theoretical basis for expanding the scope of the rule beyond marketing affiliates to encompass nonmarketing affiliates.

In short, the court found the expansion of the Standards of Conduct rule was fatally flawed in its formation. As the court noted, it lacked any basis in fact, and the Commission advanced no strong theoretical basis for the rule. The court's conclusions were limited to application of the Standards of Conduct rule to natural gas pipelines for the simple reason that electric utilities did not seek judicial review of the rule. However, the reality is that the Commission offered no more substantial basis for expanding the scope of the rule on electric utilities than it did on natural gas pipelines. There appears to be no factual record justifying expansion, and the Commission advanced no strong theoretical argument. That suggests the rule may be arbitrary and capricious as it applies to electric utilities.

The court in *National Fuel* indicated the Commission could seek to justify application of the expanded scope of the Standards of Conduct rule on natural gas pipelines, if we could provide new record evidence or a compelling theoretical argument. The

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court also held open the prospect we could justify the expanded scope of the rule on purely theoretical grounds. Today, we decline to justify application of the expanded scope of the Standards of Conduct rule to natural gas pipelines, and propose instead to narrow application to marketing affiliates, consistent with the interim rule.

The question then turns to whether we should revise the Standards of Conduct rule as it applies to electric utilities. We are under no obligation to do so, but I think we must ask the question. We do so in the proposed rule.

If there was no more record evidence of abuse involving electric utility nonmarketing affiliates than there was for pipeline affiliates, the unavoidable conclusion appears to be that the foundation of the expanded Standards of Conduct rule is fundamentally flawed. However, since there was no judicial challenge to the rule in this respect, we have the discretion to enforce a rule that may be arbitrary and capricious in its formation. I, for one, do not know why we would choose to do so.

To my mind, the threshold question before us is whether a new foundation can be provided for application of the expanded Standards of Conduct rule to electric utilities, or whether the scope of the rule should be narrowed to conform to what we are proposing today for natural gas pipelines. If a new foundation – a sound foundation – can be provided for application of the expanded Standards of Conduct rule to electric utilities, then perhaps we should retain the rule. However, if we conclude there is not new record evidence of abuse involving nonmarketing affiliates and there is no compelling theoretical argument then I believe we should narrow the scope of application to marketing affiliates. There was record evidence supporting application of the rules to marketing affiliates, as well as a strong theoretical basis.

To be clear, I do not rule out that a theoretical threat only would suffice to justify application of the expanded Standards of Conduct rule on electric utilities, if the argument is compelling. The structures of the natural gas pipeline and electric utility industries are different, so I do not rule out the prospect that a compelling theoretical argument can be fashioned.

If the actual purpose of expanded application of the rule is to prevent undue discrimination and preference, the question is whether the rule does so effectively. If the rule does not achieve its stated purpose it is ineffective, and offers little or no public benefit.

The court in *National Fuel* expressed concern about the burden of the rule on vertical integration. The court stated that the Commission cannot impede vertical integration without adequate justification. The question is whether adequate justification exists to maintain the expansive approach of the current Standards of Conduct rule to electric utilities. If the expansive scope of the application of the Standards of Conduct rule imposes undue burdens, it may lack adequate justification.

In its issuance of Order No. 2004, the Commission recognized the importance of consistency in application of the rules to natural gas pipelines and electric utilities. One of the rationales for Order No. 2004 was establishing consistency between application of rules to natural gas pipelines and electric utilities, formerly subject to disparate rules. In my view, this consideration still exists.

Beyond the burdens imposed by Order No. 2004 on the regulated community, there are the administrative burdens on the Commission itself presented by the rule. Order No. 2004 is a difficult rule to administer, and accounts for a significant amount of our enforcement resources. Inconsistency between gas and electric rules would make an already complicated rule even more complex.

Since Order No. 2004 was adopted, the Congress has given us new duties to enforce reliability and anti-manipulation rules in both power and gas markets. While our enforcement resources are growing, they are finite. We face competing demands on those resources, and we have new enforcement missions. How should we allocate our enforcement resources: preventing market manipulation, enforcing reliability rules, or policing an expansive Standards of Conduct rule? I respectfully submit that enforcing reliability rules and preventing market manipulation are higher priorities.

Integrated Resource Planning and Competitive Solicitation

The proposed rule not only responds to the court decision in National Fuel, it also acts on issues raised at technical conferences the Commission has held on the rule. Two issues raised at the technical conference held last spring in Phoenix were integrated resource planning and competitive solicitation.

The proposed rule recognizes the importance of integrated resource planning in many states. Some states require public utilities to periodically submit an integrated resource plan. Some states are requiring greater consideration of transmission in integrated resource planning. Such consideration can conflict with the Standards of Conduct rule. The proposed rule seeks to accommodate state mandated integrated resource planning. Under the proposed rule, the new category of "planning employees" who are permitted to engage in all aspects of integrated resource planning would be limited to planning for bundled retail load. We seek comment on whether the scope of these planning activities should be broadened to include providers of last resort, grandfathered wholesale contracts, and other wholesale requirements loads.

Another area where we respond to concerns of the regulated community, state regulators, and stakeholders is competitive solicitation. Integrated resource planning may call for long term procurement through a competitive solicitation. Such solicitations may be subject to state review, and, if they result in an affiliate transaction, Commission review. We understand the importance of transmission in procurement, and propose to allow "competitive solicitation employees" to conduct competitive solicitations intended to serve bundled retail load, but also seek comment on expanding the coverage to include other loads as well.

This is an area where we must be careful. There is always potential for undue discrimination and preference in affiliate transactions, and the draft being considered today points that out in several places and seeks input from the public on whether the proposal strikes the correct balance.

In conclusion, I emphasize that this is a proposed rule. We have not made final determinations; those will come when we act on a final rule. We seek comment on the important elements of the proposed rule. In particular, we seek comment on the scope of application of the Standards of Conduct rule on electric utilities. Depending

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on the quality of the comments, we may narrow the rule the final rule to conform to our approach with respect to natural gas pipelines or we may propose a new foundation for expanded application of the rules. With respect to integrated resource planning and competitive solicitation, the strength of the comments may affect the scope of the exemptions proposed today. To be clear, from my point of the view what is important is the quality of the argument, not the quantity of the argument.

We have been careful in our approach in this proposed rule. Given the path that led us here today, it is important that we stay within the law, and base our decisions firmly on the law and the facts. We are seeking comment on a number of important changes. I ask stakeholders to give us their best arguments on all the issues raised in the proposed rule, so that we can be certain of acting based on a good record.

As a final point, we intend to move expeditiously towards a final rule. We had a sound basis for issuing the interim rule last week, namely eliminating regulatory uncertainty about how the rule will apply to natural gas pipelines. However, the interim rule stated our intent to issue a final rule revising the Standards of Conduct rule in due course."