Summary of Testimony of
Cynthia A. Marlette
General Counsel, Federal Energy Regulatory Commission
Before the Subcommittee on Energy and Air Quality
Of the Committee of Energy and Commerce
United States House of Representatives
February 10, 2005

Congress should enact legislation to support the competitive wholesale electric markets envisioned in the Energy Policy Act of 1992, help ensure the development of electric and natural gas infrastructure, provide enforceable oversight of the electric transmission grid's reliability, and provide additional regulatory tools to deter market power abuse. The conference report on H.R. 6 addresses the most pressing issues in the areas regulated by the FERC, including a mechanism for mandatory and enforceable reliability standards, providing Federal backstop electric transmission siting authority, providing enhanced civil and criminal penalty authority and enhancing market transparency authority, among others. However, the bill could be further improved with changes to certain provisions in the conference report on H.R. 6 and the addition of other provisions.

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Mr. Chairman and Members of the Subcommittee:

Good morning. My name is Cynthia A. Marlette, and I am General Counsel of the Federal Energy Regulatory Commission (FERC or Commission). Thank you for the invitation to appear here today to testify on the provisions of the Energy Policy Act of 2005. My testimony will focus on issues affecting the responsibilities of the FERC, including wholesale electricity and natural gas markets and the siting of liquefied natural gas (LNG) facilities. I appear today as a Commission staff witness and do not speak on behalf of any Commissioner.

The Congress needs to enact comprehensive energy legislation, including amendments to the Federal Power Act (FPA) and the Natural Gas Act (NGA). Since the Congress last enacted major energy legislation in 1992, significant changes have occurred in energy markets and in the electric industry in particular. The Commission, state commissioners and the industries we regulate continue to face new challenges following the 2000-01 energy crisis in California and the Western United States, the collapse of Enron and the financial problems facing other utilities as a result of that crisis, and the August 2003 blackout that left some 50 million people with no electricity. These events and others underscore the need for Federal legislation. Congress should enact legislation to support the competitive wholesale electric markets envisioned in the Energy Policy Act of 1992, help ensure the development of electric and natural gas infrastructure, provide enforceable oversight of the electric grid's reliability, and provide additional regulatory tools to deter market power abuse.

The FERC-related provisions of the conference report on H.R. 6 address the most pressing issues in the areas regulated by the FERC. The discussion below updates the Subcommittee on progress made by the Commission in the key FPA and NGA areas addressed by the conference report on H.R. 6, recommends changes to certain provisions in the conference report on H.R. 6, and recommends the addition of some new provisions. Since the Energy Policy Act of 2005 had not been introduced at the time this testimony was prepared and may contain provisions that differ from those in the conference report on H.R. 6, this testimony does not include specific recommended legislative text. I would be happy to provide such text once Commission staff has reviewed any newly introduced bill.

Key Provisions in the Conference Report on H.R. 6

The provisions in the conference report on H.R. 6 address the major areas in which FPA and NGA legislation is needed. My testimony identifies possible improvements to the bill.

Reliability

In the past year, in the wake of the Task Force Report on the Blackout of August 2003, the Commission has taken certain actions to enhance the reliability of the electricity grid. On April 19, 2004, the Commission issued a policy statement clarifying that it interprets the term "Good Utility Practice" – which is a requirement currently contained in all public utility open access transmission tariffs – to include compliance with North American Electric Reliability Council (NERC) reliability standards or more stringent regional reliability council standards. Accordingly, public utilities that own, control or operate transmission systems subject to FERC jurisdiction are required to operate their systems in compliance with NERC reliability standards.

In addition, concurrent with the issuance of the policy statement, the Commission issued

an order directing transmission providers to report on their vegetation management practices related to certain overhead interstate transmission lines. The Commission later submitted a report to the Congress summarizing the responses it received from transmission owners, and making certain recommendations on vegetation management practices.

Most recently, in December 2004, the Commission directed certain control area operators and transmission providers to complete a survey on their operator training practices to help determine best operator training practices for the industry. Responses were due on January 31, 2005 and the Commission will report the results to the Congress.

These actions, however, clearly are not a substitute for much-needed reliability legislation. Federal legislation is necessary to provide a clear, enforceable framework for reliability rules. Specifically, a system of mandatory reliability rules, with penalties for violations of these rules, is needed to maintain the reliability of our nation's transmission system. The reliability provisions in the conference report on H.R. 6 generally are adequate. However, the Congress also should consider improving the reliability provisions by giving the Electricity Reliability Organization (ERO) a role in directing utilities to build transmission facilities needed for reliability purposes. Specifically, the ERO should be allowed to direct the expansion of transmission facilities for reliability purposes in areas of the country where a formal, Commission-recognized, regional planning process does not exist. Any expansion directed by the ERO should be subject to siting authorization by states or other governmental entities with jurisdiction. If such governmental entities do not have authority to approve siting or do not act timely on a request for siting, the matter should be subject to the Federal backstop siting procedures contained in section 1221 of the conference report on H.R. 6.

Federal Backstop Electric Transmission Siting Authority

Unlike its authority under the NGA, the Commission currently has no authority to site electric transmission. The conference report on H.R. 6 would provide the Commission with backstop interstate transmission siting authority for certain backbone electric transmission corridors identified by the Secretary of Energy, in the event a state or local entity does not have authority to act or does not act in a timely manner. These provisions would help facilitate the development of important transmission expansions and thus enhance the reliability of the grid, reduce the total cost to customers, or both.

Criminal and Civil Penalties under the FPA and the NGA

The conference report on H.R. 6 would provide the Commission with greater penalty authority under the FPA and the NGA. Specifically, sections 1283 and 332 of the conference report on H.R. 6 propose to increase criminal penalties for violations of the NGA and the FPA and to expand civil penalty authority for violations of Part II of the FPA.

Expanded criminal and civil penalty authority remains a high priority of the Commission. The Commission's current civil penalty authority is extremely limited; for example, civil penalties are available only in very limited circumstances under Part II of the FPA and not at all for violations of the NGA. For violations not subject to civil penalties, the only available civil remedies are refunds, the disgorgement of unjust profits, or revocation of market-based rate authority. While such remedies are significant, they do not serve the same deterrent function that civil penalties could.

Section 1283 of the conference report on H.R. 6 addresses the major gaps under the FPA in civil penalty authority by increasing civil penalty amounts and applying civil penalties to any violation of Part II of the FPA. However, I recommend that this provision be modified to also

apply to any violation of Part III of the FPA. In addition, a similar provision should be enacted to provide for civil penalties for any violation of the NGA.

Price Transparency in Natural Gas and Electric Markets

The Commission has made significant progress on price discovery and price transparency issues, and effective monitoring of natural gas and electric markets. Technical conferences and workshops in the spring of 2003 led the Commission to issue a policy statement on natural gas and electric price indices on July 24, 2003. The Commission then conducted two broad surveys of industry price reporting practices in September 2003 and March 2004; held a public workshop on liquidity issues in November 2003; issued market behavior rules for both electric and natural gas market-based rate jurisdictional sellers in November 2003; issued a comprehensive staff report on price formation issues in May 2004; held a further technical conference on progress to date and the use of price indices in jurisdictional tariffs in June 2004; and, most recently, issued an order on November 19, 2004, outlining plans for further monitoring and adopting requirements for price indices used in jurisdictional tariffs.

With respect to jurisdictional electric sellers, the Commission in April 2002 also finalized new requirements for the electronic filing of quarterly transactions reports. These reports summarize the contractual terms and conditions in public utilities' agreements for all jurisdictional services (including market-based power sales, cost-based power sales, and transmission service) and transaction information for short-term and long-term power sales during the most recent calendar quarter.

Legislation on price transparency would reinforce and help ensure continued progress on these issues. It would be helpful if the Congress clarified the Commission's authority to require the development of an electronic price reporting system, and if the Congress gave the

Commission the ability to require all electric market participants to participate in such a reporting system. If the quality of price discovery continues to improve, continued monitoring may be sufficient, and continued reliance on commercial vendors would be appropriate. If not, the Commission should have the tools to step in and require market participants to provide price information. The Congress also should consider allowing the Commission to rely on a non-governmental entity to compile this information and make it publicly available.

The general framework of section 1281 of the conference report on H.R. 6, which applies to electric market transparency, should also be used for gas transparency legislation. However, several modifications are recommended. First, the provisions should be drafted to permit, but not require, the Commission to adopt an electronic reporting system. Second, the Commission should be able to obtain information from all market participants, subject to appropriate confidentiality protections. While the electric provision permits the Commission to collect market information from all market participants, the gas provision does not. The Commission cannot adequately monitor markets if it is able to obtain information from only a subset of market participants. Third, the Commission should be able to rely on external commercial vendors to collect and publish information, if appropriate. Finally, the savings clause referring to the CFTC should be modified so that it does not inadvertently limit the FERC's existing information collection authority in the context of specific investigations.

Repeal of PUHCA

The conference report on H.R. 6 would repeal the Public Utility Holding Company Act of 1935 (PUHCA), but give the Commission and State regulatory commissions broader access to the books and records of holding companies and their affiliates. This is appropriate. PUHCA was enacted primarily to undo the harms caused by certain holding company structures that no

longer exist. In the almost 70 years since PUHCA was enacted, utility regulation has increased substantially under the FPA (including more rigorous oversight of corporate restructurings such as electric utility mergers), federal securities law and state laws, all of which ensure that customers are protected. The existing integration requirement of PUHCA may actually encourage market structures that impede competition. In particular, under PUHCA acquisitions by registered holding companies generally must tend toward the development of an "integrated public-utility system." To meet this requirement, the holding company's system must be "physically interconnected or capable of physical interconnection" and "confined in its operations to a single area or region." This requirement tends to create greater geographic concentrations of generation ownership, which may increase market power. Further, PUHCA may impede investment in transmission companies in more than one region because it could subject any owner of ten percent or more of a company to becoming a holding company and possibly being required to register under PUHCA.

Repeal of PURPA "Must Purchase" Obligation

The Congress should repeal the Public Utility Regulatory Policies Act of 1978 (PURPA) must purchase obligation where there is a competitive market, but "grandfather" existing PURPA contracts. Section 1253 of the conference report on H.R. 6 limits prospective PURPA repeal to those states where all generation entities have the ability to sell their output to the widest possible range of customers. The provision in the conference report on H.R. 6 on PURPA is adequate.

Electric Utility Mergers

Section 1292 of the conference report on H.R. 6 would amend section 203 of the FPA to increase to over $10 million the value of Commission-jurisdictional facilities that would trigger the need for Commission approval of jurisdictional mergers, dispositions or acquisitions of

securities. The current value is $50,000. It would also amend section 203 to require Commission approval of mergers of holding companies that have public utilities in their holding company systems. Further, it would add specific public interest criteria that the Commission must consider in reviewing section 203 transactions, including whether the proposed transaction would protect consumer interests, would be consistent with competitive wholesale markets, or would impair the financial integrity of any public utility that is a party to the transaction. These criteria are generally consistent with the criteria applied by the Commission under existing law to determine whether a transaction is consistent with the public interest.

Regional Transmission Organizations

Major portions of the country are now served by Regional Transmission Organizations (RTOs) or Independent System Operators (ISOs). The areas covered are the Northeast (ISO New England and the New York Independent System Operator), the mid-Atlantic (PJM Interconnection), the Midwest (Midwest Independent Transmission System Operator (MISO) and Southwest Power Pool (SPP)), California (California Independent System Operator) and most of the state of Texas (ERCOT). This means that electricity customers over a large part of the nation now enjoy the benefits of coordinated regional planning, operation and reliability oversight as well as independent grid decision-making that RTOs and ISOs deliver.

Of recent note are new RTO developments in the Southwest. As a result of efforts in the SPP region, the Commission was able to issue a series of orders resulting in SPP becoming one of four RTOs in the nation. Many of the state commissions in the SPP region (Arkansas, Kansas, Missouri, Oklahoma, and Texas) formed a regional state committee that is already addressing such key issues as transmission cost responsibility and transmission pricing. The Commission has also approved a joint operating agreement between SPP and MISO that will facilitate trade

and reliability oversight between these regions and we have staffed a regional office in Little Rock, Arkansas, to support the SPP and the regional state committee in RTO development and operations.

The Commission also has worked to improve the design and operations of the existing regional transmission organizations. For example, it has devoted extensive resources to working with the MISO staff, participants, and the Organization of Midwest ISO States (the state regulators in the region) to design and establish a single regional dispatch and organized electricity market that will stretch from Ohio to Manitoba to Missouri. This effort has required extensive discussions among market participants and a number of Commission orders addressing regional approaches to a host of market design and operational factors, including protection of existing transmission rights and market monitoring and mitigation. Through these efforts, the MISO market is now scheduled to begin operation on April 1, 2005. The Commission has also approved a joint operating agreement between MISO and PJM that will facilitate trade and reliability oversight between these regions.

The Commission's policy is to encourage membership in RTOs, since RTOs enhance the reliability and economic efficiencies of a region's transmission grid and power supply. The conference report on H.R. 6 endorses voluntary participation in RTOs in section 1232's "Sense of the Congress" statement. This provision is beneficial in light of the major benefits that RTOs can bring to electric markets. In addition, increased membership in FERC-approved RTOs or ISOs by governmental transmitting utilities would provide even further benefits to electric customers, and section 1232 of the conference report on H.R. 6 would facilitate this result for federal power marketing agencies and the Tennessee Valley Authority.

Electric Transmission Rate Incentives

Electric transmission rate incentives can help address the need for transmission in areas where the system has not kept pace with market needs, can increase reliability, and can foster new entry by additional generation options.

The Commission has addressed the issue of transmission rate incentives in a number of recent orders. In 2003, the Commission issued a proposed policy statement to provide rate incentives to transmission owners to promote transmission independence and to provide for efficient expansion of the transmission grid. Specifically, the proposed policy statement would allow a higher return on equity when a utility participates in an RTO or independent transmission company (ITC), sells its RTO-operated transmission assets to an independent company, or pursues additional measures that promote efficient operation and expansion of the transmission grid. The Commission is evaluating the comments received in response to this proposal.

On a case-by-case basis, the Commission also has authorized transmission rate incentives for a number of entities that have proposed to expand transmission infrastructure or taken steps to make their transmission facilities independent from activities of other market participants, such as becoming members of RTOs or forming ITCs. For example, in 2002, it allowed a 50 basis point adder for utilities joining the Midwest ISO, and in 2004, it permitted an independent transmission company alternative incentives for building of transmission infrastructure.

The Commission currently has adequate authority to provide transmission incentives. However, action by the Congress on transmission incentives could provide greater certainty to investors and thus encourage quicker, appropriate investments in grid improvements. The provisions in the conference report on H.R. 6 would lay to rest any potential legal arguments that the Commission lacks authority to provide transmission rate incentives.

Sanctity of Contracts

The enactment of section 1286 in the conference report on H.R. 6 would help resolve disputes about the standard of review to be applied to contracts that do not clearly provide the standard of review. Under the "public interest" standard of review, as opposed to the "just and reasonable" standard of review, a contract may be modified only if it would be contrary to the public interest to allow the contract to remain, e.g., where the financial integrity of the selling utility might be impaired, the rate is unduly discriminatory, or the rate would cast an excessive burden on other customers. Section 1286 of the conference report on H.R. 6 addresses the sanctity of contracts and requires a "public interest" standard of review for new contracts unless a contract expressly provides otherwise. This section would clarify an unclear body of judicial and administrative precedent in an appropriate way that ensures greater preservation of the terms of contracts.

Alaska Natural Gas Pipeline

Last year, the Congress enacted the Alaska Natural Gas Pipeline Act, which clarified issues regarding proposed Alaska transportation projects, and established a framework for the Commission's consideration of applications for such projects. Emergency Supplemental Appropriations for Hurricane Disasters Assistance Act, 2005, Pub. L. No. 108-324, ch. 12, sec. 1201, §101-116, 118 Stat. 1220, 1255-67 (2005). That Act and the pre-existing NGA and Alaska Natural Gas Transportation Act provide the Commission with sufficient authority to address such matters.

An Alaska natural gas pipeline is one of the Commission's highest regulatory priorities. As required by the Alaska Natural Gas Pipeline Act, the Commission is in the process of drafting regulations governing open seasons for the allocation of capacity on Alaska pipeline projects,

and is scheduled to issue those regulations this week. The Commission stands ready to work with potential pipeline proponents, shippers, the State of Alaska, other government agencies, Canada and the public to do everything possible to ensure prompt consideration of proposals to move Alaska natural gas to markets in the lower 48 states.

Alternative Conditions and Fishways for Hydroelectric Projects

Section 231 of the conference report on H.R. 6 would require federal resource agencies that have authority under the FPA to prescribe fishways and establish mandatory conditions in hydroelectric licenses to consider alternative prescriptions and conditions proposed by license applicants. It would also allow alternatives to be proposed by other interested entities.

FPA Refund Effective Date

Section 1284 of the conference report on H.R. 6 would allow refunds from the date a complaint is filed or from publication of a notice that the Commission has instituted a proceeding under its own motion under section 206 of the FPA. This provision appropriately would protect customers by providing an additional 60 days of refund protection.

Additional Legislation

The conference report on H.R. 6 adequately addresses the urgent need for energy legislation. However, there are three additional areas the Congress might want to consider addressing, as described below.

Siting of LNG Facilities

With regard to liquefied natural gas (LNG), in order to effectively and efficiently site infrastructure that is in the public interest, the Congress should consider clarifying the Commission's jurisdiction to site LNG facilities onshore or in state waters, and provide for a

single federal record and for direct appeal of LNG-related decisions to a United States court of appeals. The Commission currently is involved in litigation in the U.S. Court of Appeals for the 9th Circuit with respect to the scope of its authority to site LNG terminal facilities. Legislation could end regulatory uncertainty by clarifying the Commission's authority in this area. A single federal agency should have the statutory authority to determine whether a specific proposal for LNG infrastructure development is in the public interest. While no federal or state agency acting under federal law should lose its existing statutory authority, for example, Coastal Zone Management Act determinations and Clean Water Act certifications, a single agency should be responsible for the final public interest determination and be held accountable for that determination. In addition, the creation of one federal record would allow a single agency to serve as the lead agency for National Environmental Policy Act purposes. All federal and state agencies should work with the lead agency as it develops the record, and provide their decisions under their respective laws to the lead agency, within a timeframe set by that agency. Such a requirement would avoid sequential permitting. Finally, direct appeal to a United States court of appeals would avoid the long delays as individual permit appeal processes wend their way through state and federal administrative appeals, state court and finally federal court appeals over several years.

Economic Dispatch of Electric Facilities

The Congress should consider expanding the provision on "economic dispatch" contained in section 1237 of the conference report on H.R. 6. Economic dispatch refers to a public utility meeting the power needs of its customers by using the most economical facilities available, including those owned or operated by independent power producers. Specifically, the Congress should consider allowing the Commission to require a multi-state public utility to use economic

dispatch if it will reduce the costs incurred in supplying power to the utility's customers. Economic dispatch also could reduce the amount of natural gas used to generate electricity and help alleviate the demand pressures on today's natural gas prices.

Authority to Require Emergency Revisions to FPA Tariffs

It would be helpful if the Congress gave the Commission emergency authority to approve temporary changes to, or temporarily suspend, tariff provisions on file with the Commission, if necessary to ensure reliability or prevent market power abuse. Today's markets are much more dynamic than traditional cost-based arrangements and can need corrective action much more quickly than the procedures historically used under the FPA. Legislation providing temporary authority to change or suspend tariff provisions without notice and comment, for a period up to 30 days, would allow the Commission to better protect customers in emergency circumstances.

Conclusion

Thank you again for the opportunity to address legislative recommendations to the Congress. The conference report on H.R. 6 would resolve appropriately the most important issues raised by the need to ensure an adequate supply of energy at reasonable prices. My testimony offers some additional improvements that the Congress should consider. With or without these improvements, the Congress needs to pass an energy bill. Our Nation's energy customers deserve no less. I would be happy to provide additional information or assistance as the Subcommittee reconsiders this legislation.