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 already has substantive authority to do this under the FPA now that PUHCA 1935 has been repealed.

The Commission implemented its responsibilities under EPAct 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 EPAct 2005's Merger and PUHCA Provisions

Upon enactment of EPAct 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 detailed 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

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

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 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.