

**Testimony of Chairman Jon Wellinghoff
Federal Energy Regulatory Commission
Before the Energy and Environment Subcommittee
Of the Committee on Energy and Commerce
United States House of Representatives
Impacts of H.R. 3795,
the Over-the-Counter Derivatives Markets Act of 2009,
on Energy Markets
December 2, 2009**

Mr. Chairman, Ranking Member Upton and members of the Subcommittee:

Thank you for the opportunity to appear before you today. My testimony will address the creation, operation and oversight of electric markets conducted by regional transmission organizations (RTOs) and independent system operators (ISOs), and how they may be affected by current or future laws focused on financial derivatives. Whatever decisions Congress makes for currently-unregulated financial derivatives, those decisions should not apply to RTO/ISO markets, which are already regulated fully, comprehensively and effectively by FERC. Any amendments to the Commodity Exchange Act should preserve FERC's exclusive oversight of RTO/ISO rates, terms and conditions for power sales and transmission service, and prevent dual regulation of RTO/ISO markets by FERC and the Commodity Futures Trading Commission (CFTC).

As my colleague, Chairman Gensler, recently testified to the House Committee on Agriculture about certain financial markets: "While seeking to address the gaps and inconsistencies that exist in the current regulatory structure of complex, consolidated financial firms, the proposals also may have unintentionally encompassed robustly regulated markets...." The RTO/ISO markets are just such robustly regulated markets, developed and refined under FERC's supervision over the last ten years. They are, as Representative Frank Lucas at the same hearing reportedly described, "specialized, nuanced market[s]," with "competent regulators and an effective regulatory scheme."

Background

Since the late-1970s, Congress has encouraged competition in the electric industry. This effort has included legislation such as the Public Utility Regulatory Policies Act of 1978 (facilitating market entry by combined heat-and-power facilities and small renewable energy facilities), the Energy Policy Act of 1992 (expanding FERC's authority to require transmission service upon customer application, and reducing barriers to entry by independent power producers) and the Energy Policy Act of 2005 (reducing barriers to investment in the industry, subject to protection against cross-subsidization by ratepayers).

The Commission also has encouraged competition. FERC's Order No. 888, issued in 1996, was a landmark in this effort, requiring public utilities to offer transmission service to others on non-discriminatory rates, terms and conditions. Order

No. 888 also encouraged the formation of ISOs, to operate all of the transmission facilities in a geographic area. ISOs were aimed at encouraging competition by facilitating development of regional power markets, and enhancing trading opportunities for a region's buyers and sellers. Several years later, FERC's Order No. 2000 encouraged the formation of RTOs, which perform the same transmission functions as ISOs but generally are larger in geographic scope. Today, RTOs and ISOs operate not only transmission facilities but also markets for trading electric energy among utilities.

RTO and ISO power markets and transmission services are tightly integrated, and regulated to an extent beyond most other markets. The rules for RTO and ISO markets are specified in lengthy tariffs (hundreds or thousands of pages) reviewed and approved by FERC. In order to analyze these tariffs, the Commission draws upon expertise in various disciplines, including attorneys, economists, energy industry analysts, and engineers. The tariffs contain numerous requirements and mechanisms to ensure reasonable rates and a reliable supply of electricity. These rules are carefully designed to facilitate competitive forces within a heavily-regulated industry. The RTOs and ISOs themselves are not "self-regulating organizations," but are legally considered to be "public utilities" and in fact are regulated more extensively than other public utilities.

Generally, the Commission's responsibility in the energy industries is to ensure that consumers have adequate supplies of energy at reasonable prices. More specifically, Federal Power Act sections 205 and 206 require the Commission to ensure that the rates, terms and conditions offered by RTOs, ISOs and other public utilities are just, reasonable and not unduly discriminatory. This responsibility applies to wholesale sales and transmission of electricity in interstate commerce, as well as contracts or other arrangements and practices significantly affecting those sales and services.

Commission staff monitors the RTO and ISO markets to ensure that the markets are functioning efficiently and appropriately. This is done by monitoring market results and conditions (e.g., RTO and utility load forecasts, weather and outages) and identifying anomalies. When the available data does not explain the anomalies, staff examines the matter and, if legitimate reasons are not found, investigations are initiated to determine if fraud or manipulation has occurred.

The Commission also requires each RTO or ISO to have an independent market monitor. The market monitors can review all market activities in real-time. They also evaluate market rules and recommend changes, review and report on the performance of these markets, and must refer to the Commission any potential violations of the Commission's rules, regulations or orders.

The Energy Policy Act of 2005 gave the Commission the authority to assess substantial penalties (a million dollars a day per violation) for fraud and market manipulation, including manipulation of RTO and ISO markets. The Commission has initiated several proceedings based on this authority. This authority applies to participants in RTO and ISO markets as well as any other entity engaging in fraud or market manipulation in connection with a FERC-jurisdictional transaction.

FERC's efforts on market oversight and enforcement have increased greatly in recent years. At the start of this decade, FERC investigatory staff consisted of 14 attorneys and a few support personnel within its Office of General Counsel. Today, staff in FERC's Office of Enforcement (including market oversight, investigations, audits and financial regulation) numbers over 180, including 40 attorneys in its Division of Investigations. For fiscal year 2009, FERC's efforts yielded settlements worth approximately \$38 million in penalties and \$38 million in disgorgement. Six of those matters involved market manipulation claims and accounted for approximately \$20.8 million in penalties and \$28.8 million in disgorgement.

Financial Transmission Rights

The question of CFTC regulation of RTOs and ISOs has arisen in several contexts. Examples include RTO/ISO markets for financial transmission rights (FTRs), capacity markets and day-ahead markets. Another example is the question of whether RTOs/ISOs should be considered "clearing" organizations within CFTC jurisdiction. I will focus on FTRs, as an illustration of the possible effects of CFTC regulation in these areas.

FTRs allow customers to protect against the risk of price increases for transmission services in RTOs/ISOs. An FTR is a right to avoid, or be compensated to the extent of, congestion costs between two specific points. For example, if the transmission capacity going from Point A to Point B is 500 MW, but transmission customers seek to send 600 MW of power from Point A to Point B, the path will be congested, and the price of service will increase. The increase is referred to as congestion costs.

In general, load-serving entities in RTOs/ISOs are allocated either FTRs or rights convertible into FTRs. The allocation is generally based on usage during a historical period, as modified in certain circumstances for later changes. While allocated FTRs are generally limited to load-serving entities and to those who funded construction of specific transmission facilities, other FTRs are auctioned and these generally can be purchased by any creditworthy entity.

Historically, FTRs were developed to give load-serving entities price certainty similar to the pricing methods in non-RTO/ISO markets. In most cases, FTRs have terms of one year or less. In the Energy Policy Act of 2005, however, Congress enacted Federal Power Act section 217, requiring FERC to use its authority in a way that enables load-serving entities to secure FTRs on a long-term basis for long-term power supply arrangements made to meet their customer needs.

Unlike "futures contracts," FTRs are available only to the extent allowed by the physical limits of the grid. All of the FTRs must be "simultaneously feasible" on the grid. Markets for FTRs include hundreds or thousands of different FTRs (for each

pairing of receipt and delivery points) and thus are much more fragmented and less liquid than typical contracts traded on futures exchanges.

FTR markets do not pose systemic risk to the economy. All FTR markets combined amount to roughly several billion dollars. This market level fluctuates depending on the level of physical congestion in each RTO and is expected to decrease substantially as more transmission is built relieving congestion.

The Commodity Exchange Act and H.R. 3795

Questions have been raised about whether RTOs and ISOs, including FTRs or other RTO/ISO products, fall within CFTC jurisdiction under the Commodity Exchange Act. Similar questions arise under H.R. 3795.

For example, some may argue that an FTR is a solely financial arrangement and constitutes a futures contract under the Commodity Exchange Act, or that an RTO or ISO is a “derivatives clearing organization” under that Act. Either of these arguments, if accepted, may establish CFTC jurisdiction.

Moreover, my understanding is that the CFTC construes its jurisdiction under the Commodity Exchange Act to be exclusive. If so, the issue could become, not whether to allow dual regulation by FERC and the CFTC, but whether FERC regulation will be ended and replaced by CFTC regulation.

Under H.R. 3795, some may argue that FTRs fit within the definition of a “swap,” or that RTOs/ISOs fit within the definitions of a “swap dealer” or “major swap participant.” If so, these markets or entities may be subjected to a regulatory scheme crafted for circumstances entirely unrelated to, and arguably ill-suited for, the organized power markets.

Application of H.R. 3795 to RTOs and ISOs may raise an additional problem. The Commodity Exchange Act currently allows the CFTC in certain circumstances to grant exemptions from its requirements. Even if the CFTC interprets the Commodity Exchange Act as applying to RTOs and ISOs, the CFTC may have discretion under the current provisions of that Act to exempt RTOs and ISOs from some or all of its requirements. H.R. 3795, however, would limit more narrowly the CFTC’s authority to grant exemptions from its requirements, and may preclude the CFTC from taking such action. I am not arguing against this aspect of H.R. 3795, but merely noting its possible effect if H.R. 3795 is applied to RTOs and ISOs.

Congress Should Preserve FERC Regulation of RTOs/ISOs

In addition to offering FTRs, certain RTOs and ISOs operate day-ahead and real-time energy markets, capacity markets and ancillary service markets. The rules for determining the prices for various power sales and transmission services – including

congestion costs – are inextricably intertwined in the tariffs and in software as an integrated market design.

All elements of these markets are approved by FERC, incorporated into FERC-approved tariffs, and monitored closely by the independent market monitors and FERC. Subjecting one or more of these to CFTC regulation could disrupt the integrated functioning of RTO/ISO markets, leading to market inefficiencies and higher energy costs for consumers.

For example, as noted above, load serving entities generally are allocated FTRs as a means to hedge the transmission costs they incur and, ultimately, recover from their customers. CFTC requirements on position limits could conceivably require different allocations than the tariff rules approved by FERC, even though CFTC-type position limits have not been needed in the past to ensure reasonable results. A utility currently allocated, *e.g.*, half of the FTRs on a transmission path it has used and funded for many years could find its allocation reduced significantly, and find itself unhedged against congestion costs.

Similarly, subjecting FTRs to CFTC clearing rules could conflict with FERC-approved tariff provisions on creditworthiness. FERC-approved tariffs reflect a balance between limiting the risk of defaults and unduly increasing the costs incurred by market participants and, ultimately, consumers. FERC also recognizes that different approaches to credit may be warranted for different types of power market participants (such as municipal utilities, cooperative utilities and federal agencies), unlike the one-size-fits-all approach that may suit other markets. There is no reason to assume that policies crafted by the CFTC in a different regulatory context apply equally well here.

Congress has recognized FERC's role in ensuring that FTRs help protect utilities and their customers from increases in the cost of transmission service. As noted above, Congress in 2005 enacted Federal Power Act section 217, requiring FERC to use its authority in a way that enables load-serving entities to secure FTRs on a long-term basis for long-term power supply arrangements made to meet their customer needs.

Moreover, Congress has indicated that RTOs and ISOs should be regulated exclusively by FERC. When Congress enacted the Food, Conservation, and Energy Act of 2008 and gave the CFTC authority over “significant price discovery contracts [SPDCs],” the Conference Report stated (on page 986) that “[i]t is the Managers’ intent that this provision [on SPDCs] not affect FERC authority over the activities of regional transmission organizations or independent system operators because such activities are not conducted in reliance on section 2(h)(3) [of the Commodity Exchange Act].” In a colloquy with Senator Bingaman, Senator Levin emphasized this point, stating that “it is certainly my intention, as one of the amendment’s authors – that FERC’s authority over RTOs would be unaffected.” Cong. Rec., Dec. 13, 2007, S15447. More recently, the House of Representatives passed H.R. 2454, the American Clean Energy and Security Act of 2009, which (in section 351) would amend the Commodity Exchange Act to define “energy commodity” as including “electricity (excluding financial transmission

rights which are subject to regulation and oversight by the Federal Energy Regulatory Commission.)”

Congress has taken care to avoid duplicative regulation elsewhere in the electric industry. For example, the Federal Power Act exempts state agencies from regulation as public utilities; preserves State authority over local distribution and intrastate commerce (including much of Texas); and exempts cooperatives from regulation as public utilities if they are financed by the Rural Utilities Service. The same approach of avoiding duplicative regulation is warranted for the organized power markets.

The impetus for H.R. 3795 is the recent financial turmoil caused by certain unregulated financial derivatives and other factors. As Chairman Gensler stated in recent testimony before the House Committee on Agriculture: “One year ago, the financial system failed the American public. The financial regulatory system failed the American public.” He also stated that “[w]e now face a new set of challenges as the nation continues to recover from last year’s failure of the financial system and the financial regulatory system.” The organized power markets, and FERC’s regulatory system, did not cause these problems. Any response by Congress should address the source of these problems, and not inadvertently sweep in the FERC-regulated markets, since these have continued to perform well.

In short, the RTO and ISO markets should remain subject to FERC’s exclusive jurisdiction. FERC encouraged development of these markets, and has regulated all of their rules, for the purpose of facilitating pro-consumer competition. FERC has many years of experience with the development and functioning of these markets. While I and others continue to seek improvements in these markets, I see no problem in these markets that would be solved by supplementing or displacing FERC oversight with CFTC oversight. No regulatory failure has occurred that would warrant such a major shift in oversight of these markets. These markets are vital in meeting the electricity needs of many millions of Americans, and nothing has been proffered to warrant the uncertainty of inserting a new regulator and a new regulatory regime.

Conclusion

Last month, Chairman Gensler testified that giving the Federal Reserve certain authority in financial markets “has the potential of setting up multiple regulators overseeing markets and market functions in the United States.” He also stated that “[w]hile it is important to enhance the oversight of markets by both the SEC and CFTC, I think Congress would want to closely consider whether it’s best to set up multiple regulators for some functions.” The context of today’s hearing is different, but the concern is the same. Any improvements warranted in RTO and ISO markets can be made by FERC. Interposing a new regulator, or having multiple regulators, has not been justified, is not needed and would be harmful.