

**Summary of Testimony of
William L. Massey, Commissioner
Federal Energy Regulatory Commission**

**Before the Subcommittee on Energy and Air Quality
Committee on Energy and Commerce
United States House of Representatives
March 5, 2003**

I applaud Chairman Barton's efforts to enact energy legislation and appreciate this opportunity to testify on the discussion draft of the Energy Policy Act of 2003. I generally support the policy direction in most of the draft provisions.

In the electricity title of the draft, I agree with the call to form Regional Transmission Organizations. I urge Congress to clarify that the FERC has the authority to require their formation. The proposal to provide the Commission with backup authority for transmission siting is an excellent idea. I support the authorization to develop an electronic information system regarding the price and availability of services in the market and the prohibition of round trip trading and urge the Congress to extend these provisions to natural gas markets. Increasing the level of civil penalties the Commission may impose is a welcome addition to the tools we have to police markets. I recommend that the Commission be given direct authority to mitigate market power in jurisdictional markets. Removing the 60-day delay in the refund effective date for complaints provides additional customer protection, but the Commission needs clear authority to order refunds for past periods when flawed markets or anticompetitive behavior resulted in unjust and unreasonable rates. I cannot support repealing the Commission's merger review authority under the Federal Power Act.

Recent gas price volatility is of great concern, and we should investigate the phenomenon to determine whether the price spikes are a dramatic response to normal weather cycles, or whether other forces are at work. I am deeply concerned about the impact of these high prices on customers. The Commission would be better able to evaluate natural gas price spikes if there were greater price transparency. I would amend section 7081 to extend its information availability provisions to natural gas markets. Likewise, I would also amend Section 7084 to provide the Commission with authority to impose civil penalties for violations of the Natural Gas Act, which FERC now lacks.

I fully support measures to facilitate natural gas supply projects, such as FERC's light-handed regulation of LNG, and efforts to streamline processing of natural gas infrastructure applications. Finally, I am ready to consider any proposal or proposals for new pipelines to bring Alaska natural gas to consumers in the state and to the lower forty-eight states.

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Mr. Chairman and members of the Subcommittee on Energy and Air Quality, thank you for the opportunity to provide testimony about the important energy policy issues facing both this subcommittee and the Federal Energy Regulatory Commission.

There are high prices in energy markets as the much colder than normal winter of 2003 lingers and demand for natural gas remains high. Natural gas prices both in the production and market areas are sharply higher than normal and unusually volatile. Members of Congress have asked the Commission to investigate the cause of these dramatic price spikes. Higher natural gas prices have caused a sharp spike in electricity prices as well in a number of markets. These events are rippling through the U.S. economy, impacting industrial users, businesses and residential consumers.

In addition, the western energy crisis, coupled with the collapse of Enron, have left their wake within the energy industry. Investor and lender confidence has been shaken by these events, by a declining national economy, indictments of energy traders, accounting irregularities, downgrades by rating agencies, and continuing investigations by the FERC, CFTC, SEC and Justice Department. These investigations are important and necessary, and must leave no stone unturned. Nevertheless, all of these events have an impact on

investor and lender confidence and have severely eroded capital availability for the energy industry.

In these times, it is particularly important for the Commission to promote clear market rules and structure, reasonable and stable regulation of energy transmission, and comprehensive market monitoring. The Commission must conduct thorough and forceful investigations and oversight to ferret out abuses.

In his testimony, Chairman Wood provides a thorough outline of the initiatives underway at the Commission that are aimed at reforming electricity and natural gas markets to ensure just and reasonable prices and customer benefits. I would like to applaud Chairman Wood's leadership. I share his vision of well functioning markets with regulators playing an important role in determining market structure, prohibiting discrimination, enforcing transparent market rules, and engaging in vigilant oversight and monitoring. In the interest of brevity, I would like to associate myself with his excellent testimony.

I will comment on particular issues raised by Chairman Barton's draft legislation and by the subcommittee in its letter of invitation to testify.

I. Electricity Issues

The development of competitive efficient wholesale electricity markets is a highly desirable goal. This is primarily a federal responsibility, and achieving this goal will

benefit our nation's consumers and economy. There are, however, a number of barriers to the creation of robust markets, including grid operation influenced by merchant interests and a patchwork of markets and rules governing the grid. Almost a third of the grid is not subject directly to the FERC's open access and nondiscrimination requirements.

Necessary grid expansion is not keeping pace with the requirements of robust wholesale markets. This means that cheaper power cannot always reach the customers who want it. The lack of uniformity in generation interconnection standards among regions and utilities poses unnecessary barriers to entry by generators that could provide cheaper power for consumers. Demand responsiveness could act as a brake on price run ups, yet is generally absent from electricity markets. Vibrant markets require a reliable trading platform, yet there are no legally enforceable reliability standards.

Ensuring just and reasonable prices must be addressed far differently as we move to competitive markets than under the monopoly structure. It is more complex now. The basic nature of our regulatory tasks is changing. We are moving away from reviewing cost-based prices charged by individual sellers and toward ensuring good performance by markets.

Transmission infrastructure improvement rulemaking

Section 7011 of the discussion draft submitted by Chairman Barton requires the Commission to adopt rules providing for incentive-based and performance-based

transmission rates. I support such a policy direction. The Commission has already taken a step in this direction with our proposed policy on incentive transmission rates that provides enhanced returns on equity for transmission assets that are operated independently from market participants and for new infrastructure investment.

Transmission will remain a monopoly service in restructured markets and will need to be regulated, but a performance-based rate approach, while presenting its own significant challenges, shows promise as a way to reward efficient behavior while protecting customers.

Section 7011 also requires the Commission to adopt rules allowing participant funding for new transmission investment if it is requested by an RTO or other Commission-approved transmission organization. I support this policy direction. I have strongly supported the participant funding provision in the Commission's Standard Market Design proposal. It allows participant funding where there is a locational pricing regime in place and the grid is managed by an entity that is independent of market participants.

Transmission Siting

Although the Commission is responsible for well functioning electricity markets, it has no authority to site the electric transmission facilities that are necessary for such markets to thrive and produce consumer benefits. Existing law leaves siting entirely to

state and local authorities. This contrasts sharply with section 7 of the Natural Gas Act, which authorizes the Commission to site and grant eminent domain for the construction of interstate gas pipeline facilities. Exercising that authority, the Commission balances local concerns with the need for new pipeline capacity to support evolving markets.

The transmission grid is the critical superhighway for electricity commerce, but it is becoming congested because of the new uses for which it was not designed.

Transmission expansion has not kept pace with changes in the interstate electricity marketplace. Adequate grid facilities are essential to robust wholesale power markets. I am confident that transmission will be built in sufficient quantities if siting authority is rationalized, appropriate price signals and independent regional grid operation are put in place, and adequate cost recovery mechanisms and risk-based rates of return are allowed.

Proposed section 7012 provides the Commission with backstop siting authority to ensure that the necessary transmission facilities are built in areas designated as an "interstate congestion area" by the Secretary of Energy, and grants authority for states to form interstate compacts for regional siting coordination. This provision appears to provide appropriate respect for the siting prerogatives of the states and recognizes the regional nature of today's electricity markets. The provision has my support.

One Set of Transmission Rules

All interstate transmission should be provided under one set of open access rules. That means subjecting the transmission facilities of municipal electric agencies, rural cooperatives, the Tennessee Valley Authority, and the Power Marketing Administrations to the Commission's open access rules. These entities control a substantial share of the nation's electricity transmission grid. Their current non-jurisdictional status has resulted in a patchwork of rules that may hinder seamless electricity markets. Markets require an open non-discriminatory transmission network in order to flourish.

Section 7021 of the discussion draft would allow the Commission to require open access service under a comparability standard by entities that are currently not covered under our open access rules. I support the thrust of this provision.

Regional Transmission Organizations

The Commission has made substantial progress in forming the Regional Transmission Organizations that are critical to the competitive market place. I firmly believe that large RTOs consistent with FERC's vision in Order No. 2000 are absolutely essential for the smooth functioning of electricity markets. RTOs will eliminate the conflicting incentives vertically integrated firms still have in providing access. RTOs will streamline interconnection standards and help get new generation into the market. RTOs will improve transmission pricing, regional planning, congestion management, and

produce consistent market rules. We know for a fact that resources will trade into the market that is most favorable to them. Trade should be based on true economics, not the idiosyncracies of differing market rules across the region.

I interpret section 7022 of the discussion draft as a clear declaration by the Congress that these institutions are in the public interest and should be formed. It is my hope that such a clear message from Congress will speed the formation of these critical institutions in all regions of the nation. But I believe even stronger action may be appropriate. I recommend that the Congress clarify existing law to authorize the Commission to require the formation of RTOs and to shape their configuration. Well structured Regional Transmission Organizations are necessary platforms on which to build efficient electricity markets. The full benefits of RTOs to the marketplace will not be realized, however, if they do not form in a timely manner, if they are not truly independent of merchant interests, or if they are not shaped to capture market efficiencies and reliability benefits.

Reliability

Section 7031 of the discussion draft would provide for an Electric Reliability Organization that is independent of market participants, to develop and enforce mandatory reliability standards subject to Commission oversight. I support this provision. We need mandatory reliability standards. Vibrant markets must be based upon a reliable

trading platform. Yet, under existing law there are no legally enforceable reliability standards. The North American Electric Reliability Council (NERC) does an excellent job preserving reliability, but compliance with its rules is voluntary. A voluntary system is likely to break down in a competitive electricity industry. Mandatory reliability rules are critical to evolving competitive markets.

Demand Responsiveness

Markets need demand responsiveness to price. This is a standard means of ensuring good resource allocation decisions and moderating prices in well-functioning markets, but it is generally absent from electricity markets. When prices for other commodities get high, consumers can usually respond by buying less, thereby acting as a brake on price run-ups. Without the ability of end use consumers to respond to price, there is virtually no limit on the price suppliers can fetch in shortage conditions. Consumers see the exorbitant bill only after the fact. This does not make for a well functioning market.

Instilling demand responsiveness into electricity markets requires two conditions: first, significant numbers of customers must be able to see prices *before* they consume, and second, they must have reasonable means to adjust consumption in response to those prices. Accomplishing both of these on a widespread scale will require technical

innovation. A modest demand response, however, can make a significant difference in moderating price where the supply curve is steep.

Section 7061 of the discussion draft sets out requirements for real-time pricing and time of use metering and communications. I support these provisions as necessary first steps toward increasing demand responsiveness in electricity markets. I regard these provisions as a message from the Congress that instilling a significant measure of demand responsiveness into electricity markets is in the public interest. I recommend that legislation strongly encourage FERC and state commissions to cooperate in designing markets that include demand responsiveness. This would help to ensure just and reasonable wholesale prices and would be an effective market power mitigation measure.

PURPA purchase obligation

Section 7062 of the discussion draft would remove the purchase obligation on the part of utilities for power from a QF facility if the QF has access to independently administered day ahead and real time markets, if the utility is a member of an RTO, or if the Commission otherwise finds the QF has access to a competitive market for electricity. I support the policy direction of this section.

Market transparency rules

Section 7081 of the discussion draft requires an electronic information system, under the Commission's oversight, that provides information regarding the availability and price of wholesale energy and transmission services. I support this measure as providing additional transparency to energy markets. Transparency is absolutely necessary for good market decisions and to protect against manipulation and other abuses. I recommend that Congress broaden the coverage of this section to include natural gas markets as well. Natural gas markets would certainly benefit from transparency, and natural gas is an increasingly important input to electricity production.

Section 7081 also prohibits what has come to be known as round trip trading. I strongly support this prohibition, and recommend that Congress also extend this prohibition to natural gas trading.

Civil Penalties and Enforcement

Section 7084 of the discussion draft significantly increases the penalties available to the Commission. I support this provision. If the Commission is to be the "cop on the beat" of competitive markets, we must have the tools needed to ensure good behavior. Refunds alone are not a sufficient deterrent against bad behavior. The consequences of engaging in prohibited behavior must be severe enough to act as a deterrent.

I believe additional tools are needed for the Commission to ensure that markets are structured so that the benefits of competition will inure to consumers. The FERC, with its broad interstate view, must have adequate authority to ensure that market power does not squelch the very competition we are attempting to facilitate. However, the Commission now has only indirect conditioning authority to remedy market power. This is clearly inadequate. Therefore, I recommend legislation that would give the Commission the direct authority to remedy market power in wholesale markets, and also in retail markets if asked by a state commission that lacks adequate authority. For example, such authority would allow the Commission to order structural remedies directly, such as divestiture, needed to mitigate market power.

Refunds

Section 7091 of the discussion draft would expand the refund protection under section 206 of the Federal Power Act by eliminating the 60-day delay in the refund effective date. I support this provision but would recommend additional protections. As we have seen from past experience, when market structure and market rules are flawed, or when suppliers act in an anticompetitive manner, electricity prices can quickly rise to exorbitant levels. During the time that it takes to detect the market flaws or misbehavior and to file a complaint, unjust and unreasonable rates are charged. The Federal Power Act states that such rates are absolutely unlawful. Yet, the weight of court precedent

strongly suggest that retroactive refunds are impermissible. I recommend clear statutory language that would allow the Commission to order refunds for past periods if the rates charged are determined to be unjust and unreasonable. Limitations may be appropriate on how far back in time the Commission can order refunds.

Review of Mergers

Section 7101 of the discussion draft repeals the Commission's authority to review mergers. I do not support this provision. As we strive to move toward competitive markets and light-handed regulation, the Commission's ability to remedy market power is increasingly important. Market power is likely to exist in the electric industry for a while. It is unreasonable to expect an industry that has operated under a heavily regulated monopoly structure for 100 years suddenly to shed all pockets of market power. An agency such as the FERC with a broad interstate view must have adequate authority to ensure that market power does not squelch the very competition the Commission is attempting to facilitate.

The Commission's authority over mergers is important. While mergers can produce efficiencies, they can also increase both horizontal and vertical market power. The Commission is particularly well suited to evaluate proposed mergers involving electric utilities. The Commission's detailed experience with electricity markets and its unique technical expertise can provide critical insights into a merger's competitive effects.

In addition, the Commission's duty to protect the public interest is broader than the focus of the antitrust agencies and thus allows us to better protect consumers from other possible effects of a merger, such as unreasonable costs. As the architect of Order No. 888 and Order No. 2000 (the RTO rule), the Commission must retain the authority to condition a merger to ensure consistency with broader policy goals. And unlike the antitrust agencies, the Commission's merger procedures allow public intervention and participation in proceedings critical to the restructuring of this vital national industry.

For these reasons, I would not support any weakening of the Commission's merger authority. Indeed, to ensure that mergers do not undercut our competitive goals, I recommend that the Commission's authority over electricity mergers be strengthened in a number of ways. The Commission should be given direct authority to review mergers that involve generation facilities. The Commission has been upheld in its interpretation of the Federal Power Act as excluding generation facilities *per se* from our direct authority. It is important that all significant consolidations in electricity markets be subject to Commission review. For the same reason, the Commission should be given direct authority to review consolidations involving holding companies.

I am also concerned that significant vertical mergers can be outside of our merger review authority. Under section 203 of the FPA, our merger jurisdiction is triggered if there is a change in control of jurisdictional assets, such as transmission facilities. Consequently, consolidations can lie outside of the Commission's jurisdiction depending

on the way they are structured. For example, a merger of a large fuel supplier and a public utility would not be subject to Commission review if the utility acquires the fuel supplier, because there would be no change in control of the jurisdictional assets of the utility. If the merger transaction were structured the other way, i.e., the fuel supplier acquiring the utility, it would be subject to Commission review. Such vertical consolidations can have significant anticompetitive effects on electricity markets. Those potential adverse effects do not depend on how merger transactions are structured, and thus our jurisdiction should not depend on how transactions are structured. Therefore, I recommend that the Commission be given authority to review all consolidations involving electricity market participants, however structured.

II. Natural Gas Issues

Gas Price Volatility

We have been following with great interest and concern the sharply higher and volatile natural gas prices over the last couple of weeks. The sustained cold weather brought prices at the Henry Hub up to the \$ 4 to \$ 5 range early in the winter, and prices have risen steadily as the winter weather has persisted without much letup. In recent days, there have been large price increases that we have not seen in some time. Since February 21, prices at the Henry Hub have ranged from a low of \$ 6.73 to a high of \$18.60 on February 25. It is vitally important that the Commission investigate this

phenomenon to get a clear understanding as to what is driving this volatility and to determine whether these price spikes are a dramatic response to normal seasonal cycles, or other forces are at work.

This winter has been one of the coldest in years in the Northeast, Mid-Atlantic and Midwest states. By some reports, it has been 29 percent colder in these regions than last year, and demand has increased accordingly. Late winter storage is being drawn down more rapidly than was expected, and cold weather has led to short-term freeze-offs of some sources of supply. As a result of these factors, a couple of major interstate pipelines last week instituted operational flow orders, which reduce shippers' contractual rights to draw gas from storage. Adding to the anxiety is the fact that the weather experts believe that the winter heating season will continue at least for several more weeks.

High natural gas prices have sharply increased the price of electricity in wholesale markets. Thus, consumers of both natural gas and electricity likely will feel the impact of this price volatility. The Commission must investigate the causes of the price run-up. I am deeply concerned about the impact of these prices on residential consumers, businesses and industrial users.

Adequacy of Natural Gas Supply

Natural gas exploration and production activity, as reflected in the number of gas drilling rigs, has increased over time, and will no doubt increase more in response to these

powerful price signals. Yet, it takes time to develop a gas well – up to 18 months from new drilling until gas finally flows to market. This puts more pressure on the existing pipeline infrastructure, including storage, to meet winter demands.

The Commission recently announced a new policy of light-handed regulation for LNG import facilities. The Commission was persuaded that its traditional open access requirement for LNG terminals would stifle investment in these critical energy supply projects. Hence, the Commission's new policy will allow such projects to be developed on a proprietary basis. This regulatory approach represents the prevailing view that these terminals are more akin to production facilities than to interstate pipeline facilities and thus warrant less regulatory scrutiny.

Adequacy of Natural Gas Infrastructure

The Commission has also taken steps to streamline its approval process for new pipeline infrastructure. It is axiomatic that where pipeline infrastructure is constrained, prices will rise as capacity markets tighten. Basin differential price data lead to the conclusion that perhaps several regions of the country are now short of natural gas transmission capacity: the Rockies, the New York metropolitan area and other parts of the Northeast, the Mid-Atlantic Coast, the Southeast and Florida.

Traditionally, the pipeline industry has responded to price signals and contracted with shippers to support capacity expansions, but the deteriorating health of the industry

and sharply reduced capital availability is a cause for concern. I note with concern that there are only a few significant pipeline construction applications now pending at the Commission. Our Office of Energy Projects tells me that there are 11 major pipeline certificate applications pending Commission approval, totaling 4.0 Bcf/day in new capacity and covering about 783 miles of new pipeline. By way of comparison, early in the year 2001, the Commission had under consideration project proposals for 7.3 Bcf/day of new capacity and over 2,200 miles of additional pipeline.

Clearly, constrained areas are more prone to price spikes and to market manipulation than are non-constrained areas. This puts a premium on the Commission's ability to process expeditiously applications for approval of new infrastructure additions, while balancing the need for full participation by affected parties in the NEPA process. Our track record is solid and getting better. From 2001 to the present, the Commission has certificated 4,814 miles of new pipeline infrastructure, with a total capacity of 15.8 Bcf/day. The Commission remains committed to responding promptly to facilitate the approval of necessary infrastructure projects. A vibrant market demands a solid infrastructure foundation.

The draft legislation contains a major initiative that would encourage the development of natural gas supplies in Alaska for delivery both in that state and the lower forty-eight states. The recent natural gas price spikes underscore the need to attach new sources of production. Alaskan gas supplies would bolster our domestic resource base

and will be an essential part of the nation's energy future. Our agency is prepared to process an Alaskan pipeline project application expeditiously. I stand ready to consider any proposal or proposals that are filed.

Shaken Confidence in Price Discovery Methods

It is clear that market participants must have timely access to accurate information about prevailing prices. Price discovery, the ability to access this price information, helps customers determine the price they should pay for the service or commodity, helps sellers determine and recover their investment, and allocates resources to the customers who value them most. Over the last twenty years, the trade press has created natural gas price indices through the polling of market participants. The quality of the indices depends on the integrity of the information collected and the number of active traders who report. Accurate and credible price indices for natural gas are the foundation for natural gas and electric transactions nationwide. Unfortunately, the false reporting of price and volume information has shaken confidence in these indices. The potential fallout includes the nullification of existing contracts pegged to indices, and the reluctance of parties to enter into new index-based contracts.

Accurate price indices are also required by pipeline tariffs. At a January 15 Commission meeting, Commission staff pointed to three areas of pipeline tariffs that refer to market price data: cash-out provisions, penalties and basis differentials. Most major

pipelines have cash-out mechanisms that allow them to resolve system imbalances. Accurate price information is essential if cash-out mechanisms are to account for and minimize pipeline imbalances. The Commission has approved some pipeline penalty provisions based on market indices to deter shipper misconduct that can threaten system reliability. Finally, many negotiated rate transactions peg the transportation rate to the basis differentials between two or more price index trading points.

Given the prevalence of price index information in pipeline tariffs and contracts, it is imperative that there be trustworthy indices. As a first step, the Commission will probably adopt minimum standards for the natural gas price indices used in pipeline tariffs or new contracts. We will sponsor a technical conference this spring to explore price index issues and various proposed remedies.

The Commission is also analyzing natural gas price index issues in its massive ongoing Western market manipulation investigation. This investigation has already found significant manipulation of published price indices that were used by traders, pipelines, and power generators. These indices also had been used by the Commission in establishing a formula for determining refunds of overcharges arising from the dysfunctional electric western power markets. FERC staff has recommended that the Commission modify the refund formula to eliminate any reliance on manipulated indices. Hundreds of millions of dollars, perhaps billions of dollars, are at stake in that huge refund proceeding. This only underscores that reliable price discovery methods are an

imperative in well-functioning natural gas and electric markets.

In addition to developing minimum standards for natural gas price indices, some have suggested that the Commission take even more aggressive actions. Some have suggested that the Commission gather and report price data. I have an open mind about how to achieve price transparency and facilitate price discovery. However, it is critical that the Commission be prepared to take whatever action is necessary to restore confidence in the natural gas price indices that undergird natural gas pipeline tariffs and negotiated rate contracts.

Section 7081 of the discussion draft amends the Federal Power Act to promote price transparency. FERC is directed to establish an electronic information system. As I said earlier, I fully support this provision and recommend that it be modified to apply explicitly to natural gas markets as well.

Penalties and Refund Effective Date

Section 7084 of the discussion draft should be modified to provide penalties for prohibited behavior under the Natural Gas Act.

I also recommend that the Natural Gas Act be amended to include the refund effective date provisions of Section 7091 (with the further modification I recommended earlier).

III. Hydroelectric Licensing Issues

The Commission has recently proposed a rulemaking to streamline the hydroelectric licensing process to provide more efficient decision making. A new process, an integrated process, is proposed to facilitate increased assistance by Commission staff early in the process and to promote greater coordination among federal and state agencies.

The proposed amendments of section 3001 of the discussion draft outline a process to ensure that viable alternative conditions are given adequate consideration in the licensing process. These amendments are worthy of serious consideration by the subcommittee.

This concludes my testimony. I stand ready to answer questions and to assist the Subcommittee in any way. Thank you for this opportunity to testify.