FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, DC 20426

OFFICE OF THE CHAIRMAN

June 11, 2009

The Honorable Edward J. Markey
Chair
Energy and Environment Subcommittee
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Chair Markey:

I am writing in response to your June 9, 2009 letter seeking information from the Federal Energy Regulatory Commission (Commission) regarding the effects of the Energy Policy Act of 2005 repeal of the Public Utility Holding Company Act of 1935 (PUHCA) on investment in wholesale transmission.

Enclosed are my responses to your questions one through six. With respect to your June 10 clarification letter emailed today, I do need to determine how long it will take to provide the analysis, particularly for question seven.

I hope the enclosed information adequately addresses your first six questions. If I can be of further assistance with this or any other Commission matter, please do not hesitate to contact me.

Sincerely,

Jon Wellinghoff
Chairman

cc: The Honorable Fred Upton, Ranking Member

Questions for Chairman Wellinghoff
FERC
Subcommittee on Energy and Environment

<u>Questions from Chair Edward J. Markey</u>:

1. How many merchant transmission projects, encompassing how many total miles of transmission lines, has FERC approved since PUHCA's repeal in 2005? What is the percentage of total transmission investment resulting from these merchant lines?

<u>Answer</u>: Since the repeal of PUHCA, the Commission has approved pricing for three merchant transmission projects, encompassing 2,100 miles of transmission.[1] The total projected investment associated with these projects is approximately $6.01 billion. According to data provided in annual reports by public utilities to the Commission, total transmission investment for new lines and transmission upgrades completed during the years 2006, 2007, and 2008 combined was $6.09 billion. It should be noted, however, that these figures are not readily comparable, in that the total projected investment associated with merchant transmission projects will be incurred over numerous years as construction progresses, while the total transmission investment during the years 2006 through 2008 represents actual costs of transmission additions completed in those years.

2. Could these transmission lines have been built even without PUHCA's repeal? Are there other quantifiable benefits in terms of increased transmission investments that have been demonstrated from the restrictions on the PUHCA 1935 being eliminated?

<u>Answer</u>: Prior to the repeal of PUHCA, certain merchant transmission line projects were proposed or developed.[2] Additional merchant transmission lines have been proposed or developed since the repeal of PUHCA. I do not know and have no basis on which to provide an opinion as to whether the post-PUHCA projects could have been, or would have been, developed without PUHCA's

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[1] *See Chinook Power Transmission, LLC and Zephyr Power Transmission,* LLC, 126 FERC ¶ 61,134 (2009); *Linden VFT, LLC*, 119 FERC ¶ 61,066, *order on clarification*, 120 FERC ¶ 61,242 (2007).

[2] *See, e.g., Neptune Regional Transmission System, LLC*, 96 FERC ¶ 61,147 (2001).

repeal. I do not have information regarding other quantifiable benefits in terms of increased transmission investments that have resulted from PUHCA repeal.

3. How many utility mergers have taken place as a result of PUHCA's repeal that would not have been permissible had PUHCA remained in place?

Answer: Since the repeal of PUHCA, the Commission has approved several large mergers (as noted in the Answer to Question No. 4 below). I cannot state with certainty whether these transactions would or would not have been permissible under the relevant standards of PUHCA. To secure the approval of the Securities and Exchange Commission (SEC), proponents of mergers involving non-contiguous utilities (that is, utilities that are not directly interconnected and with non-adjoining service territories) needed to satisfy PUHCA's "integration" standard. I do not know whether the SEC would have found that the MidAmerican/PacifiCorp merger or the acquisition by Macquarie (which already owned a Pennsylvania utility) of Puget Energy (in the State of Washington), for example, would have satisfied the "integration" standard under PUHCA. In that regard, however, the SEC did approve certain mergers of non-contiguous utilities prior to PUHCA repeal (*e.g.*, Exelon/PECO, American Electric Power/Central and South West, Carolina Power & Light/Florida Progress).

4. What changes in utility market share has resulted from these approved mergers?

Answer: Among the more significant mergers the Commission has approved since the enactment of PUHCA 2005, please note the following: In the KeySpan/National Grid merger, the market share increased from 16 to 17 percent in the New York City zone of the New York Independent System Operator (New York ISO); from 71 to 72 percent in the Long Island zone; and from 16 percent to 20 percent in the New York ISO as a whole. The markets operated by the New York ISO are subject to Commission-approved market monitoring and market power mitigation. In addition, as a condition of the merger authorization, KeySpan and National Grid must seek prior Commission authorization for sales from upstate New York generating resources into the New York City or Long Island zones.

In the other two of the three largest mergers authorized by the Commission since the repeal of PUHCA, there was little or no geographic overlap between the merging companies, so the market shares were not affected. In the Duke/Cinergy merger, Duke's market share in its home balancing authority area remained at approximately 75 percent. Duke is not authorized to make market-based rate sales in its balancing authority area because of its dominant position in the area and therefore can only make wholesale sales pursuant to a cost-based tariff approved by the Commission. Cinergy's market share remained at approximately nine percent in the market operated by the Midwest Independent System Operator. In the MidAmerican/PacifiCorp merger, MidAmerican's market share in its home balancing authority area remained at 56 percent. PacifiCorp's market share remained at 56 percent in the PacifiCorp-East area (covering parts of Idaho, Wyoming and Utah) and 58 percent in the PacifiCorp-West area (covering parts of Montana, Oregon and northern California). Like Duke, MidAmerican does not have market-based rate authority in its home area. PacifiCorp, by virtue of its significant retail native load obligation, has a much lower number of megawatts available to compete in the wholesale market (less than 20 percent in almost all season/load conditions), and thus was able to retain its market-based rate authorization in its home balancing authority areas.

5. Please respond to the following questions regarding the concerns raised by the GAO report cited above:

a.) Why has the FERC failed to beef up its oversight of utility mergers and acquisitions following PUHCA's repeal?

Answer: As you know, in conjunction with the repeal of PUHCA, FPA section 203 was amended to give the Commission significant new authority to review certain holding company mergers, acquisitions of utility and holding company securities, and certain transfers of generating facilities. Amended FPA section 203 sets forth specific standards that must be met before any proposed transaction can be approved. As described more fully in the response to Question No. 6, below, beginning in December 2005, the Commission revised its regulations specifically to address possible cross-subsidization or encumbrance of assets resulting from a merger or other FPA section 203 transaction. Subsequently, the Commission also issued a policy statement to provide guidance on the types of section 203 transactions that do not raise cross-subsidy concerns and guidance on the types of commitments applicants could make and the ring-fencing measures applicants could offer to address potential cross-subsidy concerns. See FPA Section 203 Supplemental Policy Statement, FERC Stats. & Regs. ¶ 31,253 (2007) (Supplemental Policy Statement), order on clarification and reconsideration, 122 FERC ¶ 61,157 (2008). The Supplemental Policy Statement also supplemented the Commission's 1996 Merger Policy Statement, the analytical framework for the Commission's analysis of the impact of a merger on competition.

In addition to these measures, the Commission announced in one of the first mergers following the effective date of the new section 203 provisions, National Grid plc, 117 FERC ¶ 61,080 (2006), that it would impose on all section 203 transactions involving a holding company a condition that members of the holding company adhere to specific pricing restrictions on non-power goods and services transactions between "unregulated" companies and their public utility affiliates with captive customers. Further, the Commission in February 2008 also adopted in its regulations non-power goods and services pricing restrictions on all transactions between unregulated companies and their public utility affiliates with captive customers. The Commission also adopted recordkeeping and reporting requirements for utility holding companies and their service companies, and detailed accounting requirements for centralized service companies. These requirements will enhance the ability of the Commission and the public to monitor for cross-subsidization.

The Commission has taken appropriate actions to ensure careful review and diligent monitoring of mergers and acquisitions. The Commission understands the importance of scrutinizing merger applications and imposing any conditions needed to prevent harm to consumers. Our orders in merger cases demonstrate our vigorous implementation of this approach. For example, as noted above in the response to Question No. 4, in order to protect consumers from merger related harm to competition, as a condition of the KeySpan/National Grid merger authorization, KeySpan and National Grid must seek prior Commission authorization for sales from upstate New York generating resources into the New York City or Long Island zones. The Commission also recognizes the need to monitor post-merger compliance with Commission conditions, and has bolstered its efforts in this regard.

For example, we have performed an audit involving merger conditions in NSTAR (Docket No. FA07-1) and are in the process of conducting audits involving merger conditions, holding company and service company books and records, and market-based rate authority in American Electric Power, Inc. (FA09-7-000), Duke Energy Corp., (FA09-8-000), Entergy Services, Inc. (FA09-9-000), and National Grid, USA, (FA09-10-000). Also, as part of our annual audit planning cycle, the Commission will take additional merger-related audits into consideration with our other priorities and the number of available resources.

b.) Why has FERC chosen to rely largely on utility self-reporting of post-merger cross-subsidization rather than step up its oversight or auditing activities to ensure that such cross-subsidization does not occur?

Answer: As previously stated in its response to the draft GAO report, the Commission has never relied on self-reporting as its primary enforcement mechanism to prevent inappropriate cross-subsidization or assure compliance with other regulatory requirements. Cross-subsidization, by its very nature, does not lend itself to being self-reported.

The Commission relies on other tools to police cross-subsidization. The Commission has in place affiliate pricing restrictions - which are not limited to public utilities involved in mergers - addressing both power and non-power sales between affiliates and recently completed a rulemaking on this subject. See Cross-Subsidization Restrictions on Affiliate Transactions, Order No. 707, FERC Stats. & Regs. ¶ 31,264, order on rehearing, Order No. 707-A, 73 Fed. Reg. 43,072 (July 24, 2008), FERC Stats. & Regs. ¶ 31,272 (2008). The Commission also has specific and detailed record retention rules for holding companies and their affiliates, as well as a new standardized Uniform System of Accounts (adopted in October 2006) that must be followed by all centralized service companies, thus providing greater transparency to protect ratepayers from paying improper service company costs. Centralized service companies must also file an annual report (Form No. 60) containing financial information and information related to non-power goods and services provided to affiliates. Information collected in this form, which is available electronically to market participants and the public, can be used in detecting potential cross-subsidization. Other types of service companies (e.g., a special purpose service company) also have an annual reporting requirement containing a narrative description of the service company's functions during the prior calendar year. These measures, coupled with our ratemaking authority, compliance measures, auditing, and the penalty authority under the Federal Power Act provide adequate customer protection and policing over a regulated entity's transactions with its affiliates.

Moreover, it is important to note that the Commission commenced and subsequently completed the audits of Exelon Corporation (FA08-4-000), Allegheny Energy, Inc. (FA08-3-000) and The Southern Company (PA08-6-000) shortly after the effective date of PUHCA repeal in February 2006. The Commission is currently conducting the audits of American Electric Power, Inc. (FA09-7-000), Duke Energy Corp., (FA09-8-000), Entergy Services, Inc. (FA09-9-000), and National Grid, USA (FA09-10-000). The audits involve an examination of merger conditions, holding and service companies' books and records, and market-based rate authority. These companies are some of the largest utility holding companies in the nation.

c.) Why has FERC chosen not to undertake a risk assessment for companies it regulates in order to better focus its audit and oversight activities on those companies whose consumers might be most at risk of being harmed as a result of cross-subsidies or other anti-competitive actions by the utility?

Answer: The Commission uses a risk-based approach in selecting merger and PUHCA audit candidates. Our risk-based approach entails a comprehensive review of all section 203 merger orders, audit materials obtained from the SEC; examination of financial information contained in FERC Form No. 60 (service company report), FERC Form No.1 (annual report of public utilities), and SEC filings; rate information gathered from Commission filings; and discussions with the Commission's legal and technical experts. The risk-based approach described above results in a preliminary risk assessment that takes into account, for example, the amount and type of costs reported in the FERC Form No. 60 and FERC Form No. 1; compliance problems gleaned from the non-public audit reports previously issued by the SEC; information on affiliate transactions included in SEC filings as well as other pertinent financial information affecting stock and bond prices; a review of Federal and state commission actions regarding affiliate transactions; and discussions with Commission legal and technical experts. Finally, shortly after the audit commences, the Commission audit staff discusses the audit scope, objectives and any other matters with state commission officials.

d.) In the absence of strong protections against cross-subsidization, how can the Subcommittee be assured that the higher "incentive" rates the Commission has been approving for utility investments in transmission actually go for that purpose, rather than subsidizing other utility expenses or even being diverted to non-utility affiliates of a utility holding company?

Answer: As noted above, the Commission has taken several significant steps to ensure strong oversight and protection against improper cross-subsidization. It also must be emphasized that Congress, in directing the Commission to adopt incentive-based transmission rates for jurisdictional utilities, did not change the "just and reasonable" ratemaking standard under FPA section 205. Thus, the Commission reviews incentive rate proposals under the standards of section 205. Utilities must also follow the accounting rules established by the Commission which provide the Commission a basis for determining what costs are being incurred. Also, as part of our annual audit planning cycle, the Commission will take audits of utility investments in transmission into consideration with our other priorities and the number of available resources.

In addition, the Commission monitors any transfer of assets and dividends between regulated utilities and their parent companies or affiliates via the FERC Form 1, filed on an annual basis, and the FERC Form 3-Q, filed on a quarterly basis.

6. On the day that the Energy Policy Act of 2005 was signed into law, Representative Dingell and I wrote to then-Chairman Kelliher and other federal agencies regarding needed compensatory measures to be undertaken following PUHCA's repeal in order to spare utility consumers and investors from a repetition of the types of abuses that led to PUHCA's enactment in the first place. In that letter, we requested, among other things, that "FERC use its existing legal authority under the Federal Power Act, which section 1267(a) of EPACT expressly preserves, to adopt such general rules" as the Commission determines necessary to protect against mergers that 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." [footnote omitted] To my knowledge, the Commission never did so. Would the Commission now be willing to consider taking such action? If not, how can the Subcommittee be assured that utility consumers are not having their rates raised to pay for transmission assets that are not being used for their designated purpose, but are instead being used to cross-subsidize some other activity or are being used to overpay a non-utility affiliate for products or services relating to such transmission construction?

Answer: As noted, in December 2005, the Commission exercised its legal authority under the Federal Power Act to revise its regulations specifically to address possible cross-subsidization or encumbrance of assets resulting from a merger or other FPA section 203 transaction. Merger applicants must now make what is called an "Exhibit M" filing, which is a detailed showing (based on facts and circumstances known or reasonably foreseeable) that the merger will not result (at the time of the transaction or in the future) in the following activities by a traditional public utility that has captive customers or that operates Commission-jurisdictional transmission facilities, in each case for the benefit of an associate company: (a) the transfer of facilities, (b) the issuance of securities, (c) the pledge or encumbrance of assets, and (d) the execution of contracts other than approved contracts for non-power goods and services. Also, the applicants must disclose any pledges or encumbrances of utility assets existing at the time of the application. If the applicants cannot provide adequate assurances against such activities, they must demonstrate that the activities are consistent with the public interest.

Following two technical conferences, in which the Commission sought input from state commissioners and others on what additional measures (including ring-fencing) the Commission should take to protect customers against inappropriate cross-subsidization, in July 2007 the Commission also issued the Supplemental Policy Statement. The Supplemental Policy Statement provided clarification and guidance on the types of section 203 transactions that do not raise cross-subsidy concerns and guidance on the types of commitments applicants could make and the ring-fencing measures applicants could offer to address potential cross-subsidy concerns. First, the Commission adopted a policy to defer to state commissions where the state adopts or has in place ring-fencing measures to protect customers unless those measures are inadequate to protect wholesale customers. If, based on the record of the transaction before the Commission, however, the state measures are inadequate to protect customers in a given case, the Commission will adopt supplemental measures as appropriate. If the state does not have authority to act on a section 203 transaction, the Commission will fill any regulatory gap by imposing ring fencing protections where appropriate. It is important to note that, where the Commission does defer to ring-fencing protections adopted by a state, the Commission's approval of the proposed section 203 transaction is premised on compliance with those ring-fencing protections and the Commission may audit and enforce compliance with those protections just as it enforces any additional protections it may accept or impose for a particular transaction; failure to abide by the restrictions constitutes a violation of the Commission's order approving the transaction. In addition, the Commission made clear in the Supplemental Policy Statement that, if it approves a transaction under section 203 (with or without ring-fencing measures), the Commission retains authority under FPA section 203(b) to later impose additional cross-subsidy protections or modify any previously-approved measures.

Second, the Supplemental Policy Statement also provided specific guidance on the types of protections companies might adopt to make the demonstration required by Exhibit M, referred to above, where a state has not required or does not have authority to require ring-fencing provisions. For example, the Commission stated that a ring-fencing structure related to internal corporate financings, i.e., money pool or cash management transactions, could include some or all of the following elements, depending on the circumstances of the proposed transaction:

(1) the holding company participates in the money pool as a lender only and it does not borrow from the subsidiaries with captive customers;

(2) where the holding company system includes more than one public utility, the money pool for subsidiaries with captive customers is separate from the money pool for all other subsidiaries;

(3) all money pool transactions are short-term (one year or less), and payable on demand to the public utility;

(4) the interest rate formula is set according to a known index and recognizes that internal and external funds may be loaned into the money pool;

(5) loan transactions are made pro rata from those offering funds on the date of the transactions;

(6) the formula for distributing interest income realized from the money pool to money pool members is publicly disclosed; and,

(7) the money pool administrator is required to maintain records of daily money pool transactions for examination by the Commission by transaction date, lender, borrower, amount and interest rate(s).

Thus, while not adopting a set of mandatory one-size-fits-all federal ring-fencing protections in the Supplemental Policy Statement, the Commission gave detailed guidance regarding the types of restrictions that, from the federal viewpoint, might be appropriate depending upon the particular facts presented. It made clear that the forms of ring-fencing protections listed were examples of protections the Commission would consider in evaluating proposed ring-fencing measures and stated that appropriate ring-fencing measures would depend on the facts presented and the specifics of an applicant's corporate structure, to be evaluated on a case-by-case basis. It also noted that the listed measures were among those typically approved by the SEC under PUHCA and/or adopted by state commissions.

In addition to the adoption of the new FPA section 203 requirement for an Exhibit M filing and the policies and guidance set forth in the Supplemental Policy Statement, the Commission announced in one of the first merger cases following the effective date of the new section 203 provisions, National Grid plc, 117 FERC ¶ 61,080 (2006), that it would impose on all section 203 transactions involving a holding company a condition that members of the holding company adhere to specific pricing restrictions on non-power goods and services transactions between "unregulated" companies and their public utility affiliates with captive customers. Further, because cross-subsidy concerns regarding both power and non-power goods and services transactions can arise not only at the time of a proposed merger, but rather on an ongoing basis, the Commission in July 2007 also adopted in its regulations non-power goods and services pricing restrictions on all transactions between unregulated companies and their public utility affiliates with captive customers. The Commission also adopted recordkeeping and reporting requirements for utility holding companies and their service companies, and detailed accounting requirements for centralized service companies. These requirements will enhance the ability of the Commission and the public to monitor for cross-subsidization.

Also, as noted above, in response to PUHCA 2005, the Commission's Office of Enforcement is auditing affiliated transactions to detect and deter cross-subsidization. These audits include some of the largest utility holding companies. If information gained from these audits or elsewhere indicates a need for increased auditing, the Commission will either shift resources to such audits or, if necessary, seek additional resources from the Congress.

Importantly, all of these new requirements are in addition to the Commission's traditional and broad ratemaking authority to disallow rate recovery of costs found unjust and unreasonable as improper cross-subsidies. This authority applies to all utilities, whether or not they engage in cross-subsidies resulting from a merger.