UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Technical Conference on Public Utility Holding Company Act of 2005 and Federal Power Act Section 203 Issues	Docket No. AD07-2-000

TECHNICAL CONFERENCE STATEMENT OF AMERICAN PUBLIC POWER ASSOCIATION AND NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

The American Public Power Association (APPA) and the National Rural Electric Cooperative Association (NRECA) appreciate the opportunity afforded by this technical conference to address issues related to the Public Utility Holding Company Act of 2005 (PUHCA 2005)[1] and Section 203 of the Federal Power Act (FPA).[2] APPA and NRECA strongly concur in Chairman Kelliher's statement that the Commission's "primary task" under the FPA is to "guard the consumer from exploitation by non-competitive power companies."[3] APPA and NRECA have been encouraged by many aspects of the Commission's rules implementing PUHCA 2005 and amended Section 203 of the FPA and by the Commission's commitment to explore these issues further by means of technical conferences.

In this statement, APPA and NRECA provide an overview of their position concerning cross-subsidization issues and respond to a number of the specific questions posed by the Commission to Panel 1 in its Supplemental Notice of Technical Conference

---

[1] Energy Policy Act of 2005, §§ 1261-1277, 119 Stat. 594, 972-78 (to be codified at 42 U.S.C. § 16451-16463).

[2] 16 U.S.C. § 824b, *as amended by* Energy Policy Act of 2005, § 1289, 119 Stat. 594, 982-83.

[3] Joseph T. Kelliher, Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission, 26 Energy L.J. 1 (2005) (*quoting NAACP v. FPC*, 520 F.2d 432, 438 (D.C. Cir. 1975)). *See also id.* at 2-5 (describing legal duties of the Commission).

of November 27, 2006.

I. Overview

For seventy years the Public Utility Holding Company Act of 1935 (PUHCA 1935)[4] confined the geographic reach of public utility holding companies, limited the investment in public utilities by nonutility companies, and largely prevented registered holding companies from diversifying into nonutility businesses.

The repeal of PUHCA 1935, it was claimed by many, would remove these shackles, enable the efficient deployment of capital, promote new investment—particularly in transmission infrastructure—and facilitate a new round of "efficient" mergers and restructuring.

It remains to be seen whether these benefits will occur. But supporters of the repeal of PUHCA 1935 also claimed that the statute was no longer necessary—that other federal and state regulation would take care of the concerns that had led Congress to pass the statute.

What were those concerns? Byzantine corporate structures, accounting irregularities, self-dealing by holding companies with their public-utility subsidiaries, highly leveraged capital structures, and mergers resulting in highly concentrated wholesale power markets.

The potential for these problems has not disappeared, as events in the energy and non-energy corporate world over the last five or six years have amply demonstrated. The question is whether other regulatory protections will take the place of PUHCA 1935, and

[4] 15 U.S.C. §§ 79 to 79z-6 (2000), *repealed by* Energy Policy Act of 2005, § 1263, 119 Stat. 594, 974 (effective Feb. 8, 2006).

whether those protections will be sufficient. Otherwise, the repeal of the statute raises the possibility of consumer exploitation through the merger and consolidation of public utilities and the cross-subsidization of regulated and nonregulated affiliates within holding companies. In its recent rulemakings and in this technical conference, the Commission is asking the right questions—and to this point reached many of the right answers.

However, APPA and NRECA believe that the Commission should promulgate additional rules and adopt additional policies pursuant to its authority under the Federal Power Act (FPA) to protect against inappropriate cross-subsidization or encumbrances of public-utility assets. These actions should include structural protections that may be necessary where ratemaking authority alone cannot serve to protect consumers. In this overview we summarize the standard protections available to the Commission. All should remain in the toolbox, so the Commission can calibrate the protections needed to the new corporate arrangements that develop.

A. The rationale for structural protections: rate setting protections alone are insufficient.

New corporate arrangements will cause new internal pressures. The repeal of PUHCA 1935 increases the possibility of mergers motivated by earnings growth rather than operational efficiencies and of regulated public utilities becoming cash cows for nonregulated utility or nonutility businesses.

Ratemaking alone is not a sufficient tool to prevent or fix these problems. Structural cost increases can occur between rate cases, and declines in performance capability can remain latent until demand for lost talent surfaces. Penalizing these problems in rate proceedings can make matters worse. For a wholesale transmission customer interconnected with only one transmission provider, ditching the shaky company is not an option. Moreover, wholesale customers often co-own generation or transmission facilities with their neighboring Commission-regulated public utility. The regulatory goal should be to prevent the problem, rather than allow it to fester and then, when detected, investigate and impose remedies after the fact.

Moreover, the problem is not simply one of ratepayer protection via the setting of cost-based rates by this Commission and the state commissions. As the Commission stated in *Ameren Energy Generating Company*, 108 FERC ¶ 61,081, at P 48 (2004), the problem also involves the protection of the Commission's pro-competition policies:

> While effective state regulatory review can prevent excessive rates to the retail customers of the acquiring utility, it is not a remedy for the anticompetitive effects of affiliate preference, which harm all customers. The possibility of eventual regulatory review does not prevent the exercise of affiliate preference before the transaction occurs. We are also not convinced that such eventual regulatory review of rates is an effective remedy for anticompetitive effects that arise at the time affiliate preference occurs. Ultimately, all customers are harmed because competition is undermined.

B. The principle: no harm to public-utility customers from nonutility businesses

For rates to be just and reasonable and not unduly discriminatory or preferential, the wholesale customer must receive the service contracted for, at either (a) a cost-based price reflecting reasonable expenses and reasonable capital cost; or (b) a market-based price fully disciplined by effective competition.

Where a public utility is affiliated with nonutility businesses, the customer is forced into a more complicated picture. That picture includes not only electric service at a cost-based or market price, but also a portfolio of nonutility businesses whose effects on the quality and cost of public utility service are difficult to predict. The Commission's challenge is to address this risk in a manner consistent with the statutory requirement of justness and reasonableness.

Just and reasonable rates require that wholesale customers of a public utility be fully insulated from the risks associated with affiliates' nonutility businesses. Otherwise, the public utility has forced the customer to buy a product she doesn't want: a piece of the nonutility risk. Under the FPA, ratepayers are customers, not insurers. The Commission must ensure complete protection, so that the public utility's affiliation with a nonutility business causes no additional, nonutility risk. Any other result imposes on the customer a risk unrelated to the power supply or transmission service he has agreed to purchase.

Some public utilities may argue that it is impossible to eliminate all nonutility risk without banning all public utility affiliation with nonutility businesses, and therefore the Commission should deem the public utility's rates to be just and reasonable as long as the risk-reward relationship is be symmetrical—i.e., as long as the upside is equivalent to the downside. APPA and NRECA respectfully disagree with this reasoning. Commission-jurisdictional electric service by public utilities is part of the nation's essential infrastructure. Public-utility service should not be subject to wide swings from great certainty to great uncertainty, even if those swings are in theory symmetrical (a result that is probably impossible to achieve in practice). And at bottom, the risks are fundamentally asymmetrical. If a seller fails financially, it can enter bankruptcy and seek relief from contracts, leaving its creditors and customers to scramble for other options. The Commission will need to impose structural limits that ensure that service quality and rate predictability for customers of a public utility will not be disrupted by a nonutility affiliate's troubles or ultimate failure.

C. Application: Structural options for carrying out risk insulation

Application of the foregoing principles may require limits on the structural relationships between public utility and nonutility businesses to mitigate the risks to ratepayers posed by the new corporate organization and ownership structures permissible after the repeal of PUHCA 1935. Examples include:

- Public utility business must not be conducted within companies that also engage in nonutility business. Instead, public utility business must be conducted through corporations legally distinct (and financially insulated) from nonutility affiliates.
- Public utilities must maintain books and records that are separate from the books and records of nonutility affiliates, and must prepare separate financial statements.
- Public utilities must not commingle their assets or liabilities with the assets or liabilities of a nonutility affiliate, or pledge or encumber their assets on behalf of a nonutility affiliate. Effective "ring fencing" provisions should apply to protect public utility assets from the negative impacts of financial problems with unregulated affiliates or parent holding companies.
- Service or management fees charged by a public utility's holding company parent or affiliated service company to the public utility must not include allocations of financing costs for entities other than the public utility, charges against equity in other subsidiaries of the parent holding company, or operating losses of the parent holding company or other affiliated companies.

The Commission should keep all these options in reserve, imposing them as the facts require. The Commission has the legal authority to impose these prophylactic conditions, upon the proper factual record, in proceedings under section 203 of the FPA as well as in rate proceedings under sections 205 and 206. The Commission should not delay action until harm occurs. When harm is possible, the Commission should impose those structural limits necessary to eliminate the risks.

II. Response to Questions in Supplement Notice to Panel on Cross-Subsidization

A. FPA Section 203 Authorities

1. Should the Commission adopt specific generic cross-subsidization safeguards in its section 203 regulations or is it preferable, particularly in light of state authorities, for the Commission to permit applicants to implement safeguards on a case-by-case basis subject to audit oversight?

APPA and NRECA do not believe that it would be appropriate for the Commission to adopt cross-subsidization safeguards that would apply to all section 203 transactions, because the same protective conditions will not be appropriate in all cases. Hence, the Commission must impose them on a case-by-case basis.

That said, however, the Commission's existing regulations are absolutely silent on what kind of protections applicants might be necessary and appropriate in different cases. Rather than leaving these matters to the applicants to propose, we believe the Commission should adopt regulations setting forth the minimum measures necessary to guard against cross-subsidization in all cases, as well as the additional measures (such as the structural conditions outlined above) that may be warranted in individual cases. In all cases, Applicants should be required to demonstrate that they have adopted "sufficient safeguards, including any necessary cash management controls (such as restrictions on upstream transfers of funds, ring fencing, etc.) to prevent any cross-subsidization between holding companies and their new subsidiaries before receiving section 203 approval."[5] The existing regulatory text, in our view, does not accomplish this goal.

The minimum measures to guard against cross-subsidization, which all Applicants should be required to adopt, should include at least the following items:

[5] Transactions Subject to FPA Section 203, Order No. 669, FERC Stats. & Regs. ¶ 31,200, at P 143, *order on reh'g*, Order No. 669-A, FERC Stats. & Regs. ¶ 31,214, *order on reh'g*, Order No. 669-B, FERC Stats. & Regs. ¶ 31,225 (2006).

- A code of conduct for all public-utility subsidiaries of the merged company, applicable to both power and non-power goods and services transactions between the public-utility subsidiaries and their nonregulated utility and nonutility affiliates, as required in the Commission's recent *National Grid plc* order.[6]

- For public utilities that must obtain authorization under FPA section 204[7] to issue securities, compliance with the Commission's *Westar Energy* conditions.[8]

- Wholesale and transmission ratepayer-protection conditions (such as hold-harmless commitments).

Applicants that rely on state-imposed protections against cross-subsidization should be required to demonstrate to this Commission the adequacy of those conditions to protect against cross-subsidization relevant to Commission-regulated wholesale and transmission rates. Applicants relying on such state-imposed conditions should also be required to propose those conditions as part of the section 203 application. If this Commission relies on such state-imposed conditions, the Commission should incorporate those conditions into its conditional approval of the transaction under section 203.

Not every state has the legal authority or the resources to deal with these issues in merger proceedings or on an ongoing basis. Moreover, states' concerns are naturally focused on protecting the retail ratepayers of the utilities they regulate—not on protecting wholesale customers or wholesale competition protection. The regulatory and legal resources of the various state public utility commissions to oversee, audit, and enforce these conditions also vary substantially. Thus, the Commission cannot rely on state regulation to prevent cross-subsidization. It must act independently under its own statutory authority to address these issues.

---

[6] *National Grid plc,* 117 FERC ¶ 61,080, at P 66 (2006).

[7] 16 U.S.C. § 824c.

[8] *Westar Energy*, 102 FERC ¶ 61,186, *clarified,* 104 FERC ¶ 61,018 (2003).

2. *With respect to FPA section 203 merger/corporate applications, should the Commission require more specific cross-subsidy protections in addition to the general requirement that there shall be no cross-subsidization resulting from or reasonably foreseeable as a result of a FPA section 203 transaction?*

APPA and NRECA answer yes to both of these questions. The existing regulatory language, as amended in Order 669-B, does not need to be modified. But the Commission should adopt additional regulatory language explaining both the minimum specific cross-subsidization protections that all applicants must adopt, as well as a non-exhaustive menu of additional protections that applicants (or other participants) may propose or that the Commission may impose in appropriate cases, including ring-fencing, restrictions on upstream transfers of funds, etc.

3. *Should the Commission adopt, by regulation, generic "ring fencing" or other conditions of merger approvals (other than codifying a version of its current code of conduct/merger restrictions) or should the Commission continue to consider such conditions on a case-by-case basis? In light of the fact that most states have authority to adopt such protections, is further generic action by the Commission inappropriate or unnecessary at this time?*

As explained above, the Commission should adopt generic minimum conditions of merger approval, including codifying its current code of conduct requirements, and should adopt a non-exhaustive menu of additional protections that it will consider on a case-by-case basis.

The fact that most states have authority to adopt such protections does not make further generic action by the Commission inappropriate or unnecessary. The fact that not every state has such authority is reason enough for Commission action. And even where a state has the legal authority, a section 203 applicant should be required to show that the state's implementation of that authority is sufficient to meet this Commission's objectives, and should propose these same conditions, as appropriate, as part of their section 203 application. In this way, these conditions would be enforceable by this Commission as well as the states.

4. *Is the Commission getting sufficient information in FPA section 203 applications to make a determination that a merger or other corporate transaction will not result in cross-subsidization or the encumbrance of utility assets? If not, what additional information should the Commission require FPA section 203 applicants to file?*

APPA and NRECA do not believe that the Commission is getting sufficient information in section 203 applications to make these determinations. An example is the now-withdrawn merger application of FPL Group, Inc., and Constellation Energy Group, Inc.[9] Although this proposed transaction was a complex merger of large companies with substantial public-utility and nonutility businesses, the information on cross-subsidization consisted of a hold-harmless commitment and one-page verifications by corporate officials of each merging party that their merger agreement did not "provide for" prohibited cross-subsidization or encumbrance of public-utility assets. The fact that the applicants had not already agreed to violate the statute did not provide much comfort. What was lacking was any analysis of what steps the applicants were taking to ensure that merged company would operate to insulate its regulated public-utility operations from its huge nonregulated utility and nonutility businesses. This was a very important issue, as the first principle underlying the entire merger was the desire of the applicants to use the superior financial position and credit rating of FP&L Group (based on its large

[9] *FPL Group, Inc.*, Docket No. EC06-77-000 (application withdrawn Oct. 26, 2006).

regulated business) to financially undergird additional activities of Constellation Energy Group's extensive unregulated businesses.[10]

B. FPA and NGA Rate and Accounting Authorities

1. Are there additional generic actions the Commission should take under its FPA or NGA authorities (other than FPA section 203, which is discussed in other questions above) to protect customers against inappropriate cross-subsidization or encumbrances of utility assets? Are reporting requirements, rather than restrictions, a better way in which to protect against cross-subsidization and the encumbrance of utility assets?

As outlined above, APPA and NRECA believe the Commission has the authority under sections 205 and 206 of the FPA to impose conditions to protect customers against cross-subsidization or encumbrances of public-utility assets. Such conditions include ring-fencing to protect traditional public utilities with captive customers from financial collapse of upstream holding companies and affiliated power marketers, and requirements that nonutility business be conducted in corporate entities separate and distinct from public-utility business.

While the Commission undoubtedly has authority to impose such conditions generically, at this point we believe such conditions should be imposed on a case-by-case basis. The Commission should also consider, however, whether to adopt reporting thresholds, such as a requirement that a holding company or a public utility in a holding company system report to the Commission when the holding company system makes substantial nonregulated investments (e.g., as a percentage of total capital).

---

[10] *See* Motion to Intervene and Protest of American Public Power Association and National Rural Electric Cooperative Association, *FPL Group, Inc.*, Docket No. EC06-77-000 (filed Apr. 10, 2006).

2. *Should the Commission adopt regulations under FPA sections 205 and 206 to codify existing restrictions regarding power and non-power goods and services transactions between traditional public utilities and their "unregulated" affiliates? Should these existing restrictions apply to all traditional public utilities and their affiliates irrespective of whether they are seeking merger approval under FPA section 203 or market-based rate approval under FPA section 205? Should the scope of the existing power and non-power goods and services restrictions be expanded and, if so, how?*

APPA and NRECA believe the Commission should codify its code of conduct requirements in its regulations rather than imposing them in merger or market-based rate proceedings. These restrictions should apply to all traditional public utilities and their unregulated affiliates.

3. *In light of the submissions to date of the FERC Form No. 60 (Service Company Report), which applies to centralized service companies, is the Commission getting sufficient information to protect against inappropriate cross-subsidization and the encumbrance of utility assets? Is there other information the Commission should routinely collect, or is case-by-case access to books and records in audit and rate proceedings sufficient to ensure that customers are protected against inappropriate cross-subsidization?*

It may be too early to answer to determine whether Form No. 60 is providing adequate information. Over time, the Commission's ability to rely on Form No. 60 may well decline. Only traditional, centralized service companies must file Form No. 60. The myriad of special-purpose service companies that now exist or may be formed do not have to submit any cost-allocation agreements with the Commission. By reconfiguring its service-related operations into special-purpose service companies, a holding company could evade all scrutiny of its cost allocations. The Commission does not in Order No. 667 or later orders draw a clear distinction between traditional, centralized service companies and special-purpose service companies. Moreover, the difference may become even more illusory (if not superseded) in the future.[11]

Respectfully submitted,

AMERICAN PUBLIC POWER ASSOCIATION

/s/ Susan N. Kelly________________________

Susan N. Kelly
Vice President of Policy Analysis
and General Counsel
Allen Mosher
Director of Policy Analysis

American Public Power Association
2301 M Street, N.W., Suite 300
Washington, D.C. 20037-1484
(202) 467-2900
Fax: (202) 467-2910
Email: skelly@appanet.org
amosher@appanet.org

NATIONAL RURAL ELECTRIC
COOPERATIVE ASSOCIATION

/s/ Richard Meyer ______________________

Wallace F. Tillman
Vice President, Energy Policy and General Counsel
Richard Meyer
Senior Regulatory Counsel

National Rural Electric Cooperative Association
4301 Wilson Blvd.
Arlington, VA 22203
(703) 907-5811
Fax: (703) 907-5517
E-mail: richard.meyer@nreca.coop

[11] *See* Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005, Order No. 667, FERC Stats. & Regs. ¶ 31,197, at P 171 n.178 (2005), *order on reh'g*, Order No. 667-A, FERC Stats. & Regs. ¶ 31,213, *order on reh'g*, Order No. 667-B, FERC Stats. & Regs. ¶ 31,224 (2006), *reh'g pending*.

/s/ Randolph Lee Elliott __________________

Randolph Lee Elliott
Miller, Balis & O'Neil, P.C.
1140 Nineteenth Street, N.W.
Suite 700
Washington, D.C. 20036
(202) 296-2960
(202) 296-0166 (fax)
E-mail: relliott@mbolaw.com

Counsel for American Public Power Association
and National Rural Electric Cooperative
Association

December 7, 2006