

**Summary of Testimony of
Commissioner William L. Massey
Federal Energy Regulatory Commission
Before the Subcommittee on Energy and Air Quality
United States House of Representatives**

**Washington, D.C.
December 12, 2001**

I respect and applaud Chairman Barton's efforts to enact electricity restructuring legislation. I support a number of provisions of H.R. 3406, and have strong concerns about others.

In particular, I support the provisions related to standardized generation interconnection, ensuring demand responsiveness, mandatory reliability rules, civil penalties, and transmission infrastructure and siting. These are all excellent provisions. I support placing all transmission, including the transmission of TVA, BPA and the PMAs, under one set of Federal rules. The bill sends a strong signal that RTOs are in the public interest and that FERC may require their formation. I applaud this. I support the repeal of PUHCA with a strong books and records provision, and would support the prospective repeal of PURPA so long as there is a mechanism such as a portfolio standard to ensure the development of renewable resources.

The legislation also includes provisions that I cannot support, however. The Commission's merger review authority should not be repealed. Indeed, this authority should be strengthened to ensure that consumers are protected from consolidations that may choke off the very competition we are striving to facilitate. In addition, I do not support legislatively tying FERC's hands with respect to RTO approval standards and hearing procedures. These should remain a matter of Commission policy that may evolve over time with the changing needs of competitive markets.

The Commission continues to insist that transmission owners form geographically large RTOs that are independent of merchant interests. The Commission will act in the near future on pending RTO applications and will issue a new time line for RTO operations. The Commission will soon initiate a rulemaking to standardize market rules, as appropriate, among RTOs and plans to finalize a rule in the spring standardizing generation interconnection procedures and agreements. The Commission has issued a new standard for measuring generation market power and a new tariff condition prohibiting anticompetitive behavior by sellers. All of these recent Commission actions will help make the markets work well for wholesale sellers and buyers alike.

**TESTIMONY OF
COMMISSIONER WILLIAM L. MASSEY
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Mr. Chairman and Members of the Subcommittee on Energy and Air Quality:

Thank you for the opportunity to testify on the important electricity legislation now pending before the House and recent Commission activity promoting efficient and reliable electricity markets.

I. H.R. 3406 - The Electric Supply and Transmission Act

A. Interconnection

I am generally supportive of the provisions of Title I. Section 101 addresses interconnection standards. The Commission has made a firm decision to move forward on developing standard procedures and agreements regarding interconnection and will likely do so in a way that is consistent with section 101.

B. Demand response

Section 103 provides for implementation of price responsive demand programs. As I have testified previously, markets need demand responsiveness to price. This is a standard means of 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. If the price, say, for a head of cabbage spikes to \$50,

consumers simply do not purchase it. 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.

Once there is a significant degree of demand responsiveness in a market, demand should be allowed to bid demand reductions, or so called "negawatts," into organized markets along with the megawatts of the traditional suppliers. This direct bidding would be the most efficient way to include the demand side in the market. But however it is accomplished, the important point is that market design simply cannot ignore the demand half of the market without suffering painful consequences, especially during shortage periods. There was virtually no demand responsiveness in the California market. Customers had no effective means to reduce demand when prices soared.

It is important for Congress to send a message that instilling a significant measure of demand responsiveness into electricity markets is in the public interest. This legislation does just that, and I endorse it.

C. PUHCA and PURPA

Subtitle B of Title I repeals PUHCA. I am pleased that the bill appears to include important provisions regarding state and federal access to the books and records of holding companies and their subsidiaries.

Subtitle C of Title I repeals PURPA on a going forward basis. I would support such repeal of PURPA if there were a mechanism to promote the development of renewable resources, such as a reasonable portfolio standard.

D. Review of Mergers

Section 141 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 FERC with a broad interstate view must have adequate authority to ensure that market power does not squelch the very competition we are attempting to facilitate.

The Commission's authority over mergers is important. We are seeing unprecedented industry consolidation now. 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 the RTO Rule, Order No. 2000, 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, the Commission's authority over electricity mergers must be strengthened in a number of ways. The Commission should be given direct authority to review mergers that involve generation facilities. The Commission has interpreted the Federal Power Act as excluding generation facilities *per se* from our direct authority, although that interpretation is currently before the courts. 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.

E. Open Transmission Access

Section 201 allows the Commission to require all transmitting utilities as well as public utilities to offer open access transmission service. I am generally supportive of placing all transmission owners under the same set of rules. I have concerns, however, with codifying the manner in which the Commission should calculate stranded costs. Such calculation should be left to the Commission's discretion and judgment.

F. Regional Transmission Organizations

Section 202 sets out a number of provisions regarding RTOs and RTO formation. I am particularly pleased that this legislation sends a clear message that RTOs are in the public interest. Nevertheless, I am concerned with the proposals to codify matters such as RTO standards, hearing requirements, and when the Commission may or may not make modifications to existing RTOs. It would be far more useful to give the Commission express authority to require RTO formation

under standards determined to be appropriate by the Commission. This would allow standards to evolve along with the requirements of competitive markets.

G. Reliability

Section 301 provides for Commission certification of an organization to develop and enforce reliability standards. The industry needs mandatory reliability standards. Vibrant markets must be based upon a reliable trading platform. Yet, under existing law there are no legally enforceable reliability standards. Compliance with the reliability rules of the North American Electric Reliability Council (NERC) is voluntary. A voluntary system is likely to break down in a competitive electricity industry.

I support legislation that would lead to the promulgation of mandatory reliability standards. A private standards organization with an independent board of directors could promulgate mandatory reliability standards applicable to all market participants. These rules would be reviewed by the Commission to ensure that they are fair and not unduly discriminatory. The mandatory rules would then be applied by RTOs, the entities that will be responsible for maintaining short-term reliability in the marketplace. Mandatory reliability rules are critical to evolving competitive markets, and I urge Congress to enact legislation to accomplish this objective.

Section 301 seems reasonable and I support its adoption.

H. Transmission Infrastructure

Section 401 directs the Commission to adopt policies that facilitate construction of transmission facilities needed for competitive electricity markets, and to report to the Congress

on transmission adequacy. I support these goals. I am particularly supportive of the legislation's specific goals such as promoting economically efficient enlargement of transmission networks, including the provision of proper price signals so that new generation and transmission is built where it provides the lowest overall cost to consumers.

I. Transmission Siting

Section 402 enacts backstop transmission siting authority for the Commission. In previous testimony, I have recommended that Congress transfer to the Commission the authority to site new interstate electric transmission facilities. 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.

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 to state 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. We have certificated well over 15,000 miles of new pipeline capacity during the last six years. No comparable expansion of the electric grid has occurred.

I continue to recommend legislation that would transfer siting authority to the Commission. Such authority would make it more likely that transmission facilities necessary to reliably support

emerging regional interstate markets would be sited and constructed. A strong argument can be made that the certification of facilities necessary for interstate commerce to thrive should be carried out by a federal agency.

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, rate jurisdiction is clarified, and adequate cost recovery mechanisms and risk-based rates of return are allowed.

Proposed section 402 provides the Commission with backstop siting authority to ensure that the necessary transmission facilities are built. This provision appears to provide appropriate respect for the siting prerogatives of the states and has my support.

J. Federal Utilities

I have long advocated placing all transmission providers under the same set of rules. Placing TVA, BPA and the Federal Power Marketing Administration under Commission authority has my full support.

Section 523 permits BPA to transfer operational control of its transmission facilities to an RTO. Although I strongly support allowing BPA to participate in an RTO, I would not limit its participation in an RTO of a specific scope as this section does. In addition, I would recommend that Congress specifically authorize TVA and the PMAs to participate in RTOs determined to be appropriate by the Commission.

K. Penalties

Section 703 expands the scope of civil penalties to include all of Part II of the Federal Power Act. This provision moves toward giving the Commission much needed tools to police the markets and I support it.

II. Recent FERC Action on RTO Formation and Markets

A. RTO Formation

The Commission has received a number of proposals to form RTOs, and has acted on most such proposals. In general, the Commission has strongly encouraged RTOs to grow larger and has provided guidance on independence and RTO governance. In July, the Commission issued an order expressing its preference for no more than four large RTOs in the nation, but has recently indicated that greater flexibility will be allowed in RTO formation.

During October 15-19, 2001 the Commission held five days of public hearings on a wide range of issues related to RTO formation and market design. In an order issued November 7, the Commission indicated a desire to receive additional comment from state commissions with regard to RTO formation, and indicated that additional cost benefit analyses on RTOs would be conducted. Also, the Commission stated its intention to standardize market design rules as appropriate. The November 7 order stated that since it is not possible for all RTOs to be in operation by our December 15, 2001 deadline, the Commission will set out in future orders a time line for continuing RTO progress in each region. I expect the Commission to act on such orders in the near future.

B. Market-based Rates

In two orders the Commission issued November 7, 2001, we began to correct severe weaknesses in our market based pricing policy. My longstanding concerns had been sharpened by the failure of the California market and the economic consequences that spun from it. We've learned that we must accurately assess market conditions when depending on markets to discipline prices. And we must provide adequate refund protection to customers when poorly functioning markets do not protect them from unreasonable prices.

In *AEP Power Marketing, et al.*, the Commission took three important steps in our market based pricing policy. First, we concluded that our traditional market power analysis no longer adequately protects customers against generation market power.

Second, we announced a new interim analytic screen to protect customers until we develop the tools we need for the longer term. That interim tool is the Supply Margin Assessment, or SMA, and will be applied to all sales except those into an ISO or RTO with approved monitoring and mitigation. This is a major step in the right direction. The SMA improves on the old analysis by taking into account transmission capability and by looking to the critical notion of a "pivotal supplier" in a market. When supplies are tight, prices in electricity markets can run up quickly, especially when there is a pivotal supplier whose capacity is needed to satisfy demand. The SMA addresses that problem and does not allow pivotal suppliers to charge market based prices. The SMA is a major improvement. Like most new policy tools, it is not perfect, but we are moving in the right direction. As with any analytic method, it is only a snapshot of current market

conditions. But if market conditions change, parties are free to file a complaint showing that the new conditions result in a seller failing the SMA screen.

Third, the Commission applied the SMA to three sellers in the context of their triennial updated analysis, found that they fail, and put in place innovative mitigation measures requiring the applicants to offer all uncommitted generation capacity into the spot market. Sales will be priced at the traditional split savings adder. As the order points out, maintaining an accurately priced spot market is the single most important element for disciplining longer term transactions. Thus, with the spot market mitigation in place, an applicant may freely negotiate longer term transactions but must post on its web site a portfolio of long term products and prices that are available.

In another order issued November 20 in EL01-118, the Commission took two additional important steps. First, we announced the start of a generic proceeding to develop new analytic methods for evaluating markets and market power on a long term basis. I fully support launching this important initiative. Second, the order initiated a section 206 proceeding to place a refund condition in the tariffs of sellers with market based pricing. That condition would prohibit anticompetitive behavior and the exercise of market power. This is an improvement providing customers with some added protection, and to that extent I support the order.

But we should do more for customers. The order fails to provide any refund protection to customers when market structure and market rules are flawed and unjust and unreasonable rates result. The Federal Power Act states that such rates are unlawful. This is precisely the situation in which the Commission found itself in the California proceeding. We did not make any

findings of bad behavior on the part of any sellers. We found only a market that was badly broken. The risk of a broken market should not be placed solely on customers. Our tariff condition should provide for refunds whenever the Commission finds that unjust and unreasonable rates are charged.

III. Conclusion

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