

**ELECTRIC TRANSMISSION POLICY: REGIONAL
TRANSMISSION ORGANIZATIONS, OPEN ACCESS,
AND FEDERAL JURISDICTION**

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND AIR QUALITY

OF THE

COMMITTEE ON ENERGY AND
COMMERCE

HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

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WEDNESDAY, OCTOBER 10, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON ENERGY AND AIR QUALITY,
Washington, DC.

The subcommittee met, pursuant to notice, at 9 a.m., in room 2123, Rayburn House Office Building, Hon. Joe Barton (chairman) presiding.

Members present: Representatives Barton, Largent, Burr, Whitfield, Norwood, Shimkus, Wilson, Bryant, Radanovich, Tauzin (ex officio), Boucher, Sawyer, Wynn, Waxman, Rush, McCarthy, Strickland, Barrett, and Luther.

Staff present: Sean Cunningham, majority counsel; Jason Bentley, majority counsel; Brendan Williams, legislative clerk; Hollyn Kidd, legislative clerk; Sue Sheridan, minority counsel; and Rick Kessler, minority counsel.

Mr. BARTON. The subcommittee will come to order. If our audience would find a seat.

We have an unusual situation this morning. We have two separate hearings with a separate lunch break in between. We also have the Democratic Caucus meeting to elect a new Whip. I spoke with the ranking member, Mr. Boucher, last evening and he agreed that we could do our opening statements and then I would call a recess until our Democrats got here to hear the testimony.

Now, it's possible the Democratic Caucus will be all peace and harmony, and there'll be a unanimous consent election, but it's probable that it's going to be fairly contested and take a number of ballots, and the Democratic process will go slowly. So, it could be that we'll do opening statements and then recess until approximately 11 a.m. I hope that we have some folks show up before then.

So we're going to start our opening statements and get as many as the Republicans on the record, and then wait until Mr. Boucher and some of his colleagues come on the majority side.

So the Chair would recognize himself for an opening statement.

First, I want to thank all our panel members for coming back. I believe this panel was scheduled to be here on September 11, and as we all know a very bad thing happened that morning which required us to postpone this hearing. But we're glad to have you all

here and I'm told that everybody that was here September 11 is back here.

We give special thanks to Mr. English. We understand that you're going to be here this afternoon, too. So, we'll get a double dose of your wisdom.

We're going to hear this morning about Siting, Incentives and Reliability. It's my belief that the Congress and the FERC should do what it can to encourage the expansion of transmission capacity where needed, particularly through private sector investment. The FERC should take a new look at incentive rate making in the discussion draft that's now publicly available. We have some incentives to make that happen.

I believe the States should continue their traditional role of siting transmission lines, but I now believe that the Federal Government should impose a deadline on States for timely consideration for looking closely at transmission lines that are in the public interest.

The discussion draft calls for the FERC to act as a backstop for applicants after 1 year of work or lack thereof at the State level.

On reliability there is broad agreement that some organization or organizations should have the power to enforce reliability standards. The question now is how to do it. Many on this subcommittee, including my good friend Congressman Wynn of Maryland have been leaders in encouraging consideration of reliability proposals.

Today we're going to have before us several witnesses who are all committed to some reliability legislation. I look forward especially to hearing that testimony and working with the members about the proper plan to put that forward.

This afternoon after a short break in our second hearing we're going to reconvene and hear from the second panel on the RTOs or regional transmission organizations. The issue of open access for transmission and the jurisdictional issue of who should have jurisdiction over those RTOs.

I want to thank any of our witnesses who are already here in the audience that are going to participate on the second panel.

Last night I released a revised discussion draft on a proposed starting point on RTO policy. I would like to say that it is, at the moment, my best guess about where the middle ground is on RTOs, but it is a draft. And I certainly expect people, some people to be for it and some people to be against it, and some people to be undecided and sit on the fence. That's the whole reason we put out discussion drafts.

The language that we released late last evening all transmitting utilities must file, perform or participate in an RTO, and that's all—A-L-L, not O-I-L.

FERC must approve RTO applications that meet—you've got to wake up now. We got a lot of time this morning. Ralph Hall's not here to entertain you, so I've got to do the best that I can.

FERC must approve RTO applications that meet certain minimum standards, but may propose changes to applications if they do not meet those standards. If there is no agreement, the FERC in the discussion draft could order participation in an RTO, but the applicant could appeal that FERC mandate to the Federal courts.

FERC shall continually enforce uniform market rules including seams agreement between RTOs.

Finally, under the proposed draft language, the FERC may not require approved RTOs to merge. So what we've tried to do is hit a middle ground between a FERC mandate and let the FERC do whatever it wants to give FERC no authority and let the private sector participate or not participate as it so chooses.

It's my personal belief that all utilities should be in an RTO. It's also my belief that there's no magic about a specific number of RTOs. The No. 4 has been bandied about quite a bit recently. That's a good number, but it's not the only number out there.

There's no magic about having three RTOs in the Eastern Interconnect and one in the Western Interconnect. I believe that if all—A-L-L—utilities are in an RTO, the RTOs work well within themselves and with other RTOs, we will have greatly helped to establish a seamless national network.

The open access provision and the discussion draft are equal to what was in the Electricity Restructuring legislation in 2944 in the last Congress. There is a way to ensure equal terms and conditions for transmission access while retaining the unique characteristics of public power and coops. Now I want to pursue that, but I also want to make sure that all who depend upon transmission lines to sell power in the wholesale markets or to purchase wholesale power for their consumers can gain the proper access to the bulk power transmission network.

Finally, we're going to welcome witness testimony on the jurisdiction issue. Who should have jurisdiction over the transmission component of a bundled retail sale? This issue is wrapped up in the RTO debate and it may be that members solve this issue when we decide about RTOs. The Supreme Court just last week heard arguments on jurisdiction. I believe that the Congress should step in and provide clarity to the law if a consensus is possible. I want an appropriate role for the States, but I do think that we need a less balkanized system.

After this hearing and after the proper time period to let members digest the testimony in its written form, it's my intent to begin discussion of the subcommittee members on both sides of the aisle on a second electricity draft. Mr. Boucher, of course, will be deeply involved in it, as will full committee ranking member Mr. Dingell.

Electricity has not been and should not be, and as long as I'm subcommittee chairman will not be a partisan issue. We have a good base of member education and member interest on both sides of the aisle. Time is short in this Congress. I'm under no illusions that if the Congress adjourns very quickly, there's a good chance that we'll have to roll this over to next spring. But there's also a possibility, and when I walked in I was told by staff that it looks like the ice is beginning to break in the Senate and the energy bill is going to go forward. So, I think there is a chance that if we could have two good hearings today and member interest and the Congress stay in session longer than another week or 2, we could move to a markup on this bill in this Congress in the next month or so. I hope that's the case. I would love to move a bill out of subcommittee and have it ready to go, perhaps, for discussion in a

comprehensive energy bill that we go to conference with the Senate.

Our goals for an electricity restructuring are several. In a simplified form, we want to increase the supply of electricity. We want to improve the effective operation of our transmission grid and we want to increase the capacity, at least the potential to increase the capacity of our transmission grid.

Those of you that are here testifying on behalf of the various State utilities today can help put those goals forward. Now, you can help us toward a better function electricity system. As I've told some of you privately, this is not the time to tell what you think what I want to hear or what Mr. Boucher wants to hear, or anyone else for that matter. It's the time for you to tell us what you really believe. Look beyond the interest of your special interests; look at the broader national purpose. And if you'll help us in that regard, we can reach a compromise that's good for the country.

So I look forward to these two hearings today. These are the last two hearings I propose to hold unless we need to have a legislative hearing on the bill that we introduce. So this is a very, very important day.

[The prepared statement of Hon. Joe Barton follows:]

PREPARED STATEMENT OF HON. JOE BARTON, CHAIRMAN, SUBCOMMITTEE ON ENERGY AND AIR QUALITY

Today's hearing takes the place of two hearings that were canceled during the week of September 11. I would like to thank the members of the first panel for coming back. I know some of you were stranded here for a while last time.

This morning, we will hear about siting, incentives and reliability. I believe Congress and the FERC should do what it can to encourage the expansion of transmission capacity where needed, particularly through private sector investment. FERC should take a new look at incentive ratemaking, and my discussion draft would make that happen. States should continue their traditional role of siting transmission lines, but I now believe the Federal government should impose a deadline on them for timely consideration and for looking closely at lines that are in the public interest. My discussion draft calls for FERC to act as a "backstop" for applicants after one year of work at the State level.

On reliability, there is broad agreement that some organization or organizations should have the power to enforce reliability standards. The question now is how to do it. Many on this Subcommittee, including Congressman Wynn of Maryland, have been leaders in encouraging consideration of reliability proposals. Today we have before us several witnesses who are all committed to passing some reliability legislation. I look forward to hearing the testimony and working with Members about the proper plan to put forward.

Later today, after a break, we will reconvene and hear from a second panel on Regional Transmission Organizations (RTOs), open access for transmission, and the jurisdiction issue. If those witnesses are already here, I thank you for coming and hope you enjoy Round One.

Just last night, I released a revised discussion draft with my proposed starting point on RTO policy. In the language, all transmitting utilities must file to form or participate in an RTO. FERC must approve RTO applications that meet certain minimum standards but may propose changes to applications if they do not meet the standards. If there is no agreement, FERC can order participation in an RTO but the applicant can appeal to Federal courts. FERC shall continually enforce uniform market rules, including seams agreements between RTOs. Finally, FERC may not require approved RTOs to merge.

I believe all utilities should be in RTOs. To me, there is no magic in having 3 RTOs in the eastern interconnect and 1 in the western interconnect. I believe that if *all* utilities are in RTOs, and the RTOs work well within themselves and with other RTOs, we will have greatly helped establish a seamless national network.

The open access provisions in the discussion draft are equal to what was in electricity restructuring legislation in the last Congress. There is a way to ensure equal terms and conditions for transmission access while retaining the unique characteris-

tics of public power and cooperatives, and I want to pursue that. But I also want to make sure that all who depend on transmission lines to sell power on the wholesale markets, or to purchase wholesale power for their consumers, can gain the proper access to the bulk-power transmission networks.

Finally, I welcome witness testimony on the “jurisdiction issue”—who should have jurisdiction over the transmission component of a bundled retail sale. This issue is wrapped up in the RTO debate, and it may be that Members solve this issue when we decide about RTOs. The Supreme Court just last week heard arguments on jurisdiction, and I believe that Congress should step in and provide clarity to the law if a consensus is possible. I want an appropriate role for the States, but I want a less balkanized system. After this hearing, I will begin discussions with Subcommittee Members on electricity. These, of course, will start with Subcommittee Ranking Member Boucher and full Committee Ranking Member Dingell. Electricity is not a partisan issue, and there is a good base of Member interest and education on both sides of the aisle. If there is interest in moving forward, and if Congress will remain in session for sufficient time, I will work to introduce a bill in the coming weeks and move toward markup. I look forward to working with all Members and stakeholders for suggestions on revising the discussion draft.

Our goals with electricity restructuring should be many. Simplified, they are:

1. Increasing the supply of electricity;
2. Improving the effective operation of our transmission grid; and
3. Increasing the capacity of our transmission grid.

The witnesses today can help us on that path toward a better-functioning electricity system. I encourage your honesty and also your consideration of the national interest. Now is the time to look beyond the reasons to oppose compromises or be parochial. Now is the time to establish an electric grid and trading system for the 21st Century that we can all be proud of.

Mr. BARTON. We’d like to welcome Mr. Shimkus for an opening statement. I’m assuming you were the first member here? Mr. Norwood was here first. Well, we’re going to welcome Mr. Norwood for an opening statement then.

Mr. NORWOOD. Thank you, Mr. Chairman. I know it’s hard for you to know which one of us was here first.

Mr. BARTON. Just glad you all both were here.

Mr. NORWOOD. I promised John I’d get that in.

Thanks for holding this hearing today on the important issue of transmission and all the critical issues associated with that. I plan to be brief with our statement and get as fast as we can to this very impressive array of witnesses that we have.

Over the last 10 years marriages enacted both by the Congress and the FERC, this country’s transmission network has undergone significant changes evolving from what used to be historically small wholesale power sales that ensured reliability. Today’s current wholesale megamarket allows many different buyers and sellers to transfer power back and forth from one end of the grid to the other. In fact, the wholesale market today is now 400 percent larger than it was just 10 years ago.

Unfortunately, our current infrastructure was not developed with this new wholesale market in mind, and is really not equipped to handle such large bulk power transfers efficiently and reliability. Today bottleneck areas and problems of congestion on the grid are common. With these growing pains it is clear, I believe, that this committee and the Congress face new challenges to find thoughtful and well-balanced solutions. That’s what really what this is all about today.

I look forward to hearing the testimony from both panels today, both panels, and commend this collection again of witness that you have brought before us.

Mr. Chairman, as usual, I truly applaud your leadership in this committee in trying to craft coherent national energy policy, and we're grateful for all the work that you do. And with that, I'll yield back.

Mr. BARTON. Thank you, distinguished gentleman from Georgia.

And we would welcome the gentleman from Illinois for an opening statement.

Mr. SHIMKUS. Thank you, Mr. Chairman. I appreciate this hearing and I want to welcome our panelists, both this one and the next one. And I think it'll be a long day, so I hope you got comfortable seats.

The \$64 million question this year has been what do we do about transmission? So as long as many of us have been involved in this process, this is my fifth year, it's really boiled down to transmission in the eyes of many of us.

Do we let FERC or the States have jurisdiction over siting, or is there some mixture? Do we make RTOs mandatory or do we make them voluntary, or we allow them to be voluntary? How many RTOs do we have; the chairman mentioned that, 4, 8 or more? What kind of incentives do we offer? The list goes on and on and that is why today's hearing and all you panelists here are so important to help us sort through some of this process as we have draft legislation proposed and changes to drafts, and as the chairman as said, willingness to continue to work through this process.

But the fact remains that we have to change the way the transmission system is run and governed. RTOs were the first step in the process, but we still have a lot more to do. The whole industry is dramatically different from the past. The era of big monopolies and set service areas will soon be a thing of the past in most areas of the Nation. Illinois is moving to the deregulated market, but we've experienced three RTOs within the State of Illinois for a period of time.

Power will easily be generated in one State and be sent to another grid for use in other States, but the transmission infrastructure has not kept up with the demand. We have to make sure that can happen without the problems.

The easier we can get power to consumers, the cheaper it will be for them. The task ahead of us is not easy. There are a lot of different constituencies that have a lot of different ideas about how we should proceed, and we've heard from many of those constituencies already and we look forward to working with the.

I believe Chairman Barton has shown that he's ready for the task, and really this subcommittee as we've dealt with it for many, many years in working with our colleagues on the other side. We are excited about getting to some compromise and moving forward. And I look forward to working with the chairman on this issue.

Again, Mr. Chairman, thank you for this hearing and I yield back my time.

Mr. BARTON. We thank the gentleman from Illinois.

We'd welcome the gentleman from Tennessee for an opening statement.

Mr. BRYANT. Thank you, Mr. Chairman.

I, too, thank you for holding this hearing this morning, and I believe we have another one this afternoon. And I'm coming in late

and having to move between meeting and meeting, which I will continue to do today, so I may be out as other members may be out today. I want to go ahead and apologize to this very distinguished and numerous long panel here today. I think it's better to go one panel than 2 or 3 smaller panels. It cuts down on the number of questions we ask.

I heard the end of my colleague from Georgia, Mr. Norwood's statement, and it sounded very articulate and I'm very tempted to adopt it, because he's always a man of wisdom, and I may do part of that. But I'm going to cut my—I will adopt his statement. I'm sure our chairman's was also good, and I'll adopt his statement also. I will add one comment and I will yield back my time after that.

I'm not sure anyone on the panel, I haven't had the opportunity to see the statements yet, addresses this issue. But an open question as we move forward on the siting issues, the issue of acquiring right-of-way, acquiring properties, eminent domain and that tension, and it's tension I think is an understatement that exists with property owners being from an area that is very mindful; representing a constituency that's very mindful of property rights, I want to make sure that we pay proper respect to that. And that any governmental powers that we have out there or that we create to expand, enlarge or whatever, eminent domain and the authority to use it, I think we have to be careful in doing that.

On balance with the not-in-my-back-yard syndrome, I understand fully that we have a transmission problem in this country and we have to move forward aggressively with the stability of legislation behind it, the force of law behind it to go ahead and built new transmission. So we have to find that balance in there between protecting property rights and yet doing something for the common good and avoid the not-in-my-back-yard syndrome.

So, it is a complicated issue, I understand. And perhaps someone on this panel can address the eminent domain issues and who should exercise that, should that be delegated to the private sector; those kinds of things if it's possible.

And with that, Mr. Chairman, I would yield back my time.

Mr. BARTON. Thank the gentleman.

Seeing no other members present, the Chair would ask unanimous consent that all members not present have the requisite numbers of days to put their opening statement in the record in its entirety at the appropriate point. Is there objection? Hearing none, so order.

The Chair would also announce that Mr. Norwood, Mr. Bryant and myself are going to briefly change parties, go as a block to the Democratic Caucus, see what we can get for voting for either of the candidates up for the Whip, probably some votes on health care for Mr. Norwood, and I'll take votes on electricity bill and Mr. Bryant can take votes on some good deed for the TVA, or something at that point.

We're going to be in recess. I would ask my first panel to not wander too far. I think there's an outside chance that we could get started around 10. So you're at liberty to move about the compound, but don't go back to your offices. Let's stay in this general area.

And we will reconvene as soon as we have some of our Democratic friends here to start the panel.

[Brief recess.]

Mr. BARTON. The Chair recognize the distinguished ranking member for an announcement on who the new Whip is, and for an opening statement.

Mr. BOUCHER. Well, thank you, Mr. Chairman. I will have to disappoint you with regard to one of those matters, but not with regard to the other. We are still counting votes, and I was so interested in coming to take part in your hearing today that I left before the result was announced. But I'm sure that all of us in due course will find out what that result is.

Mr. BARTON. Okay.

Mr. BOUCHER. It will not be a secret.

Mr. BARTON. Well, there are several of us that are available for a brief switch in parties if it's so close that one or two votes makes a difference.

Mr. BOUCHER. We would be glad to talk with each of those individuals, and if there are as many as six of them, that truly would be excellent news for us.

Thank you very much, Mr. Chairman. Today's hearings assemble a group of expert witness who can help frame the questions at the root of the electricity restructuring debate and indicate to us what problems effect the Nation's electricity system, and suggest how Congress can improve the system through the passage of legislation.

Today we will hear from two panels on matters related to electricity transmission policies. This morning's witnesses will address the siting of new transmission lines and system reliability. And this afternoon's panel will address regional transmission organizations, matters relating to open access and the balance between State and Federal jurisdiction.

I want to commend Chairman Barton for his diligent effort to conduct thorough and balanced hearings on these matters of fundamental importance, and I also want to commend him for his usual practice of working closely with members on our side as we approach these important considerations.

My State and many others have adopted some form of retail competition plan, although approximately one-half of the Nation remains subject to traditional utility structures. At this point I think it seems unlikely that Congress will enact a direct retail competition mandate and our legislature debate, therefore, centers on electricity transmission policy questions including how best to allocate existing transmission capacity and whether and to what extent, and by what means the Federal Government should encourage the construction of new transmission capacity.

We should also bear in mind that some of the most fundamental questions regarding the balance between Federal and State authority over transmission were last week argued before the United States Supreme Court, and a decision on those very important matters should be forthcoming from the Court in the near term. That fact may influence to some extent our considerations in this subcommittee.

As we consider these matters it is essential to reflect not only on the best policy approach, but also how much of the goal of our best policy choices can be accomplished within the confines of existing law. Does the FERC believe that it has sufficient authority under the Federal Power Act to perform its responsibilities and to carry it to the conclusions that it might desire to reach?

Beyond the issues relating to transmission policy, we have a number of other associated concerns. What problems, for example, arise from the continued application of PUHCA. If PUHCA is to be repealed, what consumer protections need to be put in place in any electricity legislation that we consider? Can we achieve a more efficient use of existing generator capacity through real-time pricing and how can real-time pricing be encouraged? What are the merits or the problems associated with the continued application of PURPA. And what is the position of the Administration with regard to this entire set of issues and what legislative recommendations would the Administration make to us at this time?

These are questions that we will examine during the course of this day and in future weeks. And as we do so I want to thank Chairman Barton for his singular dedication to a major reform of Federal policy with respect to electricity. And I very much look forward to working with him as we seek the best approach to these complex matters.

Thank you, Mr. Chairman.

Mr. BARTON. We thank the gentleman.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. STEVE LARGENT, A REPRESENTATIVE IN CONGRESS
FROM THE STATE OF OKLAHOMA

Mr. Chairman, in light of the tragic events of September 11th, the Committee correctly chose to postpone the two hearings that we will be holding today. As someone who has spent a considerable amount of time on the electricity restructuring issue, and more specifically transmission related issues, I want to thank you for promptly rescheduling these two very important hearings.

For those of us who are old enough to remember the movie "The Graduate," there is a memorable line from the film in which Dustin Hoffman's character is offered a one word piece of advice—"plastics." Well I believe there is one word that this Subcommittee should keep in mind as it proceeds forward with comprehensive electricity restructuring legislation. That word is "transmission."

California's energy problems earlier this year clearly demonstrated the economic chaos caused by a lack of generation. That being said, if we do not clarify the rules of the road for the interstate transmission system, generators will continue to be precluded from moving power across State lines because of a lack of investment, siting problems, a patchwork of different regulatory guidelines, or the abuse of market power.

As members of this Subcommittee and our witnesses know all too well, the current transmission system was not built for the number of wholesale transactions that take place on a daily basis.

It was designed largely to supply intrastate demand. Yet since the enactment of the Energy Policy Act of 1992, there has been an increase in interstate bulk power transfers, something the existing system was not designed to handle.

Our current transmission system is analogous to the way our road system was connected, or more accurately, not connected prior to the construction of our interstate highway system in the 1950s.

The regulation of our transmission system varies depending on whether the lines run through an open state or a closed state. The regulation varies depending on the ownership of the lines. Investor owned utilities are regulated by FERC while lines owned or operated by municipals, co-ops, TVA, or BPA are largely exempt from FERC regulation. Even the type of sale, be it an unbundled or bundled retail sale is subject to different types of regulation.

It's my hope that we can create some form of regulatory parity to put all industry participants on an even playing field.

I believe FERC has taken several pro-active steps with the issuance of FERC Orders 888, 889, and 2000 to develop competitive wholesale power markets.

Clearly, FERC is not content to sit on the sidelines while industry and Congress decide how to restructure. On September 26th newly appointed Commissioner Pat Wood outlined a very ambitious, some say too ambitious, policy directed at the formation of competitive wholesale power markets.

Mr. Chairman, I know you recently released a draft of your comprehensive restructuring bill. With what time we have left in the remainder of the session, I look forward to working with on this legislation, in particular Section 201 and Section 202, the open access and RTO provisions.

With that I look forward to hearing from our distinguished panels of witnesses and I yield back.

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON ENERGY AND COMMERCE

First, let me thank Chairman Barton for continuing this series of hearings on our Nation's electric power industry. In today's two-part hearing we will focus on the transmission system—the infrastructure that is necessary for getting power efficiently and reliably from the generator to the consumer, and the competitive interstate marketplace that is needed to ensure affordable electricity supplies.

Attention to reliable transmission goes in hand with Committee efforts to assure that our Nation has an affordable, reliable electricity supply that will keep pace with the demands of the 21st Century. This will require that we put an end to the uncertainty over the operation and governance of the interstate transmission system and establish clearly defined rules for competitive wholesale markets.

Since 1992, Congress has encouraged the development of competitively generated wholesale power, which resulted in a general decline in electricity prices, as well as cleaner and more efficient production of power. The increased efficiency came at an essential time. The Energy Information Administration recently reported that, since 1990, as retail electricity sales (our demand) grew by 26%, power generating capacity increased by only 10%, and transmission capacity grew only 15%. So our success fueling the recent period of economic growth with electricity was achieved only because we were able to generate more power, more economically from existing plants.

Yet success generating power more efficiently would have been meaningless without the ability to deliver the electricity to where it was economic and most needed. This has prompted a rethinking of our Nation's interstate transmission system and has made clear that we need a vibrant, accessible interstate transmission system if we hope to deliver the full benefits of that low-priced power to consumers.

According to the Electric Power Research Institute, the number of wholesale power transactions increased 400% over the past decade—on a patchwork system designed to serve individual utilities. At the same time, investment in transmission infrastructure has steadily declined.

We now know that the coordinated use of a number of transmission systems can allow a low-cost producer in one state to sell power cheaply to buyers in another. As our demand for electricity continues to grow, it is becoming more important than ever that we have the ability to share electric power freely within regions and among states. To do this, we cannot continue to view transmission as individual power lines; we must look at it as part of a broader, interstate system.

Therefore, it is critical that our Nation begin designing and building modern, 21st Century transmission systems. This, of course, will require a legal and regulatory framework to make it happen.

We must look at a variety of issues to determine how best to proceed in these matters. Today's hearing will allow us to focus on grid reliability, transmission siting issues, and incentives to encourage new transmission-system investments. This afternoon, we will hear testimony on the formation of Regional Transmission Organizations (RTOs), open access to transmission, and the role of the Federal government and States in ensuring that we have vibrant, competitive wholesale power markets. It will be a long day, but very informative.

It is important that we address these issues, especially at this time of uncertainty over our Nation's energy security. I thank Chairman Barton for holding these hearings, and I look forward to the testimony of our witnesses.

Mr. BARTON. We have 8 of our 10 panelists here. We're going to start with Mr. Schriber and just head right down the line, and we'll make sure that Mr. Nordhaus and Mr. Ken get here and get an opportunity to participate.

We're going to welcome you, Mr. Schriber, as Chairman of the Ohio Public Utilities Commission. He's here on behalf of the National Association of Regulatory Utility Commissioners. Put your statement in the record and ask you to summarize it in 5 minutes.

STATEMENTS OF ALAN R. SCHRIBER, CHAIRMAN, OHIO PUBLIC UTILITIES COMMISSION ON BEHALF OF NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS; STANLEY F. SZWED, VICE PRESIDENT, TRANSMISSION, FIRSTENERGY CORP. ON BEHALF OF EDISON ELECTRIC INSTITUTE; ROGER A. FONTES, GENERAL MANAGER, FLORIDA MUNICIPAL POWER AGENCY ON BEHALF OF AMERICAN PUBLIC POWER ASSOCIATION; ROBERT R. NORDHAUS, VAN NESS FELDMAN ON BEHALF OF LARGE PUBLIC POWER COUNCIL; GLEN ENGLISH, CEO, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION; DAVID N. COOK, GENERAL COUNSEL, NORTH AMERICAN ELECTRIC RELIABILITY COUNCIL; PHILLIP G. HARRIS, PRESIDENT AND CEO, PJM INTERCONNECTION; JAMES D. STEFFES, VICE PRESIDENT OF GOVERNMENT AFFAIRS, ENRON CORPORATION ON BEHALF OF ELECTRIC POWER SUPPLY ASSOCIATION; JOHN ANDERSON, EXECUTIVE DIRECTOR, ELECTRICITY CONSUMERS RESOURCE COUNCIL; MARTY KANNER ON BEHALF OF CONSUMERS FOR FAIR COMPETITION; ANDREW M. VESEY, VICE PRESIDENT, ENERGY AND UTILITIES, FOR THE CAP GEMINI ERNST & YOUNG

Mr. SCHRIBER. Thank you, sir. And thank you for giving me the opportunity to testify here today.

In addition to being Chairman of the Public Utilities Commission of Ohio, I'm also Chairman of the Ohio Power Siting Board, and I'm prepared to talk about many of the issues that you've raised earlier and have spoken of, but I'll stick specifically to power siting at this point.

Ohio, I believe, has perhaps more authority as a siting board than most States, and it's been a very effective siting board. It's very socialized in the way it's constructed. I, as Chairman of the Public Utilities Commission, I'm also Chairman of the Power Siting Board. We have the Director of the EPA, Department of Health, Department of Development, Agriculture, Natural Resources, Engineers and legislative members that comprise our board.

In order to receive approval for construction of a new facility in Ohio an entity, any entity, must apply for and obtain a certificate of need and convenience and environmental compatibility.

I will point, and I think what's come to my mind as a casual observer, is that a lot of the issues that we see, and if you were to scan the testimony, come into whether it should be State or Federal issues who should exercise the power in this regard with respect to siting. And although a lot of arguments can be made either way, I believe very strongly, and I think reality suggests, that the

States for various reasons have some issues before them which we can handle as far as siting is concerned.

Most of the siting issues turn out to be landowner issues, and these as State authorities we become very intimately involved with. Many of the issues regarding siting have to do with natural resources within the State, and a lot of them have to do with agricultural land, the displacement of agricultural land and the optimum use of agricultural land.

As a State authority we move much, much faster than might be done in either other States or at the Federal level. And we certainly have the infrastructure already in place.

In Ohio our authority enables us to look beyond State boundaries in proceedings with other jurisdictions when we site major power plants, transmission lines or gas pipe lines. For electric power lines the statute requires that we look to the grid to the facilities beyond the State boundaries to make sure we are compatible with that.

And finally, in Ohio our jurisdictional trigger goes to all facilities. So not only would a public utility who needs or wants to build a facility have to come before the Ohio Power Board, but any facilities. It could be a merchant company, it could be a nonpublic utility. So that in effect in Ohio we believe we have sort of a one-stop shop where all utilities or nonutilities that wish to build facilities would come before us.

I would say that our record speaks for itself. It's not before you, but our record would suggest that since in the years 2000 and 2001 we've added 2200 megawatts of electricity, most are gas peaking plants, although we have combined cycle baseload gas plants under construction, by and large we move people in and out within 6 months upon application.

I would also point out that we have a pipeline, the Independence Pipeline that has been proposed through Ohio over which FERC has jurisdiction. That pipeline has taken years. It's been a contentious debate for over 2 years. Interestingly, although FERC has jurisdiction, we've gotten thousands of letters because for some reason, I think that may be obvious, that the State authorities are those who usually get the flake when things don't quite work out for the landowners within our States.

So, if Ohio could be a model for other States, I would say that would be an optimum solution in my mind. Now, does this mean that FERC could not adopt the Ohio model? They probably could, but as I've suggested because of our sensitivity to landowners, because of our sensitivity to the use of our resources, I would suggest that the States would, if they could, be somehow compelled to adopt our model, move forward much more expeditiously in power siting.

And I'll stop with that. As I said, I could go on other issues, but we have a lot of panelists here. And I appreciate the opportunity to be here.

[The prepared statement of Alan R. Schriber follows:]

PREPARED STATEMENT OF ALAN SCHRIBER, CHAIRMAN, OHIO PUBLIC UTILITIES
COMMISSION

Mr. Chairman and Members of the Subcommittee: Good morning. My name is Alan Schriber. I am the Chairman of the Ohio Public Utilities Commission. I am here today on behalf of the National Association of Regulatory Utility Commis-

sioners, commonly known as NARUC. I greatly appreciate the opportunity to appear before the House Energy and Commerce Subcommittee on Energy and Air Quality and I respectfully request that NARUC's written statement be included in today's hearing record as if fully read.

NARUC is a quasi-governmental, nonprofit organization founded in 1889. Its membership includes the State public utility commissions for all States and territories. NARUC's mission is to serve the public interest by improving the quality and effectiveness of public utility regulation. NARUC's members regulate the retail rates and services of electric, gas, water and telephone utilities. We have the obligation under State law to ensure the establishment and maintenance of such energy utility services as may be required by the public convenience and necessity, and to ensure that such services are provided at rates and conditions that are just, reasonable and nondiscriminatory for all consumers.

I would like to begin today by addressing electric transmission siting.

NARUC strongly disagrees with the presumption permeating here in Washington that "the root cause of all transmission congestion problems in this country is State eminent domain and siting authority, and therefore the Federal government must step in." This theory is, at best, simplistic.

As a nation, we want the lights to come on whenever we flip the switch. We want to run consumer goods using electricity that is inexpensive. We want to be able to be employed by and own stock in companies that produce these electric-powered consumer goods. We want our companies to be able to buy power at interruptible rate levels, but never have to be interrupted.

However, we do not want generation facilities fouling the air, water, and land, nor do we want transmission lines running through our communities or near our schools or homes. We do not want gas pipelines running under our feet or near our communities. We do not want to pay any additional costs associated with renewable energy. We do not want to spend the money necessary on research to find technologies to replace the energy sources we currently depend upon.

Therefore, the conclusion that we must draw from all of this is that a major impediment to siting energy infrastructure in general and electric transmission in particular is the great difficulty in getting public acceptance for needed facilities. Quite frankly, this tells us that no matter where siting responsibility falls, with State government or the Federal government, siting energy infrastructure will not be easy and there will be no "quick fix" to this situation.

Giving the Federal Energy Regulatory Commission (FERC) eminent domain and siting authority is not a panacea. Beyond the practical matter of the time FERC would need to be prepared to assume this new role and the additional funds that Congress would need to appropriate to accomplish this, how many examples actually exist where a State action (or inaction) is solely responsible for unreasonably preventing a needed transmission project?

Currently, the States have the responsibility and authority to site transmission. In fact, the transmission infrastructure that is currently in operation now has received State siting approval. Additionally, those projects that are in the planning stages are being planned with State approval in mind.

Make no mistake, NARUC and its membership understand that additional transmission is necessary in all regions of the country. NARUC's members are also well aware of the difficulties involved with the siting of these facilities. The fact remains that in spite of these difficulties, the States have been successful in siting the electric transmission infrastructure that exists today. However, we must also continue to be cognizant of the basic laws of physics. As much as we all would like to be able to move electrons from wherever they are produced to wherever they are needed, like we can with natural gas molecules, the electric transmission system is not able to accommodate those types of transactions. In other words, the transmission system as it now exists was not built to handle the types of wholesale transactions that a competitive market will require. This means we will have to be innovative to make the system function the way we need it to function.

For instance, as we look for innovative ideas, we can begin by remembering that generation and transmission are substitutable. A State may determine that a transmission line is not necessary if, for example, distributed generation is used instead, thereby saving valuable resources and protecting citizens from the unnecessary costs of the transmission project. FERC does not now have the ability to make such a determination, and we do not support proposals to expand FERC authority over generation.

NARUC believes that the States should do more to improve upon the tremendous success story of the nation's electricity infrastructure. States exercising jurisdiction over the siting and certification of transmission facilities should not discriminate against interstate facilities, meaning that in general, interstate facilities should be

sited, certificated, and otherwise regulated under the same standards and procedures as intrastate facilities.

NARUC supports voluntary regional bodies that permit the States in which an interstate transmission facility is proposed to be sited, to issue certificates authorizing the construction of the proposed facility through collective decisionmaking. If States choose to retain certification authority for themselves, there should be agreed upon mechanisms to resolve disputes where individual States involved have come to conflicting and/or inconsistent determinations in their respective deliberations. These voluntary regional bodies could: address siting of transmission; identify regional bulk power market needs for State siting agencies to consider in their respective deliberations; and, plan for the construction of new interstate transmission facilities.

Congress should affirm that States have the primary authority to establish, operate and govern these voluntary regional siting bodies, and FERC could act as an appropriate "backstop" authority where States or regions fail to act. Additionally, Congress should provide an explicit grant of authority to the States and FERC to act in cooperation.

Until all stakeholders (residential and commercial consumers, industrial consumers, utilities, energy suppliers and marketers, transmission owners and environmentalists) begin to make sacrifices, it will continue to be extremely difficult to improve our electric transmission system. We as public officials must also try to use our positions to apply reason rather than fanning the flames of emotion.

Mr. Chairman, NARUC would like to thank you for efforts to produce legislative language that does not take the draconian step of overt Federal preemption of State authority over siting and eminent domain for transmission facilities. However, for the reasons I have just mentioned, NARUC must respectfully oppose the Federal transmission siting provisions found in section 402 of your electricity legislation discussion draft.

I would now like to briefly comment on reliability.

The reliability of the nation's electric system is one of the most important issues in this debate, and NARUC believes that Federal legislation must indeed address this subject. NARUC continues to support the NERC process that has developed legislation mandating compliance with industry-developed reliability standards and provides explicit authority to FERC and the States to cooperate to enforce those standards. NARUC also supports legislation that includes workable mechanisms to support energy efficiency programs that enhance reliability.

Enforcement of operational standards and criteria should be supervised by the FERC in cooperation with the States through existing State authority, joint boards, or other mechanisms. Enforcement of compliance with planning and system adequacy standards should rest first with the States and regional bodies. Congress should explicitly affirm the public interest in transmission grid reliability and the need for mandatory compliance with reliability standards. Congress should expressly include in legislation: (1) a savings clause to protect existing State authority to ensure reliable transmission service, and (2) a regional advisory role for the States.

Federal legislation should also facilitate effective decisionmaking by the States and recognize the authority of the States to create regional mechanisms including, but not limited to, inter-state compacts or regional reliability boards, to ensure transmission reliability. NARUC cannot support reliability language that fails to provide a continuing role for States in ensuring reliability of all aspects of electrical service, including generation, transmission, and power delivery services or results in FERC's preemption of State authority to ensure safe and reliable service to retail consumers. State officials will be held accountable by the public when the lights fail to stay on. Because of this responsibility, State officials and regulators are particularly concerned that they be able to act effectively to ensure uninterrupted electricity service.

NARUC witnesses have appeared before your Subcommittee many times prior to today requesting a State savings clause and a regional advisory role for the States. However, the Chairman's electricity discussion draft legislation fails to include these two "must have" provisions. Mr. Chairman, NARUC must therefore respectfully oppose the reliability title of your discussion draft.

The third topic I was asked to comment on today was "incentive rates." NARUC has begun to hold discussions on this issue, though we have not developed an official position as of yet. I would be happy to provide you with my own thoughts on this topic during the question and answer portion of this hearing.

Thank you for your time and attention. NARUC members and staff look forward to working with the members of this Subcommittee to put forth a successful national energy policy. Thank you again and I look forward to your questions.

Mr. BARTON. Thank you, Mr. Schriber.

We now want to hear from Mr. Stanley Szwed, who is Vice President of Transmission for FirstEnergy Corporation. He's here on behalf of the Edison Electric Institute.

Your statement's in the record, we would ask you to summarize it in 5 minutes.

STATEMENT OF STANLEY F. SZWED

Mr. SZWED. Thank you, Mr. Chairman. And I do very much appreciate the opportunity to testify here today.

I'm Stan Szwed, Vice President of Transmission for FirstEnergy Corp of Akron, Ohio, and I am testifying on behalf of the Edison Electric Institute.

Mr. Chairman, thank you also for your discussion draft. It includes good provisions on nearly all of the transmission priorities that we support.

My testimony today will focus first on why transmission is critical to competition and reliable electric service, and second on specific legislative recommendations.

Mr. Chairman, wholesale competition is here, so is retail competition in many States. Transmission capacity is critical to competition. There is not enough of it and, clearly, it is a Federal responsibility. If you want competition to work, Congress must address transmission needs. It's that simple.

Transmission is the critical backbone of the entire electrical network. It is not a service that would be nice to have that we won't have enough of, like broadband, for example. This is electricity and we all depend on it daily.

We do have the greatest transmission network in the world, but it wasn't built for what we're trying to accomplish in competitive markets today. The transmission system we have today, many times we can't get power from a point A to a point B. It's no one's fault. The lines simply were just not designed to move power between points that people now want to connect to. So we have to transform what I call a system of local roads network into what we need now, and that is more of an interstate highway system. And the key to building the highway system we all want is to set the right regulatory atmosphere necessary to attract investment.

In essence, with the formation of regional transmission organizations, RTOs, we're establishing a separate new industry. If Congress and FERC get sidetracked on the perfect RTO size and boundaries, if Congress and FERC bog down on the perfect rules of the road, we'll be in the theoretical classroom forever.

Investors want us out of the classroom and into operation. Turning off investors will stifle competitive markets and harm consumers. Our collective efforts to get it perfect will not mean getting it at all.

Now I'd like to turn my attention to suggesting seven specific legislative aspects that we would ask to be considered in any legislative work done. The first is that of reforming transmission rate making.

Congress should reform transmission rate making to reflect risks in the new transmission industry and to make transmission a rea-

sonable investment proposition. Returns on transmission assets should be in line with assets in industries with equal risk.

The Barton discussion draft section 401 is a good step. We also thank Congressman Sawyer and Burr for introducing H.S. 2814 which would reform transmission rate making. In the last Congress this subcommittee adopted by voice vote the rate reform provisions from their similar 1999 legislation.

Second, we do need to reform transmission siting. EEI supports a FERC siting rule which States are unable to act on new transmission line applications. If a State failed to act on an application or materially altered it, FERC could issue a certificate of public convenience and necessity for a transmission line. This is essentially what the Barton discussion draft calls for.

Third, adopt mandatory reliability standards. Effective competitive markets need to have mandatory reliability standards. We also believe there should be a single national reliability organization. The discussion draft contains reliability provisions we generally support.

Fourth, remove tax barriers. We need to allow tax deferred sales and tax free spinoffs of transmission property as provided in H.R. 4 Such taxes impede RTO formation. This language resulted from an agreement between investor owned and public power providers of electricity. Thank you for including this in your discussion draft as well.

Five, repeal the Holding Company Act. It is a significant disincentive for transmission investment if entities with more than a 10 percent ownership stake in RTOs are required to become a registered holding company. the Holding Company Act is outdated. It has no benefit to customers and in stifling progress on policy goals. We should simply get rid of it.

Six, avoid RTO mandate authority for FERC. Congress should not mandate RTO participation or authorize FERC to do so. RTOs are forming and mandate authority for FERC is risky. Investors must know their investments cannot be summarily forced into a structure with wholly different financial fundamentals.

And last, streamline section 203 of the Federal Power Act. The Barton discussion draft would repeal this section, and we support repealing it as we support other measures that address the lengthy and duplicative FERC reviews.

Thank you, Mr. Chairman. Your actions will have very important consequences for our future infrastructure needs.

[The prepared statement of Stanley F. Szwed follows:]

PREPARED STATEMENT OF STANLEY F. SZWED, VICE PRESIDENT-TRANSMISSION,
FIRSTENERGY CORP. ON BEHALF OF EDISON ELECTRIC INSTITUTE

INTRODUCTION

Thank you for the opportunity to testify before the Subcommittee today. I am Stan Szwed, Vice President of Transmission for FirstEnergy Corp. FirstEnergy is a diversified energy services company headquartered in Akron, Ohio, and is the nation's 10th largest electric utility. We serve 2.2 million customers in Northern Ohio and Western Pennsylvania. We are in the final stages of our proposed merger with New Jersey-based GPU. GPU serves 2.1 million customers in Pennsylvania and New Jersey. When our merger is completed, FirstEnergy will be the 4th largest electric utility in the nation based on customers served. As Vice President of Transmission, I am responsible for the operation of the FirstEnergy transmission system—that is, managing the electric power grid and keeping it available 24 hours

a day, seven days a week, 365 days a year. Our system—and others like it in three major interconnections in North America—is always on.

I am testifying today on behalf of the Edison Electric Institute (EEI), the association of U.S. shareholder-owned electric utilities and industry affiliates and associates worldwide. I am pleased to have the opportunity to testify before the Subcommittee on critical transmission issues that should be addressed in electricity restructuring legislation.

At the outset, let me express my sympathies to all those affected by the attacks on America on September 11, which was the date this hearing was originally scheduled to have taken place. Electric transmission facilities are critical infrastructure, and the industry takes very seriously its responsibility to maintain the security and reliability of those facilities.

EEI is a leader in advocating public policy to support competitive electric generation markets with market-based pricing and a wide diversity of market participants. EEI and its members firmly believe that market-oriented restructuring of the electric industry remains the best opportunity to provide consumer benefits and to develop reliable new sources of supply. To accomplish this goal, EEI strongly supports passage of comprehensive energy legislation.

FirstEnergy has been an industry leader on electric transmission issues. With many partners, we have accomplished groundbreaking work to develop what was, when we proposed it, a first of its kind: a for-profit transmission company as a regional transmission organization. During the course of our work, we have tried to help policy makers set the right course for transmission. I hope that my experience on these two efforts—the development of a for-profit RTO (The Alliance) and the promotion of proper federal policy on transmission—will be of value for the Committee.

BACKGROUND

The Energy Information Administration (EIA) projects that more than 1,300 new power plants will need to be built between now and 2020, to meet our economy's electricity needs. However, without an adequate transmission system, that power will not get to where it is needed.¹

In many areas transmission capacity has not expanded to keep pace with new demands to support competition. Utilities built the bulk of today's transmission system before the advent of wholesale and retail electricity competition, primarily to move power limited distances and to bolster reliability. The current transmission grids were not designed to serve as the interstate super-highway system for competitive electricity markets. Therefore, it should not come as any surprise that transmission congestion is on the rise.

Fundamental changes in the industry are imposing tremendous demands on transmission systems to carry more and more transactions across even greater distances. Between August 1999 and 2000, transmission congestion in the Eastern Interconnection grew by more than 200 percent.² In the first quarter of 2001, this transmission congestion was already three times the level experienced during the same period in 2000.³

Maintaining transmission adequacy at current levels would require about \$56 billion in investment during the present decade.⁴ The Electric Power Research Institute ("EPRI") estimates it will cost up to \$30 billion to bring the western regional transmission system back to a stable condition and \$1 billion to \$3 billion a year after that to maintain this condition in the face of continued growth.⁵ Such investment must come from transmission-owning companies and, ultimately, from investors.

This will be a major challenge. The fact is—annual investment in transmission has been declining by almost \$120 million a year for the past 25 years.⁶ Trans-

¹ As the PA Consulting Group stated in its 2001 report, "Transmission represents only a small portion of the cost of electricity, but has a substantial effect on the success of electricity markets by increasing access to supplies and reducing electricity prices. However, the inability of the restructuring process to adequately address as yet the needs of the transmission sector is jeopardizing the health of both the sector and of the entire electric power industry, which it supports." Roger Gale et al., PA Consulting Group, *The Future of Electric Transmission in the United States* § 1-1 (2001).

² Eric Hirst and Brendan Kirby, Edison Electric Institute, *Transmission Planning for a Restructuring U.S. Electricity Industry* 8 (2001).

³ *Id.*

⁴ *Id.* at v.

⁵ *The Western States Power Crisis* vi (2001).

⁶ Hirst and Kirby, *supra* note 2, at 5.

mission investment in 1999 was less than half of what it had been 20 years earlier.⁷ As the North American Electric Reliability Council (“NERC”) testified earlier this year: “[i]n North America 10 years ago we had a little less than 200,000 circuit-miles of high voltage transmission lines. Right now we have about 200,000 circuit-miles of those lines. And ten years from now we are projecting that we will have just over 200,000 circuit-miles of high voltage transmission lines.”⁸ For a graphical representation of the decline in transmission investment over the last 25 years and the increase in the number of wholesale transactions using the transmission system, please refer to the charts included at the end of this testimony.

THE TRANSMISSION BUSINESS

The new transmission business must be able to make a case for itself. It must be able to demonstrate to investors, employees, customers, regulators, suppliers, and others that it can perform and grow—that it can be a stand-alone enterprise. For a stand-alone transmission company operating independently of affiliated generators, distribution companies or other market participants, this means it must demonstrate that it can attract investment, recruit and keep highly talented, highly motivated people, and pay a just and reasonable return to its owners. Investors need to know that investing in the new transmission industry has commensurate opportunity for reward as investments of similar risk.

Federal and state regulatory policies seek to promote competition for electric service by permitting both retail customers and generators access to the transmission system on a nondiscriminatory basis. In particular, the FERC, by promoting the formation of regional transmission organizations, is requiring transmission service to be furnished by large multi-state organizations independent of transmission owners. This policy requires the transmission business to stand on its own in providing reliable transmission service, expanding its facilities to support growing competition for electric service, and providing reasonable compensation to stockholders. Since reliable and readily available transmission service is one of the keys to effective competition, a regulatory environment absolutely, without fail, must be created that gives this new transmission business the opportunity not simply to survive, but to thrive. California demonstrates that we cannot overlook the direct relationship between investing to keep up with changing demands and electric reliability.

Open access to transmission facilities, which FERC required in Order No. 888, means that transmission lines once solely used for the vertically integrated company that owned the line, are now part of an interstate transmission system that could be used by anyone. The problem is that as a whole, the systems were not built to serve as an interstate highway. They were built to deliver electricity from a specific power plant to a specific load center within the regulated service area of a single utility or utility system. The separation of transmission from the traditional utility and the transfer of control over transmission service to RTOs introduce new requirements and dictate a new approach to ensuring reliability of transmission service.

The new transmission industry will need to compete with the private sector to attract investment, build a business, and serve its customers. Don’t just take my word for how important it is to get the new transmission industry right. The PA Consulting Group stated in its 2001 report that “the inability of the restructuring process to adequately address as yet the needs of the transmission sector is jeopardizing the health of both the sector and of the entire electric power industry, which it supports. . . . [The] lack of additional incentives in the face of new risks lies at the heart of many of the problems now facing the transmission sector.”⁹

In a comprehensively regulated service such as transmission, setting out the right business proposition depends very heavily on Congress and federal regulators establishing the right federal policies. I especially want to commend Representatives Sawyer and Burr, who have looked at transmission from the perspective of trying to increase investment, encourage construction and expand markets. FirstEnergy endorses their legislation, H.R. 2814, and encourages the Committee to include it or similar elements in any electricity restructuring legislation. Based on the legislative principles outlined above, an electricity bill should address the following areas:

⁷*Id.*

⁸*National Energy Policy with Respect to Federal, State, and Local Impediments to the Siting of Energy Infrastructure: Hearing Before the Senate Comm. on Energy and Nat. Resources, 107th Cong. (2001)* (statement of David N. Cook, General Counsel, North American Electric Reliability Council).

⁹Roger Gale et al., *supra* note 1 at § 1-1.

Reform Transmission Rates

Congress should provide definitive pricing direction to FERC with the policy goal of having a healthy, robust transmission system for the nation that can help deliver the many benefits of electric competition to all consumers. As such, Congress should reform transmission rate making to reflect the risks and uncertainties in the brand new transmission industry. FERC has a legal obligation to set rates that simultaneously protect consumers' interests in having reasonable rates and investors' interests in reasonable returns. However, transmission rate reform, which many parties acknowledge is needed, has been too long in coming. As has been noted, "The transmission sector, as the provider of services to participants in both the wholesale and retail markets, has . . . seen an increase in risk, but there has been little if any increase in potential rewards."¹⁰ The best thing for consumers is a robust, growing transmission network, and it will require some different regulation to bring that about.

We support transmission rate reform so that returns on transmission assets are in line with assets in industries having commensurate risk.¹¹ The September 21, 2001, electricity discussion draft circulated by Chairman Barton ("Barton discussion draft") directs FERC to conduct a rulemaking that would improve transmission rates with the goal of promoting the expansion and improvement of interstate transmission networks. We also support innovative rate treatments, such as allowing transmission owners to share with customers some of the financial benefits of providing more cost-effective service.

We believe that if reform of transmission pricing is undertaken, prices for delivered electricity will remain stable and may even decline. Generation accounts for the lion's share of electricity costs—some 75%. A more vigorous transmission sector should strengthen competition. Increasing access to supply should lead to more competition and lower delivered prices.

The President's National Energy Policy Report called for the Department of Energy to work with FERC to encourage the use of incentive rate making proposals. H.R. 2814, the bill introduced by Representatives Sawyer and Burr, also directs FERC to utilize innovative transmission pricing policies. Chairman Barton's discussion draft contains helpful language on this point. And H.R. 2944, the electricity bill passed by this Subcommittee in 1999, included innovative pricing language. FERC is moving in the right direction on issues like these, but encouragement from Congress, especially in the form of legislative language directing FERC to consider the need for transmission investment and expansion when setting rates, is very important.

Reform Transmission Siting

One of the key impediments to increasing transmission capacity is the problem of siting new lines, particularly lines that are built to facilitate interstate power transactions. To help site new transmission lines, EEI supports giving FERC a role as backstop. This backstop would come into play only when states are unable or unwilling to act on the application. Under this proposal, if a state failed to act on an application, or materially altered it, FERC would be given the authority to issue a certificate of public convenience and necessity for a transmission line. FERC would have similar authority if other Federal agencies failed to act or materially altered a regionally approved proposal.

The proposal to grant FERC a key role in siting new transmission lines has gained support across the political spectrum. The President's National Energy Policy Report recommends developing legislation to grant FERC siting authority for new transmission. The Barton discussion draft would grant FERC a backstop role if a state lacked authority to site a new transmission line, withheld approval or delayed final approval for more than one year. H.R. 2814 also would grant FERC a similar backstop role. In his draft bill on electricity legislation, Senate Energy Committee Chairman Bingaman proposed granting FERC siting authority.

It made sense in 1935 when the Federal Power Act was adopted to leave transmission siting authority with the states, since transmission lines were generally local in nature. It also made sense for Congress to grant FERC's predecessor, the Federal Power Commission, authority to make siting decisions for natural gas pipelines, since they tend to be interstate in nature. Now, however, our transmission

¹⁰ *Id.*

¹¹ In recent years the S&P 500 companies have, on average, yielded a rate of return on equity (ROE) of approximately 20 percent, while vertically integrated electric utilities have lagged behind at 10-13 percent on average. See Joint Comments of Kit Konolige et al., regarding the Commission's Notice of Proposed Rulemaking on Regional Transmission Organizations, at 9, FERC Docket No. RM99-2-00.

system is being asked to meet obligations similar to natural gas pipelines: move large amounts of energy across long distances and across state lines.

FirstEnergy endorses federal siting authority, even though in Ohio we have a comparatively good siting process. In the early 1970s, Ohio established a transmission siting board. Today in Ohio, if you propose a transmission facility, the application need only be approved by the state siting board. The applicant must demonstrate a need in Ohio for the facility, and must demonstrate that environmental considerations are given due regard. Once these thresholds are met, the board issues a certificate on environmental compatibility and public need. Roughly 28 states have siting statutes, while the remaining states retain roles for local authorities in siting decisions.

We understand that the issue of federal eminent domain authority raises concern. Of course, to carry out necessary siting, there must be a certificate of public convenience and necessity issued. Only then may the holder of the certificate exercise the authority. The FERC currently has authority to issue certificates for natural gas pipelines and for electric transmission for hydroelectric projects. In addition, the federal electric utilities that own transmission have eminent domain authority.

Electric utilities currently exercise the power of eminent domain when issued state certificates of public convenience and necessity if they are unable to acquire the rights-of-way through other means. EEI recently surveyed its member companies on their use of eminent domain authority. The companies that responded have transmission operations in 39 states. They reported acquiring 4,107 miles of transmission line rights-of-way over the last five years, involving more than 14,000 parcels of land. Of those parcels, only 417—or 2.9 percent—required the use of eminent domain authority. Utilities clearly exercise eminent domain as a last resort.

Remove Tax Barriers

Congress should enact tax reform to remove disincentives to formation of regional transmission organizations and to provide incentives for new investment. Specifically, we need to allow for tax-deferred sales and tax-free spinoffs of transmission property, as provided for in H.R. 4. This language resulted from an agreement between the Edison Electric Institute, the American Public Power Association, and the Large Public Power Council. In addition, we need to accelerate depreciation periods for transmission property, as called for in S. 596, introduced by Senator Bingaman.

Forming a for-profit transmission company or transco, which is what my company and many others are doing to comply with Order No. 2000, is extremely difficult, and is complicated by the tax laws. To meet the Order's independence requirement, many utilities would prefer to find a way to divest transmission assets. In other cases where government action requires a taxpayer to sell property, the tax code prevents incursion of tax penalties. If utilities sell transmission property and reinvest the proceeds into other utility property, taxes should be deferred until a taxable event involving the property occurs. If utilities spin off transmission property, this should not be considered a taxable event.

As for depreciation of transmission assets, the depreciation period should be brought into line with periods for property in other industries, given the changed circumstances under which the industry must attract capital.

Remove PUHCA Barriers

Congress should repeal the Public Utility Holding Company Act. It is now a significant barrier to investment in RTOs. When the Senate Banking Committee held a hearing on S. 206, the Public Utility Holding Company Act of 2001 (which has now been adopted by that committee by a 19-1 vote), Cindy Marlette, FERC's Deputy General Counsel, testified to the impact of PUHCA on RTO formation, stating:

PUHCA may cause unnecessary regulatory burdens to utilities who, in compliance with Commission policy and regulations, seek to form or join regional transmission organizations (RTOs)... Under PUHCA, any entity that owns or controls facilities used for the transmission of electric energy—such as an RTO—falls within the definition of public utility company, and any owner of ten percent or more of such a company would be a holding company and potentially could be required to become a registered holding company. This could serve as a significant disincentive for investments in independent for-profit transcos that qualify as RTOs.¹²

Put simply, the Holding Company Act stifles investment in the emerging independent transmission industry. As EEI member companies attempt to raise financ-

¹²Hearing on S.206 "The Public Utilities Holding Company Act of 2001: Before the Senate Comm. on Banking, Housing and Urban Affairs, 107th Cong. (2001) (Statement of Cynthia A. Marlette, Deputy General Counsel, Federal Energy Regulatory Commission).

ing for newly forming RTOs, they are discovering that PUHCA's restrictions are a significant concern to Wall Street firms and a barrier to investment.

Avoid Market Structuring Authority for FERC

Congress should avoid giving FERC new authority to restructure the industry. As noted above, RTOs are forming. This process is already subject to intense FERC review and approval.

FirstEnergy has been actively involved in RTO formation for the last four years. Our company joined the Alliance filing in June 1999, well before Order No. 2000 was issued. With four major FERC orders behind us, each conditionally approving our filings and encouraging us to continue, the Alliance is nearing operations. And we are not alone; electric utilities in the Northeast and the Southeast have also spent countless hours and invested millions of dollars in efforts to form their own RTOs. Giving FERC additional authority to alter the process at this stage could damage and impede the progress already made. Now is certainly not the time to increase uncertainty. With 98 percent or more of investor-owned transmission assets committed to RTOs in development, the industry is demonstrating that many proposals in the last Congress for additional RTO authority were unnecessary. FERC is an economic regulatory agency. Market structuring decisions should remain primarily where they reside today—in the Department of Justice, Federal Trade Commission, and with the state antitrust authorities.

Furthermore, if the federal government focuses the transmission debate on the authority of the commission to restructure the industry, it conditions the industry to be concerned with regulation, and not with making transmission systems work. The businessmen will be regulatory experts, not transmission experts. Lately my colleagues and I have spent a lot of time negotiating our way through regulatory changes and policy debates, when what we need to do most is run this critical business and focus on customer satisfaction.

Adopt Mandatory Reliability Standards

In a competitive electricity market, voluntary reliability rules that market participants may or may not obey, depending on their economic incentives, will not work. We have already seen market participants bending and even ignoring the existing voluntary rules for their own gain. The North American Electric Reliability Council (NERC) is reporting numerous violations of its voluntary reliability rules. A comprehensive restructuring bill should include provisions to ensure reliability standards developed by technical experts are mandatory and enforceable on all market participants, with FERC oversight. Also, the rules should apply uniformly to provide stability and security for new markets with new boundaries.

The President's National Energy Policy Report calls for such legislation. H.R. 312, legislation introduced by Representative Wynn, contains reliability provisions developed by NERC and numerous industry stakeholders. H.R. 2814 includes the same reliability provisions. H.R. 2944, as approved by this Subcommittee in 1999, contained similar provisions. Also, the Senate passed a version of this bill last year. The Barton discussion draft contains different language, but we believe its overall goal is consistent with the previous proposals and that, with a few modifications, this language would be acceptable to a majority of EET's member companies.

Streamline Merger Review Authority

Congress should streamline, at the very least, the review of dispositions of utility property by the FERC under Section 203 of the Federal Power Act. Among other things, this review is a barrier to consolidation of transmission networks and formation of RTOs.

Section 203 of the Federal Power Act is currently a "one-size-fits-all" provision that applies to the disposition of all jurisdictional assets with a value of \$50,000 or more. It applies to everything from a simple sale of a transmission substation to the most complicated utility transactions. FERC reviews of dispositions of property under section 203 take far too long and are often duplicative of reviews conducted by other agencies. For some transactions, review is required by FERC, the Department of Justice, the Federal Trade Commission, the Securities and Exchange Commission, the Nuclear Regulatory Commission, and each affected state. Utility transactions should be reviewed by the government, commensurate with the way transactions involving other industries are reviewed. However, the massive, time-consuming, duplicative review specific to the electric utility industry is contrary to consumer interests because it delays companies' ability to respond to market needs and needlessly increases transaction costs.

Both the Barton discussion draft and H.R. 2814 would repeal Section 203 of the Federal Power Act, which grants FERC authority to review public utilities' disposition of property, consolidation and purchase of securities. This eliminates duplica-

tive federal merger reviews, leaving the Department of Justice or Federal Trade Commission to review such mergers.

THE ALLIANCE RTO

FirstEnergy is one of the leaders in forming the Alliance Transco Limited Liability Company (Alliance Transco LLC) that we anticipate will be qualified as the Alliance RTO. We anticipate that an affiliate of National Grid USA, itself part of a worldwide independent transmission-only company, will be the independent Managing Member of Alliance Transco LLC. As part of the transaction, National Grid expects to make very substantial investments in Alliance Transco LLC to fund start-up and to acquire assets. Alliance Transco LLC will be a for-profit transmission company. The business of the company will be to provide transmission service. The EEI member companies that now own the transmission assets expected to be controlled by Alliance Transco LLC will become its customers, aligning their interests more closely with other generators and utilities. As I mentioned, with two years of regulatory proceedings behind us and substantial approvals already obtained, Alliance Transco will be ready to operate by the end of this year in accordance with the ambitious timetable set by Order No. 2000 if it gets final approval from FERC this fall.

Over the last four years, and especially since the first Alliance filing in 1999, a major portion of my daily activity and the people I work with has been focused on forming the Alliance. The model we built has attracted five newer members to the Alliance, which will now be able to provide transmission service roughly from the Gateway Arch in St. Louis to Kitty Hawk, North Carolina. It will link large load centers such as Chicago, Cleveland, and Northern Virginia.

Alliance is but one RTO being developed by EEI member companies. In each case and under each model, there are business and human challenges that must be overcome. On the business side, we are focused on crafting and executing the business and financial arrangements necessary to establish electric transmission institutions that can serve growing competitive markets for electricity. This is the cutting edge of financial restructuring.

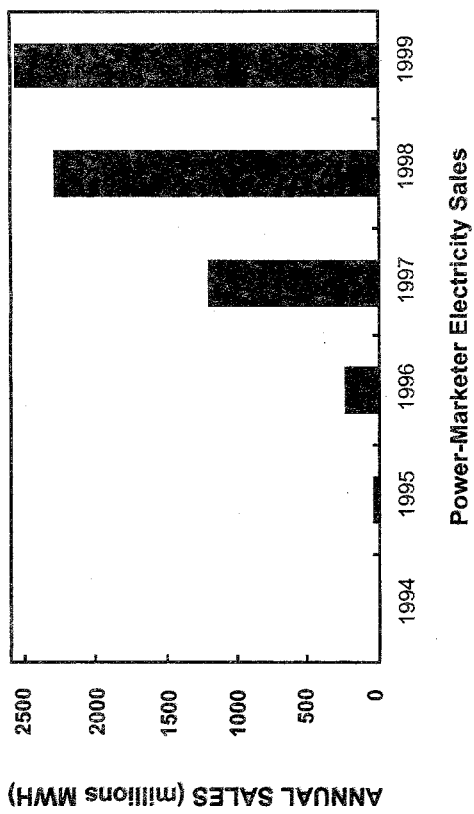
On the human side, the new transmission industry will need experienced and highly trained, highly motivated personnel. It takes experienced people to run these systems. The system operators are the finest people around. The last thing they want to happen is to reduce load or have a blackout. They take pride in making sure that we effectively balance resources and load, and they work day and night—literally 24 hours a day, seven days a week, 365 days a year—to keep the lights on. We must keep these operators. However, without the right business proposition, and without some certainty about the direction and promise of this emerging industry, how will we keep them?

I implore you to craft legislation in such a way that accelerates and does not retard the development of this new transmission industry and the start-up of RTOs in development.

CONCLUSION

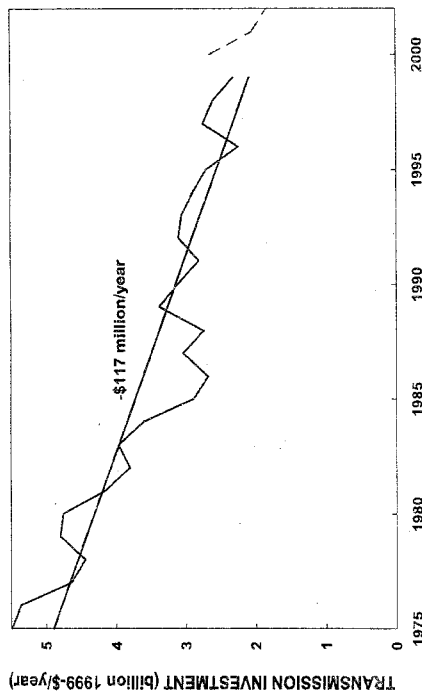
Our country needs a comprehensive electricity restructuring bill. And since transmission is the backbone of the entire industry, Congress needs to ensure that wholesale electricity markets are capable of delivering adequate, affordable and reliable electricity to consumers. Without sufficient transmission capacity it won't happen. Transmission is the linchpin to well-functioning wholesale and retail markets. We look forward to working with this Subcommittee to develop the transmission reforms necessary to enable the industry to launch the independent transmission businesses of the future and close the transmission investment gap.

The number and complexity of wholesale transactions have grown enormously, resulting in increased use of transmission systems



Source: Eric Hirst "Expanding U.S. Transmission Capacity" August 2000

Annual transmission investments (in constant, inflation-adjusted dollars) have been declining for almost 25 years at an average rate of \$117 million/yr.



Source: Eric Hirst and Brendan Kirby, "Transmission Planning for a Restructuring U.S. Electricity Industry," June 2001

Mr. BARTON. Thank you, Mr. Szwed.

We now want to hear from Mr. Roger Fontes, is that correct? Who is the General Manager of the Florida Municipal Power Agency and he's here on behalf of the American Public Power Association.

You're recognized for 5 minutes.

STATEMENT OF ROGER A. FONTES

Mr. FONTES. Good morning, Mr. Chairman, and thank you, members of the subcommittee for the opportunity to testify today.

I am testifying on behalf of the American Public Power Association which represents 2,000 publicly owned utilities serving 40 million customers.

APPA supports the implementation of Federal policies that will establish effective wholesale competition, and we share the view of many members of the subcommittee that getting the transmission issue right is the key to achieving that goal. Nowhere is this more evident than in my State of Florida where we have inadequate interstate connections with other States and where prior transmission discrimination has led to lengthy litigation on transmission access issues.

Getting it right means resolving all of the issues you have identified for these hearings today, but you've also asked the panel to specifically address three key ones: Siting, incentive rates and reliability of the grid. So let me address each of these.

Siting. It is widely recognized that the Nation's transmission system is weak and highly constrained. These problems inhibit competition and threaten reliability. The biggest obstacle to new transmission lines is the difficulty of siting.

Currently the balkanized State-by-State process is not working. Since these facilities are necessary to support interstate commerce, a Federal role is appropriate and essential. APPA supports the concept of Federal eminent domain authority for major transmission facilities and in that regard we support section 402 of the chairman's draft bill.

Given the political problems involved, however, we think this authority should only be used after appropriate consultation and cooperation with State and local governments. Thus, we suggest that this section be expanded to include an authority to create States creating joint siting boards that mirror RTO boundaries, require these boards to provide one-shop review and approval processes for RTO approved facilities and provide FERC with siting authority if States fail to establish boards or act on RTO plans.

Regarding incentive rates. Many transmission owners are urging Congress to direct FERC to institute incentive rates to encourage transmission construction. We strongly believe that this is the wrong approach and is unnecessary. We must stop looking to the entities that both own transmission and generation to build new transmission facilities. The risk of losing generation sales to competitors by building new transmission is so great that we believe the incentive will not help. And extensive profits really only spill through to higher consumer rates for everyone.

Indeed, the chairman's discussion draft includes a proposal, and we respectfully request that it be deleted.

First, really, the obstacle to transmission is not the lack of capital or investors. The main obstacle is siting. Transmission is a low risk traditionally regulated utility investment. It has been successful in attracting capital at reasonable and regulated rates of return. I believe Thomas Lane from Goldman Sachs testified before your committee in late July and said "There is definitely a role in the markets for low risk/low return investments, which is what transmission represents." We agree with this statement.

A recent example of this is Department of Energy's request for interest in constructing what's now become the famous Path 15 in California, which I understand garnered more than a dozen responses.

Second, additional legislation is not needed. FERC already has existing authority to approve innovative or performance based rates. FERC has had an incentive rate policy since 1992. Personally I find it ironic that the same time large transmission owners are demanding higher rates to build new transmission, they are steadfastly refusing to allow public power and cooperative system to be paid by RTO's for their prior transmission investments. Congress should not support this gambit.

Transmission will be built if we resolve siting issues and support FERC's authority to require RTOs to have the full authority to plan and construct the grid.

Reliability. Certainly events of the past year have reenforced the importance of maintaining and improving the reliability of the transmission system. APPA supports enactment of Federal legislation to establish a national electric reliability organization to set and enforce reliability standards with FERC oversight. In this regard we support section 301 of the chairman's draft. We also support some changes to that section as proposed by the NERC, National Electric Reliability Council, that would impart, underscore the need for FERC to oversee implementation of the standards and enforce compliance by RTOs and others using the Nation's transmission grid.

Thank you for the opportunity to be here today. Public power looks forward to working with the subcommittee to address these issues for the benefits of all consumers. Thank you.

[The prepared statement of Roger A. Fontes follows:]

PREPARED STATEMENT OF ROGER A. FONTES, GENERAL MANAGER AND CEO, FLORIDA MUNICIPAL POWER AGENCY, ON BEHALF OF THE AMERICAN PUBLIC POWER ASSOCIATION

Thank you, Chairman Barton, Ranking Member Boucher and Members of the Subcommittee for this opportunity to testify. I am pleased to appear today on behalf of the American Public Power Association to discuss several important issues involved in restructuring the nation's electric transmission grid.

I am General Manager and CEO of the Florida Municipal Power Agency (FMPA), a joint action agency providing wholesale power and other services to 29 municipal electric utilities in Florida. APPA represents the interests of more than 2,000 publicly owned electric utility systems across the country, serving approximately 40 million customers. APPA member utilities include state public power agencies and municipal electric utilities that serve some of the nation's largest cities. However, the vast majority of these publicly owned electric utilities serve small and medium-sized communities in 49 states, all but Hawaii. In fact, 75 percent of our members are located in cities with populations of 10,000 people or less.

Public power systems' first and only purpose is to provide reliable, efficient service to their local customers at the lowest possible cost. Like hospitals, public schools, police and fire departments, and publicly owned water and waste water utilities,

public power systems are locally created governmental institutions that address a basic community need: they operate to provide an essential public service, reliably and efficiently, at a reasonable, not-for-profit price. Publicly owned utilities also have an obligation to serve the electricity needs of their customers and they have maintained that obligation, even in states that have introduced retail competition. And, because they are governed democratically through their state and local government structures, public power systems operate in the sunshine, subject to open meeting laws, public record laws and conflict of interest rules. Most, especially the smaller systems, are governed by an elected city council, while an elected or appointed board independently governs others. Democratically governed, not-for-profit, obligated to serve all customers—understanding the underlying structure and mission of public power is essential in crafting balanced electricity legislation that will maintain industry diversity and promote the consumer interest.

Wholesale Competition First—the Role of the Federal Government

There is only one reason for Congress to enact comprehensive electric utility restructuring legislation—to promote wholesale competition for the benefit of all consumers. The overriding objective must be to restructure the industry in a way that has a high probability of benefiting all classes of consumers with no degradation of reliability of service.

Moving from a monopoly model to a competitive model is very difficult. Those in this transition who are threatened with a loss of market control can be expected to fight tenaciously to retain competitive advantages or seek to gain market power. The biggest obstacles to the creation of robust wholesale competition in the electric utility industry are: 1) the inadequacies of our nation's transmission infrastructure; 2) the failure to establish on a comprehensive basis efficient, competitively neutral regional transmission organizations and to plan, construct, operate and provide the transmission service needed for regional markets to succeed, and; 3) the pervasive existence of market power in regional generation markets that can be exercised to keep prices for consumers well above truly competitive levels.

The evidence of the continuing abuse of transmission and generation market power is abundantly clear from the hearing record of this Subcommittee. The vast majority of witnesses from very diverse constituencies and interests that have appeared at Subcommittee hearings over the past five years—whether it was on specific restructuring legislation or in response to the western electricity crisis of the past year—have pleaded for Congress to address this problem.

Because they involve interstate commerce, Congress can only address the market power problems in generation and transmission. Federal antitrust laws may remedy problems in mature markets, but they are not effective to guide the transition to competition for industries, like the electric utility industry, that must evolve from highly concentrated monopolies. Antitrust laws cannot convert such industries to ones that are capable of being controlled by competitive forces.

The identification of market abuses in any modern industry is hard, but in the electric utility industry, it is extremely difficult. Electricity is a real-time product. It is literally consumed as it is produced. It cannot be stored. This makes transactions in the electricity market very vulnerable to subtle discrimination and manipulation, including the ability to withhold transmission from competitors through reservations of capacity for “reliability” and to manipulate the timing of maintenance of strategically located generation and transmission facilities. For these reasons, the primary federal antitrust agencies, the Federal Trade Commission and the Department of Justice, have previously testified in favor of remedying the electricity market structure.

Transmission: the Key to Competition

Since today's hearing is focused on transmission issues and how they are addressed in Chairman Barton's discussion draft, my testimony will delineate transmission provisions that are essential in federal restructuring legislation and will also cite specific provisions in the draft bill, including those that could be modified or eliminated. It is important to remember, however, that generation markets and the transmission system are inextricably linked. In particular, it is essential that federal legislation provide the Federal Energy Regulatory Commission (FERC) with authority to prevent and, where necessary, remedy the exercise of market power.

It is widely recognized that our current transmission system is weak and highly constrained. The weaknesses of the grid not only threaten reliability; they undermine our ability to achieve robust competition. Competitive wholesale markets simply cannot work unless numerous competitors are able to deliver their product to buyers. Today, our regional grids are characterized by ever increasing congestion leading to more and more interruptions and providing buyers with fewer and fewer

reliable choices of supply. We need to fix the grid, physically by enabling prompt construction of needed facilities, and institutionally by providing for independent, competitively neutral planning, operation, and service.

Thus, APPA shares the view of many Members of the Subcommittee that getting transmission “right” is the key to building an effective, competitive wholesale market and that expansion of the grid is critical to making the interstate transmission system more robust and efficient.

The way to achieve these goals is four-fold:

- 1) reform the balkanized, state-by-state transmission siting process;
- 2) stop looking exclusively to entities that own both generation and transmission to build new transmission facilities. The risk of losing generation sales to competitors by building more transmission is so great that these entities will not do it without hefty incentive payments—payments that will unnecessarily increase electricity costs for consumers;
- 3) grant FERC the authority to establish large, rationally scoped and truly independent Regional Transmission Organizations (RTOs) with full authority to plan and expand the regional transmission system; and
- 4) ensure that RTOs fully compensate all transmission owners—whether large vertically-integrated utilities, smaller transmission dependent utilities, or a non-industry investors—for their investment in transmission facilities turned over to an RTO’s control and operation.

The Chairman’s draft admirably addresses the first item, goes in the wrong direction on the second, and has not yet addressed the third and fourth.

Regional Planning and Siting

The Administration’s National Energy Policy Report directed Department of Energy Secretary Abraham to “develop legislation to grant authority to obtain rights-of-way for electricity transmission lines, with the goal of creating a reliable national transmission grid.” APPA supports the approach employed in Section 402 of the discussion draft that provides FERC with siting authority when States or other entities designated to review siting requests are either unable or unwilling to act.

As the Subcommittee reviews the discussion draft, we would suggest that these additional provisions be added to Section 402 to further streamline the siting process:

- 1) Authorize the creation of joint state siting boards that mirror RTO boundaries.
- 2) Require these siting boards to provide a one-stop review and approval process for facilities in approved RTO regional plans.
- 3) Establish reasonable deadlines within which these siting boards must act on RTO plans. Although Chairman Barton’s draft authorizes FERC to be given siting authority on a particular project if a State or siting entity has failed to act within a year, we believe that certain projects may need more immediate action.
- 4) Grant the RTO federal eminent domain authority for the project so that it will not have to proceed in multiple state courts under different standards once a project has been approved either by a joint board or by FERC.

As the Chairman has acknowledged by including FERC siting authority in his draft, the adequacy of the interstate transmission grid is vital to our nation’s economic and security interests and should be addressed on the national level. The current bureaucratic maze of state regulations and the threat of possible judicial action in multiple state courts substantially hinder the siting of new interstate transmission lines. By substituting a single joint siting process for reviewing projects in multiple states that are subject to different rules and standards, investors will be able to proceed with much greater certainty that a project will be approved and completed.

Incentive Pricing

We are aware that some transmission owners have been urging Congress to legislate to direct FERC to institute “incentive,” “innovative,” or “negotiated” rates to encourage owners to expand the grid. In fact, the Chairman’s draft directs FERC to conduct a rulemaking on incentive and performance-based transmission rates. This provision is unnecessary; APPA believes that FERC, under the Federal Power Act and Order 888, already has sufficient authority and flexibility to design transmission rates to “promote economically efficient transmission and generation of electricity.” These rates remain subject to the “just, reasonable, and not unduly discriminatory or preferential” standard that has been the hallmark of FERC rate-making authority. (This standard was recently affirmed by FERC in Order 2000 on RTOs.) Further, APPA believes that incentive rates will undoubtedly lead to increases in overall transmission costs, which are decidedly not in the public interest.

As is mentioned above and will be discussed in more detail below, the most significant impediment to achieving a robust transmission system is the current, fractured, siting process. Because the Chairman's discussion draft addresses this most vital of transmission-related issues, the codification of "incentive," "performance-based," "innovative," or "negotiated" rates is unnecessary and the wrong approach. For these and the following reasons, we feel strongly that Section 401 should be eliminated from the draft bill.

Additional Legislation Is Not Necessary; FERC Is Already Empowered to Approve Innovative or Performance-Based Rates:

Legislation endorsing innovative rate-making to encourage transmission owners to join RTOs, invest in new facilities, and operate the transmission system efficiently is not necessary. The Federal Power Act (FPA) already makes ample room for incentives and performance-based rates that satisfy the "just, reasonable, and not unduly discriminatory or preferential" standard that is the hallmark of utility rate-making. In addition to this fundamental standard, Section 212(a) of the Federal Power Act, which FERC has read into Sections 205 and 206, already provides FERC all the flexibility needed to design rates to "promote economically efficient transmission and generation of electricity," but subject to the essential protections of the "just, reasonable and not unduly discriminatory or preferential" standard. Requests for additional legislative pricing authority should be recognized for what they are—requests for rates that would not otherwise meet the longstanding and fundamental requirement that rates be just, reasonable, and in the public interest.

The concept of incentive rates is not new to FERC. Since 1992, FERC has had an incentive rate policy.¹ That long-standing policy recognizes that to be fair, "Incentive rate-making must simultaneously protect customers' interest and offer potential rewards to the utility for good performance." They also must be balanced: "[I]ncentive regulation should be designed to penalize utilities that fail to achieve these efficiencies—opportunities for reward should be offset by symmetric downside risk." The policy statement establishes sound regulatory standards to guide evaluation of incentive rates, including the requirement to quantify benefits to consumers and maintain quality of service.

FERC's RTO rulemaking, Order 2000, expressly endorses its 1992 incentive rate policy and applies it to the RTO context. In Order 2000, FERC both outlined a series of incentives and pricing innovations that RTOs could propose, and endorsed performance-based rates. FERC's RTO rule expressly invites rate treatments, such as rate moratoriums, rates of return that consider "risk premiums and account for demonstrated adjustment in risk," and "non-traditional depreciation schedules for new transmission investment," 18 C.F.R. § 35.34(e). At the same time, the Commission's rule requires a demonstration as to "how any proposed rate treatment would help achieve the goals of Regional Transmission Organizations, including efficient use of and investment in the transmission system and reliability benefits to consumers," as well as a cost-benefit analysis.

Existing law expresses policies on reasonable incentives and rate innovations, and demonstrates that new incentive rate legislation is not necessary. Existing law gives FERC ample authority to provide balanced and justified rate incentives and performance-based rates that foster investment in and efficient operation of an expanded grid capable of supporting a robust competitive market, and ensuring reliable service to all consumers. No additional pricing language is needed to permit pricing innovations or incentives that meet the Federal Power Act's just and reasonable and not unduly preferential standard.

FERC has the ability to approve performance-based rates that reward above-average performance in the timely and cost-effective construction of needed facilities, but FERC also has the ability to penalize poor performance and significant congestion not remedied in a reasonable time. It needs no new congressional directive to reward RTOs that reduce their costs, increase throughput and customer satisfaction, and eliminate congestion, while enhancing reliability.

Some proposals appear designed to raise rates to a level where the requirements of Order 2000 and FERC's incentive rate policy would not be satisfied, and to rewrite the FPA's long-revered rate-making standard. By legislating incentives, without requiring the quantification of benefits to consumers and any cost benefit analysis, the legislation would tip the balance achieved by the just and reasonable standard, as reflected in Order 2000. In addition, some proposals would provide for incentive rates even where a transmission owner does *not* join an RTO.

As to RTOs, these proposals would legislate continued "pancaked" rates that violate Order 2000. A centerpiece of Order 2000 is the elimination of cumulative

¹ Policy Statement on Incentive Regulation, 61 FERC ¶61,167 (1992).

pancaked rates (or tolls) that must be paid whenever a transaction crosses the corporate boundaries separating one transmission owner from the next, a rate practice that FERC found to impede development of competitive markets. To remove such barriers to competition, FERC's RTO rule expressly requires: "Customers under the Regional Transmission Organization tariff must not be charged multiple access fees for the recovery of capital costs for transmission service over facilities that the Regional Transmission Organization controls" 18 C.F.R. § 35.34(l)(ii).

In addition, it is neither necessary nor appropriate for Congress to legislate utility rates of return. This determination, which FERC makes with the help of expert testimony, as well as information from the financial community on what would constitute an appropriate rate of return should be left to an expert agency, governed by long-standing Supreme Court precedent as to what rate of return is reasonable.

Lastly, and most inappropriate for a monopoly service, is the proposal of some IOUs for "negotiated rates" that are expressly "without regard to costs." FERC has repeatedly found non-discriminatory, open access transmission service to be the necessary foundation for competitive wholesale markets that the Energy Policy Act of 1992 intended to foster. Negotiated rates would undermine this fundamental policy objective. Vertically integrated transmission owners could use this provision to burden their competitors, for example, by refusing to provide service on a timely basis, or without extensive or expensive litigation, absent "voluntary" agreement to an extortionate rate. Indeed, congressional authorization of "negotiated" rates would signal a "Back to the Future" approach, inviting the very discrimination and self-preferences that formed the factual foundation for Order 888 and FERC's open access requirements.

Even as they relate to RTOs, "negotiated rates" are a bad idea. RTOs, while independent of market participants, are still transmission monopolists, providing a service essential to their electricity markets, and our nation's economic well being. The concept of rate "negotiation" makes no sense in this context, where customers are necessarily captive to the RTO on which their loads or generations are located. RTOs, seeking to maximize profit from their expansive regional transmission monopoly, might well be tempted to use "negotiated rates" as a mechanism to extract excess profits for providing customers the service to which they should be entitled at regulated rates. (Of course, the just and reasonable requirement does not prevent compensation to RTOs for providing enhanced or expedited service.) Indeed, protecting consumers from the ability of public utilities to insist on excessive charges for essential services is a core purpose of the FPA and the fundamental premise for subjecting monopoly services to be regulated, just and reasonable, and not unduly discriminatory or preferential rates.

Enhancing FERC's Authority to Require RTOs that Have Full Authority to Plan and Cause Expansion of the Regional Grid is a Far More Effective Way to Ensure Investment in a Robust and Reliable Transmission System:

Today, the only parties that can build additions to the integrated transmission grid are the existing transmission owners. A weakness of many of the RTOs being formed is that they are not permitted to construct transmission lines themselves, but have to order or cajole existing vertically integrated owners to construct. This gives tremendous leverage to the owners. It should not surprise anyone that owners in this negotiating position are holding out for higher rates of return and depreciation schedules much shorter than the useful life of facilities, while the situation gets worse.

A key factor discouraging construction is the fact that owners of local generation who also own transmission have a significant conflict of interest when it comes to transmission construction that will open their generation up to competition. For instance, a new transmission line may cost \$200,000,000 (\$100,000,000 of equity) and the FERC return on equity may be 12%, or \$12,000,000 per year. But construction of the line may also expose the owner to losses of up to \$30,000,000 a year in generation sales. Thus, it is not surprising that such an owner will be reluctant to build transmission and needs a large incentive to proceed.

A second important problem with looking to existing, vertically-integrated transmission owners to finance the transmission needed is that many of these owners are diversifying into unregulated generation and other investments that have significantly different risk profiles than transmission. If a company is willing to take high risk and its "hurdle" rate to justify new investments is a 15-20% return with a 5-8 year payback, a transmission investment is not going to pass the test without a major incentive paid by captive customers. This is particularly true in light of the competitive downside to major transmission improvements for an owner of local generation. Similarly, transmission projects are not going to meet the investment criteria of venture capitalists or those interested in Internet stocks. This does not

mean, however, that the rate of return for transmission should compete with the potential returns for those alternative investments, which involve much more risk.

Notwithstanding, owner attempts to justify incentives by claiming that transmission is risky is quite untrue. Transmission is the prototypical low risk, traditional, regulated utility investment that has been very successful in attracting capital at reasonable, regulated rates of return.

The most significant risk associated with transmission is in getting facilities built in the first place (the long lead times required to build and the fact that a line may ultimately not get built because of siting controversy. This risk can be mitigated by allowing recovery of prudent planning and siting costs for facilities in approved RTO plans, whether or not the facilities are ultimately built.

But once a transmission line is built, the risk is relatively low, and certainly significantly lower than with generation. A good example is the recent Fitch Report on the new American Transmission Company in Wisconsin, a transco that began operations on January 1, 2001. As the report points out, over 95% of this transmission-only company's revenue requirement is guaranteed by recovery from its firm, network customers regardless of changes in load, weather, etc. The way costs are allocated and charged under FERC procedures to the network customers of a monopoly transmission system provides a very certain and steady recovery of revenues. The primary remaining risk is that variable O&M costs (which are minor) will exceed what is included in rates, or that management will do a poor job otherwise and the authorized return will not be realized. This risk profile certainly does not justify a rate of return on equity in excess of a just and reasonable regulated utility return (or accelerated depreciation, for that matter.

There is certainly adequate capital in the markets for a safe, regulated annuity-type investment, which is what monopoly transmission should be. The new RTO regime needs to be designed to attract capital for projects from investors that are looking for solid 11-12% utility returns, year in and year out, with low risk (the risk being that the return may go to 10% in one year or up to 13% in another. These are very different investors than those looking for a 15-30% return and are willing to risk 0-5% or a loss.

As Thomas Lane, Managing Director, Goldman Sachs & Co. testified to this Subcommittee on July 27, "There is definitely a role in the markets for a lower risk, lower return investment which is what transmission represents. Whether it's 11%-12%, somewhere in that neighborhood is what we still need to ferret out with the investor base."

There is no reason to think that "cost plus" regulation, plus a reasonable return on prudent investment, will be insufficient to attract investment in transmission, without added "inducements." Cost plus rate-making has been blamed for inducing over-investment in expensive generation facilities, pre-competitive generation markets; a utility would only earn more by building more. Once decisions to expand transmission are divorced from existing owners, with their competitive and financial conflicts of interest, this same regulatory regimen would be ample to spur investment.

For these reasons, we believe it is very important that RTOs be specifically authorized in legislation to build transmission—whether they are for profit or nonprofit organizations—or, if they choose, to bid out passive ownership. If there is a major transmission project the cost of which will be \$100,000,000, the RTO should be able to finance the project itself as a regulated utility or raise the needed capital by bidding out the return required, taxes, and depreciation (the fixed costs of ownership). Individual companies or pools of investors, willing to be passive owners and looking for the solid annuity-type of return of a monopoly transmission utility will certainly bid.

In addition, public power and co-op systems should be not only permitted, but also encouraged, to finance at least their share of transmission additions through debt. This will help keep the cost of service down for everyone.

To this end, it is essential that RTOs be structured to compensate all transmission owners—whether a large vertically-integrated utility, a smaller transmission dependent utility, or a non-industry investors in transmission—for their investment in transmission facilities. Transmission expansion (and RTO participation) will be discouraged if, as is now proposed by several RTOs, transmission dependent utilities that own transmission are to be paid only a fraction of their revenue requirement (if that) for transmission facilities turned over to an RTO's control and operation. RTOs will not fulfill their purpose if only incumbent large transmission owners are fully compensated for their transmission investment.

In other words, we should not accept transmission owner efforts to retain exclusive rights to construct while seeking rate incentives as an inducement to do so. Rather than granting existing owners an exclusive right to build for RTOs and giv-

ing in to their incentive demands, we should enable RTOs to put competitive pressure on the cost of capital.

Thus, Congress should adopt legislation that arms FERC with authority to require formation of large, rationally-scoped and truly independent regional transmission organizations with full authority to plan and expand the regional transmission system. This would fully separate transmission from generation interests, so expansion decisions are not influenced by how the expansion affects the value of the transmission owner's generation. Providing RTOs the authority to cause needed construction by the transmission owner or others opens the doors to market-based means to get the needed transmission constructed efficiently—by bidding out construction to third parties.

Reliability

APPA supports the goal of the Chairman's draft in creating a national electric reliability organization to set and enforce reliability standards, subject to FERC oversight. The Administration's National Energy Policy report also calls for enactment of mandatory reliability standards by an independent body and overseen by FERC to "address the problems created by increased demands on the transmission system that have resulted from changes within the industry brought on by wholesale competition."

Even though the United States has the most reliable electric system in the world, the electricity crisis in the West demonstrated the delicate balance between reliability and the markets within which the electric grid must operate. Consequently, great care needs to be taken to ensure that the current level of reliability is not sacrificed in any restructuring of the industry. As the industry has become more competitive, more participants have been executing an increasingly greater number of transactions every day. The focus of most of these transactions is on short-term costs rather than on system stability.

The North American Electric Reliability Council (NERC) and its regional councils currently promulgate and implement standards to ensure the adequate availability of electricity throughout the country. This voluntary system of compliance with reliability standards works reasonably well in the regulated environment in which the industry previously operated, but it will not continue to provide the necessary safeguards in a competitive market nor in an era of heightened threats of terrorist attacks.

It is our understanding that NERC has submitted suggested changes to Title III, Section 301, of the Chairman's draft bill. APPA concurs with NERC's comments, and would underscore the need for FERC to oversee the implementation of reliability standards and enforce compliance by RTOs. The Chairman's draft should be modified to explicitly require this obligation to comply. RTOs will be responsible for the reliable operation of the bulk system in real time. They also need to be responsible themselves by complying with reliability standards.

OTHER TRANSMISSION ISSUES

FERC Transmission Jurisdiction

Local control is one of the most fundamental aspects of public power. However, it is difficult to envision effective wholesale markets, which, as noted, APPA strongly supports, without some degree of federal involvement in public power transmission that is part of the regional grid. APPA members have struggled with the problem of balancing the retention of local control with the recognition that transmission is a matter of interstate commerce. While publicly owned utilities with transmission facilities are not anxious to be subjected to FERC jurisdiction, the limited jurisdiction contemplated in Chairman Barton's restructuring bill (H.R. 2944) from the last Congress, known as FERC-lite, is an acceptable compromise and is consistent with APPA policy. In essence, FERC-lite would extend FERC jurisdiction to public, cooperative, and federal utilities with transmission facilities interconnected to the national grid. The FERC-lite language makes the important exception, however, that FERC would not be given the authority to set transmission rates for these transmitting utilities. Instead, FERC would determine whether the rates to others are comparable to those charged to themselves. If they are not, FERC would remand the issue to the publicly owned utility.

While the Chairman's draft includes the essential provisions of this FERC-lite approach, unfortunately, it also includes new provisions giving FERC the authority to order refunds by public power systems, and in so doing, providing FERC authority over public power systems' transmission rates under Sections 205 and 206 of the Federal Power Act. The combination of these authorities, in fact, results in very

heavy federal regulation of public power and cannot be supported by APPA. We suggest that the provisions related to FERC refund authority be deleted.

The issue of transmission jurisdiction in a bundled vs. unbundled transaction is an important issue now before the U.S. Supreme Court. Within APPA's membership, there are different positions on this issue. Transmission dependent utility (TDU) members believe that service to them must be fully comparable to utility owners' own use of the system. The native load of a TDU system should not be shed before the native load of the owner or there can be no fair competitive market. Public power transmission owners that are vertically integrated are equally concerned that FERC not interfere with their primary obligation to provide highly reliable, economic service to the consumers that own them and for whom their systems have been built.

Creation of Regional Transmission Organizations (RTOs)

The single most important step that can be taken to achieve the goal of a robust transmission system is the establishment of large, truly independent RTOs that have primary planning responsibility for the regional grids under their control. APPA continues to support the authority of FERC to establish and require public utility participation in strong, truly independent RTOs in order to facilitate the development of vigorously competitive retail markets. Any federal legislation should provide FERC with the authority needed to achieve this goal. In addition to mandating true independence, and sufficient size, and rational scope of RTOs, the statutory criteria should accommodate the unique characteristics and legal requirements of public power to ensure that public power's participation by FERC order is not inconsistent with state laws and constitutional requirements. Furthermore, the additional criteria for public power participation must be consistent with bond covenant requirements and should not impair control of local system operations of reliable and economic service to customers of public power systems.

In order for an RTO to be effective in promoting a competitively neutral transmission system, it must have several specific characteristics. It must be independent to ensure that owners of transmission cannot exercise vertical market power. It must have boundaries that are rational and that eliminate the current balkanization and gerrymandering of the grid. It must take into consideration the needs of all stakeholders—including the needs of public power transmitting utilities—to ensure fair and equitable treatment of all users. In addition, while it may be appropriate for FERC rates to reward excellent performance as previously discussed, it is not appropriate for FERC to provide incentives for participation in RTOs. Instead, RTO participation should be a key condition to enjoying the benefits of market pricing and relaxed wholesale regulation.

It is absolutely essential to clarify FERC's legal authority to accomplish these objectives or we will experience continued long delays and unnecessary litigation. Without a clarification of FERC's authority, utilities will continue to resist and delay RTO formation—and the current chaotic state of development will continue indefinitely.

Publicly owned utilities have been willing to participate in RTOs which are consistent with the specific criteria set forth by FERC in Order No. 888 and clarified in Order No. 2000. In fact, FERC commissioners and various FERC orders have specifically addressed public power participation, not to encourage public power systems to join but rather to encourage private utilities to let them join on fair and reasonable terms.

RTO Participation

FERC has indicated that it believes it currently has the authority to order jurisdictional utilities to participate in RTOs, and we agree that restructuring legislation should affirm this existing authority while expressly confirming and providing for:

- 1) The authority asserted in Order No. 2000 to order RTO participation by a jurisdictional utility to remedy undue discrimination or anti-competitive effects and as a condition for mergers or market based rates. Legislation should also confirm FERC's authority that was the foundation for Order No. 888.
- 2) Recognition and reinforcement of FERC's existing authority to require RTO participation as a condition to authorizing market-based rates for jurisdictional utility wholesale power sales. Where such authority has already been granted, FERC should be required to review those prior actions and determine whether, absent the participation of the wholesale supplier in an RTO, continued market-based wholesale rates are consistent with promoting competition or in the public interest.

- 3) RTO participation by jurisdictional utilities should be a necessary condition in determining proposed mergers of vertically integrated utilities are consistent with the public interest.
- 4) RTO participation by jurisdictional utilities should be a condition precedent to any relaxation of Public Utility Holding Company Act (PUHCA) requirements.
- 5) As mentioned above, FERC should be allowed to reward superior performance by RTOs, but prevented from providing financial incentives simply for RTO participation.
- 6) FERC must have the authority and responsibility to ensure that RTOs are capable of providing the infrastructure and services required for competition to thrive. This authority should include the responsibility to determine what constitutes "independence" of RTO operations from control, direct or indirect, of the owners of transmission committed to the RTO (as well as other market participants); whether a proposed RTO will have the authority to operate, control, plan and cause expansion of the grid for the benefit of all customers; and what boundaries are necessary to ensure a regional scope sufficiently broad so as to ensure development of robust and efficient regional electricity markets.

In addressing the participation of non-jurisdictional utilities—public power systems and rural electric cooperatives—FERC should be given the ability to direct RTOs to accommodate their unique tax and legal requirements. And, if a RTO also administers wholesale markets, FERC should—after reviewing all market rules, tariffs and protocols promulgated by the RTO—make a finding that the rules and protocols do not allow sellers or buyers to exercise market power.

Regarding the issue of FERC mandating the participation of non-jurisdictional utilities in RTOs, deference should be provided to publicly owned utilities, similar to the restraints on FERC jurisdiction over transmission facilities noted above. Specifically, APPA recommends that FERC's authority to order publicly owned utilities to join a regional transmission organization should be limited to situations in which FERC finds that (1) the publicly owned transmission owner has (a) engaged in undue discrimination in the provision of transmission services, or (b) abused its control over transmission so as to disadvantage competitors; and (2) that the FERC open access transmission tariff has not and is not likely to remedy the problem. In such cases, APPA agrees FERC should be authorized to require the publicly owned utility at issue to surrender control of its transmission to an independent regional transmission organization that meets FERC RTO criteria.

We also believe Congress, in clarifying FERC's authority to order utilities to join RTOs, should take into consideration the cost consequences of such action. Clearly, RTOs should decrease, not increase, total transmission costs. Cost shifts and increases have been a very significant problem for public power systems in California. Obviously, it would be imprudent for a public power system, which has financed transmission with public funds, to join an RTO that will significantly increase the cost of power to its customers. Some cost shifting may be inevitable, but any FERC action in this area should be premised on the principle that adverse cost consequences for utilities ordered to join RTOs should be held to the minimum possible. This is particularly important with respect to public power systems that have constructed their facilities with public funds.

APPA appreciates the Subcommittee's willingness to address the important issue of comprehensive electric utility restructuring legislation and the key role of the transmission system in fostering a competitively neutral wholesale electric market for the benefit of all consumers.

Mr. BARTON. Thank you very much.

We now want to hear from Mr. Robert Nordhaus, whose with Van Ness Feldman. He's here on behalf of The Large Public Power Council.

Your statement's in the record. We'd ask you to summarize it for 5 minutes.

STATEMENT OF ROBERT R. NORDHAUS

Mr. NORDHAUS. Mr. Chairman, members of the subcommittee, I'm Robert Nordhaus here on behalf of LLPC. I'm standing in for our originally scheduled witness, Chuck Manning of Austin Energy who was not able to make it back for this hearing.

By way of background, LLPC is an association of the 22 largest public power systems in the country, and among our members are the principal public power transmission owners.

We will have a witness in the afternoon who will address a number of specific issues with respect to FERC jurisdiction and RTO policy. I'm addressing three matters; reliability, siting and transmission rate making.

With respect to reliability, LLPC does support the general approach of the NERC consensus bill from last year. We realize the consensus seems to have evaporated, but we do believe that it is necessary to provide for mandatory reliability standards and for an enforcement mechanism that applies to all players in the electric power industry.

FERC's authority now is limited. The mechanism for enforcing the current voluntary reliability standards is largely limited to contracts and tariffs and there's no public suasion behind them. So, we would recommend that any comprehensive electric restructuring legislation include provisions that make the current voluntary standards mandatory, provide for an adequate enforcement mechanism. We do believe that it's appropriate for the day-to-day work in developing standards and enforcing them be delegated to a private organization acting under FERC supervision.

With respect to siting, the LLPC support carefully circumscribed eminent domain authority. We think that it's important to make sure that those who exercise this authority do it after a careful coordination with whatever regional transmission planning mechanisms are set up, presumably through RTOs, and that the interests of State and local governments in the process be respected.

We have suggested in the testimony a couple of things. One is that the committee may wish to limit the exercise of this authority, the eminent domain authority, in the chairman's bill discussion draft to RTOs and to transmission owners acting with the approval of an RTO whose transmission is under the operation of an RTO. Similarly, as we look at where the real problem is, it may be that a further condition that could be appropriate is that the exercise of this authority be predicated on a finding by FERC that it's necessary to ensure adequacy of interstate transmission service.

With respect to rate making, the LLPC believes that the starting point for transmission rate making should be cost service rate. In our testimony we set out several circumstances under which it may be appropriate to depart from that. As a general matter, we do not think that market based rates for transmission services are feasible or appropriate under virtually any circumstances.

With respect to negotiated rates, we suggest that that may be possible where the transmission users has an unqualified right to elect a cost based rate in lieu of a negotiated rate.

With respect to performance based rates, we think that there's actually some significant latitude for coming up with workable performance rates using a split savings formula that gives a portion of efficiency savings or savings through construction of new transmission facilities, a portion of the savings to the transmission owner as long as a portion of the savings is reserved for the transmission users.

With respect to incentive rates generally, our view has been, particularly with rates of return, that current rates of return look pretty good compared to what investors are doing on the stock market right now. That the place for incentive rates of return is not for all transmission investment, but perhaps for critically needed new investments, and that's something that we think could be considered.

I would also echo Mr. Fontes' point, and that is FERC does have adequate authority under existing law to deal with all of these issues. It's not clear that it needs to be addressed in legislation.

Mr. Chairman, those are our remarks. And with that, I'll yield to the next speaker. We thank you.

[The prepared statement of Robert R. Nordhaus follows:]

PREPARED STATEMENT OF ROBERT R. NORDHAUS ON BEHALF OF THE LARGE PUBLIC POWER COUNCIL

My name is Robert R. Nordhaus and I appear today on behalf of the Large Public Power Council (LPPC). I am a member of the law firm of Van Ness Feldman, PC, and serve as outside counsel to LPPC. The LPPC is an association of 22 of the largest public power systems in the United States. LPPC member systems directly or indirectly provide reliable, affordably-priced electricity to approximately 18 million customers and we own and operate over 44,000 megawatts of generation and approximately 26,000 circuit miles of transmission lines. LPPC members are located in states and territories representing every region of the country, including several states represented by members of this Committee—such as Tennessee, Texas, California, New York, and Arizona.

LPPC members are publicly-owned, service-focused and committed to the local residents and communities they serve. The benefits of their reliable and cost-effective provision of generation, transmission, and distribution service flow directly to their customers and communities.

Mr. Chairman and members of the Subcommittee, the LPPC appreciates your efforts to develop comprehensive electricity legislation. The LPPC supports the enactment of comprehensive legislation that promotes a competitive, efficient wholesale power market of benefit to all consumers. The LPPC believes that a robust wholesale market should be encouraged and supports efforts to increase competition so long as low-cost, reliable service is ensured for consumers.

The LPPC also appreciates the efforts this Subcommittee has made to advance the debate on how to achieve a competitive market that benefits consumers. The Large Public Power Council offers its continued assistance in crafting legislation to facilitate competitive markets. The LPPC has reviewed the Discussion Draft dated September 21, 2001, issued by Chairman Barton, and while we will not comment extensively on this draft, my testimony and that of Bob Johnston later today will highlight several of LPPC's specific concerns. We understand that this is a discussion draft and that it is intended to foster significant discussion among the affected parties and the Committee members. The LPPC would like to continue to participate in this dialogue.

I would like to comment on the issues that are the focus of the Committee's attention today.

INCENTIVE RATES

The LPPC supports the continued establishment of transmission rates according to well-established, cost-based rate principles. Allowed rates of return should be sufficient, as determined under conventional approaches, to compensate transmission owners for the risk and costs caused by increased use of the existing transmission facilities and reasonable costs to attract capital for the new transmission construction. However, the costs related more appropriately to the generation or distribution businesses of the transmission owner should not be included. Given the substantial uncertainties accompanying the restructuring of transmission ownership and operation, as well as the nature of the business going forward, it may be premature to depart from cost-based ratemaking principles in establishing transmission rates.

We do not support the concept of market-based rates for transmission service. Except for isolated circumstances involving the construction of merchant transmission facilities, there is no evidence of competition among transmission providers for wholesale or retail customer business. Only a tiny minority of wholesale or retail

customers enjoy physical interconnections with more than one transmission provider. Under current circumstances, there is no competitive market pressure to limit transmission rates; thus there is no economic justification for implementing market-based transmission rates.

The LPPC believes that the establishment of transmission rates through negotiations between transmission providers and customers should be permitted only when the customer has either or both of two demonstrated alternatives: the ability economically to continue to conduct business without the proposed transmission service or the availability of the transmission provider's cost-based default tariff (similar to the "recourse rate" in natural gas regulation). The use of negotiated rates may also be appropriate when lining up customers for a new merchant or project-financed transmission facility.

Finally, the LPPC is willing to consider the appropriateness of a performance-based or other form of incentive rate for transmission service. We believe that the building of new transmission should be encouraged and believe that properly structured incentive rates might be able to encourage such investment. However, any incentives must be tied to acceptable and demonstrable benchmarks of performance. An acceptable proposal could provide for a "split the savings" formula under which the transmission provider would be permitted to retain a percentage of demonstrated savings achieved through improved efficiency of operation (as compared to an accepted baseline cost of service) or through construction of new facilities that relieve congestion and lower transmission users' congestion costs. The form of incentives or savings must not disadvantage or discriminate among different types of wholesale energy customers or transactions. In addition, we believe that such proposals should be made only in the context of a filing by an RTO or subsidiary organization encompassing more than one transmission provider's system, (*e.g.*, an independent transmission company).

Section 401 of the Discussion Draft directs FERC to conduct a rulemaking to establish incentive rate policies, designed to promote expansion of and improvements in the transmission network. The LPPC urges a more narrow application than is contemplated by the Discussion Draft. For example, while we could support higher rates of return for critical new transmission investment, we would not support a general increase in rates of return for sunk investments that is unrelated to changes in market interest rates or equity returns.

SITING ISSUES

A thorough review of the various processes that serve as a barrier to constructing new power generation and to the more efficient use of existing power generation should be undertaken. There are multiple, sometimes duplicative permitting requirements for new generation facilities. In addition, various regulatory requirements make construction of new facilities time-consuming, costly, and unpredictable. Recognizing the need for a more efficient and transparent permitting system, the LPPC would encourage a review of the permitting requirements for new and existing generation and, where possible, require that the processes be streamlined, conducted in parallel and expedited to the maximum degree feasible. The LPPC supports the creation of an inter-agency process among the Environmental Protection Agency, the Department of Interior, FERC, and the Nuclear Regulatory Commission that would streamline the current requirements.

Coordination of federal approvals on the multiple permits would reduce time-lines, uncertainty, and costs for companies constructing or modifying generation facilities. Given the importance of getting power on line, this issue can make a real contribution to a comprehensive energy strategy.

The difficulty in constructing new transmission facilities and upgrading existing facilities on a timely basis is one of the key obstacles to assuring the delivery of low-cost, reliable electric power to consumers. Prompt federal and state action is necessary to enable transmission providers to install new facilities and upgrades where needed. The LPPC supports giving FERC carefully circumscribed authority to provide transmission-owning RTOs or ISOs the right of eminent domain if they demonstrate that the installation of transmission facilities is required to ensure adequate and reliable service. Owners of transmission facilities under operational control of an RTO or ISO would be given similar authority. Section 402 of the Discussion Draft provides federal eminent domain authority to an applicant seeking to construct or modify transmission facilities. As currently drafted, there is no requirement that the transmission facility be part of a regional planning process or approved by an RTO or ISO, or that it be necessary to enhance or improve reliability or economy of service. The LPPC would urge that this provision be revised to provide the eminent domain authority to the RTO (or to transmission owners whose

facilities are operated by an RTO) and that the role of the state and local governments be given greater weight. One possibility would be to limit exercise of this authority to circumstances where adequacy of interstate service is at issue.

The LPPC also supports the development and use of mechanisms—such as interstate transmission siting agencies or joint boards (comprised of members of federal and state regulatory agencies)—that encourage the coordination of federal and state environmental permitting and certification activities.

RELIABILITY

As the recent crisis in the West has demonstrated, great care must be taken to ensure the continued and reliable supply of electricity as the industry is restructured. The LPPC supports mandatory reliability criteria and standards developed by national or regional reliability organizations overseen by FERC. We supported the NERC reliability consensus legislation last Congress. Although it appears that the consensus has evaporated at this time, we remain committed to supporting the general concepts contained in that legislation. The LPPC believes that there is a need to clarify FERC authority over reliability, that there should be binding electric reliability standards, and that there should be a clear mechanism to enforce these reliability standards.

The LPPC believes that regional modeling should be done to assess the impacts of the creation and development of RTOs on the transmission grid. As the transmission grid is regionalized, an evaluation of the lessons learned should be done so that reliability is ensured and the potential benefits are maximized.

We believe that any legislative proposal should make it clear that compliance with reliability organization rules or standards does not subject entities to the jurisdiction of FERC for purposes other than to ensure reliability. Also, reliability standards need to be supported by long-term contracts that will ensure the availability of operating reserves.

CONCLUSION

As the Subcommittee continues to move forward with electricity legislation, the LPPC offers our continued assistance. We look forward to helping you to develop comprehensive electricity legislation that addresses our concerns, garners wide support and can ultimately be enacted. I will be happy to answer any questions you have.

Mr. BARTON. We thank you, Mr. Nordhaus.

We now want to hear from Mr. Glenn English, who is CEO of the National Rural Electric Cooperative Association. He's also a distinguished former Member of the House of Representatives.

Your statement's in the record in its entirety, and we would welcome you to summarize it in 5 minutes.

STATEMENT OF GLENN ENGLISH

Mr. ENGLISH. Thank you very much, Mr. Chairman. I appreciate that, and I want to follow up on what Mr. Nordhaus was talking about, focus on one particular aspect of the draft that was circulated and one that, quite frankly, I find to be very puzzling.

It has to do with the whole question of incentive rates. We've had a lot of discussion about incentive rates. What does not seem to be generally recognized is the fact the Federal Energy Regulatory Commission already has the authority for incentive rates. That's under the existing law. They are required to provide incentive rates that are just and reasonable.

Well, that gives anyone an awful lot of discretion to simply use your judgment to determine what is just and reasonable, what is necessary to get this job done. But it appears from the language in the draft that that simply is not adequate. So if it is not adequate, obviously that brings one to the conclusion that if you are including just and reasonable to be redefined in this legislation, then you must be attempting to redefine it to something that's un-

just and unreasonable. And quite frankly, I have a hard time understanding how in the world anyone could justify insisting that the Federal Energy Regulatory Commission in effect grant rates that are unjust and unreasonable. That's what I find to be particularly disturbing about this proposed legislation.

Now, as it stands now we think the Federal Energy Regulatory Commission has all the authority they need to use their good judgment and to act in the public interest. There is no disagreement over the fact that there needs to be more transmission built in this country. There is no disagreement over the fact that this country needs a transmission system to meet the needs of the country everywhere. And we all join in supporting that. But this particular segment to give the Federal Energy Regulatory Commission more tools, instead it takes away the tools that FERC has and it requires the FERC to act in a way that they find to be unfair. To act in a way that will obviously discriminate against the consumers of this country.

And, in fact, I think a very strong case can be made, Mr. Chairman, that this particular provision is nothing but a transfer of wealth from the consumers of this country to the utilities that are building this transmission.

Now, the outrage with regard to this particular section doesn't stop there, Mr. Chairman, because it isn't just new transmission that would come under this new provision of requiring the Federal Energy Regulatory Commission to provide more than what they feel to be just and reasonable. They're required now to provide it on transmission that already exists.

now, if we were in fact going to raise rates to consumers with regard to the transmission line to require that consumers pay an unjust and an unreasonable rate on existing transmission, we would hope that there would be something done with that money that'd be productive. But there's absolutely nothing in this legislation that require those funds to be used to build new transmission. In fact, there's nothing to prohibit the additional funds from being overseas. That simply doesn't make any sense, Mr. Chairman.

So we find this to be a very unfair segment and certainly we think that at the very least if consumers are going to be required to pay an unfair, an unjust and unreasonable amount of money for transmission in this country that there should be some provision that requires that money to be used to build new transmission in this country.

Now, what we find to make far more sense, and since we're going to get out of the classroom and out of the academics with regard to this issue, Mr. Chairman, is your own State of Texas. We think your own State of Texas has the right approach with regard to building transmission of this country, and we take note of the fact for all of those that are interested in more than an academic exercise, that this year in the State of Texas three-quarters of a billion dollars is going to be building transmission. And next year they already have scheduled over a billion dollars of more transmission being built in the State of Texas. But they don't find that there's any requirement for an unjust or unreasonable rate. In the State of Texas that's being done with a 10-percent return on investment,

which is in line with what the testimony was for this committee from the investment community from Goldman Sachs.

In addition, Mr. Chairman, there are no incentives that are being provided in the State of Texas. There's no accelerated depreciation as this legislation includes in the State of Texas, but they're building transmission in the State of Texas. Now, if it can be done in the State of Texas, I'd ask you why can't it be done in the rest of this country. It has certainty, Mr. Chairman, in the State of Texas; that's the reason. They let others do it in the State of Texas. They open it up and let everybody compete. Anybody that wants to build transmission, let them do it. That's what they do in the State of Texas.

And they let the shareholders, all those people that are going to be using it and making the decision on where that transmission is going to be built.

Now, that makes sense, Mr. Chairman. And I would suggest to you if we're going to do something productive in this legislation on building transmission, that we should in fact allow FERC to use the State of Texas proposal in order to build transmission in this country. Give them the options. You know, if you feel it's necessary, give FERC whatever authority they feel they need to get this job done, but let's not limit the options. Let's not require the FERC to do something that's contrary to what their good judgment allows.

Mr. Chairman, I'd only say if it's good enough for the State of Texas, it's good enough for the rest of this country.

Thank you very much.

[The prepared statement of Glenn English follows:]

PREPARED STATEMENT OF GLENN ENGLISH, CHIEF EXECUTIVE OFFICER, NATIONAL
RURAL ELECTRIC COOPERATIVE ASSOCIATION

INTRODUCTION

Chairman Barton and Members of the Subcommittee, I appreciate this opportunity to continue our dialogue on the restructuring of the electric utility industry. For the record, I am Glenn English, CEO of the National Rural Electric Cooperative Association, the Washington-based association of the nation's nearly 1,000 consumer-owned, not for profit electric cooperatives.

These cooperatives are locally governed by boards elected by their consumer owners, are based in the communities they serve and provide electric service in 46 states. The 35 million consumers served by these community-based systems continue to have a strong interest in the Committee's activities with regard to restructuring of the industry.

Electric cooperatives comprise a unique component of the industry. Consumer-owned, consumer-directed electric cooperatives provide their member-consumers the opportunity to exercise control over their own energy destiny. As the electric utility industry restructures, the electric cooperative will be an increasingly important option for consumers seeking to protect themselves from the uncertainties and risks of the market. I would like to thank you, Mr. Chairman, and Members of the Committee for your receptiveness to the concerns and viewpoints of electric cooperatives.

TRANSMISSION RELIABILITY

North America needs the electric transmission equivalent of the interstate highway system. The current transmission system cannot reliably handle the dramatic increase in transactions since the enactment of the 1992 Energy Policy Act. Transmission deficiencies are contributing to wholesale and retail electric market failures that are harming consumers.

Based on the following reasons, NRECA does not believe that these problems can be solved only by offering utilities high incentive transmission rates or other financial incentives to build transmission.

- *FERC's Existing Authority.* FERC already has the authority to establish incentive transmission rates. FERC issued a policy statement in 1994 that would permit "more flexibility to utilities to file innovative pricing proposals..." In Order 2000, FERC stated that it was "critically important for RTOs [regional transmission organizations] to develop ratemaking practices that...provide incentives for transmission owning utilities to efficiently operate and invest in their systems."¹ In testimony before the Energy and Air Quality Subcommittee on September 20, 2001, Deputy Secretary of Energy Frank Blake stated that "FERC has great flexibility under current law to set transmission rates at a level to attract investment." Since FERC has existing ratemaking authority to approve incentive transmission rates, legislative language is unnecessary.
- *Higher Electricity Prices for Consumers.* Currently, FERC has wide discretion in determining whether a public utility's transmission rate is reasonable. Legislative language requiring FERC to approve incentive transmission rates is designed solely to handcuff FERC by curtailing its authority to reject unreasonably high transmission rates, resulting in higher electricity prices for consumers. Also, by limiting FERC's ability to reject unreasonable rates, the opportunity for profiteering based on transmission rates exists.
- *The Investment Community Is Unconvinced.* During the July 26 hearing before the Energy and Air Quality Subcommittee, Thomas Lane, Managing Director in Goldman Sachs Energy and Power Group, responded to Member questions and stated that there is a role for transmission rates that include the more traditional return on investment of around 12%. Since Wall Street believes that investments will flow into the transmission sector based on the current rate structure, it is unnecessary to force FERC to rubber stamp unreasonable rates.
- *Lack of Newly Constructed Transmission.* Legislative language forcing FERC to approve incentive transmission rates will not automatically result in the construction of new transmission for two reasons. First, the language fails to guarantee that transmission facilities will, in fact, be built in exchange for FERC's approval of incentive rates. Second, the language would require FERC to approve incentive rates for the operation of *existing* transmission facilities. High rates of return associated with existing transmission facilities will act as disincentives to the construction of new transmission that is needed to support a robust wholesale market.
- *Impediment to Generation Markets.* The interstate transmission system should exist to enhance the competitive generation market not to balkanize it further. Any approach that allows individual companies with a financial interest in the energy market to control transmission would have the unwelcome effect of erecting tollgates on the interstate system, thereby narrowing generation markets and protecting the existing power of local generators.

NRECA is concerned that the incentive approach would raise the rates of return and increase the costs for consumers, the intended beneficiaries of lower prices from competition. Also, FERC not only has that authority under existing law, but also has been encouraging utilities to propose innovative incentive-based rate designs for years.² In fact, FERC recently offered utilities a 300 basis-point increase in the rate of return and a 7-year recovery period if they would build transmission in the West by a stated deadline.

Given FERC's current efforts to encourage innovative rates, NRECA is concerned that legislative language establishing only incentive rates may handcuff FERC, limiting the agency's ratemaking discretion at a critical time in the development of a competitive industry.

As an option to legislating higher rates of return, NRECA believes Congress should lower the risk of building transmission. Congress should direct FERC to allow any entity that builds a qualifying transmission project to recover its costs. By reducing the risk, Congress could encourage institutional investors and others looking for low risk investments invest in improvements to the nation's transmission grid.

To qualify for assured cost recovery, NRECA believes that transmission projects must:

¹ FERC has also been encouraging the submission of incentive transmission rate proposals. According to FERC in Order 2000, "we have approved five ISOs [independent system operators] with innovative transmission pricing, but otherwise have received few innovative transmission pricing proposals."

² FERC's Pricing Policy for Transmission Services, 59 Fed. Reg. 55,031 (1994) (codified at 18 C.F.R. Part 2); Formation of Regional Transmission Organizations, 65 Fed. Reg. 810, 913 (2000) (codified at 18 C.F.R. Part 35).

- be identified through a regional joint-planning process that coordinates and has oversight for the reliable operation of the regional transmission system
- be constructed according to best engineering practices
- be operated by the relevant Regional Transmission Organization (RTO)
- offer service pursuant to traditional cost-of-service principles, with the cost-of-service analysis taking into account the low risk provided by FERC's obligation to assure cost recovery.

By mitigating risk, spreading the cost of new facilities broadly, and enabling new competitors to build transmission, NRECA's approach to new transmission helps to ensure that the interstate highway system can be built at the lowest possible cost to consumers.³

ELECTRIC RELIABILITY

Since 1968, the electric utilities of the United States, Canada, and part of Mexico have worked together through NERC to develop voluntary standards that have provided North America with the most reliable energy in the world.

The introduction of restructuring, however, is putting pressure on the voluntary system. Under regulation, regulators have placed a premium on reliability and utilities were guaranteed to recover reasonable reliability-related expenses. In a competitive environment, however, investor-owned utilities are rewarded for cutting costs and no one has the authority to ensure that those cost-cutting measures do not degrade the reliability of the bulk transmission system.

It is necessary for Congress to replace NERC with a new self-regulating industry organization that has the authority, under FERC oversight, to develop and enforce mandatory reliability standards.

For that reason, NRECA supports the NERC consensus language that has been included in several bills introduced in the House and Senate. That language would require FERC to approve a new North American Electric Reliability Organization that would have the power to ensure the reliable operation of the interstate bulk transmission grid. NRECA believes that similar legislation needs to be enacted as soon as possible.

NRECA opposes a competing proposal that would grant authority over reliability directly to FERC. The Commission lacks the expertise or the resources to address reliability on its own. There are questions whether it has been able to handle adequately its existing mandate to regulate wholesale markets. Responsibility for the reliability of the nation's grid would strain its existing staff even further. On the other hand, while stronger enforcement authority is needed, there is no question that NERC has done an admirable job of setting reliability standards. Congress should not reject an industry-based model that has worked extremely well for over 20 years.

Mr. BARTON. Well, I don't know about all that, but it's certainly well spoken. You can always tell a former congressman.

Mr. ENGLISH. Well, and someone from Oklahoma, you don't know how difficult it was for me to say that, Mr. Chairman.

Mr. BARTON. Well, your team won the football game on Saturday, so you got the right to come here and pontificate a little bit.

Mr. ENGLISH. Well, thank you very much.

Mr. BARTON. It goes with the territory.

We now want to hear from Mr. David Cook who is general counsel for the North American Electric Reliability Council.

Your statements in the record, and we ask you to summarize in 5 minutes.

STATEMENT OF DAVID N. COOK

Mr. COOK. Good morning, Mr. Chairman, Mr. Boucher and members of the subcommittee.

My name is David Cook. I am general counsel for the North American Electric Reliability Council (NERC).

³FERC's Pricing Policy for Transmission Services, 59 Fed. Reg. 55,031 (1994) (codified at 18 C.F.R. Part 2); Formation of Regional Transmission Organizations, 65 Fed. Reg. 810, 913 (2000) (codified at 18 C.F.R. Part 35).

I appreciate the opportunity to testify this morning on the critical issue of assuring the continued reliability of the North American bulk power system. NERC strongly urges Congress to enact reliability legislation in this session of Congress. NERC and a broad coalition of State, consumer and industry representative support legislation that would transform the current set of voluntary electric system operating guidelines into a set of mandatory transmission system reliability rules, developed and enforced by an industry-led self-regulatory organization with FERC oversight in the United States. For more than 30 years a voluntary industry based system for maintaining the reliability of the bulk electric system has worked very well. But for the reasons outlined in my testimony, voluntary standards will not serve us well for the future.

This past June 14 major organizations wrote to the Congress and the Administration in support of legislation making the reliability rules mandatory and authorizing creation of an industry electric reliability organization subject to FERC oversight in the U.S. Such an organization would be the best position to marshal the technical expertise and market expertise of the whole industry to develop rules for running the higher complex interconnected transmission system. Such an organization would be able to focus on reliability as its primary mission while the electric industry and electricity markets continue to evolve and new forms of business organizations come into existence.

An electric reliability organization would also address the international nature of the interconnected grid. That organization with participation from the U.S., Canadian and Mexican interests could, subject to regulatory oversight from those countries, develop the common set of rules necessary to operate the interconnected grid that spans national borders.

This subcommittee approved one version of the NERC coalition language when it passed H.R. 2944 in 1999. Last year the Senate passed the NERC consensus legislative proposal as S. 2071, but that bill was not considered in the House.

The President's National Energy Policy endorses development of legislation authorizing an industry self-regulatory organization subject to FERC oversight in the U.S.

I wanted to thank to Mr. Wynn and those who joined him in reintroducing that proposal this year as a H.R. 312. I also want to acknowledge Mr. Burr and Mr. Sawyer for including the NERC language as part of their bill, H.R. 2814.

Since the June letter those groups have worked with others to develop a shorter less detailed version of the reliability legislation. I have submitted a copy of that revised language with my testimony.

The revised legislation provides for the creation of a self-regulatory organization under FERC oversight of reliability. In addition, it provides FERC with greater flexibility and authority to oversee the work of the electric reliability organization. It clarifies the role of the electric reliability organization and regional transmission organizations. And it includes definitions of "adequacy" and "security" to more clearly delineate the scope of that organization's authority.

A number of organizations have announced they will support the revised version of the legislations, others are still reviewing the matter.

With respect to the September 21 discussion draft circulated by Chairman Barton, NERC believes that Title II with the changes that we have recommended in correspondence included with my testimony provides a workable basis to move forward on reliability legislation. NERC stands ready to work with the members of the subcommittee and their staff as well as others in the industry to make improvements to the language, but we continue to believe that creation of an industry electric reliability organization is critical.

The need to change how we deal with reliability is clear. Mr. Chairman, I was in Colorado last month and heard you say to those in the industry now is the time to act. I completely agree with you. The electric industry is undergoing profound changes and our system of reliability needs to change to keep pace.

The events of September 11 served to underscore the importance of the effort. As this subcommittee has heard, NERC plays a critical role in the protection of the security of our electric transmission infrastructure. In the future it will be that new electric reliability organization that serves as a point of contact and coordination on this industry-wide security efforts.

Those who would simply give the job of reliability to FERC without authorizing an industry electric reliability organization ignore this important function currently served by NERC.

NERC urges Congress to adopt legislation authorizing creation of such an organization for reliability and for security.

Thank you very much. Be happy to answer your questions.

[The prepared statement of David N. Cook follows:]

PREPARED STATEMENT OF DAVID N. COOK, GENERAL COUNSEL, NORTH AMERICAN
ELECTRIC RELIABILITY COUNCIL

Good morning, Mr. Chairman and members of the Subcommittee. My name is David Cook and I am General Counsel for the North American Electric Reliability Council (NERC).

Summary

NERC strongly urges Congress to enact reliability legislation in this session of Congress. NERC and a broad coalition of state, consumer, and industry representatives are supporting legislation that would transform the current set of voluntary electric system operating guidelines into a set of mandatory transmission system reliability rules, promulgated and enforced by an industry-led reliability organization, with FERC oversight in the United States. NERC firmly believes that steps must be taken now to ensure the continued reliability of the electricity transmission system if the Nation is to reap the benefits of competitive electricity markets. The changes taking place as the electric industry undergoes restructuring are recasting the long-established relationships that reliably provided electricity to the Nation's homes and businesses. Those changes will not jeopardize the reliability of our electric transmission system IF we adapt how we deal with reliability of the bulk power system to keep pace with the rest of the changes that the electric industry is now experiencing. NERC believes that the best way to do this is through an independent, industry self-regulatory organization, modeled after the securities industry, where the Securities and Exchange Commission has oversight of several self-regulatory organizations (the stock exchanges and the National Association of Securities Dealers).

NERC is a not-for-profit organization formed after the Northeast blackout in 1965 to promote the reliability of the bulk electric systems that serve North America. It works with all segments of the electric industry as well as consumers and regulators to "keep the lights on" by developing and encouraging compliance with rules for the

reliable operation of these systems. NERC comprises ten Regional Reliability Councils that account for virtually all the electricity supplied in the United States, Canada, and a portion of Baja California Norte, Mexico.

What is Reliability?

Reliability means different things to different people. For the consumer it could mean, “Does the light come on when I flip the switch?” Or, “Does a momentary surge or blip re-boot my computer or cause me to lose a whole production run of computer chips I was manufacturing?”

To NERC, reliability means making sure that all the elements of the bulk power system are operated within equipment and electric system thermal, voltage, and stability limits so that instability, uncontrolled separation, or cascading failures of that system will not occur as a result of sudden disturbances such as electric short circuits or unanticipated failure of system elements. It also means planning, designing, and operating each portion of the bulk power system in a manner that will promote security in interconnected operations, not burden other interconnected systems, and not interfere with the functioning of competitive markets.

NERC sets the standards by which the grid is operated from moment to moment, as well as the standards for what needs to be taken into account when one plans, designs, and constructs an integrated system that is capable of being operated securely. The NERC standards do not specify how many generators or transmission lines to build, or where to build them. They do indicate what tests the future system must be able to meet to ensure that it is capable of secure operation. NERC’s rules, which are not enforceable, have generally been followed, but that is starting to change. As economic and political pressures on electricity suppliers increase, NERC is seeing an increase in the number and severity of rules violations. Hence, the voluntary approach is no longer adequate for maintaining the reliability of the bulk power system. Just as the rest of the electric industry is changing, the reliability infrastructure must change too.

Voluntary Reliability Rules Will Not Work in a More Competitive Electric Industry

NERC’s formation in 1968 was the electric industry’s response to legislation that had been introduced in the Congress following the 1965 blackout in the Northeast. That legislation would have given the then Federal Power Commission (FPC) a central role in the reliability of the bulk electric system. Instead of adopting that legislation, Congress opted for an industry-led effort. For more than thirty years, this industry-based voluntary system has worked very well and we have had an extremely reliable electric system. But the reliability rules or standards have no enforcement mechanism. Peer pressure has been the only means available to achieving compliance.

As good as that system has been, voluntary standards will not suffice in the future. Here is why:

- The grid is now being used in ways for which it was not designed.
- There has been a quantum leap in the number of hourly transactions, and in the complexity of those transactions.
- Transmission providers and other industry participants that formerly cooperated willingly are now competitors.
- Rate mechanisms that in the past permitted utilities to recover the costs of operating systems reliably are no longer in place, or are inadequate given increased risks and uncertainties.
- The single, vertically integrated utility that formerly performed all reliability functions for an area is being disaggregated, which means that reliability responsibilities are being divided among many participants.
- Some entities appear to be deriving economic benefit or gaining competitive advantage from bending or violating the reliability rules.
- Construction of additional transmission capacity has not kept pace with either the growth in demand or the construction of new generating capacity, meaning the existing grid is being used much more aggressively.

A number of factors have contributed to our present circumstance. Demand has been steadily increasing over the past decade and is expected to increase. This past summer several utilities in the Eastern Interconnection experienced new all-time peak demands on their systems. The good news is that merchant generators are now building or planning to build hundreds of new plants across the country to meet this increased demand. The bad news is that the same is not true for transmission.

Ten years ago North America had a little less than 200,000 circuit-miles of high voltage transmission lines. Today we have about 200,000 circuit-miles of lines. Ten years from now we are projecting that we will have just a little over 200,000 circuit-

miles of high voltage transmission lines. All of these new generators will need to access the transmission grid to get their power to where it is needed. For the most part, however, the transmission dollars that are being spent today are just to connect new generation to the grid; they are not going to build major new power lines that will strengthen the grid's ability to move large blocks of electricity from one part of the country to another, or in some instances, such as Texas, from one part of a State to another. That lack of additional transmission capacity means that we will increasingly experience limits on our ability to move power, and that commercial transactions that could displace higher priced generation with lower priced generation will not occur.

Moreover, the existing grid is being pushed harder and is being used in ways for which it was not designed. Historically, each utility built its generating stations close to load centers, which were largely cities. As the cities grew, the electric systems grew with them, spreading outward from the center. The weakest part of the electric grid is generally where one system abuts another. Initially, utilities installed connections between adjacent systems for emergency purposes and to share generating reserves to keep costs down. Gradually those interconnections were strengthened so that adjoining utilities could buy and sell electricity when one had lower cost generation available than did the other. But these systems were not designed to move large blocks of power from one part of the country to another, across multiple systems, as is happening today. The volume and complexity of transactions on the grid have grown enormously since the advent of open access transmission.

Electric industry restructuring adds to the challenge. In the past, vertically integrated utilities with monopoly franchise service territories had complete responsibility for all aspects of their electric systems. They planned and built their transmission systems, ensured that sufficient generation was constructed, and operated and maintained their transmission and distribution systems, all to serve customers within designated service areas. With restructuring, there may no longer be a designated group of consumers for which to plan service. Instead, responsibilities to construct and maintain generation, transmission, and distribution are being divided among multiple entities. In some cases, those responsibilities may be falling between the cracks. Regional Transmission Organizations (RTOs) may provide a means to reintegrate some of these functions. But the RTO proposals that have been filed to date vary considerably in the extent to which the RTO will have the authority to plan and expand the transmission system, not only to connect new generation, but also to meet broader needs of wide-area reliability and commerce.

The result of all this is that the transmission grid is being increasingly stressed. NERC is seeing more congestion on the grid, for more hours of the day. NERC is also seeing increasing violations of its reliability rules. If these trends continue, we risk the increased likelihood of grid failure.

Legislation is Needed to Ensure Bulk Power System Reliability in a More Competitive Electricity Market

We need legislation to change from a system of voluntary transmission system reliability rules to one that has an industry-led organization promulgating and enforcing mandatory rules, backed by FERC in the United States and by the appropriate regulators in Canada and Mexico. In August 1997, NERC convened a panel of outside experts to recommend the best way to ensure the continued reliability of North America's interconnected bulk electric systems in a competitive and restructured electric industry. On a parallel track, in the aftermath of two major system outages that blacked out significant portions of the West in July and August 1996, the Secretary of Energy convened a task force on reliability, chaired by former Congressman Phil Sharp. Both groups came to the same conclusion: The current system of voluntary guidelines should be transformed into a system of mandatory, enforceable reliability rules, AND the best way to accomplish that was to create an independent industry self-regulatory organization, patterned after the self-regulatory organizations in the securities industry, with oversight in the United States by the Federal Energy Regulatory Commission.

On June 18, 2001, NERC and a broad coalition of state, consumer, and industry representatives (the American Public Power Association, the Canadian Electricity Association, the Edison Electric Institute, Institute for Electrical and Electronics Engineers—USA, the Large Public Power Council, the National Association of Regulatory Utility Commissioners, the National Association of State Energy Officials, the National Association of State Utility Consumer Advocates, the National Electrical Manufacturers' Association, the National Rural Electric Cooperative Association, the Northwest Regional Transmission Association, the Transmission Access Policy Study Group, and the Western Interconnection Coordination Forum) sent a letter to each member of the House Energy and Commerce Committee in support of legis-

lation to authorize creation of such an industry self-regulatory organization to develop and enforce reliability rules. That legislation would accomplish the following goals:

- Reliability rules would be mandatory and enforceable.
- Rules would apply to all operators and users of the bulk power system in North America.
- Rules would be fairly developed and fairly applied by an independent, industry self-regulatory organization drawing on the technical expertise of industry stakeholders.
- FERC would oversee that process within the United States.
- Approach would respect the international character of the interconnected North American electric transmission system.
- Regional entities would have a significant role in implementing and enforcing compliance with these reliability standards, with delegated authority to develop appropriate regional reliability standards.

This Subcommittee approved one version of the NERC legislative language when it passed H.R. 2944 in 1999. Last year the Senate passed the NERC consensus legislative proposal as S. 2071, but that bill was not considered in the House. This year, Mr. Wynn and a number of other members have reintroduced the NERC legislative proposal (H.R. 312). In addition, the President's National Energy Policy endorses development of legislation authorizing an industry self-regulatory organization subject to FERC oversight within the U.S.

Since the June letter, the organizations supporting the NERC reliability legislation have continued to work with representatives from across the electric industry, as well as state and consumer interests, in an effort to strengthen and broaden support for the legislation. One of the major criticisms of the earlier legislative language has been that the proposal is longer and more detailed than may be appropriate for a legislative enactment. To address that concern, as well as to respond to other concerns that have been raised over the recent months, we have developed revised legislative language that is shorter, less detailed, and more flexible to accommodate whatever structural changes emerge in the industry. I have attached a copy of that language to my testimony.

The revised legislation preserves from the earlier version the essential features for authorizing creation of a self-regulatory electric reliability organization. In addition, the revised legislation:

- provides FERC with additional flexibility and authority in shaping the development of the electric reliability organization and in overseeing its ongoing standards development and enforcement activities;
- clarifies the respective roles of the electric reliability organization and evolving regional transmission organizations; and
- includes definitions of "adequacy" and "security," the two components of reliability.

Together with the state savings clause from the earlier legislation, these new definitions place bounds on the scope of the electric reliability organization's standard-setting authority.

Under this legislation, FERC can assure harmonization of reliability standards developed by the electric reliability organization and market rules in two ways. First, FERC must approve the process by which reliability rules are developed. The legislation requires that process to be open, balanced, not dominated by one particular sector, and consistent with the requirements of due process. FERC can assure that market interests are adequately represented in that process. Second, FERC must approve the reliability rules before they take effect. If, despite the balanced process, a proposed reliability rule intrudes too far into commercial or market activities, FERC can reject the proposed rule and direct the electric reliability organization to make appropriate changes.

Changes to this revised reliability legislation were made just before the horrific events of September 11, and those events have interrupted efforts by those who have supported the NERC legislation in the past, as well as others, to complete their review of this language. In light of the Subcommittee's hearing schedule and the Chairman's stated desire to move forward on electric restructuring legislation, including reliability, NERC believes it appropriate to submit the proposed language to the Subcommittee now. NERC as well as all those that supported the earlier language believe this revised legislative proposal to be a considerable improvement over the earlier language, but it maintains all the essential features of that earlier language. Support for this proposal is not unanimous, and doubtless the language can be improved further. NERC is prepared to work with Members of this Sub-

committee and Subcommittee staff, as well as with others from the industry, to make whatever changes are necessary.

In addition, on September 21 Chairman Barton released a discussion draft of electric restructuring legislation. NERC commented on Title III, the reliability provisions of that draft, in a letter to Chairman Barton on October 2. A copy of that letter is attached to my testimony. NERC believes that Title III of the September 21 discussion draft, with the changes recommended in our October 2 letter, would form a workable basis for moving forward with reliability legislation. NERC stands ready to work with Members of this Subcommittee and Subcommittee staff, as well as with others in the industry, to develop appropriate language. What is critical is that we act now to update how we deal with reliability, even as the rest of the electric industry is undergoing profound changes. The horrific events of September 11 only serve to underscore the importance of that effort.

An Industry Self-Regulatory Organization Is the Best Approach for Developing and Enforcing Reliability Standards

Having an industry self-regulatory organization develop and enforce reliability rules under government oversight takes advantage of the huge pool of technical expertise that the industry has been able to bring to bear on this subject over the last 30 plus years. FERC does not now possess and is not likely to achieve anything approaching the level of technical sophistication inherent in the NERC standard-setting process, which involves dozens of committees and working groups and thousands of professionals representing all segments of the electric industry. Having FERC itself set the reliability standards through its rulemaking proceedings, even if based on advice from outside organizations, converts matters that ought to be resolved by those with technical engineering expertise and commercial markets expertise into matters that are the province of lawyers. These complex rules need to be worked out together, using a fair and open process, in a collaborative fashion by all segments of the industry.

The electric industry is in a great state of flux, as regional transmission organizations are forming, reforming, and consolidating. The path is not yet clear about how many RTOs there will be, or how extensive will be the participation in those RTOs, or when they will all come into existence. With all the uncertainty as to who will ultimately operate and plan the interconnected transmission system, it is more important than ever that an industry-led self-regulatory organization be created to establish and enforce reliability standards applicable to the entire North American grid, regardless of who owns or manages it. The self-regulatory organization can focus on reliability as its primary mission, even while new market structures and new RTOs are being formed. Because FERC will provide oversight of the self-regulatory organization in the U.S., FERC can ensure that the self-regulatory organization's actions and FERC's evolving RTO policies are closely coordinated.

An industry self-regulatory organization also addresses the international character of the interconnected grid. There is strong Canadian participation within NERC now, and that is expected to continue with the new organization. Having reliability rules developed and enforced by a private organization in which varied interests from both countries participate, with oversight in the United States by FERC and with oversight by provincial regulators in Canada, is a practical and effective way to address the common set of rules needed for the international grid. Otherwise, U.S. regulators would be dictating the rules that Canadian interests must follow—a prospect that would be unacceptable to Canadian industry and government alike. Or regulators on either side of the border might decide to set their own rules, which would be a recipe for chaos. There are also efforts under way to interconnect more fully the electric systems in Mexico with those in the United States, primarily to expand electricity trade between the two countries. Expanded international electricity trade is a key element of the President's National Energy Policy. With that increased trade, the international nature of the self-regulatory organization will take on even more importance, further underscoring the necessity of having an industry self-regulatory organization, rather than FERC, set and enforce compliance with grid reliability standards.

Conclusion

NERC commends the Subcommittee for attending to the critical issue of ensuring the reliability of the interconnected bulk power system as the electric industry undergoes restructuring. A new electric reliability oversight system is needed now. The continued reliability of North America's high-voltage electricity grid, and the security of the consumers whose electricity supplies depend on that, is at stake. An industry self-regulatory system is superior to a system of direct government regulation for setting and enforcing compliance with grid reliability rules. The revised

NERC Coalition legislative language presents the best approach for achieving that goal. It is also the approach that has had the most consistent, widespread support among industry, state, and consumer interests. Title III of the September 21 discussion draft, with the changes we have recommended, would also provide a workable basis for moving forward. It would then contain the essential features of the NERC approach. The reliability of North America's interconnected transmission grid need not be compromised by changes taking place in the industry, provided reliability legislation is enacted now.

Mr. BARTON. Thank you, Mr. Cook.

We now want to hear from Mr. Phillip Harris, who is President and CEO of the PJM Interconnection in the northeast or the Atlantic Mid-Atlantic.

Your testimony is in the record and we ask that you summarize in 5 minutes, please.

STATEMENT OF PHILLIP G. HARRIS

Mr. HARRIS. Thank you, Mr. Chairman.

Someone once said that in addressing complex public policy that the main thing was to keep the main thing the main thing. And the main thing is about customers. This is all about ensuring customers of the benefit of competitive price generation. That was the intent of the amendments to the Federal Power Act in 1992 and the fact that certain missteps have occurred in implementation in certain areas of the country should not overshadow that in the mid-Atlantic region, a region that has now grown to serve seven States plus the District of Columbia, competition has worked. This represents about 10 percent of the electric capacity in this Nation.

What we have found is that FERC already has the authorities they need for the most part under the Federal Power Act. Encouragement of this Congress should be to encourage FERC to get through the transition. In our area, we've got most of the transition and it's working, and the numbers are somewhat staggering. But from that practical experience for 10 percent of the Nation's electricity supply, we have certain facts that we think are an indicator of how to move through the transition sooner.

We know there are those who suggest complex additions to law to create new organizations with exclusive authorities. But we believe this is a step backward.

To my testimony I've attached a graph that really tries to demonstrate that electricity is a giant ecological system. It touches the very fabric of all our lives; from the fuel that is used to the ultimate choice by the consumer. We simply can't carve out a transmission only reliability standard without realizing the effects on everything else.

We have also discovered that there are no such things anymore as pure reliability standards. When you truly have competition that delivers value to customers, then ultimately the economics provide the value. Competition does work and competition can increase the liability. And with the technology that is rapidly advancing today, we've been able to find solutions to what was heretofore seen as only reliability problems. And these technological solutions do work.

We've also seen the emergence of new organizations such as the Gas Industry Standards Board that's been remarkable in what they've accomplished over the past few years. They have inter-

national cooperation. They are voluntarily developing standards. They're receiving accreditation from the American National Standards Institute as a standard setting body and then their standards go to FERC, which are approved as a model that should also be looked at.

And also we have found in the past 5 years of working with competition that our compliance with NERC standards has improved, not deteriorated.

There are also those who seem to think that the competition is simply about transmission. It is not. It is about providing value to customers through competitive price generation. This means that you need to have regional planning protocols. FERC Order 2000 stipulates that all RTOs will be involved with regional planning. From 1994 to 1996 we developed a regional planning protocol for the mid-Atlantic area. This was a venture that involved the environmental community, all the States, deciding agencies in our States. Our regional planning protocol has resulted in over \$700 million of transmission construction that is currently underway. Our current plans see no need for anything major that would be an impediment over the next 5 or 10 year horizon. The problem is getting to regional planning and get it into effect throughout the Nation, that then begins to solve the problem of siting and the coordination that's necessary to move forward.

We have also found that keeping the emphases on the consumer creates value. Over the 5 years we have seen the customer prices in PJM go to less than \$100 99 percent of the time. Our competition has shown that 71 percent of the time the price has been less than \$30.

We have 7,000 megawatts of new generation under construction. We have 40,000 megawatts from 140 different companies under different stages of planning for generation construction. This is competition that works and competition that FERC can put into place with their current authorities.

We think the evidence for competition is viable and the evidence is real. We think there are probably three simple things that we would suggest to you as you look forward to your legislative activities.

One, you should send a clear, simple and flexible authority of FERC to address all the reliability issues.

We think you should encourage and support the FERC to get through the transition. The problem is the transition. We get through the transition that will enable regional planning and competition to provide value to customers sooner rather than later is the key to success.

And third, ensure that FERC has the resources to be effective in enforcement actions in a 21st century information economy.

Thank you, Mr. Chairman.

[The prepared statement of Phillip G. Harris follows:]

PREPARED STATEMENT OF PHILLIP G. HARRIS, PRESIDENT AND CEO, PJM
INTERCONNECTION, L.L.C.

"The future requires a higher sophistication in acknowledging and dealing with differences..."

Peter F. Drucker

This insightful quotation from Peter Drucker sums up the challenge for all of us in the electric industry sector. As policymakers and as members of the industry, we must achieve 21st century information solutions which ensure that our policies and institutions match the efficiency and pace of this speed of light product known as electricity.

My name is Phillip Harris. I am the President and CEO of PJM Interconnection, the country's only fully functioning FERC-approved Regional Transmission Organization (RTO). We operate the largest competitive electricity market in the world, serving over 8% of the U.S. population. We also ensure the reliability of the electric power grid in a five-soon to be seven-state region including Washington D.C. (and this Capitol Building) as well as all or parts of New Jersey, Pennsylvania, Delaware, Maryland, Virginia, West Virginia and Ohio. We are honored to have been designated as the platform for use in FERC's planned Northeast RTO (NE RTO). As evidenced on the attached chart, the proposed NE RTO will encompass approximately 183,000 MW and is larger than the entire western grid of the United States and western Canada.

The critical test of any idea is the test of use. In the PJM region, restructuring of this industry has worked to deliver real value to the 24 million inhabitants therein. During the year 2000, PJM spot market prices were below \$100/MWH 99% of the time and approximately 71% of the time our prices were less than \$30/MWH. New investment in this capital-intensive industry is flocking to our region. Over 140 new generating projects have been announced, which would add over 40,000 MW of generation to our region, as well as over \$700 million in new and upgraded transmission investment. We were recently designated by *Business Week* as one of the top 50 businesses in the United States successfully integrating Internet technologies—the only utility to receive such designation. More than 70 nations have sent delegates to PJM to learn about its market model and the operation of the grid in the mid-Atlantic region. The Pennsylvania retail restructuring plan has been widely recognized as the most successful in the nation.

With this background, I wish to address the fundamental points the Subcommittee raised in its October 5 letter.

I. THE CURRENT STATUS AND FUTURE OUTLOOK FOR THIS INDUSTRY

Congress decreed competition in bulk power electric markets as the law of the land back in 1992. Although nine years later this vision has yet to be realized in much of this country, in the PJM region, with the support of our States and our market participants we have been able to meet Congress' expectations. The key to our success has really been quite simple—we have made our mission the efficient assimilation, use and widespread dissemination of information that makes the markets work.

As the attached chart indicates, despite the product moving at the speed of light, this industry has traditionally been operated through various "silos" of data and operation with little in the way of networking and integration. There were separate silos of data associated with the acquisition and delivery of fuel, the generation of electricity, its transmission and ultimately its distribution. Each of these silos operated as autonomous islands with little sharing of data. For example, even though the actions of a residential customer in flipping on a light switch had a speed-of-light effect back at the generating station, due to the lack of effective information flows, the customers receive bills for usage weeks later with no ability to evaluate, in real time, the economic effect of their actions. So too the transmission system was sized and built years earlier to deliver power from generating stations to load centers at peak times with little thought given to siting such lines at places that would relieve critical congestion on that system. In short, even though the physics of the product was sending us key information in real time, we didn't adequately listen to those signals and instead built infrastructure in an inefficient manner reflecting that failure.

By the same token, we have created silos in the form of institutions which govern the delivery of this product. We have the NERC looking at reliability standards, the FERC looking at markets, the DOE looking at infrastructure and the state PUCs looking at retail issues. Some of this can be expected from the natural evolution of our laws over time. However, just at the time we should be looking to network these different functions and break down these walls, NERC urges you to create yet a new silo—an industry organization, with funding authority granted by Congress, which would dictate standards on the physical operation of only the bulk transmission system without regard as to whether those standards properly integrate with the functioning of the marketplace—a role beyond its competence. You can't pigeonhole reliability standards and separate it from the marketplace and retail electric programs

any more than you can design a pen cap without also working in the design of the pen. There is no “pure” reliability issue separate from economics. For example, with an effective demand response system, customers through the marketplace will be voting with their dollars on the level of reliability of service they seek. They will be individually deciding whether they wish to incur a temporary curtailment of service and should receive economic compensation for so doing. No “core” national reliability standard can take the place of empowering customers to make economic decisions in their best interest. For this reason, we should avoid creating a new silo called “reliability.”

However, to date RTO development in the country has also involved the creation of silos. In the northeast we have three ISOs, each with their own rules despite the fact that the New York, PJM and New England markets (as well as the ECAR market) are essentially one large market crying out for a uniform set of rules and operations. We have proposed solutions in the FERC mediation process that will enable those markets to rapidly network into one while still maintaining essential local practices and enhancing the security and operation of the northeast grid. We need to embrace these solutions rather than slow them down.

It is for those reasons, as you wrestle with provisions dealing with reliability, RTOs, siting, etc., we urge you not to create new “silos” of institutions that look at parts, rather than the networked whole. In the PJM region, we have worked to avoid such silos, to the degree practicable:

- The PJM States work directly with us as the RTO, rather than having disparate sets of rules that change at every border. Our State PUCs deserve much credit for their leadership in making this happen.
- We integrate reliability standards and the marketplace on a daily basis. We have networked our regional reliability organization very closely with the market participants and the states because the needs of the marketplace and reliability are interdependent.
- We have come up with new solutions in our PJM West marketplace, to network the needs for delivery of capacity with a vibrant marketplace while retaining their local reliability standards.

Through the intended creation of four large RTOs in the country, the new FERC has set forth a vision which can work to network all of these important functions and, for the first time, match the borders of natural markets in the country. This is a wise and forward-thinking policy that deserves all of our support. We believe FERC needs all of our support to make the right decisions to put these large RTOs in place rapidly and ensure participation therein, in order to deliver real and measurable results to customers.

II. HOW CONGRESS CAN HELP

What can this Congress do to further these efforts? We would recommend the following:

1. *Reliability Issues*—Congress should adopt simplified reliability legislation assigning the ultimate responsibility for devising and enforcing mandatory reliability standards to the FERC. As noted before, the pace of change and the speed of light of this product mandate that we not “hard wire” in new private institutions with their self-regulating ability to, in effect, tax the public. Rather, the FERC should have the flexibility to assign all or parts of these tasks to different entities as it sees fit. Flexibility and simplicity should be the hallmark of reliability legislation. We have proposed legislation that would accomplish this and stand ready to work with you and others to refine any proposed reliability provisions.

2. *Siting*—Congress should provide deference to decisions reached through balanced regional planning processes that are open and which do not favor transmission solutions over generation solutions or one technology over another. State siting processes should be part of the planning process undertaken by the RTO and State siting decisions arrived at through such open balanced regional processes should be afforded Federal and State deference. By embracing and enhancing open regional planning processes that involve the states, Congress would avoid the Hobson’s Choice of favoring federalization of siting or continuing individual state decisions that could conflict with one another.

3. *More Standardization of Market Design*—FERC needs to more clearly delineate the exact market functions to be performed by emerging RTOs and ensure a certain degree of standardization of design, so as to promote the free flow of information to enable commerce in this speed of light product. We remain concerned that while we have the ISOs involved in facilitating the markets in the northeast, in much of the rest of the country the developing RTOs seem to want to remain passive grid operators with no obligation to ensure a vibrant marketplace.

As I indicated at the beginning the RTOs maintain critical data in real time on each aspect of the production and delivery of electricity. Neither retail competition nor your direction for vibrant wholesale competition back in 1992 will work without a clear role for the RTO to assimilate and distribute that critical information to the marketplace in real time. After all, the New York Stock Exchange would not work very well without the publication of prices. So too the RTOs must have a role in facilitating the marketplace by timely assimilating and delivering that critical data to serve as a “platform” on which competition can flourish.

Although we must allow for a certain degree of regional flexibility, the FERC’s prior approach of letting a thousand flowers bloom has not worked quickly enough to keep up with the needs of this speed-of-light product. We are heartened by the creation of an Energy Industry Standards Board using the successful Gas Industry Standards Board model. Their model presumes a linkage between wholesale gas, retail gas, wholesale electric and retail electricity services. A model much more functional for networking the needs of the 21st Century. By the same token, we believe the new FERC’s initiatives outlined so far are worthy of this Congress’ full support. This is not the time to “dumb down” what is otherwise needed by these still immature markets.

4. *FERC Resources*—Congress should ensure that FERC is fully staffed and has the resources needed to appropriately monitor the markets and regulate in those areas where the market is not properly functioning. This is not the time to pull the rug out of FERC’s efforts to deliver on the promise of the Energy Policy Act of 1992 and Order 2000.

5. *Enhancing Grid Security through a Hierarchical Network Model*—The events of September 11 have made us painfully aware of the need to keep security of infrastructure foremost in our minds. Unfortunately, those that presume “silos” proffer the risk inherent in them. Whereas the value of networked organizations provide resiliency, security and connectivity to meet the heightened security challenges of this century.

The creation of large RTOs under the Regional Network Model that PJM proposed for the Northeast will significantly enhance the security and continuity of the national grid. Under the PJM Regional Network Model approach, data and responsibility will be decentralized among multiple paths while, through a hierarchical design, the benefits of integration and uniformity are realized. This is far more secure than the system that presently exists, wherein we have individual “silos” of security responsibility among each of the individual utilities in much of the country. If models such as those we proposed are accepted by the FERC, we can go a long way to ensuring the benefits of a networked model while strengthening those decentralized features necessary to resist terrorist or cyber attack. In short, the NE RTO, if designed correctly, will enhance the security and reliability of the northeast grid from what presently exists today.

6. *Role of Technology*—The nation is moving rapidly to networked information through advanced technology. FERC should have these advanced tools and the staff resources to use them in order to identify and be responsive to market dysfunctions in a timely manner. And even more importantly, in writing laws in the electricity area, Congress should provide broad authority to the FERC and other government institutions rather than codifying constraints which will tie the agency’s hands. New technology solutions that we have not even dreamed of will solve problems that seem intractable today. But if we hard-wire in solutions and institutions, we will unknowingly stifle that very technology we so much want to succeed.

Our message is simple: with the wise use of information and with institutions such as the FERC having broad and flexible authority and a clear mission to promote competitive markets, our laws and institutions can begin to catch up and operate nearer to the speed and efficiency of this product known as electricity. At PJM, we have used the assimilation and ubiquitous delivery of information to empower our customers to meet their needs. We believe that this Congress should embrace similar 21st century solutions. We at PJM look forward to working with you to achieve this important goal.

Mr. BARTON. Thank you, Mr. Harris.

We now want to hear from Mr. James Steffes, who is Vice President of Governmental Affairs for ENRON Corporation. He’s here on behalf of the Electric Power Supply Association.

Your statement’s in the record in its entirety. We would ask that you summarize it in 5 minutes.

STATEMENT OF JAMES D. STEFFES

Mr. STEFFES. Thank you, Mr. Chairman.

My name is Jim Steffes. I'm pleased to be here today representing the member companies of the Electric Power Supply Association (EPSA), of which I presently serve as Chairman of the Regulatory Affairs Committee.

I would first like to discuss reliability. It's a fair statement that just about everyone within the industry agrees on the need to implement mandatory reliability standards. The old system of voluntary compliance no longer ensures a reliable network. It is also a fair statement that there is not consensus on how best to develop and enforce these mandatory standards.

EPSA recommends that Congress provide FERC with a straight forward delegation of authority to implement and enforce mandatory reliability standards. This authority, coupled with FERC's current economic regulation of wholesale electricity markets, will best provide for reliable and low cost electricity service for American consumers.

We do not think that enacting reliability language that tries to separate commercial matters from reliability matters is the right approach. It is critical that reliability legislation be aligned with FERC's approach to nondiscriminatory open access transmission and most importantly, to appropriate size RTOs.

EPSA is also troubled by proposed language that would hard wire significant issues such as mandating the role of regional reliability entities. These issues are better left to the flexibility of the regulatory process. FERC should evaluate the merits of this and other issues in a rulemaking proceeding. It is simply unwise to statutorily mandate the authority of regional reliability entities.

We are equally troubled by any limit on FERC's ability to seek necessary reliability rule changes on its own motion. Our industry continues to change at a rapid pace. Unfortunately, if we leave reliability rule changes in the hands of a self-regulating organization, it is highly likely that we will never reach consensus on the most pressing matters. A good example is the question over the independence of security coordinators. This issue has been discussed for many years inside NERC, but no consensus has reached the NERC Board of Trustees. I would submit that given the nature of the issue, none will.

The latest NERC legislative proposal still contains procedural mechanisms that limit, rather than enhance, FERC's role on moving forward with reliability matters.

EPSA respectfully recommends that Congress direct FERC to establish and enforce mandatory reliability standards. The approach we support is based on the traditional model that Congress normally follows: Establish a general a policy and direct the appropriate agency, FERC, to carry it out. This is not to say that we disagree with an industry led standard setting organization. We believe that the industry has the knowledge and technical skills to continue to staff this work. We simply want to make it clear that FERC is in charge.

Let me conclude on this topic by reiterating the central message. Trying to divorce commercial matters from reliability matters makes no sense in a competitive electricity market. Too many sub-

jects. In fact, I would argue all subjects are both reliability and commercial in nature.

In sum, the best way to strengthen reliability and establish robust competitive markets is to leave FERC with the discretion to make appropriate changes to a mandatory reliability regime as changes in the industry require.

Let me end by making two points on siting and incentive rates.

First, while physical improvements in the grid may be necessary, FERC and Congress must first focus on getting the rules of access right. Implementing right sized and well functioning RTOs and ensuring that all users take transmission service in a nondiscriminatory manner will properly define where more transmission is needed.

Second, while EPSA has no hostility toward the idea of incentive rates, we truly wonder if any additional language is needed. FERC clearly has authority to be flexible in setting an allowable rate of return.

In conclusion, Mr. Chairman, EPSA wishes to thank you and the subcommittee for this opportunity to discuss our views on these important issues. We look forward to continuing to work with you and your colleagues as you develop electricity legislation in the weeks to come.

Thank you.

[The prepared statement of James D. Steffes follows:]

PREPARED STATEMENT OF JAMES D. STEFFES, VICE PRESIDENT, GOVERNMENT AFFAIRS, ENRON CORP. ON BEHALF OF THE ELECTRIC POWER SUPPLY ASSOCIATION

Mr. Chairman and members of the Subcommittee, my name is Jim Steffes. I am a Vice President, Government Affairs for Enron Corp. based in Houston, Texas, where my responsibilities center on regulatory policy including the topics you are considering in this hearing. Enron is one of the world's leading energy, commodities and services companies. Enron markets electricity and natural gas, delivers energy and other physical commodities, and provides financial and risk management services to customers around the world.

I am pleased to be here today representing Enron and the member companies of the Electric Power Supply Association (EPSA), of which I presently serve as chairman of the Regulatory Affairs Committee. EPSA is the national trade association representing competitive power suppliers, including independent power producers, merchant generators and power marketers. EPSA members provide reliable, competitively priced electricity from environmentally responsible facilities in U.S. and global power markets. On behalf of the competitive power industry, I thank you for this opportunity to address reliability, siting and transmission pricing incentives, as you consider electricity issues.

RELIABILITY

Mr. Chairman, regarding the fundamental subject of the reliability of the bulk-power transmission system, there is general agreement on the need to replace today's voluntary standards with mandatory standards that apply to all system users. However, there is not a consensus on how best to develop and enforce mandatory standards. It is critical that reliability legislation be consistent with the Federal Energy Regulatory Commission's (FERC's) approach to non-discriminatory, open access transmission, including large Regional Transmission Organizations (RTOs), if we are to bring the benefits of competition to consumers.

Congress faces an important choice between two alternative legislative approaches to achieving mandatory reliability standards. Under the first approach, Congress could enact a lengthy electric reliability title sponsored by the North American Electric Reliability Council (NERC) that entombs numerous details in statute that are normally left to the flexibility of the regulatory process. Under the second approach, Congress could instead place mandatory reliability standards squarely under FERC's jurisdiction and direct the agency to promptly conduct a rulemaking to es-

establish an efficient standards-setting process and an effective enforcement mechanism. We strongly favor the latter approach for the following reasons.

NERC and those in its self-described “consensus group” continue to advocate what we and others regard as an unworkable regime that seeks to draw a false line between reliability and commercial matters. The NERC proposal would hand over “reliability issues” to a newly created “self-regulating organization.” The problem with this strategy is that too many subjects are not purely either reliability or commercial in nature; in fact they are inseparable. For example, scheduling of specific power transactions over a transmission system is a commercial matter with reliability implications. Because FERC is squarely responsible for commercial practices in the electric industry, NERC’s reliability approach will undermine FERC’s responsibilities under the Federal Power Act.

Given the importance Enron and other EPSA members attach to reliability, we participated in extensive discussions with NERC and others over the past several years to attempt to resolve our differences. While that process did not produce an agreement, we commend the extensive efforts that produced several legislative proposals, including the version NERC released last month. However, while the text of NERC’s latest proposal is shorter, it is still needlessly lengthy and cumbersome because it seeks to tackle matters best left to FERC.

Unfortunately, the latest NERC proposal is still laden with procedural mechanisms and delegations of authority that limit, rather than enhance, FERC’s role on reliability matters. It is clear to us from participating in the NERC discussions that those who endorse its approach intentionally seek to limit FERC’s authority over reliability in the name of enhancing reliability. For example, the NERC legislation proposes to create a new “self-regulating organization” that is in many respects independent from FERC. While there is certainly a key role for industry input on reliability standards, the “self regulating organization” as NERC proposes it would be too removed from FERC’s general regulatory responsibility over wholesale power markets.

Similarly, while it may make sense for FERC to defer to specific regional entities or approve regional variances from otherwise uniform reliability rules, FERC should evaluate the merits of doing so on a case-by-case basis. It is simply unwise, as the NERC legislation proposes, to statutorily mandate across-the-board regional reliability entities and regional rules variances. If those seeking approval of such entities can make a strong case in a particular instance, then they should make that case to FERC for its determination based on a factual record. FERC should not be forced to accept those entities or variances by force of federal law.

The approach we support is based on the traditional model that Congress normally follows of setting a general policy and directing the appropriate regulatory agency to carry it out, subject to congressional oversight. With reliability, we respectfully recommend that Congress direct FERC to establish mandatory reliability standards. After receiving public comments, FERC should determine the appropriate role of an industry organization to recommend standards and when to permit regional variances, among other details. Nothing is gained by giving regulators a responsibility as important as keeping the lights on and then tying their hands.

In sum, the agreed upon interdependent goals of strengthening reliability and establishing robust competitive markets can best be achieved by leaving FERC with the discretion to make appropriate changes to a mandatory reliability regime as changes in the bulk power system require. Both the Bush Administration and Senate Energy Chairman Bingaman appear headed in a direction on reliability consistent with our views.

SITING

The transmission grid is the backbone of the wholesale power market. Enron and EPSA have repeatedly argued in favor of regulatory reform that provides consistent, non-discriminatory access to the grid.

Beyond improved rules regarding access, we support efforts to enhance the interstate grid. The siting of new or expanded transmission facilities is critical to meeting the needs of power consumers. As you know, siting issues are presently handled at the state or local level. While this may have made sense at some time in the past, these policies need to be re-examined to allow for a reliable and low cost system.

The Subcommittee is well aware of “Path 15” in California. This transmission bottleneck has existed for many years, in spite of a well-documented need for improvements. Last winter, the impact of poor siting policies was felt by thousands of businesses and families in northern California when this bottleneck prevented available surplus power from southern California to reach the electricity-starved markets in the north. Path 15 is not an isolated example.

Members of Congress and the Administration have proposed new policies that would make the siting process of *interstate* transmission facilities reflect *interstate* priorities. EPSCA strongly endorses these reforms as necessary and appropriate. It will continue to be important to consider carefully the demands of the citizens in the towns and states where new transmission facilities are built. However, the siting process must also reflect regional and national priorities. Whether Congress adopts a new policy patterned on the successful program that allows new interstate natural gas pipelines to be built, or crafts a new approach that starts at the state and regional level, but uses a federal siting "backstop," the time has come for new ideas and a new approach.

TRANSMISSION INCENTIVES

The need for reform of the siting process is often coupled with a call for new financial incentives for transmission. In general, Enron and EPSCA have no objection to allowing a higher return on the development of critically needed transmission facilities. In at least one instance, EPSCA has made a direct plea to FERC to raise the rate-of-return for transmission facilities. However, we have three caveats with regards to any policy that would expand or enhance financial incentives:

First, FERC clearly has authority to be flexible in setting an allowable rate-of-return for new facilities. Anyone advocating new legislative authority or requirements should first demonstrate why this existing authority is insufficient to encourage new development.

Second, if the Congress endorses new policies to create new financial incentives, the projects to receive these incentives should be determined by FERC with input from a balanced, independent organization, such as an RTO.

Third, if higher rates for new facilities are contingent upon a determination of critical need, it will be important to ensure that this policy does not inadvertently encourage a disregard of timely upgrades in the expectation that improvements to deteriorated infrastructure will bring a greater reward.

INTER-RELATIONSHIP OF TRANSMISSION POLICY ISSUES

While the Subcommittee will hear testimony later today on Regional Transmission Organizations (RTOs), we want to stress how appropriately structured RTOs are the strongest foundation for sound transmission policies, including those topics being considered in this hearing.

In our view, it is critical that Congress support the formation of RTOs of sufficient size and configuration in order to facilitate strong regional power markets that will bring power from where it exists to where it is needed. If this overriding objective is achieved, other benefits will flow to consumers.

For example, reliability will be enhanced as large RTOs provide transmission service in a non-discriminatory manner to those that have power so they may bring power to where it is needed to meet demand. Well functioning markets—the very goal of FERC's RTO policy—will ensure reliability. Similarly, RTOs as FERC envisions them maximize efficient use of generation and transmission assets, reducing (though not eliminating) the need for some facilities and related siting decisions. As to incentives, investments for the benefit of regional markets are more likely to be made when those assets are operated within the type of RTO structure we support, rather than as part of vertically integrated utility systems.

Attached is a letter that EPSCA sent to Chairman Barton and members of the Subcommittee last month on pending legislation that centers on transmission incentives and RTO policy (H.R. 2814, the "Interstate Transmission Act"). The letter provides further details on these important points. Please place this letter in the hearing record.

CONCLUSION

In conclusion, Mr. Chairman, we thank you and the Subcommittee for this opportunity to present these views on reliability, siting and transmission pricing incentives in the context of non-discriminatory, open access transmission. We look forward to continuing to work with you and your colleagues as you develop electricity legislation in the weeks to come.

Mr. BARTON. We thank you.

We want to hear now from Dr. John Anderson, who is the Executive Director of the Electricity Consumers Resource Council.

Your testimony is in the record, and we ask that you summarize it in 5 minutes.

STATEMENT JOHN ANDERSON

Mr. ANDERSON. Thank you very much, Mr. Chairman.

Large industrial customers understand that the transmission grid is the linchpin of America's electricity system. Without adequate transmission capacity, the system fails. Similarly, without standards to ensure reliability, even a system with adequate generation and transmission will not be able to deliver power to end users on a regular and efficient basis.

The transmission system is in need of improvement. We need to have existing congestions in transmission mitigated, and we need the transmission system to be operated in a nondiscriminatory manner. Specifically, no owner of transmission facilities should use those facilities to benefit its generation at the expense of others.

Today I do address the three issues central to this hearing. First is the issue of incentive based rates for transmission, sometimes called innovative pricing or performance based rates. This issue has received much attention before this subcommittee, even today before the subcommittee and, of course, FERC.

We must remember that transmission is built and operated in the framework of a monopoly not competitive. ELCON members certainly believe that transmission owners should have a reasonable opportunity to recover prudently incurred costs and earn a just and reasonable return on the investment dollars that they put into transmission. But they should not get more than that.

Simply put, you can try to drive a monopolist, but if you try you should not expect to get the results that you were seeking.

The rate of return authorized for a monopoly transmission investment should reflect the risk that incurred. Generally investment in transmission is low risk. This subcommittee heard testimony from Goldman Sachs earlier and from several other people, and I refer you to that.

If transmission owners and transmission investors can first demonstrate a higher degree of risk, then a higher rate of return might be acceptable. But they should have to demonstrate that first.

Section 401 of Chairman Barton's draft dealing with incentive rates strikes me as overly prescriptive, unnecessary and undesirable. Ordering FERC to establish transmission pricing policies based on incentive based performance rates, both directs and confines FERC regardless of whether its expertise or market conditions may otherwise indicate.

I find it particularly ironic that this subcommittee would want to legislate so precisely when FERC only 2 weeks ago on September 25 under the leadership of its new Bush appointed Chairman, Pat Wood, a good Aggie, embarked on an ambitious new plan—

Mr. BARTON. There's no such thing as a bad Aggie.

Mr. ANDERSON. Thank you very much. Mr. Chairman, I stand corrected. Thank you very much.

Simply put, legislative direction such as is included in section 401 of the draft bill is unnecessary. It would severely limit FERC's ability to respond to market developments and should not be included.

The second issue is siting, specifically the issue of whether a Federal right of eminent domain should exist to facilitate such siting. I find it almost contradictory that some who support providing fi-

nancial incentives for new transmission oppose Federal right of eminent domain.

Congress recognized long ago that FERC should have the right of eminent domain in the siting of new natural gas pipelines. We believe the same right should exist for the siting of new transmission. Electricity clearly is interstate in nature.

The language in section 402 of your bill establishing a Federal backstop for transmission siting is generally positive. However, I emphasize that even a Federal backstop will not change the protective attitudes of transmission owners who do not want new transmission capacity because it would jeopardize their own generation.

The third issue is often called reliability, but in reality is simply the creation of a new electric reliability organization. ELCON and our members seek large seamless nondiscriminatory electricity markets. We support a strong top down reliability organization subject to FERC oversight. That organization must have fair and representative governance procedure. It should set uniform national reliability and commercial practice standards and procedures for North America. A one stop shop, to speak.

RTOs should implement, not set the standards. There's no discernable need either for affiliated regional reliability entities or regional advisory bodies, nor is there a need to statutorily prescribe variances or mandates.

The proposal put forth in section 301 of your bill is a noble effort. It recognizes that we do not need the complicated duplicative structure and process that was an integral part of the bill originally created under the auspices of NERC.

When ELCON first considered this issue we believed that reliability and commercial practices were separate components that could be treated separately. We now no longer hold that position. Although NERC purports that its standards and missions are confined to reliability, they actually overlap substantially with commercial practices. Simply stated, it is impossible to separate reliability from commercial issues so one organization should handle both.

In conclusion, ELCON seeks large nondiscriminatory seamless electricity markets. Such markets would benefit all customers by providing the opportunity to purchase electricity that is lower prices and more efficiently produced. We do not need artificial financial incentives to transmission owners or anyone else to get there. We need markets. We need a Federal approach since electricity is interstate in nature. And we need a means of siting new transmission that is efficient and effective. And finally, we need one set of rules, not several.

Mr. Chairman, thank you very much for the opportunity to be here with you.

[The prepared statement of John Anderson follows:]

PREPARED STATEMENT OF JOHN ANDERSON, EXECUTIVE DIRECTOR, THE ELECTRICITY CONSUMERS RESOURCE COUNCIL

Mr. Chairman, members of the Subcommittee, thank you very much for the opportunity to testify at this hearing this morning.

As you know, ELCON, formally the Electricity Consumers Resource Council, is the national association representing large industrial users of electricity. Our member companies come from virtually every segment of the manufacturing community.

Large industrial customers understand that the transmission grid is the lynchpin of America's electricity system. Without adequate transmission capacity, the system fails. Similarly, without standards to ensure reliability, even a system with adequate generation and transmission will not be able to deliver power to end users on a regular and efficient basis.

The transmission system is in need of improvement. We need to have existing congestions in transmission mitigated, and we need the transmission system to be operated in a nondiscriminatory manner. Specifically no owner of transmission facilities should use those facilities to benefit its generation. For the most part, the shortcomings in our transmission system are the result of a series of events.

America's transmission grid—still governed essentially by a 1935 statute—has been asked to change from a country road to an interstate highway. Electricity is being bought and sold in ways that had never been imagined.

In recent years there has been uncertainty about how the transmission grid would be operated. Logically, monopoly transmission owners have been reluctant to make necessary investments in improving or expanding the transmission market to relieve transmission congestions that often protected their own inefficient generation. This is an understandable, but undesirable, result of increasing competition in generation. Additionally, electricity restructuring on a state-by-state basis has presented transmission owners with an uncertain future, which has also contributed to a hesitant investment pattern.

Of late, given the increased attention being paid to our increasingly inadequate transmission grid, there have been a number of proposals put forth. Some we find positive, some negative, some simply incomplete.

INCENTIVES:

Let me turn first to an issue that has received much attention before this Subcommittee and before the Federal Energy Regulatory Commission—that is the issue of incentive-based rates for transmission, sometimes called innovative pricing or performance-based rates. ELCON has paid considerable attention to this issue, and in fact ELCON published an "Issue Profile" entitled *Performance-Based Regulation* in August 2000. That report is available at our web site, <http://www.elcon.org/Documents/pbr—profile.pdf>.

ELCON members are perhaps the pinnacle of capitalism. They compete in world markets. They are keenly aware of rates for investment and return on investment, of risk and aversion to risk.

Some people seem to think that increased competition in generation in some way changes the fact the transmission remains monopolistic. There is a basic difference between competitive markets, such as those in which ELCON members participate, and monopoly markets which is where we find owners of electricity transmission.

We understand perfectly well that the underlying theory of "incentive regulation" is intuitively appealing. This accounts for the growing popularity of proposals to provide "incentives" for transmission.

But we must remember—transmission is built and operated in the framework of a monopoly market. ELCON members certainly believe that transmission owners should have a reasonable opportunity to recover prudently incurred costs and earn a just and reasonable return on the investment dollars they place in transmission. But they should not get any more than that. Simply put, you can try to bribe a monopolist, but if you try, you should not expect to achieve the result that you are seeking.

We must also keep in mind that investment in transmission is essentially low-risk. As this Subcommittee heard from a Goldman Sachs analyst at an earlier hearing, a return in the historical 11-12 percent range usually is adequate. It will stimulate appropriate investment dollars. If transmission owners and transmission investors can first demonstrate a higher degree of risk, a higher rate of return might be acceptable.

This was clearly illustrated in a recent report prepared by the financial analysts Fitch on the newly formed American Transmission Company, a transmission-only company not affiliated with any one utility. That report states that ATC's "costs are recouped through an annual revenue requirement passed through rates to "network" customers" and that those network customers contribute over 95 percent of ATC's annual revenues. This is yet another illustration that investment in transmission is intrinsically low risk.

"Incentives" beyond cost of service for new monopoly transmission investments fail on several counts.

First, cost-of-service regulation should provide adequate economic incentives, because utilities are allowed to recover prudently-incurred costs and earn a virtually

guaranteed rate of return with almost no downside risk. There is no need to embellish any monopoly transmission owner's potential earnings as long as this guarantee applies.

Second, incentives cannot make a monopolist behave as a real competitor unless the monopolist is allowed to fail. Changing the rate of return does not change the underlying problem. The only way to minimize this problem is to structure the regulatory process in ways that minimize the potential for improper strategic behavior and gamesmanship.

Third, traditional cost-of-service regulation is not lacking workable incentive mechanisms. In fact, under cost-of-service, regulators often establish bandwidths around allowed returns that reward exceptional behavior or exceptional risk and punish the opposite. But those who want to construct new transmission must first demonstrate that such risk exists.

Section 401 of the "Barton draft," dealing with incentive rates, strikes me as overly prescriptive, unnecessary and undesirable. Ordering FERC to establish transmission-pricing policies based on "incentive-based and performance-based" rate treatments both directs and confines FERC regardless of whether its expertise or market conditions may otherwise indicate. Further, requiring FERC to report to Congress every year, assessing both "the level of transmission investments in the preceding year and assessment of the level and sufficiency of the Commission's allowed financial returns" will likely result in an upward spiral of rates of return on investment that might never end.

(Parenthetically I am reminded of the old, probably politically incorrect, joke where the crazy man is singing off-color and off-key tunes outside an apartment at two o'clock in the morning. One apartment dweller asks him to stop and the crazy man says yes, for five dollars. The apartment dweller throws him five dollars and the crazy man goes away. But he comes back the next night, louder, more off-color, and more off-key. The apartment dweller comes to the window and is about to throw out five dollars when the crazy man says, no, tonight the rate is ten dollars. After all, he says, "I may be crazy, but I am not stupid.")

I find it particularly ironic that this Subcommittee would want to legislate so precisely when FERC, only two weeks ago on September 25, under the leadership of its new Bush-appointed chairman, Pat Wood (Texas A&M, 1985), embarked on an ambitious new plan for "Making Markets Work." Although we do not support every provision of Chairman Wood's plan, it comprehensively addresses the need for infrastructure improvement and expansion with the stated objective of providing "clarity of cost recovery to infrastructure investors." FERC already has the authority to approve higher rates of return, FERC has the authority to approve incentive-based rates, and FERC has the authority to create innovative rate structures (for example, FERC included such a requirement in Order 2000).

Simply put, legislative direction such as is included in Section 401 of the draft bill is unnecessary, would severely limit FERC's ability to respond to market developments, and should not be included.

SITING:

Now let me turn to transmission siting and, specifically, the issue of whether a federal right of eminent domain should exist to facilitate such siting.

I find it almost contradictory that some who support providing financial incentives for new transmission oppose a federal right of eminent domain.

Those who wish to build new transmission are faced with a myriad of different state rules and regulations. What has been called NIMBY—not in my backyard—has grown into BANANA—build absolutely nothing anywhere near anything. But a word of caution—unless you change the underlying motives of transmission owners, establishing a simpler procedure, while helpful, will not get the job done.

Congress recognized long ago that FERC should have the right of eminent domain in the siting of new natural gas pipelines. We believe that the same right should exist for the siting of new transmission. It is clearly interstate in nature. Since citizens in one state may object to new power lines that provide power to citizens in another, it is up to the Federal government—in this instance FERC—to provide a means to overcome such provincialism and ensure that the needed infrastructure is in place. Because, in truth, all citizens will benefit from a well functioning, reliable, electricity grid.

The language in Section 402 of the draft bill, establishing a "Federal backstop" for transmission siting, is generally positive. However, a two-step process will by definition result in less, not more, transmission capacity. And even a Federal backstop will not change the protective attitudes of transmission owners who do not want new transmission capacity because it would jeopardize their own generation.

RELIABILITY:

That brings me to my last point—what is often called reliability but in reality is simply the creation of a new electric reliability organization.

ELCON and ELCON members seek large, seamless, nondiscriminatory electricity markets. We support a strong “top-down” reliability organization that sets uniform national standards and procedures for North America. RTOs should implement, not set, standards. We favor fewer levels of bureaucracy. We believe questions of reliability should be decided as quickly as possible, and we seek rules of the road for reliability that are consistent so that buyers and sellers face a seamless electricity market. Rules intended to increase reliability should not unnecessarily intrude into commercial practices.

ELCON has been working with the North American Electric Reliability Council (or NERC) for over four years in an attempt to draft legislation that would authorize an appropriate new reliability organization. We need a new organization because NERC as presently operating has no statutory authority. This means NERC has no enforcement or funding authority, and no antitrust immunity. NERC was created for the market of the 1960’s; it is not designed for the markets of the twenty-first century.

ELCON helped draft and then supported what is sometimes called the consensus reliability language first proposed in February 1999. That language has been revised several times over, and ELCON continues to this day to participate in NERC drafting sessions that, in truth, seem to be moving away from consensus at every meeting. The reason for the increasing lack of consensus is not really surprising. As we see the wholesale market continue to develop—what happened in California, what is happening with RTOs, what is happening at FERC—we realize that what was proposed two and a half years ago is inappropriate for today’s electricity world. It was too detailed, too cumbersome and too prescriptive. It should not be adopted.

As you are well aware, FERC is attempting to establish five large regional transmission organizations. These RTOs would be in charge of the operation of the grid within their regions. A critical question is who will draft the necessary reliability and commercial standards, a national standards organization or each RTO individually? If RTOs can draft their own standards, why do we need a national reliability organization?

The proposal put forth in Section 301 of the Barton draft is a noble effort. It recognizes that we do not need the complicated, duplicative structure and process that was an integral part of the bill created under the auspices of NERC.

The most recent version of the legislative language coming out of the NERC process establishes a new North American Reliability Organization (or NAERO) as well as a series of new Affiliated Regional Reliability Entities (or ARREs). The geography of the ARREs is expected to be identical to the geography of the RTOs. But the division of responsibility between the two is unclear.

We contend that the ARREs are at best redundant and at worst counter-productive. They will contribute to a variety of rules and regulations and heighten the “seams” issue of how power flows from one RTO to another. More importantly, those who propose that ARREs be granted the right to ask for variances for different reliability standards in each RTO only increase those dangers. And those who suggest that ARREs be allowed to seek such variances directly from FERC are really seeking a balkanized electricity grid rather than a unified one. We are pleased that the Barton draft language does not envision or sanction such entities.

Finally the NERC “consensus” language proposes, in statute, the creation of Regional Advisory Bodies which also may offer proposals to FERC and whose proposals shall receive “deference” from FERC. Again, ELCON does not believe that we should create RTOs with each responsive to multiple masters. This will Balkanize the electricity marketplace. Again, we are pleased the Barton draft does not include or create such bodies.

ELCON and ELCON members believe that RTOs can best serve the purpose of *implementing* national reliability standards and administering those standards for purpose of operating a reliable grid. The standards should be established by a national organization. We do not need ARREs. We do not need Regional Advisory Boards. And we certainly do not need a process that gives deference to regional groups, which, again, can only lead to Balkanization. It is the interest of consumers and in the interest of reliability to create a system with as few levels of bureaucracy as necessary.

That leads to one more issue—the question of standards for reliability versus standards for commercial practices. When ELCON first considered this issue, we believed these were two separate components that should be treated separately. We know longer hold that position. Although NERC purports that its standards and its

mission are confined to reliability, we believe that they overlap substantially with commercial practices. It is impossible to separate reliability from commercial issues. Along those lines, the Gas Industry Standards Board has approved a proposal that it become an Energy Industry Standards Board to develop appropriate commercial standards for electricity, with the understanding that they might also affect reliability. I don't know if this question needs to be addressed in legislation or by FERC, but it should at least be considered.

Optimally, we believe that any standard-setting organization created needs to address questions of both reliability and commercial practices—a one-stop shop so to speak. It should be a strong “top-down” organization, subject to FERC oversight and approval, that establishes standards and practices. There is no discernible need for affiliated regional reliability entities or regional advisory bodies. Nor is there a need to statutorily prescribe variances or mandates for deference. There should be an antitrust exemption based on “rule of reason,” rather than on a rebuttable presumption. And this body should have a just and reasonable funding mechanism.

CONCLUSION:

In conclusion, ELCON seeks large, nondiscriminatory, seamless electricity markets. Such a grid would benefit all consumers, providing all consumers with the opportunity to purchase electricity that is lower priced, more efficiently produced. We do not need artificial financial “incentives”—to transmission owners or anyone else—to get there. We need a federal approach. We need a means of siting new transmission that is not fraught with danger. And we need one set of rules, not several.

Thank you Mr. Chairman.

Mr. BARTON. We thank you, Doctor.

We'd now like to hear from Mr. Marty Kanner whose the coordinator for Consumers for Fair Competition.

His statement's in the record and you're recognized for 5 minutes.

STATEMENT OF MARTY KANNER

Mr. KANNER. Thank you very much, Mr. Chairman, members of the subcommittee.

You've heard this morning that transmission is critical to ensuring competitive markets. You've also heard that transmission system is constrained, and you've heard from a number of witnesses that incentive rates are unnecessary to relieve those constraints and provide the seamless highway of commerce that's needed. So my challenge this morning is to add what you've already heard.

Some have suggested that incentive rates boosting the return on investment is necessary in order to attract the capital needed to invest in the transmission system. It's absolutely true that the failure to invest in the transmission network is related to economics. But it's not the economics associated with the rate of return on those investments, rather it's the economics of the competing business; generation. When we have vertically integrated utilities any transmission constraint boosts the prices that can be charged for generation within that constraint and effectively preclude the introduction of competitors.

Looking at the economics, looking at the comparative investment and generation assets and transmission assets, it's absolutely true that if you follow the dollars maintaining constraints boosts profits. Simply adding to the return that can occur on the transmission system won't relieve those incentives, won't change the economics. It's simple: The economics dictate that transmission constraints are a good thing for transmission owners.

So the question then is what do you do to relieve the constraints and is it necessary to provide incentives. Before I answer that question, I'd like to go beyond.

In the various proposals including section 401 in the chairman's discussion draft, as well as the bill introduced by Mr. Sawyer and Mr. Burr there is not a limit on those incentives to just new investments. Rather, incentives would also inure to efficient operation of the grid, to participate in RTOs, even to those that are already RTO participants. Again, those are needed.

FERC has already taken steps to encourage RTO participation. And efficient functioning of the transmission grid should be a requirement for a monopoly owner, not something that we need to provide sweet monopoly candy for people that do their job.

On negotiated rates, it violates the basic tenant of the Federal Power Act. The Federal Power Act requires just reasonable, not unduly discriminatory or preferential rates. There's no way to ensure that if parties can simply have a sidebar agreement and tell transmission users it's take it or leave it. Pay what we are saying or else you don't get access. And there's no way for others, whether it's competing transmission users or FERC to determine whether that negotiated rate was fairly and reasonably entered into.

As you've heard today, there's plenty of latitude within the Federal Power Act to ensure just and reasonable rates—to require just and reasonable rates and ensure that transmission owners receive a reasonable rate of return. In fact, that's precisely what the just and reasonable standard calls for. It requires that rates are neither extraordinary to transmission users, nor confiscatory for transmission providers. Within those bounds, there's tremendous latitude for the commission to ensure that rates reflect the risk associated with the investment and they are provided sufficient incentives to do what's necessary for the system, which makes me wonder then what is the hidden agenda?

As you know, many utilities are seeking to sell or spin off their transmission assets. If utilities are no longer going to be transmission owners, why are they pushing so hard for incentive rates? The only conclusion I can come to is that they're looking to boost the asset value for those sales. If they can promise a potential purchaser that you'll get a 20 percent return on the investment, they can increase the sale price that they can otherwise attract.

If this is, in fact, the hidden agenda, then we need to make sure that transmission rates are based on the depreciated book value and not on the premium paid when new parties purchase these same assets. Otherwise, all we're doing is churning the assets and ensuring that transmission rates are higher.

So what can be done? You've heard from a number of my colleagues today. We need a system that ensures access to all parties under the same terms. We need viable vibrant RTOs that have the authority to plan and ensure investment in the system. That's all that's needed, Mr. Chairman. Incentive rates clearly are not.

[The prepared statement of Marty Kanner follows:]

PREPARED STATEMENT OF MARTY KANNER ON BEHALF OF CONSUMERS FOR FAIR
COMPETITION

Mr. Chairman, members of the Subcommittee, I am Marty Kanner. I am testifying today on behalf of the Consumers for Fair Competition (CFC), an ad hoc coali-

tion of consumer-owned utilities, small and large electric consumer representatives, small business interests, and others. While the interests of these organizations are diverse, we are unified in the belief that Congress and the Federal Energy Regulatory Commission (FERC) must take clear and significant steps to promote the market structure needed to foster and sustain effective competition in wholesale electric markets, and its associated consumer benefits.

CFC commends you, Mr. Chairman, for focusing attention on the needs of the electric transmission system. As the members of this Subcommittee know, the transmission system is the highway of commerce for the electric utility industry. As many of you also realize, today's electric highway system is in need of drastic repair. We are all by now familiar with Path 15—the North-South constraint in California that contributed to several of the State's rolling blackouts as well as higher electricity prices. Unfortunately, while Path 15 may be one of the most infamous constraints, it is far from the only one. Throughout the country there are constrained paths that inhibit wholesale power transactions, limit generation competition (and consequently increase rates), create "load pockets" in which market power can be exerted, and threaten system reliability.

There is a glaring need for additional investment in the transmission system. Some have suggested—incorrectly—that the lack of transmission investment is a result of inadequate returns on those investments and that "incentive rates" are needed to cure this problem. In fact, they go far beyond investment in transmission additions, calling for incentive rates to reward efficient management of the transmission system, entice membership in Regional Transmission Organization, promote deployment of new technologies and assure system reliability. While all of these goals are important, incentive rates for transmission—especially rates that are set outside the bounds of the "just and reasonable" standard that has guided nearly seventy years of utility regulation—are unnecessary and harmful to consumers.

TRANSMISSION RETURNS ARE NOT DRIVING AWAY INVESTMENT

Some have suggested that the lack of utility investment in transmission is directly caused by inadequate returns on those investments—utilities aren't investing in transmission because they can't attract capital at 10-12% returns. These assertions are simply untrue.

Utility transmission investments are not competing with the high-flying returns of high-risk investments. Traditionally, utility stocks were the investment of choice for low-risk investors—widows and orphans. Many utilities today are restructuring themselves to become pure wires companies or to separate their merchant, competitive operations from their "traditional" business in regulated functions. As noted before this Subcommittee on July 27 by Thomas Lane, Managing Director of Goldman Sachs, "There is definitely a role in the markets for a lower risk, lower return investment which is what transmission represents."

Transmission is a monopoly service. As a monopoly function, its use must be priced at cost, with a rate of return that reflects the low risk associated with a monopoly function.

OTHER FACTORS DISCOURAGE TRANSMISSION INVESTMENT

The lack of adequate investment in the nation's transmission system is due to factors other than return:

1. **Competing Profit Motives.** It is absolutely true that economics drives the failure of utilities to invest in transmission—but it is not the economics associated with the rate of return on transmission investment. The transmission network is owned by vertically integrated utilities with significant investment in generation facilities. Transmission constraints serve to boost the price that can be charged for generation within that constraint and to frustrate market entry by potential competitors. It is more profitable to maintain a constraint and we should not seek to bribe utilities to relieve those constraints.
2. **Transmission Siting.** Many transmission additions cannot be built—or are severely delayed—because of the current transmission siting regime. CFC does not have a position on the appropriateness of federal siting authority. However, we recognize that the current regime is a contributing factor to the inadequacy of transmission investment.
3. **Uncertainty Associated With RTOs.** Some utilities may have foregone or delayed investment in transmission as the world of RTOs sorts itself out. Utilities, assuming that the cost of those investments will be recovered through the RTO, may seek to avoid a rate case fight before state regulators. I want to emphasize, however, that RTOs can be the cure to needed transmission investment, as I will explain later.

4. **Uncertainty Associated With Technology and Generation Investment.** The industry is going through significant changes. It is possible that a narrow subset of transmission investments could be rendered moot by the siting of new generation. However, I would note that there are less harmful means of addressing this potentially uncertainty. Moreover, effective transmission planning by an RTO can minimize or eliminate this uncertainty.

INCENTIVE RATES ARE EVEN LESS JUSTIFIED FOR GENERAL TRANSMISSION FUNCTIONS

My testimony has focused on transmission incentive rates for new investment. However, the advocates of incentive rates go far beyond new investment—calling for incentives for joining RTOs, rewarding existing RTOs, limiting rate pancaking, promoting efficient operation and reliability.

Why are we providing incentives for RTO membership when most utilities have already joined RTOs under FERC Order 2000, itself a “voluntary” mandate, and FERC has taken additional steps to prompt RTO participation? What purpose do “sign up” incentives serve for those RTOs that already exist? Why should we provide incentives to *limit* rate pancaking when FERC Order 2000 already calls for the *elimination* of rate pancaking?

NEGOTIATED RATES VIOLATE THE UNDERLYING TENET OF FERC REGULATION

The notion of “negotiated rates”—FERC approving rates without regard to cost—is most abhorrent. The Federal Power Act prevents the charging of rates that are “unjust, unreasonable, unduly discriminatory or preferential”. Negotiated rates can violate each of those standards. A transmission owner can impose excessive charges and tell the transmission user to “take it or leave it”. Alternately, a transmission owner can discriminate between competing generation developers, facilitating interconnection only for the generator willing to pay top dollar. Moreover, if FERC (and competitors) are unable to review the underlying costs, no one will know if the negotiated deal reflects a fair rate or simply the transmission equivalent of “an offer you can’t refuse”.

INCENTIVE RATES: THE HIDDEN AGENDA?

Many utilities are seeking to sell or spin-off their transmission assets. If utilities are no longer going to be in the transmission game, why are they calling so loudly for incentive rates. I fear that the underlying motivation is to increase the market value of those assets. Didn’t we already see this phenomenon in the sell-off of utility generation assets (a study by Professor Harry Trebing shows that 93% of those were for well above book value)—with its obvious negative impacts for consumers in California? Potential investors may be willing to pay a higher purchase premium if they can be assured of inflated returns.

If this is, in fact, the hidden agenda, it is critical that we ensure that future transmission rates are based on the underlying book value of transmission assets and not on the acquisition cost.

“JUST AND REASONABLE” REMAINS THE PROPER STANDARD

The Federal Power Act directs FERC to ensure that all transmission rates are “just and reasonable”. This standard provides sufficient latitude for FERC to: (1) adjust rates of return to reflect any increase in investment risk, (2) allow performance based rates to reward exceptional performance that benefits consumers, (3) send price signals (e.g., congestion pricing) to encourage investment to relieve constraints. Significantly for the members of CFC, the “just and reasonable” standard also requires that consumers do not pay extortionary rates.

There is significant risk of consumer harm in flipping that model and directing FERC to provide incentive rates every time a transmission owner comes forward.

HOW DO WE RELIEVE TRANSMISSION CONSTRAINTS?

Mr. Chairman, I have spent my testimony critiquing the notion of incentive rates. But given the reality of today’s transmission constraints, I feel obligated to also offer constructive suggestions for relieving those constraints.

1. **Ensure Fair and Equal Access.** “Phantom” transmission constraints exist throughout the system. Transmission owners reserve more transmission capacity than is needed, creating artificial constraints that impede transactions. Similarly, inadequate or untimely postings of available transmission capacity suggest constraints that do not exist. Congress must ensure full, fair and equal access for all parties to the nation’s transmission grid.

2. **Independent Planning.** As noted above, vertically integrated utilities have little economic incentive to relieve constraints. RTOs—as independent managers of the grid—must have robust and effective planning authority and responsibility.
3. **Authority to Compel Construction.** All too often, utilities will ignore or defer transmission investment needs. RTOs must have the authority to compel utilities to build needed transmission. If utilities are unable or unwilling, then the RTO should be authorized to build the facilities itself or solicit competitive bids.

CONCLUSION

There is no doubt that significant investment in the nation's transmission system is needed. However, incentive transmission rates are not the cure. Transmission rates—as a monopoly service—must continue to be guided by the “just and reasonable” standard.

Mr. BARTON. We thank you, Mr. Kanner.

Before we recognize Mr. Vesey, the Chair wishes to make a housekeeping announcement. We're moving expeditiously through this panel. Based on the number of members present and those expected to be present, I think we can conclude the questioning of this panel by approximately noon. Given that, we have called the representatives for the second panel and we're going to start the second hearing at 1 p.m. instead of at 2.

So those of you that need to go make phone calls.

We expect to start the second hearing at 1 p.m. instead of 2. We've notified the panelists and they're agreeable. So if people need to know that information, please be notified.

We now want to welcome our last testifier on the first hearing, Mr. Andrew Vesey, who is Vice President Energy and Utilities for the Cap Gemini Ernst & Young L.L.C.

Your testimony is in the record, we recognize you for 5 minutes.

STATEMENT OF ANDREW M. VESEY

Mr. VESEY. Thank you, Mr. Chairman.

Over the past 25 years capital investment in the transmission system has remained stable despite rising off system sales and falling reserve margins. However, since the mid-1970's the transmission system has grown at half the rate of demand. Transmission sector needs investment.

Today's transmission goods grew incremental over time as the industry met the requirements of growth and the pressures for increased reliability. There was little reason to believe, however, that the current structure's the most economic or the most reliable in light of current market needs. In some parts of the country inadequate transmission capacity already diminishes the prospect for competitive power markets.

On the rate of return regulation utilities make money by investing in assets. The apparent lack of investment in transmission is most likely the result of the market not believing that the owners of transmission have the ability to generate future revenues sufficient to cover their costs and provide a competitive return.

If the market is doubtful, it is because the cost of capital used to establish prices is believed to be too low. Too low because the market sees risks that are not being acknowledge in the rate making process.

What are these risks? Well, among them are competition. Competitions of the grid exist now and will grow over time. The emergence of distributed generation technology such as small gas tur-

bines and fuel cells provides the potential of bypassing the transmission grid and the risk of straining transmission investment.

Difficulty of siting new facilities is also one of the risks not recognized. With the passage of the Energy Policy Act of 1992 the transmission grid was required to act as a common carrier for bulk power transactions. It is this new responsibility that has revealed that the system, which was interconnected for liability purposes, could not longer be relied upon for the level of interregional commerce demanded by the bulk power markets.

Significant investment in interregional transmission capacity is needed. The current siting process, however, is ill-equipped to adequately handle this type of project given the mismatch between those incurring the costs and those receiving the benefits of this type of project across local, State and regional boundaries.

Finally, there's the investment risk associated with ongoing activities regarding the governance of transmission owning entities to ensure independence for market participants. The desire to separate asset ownership from the control and operation of those assets, if not done thoughtfully, has the potential of seriously deluding the powerful incentives provided by the market on for profit asset owning enterprises.

There is today no clear consensus as to which business structure is optimal for owning transmission assets. The rules of the road are not fully written, and indeed may be different region-to-region.

So how do we ensure the proper investments are made? One approach may be to simply have regulators provide higher rates of return in line with perceived risks. While fully compensating investors for risks is an absolute necessity, if these increased profits are earned through the current rate of return framework, they will at best only deliver a narrow range of the needed investments, not the broad range required by the new competitive markets. And at worse, they may result in over-building.

The new competitive market is significantly different from the markets in which today's transmission business is developed. It is a market potentially made up of thousands of commodity suppliers, hundreds of service providers and millions of individual consumers. It is characterized by high transaction costs and low barriers to entry and exit by both sellers and buyers.

The network not only has to effectively manage the flow of electricity, but also has to manage the flow of information and cash. Traditional rates of rate of return regulation rewards firms for placing assets on the ground to transport electricity. This new competitive market requires firms to be rewarded for behaviors that promote customer focused, market driven solutions to facilitate commerce.

With properly designed pricing transmission companies will succeed only by maximizing throughput, maintaining broad non-discriminatory access and making system investments to maintain optimal congestion levels. When the benefits of lower costs and higher volume flow to the bottom line, transmission companies will seek efficient decisions inducing competitively neutral solutions. They will find the most cost effective, not the most asset intensive answers to customer needs and they will devise innovative operating procedures and a range of tailored cost effective offerings that

fully utilize their facilities. But most importantly, they will be driven to enrich their customers by maximizing the value of commerce along their networks.

Thank you.

[The prepared statement of Andrew M. Vesey follows:]

PREPARED STATEMENT OF ANDREW M. VESEY,¹ VICE PRESIDENT, CAP GEMINI ERNST & YOUNG LLC

Over the past 20 years capital investment in transmission remained relatively stable, in real terms, despite rising off-system transactions and falling reserve margins. In the 10 years preceding the Northeast Blackout of 1965, and in the decade following, utilities did build high voltage lines at a rapid pace that kept up with growing demand. From the mid-1970s to the present, however, the transmission system has grown at less than half the pace of demand.

With generating reserves falling and transmission plant showing little expansion, transmission operators have responded by running the system in emulation of *just-in-time* inventory management concepts, which rely on coordination of all suppliers without the “safety-net” provided by system availability in excess of current needs. This operational response will work only as long as all suppliers continue to produce and ship on schedule and as long as buyers readily can find alternative suppliers.

The transmission sector needs investment. Our transmission grids grew incrementally over time as the industry met the requirements of growth and the pressure for increased reliability. There is little reason to believe, however, that the current structure is the most economic or the most reliable in light of current market needs. Moreover it is doubtful that the existing structure represents an appropriate trade-off between economy and reliability, or that it incorporates the levels of reliability that customers want. In some parts of the country inadequate transmission capacity already diminishes the prospects for competitive power markets and decreases the system reliability during power plant outages. System operators, fortunately, have learned to compensate for some of the physical deficiencies by running the networks more efficiently.

It is not clear, however, that transmission owners have avoided physical expansion because they could achieve their goals through the clever operation of their systems: owners more likely decided to avoid expansion because of siting difficulties or inadequate potential returns on their investments. The siting difficulties are well documented, but they have to be placed in the context of incentives, as well. Under rate-of-return regulation, utilities make money by investing in plant. Utility managers, therefore, never have avoided large, lumpy investments when they expected that the allowed rate of return would equal or exceed their cost of capital.

Capital flows to a business based on the market's expectation that the business's management has the ability to use the capital to generate a stream of revenue that exceeds the cost of generating that revenue by an amount that is at least equal to the next best use of that capital. Simply stated capital flows to return. The market's “expectation” is based on consideration of all the risks to which the generation of revenue is exposed and the period of time to fully recapture the invested capital and its return. The flow of capital to a business is directly proportional to that business's management's ability to create value by generating earnings that are greater than the business's cost of capital in the long run.

The apparent lack of investment in the transmission sector is most likely the result of the market not believing that the business has the ability to generate future revenues sufficient to cover its cost and provide a competitive return. Under rate-of-return regulation the amount of revenue required is predetermined by calculating a unit price which, based on forecasted sales, will generate sufficient revenue to cover all production costs plus a profit. Calculating the firm's cost of capital determines the profit. If the market is doubtful that revenues are sufficient to yield the required return it is because the cost of capital used to establish prices is too low. It is too low because the market sees risks that are not being compensated for in the ratemaking process.

Among the risk that the market sees are:

- Competitive challenges to transmission's monopoly status
- Difficulty in obtaining right-of-way and siting new transmission

¹This testimony is based in large measure on the material presented in the book “*Unlocking The Benefits of Restructuring: A Blueprint For Transmission*”, By Shimon Awerbuch, Leonard Hyman and Andrew Vesey, Published by Public Utilities Report Inc; Vienna, Virginia, November 1999.

- The Evolving regulatory framework governing transmission

Firstly, competition to the grid does exist and will grow over time. The rapid expansion of distributed generation technology such as gas-fired turbines as well as the advent of fuel cells clearly suggest that the role of transmission may change significantly over the next one or two decades. This competitive pressure should provide powerful incentives to a profit-oriented transmission owner to provide high quality service, efficiently manage embedded plant, and to add new capacity (where warranted) to enhance the functioning of the system, rather than lose market share to competitors. This new capacity, incidentally, would not be limited to wires and structures, but must be extended to include software, information systems, and new electronic and technical devices. All of which enhance the firm's capability to facilitate high value commerce in the emerging competitive electric energy market.

As mentioned earlier, the emergence of distributed generation technology has the potential of contesting the monopoly status of the transmission sector. This raises the increased specter of bypassing the transmission grid and the risk of stranding transmission investment.

Secondly, the current interconnected electric grid evolved over time to (1) transport energy from remotely located generating stations to local load centers required to serve local load, (2) aggregate diverse local load to lower overall generation investments and (3) enhance local reliability by inter-connecting neighboring systems. All these objectives provided local benefits in either cost or reliability. The cost and environmental impacts of providing right-of-way for transmission was evaluated against the anticipated local benefits. On the occasion when a transmission line crossed local jurisdictional or State boundaries the siting process became much more difficult as parties that bore costs did not readily perceive the benefits.

With the passage of the Energy Policy Act of 1992, the transmission grid was required to evolve further to act as a common carrier for bulk power transactions. It is this last responsibility that has revealed that the system that was inter-connected for reliability purposes could no longer be relied upon for the level of inter-regional commerce demanded by the bulk power market. Significant new investment in inter-regional transmission is required. The traditional local siting process is ill equipped to adequately handle this type of investment given the increased mismatch between those incurring the cost and those receiving the benefits, a source of considerable investment risk.

Finally, the ongoing activities regarding the governance of transmission owning entities to ensure independence from market participants through the creation of new entities such as RTOs, ISOs and TRANSCOs creates investment risk. The separation of asset ownership from the control and operation of those assets, if not done correctly, has the potential of seriously diluting the powerful incentive provided by profit maximization. There is today no clear consensus as to which business structure is optimal for transmission. The rules of the road are not yet fully developed and may be different region to region.

So how do we ensure that the proper investments are made? One approach might be to conclude that all that is needed is to compensate transmission owners by having regulators provide them with higher rates-of-returns, commensurate with the perceived risks. While fully compensating investors for risk is absolutely necessary, if these returns are gained through the current rate-of-return regulatory framework they will at best only deliver a narrow range of investments not the broad range required in the new competitive electric energy markets. At worst they may result in non-value-adding over investment.

To understand why this is so it is important to change our view of transmission from as an enabler of the generation market to an enabler of commerce in the competitive electric markets.

The pre-1992 view of transmission was as a transportation system delivering electricity from company owned large plants, distant from company owned loads, to ratepayers over a system of company owned wires. Our post-1992 view has been modified to transmission being a transportation system delivering electricity from independently owned large plants, distant from loads, to customers over a system of company and non-company owned wires. While this view accurately describes the current state of transmission it does not accurately reflect the role of transmission, i.e. how transmission creates value in the new competitive market. It will not help identify the types of investment needed or give guidance on how best to induce firms to make those investments.

A more helpful view of transmission is as a network, facilitating commerce in a competitive energy market, where every consumer is a potential repackager and reseller of product and every one connected to the network is a customer.

A *network* is a set of dynamic, sustainable, value-producing relationships between parties with common interest. A network can be physical or virtual. The network

is a medium through which exchanges between the parties can take place. The exchanges can be knowledge, information, or goods and services. The network is viable as long as it is value adding by offering those using it an economic advantage over alternative relationships.

The set of dynamic, sustainable, value producing relationships between parties with common interest in this case is the competitive energy market. This competitive market is significantly different from the markets in which today's transmission businesses developed and currently operate. It is a market made up of thousands of commodity suppliers, hundreds of service providers and millions of consumers. High transaction costs and low barriers to entry and exit by both sellers and buyers characterize it. The network manages not only the flow of electricity but also the flow of information and cash. Traditional rate of return regulation rewards firms for placing assets in the ground. The new competitive market requires behaviors that promote customer focused, market driven solutions by having transmission businesses rewarded for:

- Providing access and throughput at lowest cost
- Efficiently utilizing its assets
- Providing new service offerings
- Efficiently meeting open access, service quality and other, public policy objectives
- Maximizing throughput subject to efficient reliability constraints
- Promoting volume and commerce: increasing the value of transactions

We need to move from seeking to create incentives that focus mainly on inducing capital investments in new transmission lines to those that induce the correct organizational behaviors. With properly designed pricing, flow based, market driven, transmission companies succeed by maximizing throughput, maintaining broad, nondiscriminatory access and making system investments to maintain "optimal" congestion levels.

When the benefits of lower cost and higher volume flow to the bottom line, transmission companies will:

- Seek efficient decisions—inducing competitively neutral solutions
- Find the most cost effective—not the most asset intensive solution to customer needs
- Drive to enrich customers—maximizing the value of commerce along the network
- Devise innovative operating procedures and a range of tailored, cost effective offerings that fully utilize its facilities subject to efficient reliability constraints

Mr. BARTON. Thank you.

The Chair would recognize himself for the first 5 minutes of questions, and we're only going to have one 5 minute round.

Mr. Schriber, I thought your testimony was excellent, as it was the last time you testified before us or your representative.

What do you think the position would be of the various State PUCs if we put in the Ohio model as a Federal model for States for follow with regards to siting decisions?

Mr. SCHRIBER. Mr. Chairman, I think, at least in my interface with the other States, they would be delighted, I think, to share the same statutory authority we have.

Many States have no power siting boards. We have neighboring States that rely almost entirely upon homerule. As a result, we have many, many more projects sited in Ohio than we would find in neighboring States. I would therefore suggest that the States would probably relish the opportunity to adopt the types of authority that we've been given by the State legislature.

Mr. BARTON. Okay. Is there anybody on the panel that is opposed to the general provision in the pending draft that gives Federal backstop authority on siting if the States fail to act? Is there anybody that opposes that backstop? I see nobody shaking their heads or doing anything. So the Chair is going to announce that nobody opposes it.

Mr. BOUCHER. You haven't asked the members yet, Mr. Chairman.

Mr. BARTON. Well, I know. But the members are going to tell me. I'm not worried about that.

On the reliability issue, we've got two different views here. We've gone one view, we have a gentleman that represents NERC that says be fairly prescriptive and put it into the law. We've got another view that our friend from ENRON put into the record that FERC can do it, just give the FERC the authority.

I will note that some people's positions have changed since the last Congress, and that could be because we have a different FERC Commission, but that's just an observation. That may not be reliability.

Is this really a technical issue? Should we let the technicians do it because it's an engineering problem or is reliability more of a policy issue and we need to let the political mechanism handle it?

Mr. Cook, would you like to answer that?

Mr. COOK. Yes, Mr. Chairman. And let me speak to the issue that's been raised as well about the inner relationship between reliability rules and the commercial rules.

I agree with Dr. Anderson that they are inner linked. It's why NERC has gone to an independent board of directors, it's why we've added a market interface committee to our current committee structure. It's why we involve all segments of the industry including customers in our standard setting process to make sure that those commercial impacts are picked up as we go forward.

In fact, Dr. Anderson sits on the Executive Committee of our Operating Committee.

And in the new model I would expect that that same kind of attention to those issues would happen.

The draft requires that no single sector can veto a standard, that no two sectors can control it and it encourages broad participation in the standard setting process. So in the first instance, it would not simply be the engineers only that would be making those judgment, it would be a collective judgment by industry participants. But the organization would be able to muster a lot of technical expertise to bring to bear on those subjects. And it would come together at FERC because the organization would be under FERC oversight, the standards would not actually take effect until FERC said they could.

So that, it's a way to get the technical expertise of the industry brought to bear on these issues. And if in the inclusive standard making process that hasn't flushed out the commercial impacts and figured out way to accomplish both commercial purposes and reliability purposes, FERC is still there in a sense as an overseer back-stop role to make sure that those issues get attended to. That's the structure of our proposal.

Mr. BARTON. Mr. Steffes.

Mr. Steffes?

Mr. SCHRIBER. I want to highlight again the inner relationship between commercial and reliability matters. And while NERC proposes that they will begin to, you know, create an opportunity for the commercial elements to be recognized, we simply have found that on the hard questions—and I bring up the one in my oral testimony, the independence of security coordinators. On the hard questions a consensus body can't make that decision.

The NERC draft, even the modified NERC draft I think continues to say that FERC could say that's not the model we want, but we can't get them to pull in the right answer.

This industry is changing at a tremendously fast pace. We need FERC to be able to say I need a new rule, I need a new rule to ensure reliability to ensure the competitive markets continue to work. And we don't see that unless you just provide general oversight—general policy to FERC. That's our kind of—

Mr. BARTON. My time has expired. I'm going to let Mr. Harris answer this question, then I'm going to go to Mr. Boucher.

Mr. HARRIS. Thank you, Mr. Chairman.

What we've experienced in dealing with this issue from retail choice all the way through the wholesale system is that reliability isn't just a wholesale problem. It is an ecological system. It involves all elements. And so the only area that you can really deal with that is under a FERC oversight.

FERC ultimately has to make the determination. We're also finding that we can give solutions economically to what used to be reliability solutions, and many of these are driven at the retail level. You just can't carve out something that says it's only a wholesale issue.

We would suggest that FERC has the authority and through a rulemaking process they can come up with the right organizational structure where it involves NARU or GSBI, whatever, but FERC can create a structure that is vibrant and robust to deal with the technical issues that are going to be emerging, and that would be the appropriate way to address the question.

Mr. BARTON. Thank you. I'm going to not ask this as a question, just make a comment. I thought it was very interesting that my good friend, Mr. English, basically defined incentive rates by definition as just and unreasonable, and then gave a very elegant statement justifying his definition.

I want to put on record that the Chair doesn't take as definitionally correct that incentive rates are unreasonable by definition. That's a debate that we'll have as we go to markup.

With that, I would recognize my good friend, Mr. Boucher, for 5 minutes for questions.

Mr. BOUCHER. Well, thank you very much, Mr. Chairman. And I want to join with you in thanking these panelists for their very excellent presentations here this morning. We have been informed by what you have told us, and appreciate your taking the time to share your views.

But there is a kind of a generalized belief and some anecdotal evidence that we do not have adequate transmission capacity in the Nation, but I'm not aware of precise studies that pinpoint where the deficiencies are. And I would like, as an opening matter, ask if anybody here is aware of either governmental studies that clearly demonstrate inadequate capacity or perhaps think tank studies that lead to the conclusion. And if you do, can you point us to those? Is anyone aware of studies? Mr. Szwed?

Mr. SZWED. Yes, I think maybe one place you can turn is to the North American Electrical Liability Council. There's a lot of efforts that are done in terms of assessing the adequacy of the trans-

mission system as well as the adequacy of generation across the United States.

I think you can also look toward evidence in terms of evidence of the number of transactions that are taking place and the degrees of where they've have been issues or curtailments that have taken place to give you an indication of areas where there are in fact is congestion and perhaps where additional transmission capability could be enhanced.

Mr. BOUCHER. All right. That's helpful.

Mr. Cook, would you care to comment?

Mr. COOK. There are certain interfaces that are congested on a fairly regular basis. One comes to mind in the Wisconsin area that is pretty limiting on commerce a fair amount of time. And there's some other places like that in the country that can be identified.

There are also the circumstance, though, that these limits can change from season to season, year to year depending on weather patterns, for example.

Last year there was considerable congestion in the central part of the country, Tennessee/Kentucky and so on, as sort of relatively lower costs power from cooler areas tried to move south.

This year, it's interesting, the congestion was there but it was in a northbound direction because of the temperature differentials sort of went the other way.

So attention to this issue does require, you know, paying attention to that kind of thing as well.

There are currently some studies underway to try to get a better handle on this and focus on it.

Mr. BOUCHER. Whose performing those studies?

Mr. COOK. The Department of Energy, I understand, has got a current study underway.

We issue an assessment, a 10-year assessment every year that pays some attention to these issues and documents that kind of stuff.

Mr. BOUCHER. What was your most recent assessment?

Mr. COOK. The most recent assessment was last—it would have been last October/November. Our board is considering this year's 10 year assessment at its meeting next week in Vancouver, and it will be available shortly after that.

Mr. BOUCHER. Well, I would like to ask, Mr. Chairman, that we receive for the record a copy of the assessment that you issued last year and also the upcoming one to the extent that they focus on the question of inadequate transmission capacity and document those instances in which there are notable deficiencies.

Mr. Chairman, if it's appropriate, I would ask that that be made a part of this record.

And I would ask Mr. Cook that you provide it.

Mr. COOK. I'll be happy to make sure that the subcommittee has that material.

Mr. BOUCHER. It just seems to me that if we're going to legislate on the question of capacity, whether it be through incentive pricing or some backstop Federal authority to order that new capacity be built in the event that the States fail to act, that we at least ought to be absolutely confident that there is a significant problem for us to address.

And I'll note again the generalized belief that there is, but we really don't have detailed evidence of that.

Let me ask a little bit about the notion of incentive pricing, and I acknowledge that there is a debate about whether or not it's a good idea.

I would like to ask this panel whether you believe it's a good idea or not whether you think that the FERC has current statutory authority to order incentive pricing should FERC believe that it is a good idea? Does anyone want to comment on FERC's current statutory authority with regard to incentive pricing?

I think we heard very adequately from our good friend Mr. English on that very subject, so let me call on Dr. Anderson.

Mr. ANDERSON. Yes, sir. I think that it's pretty clear that they have the authority. They've already included an incentive rate provision in their Order 2000, and that has not resulted in any significant problems.

I think also to relate back to your last question, which I think is a very good one, there certainly are areas of the country where there are transmission constraints. But as Mr. Cook said, they change from hour-to-hour as various power flows change. I would relate that back to the incentive area also.

It would not be appropriate, in my view, for you to legislate across the board incentives to build transmission. It's got to be much more targeted than that. It's got to be targeted to where there are constraints. And I think the idea of getting a study is a good idea. It's going to be a very, very difficult one because it's a moving target.

But I think very strongly that the Commission has authority and has already taken action on incentives.

Mr. BOUCHER. Thank you, Dr. Anderson.

Who would like to offer a competing view? Mr. Szwed?

Mr. SZWED. Yes. I would like to say a couple of things.

First of all, I would agree, FERC does have latitude and authority to deal with alternative forms of pricing today. But I don't think we've seen any evidence of that at all recently in anything that's really been implemented by anyone.

And I think as we think about transmission and we think about transmission moving into a separate business, a separate situation apart from other aspects of a vertically integrated utility where it is a business that needs investment, it needs people, it needs innovation to be able to do and in order to be able to effect to meet the goal of achieving broad competition and securing the infrastructure of the U.S., I think what Congress needs to do here is even though FERC may have that authority, is through legislation perhaps provide a stronger encouragement for FERC to—consist with the policy of having the reliable and efficient grid to support competition, to use the authority they have with respect to incentive pricing and put those kind of things to encourage investment and attract investment in the transmission grid.

Mr. BOUCHER. Thank you, Mr. Szwed.

Does anyone else want to comment on that issue?

Mr. KANNER. If I could, Congressman.

I think it's absolutely correct that FERC has the authority for incentive rates, performance based rates to allow congestion pricing.

The boundaries, as I said in my testimony, are what's just and reasonable. What's not confiscatory to consumers or—I'm sorry—extraordinary to consumers or confiscatory to the company.

Transmission owners have the right to challenge a FERC rate of return, to say we need more money to reflect the sorts of risks that Mr. Vesey suggested exist. As long as those rates and rates of return fall within that zone of reasonableness and just and reasonable rates, then there's nothing to complain about. It's what the parameters that FERC uses in setting rates.

In terms of establishing separate transmission companies, we heard from Goldman Sachs that that sort of transmission distribution utility is likely to be lower risk and therefore require a lower rate of return, not a higher rate.

Mr. BOUCHER. Mr. English, would you like to have the last word on this?

Mr. ENGLISH. I'm reluctant to do so, Mr. Boucher.

But the issue's judgment, that's what we're really talking about. We've got people who don't like the way that FERC has exercised the authority that they have, and it's been their judgment that this is the fair, the just and reasonable way of doing it. So what this is all about is redefining just and reasonable so that they have to define the way and set aside their judgment.

Mr. BOUCHER. You would agree that they have the authority to provide for incentive pricing should they choose to do so?

Mr. ENGLISH. There's absolutely no question about it. It's in the law.

Mr. BOUCHER. Okay. It seems to me that everyone agrees with that, and that's an important consideration for us as we go about making our decisions.

So the issue really for us is, as I suppose as you phrase it, Mr. English, and that is given the fact that FERC can do this, should we take the next step and require that they do it?

Well, thank you all very much. This is a helpful discussion.

And thank you, Mr. Chairman.

Mr. BARTON. The gentleman's time expired.

I recognize the gentleman from Tennessee, Mr. Bryant for 5 minutes.

Mr. BRYANT. I thank the chairman.

As I mentioned to you, I was going to be in and out. I'm in again, and so I've missed your testimony and I'm not sure anyone has addressed the issue specifically as I raised it regarding the siting and the eminent domain, and things like that.

So, let me go ahead and ask a couple of questions related to that, and really open the panel to those of you that might feel you need to say something on this, that you're qualified to talk about this.

But in the draft of this bill the States will continue to have eminent domain authority over transmission siting, but after 1 year there's kind of a backstop where FERC if the State hasn't responded, FERC can go ahead and site the proposal. They'll be given the power to step and site new transmission if the courts determine that it's in the public interest, so you still got the public interest test of course.

My questions relate to how you would define and how we would define or how we would anticipate public interest being defined, as

well as who would be exercising authority along. I know the State law would apply in the beginning, but once the FERC got involved would there be the possibility that—I don't know. Would there be the possibility that there could be different entities authorized, delegated the authority of eminent domain beyond the governmental entity? In other words, private companies? And I may be getting a little far afield.

We've had situation in Tennessee in regard to pipelines where there were actually private company delegated that authority. And they were out trying to condemn land to put their pipeline in. And, again, it caused quite a—in my part of the State. But it was very controversial and I'm just looking for some input on, again, how do we mitigate, I guess, to some extent the consequences of eminent domain and how you define a public use as well as limiting it, perhaps, to a public entity, governmental entity to exercise that power?

Yes, sir? Is that Mr. Harris?

Mr. HARRIS. Yes, sir. It's interesting in listening to the discussion, because it's very difficult to make an informed decision without the right information.

What we've developed in the mid-Atlantic is a regional transmission planning protocol that's been approved by the FERC. This was so important in the mid-Atlantic region that we decided that this had to be developed before we began commercial operations in 1997.

This regional plan has the input of all effected parties; the States, the environmental community, the transmission owners, the generators, everyone participates in the planning.

The information on the plan is made ubiquitously available so that generation can compete and transmission planning can be enhanced.

For the areas that we serve, we now have nearly \$700 million worth of transmission planned and under construction. Our regional plan, which is publicly available, shows that those transmission expansion plans will meet the needs for the region for the next 5 to 10 years, and this is updated several times a year.

So in order to get down to do you really have a problem or not, you need to determine what is the information.

Mr. BRYANT. Well, could I ask you something?

Mr. HARRIS. It may be that there's not a problem.

Mr. BRYANT. Could I ask you when you were talking about the regional plans, and again RTOs, I guess, contemplate regional type organizations. They cross State lines.

And in this regional plan that you have experience with, you have different States with different State eminent domain laws.

Mr. HARRIS. That's right.

Mr. BRYANT. And what happens there when there's a conflict in that, let's say, or one State cannot get access to that portion of the region that's needed for this plan to work because of their laws?

Mr. HARRIS. That's a good question. I think ultimately you have to believe in the common sense of good people. When you provide the right information and people participate, they understand what the issue; that we're looking at things over a broad region. They

see what is necessary to affect the common good of the public for the whole region.

And when you also actually look at the data, back to Mr. Boucher's problem of what really is the problem you're trying to fix; when you actually look at the hard numbers and see what you need to do, what often you find is a matter of an enhancement here. We have areas where one utility is building something that is actually solving another problem for another utility in another State, but it's the most economical way to do it, and it's getting done.

So the answer is get to the real hard issues, develop the fact, allow broad public participation, understand the issue and then see what we need to do. And what we've seen in this area, which is a very sensitive area in the mid-Atlantic region, is that we've been able to solve this problem.

Now, should we have an episode where we cannot, maybe we'd have to come back. But we're saying we're able to see the synergy between the State, the regional and the local needs to work together in a way for the common good. We think this is a better way of doing it to the future.

Mr. BRYANT. Yes. I think maybe I'm talking to the policymakers, and I think that's good and it may ultimately be that the courts and the various State legislatures decide this. Ultimately the courts decide these kinds of conflicts of law.

Mr. English, you've had experience on all sides of this.

Mr. ENGLISH. I'm afraid so, and probably no group is effected more than electric cooperatives as far as land wise, 46 States across this country on this particular issue.

I think this goes to the heart of a real question that this committee needs to answer, and that is the question of what is the objective of this legislation? Are you attempting to deal with all transmission, no matter whether it be local, regional or national? Or are you truly trying to do something along the lines of identifying what needs to be a national grid? And if you're trying to do that, this gets into the question of whether or not you're going to identify what portions of the existing system and how that needs to be linked up with other regions of the country to develop that grid. That would narrow considerably what you're talking about in the area of eminent domain. And I imagine that makes it far more acceptable to the States. Certainly makes it more acceptable to our members, and I would think to a lot of members of this committee.

But if you're going to just simply have a blanket FERC provide eminent domain as the final decider of this issue for transmission no matter what its purpose, no matter where it's built, then I think that that's a different matter. And, obviously, that takes this bill, makes this a much more narrow bill and that may not be what this committee wants to focus truly on the national aspects of the transmission issue and leave the rest to the States.

Mr. BRYANT. Congressman, I'd ask unanimous consent for 1 additional minute so that the gentleman on the end can respond. Unanimous consent.

Mr. SCHRIBER. Thank you, Mr. Chairman.

Congressman, I would point out that the Natural Gas Act provides for FERC State joint participation. In Ohio, as I testified, I

believe we have a fairly broad authority to site facilities, we have engaged in those joint proceedings with anyone at the Federal level which is provided for. And I also pointed out, and I think you can imagine that in Tennessee if a landowner was exceptionally upset or aggrieved, you may get a letter. But I can assure you that your State authorities would really feel the heat, as we would in Ohio.

So I would propose, as I have proposed that the States who are very sensitive to landowner issues, who are sensitive to—very sensitive to the allocation of our land resources or the appropriate authorities, and I think that on a joint basis either regionally or regionally and with Federal participation a lot of the eminent domain, a lot of the siting problems can be overcome.

Mr. BRYANT. Thank you.

I thank the chairman for yielding me that additional time.

Mr. LARGENT. The gentleman's time has expired.

Recognize the gentleman from Ohio for 5 minutes for questions. Mr. Sawyer?

Mr. SAWYER. Thank you, Mr. Chairman.

Let me just take a moment to thank Chairman Barton for this hearing. I genuinely believe that of all of the hearings that have been called on this large and complex matter, that this particular gathering of people in these two panels may represent the central issues in the entire question of how we go about building a Federal framework within which to enable all of the things that are going on in the States.

It is critical to making available the assets necessary to real competition in a variety of regional grids throughout the United States.

And so I want to thank Chairman Barton, and I want to thank our participants today. There are a lot of unanswered questions, and I just regret that we don't have more time today to undertake some of those questions.

Let me further thank a couple of Ohioans who are here again. I regret that other matters before elements of this Congress prevented me from being able to be here to help them give appropriate introduction.

And finally, let me just say that I hope that our panelists this morning would respond in writing to questions or, perhaps, in conversation in the coming weeks to a much wider range of questions than I have the capacity to grasp today.

Mr. COOK. Be happy to do that, yes, sir.

Mr. SAWYER. Please. Thank you.

Let me turn to Stan Szwed. You have been involved in setting up the Alliance RTO. You've suggested that the flexibility to set up an entity that can attract the kind of investment that it will take to grow and nurture and facilitate real transmission entities. Can you give us examples of what that means in terms of attracting investment and how FERC authority to mandate RTO participation would effect that decision?

Mr. SZWED. I think just generally, the Alliance RTO is a structure which is developed around the for-profit independent transmission company where there is an independent owner/operator of transmission assets. And, in fact, in the development of the Alliance regional organization, we have in fact attracted a strategic investor because of the construct and structure of the model as well

as trying to provide for opportunity for that strategic investor to see that the regulatory process would, in fact, hopefully put in place a reasonable rate program and mechanism for which business could thrive and survive, and have a longevity and for future investment to be made.

So we're in that process of development today. And, in fact, the Alliance in many respects with a few additional rulings from FERC on a couple of matters that are pending, is well positioned to be in operation as early as the end of this year. And what I'm concerned about in mandate language or mandate authority is we in the utility business across so many of our investor owned companies, I think something like 98 percent of the investor owned utility transmission assets are in some form of developing RTO. If we suddenly start changing the rules and mandating authority, that could upset a great deal of effort that has gone today and just may not get to a situation where we are in fact or would have operating RTOs in place sooner than later.

Maybe just one more comment to add on that. I kind of think that in the development of all these RTO structures, earlier in my remarks I outlined what I thought was necessary no matter how many RTOs there are across the United States. The seven points that I outlined in my testimony are what we believe are important to have a successful transmission network and infrastructure in the United States. And we, the EEI companies, believe that very strongly.

Mr. SAWYER. Thank you very much.

Glenn English, it's good to see you.

Mr. ENGLISH. Thank you very much, Mr. Sawyer.

Mr. SAWYER. If we give FERC the authority to ensure the recovery of costs for new transmission facilities, it seems to me that those entities that take advantage of the FERC's protection ought to be subject to FERC's rules. The question that I would have for those entities like cooperatives receiving that protection, aren't they receiving a significant benefit without any of the attendant responsibilities under the Federal Power Act?

Mr. ENGLISH. I guess the question I have for you, are you talking about in the construction of transmission?

Mr. SAWYER. Yes.

Mr. ENGLISH. Well, most of the transmission that we have is very localized, as I'm sure that you know.

Mr. SAWYER. Yes.

Mr. ENGLISH. It's basically a transmission that applies to our own membership. We have a great sensitivity about this question of whether our membership, which actually owns the utility to provide power for themselves, is going to be able to continue to govern their own asset. We're a little bit unique and different in that we're not third parties that have an investment; we're people that actually own our own utility. We invest in that utility to provide for our needs.

If you're talking about the government coming in and then breaking that up, that would be much like someone coming in and telling you we want to get between you and your constituents. And we want, Congressman, don't be listening to what your constituents tell you, we want to tell you how we should operate.

Mr. SAWYER. Happens all the time.

Mr. ENGLISH. Happens all the time. And if you stay in office, you don't listen to them, do you? Because, you know, the issue here I think is that particular question.

As far as going out and building transmission, keep in mind we're very dependent on this transmission system in this country. We're probably more dependent than anybody else. Any costs that are unnecessary, any unnecessary costs going in that system get passed on to our members. We have great objection of that and concern.

We believe that the judgment of FERC should, in fact, determine what is just and reasonable. And what we've strongly believed is that any attempt to override that is telling those FERC Commissioners you must rule on something that you feel is unjust and unreasonable. You must provide that benefit.

What we think would make a lot more sense, as I said earlier in my testimony, let's broaden out the options that FERC has. Let's let FERC use some additional judgment. But what this proposed draft does, it restricts what FERC does. It says you can no longer use your judgment. It says you must do something that you, obviously, feel is unjust and unreasonable. That's what we think is unfair.

We'd like to see this opened up. Let's use the experience of what's gone on in this country, let's use the Texas model, which by the way this legislation we note does not effect Texas. Texas is exempt as far as the provisions of FERC on the incentive provisions contained this bill on unjust and unreasonable.

We think that we ought to go the other way and let's take the Texas model in which they're building three-quarters of a billion dollars worth of transmission this year, going to build another billion next year, it's scheduled; let's take that model and bring that into FERC and give FERC the opportunity to use that option.

Mr. LARGENT. The gentleman's time's expired.

Mr. SAWYER. Then I will yield it back.

Mr. LARGENT. I'm going to yield myself 5 minutes to ask a few questions.

It seems to me the issue that, Mr. English, you raise is one that's been handled in past pieces of legislation where we were able to craft some language that separated the definition of what is distribution versus what is transmission as it relates to cooperates that you all basically signed off on it. It seems to me that what I heard you saying earlier that's the same sort of mindset that we should have when it comes to developing this national grid versus trying to give FERC authority over every line that carries electricity, is that correct?

Mr. ENGLISH. To a certain extent. I think the real issue we have is a practical one. You know, FERC's very limited as far as the resources they have available.

You know, one could really look at this; if we were interested in deluding the influence of FERC, if we wanted to try to make sure that FERC was ineffective, let's just give them a lot of jurisdiction and no more resources to do it. We'll spread them so darn thin they can't get the job done under any circumstances. And I think that's where we are.

This bill gives FERC a lot more responsibility. Now the question is do we want FERC to do that job and do it well with limited resources, recognizing the budget problems and the difficulty if we've got? If so, then it comes down well what's really important from a Federal level in dealing with this transmission issue? And what we would suggest is it makes a lot more sense for us to truly develop this, and I'm not suggesting under any circumstances any government money be used on this, keep in mind, but along the lines we did the interstate highway system.

We've got the equivalent today of what was the old two lane system, State highways existed back in the early 1950's. We reincorporated a lot of State roads, upgraded those with new standards and made some connections in linking those roads together and developing an interstate highway system. We think that that makes an awful lot of sense concept wise, and we think that FERC should have that responsibility. FERC should have the final say so. We think, just as we did with the State highway system, that you allow the States or the local folks to have a lot of input as which roads should be upgraded, what should be incorporated into that and develop this system in partnership with the States. And I think they would welcome that. That gives FERC a job they can do.

If we're just going to go willie nillie anything that anybody can define somehow as being transmission of this country, no matter if it only goes a mile, and we've got some that would only go a mile that could possibly fit into that definition and we're going to give FERC jurisdiction on it, FERC's going to be spread so thin on—

Mr. LARGENT. Can you sum up? I only 5 minutes. Thank you for your comments.

Mr. ENGLISH. But you're right.

Mr. LARGENT. One of the things that I wanted to begin my questions with was recalling a committee hearing we had last year with what were then the sitting FERC Commissioners. And I asked them the question can any of you give me a definition for just and reasonable rates. Not one Commissioner could give me a coherent definition of what constitutes a just and reasonable rate. Not one. These are the Commissioners that we're wanting to—some of us want to give them more authority, some of us want them to give them less authority. You know, less authority in transmission, but all of you say we need to give them more authority on reliability standards.

So I guess I would start there when we deal with transmissions. Somebody in their testimony, I can't remember where I saw it, said that we could need as much as \$56 billion worth of investment in new transmission in this country. \$56 billion. Why don't we have that? Why are they not out there building transmission lines? Why are we so far behind the power curve, so to speak, in new transmission?

I think if I asked a panel nodding question, do you all agree we need more for transmission in this country, all of you would nod yes we definitely need more transmission. But then a number of you on the panel said that we don't want to incentivize by giving higher rates of return on transmission construction. So we have sort of a conundrum here in that, you know, Marty, you talk about

the fact that the current constraints boost profits. So the people who could benefit by having new transmission really don't want to do transmission, the generators, because they're actually getting higher rates of return on their generation asset because there's no transmission. And then the people that may be third party, you know, that want to develop a transco and be independent transmission owners, they're not really going to do it because the risk that's there that Mr. Vesey pointed out, they see as being as higher than the rate of return that's currently being granted by FERC.

So, there is the conundrum. We have a huge need for additional transmission, but we nearly a consensus, at least a majority of the panel that say but don't give them any higher rates of return on their transmission because, you know, it's a burden on consumers. So where do you go from there?

Mr. Kanner, I guess I would like to ask for your comments.

Mr. KANNER. Well, I appreciate that, Congressman.

I think in part it's separating the transportation function, that highway system, from the merchant function. Having RTOs with effective planning and construction responsibility is a clear step in the right direction where they're not looking at the merchant aspects and whether it boosts generation rates and profits or not.

They also could conceivably say we're going to bid it out. We're going to find whoever is willing and able to build a transmission link at the cheapest possible rates and not we're going to just say whoever will do it, we'll give them the maximum amount; rather say whose willing to do it for the least amount.

There's an independent transmission company in Wisconsin that is building new facilities. And my understanding is the rating agencies have said that's a low risk venture. So it seems like there is a model that can work, we need to get there.

Mr. LARGENT. Mr. Vesey, I give you just a moment to comment on that problem.

Mr. VESEY. Thank you. And it a problem. And I think the issue comes down all rates are incentive rates. I mean, it's not more or less the formation of capital and this question about what the right level is. If we had none of these other risks, if we would resolve all the siting issues and make the siting clear and expeditious, if we were to resolve the questions around RTOs and the question of independence, then you probably would see the current levels of return being appropriate to bring that capital to bear. So there's two ways to deal with this. You either can raise the reward or you can lower the risk; all that's within the purview of the things we're talking about here and should be part of the conversation.

I think the other part is that one has to be cautious that don't only think about incenting investment to build new capacity. There are a lot of ways to provide addition transfer capability in the transmission system. We have talked not at all about the introduction of new technologies into transmission, because there is no incentive. In current rate of return regulation a utility will not get the benefits of those efficiencies, only makes money on capital investments, so why would anybody whose in the transmission business make an investment in something that increases the efficiency, therefore lowering costs, when they have no return at all?

So, one of the points of my testimony is we have to think about this question of motivating behaviors, not looking to specifically induce capital to build new lines. It's a much broader conversation we have to have. And when we restructure the question that way, I think then you can find a balance because you can the providers of this new capacity working in tandem with their customers, which is critical.

Mr. LARGENT. Thank you, Mr. Vesey.

My time's expired.

I believe Mr. Wynn from Maryland is next.

Mr. WYNN. Thank you, Mr. Chairman.

I would like to begin by thanking our subcommittee chairman Mr. Barton for his generosity in agreeing to work with me on the subject of reliability. I sincerely appreciate his offer and look forward to working with him on this issue.

I'd like to begin by asking Mr. Harris, and I don't think this is too far afield, Mr. Harris, you can correct me if I'm wrong. I understand that PJM has some concerns regarding a recent FERC directive to join the Northeast RTO. If that is true, would you articulate your concerns? We've heard testimony that there are apparently some seams in the system that they were attempting to correct via that directive.

The second question has to do with my concern regarding reliability. And you seem to object to the notion of a self—

Mr. BARTON. Will the gentleman suspend? We want to thank Mr. Schriber or Chairman Schriber for being—we understand you have a plane to catch. If there are questions for you, we'll put them in a written statement and get them to you. But thank you for your participation.

Mr. SCHRIBER. Thank you very much, and thanks for having me.

Mr. BARTON. Certainly.

Mr. WYNN. If, in fact, you object to the notion of self-regulating entity which would have FERC oversight, would you kind of articulate your concerns. And then if the other panel members who have an opposite view would support a self-regulating entity for this purpose, I'd certainly welcome that.

So, why don't we proceed with your, Mr. Harris?

Mr. HARRIS. Thank you, Congressman.

Take on the first issue. PJM is currently the only approved RTO in the United States that's operational. With PJM West we're close to 70,000 megawatts, seven States, plus the District of Columbia. We have competition that works. We have a regional planning protocol that works.

There is concern when you talk about enlarging that or merging that that what we have that works so well may deteriorate if you try to bring in other areas or other regions too rapidly or too quick. And that is something that needs to be looked at as the large RTOs develop. And that was our concern and what we're discussing with the State of Maryland, and I think those are valid questions that need to be answered.

On the issues of where we are going with the standards. Again, let me just state the 3 or 4 points here.

The electric system must be thought of like an ecological systems; it touches everyone's life and all elements of it. It isn't simply

transmission. Generation and transmission are in competition. In planning, you can have a generation solution that may be more important than the transmission solution and more viable for the public good.

What we're about here to ensure that customers of a value of competitive price in generation, and transmission is a very meaningful role in that. So the key is having the plan that allows that to take place so everyone can participate and understand what's going on.

The standard setting that needs to take place effects everything. Ninety-eight percent of the outages on a system are distribution outages. They are under State control, not FERC control or even NERC control. So when you talk about a standard in the 21st century, you need to develop a standard that is fully consistent with retail choice program and the State needs, the bulk needs, the fuel needs, the generation needs and all of this in a holistic way.

So our concern with the proposal is that it tends to try to carve out a single element and create some organization around that. We need to move to the 21st century and look at a holistic solution. Therefore, we think that the better way to do it is to allow FERC to issue some sort of rulemaking and through a FERC process create the appropriate body that could look at these things holistically in a way that you can then provide standards that FERC can approve.

Mr. WYNN. Can I just jump in and say could not a regional entity such as you describe be a subset of a self-regulating organization such that the regional entity would purpose to the self-regulating organization rules appropriate to that region, the SRO could then approve those and if FERC did not object, proceed and then have the kind of regional impact or input that you're describing?

Mr. HARRIS. Yes, sir, that is one of the ways that this could be done. There are other ways, and that's when we need, I think, rule-making way that FERC can come up with what would be appropriate to deal with the issues that we have and be flexible enough to adapt as technology and the learning curve grows as we develop this industry of competition.

Mr. WYNN. Are there other members of the panel that want to comment on that issue?

Mr. ANDERSON. Mr. Wynn, if I could comment very quickly.

I think one of the points that Mr. Harris made, and several others have made, is that increasingly we recognize now that reliability cannot be treated as a stand-alone issue. It's overlapped with the commercial practices. It's absolutely incredible. Every reliability rule has commercial practice implications, just like very commercial practice rule has reliability implications. They need to be dealt with together.

One of the big problems with NERC is that NERC deals only with reliability and the commercial practice implications of it are second hand, their step-child sort of thing. Now, NERC could solve that by expanding itself to not be just a reliability organization, but to be both a reliability and a commercial practice organization, or on the other hand the Gas Industry Standards Board could expand, as they say they're going to do, and create an Energy Industry Standards Board and deal with both reliability and commercial

practices. To me, one or the other, either one of them would be a good way to start, but neither one of them now are doing it in this holistic way. You got to take both of them.

We believe very, very strongly that both have to be worked on together.

Mr. BARTON. The gentleman's time, unfortunately, is expired.

The Chair would recognize the gentlelady from Missouri for 5 minutes for questions.

Ms. MCCARTHY. Thank you, Mr. Chairman.

And thank you for this very important hearing. And I appreciate all the input we're getting today, very valuable input from the panelists. And I'm going to give you full disclosure before I ask my question.

Before joining the Congress, I served in the Missouri State Legislature for 18 years. And I was President of the National Conference of State Legislatures before coming to Congress. So, I very much like what I'm hearing from several of the witnesses about the fact that we, as Mr. English put it so well, you know, we have an existing system that works, how do we link it to the rest of the country? What is our real objective here? And I think the objective is to create some sort of dispute resolution that will work.

I'm going to tell you about a company in my State and region, Ameren, which is working effectively in a bistate way with Illinois. Everything's going smoothly. But should they want to put in a new line or make any other improvements or opportunities, there's really no place for them to go if Illinois disagrees.

And so I think the question we're grappling with is how do we put in place some sort of body that will resolve that for us? And coming from a State legislative background, I would like to see that body out there in the States.

So, I was very intrigued by Mr. Schriber's comments and also Mr. Harris in your text about some sort of voluntary regional body that permits the States to work in an interstate way to resolve this.

And I wonder if any of you on the panel could come up with the mechanisms that they would need specifically to do that? I would very much appreciate that.

And also, a second sort of thought for someone to ponder. You know, Ameren has invested and is investing about \$25 to \$30 million toward improvements in its efforts in those two States. So when we talk about incentive rate structures, I worry because those companies that choose not to invest in their transmission infrastructure seem to me will be rewarded through incentive rates. And so what does that say to companies that stepped up to the plate and did it without being told to?

Mr. HARRIS. Yes, ma'am.

First of all, let me go back to the planning process the mid-Atlantic that was developed in a cooperative way with all of the States, the environmental community and the transmission companies. It took us 2 years to develop that process. It is a cooperative process that has been approved by the FERC. It clearly delineates what the accounting and the cost responsibilities are among the entities. It is just absolutely crucial to have regional planning protocol.

Now, we recognize that we would not have all of the answers to the world's problems, so therefore we've engaged in a process, we entered into an arrangement with each of our States. And each of the States meet periodically and regularly with our independent board of our RTO and we discuss the issues that are ahead of us as we move forward to the next levels of evolution. And having an inner active way to deal with the issues and to move forward is a way that we address the problem.

What we've discovered is that when you really get the details of the information and allow public input with ubiquity of information, that the common sense of good people can prevail. We are building construction. Generation is competing. Things are getting done.

Do we have all the answers? No, but where we stand today is something that is working. We don't see a large need for major transmission in the next 5 to 10 years. We will continue to work with our States very carefully in this arrangement where the States have direct input into the independent board as we try to engage the problems.

So I think seeing it as a holistic thing that effects everyone and as a process as we move to the future is the wise way to go forward.

Ms. MCCARTHY. Has FERC played any role as you've moved forward with this independent board?

Mr. HARRIS. In only two ways. First of all, they approved our regional transmission expanding protocol, which bound all the companies that wanted to play with it. And the second thing when they approved us an RTO, they also directed that we consider the economic consequences when we evaluate transmission plans instead of just the load growth and the needs, but we also have to look at the economic consequences of congestion and other things, and we'll integrate that into our plan.

Ms. MCCARTHY. Thank you.

Would anyone else care to comment? Yes?

Mr. VESEY. Very briefly. I think that we shouldn't leave the impression that no transmission is being built across the United States. In fact, significant capital is being spent, but it's mostly in continued maintenance and upgrade of existing facilities.

The challenge becomes when you're building a line between States interregionally, and that's where the highest risk reside.

I think that we've come to the point where we're actually managing our transmission infrastructure on a just-in-time basis, which is one of the reasons why the critical points that were made earlier, why there is such an impact in terms of reliability and commercial issues. Because we've got to the point where that's how we run the systems. There's a clear tradeoff that we're making in terms of our ability to put new capacity in the ground versus the way we're going to operate these systems to keep the systems up.

So the only points here are that there are—it's not no transmissions being built, there are some who are building them and in some instances the risk and the reward is appropriate. In others it's not, the balance isn't right and that happens when people have to site, obtain new right away and actually site new transmission

line and are being intrastate or interregion, which is a critical issue as we're talking about the bulk wholesale markets.

Ms. MCCARTHY. So you're thinking that the incentive rate structure is for those opportunities that are not as rewarding and don't attract the investors as much as they should?

Mr. VESEY. Again, I think the issue is that all rates are incentive rates. The points of the issue is in some new project development, the risks are definitely higher than others. Two of those sources of risks are the inability of—the difficulty of siting process between which cross State boundaries or regional boundaries. And the second one is the lack of clarity on how these RTOs, transcos, ISOs are going to work effectively to produce revenues for their businesses. We don't have an effective business model yet because that rules aren't finished.

In those instances, to make investments that either cross those lines or involved in one of those forming up forming organizations, obviously the risk is if you buy the market is being higher than the return.

Ms. MCCARTHY. I just wouldn't want to put incentive rates in place that would discourage investments from companies like Ameren who stepped up to the plate. Thank you.

Oh, yes, do I have time—

Mr. ANDERSON. Ma'am, one just quick comment on your regional bodies. As the one consumer group that's here at the table, although we represent large consumers, we are a consumer group.

Consumer groups, we are very concerned about creating a third forum or a third entity that we have to participate in. Right now we have to participate at the State level. We also have to participate at the Federal level. It takes tremendous amounts of resources to participate in each one. And to add a third layer is a very difficult thing, and I urge you to do that very cautiously.

Ideally, would be to create a regional body which takes over the State roles then in siting, but the States don't want to give that up either. If the States don't want to give up their siting authorities, which I well understand for a whole lot of different reasons, I urge you to be very careful in creating a regional body that then consumes a lot of resources also.

Ms. MCCARTHY. Thank you.

Thank you, Mr. Chairman.

Mr. LARGENT. The gentlelady's time has expired.

Mr. SAWYER. Mr. Chairman, I would ask unanimous consent, Mr. English looked like he wanted to make response.

Mr. ENGLISH. Yes, thank you very much Just very quickly.

I think that we're making a couple of errors here on our assumptions. One is this is a judgment issue. FERC has all the authority. They can double rates, triple rates, quadruple rates if they find that to be just and reasonable.

The second thing, is we're ignoring one big problem, and that is it is not in the interest of a lot of present transmission holders to see new transmission built, to see bottlenecks eliminated and roadblocks eliminated. Because it all comes down to the fact that right now that's part of the monopoly aspect, that's where they can make their money, that's where they can control the generation, that's where they can prevent this competition on wholesale power that

I understand that that's what this committee is about. And unless you address that to simply increase the rewards, that doesn't overcome what these people really find to be in their best interest. And we've got to find out some way in which to break those roadblocks.

Mr. SAWYER. Mr. Chairman, Mr. Szwed.

Mr. SZWED. Yes. I just want to take exception to the fact that there seems to be the allegation that we're not building transmission because it's advantaging our generation. And I just want to remind you all that for the last 5 or 6 years utilities who own both generation and transmission have been under a code of conduct obligations with regard to Orders 888 and 889, and that's further promulgated by Order 2000 and the move to RTOs.

I think, you know, just going back, you know, we have been building transmission. My company alone spent \$35 or \$35 million just last year in transmission to connect customers, to facilitate equipment repairs. I've got a request pending to put a large transformer in now that's \$5 million alone.

The issues goes back to what a lot of what Mr. Vesey was talking about. We're trying to create a more robust national marketplace and the transmission system we have today wasn't built for that. It was built to serve local load, connect neighbors and provide for reliability. What we've got to do is transform that, and that needs new investment.

It's going to take new investors because the rules that we're operating under require independence for all this today. And we'd really like to see new investment, new independent investment come in and be done. And that requires the right kind of rates, the right kind of pricing, the right kind of returns.

And I've heard here today the discussion of transmission is a low risk situation. I think you got to put it in the context of what it's all about. When we separate transmission from the rest of the vertical integrated utility, it takes on a different risk profile because its sole business is providing transmission service, and it has risks. And just to say that returns ought to be low because this is a low risk type proposition, I think we have to think about it. The risk reward ought to be commiserate with the comparable kinds of risk opportunities or possible kinds of other industries that have similar or equal risk, and the returns ought to be that. We haven't seen the kind of returns from FERC that recognize that yet, and that needs to be recognized as we establish the pricing reform that needs to be done.

Mr. ENGLISH. Focus on reducing the risk, Mr. Chairman.

Mr. LARGENT. We'll return to the regular order here and recognize the gentleman from Wisconsin, Mr. Barrett for 5 minutes.

Mr. BARRETT. Thank you, Mr. Chairman. And I apologize for not being here, so some of my questions may be redundant.

I think some of you have mentioned a situation in Wisconsin, and that's the State that represent. And earlier this week I was home and talking to a farmer in the State of Wisconsin. The Wisconsin Public Service Commission has just approved about a 240 mile line from Duluth, Minnesota to Wausau, Wisconsin. And the concerns that this farmer had was evidenced by a question that was asked of the current Governor, who was asked whether it was fair to move this transmission line over a number of farms that

had been there for many, many years. And the response was we're not going to let a couple of farmers stop this transmission of electricity into the State.

The farmer's argument was I thought an interesting one, in that he said the power of eminent domain has traditionally been used for the public good in the sense that you have a company that is granted the public domain. Generally in the past if it's been granted, it was either to a regulated industry where the profit was monitored or some other entity where there is interaction between the government, the State government and the company itself so that the greater good would be recognized.

His argument was that this is different, that these transmission companies are essentially simply for-profit companies and why should the law of eminent domain or whatever laws are going to be used in this situation allow a for-profit company to take the land away from a for-profit dairy farmer who is supplying milk to the people in this country?

If one or two of you can respond to that, as if I were the farmer sitting there, as to why that should happen?

Mr. English?

Mr. ENGLISH. And that farmer's probably a coop member, so he's probably one of our members. And I think he makes an excellent point.

The real issue I think you still come down to is this question, you know, is this something that is necessary for the overall public good. I think what you categorize as eminent domain and the use of eminent domain and the overall purpose of it, I think you're right, we do have to go back to the heart of that and how do we use it. And it has to be done very, very selectively, very carefully. It has to be something that is necessary for the overall good. And that's certainly true, I think, whenever you're providing that on the Federal level.

The States should be allowed to deal with this issue. It's only if it's absolutely necessary, you know, this is a final—if it can't be resolved any other way that the Federal Government says it has to be done for the overall national good. But that should be a last resort. Last, last resort.

Mr. BARRETT. Well, and I think the debate we're having here, though, exemplifies that. The discussion, and I understand that the draft bill has some flexibility allowing the Federal Government to come in and take this over. But I can tell you, not with this farmer this week, but with a farmer that I met with in the last 2 months, walking into his farm—their farm, a man and woman's farm, I felt like a character out of an "Erin Brockovich" movie. Someone just coming in from the Federal Government who didn't care at all about this poor farmer in Edgar, Wisconsin whatsoever. And we were going to use whatever methods we could to put this power line in.

So, I am concerned about the provisions in here that give the Federal Government more authority, because there are people who feel this disenfranchised from State government because the public service commissioners wouldn't even come and hold public hearings in their part of the State of Wisconsin. And now we're being told

well those people are too close to you and we're going to remove you even further from the decisionmaking power of this democracy.

And I think that's one of the reasons you've got the western Governors—because I think that this is an offshoot of the whole issue of private rights and people feel as though the Federal Government is going to come in and just squash them. And I haven't heard a compelling reason why that isn't the case with the provisions in this draft bill, and I'd be interested to hear someone who can defend those. Someone who wants to defend those. Mr. Szwed?

Mr. SZWED. Just a general comment. I think, as I said in my testimony, I think we are looking toward the States as the primary vehicle for accommodating that. And, again, the language really provides for FERC as the backstop. And I think, you know, I sometimes feel like we're between a rock and a hard place on this, maybe even more so when Chairman Schriber was here, because it's a tough situation between State and Federal. But as we move toward larger regional marketplace that has an interstate nature to it, obviously we'd like to see the States resolve the issues of siting first. But at some point there seems to be the need to have a backstop and some entity to go to or some authority to go to to resolve the issue if in fact that is important for the greater good of the competitive region of the electric marketplace.

Mr. BARRETT. But the legislation we're talking about, under the Natural Gas Act, when FERC acts don't they have to have at a minimum of certificate of convenience and necessity for the public good? And I don't see that here. Here it's just whatever's good for the transmission company and no time at all for the public good or public necessity.

Mr. SZWED. Yes, I believe that's the case with the gas side. And even in the case of Ohio where in Ohio if you take Ohio as a microcosm where years ago we used to do this county-by-county sort of thing and now it's rolled into the Ohio Power Siting Board, there's still in that cases also a requirement for the need and the benefit of the facility as well.

Mr. BARRETT. Shouldn't we need that in this situation?

Mr. SZWED. And I would think that we probably would want to demonstrate the need for the facility and the reasons, and the benefits that it would provide, right.

Mr. BARRETT. I yield back, Mr. Chairman.

Mr. LARGENT. All right. With that, I think everybody has had a chance to ask questions.

I want to thank all the panelists for your time. Many of you are familiar faces that have been contributors in panels in the past. We want to say thank you to all of you for your participation.

We'll convene the second panel at 1. Thank you.

[Whereupon, at 12:31 p.m., the subcommittee recessed, to reconvene at 1 p.m., the same day.]

Mr. BARTON. If our panelists and our audience will take their seats, we'll start our second hearing of the day.

As soon as we get order, we're going to let Mr. Norwood make some introductions and then begin the hearing.

We know that we have witness that's coming by train, I think from Baltimore, he may be a little bit late so we're going to go ahead and start.

The Chair wants to thank this panel for coming back. We also want to thank you for fastforwarding an additional hour. And we especially want to thank Mr. Franklin, because I'm told that he's been under the weather and is coming in spite of somehow suffering from a cold or the flu, or something like this.

Our second hearing today is Electric Transmission Policy: Regional Transmission Organizations, Open Access, and Federal Jurisdiction.

The hearing will come to order.

The Chair would recognize Mr. Norwood to make a brief introduction, and then we will begin to hear testimony.

Mr. NORWOOD. Thank you very much, Mr. Chairman, and I commend you on your selection of witnesses. Anybody from Texas that has enough sense to have two people from Georgia on the same panel, I know I have a great deal of respect for. But I do appreciate your leadership on these issues and would like to commend you and the ranking member for the selection of the witnesses.

If I may, I'd like to take this opportunity to recognize and welcome two gentlemen from the great State of Georgia who will be testifying on this second panel today. Robert Johnson from MEAG Power and Allen Franklin from Southern Company.

Thank you, gentlemen, for being here.

Robert Johnson is the President, Mr. Chairman, and Chief Executive Officer from MEAG Power headquartered in Atlanta. MEAG Power is a public generation and transmission corporation, as you know, that provides power to 48 Georgia communities serving nearly 750,000 Georgians, many of whom are my constituents.

With over 24 years in the electric utility industry, Mr. Johnson has held several management positions at MEAG at one time or another, having overseen both engineering and operations. In addition, Bob serves on the Board of Directors for the Energy Authority, one of the largest power marketing joint ventures among public power organizations that is located in Jacksonville, Florida.

Bob received his bachelor of electrical engineering from Georgia Tech in 1978 and he's still a good guy, and his professional engineering license in 1983.

Also testifying before our second panel today is a good friend of mine, Allen Franklin, Chairman and President and Chief Executive Officer of Southern Company, also headquartered in Atlanta. Previously Mr. Franklin was President and Chief Operating Officer of Southern Company, and prior to that served in the same capacity at Georgia Power Company, Southern Company's largest subsidiary.

Allen received his bachelor's degree in electrical engineering from the University of Alabama, and a master of science from the University of Alabama, Birmingham.

Mr. Chairman, both of these gentlemen are respected leaders within the electric utility industry and within the Georgia community, as both serve on the Board of Directors for the Georgia Chamber of Commerce.

Bob and Allen, I'm very happy to have you here today before this committee, and I look forward to hearing each of your testimonies and perspectives on these critical issues affecting our national energy policy.

Thank you, Mr. Chairman.

Mr. BARTON. Thank you, Mr. Norwood.

Does Mr. Boucher wish to make a brief opening statement before we begin? Okay.

We want to welcome this panel. And, again, thank you for your attendance. We're going to start with Mr. Bennett and go right down the line.

Mr. Bennett is a Commissioner of the New York State Public Service Commission. We know it's been a very difficult time for you the last several weeks because of what happened at the World Trade Centers. We really appreciate your attendance today. We know that had to be difficult for you to take away from your duties in New York to come and testify before this subcommittee.

Your statement's in the record in its entirety, and we would recognize you for 5 minutes to elaborate on it.

STATEMENTS OF JAMES D. BENNETT, COMMISSIONER, NEW YORK STATE PUBLIC SERVICE COMMISSION, ON BEHALF OF NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS; ALLEN H. FRANKLIN, PRESIDENT, CEO & CHAIRMAN, SOUTHERN COMPANY; PETER FLYNN, PRESIDENT, NEW ENGLAND POWER COMPANY ON BEHALF OF RICHARD P. SERGEL, NATIONAL GRID USA; ROBERT JOHNSTON, PRESIDENT AND CEO, MUNICIPAL ELECTRIC AUTHORITY OF GEORGIA ON BEHALF OF THE LARGE PUBLIC POWER COUNCIL; GLENN ENGLISH, CEO, NATIONAL RURAL ELECTRIC CO-OPERATIVE ASSOCIATION; MARC S. GERKEN, PRESIDENT, AMERICAN MUNICIPAL POWER-OHIO ON BEHALF OF TAPS; PETER G. ESPOSITO, VICE PRESIDENT AND REGULATORY COUNSEL, DYNEGY, INC. ON BEHALF OF ELECTRIC POWER SUPPLY ASSOCIATION; CHARLES A. TRABANDT, FORMER FERC COMMISSIONER; AND MICHAEL J. TRAVIESO, MARYLAND PEOPLE'S COUNSEL

Mr. BENNETT. Very good. Thank you, Mr. Chairman, and thank you for your comments. It has been a hard time for the State of New York, but everyone in the State is very grateful for all the support from the Congress and from all the other areas of this great country.

Actually I'm not here just as a Commissioner from the State of New York, but also as a representative of the National Association of Regulatory Utility Commissioners, otherwise known as NARUC, which is an organization composed of all of the utility regulatory commissioners in the country.

The written statement of NARUC has been put into the record, and I'll just make a few brief comments and, perhaps, add something from the New York State perspective, and answer any questions you might have.

Three basic issues before us today: Transmission jurisdiction, regional transportation organizations or RTOs and open access.

To be brief insofar as transmission jurisdiction, it's very clear that FERC has jurisdiction over wholesale rates. It's the position in New York State and also of NARUC that the State retain authority to establish retail jurisdiction, and the jurisdiction to set retail rates including the rates for transmission services. And that

FERC's jurisdiction should not be expanded to include unbundled retail transmission service.

Second, the States should continue to exercise regulatory oversight over retail transmission service. As an alternative to State oversight, the States could be authorized to form voluntary regional bodies or RTOs to address regional transmission system issues and FERC should be required to defer to States acting on a regional basis.

Insofar as retail jurisdiction, it's our belief that the jurisdiction should remain with the States.

I think the two major issues here are reliability and pricing. New York has something of a unique position right now in that we have an ISO, an independent system operator, which is like an RTO of one State. However, we are working very cooperatively with New England and with PJM. And with experience we see that this region will be able to put together a voluntary RTO working on its own experience and its own knowledge without having the need for a direction from FERC as to how it should be done.

We would also believe that Congress, if it so elected, should provide for a State commission advisory role and RTO governance that allows deference to the State commissioners within a region that reach consensus concerning governance and operational issues.

NARUC does not support charging local retail customers for new transmission facilities to move merchant plant energy to a regional grid.

NARUC also has long supported nondiscriminatory wholesale open access for transmission services.

In conclusion, in the case of existing transmission facilities, the local retail consumers have born the vast majority of the costs of the utility's transmission facilities. It is the utility's obligation under State law or FERC approved contract to provide these consumers reliable and affordable service; they should not bear any unfair burden due to the transition to an open access transmission regime.

Thank you.

[The prepared statement of James D. Bennett follows:]

PREPARED STATEMENT OF JAMES BENNETT, COMMISSIONER, NEW YORK STATE
PUBLIC SERVICE COMMISSION

Mr. Chairman and Members of the Subcommittee: Good morning. My name is James Bennett. I am a Commissioner on the New York State Public Service Commission. I am here today on behalf of the National Association of Regulatory Utility Commissioners, commonly known as NARUC. I greatly appreciate the opportunity to appear before the House Energy and Commerce Subcommittee on Energy and Air Quality and I respectfully request that NARUC's written statement be included in today's hearing record as if fully read.

NARUC is a quasi-governmental, nonprofit organization founded in 1889. Its membership includes the State public utility commissions for all States and territories. NARUC's mission is to serve the public interest by improving the quality and effectiveness of public utility regulation. NARUC's members regulate the retail rates and services of electric, gas, water and telephone utilities. We have the obligation under State law to ensure the establishment and maintenance of such energy utility services as may be required by the public convenience and necessity, and to ensure that such services are provided at rates and conditions that are just, reasonable and nondiscriminatory for all consumers.

States have an important stake in how electric transmission services are provided to retail consumers. The transmission facilities that serve consumers were approved by State governmental entities, and importantly are being paid for by these retail

customers. We are, however, keenly aware of the interstate commerce implications of transmission service and we believe that the issue of transmission jurisdiction is now properly before the Supreme Court. Accordingly, NARUC recommends that Congress follow its prudent practice of allowing the Court to rule on transmission jurisdiction issues prior to taking any legislative action.

States should retain authority to establish retail rates that include transmission services, and FERC jurisdiction should not be expanded to include unbundled retail transmission service. FERC should continue to have ratemaking authority for interstate wholesale transactions and should have jurisdiction over transactions between suppliers and retail customers located in different States. Prior to the unbundling of rates to permit consumer retail choice, the States set the full bundled rate—including transmission service. This provided customers not only simplicity but a single source of regulatory redress when problems or complaints arose. Now that retail rates are becoming unbundled in order to allow customers to choose a generation supplier, such customers are no less in need of simplicity and regulatory oversight. NARUC believes that the best way to provide that protection is to allow the States to continue to exercise regulatory oversight over retail transmission service.

As an alternative to State oversight, States could be authorized to form voluntary regional bodies to address regional transmission system issues and FERC should be required to defer to States acting on a regional basis.

NARUC supports legislation leading to voluntary formation of Regional Transmission Organizations (RTOs), with deference given to States in RTO development, including size, geographic scope and configuration, as well as States acting collectively on a regional basis. Congress should develop a mechanism for States to address ongoing concerns in RTO functions after the initial RTO development period, including reliability, market monitoring, pricing, congestion management, planning and interregional coordination. In New York, for example we have established very high reliability standards—particularly in the highly congested New York City area. These high standards come at a cost but we believe such a cost is miniscule compared to the consequences of a major outage. We believe that the States, working in conjunction with their RTO, are best able to develop, monitor, and insure effectiveness of such standards. New York has also worked with its ISO to develop sophisticated market monitoring systems and market price mitigation programs that help prevent the abuse of market power. Because of the unique electrical configuration in New York City, such programs are essential to protect consumers from price gouging especially during times of extreme scarcity of supply. As the Northeastern RTO is being developed, we are working with the parties to ensure that these practices continue.

In order to ensure a cooperative working relationship between the States and the RTOs, Congress should provide for a State commission advisory role in RTO governance that allows for deference to State commissions within a region that reach consensus concerning governance and operational issues. In New York, PJM and New England, State commissions have a good working relationship with their respective Independent System Operators. As RTOs develop and electric systems become larger, we need to continue to find ways to have continued cooperation between the States and the emerging RTOs.

At the heart of the issues raised at today's hearing—RTOs, transmission jurisdiction, and open access—is the relatively new development of merchant generating plants and the question of who pays to get the power produced by these plants to the markets where the owners of these plants wish to sell their power. These facilities are not owned by utilities and are not necessarily constructed near where they are needed. These generation units are not being constructed solely for the purpose of supplying the electricity needs of the State or region in which they are located. The main purpose for these plants is to sell power to the wholesale market for the most profitable price, regardless of where the purchaser is located.

This raises the question of who should pay for any new transmission to get this merchant power to where it has been sold. NARUC does not support charging local retail ratepayers for new transmission facilities to move the merchant plant energy to a regional grid. In New York, for example, new generators are responsible for the costs of transmission lines necessary to connect to the grid. In addition, any grid improvements made necessary solely related to the new generation are also paid for by the generator. Any other improvements are paid for by the transmission owner and passed through to all users of that transmission system.

In the case of existing transmission facilities, the local retail consumers have borne the vast majority of the costs of the utility's transmission facilities. Because the utility's obligation under State law or FERC-approved contract is to provide these consumers reliable and affordable service, they should not bear any unfair burden due to the transition to an open access transmission regime. We clearly ex-

pect that the new RTOs working with the States will develop sound interconnection policies that fairly allocate the costs of new transmission facilities between generators and transmission users.

In closing, NARUC has long supported non-discriminatory wholesale open access for transmission services. State Commissions, however, must retain the authority to protect retail consumers by ensuring that they are not unfairly burdened by financial and environmental costs that ought to be born by other stakeholders. Further, States must continue to be deeply involved in RTO development, monitoring, and price mitigation.

Thank you for giving me the opportunity to appear before you today. I look forward to answering your questions.

Mr. BARTON. Thank you, Mr. Bennett.

We'd now like to hear from Mr. Allen Franklin, who is the CEO of Southern Company.

And, again, we appreciate you coming since I've been told that you've been a little bit under the weather.

Your statement's in the record, and we'd ask you to elaborate for 5 minutes.

STATEMENT OF ALLEN H. FRANKLIN

Mr. FRANKLIN. Thank you, Mr. Chairman.

Let me say, first of all after hearing Mr. Bennett's testimony, I largely agree with the points that he made. Let me add just a moment or state just for the record our corporate situation, which I think helps explain our position on a lot of these issues.

At this point about 90 percent of all of our net income is regulated by the States. About 10 percent is related to our participation in the wholesale market. So the big part of our business is still State regulated related to retail customers, but wholesale is important because it's a significant part of the growth of our company.

For that reason, because retail is so important, we tend to be very sensitive to what our State commissions think, and we tend to be very sensitive to how different changes to the industry effects our retail customers.

Let me also set the stage for the current state of the electric industry in the southeast. Unlike other parts of the country, there is plenty of generation in the southeast. There's massive amounts of competitive generation under construction. In fact, we expect the capacity to double in our service area in the next 5 years producing much more generation than will be needed to serve local load.

A bigger issue with us is not enough generation, there's plenty, but the huge amount of transmission that's going to be required to move that generation into the market and outside the southeast.

We're currently projecting that over the next 5 to 6 years we'll spend about \$6 billion of additional capital for new transmission. That will triple the amount of investment we have in transmission. It took 80 years to get to \$3 billion, in the next 6 years we're going to be at \$9 billion. That will create a 10 percent rate increase for our retail customers, which is a concern to us and, obviously, through our commission.

We intend to build the transmission that's required, and take that obligation seriously, but there are some FERC pricing issues I'm sure that were discussed this morning that make this transmission requirement much more severe than it should be. And the primary problem is that transmission pricing is not distant-sensitive, which results in generation being located much further from

load centers than it should be, which increases cost and reduces the reliability of the system. That's a problem I hope that can be addressed.

Now moving to RTOs. In my judgment RTOs are a good idea if done properly. I think their time has come. And I think FERC Order 2000 that was issued in late 1999 was very much on the right track. It laid out standards and expectations, and it left it to utilities and State commissions to move the process forward.

We were making great progress in the southeast in developing an RTO structure in the size and the scope along with eight other public power entities to form a large, what I think would have been a very effective RTO in the southeast. That was going extremely well until FERC issued an order in July that in essence stopped that process in its tracks. Since that time there's been a great deal of confusion about the direction RTOs would take in the south.

Where FERC goes next is not clear, but it's certainly a possibility that they would mandate not only the size, but the structure of the RTO. That's the wrong answer, in my judgment, from our standpoint in the southeast.

First of all, I think they'd take the wrong structure.

Second, it will cause public power to opt out, and in our part of the country it's critical that public power participate. There's been a severe State backlash, States all the way from North Carolina to Louisiana have objected to the FERC direction. It makes the non-distant-sensitive pricing worse, simply because an RTO is larger.

Mr. Chairman, I think there is a relatively simple solution to the current situation. I think if we can get back on the pre-July track that we're on in the southeast, and if Congress can help us do that and FERC can help us do that, that'll be a plus. If FERC can work on their pricing and make it distant-sensitive, that will be a big plus, and I would encourage Congress to do what it can to help FERC move in that direction.

I want to also discourage Congress at this time from giving any additional authority to FERC to mandate RTOs, to mandate divestiture of generation or to take additional authority from the States on bundled transmission rates. If that happens, I can give you reasonable assurance that RTOs will form in the southeast. I think they will form faster and they will perform better.

Thank you.

[The prepared statement of Allen H. Franklin follows:]

PREPARED STATEMENT OF ALLEN FRANKLIN, CHAIRMAN, PRESIDENT, AND CEO,
SOUTHERN COMPANY

INTRODUCTION

My name is Allen Franklin, and I am Chairman, President, and CEO of Southern Company. Southern Company is the owner of five operating electric utility companies including Georgia Power and Savannah Electric and Power in Georgia, Alabama Power, Mississippi Power, and Gulf Power in Florida. In our southeastern service area, we have over 35,000 MW of generating capacity and serve over 3.9 million customers at rates that are 15 percent below the national average. Southern Company is also the largest wholesale power provider in the Southeast. Our service territories cover 120,000 square miles and we have over 26,000 miles of transmission lines.

Southern Company supports removal of the remaining barriers to robust competitive wholesale markets through federal legislation. We believe continued, fair competition in wholesale markets can lead to added consumer savings while maintain-

ing the high level of reliability that consumers have come to expect. We also support the development of properly sized and configured regional transmission organizations to help further the goal of non-discriminatory access to the transmission system. Southern Company's operating subsidiaries have been participating in and benefiting from competitive wholesale markets by putting our incremental generation needs out to bid. This program has been very successful in helping to ensure that consumers in our service area pay the lowest possible price for electricity—which should be the main goal of electricity policy initiatives. Just last year, Southern's operating companies procured 3,000 megawatts of power via long-term contracts through competitive bids, and we are seeking another 3,100 megawatts this year. In response to Georgia and Alabama Power's most recent requests for proposals, generators bid over 30,000 megawatts for the solicitation of only 3,100 megawatts. Clearly a robust wholesale market already exists in the Southeast. The objective of Federal legislation and FERC policy should be only to enhance what already exists.

Evidence that the competitive market is functioning well in the Southeast can also be seen by the incredible amount of new merchant generation seeking to build in the South. We currently have signed interconnection agreements for about 18,000 MW of new generation and have pending requests for another 34,000 MW, all in our service area. In fact, we are no longer worried about a shortage in generation in the region. If all of this generation is built, it would more than double the available generation in our area—clearly much more than is needed to serve consumers in this area. We are becoming more and more concerned about the feasibility of siting, building and paying for the additional transmission facilities that may be needed to satisfy transmission service requests from all of these new generators—in addition to what we must build to serve our retail customers.

We are currently investing significantly in new transmission facilities—both to retain reliable service to our own growing load, and to provide transmission services for merchant generators building in our service area. We currently have transmission assets with a book value of 3 billion dollars. Over the next five years, we expect to double that investment to 6 billion dollars, just to keep pace with our load and the generating projects that have already requested service. If we are ultimately able to site and construct transmission for all currently announced generation projects in the region; our total transmission investment could triple in the next five to six years—from 3 billion to nine billion dollars. Retail customer rates could increase by 10 percent if we are required to pick up most of these new transmission costs, as we are under current FERC policies. It is not clear that savings in generation will ever be sufficient to offset these higher transmission costs.

This gives rise to one of our major concerns, as will be discussed in my testimony today; that FERC has not paid adequate attention to whether or not its transmission access and pricing policies are leading to rational investment in generation and transmission to minimize the total costs of electric service. Nor has FERC focused on transmission pricing policies necessary to bring forward the investment in transmission needed to support competitive markets. For example, the rationale being used for having just a few very large regional transmission organizations (RTOs) in the country is that by having a single postage stamp rate for a large region, you can have generation built anywhere to serve load anywhere. But this policy ignores several critical facts. First, building generation closer to load results in a more reliable system. Second, it is significantly less expensive to build gas pipelines to move gas to generators located near load centers than it is to build generation near the gas fields and build new electric transmission to move power to load centers. Third, FERC's postage stamp rate policy for electric transmission juxtaposed against distance sensitive rates for gas pipelines gives generators uneconomic incentives to build closer to the gas source—exacerbated by the fact that generators don't always have to pay the full cost of new transmission required as a result of their location decisions.

These economic distortions exist today—they are simply made worse by moving to very large RTOs. Before very large RTOs are considered, appropriate transmission pricing for RTOs, ensuring proper locational decisions by generators must be developed.

We do not know if the Commission's stated plan for four large RTOs across the country will best promote economically efficient, secure and reliable wholesale markets, or what costs and benefits to our customers would result from such a scheme. The Commission has yet to conduct any analysis to suggest what the optimal size or configuration for an RTO might be, and what is the most efficient and reliable market structure within an RTO. We believe such analysis is critical to ensuring our customers and state regulators that our participation in an RTO is in the best interest of all electric consumers.

Thus, we are obviously very concerned about the direction of FERC's transmission policies. While it may be true that there is a shortage of generation or transmission investment in some parts of the country, it is not the case in our service area. We are continually building new transmission facilities. And as noted, we also have a tremendous amount of new competitive wholesale generation being built in the region. Our rates are well below the national average and we consistently rate among the top utilities nationally in customer satisfaction. We are concerned that movement to very large RTOs, without careful forethought regarding implementation costs and without appropriate transmission pricing and investment policies, could have disastrous results for our consumers in terms of cost and reliability. We have been taking a careful, rational approach to the formation of regional transmission organizations to ensure that the overall goals of a competitive wholesale market are achieved and that our customers benefit.

SOUTHERN COMPANY'S RTO DEVELOPMENT EFFORTS

When FERC issued Order 2000 at the end of 1999 we immediately began to examine what strategy made sense for us in terms of forming or joining a regional transmission organization. The necessary starting point for us was the Integrated Transmission System in Georgia. The Georgia transmission system has been jointly owned by four partners since the mid-1970's. The partners are Southern Company subsidiary Georgia Power, the Municipal Electric Authority of Georgia (MEAG Power), the Georgia Transmission Corporation—a cooperative utility—and Dalton utilities—a municipal system. For an RTO to properly function in our region, it will require at a bare minimum the participation of these four utilities. That is because the facilities owned by the ITS partners are inter-mingled—sometimes we might own different wires on the same poles, or their wires will begin where our wires end. It would be impossible for an RTO to operate our transmission without also operating the transmission systems of our partners.

Thus, we began our RTO discussions with the Georgia ITS partners. These discussions continued through 2000 and into 2001. Simultaneous discussions were also held with many other utilities in the Southeast, including all of our regional investor-owned utilities and TVA, and were broadened to include the Alabama Electric Cooperative (AEC) and the South Mississippi Electric Power Association (SMEPA). However, Order 2000 required Southern Company to make a filing by October 15, 2000 either agreeing to participate in an RTO or listing the barriers precluding such participation. Because we had not yet reached agreement with other utilities on the exact form of an RTO, Southern Company filed by itself on October 15. Our filing took the form of a Request for Declaratory Order, seeking FERC's guidance on whether our proposed RTO would meet the standards of Order 2000. While it was never our intention to form a single company RTO, we were limited by time constraints.

On March 14, 2001, FERC issued a response to Southern's Request for Declaratory Order. The Commission rejected Southern's October filing on two grounds (1) Southern Company proposed that only wholesale transmission services would be subject to the RTO tariff, contrary to FERC policy, and (2) Southern Company proposed some transmission incentives that would flow to transmission owners as opposed to the RTO. FERC determined that this would violate the principles of Order 2000, in which the Commission intended to incent the entity making investment decisions, not the entity building transmission.

Southern believed that we could respond adequately to these FERC concerns. However, the Commission also noted in its' March 14th order that as an alternative to correcting the deficiencies in its October filing, Southern should explore joining with one or more other utilities to form an RTO in the Southeast. Thus, Southern continued negotiations with the ITS partners and other utilities in our sub-region and we also held discussions with GridSouth, GridFlorida, Entergy and TVA. Around the same time, several non-jurisdictional utilities in the Southeast that had been somewhat unsuccessful in their attempts to join other RTOs in the region requested to join our discussions to form the SeTrans RTO. These utilities included Santee Cooper, Jacksonville Electric Authority (JEA), and the City of Tallahassee.

At FERC's request, Southern filed a status report regarding our efforts to join or form a larger Southeast region RTO on May 14, 2001 (the status report was supplemented on June 20, 2001). Southern told FERC that since our October filing, Southern had furthered negotiations with the non-jurisdictional transmission owners in our area. To this end, we included with our status report Memoranda of Understanding with MEAG Power, Dalton Utilities, the City of Tallahassee, Jacksonville Electric Authority and the South Mississippi Electric Power Association. After the May 14 filing, Georgia Transmission Corporation, Alabama Electric Cooperative and

Santee Cooper also signed Memoranda of Understanding. Thus, nine utilities were now involved in forming the “SeTrans RTO”, representing over 39 thousand miles of transmission, \$6 billion dollars in transmission investment, and over 44,000 megawatts of generation that would be within the RTO’s purview. This would place SeTrans among the largest RTOs in the nation.

Southern Company also reported to the Commission regarding its’ discussions with Grid South, Grid Florida, TVA and Entergy. Southern decided that joining with GridSouth, Grid Florida or Entergy was not feasible at that time. These entities were far along in their RTO development. Dealing with the many issues involved with the non-jurisdictional utilities in our area, as well as the jointly owned transmission system in Georgia would slow the progress that those entities had made. Southern Company and the municipals and coops with which we are partnering also have some critical differences over the RTO governance structure of GridSouth, GridFlorida and the Entergy/Southwest Power Pool RTO. We believe that smaller RTOs could be implemented much sooner than the larger RTOs favored by FERC, and if warranted by the market and consumer benefits, merged into a larger RTO at a later date.

While TVA indicated that it does not wish to join with Southern in an RTO, we have agreed that most of the benefit of a joint RTO can be gained through coordination agreements (that provide for seamless transmission services and markets across RTO and utility boundaries). Thus, Southern signed a separate Memorandum of Understanding with TVA to develop such seams arrangements. GridSouth, GridFlorida and Entergy have also expressed interest in working on seams issues with SeTrans. We recently executed a three-way Memorandum of Understanding with TVA and Entergy to work on these issues.

The goal we expressed in our status report was for SeTrans to make a final filing with FERC for the establishment of the RTO by December of this year, with an operational date possibly as early as the fall of 2002. Up until July 12, 2001, Southern Company—in partnership with the eight other transmission owning utilities in the Southeast—was negotiating and was close to completing a formal agreement to cover the initial costs of RTO development and establish a decision-making structure. We had also hired an independent facilitator and established working groups to develop detailed market and operational protocols.

On July 12, 2001, the FERC rejected Southern Company’s Status Report and issued an order requiring jurisdictional utilities that were in the process of forming separate RTOs in the Southeast to enter into a 45 day “mediation” process to merge the separate entities into a single Southeastern RTO. The implementation of this mediation process was a deviation from FERC’s previous policy direction and applied not only in the Southeast, but in the Northeast as well. Specifically, the parties asked to merge their efforts were SeTrans, GridSouth, and Entergy. In addition, GridFlorida and the Southwest Power Pool (SPP) were invited to participate, but they were not required to participate. Also invited (but not required to participate) were state commissions, non-jurisdictional utilities (municipal utilities and cooperatives,) TVA, the Southeastern Power Administration, and all intervenors in the dockets related to these RTOs. About 200 people participated in the mediation that was led by a FERC administrative law judge (ALJ) with consulting assistance.

THE MEDIATION PROCESS

The mediation was subject to a confidentiality rule invoked by the ALJ. We provide here just a broad overview of the issues and a short summary of the mediator’s report, which was made public on September 10, 2001.

The Southeastern mediation focused on the form of governance, the market model to be adopted, how congestion pricing should be done, transmission pricing, and other required functions of RTOs, as laid out by FERC in Order 2000.

While the mediation began with a discussion of four different models (SeTrans, GridSouth, GridFlorida, and a combined Entergy/SPP proposal), the discussion narrowed down to only two options. These are (1) a Transco (independent transmission company) type model, and (2) an independent system administrator model (also know as the independent third-party operator model) that has been supported by the SeTrans group.

The Transco proposal has an RTO that is managed by a new entity that is formed via the investment on a passive basis in a limited liability company (LLC) with the anticipated divestiture of transmission by one or more parties to the LLC. Until actual divestiture of transmission assets, a Board of Directors that is selected through a fairly complex stakeholder process governs the new Transco Company. Initially, the Transco Company is owned by the utilities that have invested in it, with the percentage of ownership being based on the proportion of the amount invested. The

transmission assets of a utility can be transferred into the LLC with the passive ownership of the divesting utility's ownership interest in the LLC increasing proportionately. Eventually, the Transco might be "sold" to investors through an initial public offering, at which time, the Board of Directors for the Transco would be elected by shareholders.

The SeTrans System Administrator Model, on the other hand, would have a proven, experienced independent third-party transmission operator that would be hired by the transmission owners to operate an RTO that meets all of the requirements of FERC Order 2000. The System Administrator would have operating contracts, approved by FERC, with each of the participating transmission owners that would be similar, but that could contain certain terms and conditions specific to the needs of individual entities (particularly municipals and coops.)

The System Administrator would not own any transmission, and thus would not be biased in any way towards its own transmission or against that owned by others. However, the System Administrator would still be a for-profit company with a balance sheet substantial enough to meet its' commitments. It would receive a management fee for performing RTO functions, and would have profit incentives (and penalties) to operate reliably and efficiently. We believe the for-profit nature of the System Administrator is essential to making performance incentives work. The System Administrator would be hired for a five-year term with extension provisions, but could be fired for cause with FERC's permission.

Although there may be some surface similarities, there are fundamental differences between the two models. First, the Transco is a start-up company with an independent stakeholder-selected Board, with the option to turn it into a shareholder elected Board if an IPO occurs. The System Administrator, on the other hand, is an already existing, proven company, independent from all market participants, that has its own Board of Directors and shareholders already in place, and has contractual incentives to operate reliably and efficiently.

The second fundamental difference is in asset ownership. The Transco is specifically set up as a repository for divested transmission assets, and earns a return on those assets. Under the System Administrator model, all transmission assets remain with others—although independent Transcos would certainly be able to participate on the same basis as other transmission owners.

The mediator's final report discussed some of the pros and cons of both models, but in the end recommended adoption by FERC of the Transco model, with some modifications that were discussed during the mediation process. The mediator believed that of the two models, the Transco model "is better developed and more clearly in compliance with requirements of Order 2000 based on a 'best practices analysis' of other RTOs which have received Commission approval and prior Commission precedent with respect to the current filings." We continue to believe, however, that the System Administrator model offers the greater flexibility, is immediately more efficient, and can accommodate the requirements of all transmission owners and other stakeholders. We clearly disagree with the judge's findings.

The Commission has not yet acted on the mediator's report, but there are indications that it will act within the next several weeks.

SOUTHERN COMPANY POSITION

Southern Company actively participated in the mediation process. We are continuing to support the SeTrans model with the other SeTrans participants. We are extremely wary about turning over control of our assets and the reliability of our system to an entity that does not have a Board with direct fiduciary responsibility to anyone for the assets under its' control, as would be the case (at least until an IPO occurs) with the Transco model. We are also concerned about having our assets managed by a company that also owns transmission assets. Questions arise as to whether the Transco might favor its own assets. Finally, we are concerned about turning operation and control of transmission and system reliability over to a new, unproven entity. We prefer an experienced operator. Thus, we have made it clear that the Transco model, as currently constituted, is unacceptable to Southern Company. However, we do believe that Transcos can and will develop under the SeTrans governance model. We are certainly not opposed to for-profit transmission companies (Transcos), and we would like to retain that as an option for ourselves for the future.

Another reason for support of the SeTrans System Administrator model is that it is the only model within which public power entities have said they can participate. Participation of public power is critical in our service area because of their significant ownership of transmission. Public power is very wary of turning control of transmission over to an entity that also owns transmission. In some cases, they be-

lieve it violates their charters or other legal requirements. Without their participation, any RTO in our region would be riddled with holes—like Swiss cheese—and unable to perform all of its intended functions.

In addition to these matters, we have some even more basic concerns. Southern Company supports the concept of RTOs and believes they can improve the efficiency and reliability of wholesale power markets. However, we are not yet convinced that a super-sized, single RTO for the Southeast is in the best interest of the customers that we serve or our shareholders.

Clearly, as proposed RTO sizes become larger, local control and interest on the part of the RTO operator will become more diffuse. It is unclear whether a system operator overseeing the entire Southeast will be able to deal effectively with local reliability problems. For example, would an operator in North Carolina be able to assess and deal with a reliability issue in South Florida or Mobile, Alabama, as would a smaller RTO with more intimate knowledge of local conditions? And a very large RTO will be expensive. We don't have any idea, at this time, whether the proclaimed benefits of a very large RTO outweigh the costs. In fact, to our knowledge no one has yet done any cost-benefit or other analysis on the proper size and scope of RTOs in the Southeast.

For these reasons and others described below, Southern Company sought rehearing of the July 12 Commission order to negotiate a Southeastern RTO as have many of the other SeTrans participants and almost all of the state commissions in the Southeast. We believe that such a rehearing petition will preserve our legal options. While neither the FERC nor individual commissioners have publicly stated that a single RTO will be ordered if the parties don't come to voluntary agreement, that is certainly a course that industry observers expect FERC to take. Even if there is not a direct order to participate, there are increasing signals that regulatory pressure may be brought to bear on transmission owners who oppose FERC-prescribed solutions.

Again, it bears emphasizing that our problem is not with the RTO concept. As discussed above, Southern Company has planned to join an RTO for over two years now and has been working diligently towards that goal. Indeed, we have helped lead an effort that has attracted substantial public power support—something that few other RTOs in the country have done. Nonetheless, we are opposed to FERC mandates that determine what the RTO should look like, what area it should cover, and how it should operate. If both FERC and the Congress allow voluntary negotiations to continue—consistent with FERC objectives—along the path adopted in Order 2000, the nation will end up in a far better place than if RTO mandates come from Washington. We do not believe that there should be a concern that too many RTOs will be formed. Even before the July 12th orders, there were a maximum of 14 separate RTOs being formed, and talks were already under way to consolidate several of them. And to the extent there are “seams” issues regarding differences in markets within the separate RTOs, those seams issues could be dealt with, as the FERC Chairman acknowledged in his testimony before this Committee on September 20th, by FERC rules that would require common market procedures among RTOs.

Our clear preference is to be allowed to continue to negotiate with our public power partners and neighboring investor-owned utilities to perfect an RTO proposal that has sufficient scope, meets all of FERC's Order 2000 requirements, and is acceptable to our state regulators. State commissions throughout the Southeast, including Alabama, Georgia, Mississippi, North Carolina, South Carolina and Louisiana, all filed requests for rehearing or clarification of FERC's July 12th order. Three states—North Carolina, Louisiana and Florida—have opened regulatory dockets to examine whether the costs of RTO participation are prudent with respect to the pros and cons of RTO participation for the retail customers of jurisdictional utilities. All of the state commissions in the Southeast have taken a very strong position that FERC should not mandate a broad regional RTO until the costs and benefits to ultimate consumers have been carefully evaluated. Southeastern state regulators, legislatures, and consumers are all very much opposed to retail consumer choice at this time, and are concerned that while not directly linked to customer choice, mandated participation in RTOs will lead to that result. We fear that FERC's current path towards mandating very large and broad RTOs will cause irreconcilable differences with state commissions. Clearly if an RTO doesn't work as expected or the costs and benefits are out of line, we will be held accountable by our retail customers via our state regulators.

Southern Company has established a list of principles that are critical with respect to our participation in an RTO. These principles are set forth below:

- The RTO must meet the basic requirements of FERC Order 2000.
- The benefits of RTO participation to our retail customers must exceed the costs.

- The scope of the RTO must not prevent the RTO from being able to maintain regional *and* local bulk power system reliability.
- The RTO should be a for-profit entity with incentives (and penalties) to ensure optimal performance with respect to reliability and cost effectiveness.
- The RTO should have a Board of Directors that is accountable to its shareholders and has a fiduciary responsibility to the performance of the RTO.
- The RTO should be comprised of a third party operator with actual operating experience, as opposed to a newly created and untested entity.
- The RTO development process and structure must accommodate participation by all transmission owners, including public power, electric cooperatives, investor-owned utilities, and Transcos.
- The Third Party Operator must be independent of all market participants and transmission owners, thereby avoiding the need for complicated safeguards to ensure independence.
- The RTO must facilitate entry of other, and perhaps new forms of transmission owners, including Transcos, to ensure that needed transmission facilities will be built.
- The RTO must use operating agreements that, although substantially similar, will accommodate the legal and institutional requirements of all participants.
- The RTO must be acceptable to state regulators.

We continue to believe that the proposed SeTrans RTO will best satisfy these objectives and should be allowed to reach fruition. At this time, there is no need for a FERC mandate, or for additional authority to be granted to FERC. Indeed, such action would likely be counter-productive.

Southern Company also supports the tax provisions included in H.R. 4 that would make it possible for transmission owners to sell or spin off transmission to new corporate organizations without incurring large tax liabilities. While Southern does not currently plan to divest transmission, it should be retained as an option for the future.

DO VERY LARGE RTOS OR A NATIONAL GRID MAKE SENSE?

The desire to move towards a “national grid” or very large RTOs in this country must be tempered with economic and technical realities. The term “national grid” itself is a misnomer. Some who use the term use it as a rationale for socializing interconnection and transmission costs among all consumers, regardless of the benefits they receive. It does not make sense—from either an economic or reliability standpoint to “nationalize” the transmission grid. Having a centrally controlled grid is not feasible or desirable from the point of view of system security and reliability as discussed below. Nor does it make economic sense to remove all bottlenecks and congestion from the transmission system, because, in most cases, it is much less expensive to locate generation on the unconstrained side of the system, rather than building transmission to alleviate the constraint. In the Southern Company system alone, we have estimated that the costs of removing all bottlenecks could be \$12 billion, with commensurate rate increases to our customers of over 30%. Thus, to argue that the cost consequences of a “national grid” are inconsequential, as some have, clearly stretches the bounds of reason.

Furthermore, not all consumers benefit from transmission system upgrades, and should not be required to pay for system enhancements for which they receive no benefit. Only by requiring that cost causation principles be used—i.e., that those who create costs should pay for them—will true economic efficiency occur. Competitive wholesale markets can benefit consumers—but only if competitors face the true costs of decisions they make. Markets that are haphazardly designed by bureaucracies, without careful attention to all potential consequences, are doomed to failure.

A primary argument used by proponents of broad regional or national grids is the notion that the transmission grid is like a lake, where electrons are injected into the grid at one point to form a “pool” of electrons. Under this analogy, users can take electrons out of the “lake” from any point as needed. Under such a vision (mistaken we believe) there would be no limit to the practical size of a grid, because there would be no cost of transportation (transmission) of electrons—in fact, electrons would not be transmitted at all—and there would be no added complexities in grid operations. The “lake” analogy, however, is seriously and dangerously misleading.

The use of the “lake” analogy as support for broad geographic RTOs or a national grid represents a misunderstanding of how the bulk power system works. The fundamental problem is that a lake by its very nature is a storage medium for water. Thus, water can be “injected” into the lake when it rains (or when water from river flows into the lake) and then taken out anywhere from the lake as needs arise. If

there is more supply than demand, the lake level simply rises. If demand is greater than supply, the lake level lowers. In either case, the system remains stable.

Electricity, however, cannot be stored. There is not an equivalent “lake” where power can be injected at one point and taken out at another. Power must be produced at the instant it is needed. Power from specific units is required to meet specific customer needs. While the customer may not use the exact same electrons that are generated for the customer’s use, generation must be increased to meet a specific customer’s increase in demand, and generation must be decreased when specific customers reduce demand. If supply and demand is not kept in constant balance, the system will become unstable and widespread blackouts can result. The specific generation to be increased in response to a customer’s increase in demand must be decided by the system operator so that specific transmission lines are not overloaded, consistent voltage is maintained and system stability is achieved. The operator also has to do all this in the least costly manner possible. Thus, it is not the case that power can be injected (generated) anywhere in the system and taken out anywhere, at least not without very costly reliability consequences.

An additional complicating factor in the electric system is something called reactive power. Reactive power is a product of the production of alternating current (AC) power, and must be supplied to run all motors that are connected somewhere in the grid. Reactive power does no useful work and does not exist as a product that can be separated from the “real” component of power, but the system can’t operate without it. Operators have to ensure that reactive power is sufficient on a moment-to-moment basis. And unlike the “real” component of power, the reactive component of power can not be transported over long distances. Again, the “lake” analogy ignores the need for and nature of reactive power.

Power (although not necessarily electrons) does flow from specific generators to specific customers, over multiple paths (based on the laws of physics, power will flow from generation to load over the paths of least resistance.) A simplified example may help to explain how this works. Suppose an island utility (to eliminate the effects of interconnected systems) has a demand of exactly 100 MW at 1:06 PM. The utility will be generating 100 MW (actually slightly more because of losses) at that time. Suppose at 1:07 PM a local industrial customer starts up its assembly line and in an instant the customer’s demand jumps to 110 MW. Generation at the utility must instantaneously increase to match the increase in demands of 10 MW. The specific generating units to be ramped up again depends on the condition of the transmission system at that moment. The utility will be constantly monitoring the system to determine whether transmission lines can handle additional power. Because power cannot be directed to flow over specific lines, operators can only adjust flows on transmission lines by adjusting where power is generated. Thus, generation might actually be ramped up by 15 MW at one unit and ramped down by 5 MW at another unit to provide the 10 MW.

In this simplified example, nothing else on the system has changed. Thus, the additional 10 MW of power will be injected into the grid to specifically meet the 10 MW of new demand, and the additional 10 MW of power generated will flow directly to that customer.

The actual system is much more complicated in that demand is constantly changing. Some generators can react to changes on the demand faster than others, and systems are interconnected so that changes in the utility will affect other utilities with which that utility is interconnected. Also, most of the matching of supply and demand is done by computers although human operators can and may have to intervene.

The point of this discussion is to demonstrate the complexity of the grid and associated operational issues. Trying to maintain reliability over a small area is difficult enough. Trying to operate the system over a whole interconnection would be either impossible or extraordinarily expensive and complicated. The optimal size for a “control area” (a control area is the geographic area within which a single operator has control) or an RTO is difficult to determine and can depend on many factors. The biggest factor is the capability of the interconnections between utilities. If interconnections are weak, there is probably little trade between the utilities and little economic value to expanding the size of the control area or the RTO. From a technical standpoint, control area or RTO size is also limited by the capability of computers, software, metering and telecommunication among utilities. To change the control area size arbitrarily and without the knowledge of the control area parameters will likely increase costs to customers.

Taken together, all of these issues—both technical and economic—suggest that broad geographic RTOs or a “national grid” may create more problems than they solve. The optimal size for RTOs, while difficult to determine, should be based—as FERC suggested in Order 2000—on logical market areas and on the strength or

weakness of interconnections among sub-regions. Optimal size is also a function of technical limitations and costs. And broad RTOs raise pricing issues that must be resolved. But perhaps most importantly, the markets themselves should be allowed to determine appropriate RTO boundaries. As markets develop, RTOs will merge, break-up and reconfigure, as market needs dictate. Setting RTO boundaries by legislative or regulatory fiat would set in concrete boundaries that may or may not be the right ones. Furthermore, it has been demonstrated that seams agreements and reciprocity agreements among RTOs can achieve all of the same objectives as broader RTOs, perhaps at much lower costs. The key is to preserve flexibility as we learn more about markets and how they are working.

Implementation of very large RTOs or even a “national grid”—in particular the concept of collapsing the whole United States into just a few electrical control areas—also has reliability and security implications that are particularly critical. These issues and concerns are not and should not be considered to be a barrier to RTO formation. They are, however, issues that should be addressed in determining the proper scope, configuration and market structure for RTOs.

The transmission grid in North America has evolved over many years with one primary objective in mind—to reliably connect local area generation to serve local area load. Interconnections with neighboring systems were also developed to provide limited backup for unplanned contingencies. Market forces today require that the transmission system be used in ways it was never designed for in support of long distance energy transactions with flow patterns varying from day to day. These new uses for the transmission system complicate the jobs of security engineers and operators, and stress the lines and substations designed to serve area loads.

Today, reliability management begins with the transmission planning studies designed to connect existing and forecasted generation to existing and forecasted loads. Load serving entities such as Southern project forecasted load growth and transmission planners run contingency studies separately and jointly with neighboring systems to determine the least cost transmission solution required to meet projected needs. Additionally, any known firm transmission commitments for point to point service are included in the base transmission plan. For the projected load and generation plus the set of contingencies modeled, these studies will define the transmission additions required to avoid thermal, voltage, and stability constraints.

Once the transmission additions are constructed—which may follow a protracted siting process—operations engineers manage the day to day operation of the system using load flow programs with contingency analysis. This type analysis is critical to reliability management by ensuring that the existing system configuration is always operated to withstand the next planning contingency. By measuring actual flows on transmission lines, the real time load flow includes the effects of loop flows from other systems and can immediately analyze new configurations as lines and generators trip or are placed in service. These load flow analysis tools are also used to calculate total transmission capacity for commercially important points of receipt and delivery on the transmission system. These values are posted on an electronic bulletin board (OASIS) and adjusted as transmission capability is sold or added. As additional transmission capability requests are made, security analysis is performed to ensure that adequate transmission capability exists to honor the requests.

As transmission constraints appear, the Security Coordinator with responsibility for that area determines the appropriate action to relieve the constraint. The Security Coordinator may use local procedures, including reconfiguration of the system, redispatch of generation, or curtailment priorities using contractual agreements to relieve identified constraints. If local procedures are not sufficient, the NERC line loading relief program will be implemented to curtail lower priority energy transactions contributing to the constraint. This process has resulted in one of the most reliable electric power systems in the world.

The implementation of a single RTO in the Southeast or even for the entire eastern interconnection raises a number of reliability management issues. As discussed, these issues can be addressed with careful organization and delegation. If these issues are not properly resolved, large area management of reliability will certainly result in reduced reliability, less than optimum use of the transmission grid, delay in addressing constraints and potential cascading outages.

Large area reliability management will require that methods be developed to preserve or provide: local knowledge, observability, forecasting, control, and governance that allows hierarchical decision-making.

No matter how the RTO is structured to manage grid reliability and no matter how large an area it covers, we can maintain reliability at the lowest overall cost to consumers through the following actions:

1. *Locate generators near loads:* Consider two extreme cases. In Case 1, generating plants are widely distributed across the system to match the distribution of

load. Generation near each load center is capable of serving the load in that area and transmission capacity exists to back up local generation (and to import lower cost power to the area for economic reasons.) In Case 2, generation is located far from load centers near fuel sources and large amounts of power are moved to major load centers on a routine basis.

In the real world, neither extreme case will exist due to practical constraints ranging from environmental restrictions on locating plants near major cities, to the feasibility of siting and constructing transmission to support Case 2. But clearly the system will be more reliable and less costly if generation is more widely distributed as described in Case 1. Unfortunately, current FERC policy will not lead to this preferred result. The reasons will be discussed later in this testimony.

2. *Do not overly centralize control:* As more and more control of the electric system is consolidated for larger and larger geographic areas into one location, the opportunity to have major wide spread control failures becomes more probable. If the large area RTO implements a single control system for the entire area, a single point failure (or catastrophic event) that disables this system and any back-up systems, will leave the entire area with no control options and will certainly reduce reliability. Smaller RTOs (or at a minimum, hierarchical control areas within a larger RTO) would limit this exposure the same as distributed generation limits exposure to transmission failures. Clearly, there is a tradeoff between larger RTOs for market efficiencies and smaller RTOs for local control and reliability. The proper balance can be found. But it is our judgement that at least initially, smaller RTOs—with close coordination among RTOs—is a better near-term solution than immediate implementation of the huge RTOs currently being considered by FERC.

FERC should not mandate the boundaries for RTOs, nor should Congress give FERC such authority. Rather, FERC—as it did in Order 2000—should express its objectives for RTOs and then let market forces and regional circumstances dictate the appropriate size, scope and configuration based on natural markets, reliability and security concerns and trading patterns. It was this direction in which we were headed—successfully, we believe—before the FERC actions of July 12th.

Another critical component to maintaining reliability, whether in RTOs or otherwise, is to ensure that there are enforceable reliability standards. Congress should pass legislation that would allow reliability standards to be established and enforced by a self-regulating reliability organization, with FERC as a back-stop. In this regard, we support the reliability provision in the Chairman's discussion draft.

MAKING MARKETS WORK—OPEN ACCESS AND PRICING

If we are to rely on a competitive wholesale market for a good part of our future needs—and Southern plans to do so—we need to focus on how to ensure that such markets will operate efficiently and reliably. As stated earlier, getting markets to work efficiently by proper pricing of transmission is critically important to ensuring low costs and reliable service to consumers. Very large RTOs as suggested by FERC, without proper attention to how pricing will work, could have severe unintended consequences from both a cost and reliability standpoint. While transmission pricing was a specific subject of this Committee's previous hearing, we believe the relationship of pricing to RTO scope and configuration is critical to the long-term success of RTOs and worthy of further discussion here.

FERC has indicated that one of its main objectives for very large RTOs is to eliminate pancaking—the charging of multiple transmission rates as you cross transmission owner boundaries. While that may “sound” like a good idea, the truth is that eliminating pancaked rates and replacing them with a single postage stamp rate for a large region is exactly the wrong way to go. A postage stamp rate ignores the fact that it costs more to transmit power over longer distances than it does over shorter distances. More facilities are used for power transmitted longer distances, and losses increase as well.

The problem is made more complicated simply because not all areas of the country are created equal in terms of utility size. In the Northeast, for example, you may have 50 utilities in a single state, meaning that a wheeling transaction could require transmission service agreements with multiple utilities just for short distance service. In such cases, it may make sense to eliminate pancaking.

In the Southeast, however, we generally have very large utilities, as is certainly true in our case, which may span several states. If we had a single RTO with postage stamp rates in the Southeast that included Entergy, than the price would be the same to wheel power from southeast Texas to the Outer Banks of North Carolina as it would be to wheel power from the Atlanta suburbs to Atlanta. That just

does not make good policy or economic sense, yet FERC appears to be headed in just that direction.

The fact that under a postage-stamp rate, short-distance services subsidize long-distance services is only a part of the problem. Our greatest concern, and one that we believe you should share as well, is that it sends the wrong price signals to generators seeking locations for new plants. If it costs generators the same to transmit power over long and short distances, then it is axiomatic that generators will locate closer to the fuel source rather than closer to the load in order to save on fuel transportation costs. But locating further from the load means that more transmission facilities will be used and that new transmission facilities will be needed sooner than they otherwise might have been—it costs more to transmit over longer distances than it does over shorter distances, even ignoring electrical losses that occur on the transmission system.

The price signals and location decision-making resulting from FERC's current policies are in direct contrast with the historical method of electric system planning, where generation sites are compared based on total costs—including the trade-off between pipeline or coal-by-rail transportation costs and incremental transmission costs. And as discussed above—remember Case 1 and Case 2—the system will be inherently less reliable.

Proper transmission price signals are also essential to the effective deployment of distributed generation. If transmission users see the true costs of their use of the transmission system, then they are more likely to look at distributed generation as an alternative. Without proper price signals, there is no way to know whether distributed generation is an effective alternative to transmission investment.

FERC's current pricing policy means that we may be faced with more demand for new transmission facilities than would be the case if the true cost of transmission were properly considered in locating new generation. In our region in particular, we are concerned about the feasibility and cost to retail customers of constructing transmission on such a massive scale.

We are already planning to spend about 3 billion dollars (compared to a book value of current transmission assets of 3 billion dollars) on upgrading the transmission system just to maintain reliability and to accommodate generation now under construction over the next five years. Having to build new transmission for even more generating facilities that are locating away from load centers because of inappropriate price signals will significantly increase these investment levels, not to mention the problems of siting and constructing this transmission. Network transmission improvements for all the new generation that we believe is probable over the next five to eight years will cost an additional 3 billion dollars, increasing our total transmission investment from today's level of 3 billion dollars to a total of 9 billion dollars. We don't know how much proper price signals would reduce that amount, but we can be sure it would have substantial beneficial effect.

Consumers would ultimately pay for this transmission investment. It is not at all clear to us that added generation efficiencies from an expanded wholesale market will be sufficient to offset these added costs. We often hear that because transmission is such a small proportion of total costs relative to generation that the savings inherent in large wholesale generation markets will outweigh any potential increased transmission costs or transmission inefficiencies. If we were forced into building a whole lot of new transmission because of inefficient generation location, then it is clear that the costs of transmission will no longer be small relative to generation, and in fact may outweigh generation costs at the margin—particularly when siting costs and reliability issues are factored in.

The problem is exacerbated because FERC's pricing policies have not been consistent between gas pipelines and electric transmission. Gas pipeline pricing is generally distance sensitive, while electric transmission is not. Thus, electric generators can locate close to the gas fields and avoid distance sensitive pipeline charges, and then transmit the electricity to the load over a long distance at a postage stamp price. Again, the result does not make sense and does not efficiently allocate capital between these two competing forms of energy infrastructure.

The bottom line is that before FERC revises its RTO policies and sets boundaries, it ought to spend some time getting transmission pricing right. If large RTOs are formed under current pricing policies, we may end up over-spending for new transmission facilities and putting generation in the wrong locations. And with FERC's policy of rolling in the costs of most incremental transmission facilities, our retail consumers will bear a large proportion of those costs with little or no benefit.

Another important transmission access issue is the application of open access rules to all utilities. We believe that all transmission-owning utilities—including municipals, cooperatives, federal power marketing administrations and TVA should be subject to the same rules for open access. Our preference would be that all utili-

ties be made subject to the Federal Power Act. However, if the “FERC Lite” concept—which only gives FERC the ability to remand open access tariffs back to the transmission owner is to be adopted—we remain concerned that there is no way for FERC to ever ensure comparable open access by non-jurisdictional utilities. There could be an infinite loop, where the non-jurisdictional utility never provides a satisfactory tariff to the Commission. There must be some teeth to the Commission’s enforcement authority with respect to all utilities.

INTERCONNECTION STANDARDS AND COST ALLOCATION

Another issue that concerns us with very large RTOs is the issue of generation interconnection. With so much new generation being built in the Southeast, the question of who gets interconnected, in what order, and who pays for interconnection costs are becoming increasingly important.

The discussion draft of legislation circulated by the Chairman contains interconnection provisions which we can support, mostly because it requires generators (or their customers) to pay the direct costs of interconnection. We would, however, also like to see provisions in legislation that would require generators to pay transmission system upgrade costs when such upgrades would not have been required but for the generation. One proposal that merits attention is “participant funding” of transmission upgrades. Participant funding would allow the generator or transmission service applicant to pay for the costs of new transmission, in exchange for which they would receive rights to use the transmission system without paying congestion costs. Such rights would have a value equivalent to the transmission investment made by the market participant.

The Chairman of FERC has publicly indicated that he would like to see a change in FERC’s transmission interconnection policies with respect to cost allocation. In the past, generators wishing to interconnect with the utility system would themselves be responsible for direct interconnection costs. If network improvements were also needed, FERC has relied on its “or” pricing policy—i.e., the generator would pay embedded costs or incremental costs, whichever is greater. More recently, the Commission indicated in Order 2000 that perhaps in the RTO context, “and” pricing would be more appropriate, meaning that generators would pay for their use of the existing transmission system and for any network upgrades they cause.

The FERC Chairman has indicated that he disagrees with these policies, and that he would like to see both direct interconnection costs and network upgrades rolled into overall transmission rates and paid for by all load using the transmission system of the interconnecting transmission provider. In other words, even if a generator locates in Georgia to sell to load in Ohio, retail customers in Georgia (and everywhere else in the Southeast) would pick up a share of the interconnection costs. The implication of this potential change in policy of shifting costs from wholesale generators to retail customers is clear. The problem is particularly acute with large RTOs, because customers may have to pick up more of the costs of transmission than they would have needed locally. Given the very large number of merchant plants being built in the Southeast, a shift in policy to require all load within an RTO to pay the interconnection costs of new generators will have a significant cost impact on our retail customers, and will certainly cause new generators to be less concerned about the costs they impose on the electric system.

And again, there are inconsistencies with gas pipeline practices at FERC. When an industrial customer or gas well wants to hook up with the interstate pipeline system, they are almost always required to pay the cost of the connections. It would be unthinkable in the gas industry to have an industrial customer tie into the pipeline system for its own use and have all other customers pay for it. But that is no different than allowing generators to interconnect and having customers who receive no benefits from that generation pick up the tab. We would urge Congress to make it clear that those who benefit from interconnections and transmission upgrades should be the ones who bear the costs.

JURISDICTIONAL ISSUES

The final issue that we’d like to address is the tension between state and federal jurisdiction. This state/federal jurisdiction issue will not only be a major topic of debate in Congress and at FERC, but also now the Supreme Court has the issue squarely before it. Southern Company believes that states should continue to have authority over all aspects of bundled retail sales, including transmission. Some would go further (as NARUC has) and retain state jurisdiction for unbundled transmission services when the buyer and seller are in the same state. At the other end of the spectrum, some argue that FERC should have jurisdiction over all transmission, whether it’s used for wholesale or retail, bundled or unbundled.

This debate is about much more than turf. The real underlying issue is who gets priority use of the transmission system during periods of constraint or emergency. And whether utilities can reserve enough capacity on the transmission system to meet their native load needs before offering capacity to others. Clearly, those advocating federal jurisdiction would like to have all uses of the transmission system on an equal footing. But this ignores the fact that the transmission system was specifically built to serve our native load customers and we continue to have a legal obligation to serve retail customers in states that have not opened to retail competition.

This issue is at the heart of state commissions' concerns over giving FERC authority to regulate the transmission portion of bundled retail sales. It is the job of state regulators to protect the interests of in-state customers. We believe these customer interests can be served without constraining interstate commerce by leaving jurisdiction over bundled retail sales to the states. We do not believe that more authority at the federal level, at the expense of the states, is warranted.

A second jurisdictional issue of importance is market power mitigation. Congress will be considering bills that give FERC broad new authorities for investigating and mitigating market power, both at the wholesale and retail levels. We believe FERC and the states already have sufficient authority to prevent and remedy market power problems. FERC, certainly, can withhold authority of any supplier to sell at market-based rates. But some believe FERC should also have the authority to order suppliers to divest generation. Such authority would clearly usurp traditional state jurisdiction over generation. If given this authority, FERC might try to require divestiture of plants, even where those plants are needed to serve retail customers in states without customer choice. Furthermore, there is no other federal agency that has authority to order divestiture of assets by market participants. We believe such authority is unnecessary, and will again lead to numerous federal/state conflicts.

CONCLUSIONS

The issues currently being considered by this Committee in developing electricity legislation will have profound effects on the industry for years to come. We believe that Congress can best ensure the efficient and reliable development of competitive wholesale electric markets by:

1. Continuing to allow RTOs to develop successfully under FERC Order 2000 in a manner consistent with market needs and regional circumstances. Congress should refrain from giving FERC authority to mandate RTOs, and in fact should encourage FERC to continue along the path it started with Order 2000.
2. Providing guidance to the FERC on transmission pricing, to ensure that federal pricing policies lead to sufficient investment in transmission and ensure that pricing signals provided by transmission lead to the efficient development and location of new generating sources. Congress should also ensure that FERC pricing policies do not allow for cross-subsidization among electric customers or groups of electric customers.
3. Ensuring continuation of the proper historical boundaries between state and federal jurisdiction, by leaving with states the ability to regulate all aspects of retail sales, while providing mechanisms for more effective coordination and cooperation between state and federal regulators. If states and FERC are constantly at odds, there will likely be little that gets accomplished, no matter how much authority FERC has been granted. There are appropriate roles for both state and federal regulation in the emerging utility markets, and these roles should be respected.
4. Adopting authority for a self-regulating reliability organization to adopt and enforce reliability standards with appropriate FERC review. It is imperative that reliability and security of the nation's electric power supply system should remain our number one priority.
5. Providing that all transmission-owning utilities abide by the same regulatory rules.
6. Removing federal barriers to effective competition by repealing PUHCA and PURPA, and removing tax barriers to forming new corporate structures for transmission ownership and investment.

The greatest concern we have with respect to industry restructuring is of unintended consequences. California is certainly the best example of what can go wrong when the momentum of a process overtakes good reason and careful forethought. We need careful thought on all of these industry restructuring issues before we move forward. It's the classic case of not being able to unscramble the egg once it's been scrambled. We fear that we are all moving forward on a fast track without having reviewed the potential unintended consequences. We should move forward

in restructuring, but in a deliberate, thoughtful manner. And we should always put consumer interests at the top of our lists. The costs and benefits to consumers of all restructuring policy options need careful review. And such review should occur *before* we make critical structural changes to the electric utility industry that can not be reversed.

Mr. BARTON. We thank you, Mr. Franklin.

We now want to hear from Mr. Peter Flynn, who is President of New England Power Company up in Massachusetts. We'll get a little bit different of a regional perspective, I'm sure.

We welcome you and put your statement in the record, and ask you to elaborate on it for 5 minutes.

STATEMENT OF PETER FLYNN

Mr. FLYNN. Thank you very much, Mr. Chairman.

New England Power Company is the principal transmission subsidiary of National Grid USA. And I am appearing today in place of Richard Sergel, President and CEO of National GRID USA. Mr. Sergel provided the committee with written testimony in advance, and I'll be testifying consistent with his prefiled testimony.

Let me begin by explaining that National Grid USA is in the transmission and the distribution business in the United States and in the transmission business in other countries. We have no aspirations to be in the generation or wholesale power sales business. In fact, we're getting out of that business. So I come to you today offering the perspective of a company that intends to be and wants to be in the wires business.

I offer three observations for the committee's consideration.

First, we believe that time is of the essence to take actions that will foster the development of workably competitive wholesale markets. We are encouraged by recent statements by the Chair of the Federal Energy Regulatory Commission that indicates that that agency is ready to move forward and aggressively pursue the formation of regional transmission organizations, RTOs. And we believe that's a good thing. However, there were some actions that only this Congress can take, and key among them would be the removal of existing tax disincentives for the sale of transmission assets.

The single most important thing that Congress can do to foster the development of independent transmission sector would be to remove that tax disincentive.

Second, the transmission sector is currently evolving. Some believe it will evolve to a structure that will be governed by not for profit entities. Others believe it will evolve to a structure that in which transmission will be governed by investor owned transmission companies operating under incentive rates.

Our experience is that the business form will be better able to attract the investment and provide the innovation that will provide benefits for customers. We submit, however, that policymakers today need not choose between those two alternative structures provided that independent transmission companies operating under incentive rates have the opportunity to develop, the marketplace will ultimately choose the structure that best provides benefits to consumers.

We urge Congress to ensure that independent transmission companies have an opportunity to develop and Congress could do that

be enacting legislation that urges FERC to adopt incentive rates that will attract new investment and foster renovation.

My third and final observation is that transmission must be independent, but not impudent. Independence is critical. Some argue, however, that independence requires a form where the entity managing the grid takes an almost hands-off approach to new investment. They argue that investor owned transmission companies will over invest in the grid. We disagree with that argument. In fact, we believe that the transmission grid is the essential highway that will allow competition in wholesale markets to occur.

The danger is not that the grid will be overbuilt. The danger, we submit, is that transmission investment will continue to lag. And we suggest that policymakers should avoid relegating transmission owners to a passive ownership role only.

Thank you, Mr. Chairman. And I look forward to answering any questions that the members may have.

[The statement of Richard P. Sergel follows:]

PREPARED STATEMENT OF RICHARD P. SERGEL, PRESIDENT AND CEO, NATIONAL GRID USA

Thank you for giving me this opportunity to appear here today to discuss transmission issues related to electric restructuring. I am President and CEO of National Grid USA, the US affiliate of National Grid Group. National Grid Group is the leading provider of independent, for profit transmission in the world.

In the UK, National Grid owns and operates the 4,500 mile high-voltage transmission network in England and Wales, as well as interconnections with France and Scotland. Since privatization in 1990, National Grid has reduced controllable costs on the UK grid by over 50% in real terms, and saved a further £ 1 billion by reducing congestion on the system. At the same time, National Grid has consistently improved its record for system availability and reliability, even while demand on the system has grown to an all time high 50.6 GW in December of 1999. Moreover, in addition to balancing generation and demand, regulators have recently entrusted National Grid with the development and implementation of new commercial mechanisms for the bilateral trading of electricity throughout England and Wales, in accordance with recently adopted New Energy Trading Arrangements (NETA).

Worldwide, National Grid also operates Transener, the Argentine transmission system, through a joint venture with Perez Compac. The system consists of over 5500 route miles of 500 kv transmission lines across an area equivalent to Western Europe. Transener recently completed construction of an 800 mile transmission line that connects generation located in the Andes with Buenos Aires. National Grid is also actively involved in the construction and operation of transmission interconnections between Zambia and the Congo, Tasmania and mainland Australia, the Isle of Man and the UK, and in the North Sea.

In the United States, National Grid is likewise actively engaged in acquiring or partnering with US utilities who seek to become or create independent wires or transmission businesses. As a consequence, Grid has been an active participant in RTO formation efforts not only in New England and throughout the Northeast, but also with the Alliance Companies in the Midwest.

By virtue of our worldwide experience and our active participation in RTO formation efforts here, I believe that National Grid is uniquely qualified to offer an informed view not only on the important role that independent transmission plays in the creation of successful competitive wholesale markets, but on the challenges that we in the United States face as we attempt to create an independent transmission sector. I would like to offer three basic observations that cut across all of the subjects under discussion here today.

First, time is of the essence. In the wake of California, we need to accelerate the creation of successful, competitive wholesale markets for electricity. To put the matter bluntly, electricity restructuring needs a victory. We can hardly expect state regulators in regions that have yet to embrace restructuring to do so unless and until we demonstrate that competitive wholesale markets not only can function, but can deliver real value to consumers.

As evidenced by it's July 12th orders, the FERC recognizes the importance of expediting the RTO formation process as a means of fostering wholesale markets.

While we understand the concerns of many who argue that the FERC's action was somewhat abrupt, we embrace the FERC's underlying goal. Consequently, we have redoubled our own efforts to work through the mediation process to expedite the creation of a regional Northeast transmission organization while at the same time carving out a role for an independent transmission company. The near term creation of a successful wholesale market throughout the Northeast, a region that by and large already has embraced both wholesale and retail restructuring, is in our view critical to the overall success of restructuring, and we will do all within our power to make it a reality.

The Alliance RTO likewise offers the promise of immediate action. Assuming that the FERC approves the pending filings, the Alliance could be out of the gate by as early as December 15th of this year, creating a regional transmission organization extending over eleven states. This will dramatically hasten the formation of competitive wholesale markets. Indeed, the Alliance RTO, if approved, would serve as an invaluable platform from which to extend the benefits of wholesale markets and regional transmission to the larger region. Moreover, if approved the Alliance RTO will provide policy makers with a laboratory with which to resolve the ongoing debate concerning the future structure of the transmission sector.

Congress also can help expedite the formation of an independent transmission sector and competitive wholesale markets. Congress should enact measured electric restructuring legislation that, at a minimum, ensures the following:

- *Open Access.* The success of wholesale markets depends first and foremost upon open access to the transmission grid. Congress should ensure that the nation's transmission grid, including that owned and operated by public power, is made accessible to market participants and stakeholders.
- *Clarified FERC Jurisdiction.* Congress should clarify that the FERC has jurisdiction over all transmission, bundled and unbundled, public or private. An appropriate transition period should be considered for bundled rates, and the FERC need not have authority over rate-setting for publicly owned transmission, but it must have sufficient authority to ensure and enforce open access.
- *FERC "Backstop" Siting Authority.* Congress should ensure that the FERC has authority to assist regional transmission organizations in planning, siting and building new transmission. In the first instance, siting should remain in the province of the state and local authorities. If the process bogs down, however, regional transmission organizations should have recourse to the FERC.
- *Removing Tax Disincentives.* The single most important thing that Congress can do to foster the development of an independent transmission sector is to remove tax disincentives for the sale of transmission assets. We are convinced, based upon conversations with many market participants, that they would VOLUNTARILY exit the transmission business if they could defer or otherwise steer clear of the significant capital gains penalty they face under the existing tax code. I applaud the House for addressing the issue in HR 4, and urge the Senate and the President to promptly enact the measure into law.

Second, the transmission sector must continue to evolve. The RTO debate has spawned a far ranging discussion of the true nature of the transmission sector, and its ultimate organizational structure. Some argue that because of the grid's vital role in fostering competitive markets, transmission must be organized as a public entity, a political collective answerable to its many stakeholders.

In National Grid's experience, however, transmission is best run as a regulated business, not unlike other regulated, network businesses, e.g. natural gas pipelines, telecommunications, etc. Our experience in the UK and elsewhere strongly suggests that a properly incentivized, independent transmission company can best attract new investment, best develop and employ new technology, and best apply innovative management techniques not only to upgrade the grid, but more fundamentally to extract significant unrealized value from the existing grid, for the benefit of customers.

In reality, however, the debate about the future structure of regional transmission is probably premature. Transmission will ultimately adopt the form best suited to meet the needs of the emerging marketplace. It may emerge, as we envision, as a regulated business with unique regulatory responsibilities, or it may ultimately emerge as an extension of government regulatory authority with attendant business responsibilities. Policy makers should resist making premature judgments on which structure will work best, and allow the natural evolutionary process to continue.

Instead, we believe that policy makers should focus on those issues that will most directly benefit markets, such as uniform market rules, investment incentives for new transmission, and innovative rates that encourage the efficient operation of existing transmission assets.

Congress can aid in that process by ensuring the following:

- Financial Incentives. Congress should urge the FERC to adopt financial incentives for new transmission investment and innovative rate designs to foster efficient operation of the existing facilities.
- Interconnection Standards and Procedures. Congress should instruct the FERC to adopt uniform national transmission and distribution interconnection standards and procedures to expedite bringing new sources of supply to market.
- Removing Tax Disincentives, as previously discussed.

Third, Transmission must be Independent, but not Impotent. National Grid's experience throughout the world has affirmed that the transmission sector must be independent from market participants to assure truly competitive wholesale markets. We hold that view not merely as a result of a license condition, or business expedient, but as a central tenet of our business plan. We do not engage in the generation business outside of the US, and have already disposed of, or are actively disposing of, our minor generation assets in the US. National Grid has no interest in being a market participant.

The FERC, of course, has recognized the importance of independence in both Orders 888 and 2000, and is holding the industry as a whole, and National Grid in particular, to a very high standard of independence.

Independence, however, should not be confused with impotence. True independence assures that the transmission grid will be operated at the highest possible levels of efficiency for the benefit of all customers, including not only generators and marketers, but also industrial, commercial and residential customers who depend upon the grid for the reliable delivery of energy from a wide variety of sources.

Recently, however, a few in the ongoing RTO debate have taken the position that those who own transmission assets can never be truly independent, even if they are totally divorced from affiliated market participants. They argue that transmission owners cannot be entrusted to operate their own assets for fear that they will over-build the transmission grid, and disadvantage generators or other market participants.

In our view, and certainly in recent experience, the danger of under-investment in transmission is real. The possibility of over-investment is, at best, hypothetical. In reality, transmission doesn't compete with generation—the true competitor is the cheaper and more efficient generation that new transmission can deliver to customers. Could it be that those who purport to worry about too much new transmission are in actuality worried about too much new competition?

We would therefore oppose any Congressional enactment that would relegate transmission owners to passive ownership.

Mr. Chairman, we believe that policy makers are properly focused on how to revitalize the transmission sector to aid in the development of competitive markets. We believe that Congress can play a valuable role in that process. I'd be pleased to answer any questions the Committee might have. Thank you.

Mr. BARTON. Thank you, Mr. Flynn.

We now want to hear Mr. Robert Johnston, whose President and CEO of the Municipal Electric Authority of Georgia. He's here on behalf of The Large Public Power Council.

Your statement's in the record, we would recognize you for 5 minutes to elaborate on it. Welcome.

STATEMENT OF ROBERT JOHNSTON

Mr. JOHNSTON. Well, thank you, Mr. Chairman.

Mr. BARTON. You need to really pull that microphone close to you.

Mr. JOHNSTON. The LLPC is a collection of 22 of the largest public power systems in the country. We serve 18 million people, 44,000 megawatts of generation and 26,000 miles of transmission. We're located in all regions, including many regions represented by the members of this committee and we have long supported regional transmission entities that facilitate open access. We've also supported comprehensive legislation that promotes wholesale markets.

Addressing some specific issues today, I'd first like to address bundled retail service issues. We must be allowed to retain capac-

ity, both generation and transmission, to service our native load. Unlike wholesale energy transactions that they have no relationship to obligation to serve, we must retain this capacity because of the obligation to serve, an obligation that is imposed on us by State law.

Any legislation or regulation that requires us to provide capacity to third parties that would otherwise be used for native load service is simply unacceptable. It will potentially cause to curtail service to native load communities, it may raise the cost or it may do both. Given that exposure, we cannot do that voluntarily.

In order to fully open the transmission system the Federal legislation must also address private use tax restrictions on private power assets. Without resolution of this issue, we simply will not be able to put that 26,000 miles of lines into the system in open access; we'll be prevented from putting those resources into RTOs. And, third, we will be prevented from selling excess generation out of our system that may, in fact, be created by the open access.

We recognize that the committee does not have jurisdiction over the tax issue, but we appreciate the chairman's previous support for the issue. The chairman's draft does contain appropriate language which addresses the issues, however I will mention that the recently passed H.R. 4 legislation has inappropriate language and would not be adequate.

We supported Chairman Barton's legislation last year that incorporated the concept of "FERC-lite." The concept required nonjurisdictional transmission systems such as LLC systems to provide nondiscriminatory open access service. The new language, unfortunately, in the draft takes the "lite" out of the FERC-lite proposal.

Rate refund authority given to FERC under the draft language effectively removed any local jurisdiction over cost recovery associated with publicly owned assets. These are assets that those communities have the responsibility for the debt. The language is unacceptable in our view and should be stricken from the draft.

Regarding RTOs, LLC supports RTO development, as previously stated. That said, we strongly believe that there is a right way to evolve to the preferred state so as to do no harm to reliability and low cost to our customers.

We believe the proper approach is to build upon efforts that are already working or in development and grow the RTOs in a controlled and logical way. It's critical that you realize that every region, and in fact every State has unique economic, operational, legal and regulatory requirements that must be addressed in an RTO. Because of this, it's clear that one size and one form for all regions is not an appropriate approach, as FERC is leaning toward. It is ill-advised and raises the probability of failure.

In our opinion, you are basically throwing together extremely large geographic areas that have never operated together, turning that over to a completely new entity with zero operating experience and asking it to operate a system that is the life blood of the economy. Like it or not, that is going to raise the complexities and increase the risk.

Now, I'm saying this as a representative of an organization that believes in and supports development of RTOs, but not in a blind one size, one form approach.

Thank you, Mr. Chairman. I'll be glad to answer any questions.
[The prepared statement of Robert Johnston follows:]

PREPARED STATEMENT OF BOB JOHNSTON ON BEHALF OF THE LARGE PUBLIC POWER
COUNCIL

My name is Bob Johnston and I am the President and Chief Executive Officer of MEAG Power, located in Atlanta, Georgia. I am testifying today on behalf of the Large Public Power Council (LPPC). The LPPC is an association of 22 of the largest public power systems in the United States. LPPC members directly or indirectly provide reliable, affordably-priced electricity to approximately 18 million customers and we own and operate over 44,000 megawatts of generation and approximately 26,000 circuit miles of transmission lines. LPPC members are located in states and territories representing every region of the country, including several states represented by members of this Committee—such as Tennessee, Texas, California, New York, and Arizona—and include several state public power agencies as well.

The majority of LPPC members perform the same functions as traditional vertically-integrated utilities. However, LPPC members are publicly-owned, not investor-owned. As a result, LPPC member systems are not profit seeking entities. We are, instead, service-focused and committed to the residents and communities we serve. Therefore, the benefits resulting from the reliable and cost-effective provision of generation, transmission, and distribution service flow directly to public power customers and communities.

Mr. Chairman and members of the Subcommittee, the LPPC appreciates your efforts to develop comprehensive electricity legislation. The LPPC supports the enactment of comprehensive legislation that promotes a competitive, efficient wholesale power market of benefit to all consumers. The LPPC has long taken an active and progressive role in supporting the development of a competitive electricity market. The LPPC was the first group of transmission owning utilities to express support for open transmission access in the debates preceding the Energy Policy Act of 1992. More recently, we have led the way in developing and promoting regional transmission entities as a mechanism to manage and operate the transmission system in an open access environment and were one of the first organizations to promote the formation and implementation of Regional Transmission Groups.

The LPPC supports competitive wholesale power markets and open access, non-discriminatory transmission service. Public power systems are oftentimes net buyers in the market and greater access to competitive wholesale power markets will benefit our customers and communities. Public power also sells any excess power, when available, in the wholesale market. However, our systems are built specifically to serve our native load customers. We do not overbuild our systems or speculate on future energy needs.

Our first obligation is to our local customers and communities. Therefore, we support comprehensive energy and electricity legislation that will provide greater access to competitive wholesale power markets, that ensures open access, non-discriminatory transmission service, that improves reliability and increases efficiencies in the management and operation of the transmission grid, and that ensures delivery of services to consumers at the lowest reasonable rates. We oppose any changes in law that would undermine the use of our transmission assets to deliver reasonably-priced power to our retail customers.

We appreciate the efforts this Subcommittee has made to advance the debate on how to achieve benefits for electricity consumers and we would like to offer the Large Public Power Council's continued assistance in crafting legislation. During the debate on these issues in the last Congress, the LPPC provided our input to the Committee and contributed our views to the debate. We appreciate this opportunity to continue our involvement. We have reviewed the Discussion Draft dated September 21, 2001, issued by Chairman Barton, and, while we will not comment extensively on the Discussion Draft, we highlight a few of our specific concerns in this testimony. As noted above, we have been active in this debate for some time and have long supported Chairman Barton in his efforts to enact comprehensive energy legislation. However, we have serious concerns with the Discussion Draft in its present form, particularly with respect to (1) provisions of the draft that subject public power to virtually all of FERC's ratemaking authority and (2) the draft's repeal of FERC's authority to review mergers and asset sales. We understand that this is a discussion draft and that it is intended to foster significant discussion among the affected parties and the Committee members. The LPPC would like to continue this dialogue. We must, however, stress again that there are legal constraints—such as private use tax restrictions, bond indenture requirements, and state statutory obligations—that are unique to public power, which must be ad-

dressed before full open access can be provided or participation in RTOs can be contemplated.

I would now like to comment more fully on the issues that are the focus of the Committee's attention today.

TRANSMISSION POLICIES AND THE LEGAL CONSTRAINTS ON PUBLIC POWER

The LPPC believes that a competitive energy market should include open access to the transmission grid on a non-discriminatory basis and that the reliability of electric service must be preserved and preferably enhanced, through competition. For a competitive market to be viable, LPPC member systems must be able to continue to meet the needs of our customers and must be able to provide a reliable and cost-effective delivery system. We must be able to serve our native load at the lowest reasonable cost while meeting reliability standards. As locally-owned and operated entities, LPPC members' first obligation is to the communities that we serve. Our commitment to these communities is to continue to provide reliable and reasonably priced electric power.

It is important to emphasize that two things make us different than others in the electric industry. We are governed and supervised locally—and our performance directly affects our ratepayers rather than shareholders. We are therefore very protective of our ratepayers and our public policy positions tend to emphasize consumers rather than institutions. As a result, we believe that any transmission policy must recognize these obligations and allow us to continue to serve our native load.

In addition, since public power systems have retained the legal responsibility to meet the energy needs of their native load customers, they must maintain and retain resources to ensure the capability to supply such energy. Sufficient generation assets and assured transmission access are required to assure that the energy needs of customer-owners are met in a reliable and cost effective manner. State and local laws place requirements on public power systems that must be addressed. For example, my utility, MEAG Power, has an obligation under our state statute to serve our customers. Unlike an energy marketer who wants firm transmission rights to support a sales contract, we must preserve the capacity to supply our customers due to an obligation to serve imposed by state law.

In order to create fully open access transmission, federal legislation must resolve the "private use" tax issue and should recognize the distinct nature of public power and its contribution to the electricity industry. The LPPC has testified extensively on this issue, both before this Committee and the House Ways and Means Committee. Without resolution of current tax restrictions relating to private use, restrictions on tax-exempt bonds (1) will prevent public power from fully opening up its transmission and distribution systems for use by investor-owned utilities and marketers, (2) will prevent our full participation in Regional Transmission Organizations (RTOs), and (3) will constrain our ability to make long-term sales of surplus power. Absent adequate reform of private use, one of the key problems—how to move electric power from generation to load—will continue to plague the system, and the objectives of comprehensive legislation, the development of a robust, competitive, and fair market, will not be achieved.

While we appreciate the efforts of the House on this issue and recognize that this Committee does not have direct jurisdiction over this matter, we cannot stress our position on this issue with more conviction. We appreciate the efforts of the subcommittee and the inclusions of our agreement on private use in the Discussion Draft. Earlier this session, the House passed H.R. 4, the Securing America's Future Energy (SAFE) Act. H.R. 4, as passed by the House, addresses private use issues, but contains a number of changes to the private use provisions as introduced in the Hayworth bill [H.R. 1459] that frustrate the aim of opening up and expanding the transmission grid. The Hayworth bill represented a landmark agreement between public power and investor-owned utilities forged at the request of Congress, and all parties believe it strikes an appropriate balance with respect to removing restructuring-related tax impediments. However, the private use provisions in H.R. 4 were modified in significant ways and these changes make H.R. 4's private use provisions unworkable—and in some respects, worse than current law—for public power. The Chairman's Discussion Draft contains the language as included in H.R. 1459 and we ask the Committee's assistance in ensuring that these key private use relief provisions are revised and modified so the original objectives sought by this agreement are achieved.

The LPPC supports proposals to ensure that all market participants have access to the transmission system on a fair and open basis. "FERC-lite," as included in the subcommittee's bill in the last Congress, is part of such an open access policy. It would require public power entities to provide transmission services at rates that

are not unduly discriminatory and require non-rate terms and conditions to be comparable to those required of the investor-owned utilities. We believe that open transmission access, including the FERC-lite provision, will encourage a robust and competitive market. However, as noted above, absent adequate private use reform, public power will be unable to provide open access transmission service due to the existing legal constraints. For this reason, our support for the “FERC-lite” concept is predicated on the removal of these legal constraints.

In addition, due to “private use” tax restrictions, our transmission-owning members have sized their transmission systems to supply their own native loads. At this time, we have limited transmission capacity available for other entities. To the extent we have such capacity, we are willing to make it available to all comers on a non-discriminatory basis, as FERC-lite would require. But, a rule that required us to make available to others transmission capacity we need to serve our native load will result in power curtailments or higher prices to our own customers. Any expansion of FERC transmission jurisdiction must respect the interests of the customers for whom the transmission facilities were built.

The LPPC supported Chairman Barton’s legislation introduced last Congress. The bill incorporated the “FERC-lite” concept and required large non-jurisdictional transmission providers to provide non-discriminatory open access. However, that bill did not apply to the transmission component of a bundled retail sale, thereby allowing public power transmission owners to continue to serve our native load. Similarly, the Administration in its “Comments on Draft Electricity Restructuring Act of 2001” (Senator Bingaman’s Discussion Draft), has recommended that the provision on federal jurisdiction over the transmission component of the retail sale be eliminated from the draft. The LPPC believes that this is appropriate. Some current proposals would expand transmission jurisdiction in a way that would jeopardize the ability of public power systems to serve their own resident, retail customers. The LPPC cannot support extending FERC jurisdiction in this manner as it may interfere with our fundamental obligation to provide reliable power to our ratepayers and owners.

In addition, the LPPC has very serious concerns regarding the provisions contained in Section 702 of the Discussion Draft, which would amend Section 206 of the Federal Power Act. When combined with the amendments in Section 201, the effect is to take the “lite” out of FERC-lite. The “Uniform Refund Authority” provisions would allow FERC to set just and reasonable rates (and order limited refunds) for: (a) public power transmission to jurisdictional public utilities; and (b) public power wholesale sales to jurisdictional public utilities. This would largely negate the limitations on the Commission’s ratemaking authority over public power transmission that are an integral part of FERC-lite. The Uniform Refund Authority provision would subject public power wholesale sales and transmission rates to review by FERC when and if such rates are challenged under Section 206. While public power systems would be able to set their own rates in the first instance, these rates could, at any time, be reset by FERC. If so reset, the public power system could then be required to pay retroactive refunds. In our view, the “Uniform Refund Authority” provision, as drafted, cancels out FERC-lite and imposes unworkable, “after-the-fact” rate regulation on public power entities.

RTO POLICIES SHOULD RESPECT UNIQUE AND REGIONAL CHARACTERISTICS

As noted earlier, the LPPC strongly believes that the nation’s transmission grid should be organized in a manner that first and foremost “does no harm” to existing transmission and related delivery systems that are performing properly and as designed. Any proposed changes should be thoroughly studied to ensure that benefits exceed costs and that unintended consequences are minimized. Necessary and timely upgrades to and expansion of the transmission grid are needed. This will most likely be accomplished if transmission assets are managed through a not-for-profit regional transmission organization (RTO). Under this model, such upgrades would not need to meet the higher rate of return requirements necessary for a for-profit entity. Native load customers of one state should not be forced to bear the cost of massive grid upgrades that are to benefit marketers or customers or another state. The costs of upgrades are more appropriately borne by those who benefit from them.

The LPPC believes that RTOs should be created to foster wholesale competition. RTOs should have an appropriate geographic scope, preferably be not-for-profit, and, in all cases, be fully independent of market participants. While LPPC believes that this type of organization will operate more cost-effectively and will more likely result in the open transmission necessary for a fully functioning market, our members are open to consideration of other types of models. The LPPC opposes granting FERC broad new authority to compel transmitting utilities to join RTOs. Similarly,

the Administration in its “Comments on Draft Electricity Restructuring Act of 2001” (Senator Bingaman’s Discussion Draft), did not endorse expansion of FERC’s authority in this area and recommended that provisions providing FERC with additional authority be deleted. The LPPC does, however, support confirming the authority that FERC asserted in Order 2000 to order jurisdictional utilities into an RTO on a case-by-case basis in order to remedy undue discrimination or anti-competitive conduct.

The LPPC has significant concerns about provisions that mandate public power membership in RTOs. The LPPC believes that an evolutionary—and not revolutionary—approach is needed to ensure the continued delivery of reliable, affordable electricity to consumers. The LPPC does support the voluntary formation of RTOs. Many LPPC member systems are already participating voluntarily in RTOs or ISOs while others are working hard to establish RTOs in their regions. We have long endorsed the basic notion that coordination of transmission can have positive benefits for consumers. However, we understand that every region may have very different needs and problems. As such, we would strongly urge that the formation of RTOs proceed carefully, and without a “one-size-fits-all” approach.

Regional efforts to form RTOs and ISOs underway at this time should be recognized and the efforts made should be built upon. While the LPPC is not necessarily opposed to the concept of four large RTOs currently being advocated by FERC, this should not be the first step. We should not let the perfect be the enemy of the good. Creating RTOs over large geographic areas multiplies the complexities and has the real potential of slowing progress. We believe that the advances made on a smaller scale should be recognized and those efforts continued. It may be possible, at some later time, to build upon these efforts and create larger scale transmission systems. The LPPC believes that regional modeling should be done to assess the impacts of the creation and development of RTOs on the transmission grid. As the transmission grid is regionalized, an evaluation of the lessons learned should be done so that reliability is ensured and the potential benefits are maximized.

As our members participate in the development of RTOs and ISOs, our unique constraints have come into play. For example, my company, MEAG Power has participated in the discussions on a southeast RTO—“SeTrans.” Since we have an obligation under state statute to serve our native load, our participation in SeTrans was predicated on an ability to preserve the capacity necessary to provide power to these customers. Through negotiations, we believe we will be able to grandfather in our native load obligations and obtain recognition of our pre-existing transmission rights. In addition, under proposed SeTrans policies, we would not be required to curtail our native load unless all other mitigation measures have been attempted. This will allow us to fulfill our obligations to our customers imposed by state law. However, the same solution would not work for all public power entities. Unfortunately, recent actions at FERC may undercut the voluntary efforts underway in many regions, e.g., the SeTrans RTO proposal in the southeast, that are designed to accommodate public power.

In addition, public power systems face difficult issues in participating in RTOs. These must be addressed before a national system of RTOs can be put into place. As noted earlier, private use restrictions present a barrier for participation by public power systems. Furthermore, many public power entities operate under additional legal and operational requirements that affect their ability to participate in the ownership of an RTO or to transfer ownership or operations of their transmission facilities to an RTO. These requirements include provisions in state constitutions, state and local laws, and bond covenants that vary from system to system. For these reasons, the LPPC believes that the voluntary regional efforts undertaken by the industry should be used and built upon, since through these negotiations efforts have been made to accommodate the unique characteristics and legal requirements of public power.

The legal restrictions on public power and its participation in RTOs varies from state to state. Some states, such as Georgia, restrict the use of public funds while others limit the ability of public entities to associate with for-profit entities. Still other states specifically authorize public power entities to join with other public entities in the ownership and operation of electric transmission facilities. Attached to my testimony is a matrix that highlights some of the state and local requirements applicable to LPPC member systems which might affect their ability to participate in an RTO. What this illustrates is that a one-size-fits-all approach cannot feasibly address the myriad of issues that confront public power and its participation in RTOs.

CONCLUSION

As the Subcommittee continues to move forward with electricity legislation, the LPPC offers our continued assistance. We would be happy to work with the Subcommittee and its staff to properly tailor FERC transmission jurisdiction to the unique structures and responsibilities of public power systems, ensure market power and merger protections for consumers, and retain the appropriate level of flexibility for FERC as it approves new RTOs. However, I must again stress that any comprehensive electricity legislation must meaningful private use relief—either in the same bill or in companion legislation from the tax committee—in order to be workable.

We look forward to working with the Committee to develop comprehensive electricity legislation that addresses our concerns, garners wide support and can ultimately be enacted. I will be happy to answer any questions you have.

Examples of State and Local Legal Requirements for Public Power Participation in Ownership of an RTO

Chelan County, Public Utilities District No. 1.	<p>Wash. Const. art. VIII, § 7 provides that no county, city, town, or other municipal corporation shall give any money or property, or loan its money or credit to or in aid of any individual, association, company or corporation, or become directly or indirectly the owner of any stock in or bonds of any association, company or corporation.</p> <p>Wash. Rev. Code § 54.16.040 allows a PUD to purchase, maintain, conduct, and operate transmission lines within or without its limits, for the purpose of furnishing the district's inhabitants and any other persons, including public and private corporations, within or without its limits, with electric current for all uses.</p> <p>Wash. Rev. Code § 54.16.090 allows a PUD to enter into any contract or agreement with the U.S., or any state, municipality, or other utility district; or with any cooperative, mutual, consumer-owned utility; or with any investor-owned utility; or with an association of any such utilities, for carrying out any of the powers authorized by Wash. Rev. Code Title 54.</p> <p>Wash. Rev. Code 54.12.010 prohibits unlawful delegation of Commission authority; case law requires needs of local ratepayers to be addressed.</p>
Colorado Springs Utilities	<p>Colo. Const. art. XI, § 1 forbids a city to lend or pledge its credit or faith, directly or indirectly, in any manner to any person, company, or corporation, public or private, for any purpose whatever; or become responsible for any debt, contract, or liability of any person, company, or corporation, public or private, in or out of the state.</p> <p>Colo. Const. art. XI, § 2 prohibits a city from becoming a shareholder in any corporation or company or joint owner with any person, company, or corporation, public or private, in or out of state; but a city is not prohibited from becoming such a shareholder or joint owner to effect the transmission of energy in whole or in part for the benefit of the inhabitants of such city.</p> <p>Colo. Rev. Stat. § 31-15-707(1) allows a city to acquire electric light and power works and distribution systems and all appurtenances necessary to any of said works or systems, or to authorize the erection, ownership, operation, and maintenance of such works and systems by others, subject to voter approval, municipal bond and financing requirements, and a condition that allows the city to purchase and condemn such works or systems.</p> <p>CS Charter 6-70 restricts participation unless in the ordinary course of business.</p> <p>CS Bond Ord. 8-14 restricts participation unless in the normal course of business.</p>
JEA	<p>Fla. Const. art. VII § 10 generally prohibits a municipality, county, special district, or agency of any of them to become a joint owner with, or stockholder of, or give, lend or use its taxing power or credit to aid any corporation, association, partnership or person; but it does not prohibit laws authorizing such entities from becoming a joint owner of, giving, or lending or using its taxing power or credit for the joint ownership, construction and operation of electrical energy generating or transmission facilities with any corporation, association, partnership, or person.</p> <p>Fla. Stat. Chap. 163 & 361 authorize joint power projects among utilities, public and private, domestic and foreign, subject to restrictions that the right to full possession and to all of the use, services, output, and capacity of any such project during the estimated useful life thereof be vested, subject to creditors' rights, in the entity created pursuant to Chapter 163 or 361. Under local law and charter, may need City Council approval.</p> <p>Bond covenants prohibit adverse effect on revenues.</p>

Examples of State and Local Legal Requirements for Public Power Participation in Ownership of an RTO—
Continued

Los Angeles Department of Water and Power.	<p>Cal. Const. art. 16, § 6 prohibits any political subdivision of the state to give or lend credit in aid of or to any person, association or corporation, whether municipal or otherwise, in any manner whatever, for the payment of the liabilities of any individual, association, municipal or other corporation whatever; it also prohibits the legislature from authorizing the state or any political subdivision thereof to subscribe for stock or become a stockholder in any corporation whatever.</p> <p>L.A. City Admin. Code §§ 23.129 & 23.132 require City Council approval.</p> <p>L.A. City Charter §§ 219.4 & 390 require City Council approval.</p>
Lower Colorado River Authority	<p>Texas Const. art. 3 prohibits a public utility from owning or acquiring stock in a corporation or from owning an interest in a partnership or joint venture (except with respect to electric generating facilities with other utilities).</p> <p>Bond covenants require LCRA Board of Directors to retain authority to adjust rates to assure that LCRA can meet its debt service and coverage requirements; no prejudice to bondholder rights.</p>
Municipal Electric Authority of Georgia.	<p>Ga. Const. art. IX, § 11, ¶ VIII prohibits any county, municipality, or other political subdivision of Georgia, through taxation, contribution, or otherwise, to appropriate money for or to lend its credit to any person or to any nonpublic corporation or association except for purely charitable purposes.</p> <p>Ga. Code Ann. § 46-3-126(5) authorizes MEAG to acquire electric transmission lines by purchase or otherwise, either as owner of all or of any part in common with others or as agent, and to purchase or construct part of the capacity of transmission projects sponsored and owned by or in common with others, and to transmit power both for itself and on behalf of others.</p> <p>Ga. Code Ann. § 46-3-126(7) authorizes MEAG to exercise any one or more of the powers, rights, and privileges conferred in the section either alone or jointly or in common with one or more other parties or utilities, whether public or private. MEAG is authorized to own an undivided interest in transmission facilities with any other parties, whether public or private, and to enter into agreements with the other parties regarding the construction, operation and maintenance of such transmission facilities by any one or more of the parties to the agreement acting as agent for the others.</p> <p>Ga. Code Ann. § 46-3-127 prohibits MEAG from constructing or operating any project for profit except insofar as such profit will inure to the benefit of the public.</p>
Nebraska Public Power District	<p>Neb. Const. art. XI § 1 prohibits a city, county, town, precinct, municipality or other subdivision of the state from ever becoming a subscriber to the capital stock, or owner of such stock, or any portion or interest therein, of any private corporation or association.</p> <p>Neb. Const. art. XIII § 3 prohibits the credit of the state's political subdivisions from ever being given or loaned in aid of any private individual, association, or corporation.</p> <p>Affirmative and restrictive bond covenants covering, among other things, rate setting and compensation, revenue requirements, standards for contract or property transfer approval based on interests of NPPD and bondholders, use of proceeds or payments, and preserving the bonds' income tax exemption.</p> <p>Cannot delegate or surrender statutory authority to FERC or submit to its jurisdiction voluntarily.</p> <p>Can participate in a public RTO but only by agreement authorized under Nebraska Interlocal Cooperation Act (Neb. Rev. Stat. § 13-801 et seq.) or Joint Exercise of Powers statutes (Neb. Rev. Stat. § 70-628.01-628.04). Cannot delegate or surrender statutory duties and elected governing board powers to governing board of public RTO controlled by private persons.</p>
New York Power Authority	<p>N.Y. Pub. Auth. Law § 1005(11) requires that participation in an RTO be necessary or convenient for carrying on the Authority's business; possible restrictions in bond covenants based on permissible investment criteria.</p>

Examples of State and Local Legal Requirements for Public Power Participation in Ownership of an RTO—
Continued

Omaha Public Power District ..	<p>Neb. Const. art. XI § 1 prohibits a city, county, town, precinct, municipality or other subdivision of the state from ever becoming a subscriber to the capital stock, or owner of such stock, or any portion or interest therein, of any private corporation or association.</p> <p>Neb. Const. art. XIII § 3 prohibits the credit of the state from ever being given or loaned in aid of any individual, association, or corporation.</p> <p>Neb. Rev. Stat. § 70-601(1) defines “district” to be public entities organized within Nebraska.</p> <p>Neb. Rev. Stat. § 70-649 allows any public power district to sell to any public power district, public power and irrigation district, irrigation district, city or village, any power plant, electric generating plant, electric distribution system, or any parts thereof, for such sums and under such terms as its board of directors may deem fair and reasonable.</p> <p>Neb. Rev. Stat. § 70-628.01 allows any district that is interested in the operation of power plants, distribution systems, or transmission lines of ethanol production or distribution facilities, either alone or in association with another district or districts, may sell, lease, combine, merge, or consolidate all or a part of its property with the property of any other district or districts with the approval of a majority of the board of directors of each district involved.</p> <p>Neb. Rev. Stat. §§ 70-625 gives a public power district all the usual powers of a corporation for public purposes and authorizes it to purchase, hold, sell, and lease personal property and real property reasonably necessary for the conduct of its business, subject to any limitations in the petition for its creation.</p> <p>Neb. Rev. Stat. §§ 70-628.01-.03 authorizes a public power district to exercise its powers either alone or jointly with other districts, municipalities and public agencies, and electric cooperatives and electric membership corporations within or outside the state.</p> <p>Neb. Rev. Stat. § 70-628.04 authorizes any public power district participating jointly and in cooperation with others in an electric transmission facility to enter into agreements with the other participants, including provisions for the construction, operation, and maintenance of such facility and allocation of resulting costs among the participants.</p>
Orlando Utilities Commission	<p>Fla. Const. art. VII § 10 generally prohibits a municipality, county, special district, or agency of any of them to become a joint owner with, or stockholder of, or give, lend or use its taxing power or credit to aid any corporation, association, partnership or person; but it does not prohibit laws authorizing such entities from becoming a joint owner of, giving, or lending or using its taxing power or credit for the joint ownership, construction and operation of electrical energy generating or transmission facilities with any corporation, association, partnership, or person.</p> <p>Fla. Stat. Chap. 163 & 361 authorize joint power projects among utilities, public and private, domestic and foreign, subject to restrictions that the right to full possession and to all of the use, services, output, and capacity of any such project during the estimated useful life thereof be vested, subject to creditors’ rights, in the entity created pursuant to Chapter 163 or 361. Under charter, may need City Council approval.</p> <p>Bond covenants prohibit adverse effect on revenues.</p>
Sacramento Municipal Utility District.	<p>Cal. Const. art 16, § 6 prohibits a political subdivision of the state from lending or pledging its credit, in any manner, for the payment of the liabilities of any individual, association, municipal or other corporation, or from making a gift of any public money or thing of value to any individual, municipal, or other corporation.</p> <p>Cal. Const. art 16, § 6 prohibits a political subdivision of the state from subscribing for stock, or becoming a stockholder in any corporation.</p> <p>Cal. Pub. Util. Code § 12801 allows a municipal utility district to acquire, construct, own, operate, control or use, within or without the district, works or parts of works for supplying the inhabitants of the district and public agencies therein, or some of them, with light, water, power, and heat.</p>
Seattle City Light	<p>Wash. Const. art. VIII, § 7 provides that no county, city, town, or other municipal corporation shall give any money or property, or loan its money or credit to or in aid of any individual, association, company or corporation, or become directly or indirectly the owner of any stock in or bonds of any association, company or corporation.</p> <p>Wash. Rev. Code 35.92.052 provides cities owning their own electric utilities to enter into agreements with investor-owned utilities, cooperatives, public utility districts, other cities, and agencies of the United States for the undivided ownership of transmission and generation facilities, so long as the city is not severally liable for actions of the other participants and so long as the city assumes no larger share of the responsibility and expenses than its proportionate ownership share.</p>

Examples of State and Local Legal Requirements for Public Power Participation in Ownership of an RTO—
Continued

Snohomish County, Public Utilities District No. 1.	<p>Wash. Const. art. VIII, § 7 provides that no county, city, town, or other municipal corporation shall give any money or property, or loan its money or credit to or in aid of any individual, association, company or corporation, or become directly or indirectly the owner of any stock in or bonds of any association, company or corporation.</p> <p>Wash. Rev. Code § 54.16.040 allows a PUD to purchase, maintain, conduct, and operate transmission lines within or without its limits, for the purpose of furnishing the district's inhabitants and any other persons, including public and private corporations, within or without its limits, with electric current for all uses.</p> <p>Wash. Rev. Code § 54.16.090 allows a PUD to enter into any contract or agreement with the U.S., or any state, municipality, or other utility district; or with any cooperative, mutual, consumer-owned utility; or with any investor-owned utility; or with an association of any such utilities, for carrying out any of the powers authorized by Wash. Rev. Code Title 54.</p> <p>Wash. Rev. Code § 54.12.010 prohibits unlawful delegation of Commission authority; case law requires needs of local ratepayers to be addressed.</p>
Santee Cooper	<p>S.C. Const., art. X, § 11 prohibits the state or any of its political subdivisions from becoming a joint owner of or stockholder in any company, association or corporation; but the General Assembly can authorize Santee Cooper to become a joint owner with privately owned electric utilities, including electric cooperatives of electric generation or transmission facilities, or both, and to enter into and carry out agreements with respect to such jointly owned facilities.</p> <p>S.C. Const. art VIII, § 13 permits the sharing of lawful cost, responsibility and administration of functions with one or more governments whether within or without the state.</p>
Tacoma Public Utilities: Light Division.	<p>Wash. Const. art. VIII, § 7 provides that no county, city, town, or other municipal corporation shall give any money or property, or loan its money or credit to or in aid of any individual, association, company or corporation, or become directly or indirectly the owner of any stock in or bonds of any association, company or corporation.</p> <p>Tacoma City Charter § 4.1 allows the city to possess all powers granted to cities by state law to construct, purchase, acquire, add to, maintain, and operate, either within or outside its corporate limits, public utilities for supplying power to the municipality's inhabitants and to sell and deliver any of these utility services outside its corporate limits to the extent permitted by state law.</p> <p>Tacoma City Charter § 4.5 prohibits the use of revenues for purposes other than the necessary operating expenses of the utility, including interest on and redemption of the outstanding debt thereof, and making additions and betterments thereto and extensions thereof. The funds of any utility shall not be used to make loans to or purchase the bonds of any utility, department, or agency of the city.</p>

This document reflects preliminary analysis for discussion purposes only and is not intended to be a legal opinion with respect to any matter nor to indicate that all or part of the facilities of LPPC members are transmission facilities for purposes of FERC jurisdiction. Submitted with LPPC Comments on RTO Notice of Proposed Rulemaking, Docket No. RM99-2-000 (August 20, 1999).

Mr. BARTON. Thank you.

We have a series of two votes pending on the floor, and those are the only two votes for the day. We're going to hear from Mr. English, then we're going to recess to go vote, and then we will come back at approximately 2 p.m. to finish Mr. Gerken and Mr. Esposito and Mr. Trabandt and Mr. Travieso.

So, Mr. English, we're going to give you the last word for this session of the panel. And then we'll go vote and we'll come back and will start with Mr. Gerken.

STATEMENT OF GLENN ENGLISH

Mr. ENGLISH. Thank you very much, Mr. Chairman. I appreciate that.

As I think the members of this panel are well aware, the National Rural Electric Cooperative Association represents a 1,000 cooperatives, 46 States and 35 million consumers in those States. It is owned by those consumers.

Mr. Chairman, the National Rural Electric Cooperative Association supports the formation of large independent regional trans-

mission organizations if they're fully independent and properly designed and operated, minimizes market power and maximizes efficiencies. That's what we think the objectives of RTO should be.

Electric cooperatives expect and intend to be a part of RTOs that are established across this country. Of course, that would mean that the transmission that is a part of those RTOs would be under the FERC jurisdiction. And we have no objection to that.

Mr. Chairman, for that reason, NRECA see little reason for—to subject electrical cooperatives to additional Federal regulatory commission authority if, in fact, those cooperatives are a part of RTO.

We recognize that this would have a very heavy financial burden on those electric cooperatives and, of course, that would be on those consumer owners themselves.

As far as legislation is concerned, we appreciate the carry forward of the recognition of the importance of the relationship between the consumer and his duly elected board, and the ability of that board to carry out the intent of those consumers.

We are, however, somewhat puzzled by the insertion of section 206 of the Federal Power Act in applying that to the electric cooperatives. That seems to us to, in effect, take away what was given under the so-called FERC-lite provisions.

We're also extremely concerned about the fact that it appears we'd find ourselves with dual jurisdiction, two different Federal agencies directly us as to what we should do. First is the Rural Utility Service, and of course anyone that has a loan through Rural Utility Service, they have their own rules, regulations, mandates as to what must be done. Second would be any FERC jurisdiction, which could in the very likelihood at least on some occasion be contradictory to what we're being told with those agencies.

We think that if anything is done in this area, particularly as it applies to our assets and resources that may very well be under loan, that there should be something in the legislation that addresses that dual jurisdiction and requiring those two Federal agencies to work together to make sure that we don't find ourselves in that kind of a conflict.

Also, we believe that the States should retain their traditional jurisdiction over retail sales and electric distribution systems should not be subject to FERC jurisdiction. Particularly whenever you consider the fact that FERC does not have the resources nor does it have the experience to be able to address a number of these issues, many of which are engineer related.

So, we would strongly urge that careful consideration be given to the fact that any kind of retail sales, anything addressing the retail sales should remain with the States and should not be subject to FERC jurisdiction.

And also I would again make the point, Mr. Chairman, as I did earlier today, that unless the FERC is specifically targeted as to what their objectives are, that will do nothing except dilute the very limited resources that FERC already has and make them incapable of carrying out the responsibilities that are to be assigned to them.

We think the RTO's are extremely important. We think they need to be run right. We believe that everyone should have an equal chance to participate in those RTOs, and that's going to de-

pend on a very vigorous and very alert FERC, one that has the resources to do that job.

Thank you very much, Mr. Chairman.

[The prepared statement of Glenn English follows:]

PREPARED STATEMENT OF GLENN ENGLISH, CHIEF EXECUTIVE OFFICER, NATIONAL
RURAL ELECTRIC COOPERATIVE ASSOCIATION

INTRODUCTION

Chairman Barton and Members of the Subcommittee, I appreciate this opportunity to continue our dialogue on the restructuring of the electric utility industry. For the record, I am Glenn English, CEO of the National Rural Electric Cooperative Association, the Washington-based association of the nation's nearly 1,000 consumer-owned, not for profit electric cooperatives.

These cooperatives are locally governed by boards elected by their consumer owners, are based in the communities they serve and provide electric service in 46 states. The 35 million consumers served by these community-based systems continue to have a strong interest in the Committee's activities with regard to restructuring of the industry.

Electric cooperatives comprise a unique component of the industry. Consumer-owned, consumer-directed electric cooperatives provide their member-consumers the opportunity to exercise control over their own energy destiny. As the electric utility industry restructures, the electric cooperative will be an increasingly important option for consumers seeking to protect themselves from the uncertainties and risks of the market. I would like to thank you, Mr. Chairman, and Members of the Committee for your receptiveness to the concerns and viewpoints of electric cooperatives.

REGIONAL TRANSMISSION ORGANIZATIONS

NRECA supports the formation of large, independent Regional Transmission Organizations or RTOs for all transmission owners.

RTOs, if fully independent and properly designed and operated, can substantially mitigate the ability of transmission owners that also own generation to influence the market for electric energy and to potentially discriminate against competitors. Because an effective RTO can operate the transmission system on a regional basis to maximize efficiencies, it can also significantly improve reliability and reduce the potential for power market instability that can lead to price spikes.

NRECA has supported the formation of RTOs in a number of ways. NRECA submitted comments to the FERC in the rulemaking that resulted in Order No. 2000, and, in fact, FERC adopted several of NRECA's recommendations. NRECA representatives attended each of the Commission's five regional collaborative meetings during 2000 and facilitated presentations made by individual cooperatives at those meetings. NRECA also successfully facilitated voluntary RTO informational filings by cooperatives even though the Commission's regulations did not require most cooperatives to make such filings. Finally, NRECA and cooperatives in the southeastern United States have been very active in the ongoing FERC mediation that is seeking to establish a single, large Southeast RTO.

For cooperatives to fully participate in RTOs as they clearly wish to do, and in order for properly formed RTOs to develop, the following issues are of critical importance:

Full Recovery of Transmission Revenue Requirements. Transmission-owning cooperatives must obtain full, immediate recovery of their revenue requirements from an RTO if they agree to commit their facilities to the functional control of that RTO, as contemplated by Order No. 2000.

Comparable Inclusion of Transmission Facilities. Some transmission-owning cooperatives have had difficulty getting their transmission facilities accepted for operation/cost recovery by a future RTO on the same basis as investor-owned utilities during the RTO formation process. Those IOUs opposing inclusion of cooperative transmission facilities point to the radial, load serving nature of these facilities as a reason for excluding them, overlooking the fact that they own comparable facilities that are included in their FERC-regulated transmission revenue requirements. Cooperatives therefore favor the use of a single, consistent standard to govern the RTO's functional control of all transmission facilities, regardless of the owner.

Grandfathered Contracts. Many cooperatives have substantial contractual arrangements with neighboring transmission providers. These contracts take many forms: some are among joint transmission owners, others deal with provision of both generation and transmission, and some are transmission-only agreements (both pre-

and post-Order No. 888). Whatever their content and form, these contracts are vital to sustaining the cooperative's ability to provide on-going service to their own member-owners. Transmission-owning cooperatives will not be able to join an RTO unless they have assurances that such contractual rights will not be severed without their consent. Similarly, transmission-dependent cooperatives cannot lose access to the transmission facilities needed to serve their member loads.

Regulation by the Rural Utilities Service. Many cooperatives have substantial loans from, and, as a result, are substantially regulated by the Rural Utilities Service (RUS) of the U.S. Department of Agriculture. The Commission must take RUS regulation into account and coordinate with RUS to ensure that when cooperatives seek to join RTOs, inconsistent, inefficient regulation of cooperatives by these two federal agencies does not occur.

85-15 Revenue Test. Cooperatives lose their tax-exempt status when more than 15 percent of their revenue is received from nonmembers. The Internal Revenue Service (IRS) has not clarified that, when a cooperative joins an RTO, the revenues received by the cooperative from the RTO will not be deemed to be nonmember income for purposes of the 85-15 revenue test. Congress must ensure that cooperatives can join RTOs without unintentionally violating their current not-for-profit tax status. NRECA appreciates the Chairman's effort to address the 85-15 issue in the September 21 discussion draft. That language, however, is inadequate to solve the problem and permit cooperatives to participate in RTOs. Since the September 21 discussion draft addresses tax issues, it should incorporate the provisions in H.R. 1601.

Cost Shifting. RTO transmission rates and tariffs should (a) mitigate cost shifting and take into account the specific needs and characteristics of each affected region, including costs of operation, debt, and other expenses; (b) use the same effective return-on-investment to all participating transmission owners; and (c) recognize the goal of establishing a single non-pancaked rate structure applicable to all customers.

RTO Market Power. As transmission service remains a monopoly, and as individual RTOs assume control of larger transmission systems than individual transmitting utility owners, RTOs will possess unprecedented market power. In this context, a badly governed and operated RTO may be worse than no RTO at all. Thus, the monopoly status of an independent RTO must be acknowledged at the outset, and the RTO's transmission rate structure and associated cost-of-service should be developed using traditional cost-of-service ratemaking principles. RTOs should not be eligible for "incentive ratemaking," "performance-based ratemaking" or "light-handed regulation" that would have the effect of increasing rates to transmission customers without concomitant benefits or reducing independent regulatory oversight of such an RTO's activities.

Collaborative Process. The Commission has sought to encourage RTO forming public utilities to actively collaborate with cooperatives in order to accommodate their needs as consumer-owned entities. Unfortunately, in numerous instances collaboration has been nothing more than a thinly disguised effort of saying, "take it or leave it." For cooperatives to effectively join RTOs, public utilities must be required to meaningfully collaborate with cooperatives beginning with the earliest stages of RTO formation efforts. The Commission should not fail to act when informed of RTO formation efforts that exclude cooperative participation.

An NRECA member-approved resolution stating its conditional-support for RTO formation is attached hereto for the Committee's convenience and reference.

OPEN ACCESS AND FEDERAL JURISDICTION

NRECA opposes efforts to subject electric cooperatives to the jurisdiction of FERC. That expansion of jurisdiction would unnecessarily impose heavy financial burdens on electric cooperatives and their consumer-owners.

NRECA also opposes efforts to move jurisdiction over retail sales and the distribution system from the states, where that jurisdiction properly lies, to FERC. FERC lacks the experience and resources to regulate retail service and the distribution system, as well as the capacity to address the important state and local interests that are inherent in retail electric service.

NRECA, however, sincerely appreciates the Chairman's efforts in the 106th Congress to limit the expansion of FERC jurisdiction over electric cooperatives. NRECA looks forward to working further with the Chairman and the Committee to resolve any concerns they may have about FERC's role in a manner that minimizes the adverse impacts on cooperatives and their consumer-owners.

Expansion of FERC Jurisdiction over Cooperatives with Transmission Is Unnecessary

Proponents of expanded FERC jurisdiction argue that all transmission owners, including cooperatives, must be subject to the same regulatory scheme if they are to

move power efficiently across the grid. In fact, however, sellers of electric energy can move power across electric cooperative lines.

In the Energy Policy Act of 1992 (EPAct), Congress amended § 211 of the Federal Power Act to require electric cooperatives and other transmitting utilities to provide non-discriminatory transmission service to any eligible entity that requests service. In the event the eligible entity is unsatisfied with the service or price offered, § 211 allows that entity to petition FERC for an order requiring the transmitting utility to provide service.

Moreover, FERC's Order No. 888 requires all public utilities to provide transmission service under a pro forma tariff that includes a "reciprocity" provision. That provision permits a public utility to deny a transmitting utility open access transmission service unless the transmitting utility offers to provide the public utility equivalent transmission services in return.

EPAct and FERC's Order 888 reciprocity requirements have proven extremely effective in opening up the entire transmission grid. Any eligible entity can obtain transmission service from electric cooperatives as easily as they can from any public utility, under comparable terms.

Moreover, cooperatives simply are not large enough in most instances to pose a barrier to open markets. Whereas only 19 of the 166 independently-owned public utilities subject to Order 888 qualify as small utilities,¹ all but 26 of the nearly 1000 rural electric systems qualify as small utilities under that definition. Of those 26, four own no transmission lines at all.

To put it in perspective, FERC logically should have a more significant role regulating larger electric utilities such as Entergy—whose subsidiaries own and operate more than 14,000 miles of transmission line and sell more than 97,000,000 MWH to more than 2,400,000 metered accounts—than it should have regulating Hickman-Fulton Counties Rural Electric Cooperative— which owns 1 mile of transmission line, and sells less than 120,000 MWH per year to fewer than 4,000 member-owners.

Congress Should Not Subject Electric Cooperatives to Expanded FERC Jurisdiction Under § 206 of the Federal Power Act

Until recently, proposals to expand FERC jurisdiction over cooperatives were intended to subject all transmission facilities to the same rules. Those proposals would ensure that cooperatives provided open access to their transmission facilities at rates that were comparable to what they charged themselves.

§ 702 of the September 21 discussion draft goes far beyond that baseline. § 702 would subject all transmission service and all wholesale sales made to public utilities to FERC review and regulation under § 206 of the Federal Power Act.

H.R. 2944, the Electricity Competition and Reliability Act, as passed by the Energy and Power Subcommittee in the 106th Congress, included language to expand FERC's jurisdiction over transmission-owning cooperatives² based on a comparability standard. Specifically, the language would have authorized FERC to review the rates a transmission-owning cooperative charges its members against those it charges to non-cooperative members to ensure the rates are comparable. If the rates are not comparable, they would be remanded to the transmission-owning cooperative for revision. In this manner, the transmission-owning cooperative is allowed to maintain control of the ratesetting function, which is key to our consumer-members. The comparability standard along with the small electric utility exemption is known as "FERC lite".

Unfortunately, the September 21 discussion draft emasculates FERC lite. § 201 creates the *veneer* of establishing the comparability standard as the basis for expanding FERC jurisdiction over transmission-owning utilities. Upon close analysis, however, § 702 of the discussion draft nullifies the comparability concept that was incorporated in § 201 of the discussion draft. Under this section, rather than review cooperative transmission rates under a comparability standard, FERC would subject cooperative transmission rates to a full review under the just and reasonable standard. Rather than remand rates to boards of directors elected by cooperatives member-consumers, FERC would set the rates itself at whatever level FERC considers appropriate.

In addition to emasculating FERC lite, § 702 would also, for the first time, subject cooperatives' wholesale rates to FERC review and regulation. At a time when Congress and FERC are seeking to move towards a competitive wholesale market for electric energy, § 702 would move in the opposite direction, increasing the regulatory burden on electric cooperatives that seek to sell power in the wholesale market.

¹ FERC Stats. & Regs. ¶ 31,036, at 31,897 (citing to the Small Business Administration definition of a small utility that is a utility that sells 4 million megawatt hours or less per year).

² Transmission-owning cooperatives that have RUS loans and loan guarantees.

NRECA recognizes that some entities have abused those markets. They have exercised their market power to raise the cost of electricity. § 702 does not address those abuses.

Electric cooperatives have not been part of the problem. Not-for-profit electric cooperatives have not gamed markets, they have not abused consumers, and they have not exercised market power. It would be impossible for them to have done so. Cooperatives do not own enough generation and are not large enough players in electric markets to exercise market power. All together, electric cooperatives generate only about 5% of the electric power in the country, which is less than half of the power they need to serve their own consumers. All combined, electric cooperatives' sales to public utilities represent less than 1% of all sales in the wholesale market.

H.R. 2944 recognized the substantial differences between not-for-profit consumer-owned electric cooperatives and investor-owned utilities, and made an effort to accommodate those differences; § 702 ignores those differences.

Expansion of FERC Jurisdiction to Cooperatives with Transmission Would Subject Cooperatives to Expensive Duplicative Regulation

If FERC jurisdiction were expanded, electric cooperatives would be subject to unnecessary, duplicative, and possibly contradictory regulatory obligations.

First, all electric cooperatives are regulated by their customers. Cooperatives are not-for-profit and are owned by the consumers they serve. They are governed by boards of directors composed solely of consumer-owners, who are themselves chosen by the consumer-owners of the cooperative in open elections. The tradition of local ownership and control and democratic governance runs deep. And, because cooperatives are not-for-profit companies that are directly responsible to their consumers, all but fourteen States have delegated their power to set and regulate rates to the cooperatives' boards of directors.

Second, even those electric cooperatives that have outstanding RUS loans or loan guarantees are subject to significant regulation by FERC. As explained above, RUS borrowers with transmission facilities are subject to § 211 of the FPA. RUS borrowers must provide non-discriminatory transmission service on request, and are subject to FERC wheeling orders where disputes arise. RUS borrowers are also subject to the reciprocity requirements in FERC's Order No. 888 and 889.

Third, RUS borrowers are subject to pervasive regulation by RUS, pursuant either to RUS regulations or to the loan document that RUS borrowers must sign to obtain loans or loan guarantees. RUS regulation ranges the gamut: restrictions on depreciation rates, standards and specifications for electric system construction, uniform system of accounts, required standard contract forms, mandated competitive procurement procedures, merger review, credit management, and a myriad of additional topics—even intervention in the choice of senior managers for borrowers in financial difficulty. In all, RUS regulations cover more than 800 pages in the Code of Federal Regulations. Moreover, other RUS mandates are contained in hundreds of extant "REA Bulletins" covering most categories of electric system construction and daily operation.

If FERC's full Federal Power Act (FPA) jurisdiction were expanded over transmitting utilities, RUS borrowers would be subject to several more levels of regulation than any investor-owned utilities. RUS borrowers could also be subject to conflicting requirements from different agencies. For example, both RUS and FERC would have the authority over cooperatives' transmission rates, accounting systems, and record keeping methods. Depending on how broadly FERC's jurisdiction was expanded, both agencies could also have authority over cooperatives' mergers and asset transfers, transmission maintenance procedures, and investments in new transmission facilities.

That duplicative authority would raise costs and increase regulatory uncertainty for cooperatives, make it more difficult for cooperatives to react quickly to changes in the competitive market, and handicap cooperatives compared to public utilities, which do not face duplicative regulatory obligations.

FERC Lacks the Resources to Address Expanded Jurisdiction over Cooperatives

FERC has insufficient resources today effectively to meet its current regulatory obligations. In light of the limits on its resources, it is hard to imagine how FERC could effectively handle an expansion of its jurisdiction and authority. According to the last FERC Annual Report containing such numbers (1996 report), FERC regulates about 370 public utilities. Depending on the manner in which FERC defines "transmission", extending FERC jurisdiction over transmitting entities could add more than 450 cooperatives and many municipal systems. The number of FERC-regulated entities could more than double.

In other words, FERC would become stretched even thinner. Under such circumstances, the amount of abuse in the market would be certain to increase dramatically. The holes in the regulatory net would become so large that utilities could conclude the chance of getting caught in wrongdoing would be so remote as to pose no barrier. Thus, instead of enhancing the competitive market, expansion of FERC jurisdiction could severely handicap it, putting consumers at substantial risk.

FERC Lacks the Capacity to Regulate the Distribution System and Retail Services

Several proposals for electric legislation would: (a) grant FERC the responsibility for establishing standards for the interconnection of distributed generation to the distribution system; (b) mandate net metering for some consumer-owned generation; (c) establish principles for setting rates for retail energy service to consumers with distributed generation; and (d) grant consumers, subject to FERC regulation, the right to sell power they choose not to use ("negawatts") to third parties.

NRECA opposes the federalization of these issues for several reasons. First, electric cooperatives own 44% of the nation's distribution system. Much of these distribution systems are located in rural areas where the population density is low, averaging less than 6 consumers per mile. As a result, the revenue generated in these areas is extremely low, averaging approximately \$7,000 per mile. Net metering and distributed generation interconnection programs, for instance, if formulated and implemented without a strong sensitivity and appreciation for local conditions would lead to increased electricity costs for consumers in rural areas that could least afford to pay them.

Second, electric cooperatives have obtained \$36.4 billion in RUS financing. As a result of this financing, RUS must approve the rates and practices of distribution cooperatives and cooperatives that own generation and transmission. Negawatt and net metering programs and distributed generation interconnection standards have a direct impact on these rates and practices; however, they are being federalized without any role for RUS. This will create significant problems for cooperatives.

Third, these issues have traditionally been the responsibility of states and local regulatory bodies. Moving these issues to the federal level makes it more difficult, or in some cases impossible, for states and local regulators to protect the public interest.

Policy decisions with respect to retail electric and distribution services can have tremendous impact on local standards of living and economies. It is important, therefore, for state and local regulators to be able carefully to balance local interests and to craft tightly focussed regulations of retail electric and distribution services that meet local needs. Moving responsibility over these issues away from the local community to the federal level makes it less likely that regulatory decisions will reflect local needs or protect local interests. Moving responsibility over these issues away from the local community to the federal level also makes it harder for utilities to provide reliable, universal electric service at a reasonable cost.

The "negawatts" proposal embedded in § 104 of the September 21 discussion draft is a perfect example of the risks of federalization. At the federal level, the proposal is attractive because it appears that it would create a more liquid regional wholesale market. At the local level, however, it is clear that the proposal could cause significant price increases for retail consumers served by the same utility as a few very large industrial consumers who resell their power. It could also cause significant economic disruption in that community when industries choose to sell power and lay-off the workers no longer needed to work on idled production lines. State and local regulators are more likely to be sensitive to those kinds of concerns than federal regulators.

Moreover, NRECA does not believe that FERC has the experience or the resources to regulate effectively matters relating to retail electric or distribution services. Over more than 65 years, FERC and its predecessor, the Federal Power Commission (FPC), regulated wholesale sales and transmission service. FERC has never established technical standards for the interconnection of generation at the transmission level, and it has never had any experience whatsoever regulating retail services or distribution systems. FERC does not employ today a single distribution engineer. Further, as discussed above, FERC is experiencing difficulty meeting its existing responsibilities today with its limited resources. Multiplying FERC's responsibilities by giving it new jurisdiction over retail and distribution services would spread FERC's limited resources even more thinly to the detriment of both wholesale and retail consumers.

Mr. BARTON. We thank you. When we come back, we'll start with Mr. Gerken. We're in recess until approximately 2 p.m.

[Brief recess.]

Mr. BARTON. The subcommittee will come to order.

The pending business before us is the hearing on RTOs and transmission policy for the electricity industry. We had heard from Mr. English, we now want to hear from Mr. Gerken as soon as everybody gets settled. It looks like they're about settled.

Your statement's in the record. You're recognized for 5 minutes.

STATEMENT OF MARC S. GERKEN

Mr. GERKEN. Good afternoon, Mr. Chairman and members of the subcommittee. I am Marc Gerken, President of American Municipal Power-Ohio in Columbus, Ohio. I am testify today on behalf of AMP-Ohio and TAPS.

AMP-Ohio is a wholesale power supplier and service provider for 84 municipal power systems throughout Ohio, Pennsylvania and West Virginia.

TAPS is an association of transmission dependent utilities and other supporters of nondiscriminatory transmission access and vigorously competitive wholesale electric markets. For more than 16 years AMP-Ohio has been involved in a competitive purchase and delivery of wholesale power as an aggregator for municipal electric systems. As an active participant in the Midwest wholesale market, AMP-Ohio has experienced both benefits of competition and the limitations of the current market structure.

The topic of today's hearings, RTOs, open access and transmission jurisdictions are key to achieving an effective wholesale competition and its intended purpose meeting consumer benefits. And I stress the consumer benefit part. Compromise on these issues will do far more harm than good.

AMP-Ohio operates in five different transmission control areas today that will be part of RTOs, the Alliance RTO, the Midwest ISO and the PJM RTO, that'll be PJM West. Not only are there competing RTO proposals, but transmission owners are playing RTO musical chairs, hoping from one RTO into another created a checkerboard system with potential holes and inconsistencies. These kinds of behaviors do not advance the development of large independent rationally scoped RTOs, which TAPS believes are essential to a competitive market.

TAPS applauds FERC Chairman Pat Wood's recent statements and efforts to ensure proper RTO formation. Despite this important development, Federal legislation is still needed to clarify and affirm FERC's authority to move forward with this new organized scheme.

Absent congressional affirmation, more aggressive FERC action is likely to get mired in litigation, therefore with regards to RTOs TAP would urge Congress to do three things.

Affirm FERC's authority to require jurisdictional utilities to participate in an RTO to remedy undue discrimination, and as Chairman Woods also proposes, generic condition for market based authority and merger approval.

Second, authorize FERC to require transmission owning Federal utilities to participate in an RTO if needed to remedy undue discrimination.

And last, authorize FERC to order RTO participation by municipal and cooperative utilities upon finding that the transmitting utility has engaged in undue discrimination in the provisions of

transmission, and that open access tariffs are unlikely to remedy this problem.

On the question of FERC jurisdiction over transmission, TAPS believes that for the electricity competition to be successful it is essential that FERC have authority to establish one set of rules for the use and operation of the Nation's interstate transmission system. Somewhat like Mr. Flynn mentioned, think what pandemonium would occur if the interstate highways posted two different speeding limits for passenger cars. A higher limit for interstate in-state cars and a lower rate for out of State cars. Go on farther and think how many crashes or congestions would occur if the State established a different regime for in-state cars to switch lanes, maybe you don't have to turn your turn signal on, versus the out of State cars. Or think what would happen if a State would mandate that out of State vehicles pull over to the shoulder during rush hours so that in-state vehicles could pass. You cannot have multiple inconsistent systems for use of an interstate transportation system, it won't work; yet this is precisely what the divided transmission authority allows.

Some have suggested that the current split jurisdiction assures reliability to the transmission owner's native load. Our view is that it has the potential to subject native load customers of other utilities to less reliable and more expensive service. We do not see this as the State versus Federal issue, rather it is a State versus State, consumer versus consumer issue. And FERC is the only entity that can ensure open fair nondiscriminatory and reliable service to all.

TAPS urges Congress to recognize in the legislation that there can be only one set of rules for all users of the transmission network, and those rules need to be set by FERC. And subsequently, TAPS support FERC jurisdiction over transmission use for bundled as well unbundled retail sales and also FERC jurisdiction over the terms and conditions of service over municipal cooperative system transmission systems subject to the FERC-lite provisions.

TAPS looks forward to working with the subcommittee. And I appreciate it, and I look forward to your questions.

[The prepared statement of Marc S. Gerken follows:]

PREPARED STATEMENT OF MARC S. GERKEN ON BEHALF OF THE TRANSMISSION
ACCESS POLICY STUDY GROUP

Good afternoon, Mr. Chairman and Members of the Subcommittee. My name is Marc Gerken. I am President of American Municipal Power-Ohio in Columbus, Ohio.

AMP-Ohio is a nonprofit wholesale power supplier and services provider for municipal electric utility systems, including 79 of Ohio's 85 community-owned electric utilities, three in Pennsylvania and two in West Virginia. Ohio municipal electric systems account for approximately six percent of the retail electric sales in Ohio, serving about 360,000 meters statewide. Our organization has 186 employees, and operating revenues of more than \$228 million. Our members receive their power supply from a diversified resource mix, including: wholesale power purchases through AMP-Ohio and on the open market; energy produced at the 213-megawatt, coal-fired Richard H. Gorsuch Generating Station owned and operated by AMP-Ohio; individual community-owned generation facilities; and municipal generation joint ventures such as the 42-megawatt Belleville Hydroelectric Project and the 157-megawatt OMEGA JV2 distributed generation.

Ohio's municipal electric systems do not own significant transmission facilities, and therefore are transmission dependent. In 2000, the non-coincidental peak for AMP-Ohio member communities was 1,793 megawatts. We operate in five different transmission control areas today that will be part of the Alliance RTO, Midwest ISO

and PJM RTO. Our energy control center has handled arrangements to move power across as many as 18 different transmission systems in one year.

I am here today to testify on behalf of the Transmission Access Policy Study Group (TAPS). TAPS is an association of transmission-dependent utilities and other supporters of equal, non-discriminatory transmission access to the nation's transmission grids and vigorously competitive wholesale electric markets. TAPS members are located in more than 30 states. (Let's attach list of members and map.) AMP-Ohio, and the other municipal, cooperative and investor-owned utilities and municipal joint action agencies that are members of TAPS, are transmission dependent utilities (TDUs). We must depend on the use of transmission systems of large vertically-integrated utilities in order to reach alternative sources of power supply for our consumers. TAPS members have been active in wholesale markets for some 20 years, and have been on the "bleeding edge" of efforts to obtain transmission service, open access, and RTOs. AMP-Ohio's 20-year involvement in the competitive purchase and delivery of wholesale power as an aggregator for our members gives us a full appreciation of the central role of open and non-discriminatory access to transmission in ensuring all consumers access to reliable service and for wholesale and retail competition to be a success.

TAPS has concluded that the only way to get to a competitive electricity industry is by restructuring the industry to provide the transmission and market structure needed to allow competitive forces to work. We believe federal legislation is needed to achieve this critical objective, but it must be the *right* legislation. To promote electricity competition and ensure reliable service to all consumers, we must all work together to get the basic infrastructure right. The subjects of today's hearing—RTOs, open access, and transmission jurisdiction—are key to achieving these important objectives. Compromise on the critical issues of industry structure will do far more harm than good.

Specifically, we believe that Congress should enact legislation to:

- Clarify FERC's authority to require participation in large, truly independent and rationally configured regional transmission organizations (RTOs), with full authority to operate the regional grid as well as to plan and expand it, or cause its expansion.
- Place regulatory responsibility for all transmission service—wholesale and retail, bundled and unbundled—clearly in FERC's hands (subject to "FERC lite" jurisdiction over the transmission owned by municipal and cooperative utilities).

1. FERC NEEDS AUTHORITY TO REQUIRE STRONG, INDEPENDENT, BROAD REGIONAL RTOS

Large, rationally configured, independent and robust regional transmission organizations, with exclusive authority to operate, plan and cause expansion of the grid, are key to getting the transmission infrastructure right. The current regimen of control of transmission by individual vertically-integrated utilities must change to be compatible with and support competitive markets. Regional transmission organizations are the structure needed in a competitive electric industry. As FERC correctly found in Order 2000, RTOs are required (1) to eliminate the continued opportunity (that exists notwithstanding Order 888's requirement of open access tariffs) for discriminatory transmission practices; and (2) to achieve efficient management of the grid and improve reliability.

Today, the grid remains largely in the hands of one set of market participants (vertically-integrated utilities or utilities with transmission subsidiaries) that can use that control—in ways often difficult to detect—to favor themselves. Even if the owner is not discriminating, that potential chills the market, as FERC has found. When curtailments are called or transmission service requests are denied, a doubt arises as to whether competitive considerations came into play.

AMP-Ohio has experienced denials of service and interruptions that are frankly inexplicable except as the result of the transmission owner's manipulation of the transmission system to advantage its own generation and sales and disadvantage a competitor. For example, on June 30, 1999, AMP-Ohio's request to transmit 20 MW from a member city was denied based on a claimed lack of available transmission capacity (ATC). A check of the ATC across the interconnection in the opposite direction showed no capacity in that direction either, in apparent defiance of the laws of physics. We were amazed that an interface could be fully loaded in both directions at the same time—one would think that some unloading would occur, even be encouraged, as opposing reservations or uses are made. Our skepticism about the accuracy of the transmission providers' claimed lack of ATC in both directions was increased by the fact that we had to replace the power we had sought to transmit with a \$4,000 per megawatt hour purchase—about 40 times the cost of generating our own power—from one of the transmission providers.

As a defense against such discriminatory interruptions and service denials that are both costly and threaten reliability, AMP-Ohio has undertaken an aggressive campaign to place 157 megawatts of small, distributed generation resources in our member communities. But this defensive action only highlights the need to get operation of the transmission system out of the hands of market participants. Only truly independent RTOs, with no stake in the market, can achieve the trust required to create a marketplace—a competitively neutral platform—on which competition can thrive, with enhanced reliability and efficient use of generation resources.

Regionalization of transmission planning under the control of an independent RTO, with authority to expand or cause expansion of the grid, is also critical to a robust transmission system capable of reliably handling the competitive market's increased traffic. Single system regional planning will be a dramatic improvement over a grid planned by numerous owners with different competitive agendas. Vertically-integrated utilities who now control planning and expansion often have a competitive interest in *not* improving their transmission system. Many risk losing substantial amounts of money if they construct new transmission that opens their generation up to competition. Even hefty incentives, paid by captive transmission customers, may be insufficient to overcome this competitive disincentive. No such hurdle would impede construction if independent RTOs had full responsibility to plan and build, or cause construction of, transmission facilities necessary to create and sustain competitive wholesale markets and provide a high degree of regional reliability for end use customers. Federal legislation should confirm that RTOs must perform this critical function.

As was stated this morning by the American Public Power Association's witness, Roger Fontes, legislating new forms of incentive pricing for transmission services is NOT the right tack to take to encourage grid expansion and improvements; we should not accept transmission owner efforts to retain exclusive rights to construct while seeking rate incentives as an inducement to do so. Rather than granting existing owners an exclusive right to build for RTOs and giving in to their incentive demands, we should enable RTOs to put competitive pressure on the cost of capital. Therefore, Congress should 1) authorize RTOs to cause expansion of the regional grid by constructing transmission themselves or by bidding out construction and passive ownership; and 2) allow and encourage public power utilities to share in the ownership of the new transmission facilities.

As FERC has also recognized, RTOs can facilitate competition by ending the current balkanized markets, where an additional "pancaked" rate (or toll) must be paid whenever a transaction crosses the corporate boundaries separating one transmission owner from the next. In contrast, RTOs that eliminate rate "pancaking," as FERC Order 2000 requires, would permit competitors to sell their electricity goods throughout a broad regional market by payment of a single charge. By expanding the market, RTOs can increase the number of buyers and sellers that can transact with each other, enhancing competition and reducing market power.

FERC Order 2000 gets the minimum functions and characteristics of RTOs right. However, it relies on voluntary action to get RTOs formed. But lethal to competition are gerrymandered RTOs designed by a group of vertically-integrated utilities to enhance their market power by creating barriers to competitors. Also crippling to efforts to expand the grid, and to invest in the baseload generation necessary to serve growing customer needs, is the uncertainty created by the "RTO-hopping" spawned by reliance on voluntarism.

"Musical chair" RTOs have plagued my region, the Midwest. We have two RTOs forming—the Midwest ISO (MISO) and the Alliance RTO—where there should be one, and their configurations keep changing. This past year, three major utilities—Illinois Power, Exelon (ComEd), and Ameren—sought to exercise what they claimed were their "rights" to pull out of MISO and switch to Alliance. The result (effected through a settlement that FERC approved) creates a hole in the Midwest ISO. Even more recently, on August 31, DTE Energy Co.'s transmission subsidiary filed with FERC to join the MISO and withdraw from the Alliance, despite the fact that DTE is not directly connected with any MISO member. Revolving door RTOs will never achieve their purposes. Nor will checkerboard RTOs.

In February 2001, the Alliance and MISO reached an agreement through FERC mediation efforts that, in principle, calls for the continuation of the two RTOs, while establishing a single pricing structure for certain transactions, and an inter-RTO coordination agreement. However, the effectiveness of this arrangement remains to be seen.

Recent FERC orders and statements by FERC's new Chairman Pat Wood indicate a greater willingness to require RTO participation and ensure that RTOs have a large, rational scope. In orders issued July 11, FERC expressed a preference for four RTOs (aside from the ERCOT portion of Texas)—one in the West, one in the South-

east, one in the Midwest and one in the Northeast, and initiated a 45-day mediation as step one in forming a single RTO for the Southeast and Northeast, respectively. At FERC's September 26 meeting, Chairman Wood issued a memo in which he made clear his willingness to employ "sticks" instead of just "carrots" to ensure RTO formation:

What to do about the December 15, 2001 date in Order No. 2000? I recommend that this be changed to be the date by which all jurisdictional utilities must either elect to join an approved RTO organization or have all market based rate privileges by any corporate affiliate be prospectively revoked, following a Section 206 investigation. I would also recommend that no mergers be approved relating to entities who do not become part of an operational RTO. And for a public utility that chooses not to be part of an RTO, I believe we would need to take a hard look at the transmission rates they are permitted to charge to ensure that they are just and reasonable and recognize the interdependence of the power grid.

While we applaud Chairman Wood's statement, federal legislation is still needed to clarify FERC's authority to move forward on this newly energized course. Absent Congressional guidance, more aggressive FERC actions are likely to get mired in litigation. In fact, legal challenges to the flexible directives included in Order 2000 will be argued before the D.C. Circuit next week. TAPS therefore urges Congress to adopt in legislation the RTO participation position that was developed and is supported by APPA's transmission owning and TDU members:

- Confirm FERC's authority to require FERC-jurisdictional (as of the date of enactment) utilities to participate in an RTO as a generic condition for continued or requested market-based rate authorizations or as a standard requirement for merger approval or to remedy undue discrimination.
- Authorize FERC to require transmission-owning Federal utilities to participate in an RTO to remedy undue discrimination.
- Authorize FERC to order RTO participation by municipal and cooperative utilities based on a finding that the utility has engaged in undue discrimination in the provision of transmission service, or abused its control over transmission so as to disadvantage competitors, and open access transmission tariffs are not likely to remedy the problem. Any such orders must accommodate tax code restrictions and/or bond covenants.

2. FERC MUST BE RESPONSIBLE FOR REGULATING ALL INTERSTATE TRANSMISSION.

For electricity competition to be successful, it is essential that FERC have authority to establish one set of rules for the use and operation of the nation's interstate transmission system. For this reason, TAPS supports extension of FERC jurisdiction over the terms and conditions of service over municipal and cooperative transmission systems, subject to "FERC Lite" provisions. In addition, TAPS supports FERC jurisdiction over the transmission used for bundled as well as unbundled retail sales. In fact, TAPS believes the Federal Power Act as currently enacted encompasses such jurisdiction, as we made clear in our brief to the Supreme Court. However, we urge Congress to clarify FERC's authority to reflect today's policy objective of promoting competitive markets and ensuring reliable service for all consumers.

The Supreme Court case pertains to Order 888, in which FERC asserted jurisdiction over transmission for unbundled retail service (where states have adopted retail competition), but not transmission used for bundled retail sales (traditional retail sales where the price for power is "bundled" with the price of transmission and distribution services). The D.C. Circuit upheld FERC's assertion of jurisdiction over unbundled retail transmission as compelled by binding Supreme Court precedent as well as by deference to FERC's interpretation. Although the Court of Appeal's decision strongly suggests that FERC could exercise jurisdiction over the transmission component of bundled retail electric sales, it upheld FERC's decision not to do so as "a statutorily permissible policy choice." At the Supreme Court, a number of states are challenging FERC's assertion of jurisdiction over unbundled retail transmission; Enron is challenging FERC's failure to assert jurisdiction over the transmission used for bundled retail transactions. TAPS has stated its support of Enron, and filed a brief opposing the states' challenge. The case was argued on October 3.

Good public policy in 2001 and beyond should not depend on whether and how the Supreme Court interprets the 1935 Federal Power Act, as amended. Rather, for competitive markets to work, Congress must clarify FERC's jurisdiction over all uses of interstate transmission.

To access competitive markets, all users must rely on the same integrated transmission grid. Perhaps no other industry stands more in need of a single set of interstate rules, and a single traffic cop, to ensure the coordinated, non-discriminatory,

and efficient use of the transmission required to support competitive electricity markets.

Think what pandemonium would occur if the interstate highways posted two sets of speed limits for passenger cars, one for in-state cars and the other for cars going out of state. Think how many crashes would occur if the state established a different regime for preferred in-state cars to switch lanes—they need not look or signal, because they are to be accorded “priority.” It would also be inconceivable for Virginia to establish a rule that during rush hours, out-of-state vehicles on Interstate 95 must pull over to the shoulder so Virginia vehicles may pass.

Yet, that is precisely what divided transmission authority would allow, as determined by the Eighth Circuit. That court ruled that states could set their own rules for the transmission of bundled retail sales and favor these in-state users when there is insufficient transmission capacity. *Northern States Power v. FERC*, 176 F.3d. 1090 (8th Cir. 1999). Under NSP, each state can set its own rules for transmission of bundled retail sales within that state, without regard to what other states do, and without regard to FERC’s rules, while FERC is limited to setting rules for wholesale and unbundled (choice) retail uses. No regulatory body would have authority to ensure a coherent scheme for the use and allocation, among all users, of what is necessarily the single transmission network.

Such a system will not work. You cannot have multiple, inconsistent systems for reserving, allocating and scheduling transmission over the unitary transmission network. Reliability, efficiency, and competitive markets will all suffer in the name of preserving service to a favored subset of retail consumers.

For example, AMP-Ohio and its members serve the bundled retail customers of those member cities by paying to use the transmission of other utilities. In August, AMP-Ohio’s transmission service that permits its members to serve these retail customers under network service was curtailed, increasing costs and threatening reliability. Should these retail customers, who have long paid and continue to pay their fair share of the costs of the transmission system, be more exposed to curtailments than the bundled retail customers of transmission owners? And should retail customers that dare to exercise their retail choice options (where available under state law) be treated as second-class citizens if they receive power transmitted through a state that gives priority service to its own bundled retail customers?

As an active participant in the Midwest wholesale power market, AMP-Ohio has experienced threats to system reliability and prices spikes in recent years. While there are constrained transmission interfaces and a need for generation and transmission additions, in our opinion the root cause of these problems is market manipulation and market structure. Based on our 20 years of practical experience in the market, we can attest to the fact that the market has become increasingly dysfunctional and has taken steps backward, not forward.

Retail competition will not be successful if power supplied through the market, using FERC-jurisdictional unbundled transmission service, is less reliable than power supplied to bundled customers. Consumers will not switch suppliers if they cannot count on reliable delivery of power from their new supplier. Nor can competitive wholesale markets thrive where states retain authority to accord transmission owners serving their bundled retail customers access rights superior to those of other users.

While some will suggest that the current split jurisdiction assures reliability to the transmission owners’ “native load” customers, our view is that it creates a black box that prevents the open markets that are needed to benefit all equally “native load” consumers. If a utility says it has no transmission capacity available to others because it is needed for its own bundled retail use, can we be sure that this isn’t market manipulation in the name of reliability? Utilities have been known to reserve all of the transmission import capacity in the unlikely event that every single generation plant in the control area simultaneously shuts down. Removing such actions from FERC scrutiny by placing them behind a state-jurisdictional curtain invites discrimination and destroys any pretense of non-discriminatory open access. And they subject equally “native load” customers of other utilities to less reliable and more expensive service. Every utility, those that own transmission and those that do not, have native load customers that deserve and must have equal reliability. As was said by former FERC Chairman Martin Allday, everybody is somebody’s native load customer.

As we move toward competition on a state-by-state basis, it is essential that FERC be authorized to establish a single scheme for use of the grid that does not relegate wholesale uses or retail choice programs to second-class status. The absence of a clear, unified set of rules would enable one state to cripple choice programs in a neighboring state by according in-state bundled sales a higher priority than unbundled deliveries to its neighbors. *This is not a state versus federal issue. Rather,*

it is a state versus state, consumer versus consumer issue. And only FERC is in a position to ensure open, fair, nondiscriminatory, and reliable service to all.

TAPS urges Congress to recognize in legislation that there can be only one set of rules for all users of the interstate transmission network, and that those rules need to be set by FERC.

TAPS appreciates this opportunity to present its views to the Subcommittee.

Mr. BARTON. Thank you, Mr. Gerken.

We want to now hear from Mr. Peter Esposito, who is Vice President and Regulatory Counsel for Dynegy, Inc.

Your statement's in the record and we welcome to have you elaborate on it for 5 minutes.

STATEMENT OF PETER G. ESPOSITO

Mr. ESPOSITO. Thank you, Mr. Chairman and members of the committee for allowing me to speak here today on behalf of the Electric Power Supply Association and my company, Dynegy.

Those that are familiar with the energy situation last year in California, I know you all are, might logically ask why should I touch power? Isn't it the third rail of energy here? The simple answer is just because California didn't get it right doesn't mean the Nation as a whole can't afford to do it. Power's the life blood of the American economy. Growth and demand must be met by growth and supply and improvements in an aging infrastructure.

Today some regions are on the edge of a supply/demand imbalance, as California was. This imbalance will only get worse unless we change today's regulatory paradigm of a patchwork of ever changing rules being issued under the aging statute. Simply put, those who supply and transmit power need rules they can rely on and consumers simply want power that is reasonably priced and reliable. Consumers don't want to be surprised by price spikes or blackouts, especially given the increased threats we now face.

In this regard, incumbent monopolies have a legal obligation to provide service often at any price. New entrants are aligned with consumers because they know they will not be successful in the market unless they actually provide consumers reliable power at a reasonable price.

How do we satisfy your constituents and our customers? We satisfy their desire for reliability at reasonable prices through competitive markets that allow customers to choose from a variety of suppliers and products that reflect the balance of price and reliability risk those customers choose to assume.

It is amazing in this United States what a profit incentive can do to assure the products are on the shelves in ample supply. Mr. Radanovich was here, I'd point out, to whine.

Establishing competitive markets requires some common sense and a big picture view. There are three perspectives that are involved in any market and are involved in the electric market: That of those who produce, in this case the generators; those who deliver, the transmission owners; and, those consume, consumers.

This isn't rocket science. We need to assure that the raw material, energy, can be produced in large quantities and transported flexibly to the points where consumers want to use it. Much as the space program gave us a great political and technology benefits, forging flexible markets gives us double benefits. It trains us to reconfigure systems to make economic sense on an hourly basis al-

lowing markets to help mitigate the impacts of nefarious attacks on our infrastructure. Flexibility works very well in the gas industry to bring consumers great benefit, it'll work here in the electric industry.

More specifically, from the production side we must assure easy entry to markets. We can do that by establishing uniform interconnection rules applicable to all, as you all have proposed. But that is not all we have to do. We have to assure that wire owners do not restrict access to wires in order to favor their own generation, and to do that we need to separate control as we talk about this morning.

FERC plans to do this through RTOs and Congress should affirm FERC's authority to compel memberships in RTOs by all transmission providers, or at a minimum not interfere with the FERC's current policy of saying you're either in the old world or the new world. That policy, if implemented, will work.

The mere formation of RTOs, however, is not enough to ensure that markets can do their job effectively. We must assure that each has an open access tariff that is flexible to allow the aggregation of supply and the aggregation of customers, not just to take a static system and use it in a static manner.

We need to deal with the seams issues between transmission providers. Today's transmission system is all too often characterized by numerous relatively small franchise service areas shaped in ways that would make the best congressional redistricters proud. To move power between regions one must contract with each of these franchisees for transmission service.

Imagine changing trucking companies at each county line when trying to truck tangerines from Tampa to Trenton or oranges from Orlando to Oswego. The farmers and consumers had to pay the cost of this inefficiency, Congress would have acted decades ago to fix this problem and, in fact, it did by creating a national highway system. Yet this is how we transmit power in most regions today.

This structure of the early part of the last century has stayed in place in large part due to structural and political inertia, if not outright existence. The time is right to fix this and reducing the sheer number of transmission providers by forming RTOs is, in part, the answer. So too is making the RTOs large enough to limit the burdens associated with changing trucks at every county line. This doesn't, however, require uniform markets, just consistent business practices between the RTOs.

One problem with RTOs is that they will become big monopolies. We need to get consumer inputs through stakeholder advisor boards. Another thing is to incent them correctly. We talked about incentive rates this morning. We ought to be thinking about volumetric rates. You provide more service, you make more money. It's a pretty simple concept, works in the gas industry.

We can remove artificial barriers including PURPA and PUHCA. We can empower FERC to require consistent business practices.

From a transmission owner's perspective we need a regulatory and tax climate in which capital formation can occur. That involves regulatory certainty, changes in tax laws and the right to make a profit commiserate with risk.

Second, they need the ability to expand their service to expanded access. We talked about siting this morning.

And finally, there are other ways to expand transmission including use of existing rights of way and new technology.

Finally, consumers need to be empowered. They need to see price signals so they know how much it's going to cost when they consume power. California they predicted 260 hours of blackouts last year where this past summer we had none, zero. Why? Because the consumers got the price signal.

Finally, we need a means of consumer choice. And I know you're not going to go to mandating retail access, but you can set up a paradigm in the wholesale market where retail access can work, and I encourage you to do that.

Your bill is going in the right direction, but the devil is in the details. I'd encourage you to take a look at those details, some of them sort of reverse direction, and we look forward to working with you on those details.

Thank you.

[The prepared statement of Peter G. Esposito follows:]

PREPARED STATEMENT OF PETER G. ESPOSITO ON BEHALF OF ELECTRIC POWER SUPPLY ASSOCIATION AND DYNEGY INC.

Mr. Chairman and members of the Committee. Thank you for allowing me to speak here today on behalf of the Electric Power Supply Association. EPSA is comprised of generators and marketers of electric power. I also speak on behalf of Dynegy, a marketer and generation owner, and a member of EPSA.

Those familiar with the energy situation that developed in California over the last year will agree that incorrectly restructuring the power industry can have dire consequences. Armed with this knowledge, you may quite naturally ask: "why should I touch power; it could be just another political third rail?"

The simple answer is that just because California didn't do it right doesn't mean the Nation as a whole can afford not to do it at all. Now more than ever, power is the lifeblood of the American economy. Growth in demand must be matched by growth in supply and improvements in an aging delivery infrastructure. Today, some regions are on the edge of a supply demand imbalance. This imbalance will only get worse unless we change today's regulatory paradigm of a patchwork of ever-changing rules being issued under an aging statute.

While those who supply and transmit power need modern rules they can rely on, consumers simply want power that is reasonably priced and reliable. They don't want to be surprised by price spikes or blackouts, especially given the increased threats we now face.

Incumbent monopolies have a legal *obligation* to provide reliable service at any price. New entrants are aligned with consumers because they know that they will not be successful unless they actually provide consumers reliable power at a reasonable price.

How do we achieve these reliability and price objectives simultaneously? Everyone seems to have an idea,

- Do we have the government build power plants to create a reserve? That would be folly unless we want the government to build all the plants. Otherwise the private sector would simply back off its new construction until equilibrium of supply and demand was created. No one is going to build power plants in a glutted market if they are not going to get back their investment and some return on that investment.
- Do we require public utilities to build more generation? Go back to the "good old days?" Remember what got us here was overbuilding during the rate-based "nothing's too good for the ratepayers" construct, where the ratepayers are on the hook to pay for virtually anything and everything the utilities build, whether it is economic or not. Can our economy afford to pay large premiums on power year after year under the old regulated regime while our competitors in the rest of the world adopts the new deregulated regime? Of course not!

And how *do* we satisfy your constituents and our customers? We can satisfy their desire for reliability at reasonable prices through competitive markets that allow

customers to choose from a variety of suppliers and products that reflect the balance of price and reliability risk those customers choose to assume. It is amazing in this United States what the profit incentive can do to assure that products are on shelves in abundant supply.

Establishing competitive markets does not involve nuclear physics. It does, however, require some common sense and a big-picture view.

There are three perspectives this Committee must consider when addressing electric restructuring. These are the perspectives of:

1. **Generators:** those who produce the product and who need easy entry to markets, signified by access to the grid
2. **Transmission owners:** those who deliver the power, who need roadblocks to grid expansion removed, and
3. **Consumers:** those who purchase and consume power, and who deserve power that is reasonably priced and reliable.

These are the three basic players in any market. Each needs to be empowered.

This is not rocket science. We need to assure that the raw material—energy—can be *produced* in large quantities and *transported* flexibly to the points where *consumers* want to use it. Much as the space program gave us great political and technological benefits, forging flexible markets gives us a double benefit: By training us to reconfigure systems to make economic sense on an hourly basis, vibrant, flexible markets also help mitigate the impacts of nefarious attacks on our infrastructure.

More specifically:

First, from the production side, you must assure generators **easy entry to markets**. In power industry parlance, this means assuring that new generation can get interconnected to the grid and that, once connected, it is able to reach many consuming markets under reasonable contractual terms *and* at a price that is reasonable and determinable in advance.

Bearing in mind that transmission is presently a monopoly and will be for some time, this means:

- establishing base-line interconnection rules for all markets, in all states, that require transmission owners to provide new generators with open access to their delivery systems, even when those new generators compete with generation owned by those who control the wires.

One means of assuring that wires owners do not restrict access to wires in order to favor their own generation is to separate the control of wires from control of competing generation. FERC plans to do this through the formation of large Regional Transmission Organizations (RTOs), in effect pooling the transmission assets of many utilities under one independent operator. Congress should affirm FERC's authority to compel membership in RTOs by all transmission providers.

The mere formation of RTOs, however, is not enough to assure that markets can do their job effectively. We must:

- Assure that each RTO has **open access tariffs** that facilitate the movement of power from many generators to many consumers. These tariffs must apply fairly and across the board to *all* users of the transmission system so as to assure each a chance to compete, both in the sale and purchase of energy.
- **Deal with "seams" issues between transmission providers.** Today's transmission system is all too often characterized by numerous relatively small franchised service areas shaped in ways that would make the best Congressional redistricters proud. To move power between regions, one must contract with each of these franchisees for transmission service. Imagine changing trucking companies at each county line when trying to truck tangerines from Tampa to Trenton. If the farmers and consumers had to pay the costs of this inefficiency, Congress would have acted decades ago to fix the problem, indeed it did by creating a national highway system with characteristics like minimum bridge heights. Yet this is how we transport power in most regions of the country today. This vestige of the early part of the last century has stayed in place in large part due to structural and political inertia, if not outright resistance. The time is ripe to fix this, and reducing the sheer number of transmission providers by forming RTOs is, in part, the answer. So too is making RTOs large enough so that the burdens associated, for example, with moving power from Florida to the PJM are not overwhelming.
- One problem with RTOs is that they will, by definition, become giant monopolies. Giant monopolies generally have **no incentive to act like a competitive business** and their service tends to become "bureaucratic," to be kind. Because customers will not have another RTO to go to for service if they don't like their regional RTO, we must create incentives for RTOs to treat customers as customers. There are two ways to address this.

- First, there must be some recognized means of assuring customer input is taken seriously, for example through stakeholder advisory boards to the the RTO.
 - The second is to make RTO cost and profit recovery dependent on providing valuable service, e.g., by setting **up rate designs that are based on throughput, not merely on ownership of wires**. When the RTO does a good job, it should be rewarded; when it does not, it should not.
 - **Economies of scale** must be achievable:
 - Congress should **remove artificial barriers**, including ownership restrictions included in **PURPA** and **PUHCA**.
 - FERC must be empowered to require **consistent transmission business practices** across the country.
- Second, from the transmission provider perspective**, you must give the RTOs the tools to do their job and the ability to make a profit. This entails providing:
- **A regulatory and tax climate in which capital formation can occur.**
 - **Regulatory certainty:** Change is inevitable, but constantly changing rules need not be. Just as generators are asking for some certainty in environmental requirements and market rules, transmission owners have a right to know what is expected of them; when they will be rewarded and when they will be punished by regulators.
 - When change is required, there should be adjustments made to facilitate change. Here, **tax laws** changes are necessary to assure that taxable events do not occur simply because transmission assets are transferred under government request to RTO control.
 - Transmission owners must have the **right to make a profit commensurate with risk**.
 - The **ability to provide better service with expanded assets**. The surest way to eliminate any semblance of generator market power is to remove all congestion from the system, so that many sellers can reach many buyers and vice-versa. This will require that something be done to facilitate siting of new transmission facilities, in what could be a very painful political process. This could occur through regional compacts, or through RTO processes, with a federal eminent domain backstop. Again, consumers all over the nation will benefit from better markets and increased infrastructure security if we come together as a Nation to deal with critical siting issues. Whatever method of dealing with these issues is chosen, landowners must feel they got a fair shake.
 - Let us not forget in this quest that there are many ways to expand transmission, through the use of existing rights of way and with new technology. New wires in new rights of way are not the only way to expand and enhance the transmission system.
- Third, consumers need to be empowered.**
- **Price signals:** Consumers need to be charged power they consume, so they know how much they will be billed if they consume more or less of it. Contrary to lore, demand for power in the aggregate is elastic, as has been proven so forcefully in California this summer:
 - where the NERC predicted 260 hours of blackout and none, repeat none, occurred, and
 - where wholesale prices came down before West-wide wholesale price caps went into effect, once retail prices rose.
 - **Choice:** Getting wholesale markets right means establishing the foundation for customer choice. In California, had customers been able to choose the 5 to 6 cent power being offered by generators last year they would not now be shouldering the burden of much more expensive power that was purchased last winter, before demand dropped off. We realize that the Congress is not likely to force choice on the states, but it should at least give the states wholesale markets that allow choice to go forward should the states so choose.

Finally, but most importantly, we all need market rules that set up sustainable markets, that is, markets that are fair both to consumers and suppliers of power. Just as price caps will stifle the addition of needed generation, so too will very high prices stifle the economic growth and prosperity of our country.

Both FERC and Congress have a role in assuring we meet these goals. Congress can best help consumers receive the most reliable and reasonably priced power by reaffirming FERC's authority and providing it with policy direction and appropriate flexibility to achieve these goals. The time to do this is now.

Mr. BARTON. Thank you.

We now want to hear from Mr. Charles Trabandt, former FERC Commissioner, former general counsel to this committee, former general counsel, I think, to the Senate Energy Power Committee and until August the CEO of a company that was located, I believe, in one of the towers at the World Trade Center.

So, we really, really appreciate you being here and appreciate your expertise, and thank you for your prior service to the country. And I'm sure that you have many services yet to provide for the country. Welcome to the committee.

Your testimony is in the record and we would ask you to summarize it in 5 minutes.

STATEMENT OF CHARLES A. TRABANDT

Mr. TRABANDT. Thank you, Mr. Chairman. It's a privilege to be with the committee again.

As this morning's hearing demonstrated, there's a critical need for capital investment in the Nation's electric transmission infrastructure and I would suggest that isn't just for new interregional lines. The country is quite a bit behind in terms of sustaining capital investment for the existing system, as well as for new transmission lines. And I encourage you to think of that.

Pat Wood last week also informed the country as well as you, as I understand it, that the needs that we had prior to September 11 probably are going to increase as a result of the attacks and the requirements of the new homeland defense infrastructure requirements, which both you and the Senate are considering right now.

FERC in Order 2000 sought to address that need by providing structural and regulatory flexibility for independent for-profit transmission companies or transcos as an alternative business model for the regional transmission organizations. That flexibility, in fact, have worked and I'm sure you're well informed of this, but we have across the country in every region a large number of investor owned utilities and public power entities which have joined transcos.

Just last week a group of six southwest utilities acted to create the newest transco that would serve Arizona and New Mexico.

Today it is clear from a business and financial perspective that the for-profit business model is a viable and, I believe, preferred option for RTOs. Furthermore, I am convinced a properly structured transco will be able to access the capital markets for equity and debt financing to provide timely funding for the improvement and expansion of the transmission infrastructure, which was the nature of my responsibilities as a managing director at Merrill Lynch.

The Alliance Transco RTO with National Grid USA as the proposed managing member I suggest is one example of the transco RTO model which provides important precedence for further transco development. In that model National Grid, as you may know, has committed to a billion dollars of investment in the Alliance company's systems as part of the deal that was struck in August.

I couldn't agree more with Mr. Vesey who spoke to you this morning about the new RTO transmission business under your bill as well as under Order 2000. I think it's a mistake to think of the

new transmission business that these RTOs will be running as the same thing as transmission services that have been provided in the past. This is a new business model, it involves different risks and it certainly, in my judgment, is worthy of consideration of incentives to ensure the availability of capital to meet all the responsibilities that the RTOs will have that the utilities did not have in providing transmission services.

FERC in July, however, took actions to require mediation negotiations in the northeast and the southeast intended to support an immediate drive toward a single RTO in each region. The actions signaled a major policy change to establish four RTOs, one each in the northeast, southeast, midwest and the west and to do so without the incentives and the flexibility provided by Order 2000, which as I just indicated has been successful from the model that I support.

I would counsel caution with regards to such an immediate policy change because of the potential risk that it will materially disadvantage the transco alternative, and thereby inhibit the availability of capital for existing systems and new systems.

Also such a policy change could have a negative impact on FERC actions already taken such as the alliance, Midwest ISO settlement arrangements which will support initial operations in the midwest in the very near future.

Finally, I would recommend that the subcommittee in any legislation consider measures to preserve the structural and regulatory flexibility of Order 2000 for the RTOs, particularly in the transco business model. Such measures I believe should ensure the transcos can be a vital segment of the future electric transmission system and provide the needed capital for investment.

In addition, I would recommend that the subcommittee consider appropriate procedures to protect investments already made and approved in operating transcos, and to provide for an orderly transition to any new policy direction which, Mr. Chairman, I think you've laid out in your discussion draft which, hopefully, would continue to support a viable transco alternative and financing for the infrastructure needs of the industry.

Thank you, Mr. Chairman.

[The prepared statement of Charles A. Trabandt follows:]

PREPARED STATEMENT OF CHARLES A. TRABANDT

Thank you, Mr. Chairman, for the opportunity to testify before the Subcommittee on the subject of "Electric Transmission Policy: Regional Transmission Organizations, Open Access, and Federal Jurisdiction." At the outset, I want to commend the Subcommittee for its decision to proceed with these hearings. While we can never forget the horrific and tragic events of September 11th, we also cannot allow the perpetrators of those acts of war to paralyze our great nation. So, it is appropriate that important business such as these hearings go forward to address critical energy issues of the future.

On the morning of September 11th, I was at the Institute of Nuclear Power Operations (INPO) in Atlanta for a regularly scheduled meeting of the INPO Advisory Council and a dinner to honor Dr. Jim Rhodes, the retiring INPO CEO. As the terrible events of that morning unfolded, the meeting was canceled and INPO immediately joined nuclear utilities across the country in tightening security and implementing emergency preparedness plans with impressive professionalism. From all reports, the nuclear industry performed superbly throughout those early days of national crisis and continues to do so.

That same morning, my former colleagues in the Global Energy and Power Group of Merrill Lynch's Investment Banking Division had just arrived at their offices in

the North Tower of the World Financial Center, across from the World Trade Center. They were evacuated immediately after watching in horror as the second hijacked aircraft hit the twin towers. I am thankful to report that they all escaped without serious injury. However, it now appears that those offices could be closed for an extended period, so my old group will be relocated elsewhere in the New York City area.

I have been asked to provide testimony on FERC's Order No. 2000 RTO policy from a financial perspective, with particular emphasis on the independent transmission company or transco alternative and the incentives for transco's. My testimony reflects my eight years of experience as a Managing Director in the Global Energy and Power Group of Merrill Lynch's Investment Banking Division, from which I retired in August. As a Managing Director, I had responsibility for strategic advisory assignments for electric utility and energy company clients around the world. Among other assignments, I have advised electric utilities on specific transmission transactions, including the establishment, financing and strategy of Hydro One in Ontario and the establishment and financing of U.S. RTO's. My testimony is also informed by my prior service as a FERC Commissioner and as a Committee Counsel in the House of Representatives and the Senate.

Other witnesses in this and prior hearings have testified about the increasingly urgent need for investment in the nation's electric transmission infrastructure. Investment by any measure has fallen just as the wholesale electricity market under open access policies has grown dramatically. And, just as the electricity system moves toward Regional Transmission Organizations, the stress and strain on the transmission infrastructure is going to increase at an accelerating rate for several reasons.

Electricity demand nationwide has continued to grow and is projected to do so at a steady rate. Construction of new generation plants is underway at a record pace, requiring new interconnections and upgrades and increasing the demand for transmission services. Wholesale electric transactions for existing generation, with associated transmission service requirements, have increased several fold in recent years. Additionally, the system already is experiencing increased congestion with growing costs and fast rising transmission curtailments or TLR's. And probably not yet well understood nor fully appreciated, the existence of a new RTO can significantly change the wholesale transaction structures and transmission service requirements to execute newly economic trades. In short, there is a critical need to provide investment to maintain the national grid, which undoubtedly will increase in the aftermath of the September 11th attacks and in the new context of homeland defense.

These relatively inevitable pressures on the electric transmission system in the context of the drive to RTO's under FERC Order No. 2000 support a flexible approach to financing and structuring RTO's. FERC acted prudently to provide the electric industry with the opportunity to structure RTO's as independent for-profit transmission companies (transco's), as Independent System Operators (ISO's) or as hybrid ISO-transco organizations. Hybrid organizations could include an RTO structured as an ISO with one or more transco's as members, who also may provide various services to the RTO.

FERC also developed a transmission rate-making policy for RTO's which was intended to remove pricing disincentives for transmission owners to join RTO's and to help transmission companies become viable businesses. Under that rubric, FERC endorsed Performance-Based Rate Regulation (PBR) for RTO's to create incentives to make efficient operating and investment decisions, share benefits between customers and the RTO, protect system reliability, and prescribe rewards and penalties in advance based on benchmarks. PBR has been implemented for transmission services in Canada and the United Kingdom, in Federal regulation of telecommunications in the U.S., and by State PUC's for retail electric, gas, and telecommunications service.

Consequently, while a novel concept at FERC thus far, the PBR approach is well established in regulatory circles. What is less apparent, however, is that it will take some time to collect the required data for the benchmarks for a new, non-power pool RTO. Nonetheless, the PBR has substantial financial and regulatory appeal as an alternative to FERC's traditional transmission ratemaking policy.

In addition, FERC decided to consider innovative pricing proposals for RTO's, on a case-by-case basis, in response to its concern about continued under-investment in the transmission grid. The possible innovative pricing proposals include a formula rate of return, leveled rates, accelerated depreciation and incremental pricing for new transmission facilities. FERC also encouraged market approaches to congestion management as early as feasible. An RTO also can propose a rate moratorium for the period through January 1, 2005, and capture cost-saving benefits or increase leverage to increase earnings. Additionally, FERC will consider acquisition

adjustments on a case-specific basis where there are measurable benefits to customers.

FERC also recognized that the IRS Code created a substantial disincentive for transmission owners to divest substantially depreciated transmission systems. As a result, passive ownership rules provide specific protections and rights for those owners who transfer control to the RTO (transco). Of course, the House-passed energy legislation would address the problem and mitigate or remove that tax disincentive.

Another disincentive exists in the context of registration requirements under PUHCA with the SEC. The multi-state nature of the larger proposed RTO's could trigger a registration requirement for the owner of a small active ownership interest, with relatively severe limitations and approval requirements for other business and financial activity. Several potential strategic partners and equity financial investors have indicated that they would be unwilling to accept registration as a condition of a strategic partnership or an active equity investment in an RTO. Legislative action by the Congress or administrative action by the SEC may serve to remove this financial disincentive at some point.

Not surprisingly, many possible strategic partners and equity financial investors are themselves directly, or are affiliated with, market participants, as defined by Order No. 2000. As such, those potential investors are limited by the FERC rules to a 5% ownership stake for 5 years, in order to ensure RTO independence, although they could make qualified passive investments. Thus, the market participant limitations do constrain the investment opportunity for many potential (and knowledgeable) investors and limit the universe for marketing transco private equity. But, it does not appear that FERC will amend Order No. 2000 to address this issue.

FERC also adopted a policy of "open architecture" and required that RTO's be designed so that they can evolve over time. The purpose of open architecture is to allow RTO's to improve, evolve and accommodate technical change, albeit subject to FERC review. The open architecture policy is particularly important for transco's, given the likely substantial changes between Day 1 operations and later requirements, such as congestion management and new investment policies, which have major financial implications.

This overall regulatory flexibility has spawned transco proposals across the country, which could create the proper conditions for the nascent independent transmission industry. Transco's could support further development of the competitive wholesale electricity market by accessing capital markets to secure the much needed financing for sustaining capital expenditures, upgrades and expansion of the transmission infrastructure. As a general financial matter, transco's should become attractive as an equity investment to strategic partners, financial (private equity) investors, and the public market.

Strategic partners will be attracted by the opportunity to manage a significant asset base, share in the value creation potential ("gain sharing"), have specified rights with regards to the assets, and an acceptable projected return on the equity investment. There are indications that there are a number of potential strategic partners, however the probable requirement to register under PUHCA with the SEC is an impediment today. Financial investors will require a well-defined and meaningful investment as a private placement with a subscription agreement, appropriate limitations on liability, an acceptable return and exit strategy, board representation, and other typical features. There are definitely financial investors interested in the transco opportunity, provided that the specific transco structure can be formulated to satisfy their individual requirements.

Transco's also may become attractive to the public equity markets in the form of an IPO, a spin-off, or a tracking stock, each of which has differing characteristics and conditions. The IPO alternative probably will require, among other factors, a solid management track record of a couple of years, a good business plan and marketing story, sufficient size for liquidity, adequate projected growth and total return, well developed valuation, reasonable regulatory stability, and of course, a positive stock market environment. As a result, it is not likely that the new transco's under Order No. 2000 will be positioned for an IPO in the first or second year of operations. That factor suggests the importance of a strategic partner and/or financial investors in the initial transco financial plan.

Additionally, transco's should be capable of obtaining strong investment grade credit ratings, which will support financing by access to debt markets. Credit rating agencies have become more experienced with the transco concept and have developed a series of quantitative metrics and qualitative factors to assess the credit quality of a transco. A transco with transmission system assets should be able to achieve a solid investment grade rating with a capital structure having debt in the range of 60% to 70%, under reasonably favorable regulatory treatment.

The electric utility industry is moving with reasonable dispatch to capture the opportunity provided by the FERC regulatory flexibility. For example, the Alliance Companies (nine Midwestern utilities and Dominion Energy), Grid South (three investor-owned utilities serving the bulk of customers in North Carolina and South Carolina), Southern Company and public power groups in Georgia, Alabama, and Mississippi, Grid Florida (three investor owned utilities serving the bulk of customers in Florida), Entergy in Arkansas, Louisiana and Mississippi, and TransConnect (five investor-owned utilities in the Pacific Northwest) have proposed and committed resources in varying degrees to a for-profit Limited Liability Company (LLC) structure for their RTO. Utilities, such as First Energy, DTE and Consumers Energy, have created independent transmission subsidiaries to facilitate options for their systems. In addition, the American Transmission Company with investor-owned and public-owned transmission systems in Wisconsin already has, and the TRANSLink group, including NSP, Mid-American, Alliant, NPPD and OPPD, is in the process of forming independent transmission companies in the hybrid structure under the Midwest ISO-proposed RTO. And, last week, Arizona Public Service, Salt River Project, El Paso Electric, Public Service of New Mexico, Tucson Electric and Texas-New Mexico Power announced that they were abandoning the non-profit DesertSTAR ISO proposal in favor of a new for-profit transco RTO, WestConnect, for the southwest region. Each of these initiatives will create the opportunity in one form or another to access capital markets for financing purposes.

Two recent developments highlight the opportunity for for-profit transco's. First, a new consortium, in July 2001, won a structured auction in Alberta and signed an agreement to acquire the TransAlta transmission system which supplies 60% of the Province's transmission requirements. The consortium is 50% owned by SNC-Lavalin, one of the leading engineering and construction firms in the world, 25% owned by the Ontario Teacher's Pension Plan Board, a large institutional investor in Canada (OTPP), 15% owned by Macquarie Financial Group of Australia, and 10% owned by Trans-Elect of the U.S. The consortium paid a premium for the TransAlta assets in a competition which reportedly included several other international strategic and financial investors.

SNC-Lavalin made the investment to capitalize on its international engineering and financing expertise, which when combined with the strengths of the TransAlta team, would support high quality transmission services and much needed expansion of Alberta's interconnections with surrounding jurisdictions. OTPP concluded that Alberta wanted to make it attractive for investors to expand the electricity system, such that the TransAlta transmission business was a good asset to finance pensions. And, Macquarie also saw the acquisition as a good investment and its first of many infrastructure investments in Canada. While not directly on point in the context of U.S. RTO's, this consortium demonstrates that there are strategic investors, such as SNC-Lavalin, and financial investors, such as OTPP and Macquarie, who are prepared to make financial commitments in the transmission infrastructure under favorable financial conditions.

More recently, on August 28, 2001, eight of the Alliance Companies, announced that they had signed a Letter of Intent (LOI) with National Grid USA, by which National Grid USA would become the Managing Member of the Alliance Transco LLC. The transaction is subject to the negotiation of definitive documents pursuant to a detailed Term Sheet attached to the LOI and to a FERC determination that National Grid USA is qualified to be Managing Member. The eight Alliance Companies and National Grid USA made filings at FERC on August 28 seeking the requisite approvals of the joint Alliance Transco LLC. The Alliance RTO has already been substantially approved by FERC under Order No. 2000.

The Alliance-National Grid USA transaction is highly significant and well reflects the potential business, commercial and financial benefits of FERC's regulatory flexibility with regard to RTO structure under Order No. 2000. A key element of the transaction as filed at FERC is a non-binding declaration of intent by Commonwealth Edison to divest transmission facilities with a gross book value exceeding \$1 billion. Such a declaration of intent satisfies a critical pre-condition for establishing Alliance Transco LLC as the Alliance RTO. The resulting RTO would be structured as a for-profit transmission LLC, the first of its kind to become operational under Order No. 2000.

The Term Sheet attached to the LOI lays out the key elements of a strategic partnership which would be beneficial to the Alliance Companies, National Grid USA and the customers of the Alliance Transco RTO. National Grid USA's parent company has an excellent track record in the United Kingdom for managing transmission assets effectively and ensuring reliable delivery of electricity. The Term Sheet commits National Grid to making \$1 billion in specified investments in the Alliance RTO in exchange for a seven-year management contract and associated

compensation. At the same time, the Alliance Companies are provided with significant incentives to divest their assets in the form of cash and attractive passive investments with financial benefits and assured liquidity in several forms.

For those companies which do not divest immediately, there will be various protections to ensure that National Grid USA as Managing Member fulfills its obligations in its functional control of their systems. Both divesting and non-divesting Alliance Companies will have FERC-approved approval rights over certain National Grid USA actions, while National Grid will have a right of first negotiation on any transmission asset sales by an Alliance Company to another party. In my judgment, the Alliance-National Grid USA LOI and Term Sheet is an excellent example of the types of commercially-based business and financial transactions which are possible under FERC's transco-RTO structure.

The FERC transco-RTO structure can also be beneficial in creating a business-oriented approach and commercial culture for providing RTO services. In that regard, the Alliance Companies created a special purpose LLC structure for the start-up activities required to support initial operations of Alliance RTO. The special purpose LLC, with the nickname "Bridge Co", is a classic model of a lean but effective commercial organization in modern business terms.

Bridge Co has a CEO as the only full time employee and a staff of seconded employees, supported by consultants and contractors with tightly negotiated contract arrangements. Bridge Co is coordinating all of the start-up arrangements for Alliance RTO, but without making any market design-related business decisions. In order to minimize initial operating costs and maximize open architecture design flexibility in the future, Bridge Co has negotiated favorable contracts for virtually all RTO-required functions and has avoided any significant investment in functional assets.

All back office functions, employee benefits packages, information technology requirements, subordinate security coordination and supporting activities have been outsourced and procured by competitive bid from non-affiliated vendors. Additionally, Bridge Co has optimized organizational centralization and decentralized operations, such that staffing levels are adequate and cost-effective. The combination of these forward looking commercial approaches should support an initial RTO operation and organization that will have minimized costs on day one, while ensuring operational reliability, system security and high quality services for Alliance RTO transmission customers.

Bridge Co currently is completing RTO system tests with vendors, conducting customer training programs and beginning operational tests with the Alliance Companies and then Alliance customers. Bridge Co is now hiring the operational staff required for 24/7 transmission operations. Total cost for the Bridge Co start-up effort and payment of Alliance Companies' expenses is approximately \$75 million, which would be reimbursed by National Grid USA pursuant to the LOI. The existing Alliance master schedule contemplates that all necessary preparations will be completed and all required approvals will be received for initial operations, assuming timely FERC and state PUC actions. That result also could be another tangible benefit of the FERC transco-RTO policy, recalling that the Alliance companies operate in eleven states, stretching from Missouri to Virginia, with approximately 57,000 miles of transmission lines, 115 Gwe of generation capacity, and serving approximately 40 million customers.

The fact that the Alliance for-profit transco RTO has reached the stage of operational testing for initial operations, while at the same time negotiating the definitive documents for a strategic partnership with National Grid USA as the Managing Member of Alliance Transco LLC, is itself a testament to FERC's flexible RTO policy. Quite importantly, FERC in January 2001, ordered that the Alliance Companies and MISO participate in a settlement conference associated with the requests of Ameren, Commonwealth Edison and Illinois Power to withdraw from MISO and join the Alliance. Chief Administrative Law Judge Wagner presided over a two-month negotiation which culminated in a settlement approved by FERC.

Under the settlement, Alliance and MISO were authorized to pursue their separate RTO models, the three withdrawing companies made total payments of \$60 million to MISO, and Alliance and MISO were required to implement an Inter-Regional Coordination Agreement and develop a super-regional rate. The thrust of the latter requirement was to create a seamless market for transmission services to support a competitive wholesale electricity market across the Midwest region. Alliance and MISO have pursued that objective aggressively in so-called "seams" negotiations and in Open Access Transmission Tariff filings made at the end of August to support initial operations of both systems. Similarly, Alliance and MISO have participated in a stakeholder process to address the key market design issues associated with congestion management in their respective systems.

Of course, there is opposition to the flexibility which has resulted in the Alliance-MISO settlement agreement and the Alliance-National Grid USA LOI. Opponents generally prefer the ISO structure for a Midwest RTO and/or are anxious to put in place a single, fully integrated electricity market in the Midwest supported by one RTO, and I respect those views. FERC on July 12, 2001, signaled that the majority was in favor of four large RTO's in the Northeast, Southeast, Midwest, and West, and ordered jurisdictional transmission owners in the Northeast (PJM ISO, N.Y. ISO and N.E. ISO) and the Southeast into "mediation" negotiations facilitated by FERC ALJ's. Various parties have petitioned FERC to convene Midwest "mediation" negotiations intended to reverse the Alliance-MISO settlement and broker some form of direct merger to form a single Midwest RTO.

FERC has provided some additional detail in the past few weeks regarding its new RTO policy. Chairman Wood testified before the Subcommittee that large RTO's were not only required for competitive markets, but were now imperative for a reliable national power grid. He testified that the cost of planning and executing the necessary level of security and infrastructure protection will be significant and will require expertise that only large region-wide organizations can provide. To that end, FERC plans to make decisions in the Northeast and Southwest mediation cases in the next month or so, based on mediation reports from the assigned ALJ's. FERC has scheduled technical conferences next week on the key RTO market structure issues, including congestion management, cost recovery, market monitoring, transmission planning, business and reliability standards and the nature of transmission rights. The conferences will form the basis for a rulemaking to establish a significant amount of standardization nationwide in uniform market structure regulations. FERC also will review the status of the Alliance-MISO seams agreement and possibly consider requiring mediation for a merger, while encouraging RTO West and DesertSTAR to initiate merger discussions for a west-wide RTO which eventually would include California.

Other witnesses have testified about the legal and policy considerations in opposition to and support of the FERC-ordered mediation in the Northeast and Southeast and the concept of four RTO's nationwide. From a business and financial perspective, I would counsel caution in this immediate policy direction. Policy makers and regulators may wish to consider the potential risk that the transco RTO alternative will be materially disadvantaged by such a significant and immediate change in the FERC RTO policy.

In the area of infrastructure and transmission grid security, the Congress, the Administration and industry have responded in quick order to the heightened threat of terrorism. The Subcommittee provided leadership with the hearing on September 20th with Administration witnesses and related activities. The Department of Energy was scheduled to make legislative recommendations on security on October 9th with immediate Committee mark-up of emergency legislation in the Senate this week. NERC has been in a readiness state of high alert and an EEI task force has been working with NERC, NEI, other energy trade groups and DOE on enhanced security measures.

All of these initiatives, and undoubtedly many more in the context of homeland defense, will parallel the preparations for Desert Storm a decade ago. Government and industry worked in close cooperation then to ensure adequate protection of our vital energy sector. And, I'm confident that today's efforts ultimately will be just as successful in the face of the new terrorist threat. At the same time, I support action by the Subcommittee to pursue its legislative agenda in the area of electricity policy. The nation now will probably require even more capital investment in the electric transmission grid and there needs to be some resolution of the major policy issues to support that result.

In conclusion, the structural and regulatory flexibility provided by FERC under Order NO. 2000 has spawned a new generation of independent for-profit transmission companies and RTO's. Those transco's will be operated on a commercial business-like basis and should have access to the capital markets. Transco's should have the financial capability if properly incentivized to fund the critical transmission infrastructure improvements and expansion required to maintain system reliability and to support a competitive wholesale market. I would recommend that the Subcommittee in any Federal transmission policy legislation consider measures to preserve that flexibility, so that transco's can continue to be a viable and growing segment of the future electric transmission system. In addition, I would recommend that the Subcommittee consider appropriate procedures to protect investments already made in approved and operating transco's and to provide for an orderly transition to any new policy direction, which hopefully would continue to support a viable transco alternative.

Thank you, Mr. Chairman. I would be pleased to answer any questions.

Mr. BARTON. Thank you.

We now want to hear from Mr. Michael Travieso, who is with Maryland People's Council.

We do appreciate your expediting your schedule to get here. Your testimony's in the record, and we would welcome you to elaborate on it for 5 minutes.

STATEMENT OF MICHAEL J. TRAVIESO

Mr. TRAVIESO. Thank you very much, Mr. Chairman.

It's not easy, I guess, but it's Travieso, it's apropos here. I guess it's like the oil company used to be.

Mr. BARTON. Well, I apologize for mispronouncing it.

Mr. TRAVIESO. That's okay.

I am the Maryland People's Counsel. I was appointed to that position by Governor William Donald Schaeffer in 1994, and serve at the pleasure of the current Governor. I run a small State agency which has the responsibility for representing residential customers in the energy and telecommunications industries.

My office has been very active in the past in PJM and the formation of the PJM policies, and is currently very active in the Northeast RTO process. We've been involved in the 45 day mediation process and continue to be involved.

I would like to commend you, Chairman Barton and the members of the committee and your staff for continuing efforts to seek out and include the views of consumers or consumer representative as you proceed with your inquiry into the development of effective competitive wholesale markets. My testimony, however, is not intended as an endorsement of the deregulation and restructuring of the electric industry everywhere. While Maryland has restructured, I share the concerns of many about the ability of residential and small business customers to benefit unless wholesale markets can be made to function efficiently. Without a workably and competitive and efficient wholesale market, retail prices will be higher and perhaps much higher than necessary.

I also believe that individual States who have restructured should be able to determine their own fate and determine, if they wish, that utilities with the obligation to serve under just and reasonable rates should remain in place.

This testimony will focus on the basic principles necessary to establish a proper framework for a competitive wholesale market.

I believe that the existing transmission systems were not planned or built to serve regional markets, and therefore must be redesigned. I believe that RTOs should have the authority to conduct transmission planning, studies and have the authority backed by FERC to order the construction of new transmission.

I do not favor for-profit transmission companies. I believe that it will raise the cost of capital for transmission organizations and companies just as they have done for generators. Regulated transmission companies have not had difficulty attracting capital because under the cost of service regulation they are guaranteed a return. In fact, utility's cost of capital has traditionally been among the lowest of any businesses in the United States.

Larger regional transmission organizations are better than smaller ones because of the reduction in administrative and trans-

action costs and the increase in generating capacity and diversity. I think the 40,000 megawatts which is in the bill is too small. I think that when you have transmission RTOs of that size, there's a significant risk of the exercise of market power. And my office favors the creation of the northeast RTO, although we have lots of concerns. That would create an RTO of over 120,000 megawatts, which would have the effect of reducing the opportunity for generators, generator owners to strategically bid their generation and to raise the price.

I would say the principle difficulty in ensuring a truly competitive wholesale market would be creating one of sufficient size and scope to create uncertainty on the part of owners of generation that their bids to sell power will be accepted. I'm not talking about regulatory uncertainty. I'm talking about a situation in which there are enough sellers that the bids that these sellers are going to submit will have to be at or near marginal costs in order for them to actually sell their power. and when we redesign the electric system and returned, that's what the rhetoric was; the bids were going to be at or near marginal costs. That can only happen if there is a sufficient number of sellers, sufficient liquidity in the market, both the energy and the capacity market.

I favor fewer and larger RTOs as long as they are properly structured, cost benefit analysis are performed prior to their formation and costs are not shifted from one set of customers to another or from customers of high cost transmission owners to those of low cost transmission owners.

I oppose incentive rate making and actually NASUCA, the organization that my office is a member of, opposes incentive rate making as well for the recovery of transmission costs as unnecessary and not cost effective. It could lead to excessive earnings, higher consumer costs. There's no evidence of need. I believe that RTO planning will be sufficient to lead to the development of a transmission system that can do the job.

I believe that the FERC currently has the legal authority to do what it is now doing regarding the creation of four large RTOs, market power mitigation and the imposition of customer refunds on entities that have used market power. However, FERC needs to exercise its power more to ensure that markets work efficiently and consumers are protected.

FERC does need additional authority over transmission planning and in certain other areas. We are—I am against the FERC exercise of jurisdiction over retail transmission where in States that have not restructured, where they still have bundled rates. I believe that jurisdiction belongs to the States.

RTO markets must design and encourage the utilization of demand side peak load reduction programs. And I note that's in the draft without much greater demand elasticity than currently exists. In PJM and elsewhere peak load prices will easily be subject to the exercise of market power.

I believe that individual States must continue to play a prominent role in assuring reliability and in helping with the design of wholesale markets. However, the success or failure in obtaining workably competitive markets will ultimately depend on the FERC and on the RTO structure and authority.

Thank you very much, and I'll be happy to answer questions.
[The prepared statement of Michael J. Travieso follows:]

PREPARED STATEMENT OF MICHAEL J. TRAVIESO, MARYLAND PEOPLE'S COUNSEL

INTRODUCTION

My name is Michael Travieso and I am the People's Counsel for the State of Maryland. I have been in that position since 1994. The Office of People's Counsel is an independent state agency that represents the interests of residential utility consumers of electricity, natural gas, telephone and water services before the Maryland Public Service Commission, federal agencies, state and federal legislatures, and the courts. Created in 1924, the Maryland People's Counsel is the oldest consumer advocate agency of its kind in the United States.

My office is a member of the National Association of State Utility Consumer Advocates (NASUCA). NASUCA represents 42 state utility consumer offices from 40 states and the District of Columbia. While I am speaking on behalf of the Office of the Maryland People's Counsel today, NASUCA members have extensive experience with electric utility restructuring at the federal and the state level. NASUCA has issued a series of resolutions concerning electric deregulation and the formation of regional transmission organizations that indicate the views of consumer advocates across the country. Many of my comments here today rely on those resolutions which are available on the NASUCA website.

I would like to start by commending Chairman Barton, the members of the committee and your staff for your continuing efforts to seek out and include the views of consumers and consumer representatives as you proceed with your inquiry into the development of effective, competitive wholesale power markets.

My testimony is not intended as an endorsement of the deregulation and restructuring of the electric industry. I share the concerns being raised by many about the ability of residential and small business customers to benefit unless wholesale markets can be made to function efficiently.¹ This testimony will focus on my views on the basic principles necessary to establish a proper framework for a competitive wholesale market.

My points in summary form are the following:

1. Without a workably competitive and efficient wholesale market, retail prices will be higher than, and perhaps much higher than necessary.
2. The principal difficulty in ensuring a truly competitive wholesale market will be creating one of sufficient size and scope to create uncertainty on the part of the owners of generation that their bids to sell power will be accepted.
3. Both for reliability and market design purposes, RTOs must continue or establish installed or deliverable capacity requirements and concomitant capacity markets in addition to energy and ancillary services markets.
4. Generally speaking, larger regional transmission organizations are better than smaller ones because of the reduction in administrative and transactions costs and the increase in generation capacity and diversity.
5. Generally speaking, the existing transmission systems were not planned or built primarily to serve regional markets and, therefore, must be redesigned and enhanced to do so.
6. RTO market design must encourage the utilization of demand-side peak load reduction programs. Without much greater demand elasticity than currently exists in PJM and elsewhere, peak load prices will be easily subject to the exercise of market power.

I believe that individual states must continue to play a prominent role in assuring reliability and in helping with the design of wholesale markets. However, the success or failure in obtaining workably competitive markets will ultimately depend on the FERC and on RTO structure and authority. FERC should have clear authority and jurisdiction to:

- a. Determine the appropriate size of RTOs;
- b. Require transmission owners to join particular RTOs;
- c. Return generators to cost-of-service prices if necessary;
- d. Provide regulatory oversight to RTOs in order to monitor regional wholesale markets and impose appropriate behavior modifying penalties on parties or entities shown to have abused their market power;

¹ See Cooper, Mark N., *Electricity Deregulation And Consumers: Lessons From a Hot Spring And A Cool Summer*, (Consumer Federation of America, August, 2001), and sources cited therein).

- e. Regulate the long-range planning and cost recovery of transmission owners in order to foster the efficient sale and delivery of electricity and capacity across large regional wholesale markets;
- f. Ensure the competitive neutrality of transmission systems by assuring that transmission owners will provide for open access and use of the transmission system at just and reasonable rate without any discrimination in favor of generation owning affiliates;
- g. Ensure the provision of transmission service at the lowest cost possible;
- h. Require that RTOs meet strict standards of economic operation and investment;
- i. Require that RTOs have independent non-stakeholder boards which guarantee input from consumer advocates and state public service commissions;
- j. Provide a regulatory forum for the resolution of complaints by market participants of tariff or RTO protocol violations, violations of relevant federal law and the use and abuse of market power;
- k. Require RTOs to enforce compliance with rules and protocols promulgated by the North American Reliability Council, (NERC).

An RTO must exhibit the following characteristics and be able to perform the following functions:

- it must be independent from market participants;
- it must serve a region of sufficient scope and configuration to perform effectively and support efficient and non-discriminatory power markets;
- it must have operational responsibility for all transmission facilities under its control;
- it must have authority for maintaining the short-term reliability of the grid.
- it must administer its own transmission tariff and use a transmission pricing system that promotes efficient use and expansion of transmission and generation facilities;
- it must ensure the development and operation of efficient and fair mechanisms to manage transmission congestion;
- it must develop and implement procedures to address parallel path flow issues both within its own region and with other regions;
- it must provide for a supplier of last resort for all ancillary services that cannot otherwise be supplied efficiently by market mechanisms;
- it must be the single OASIS—the Open Access Same-Time Information System—site administrator for all transmission facilities under its control and independently calculate total transmission capacity (TTC) and available transmission capacity (ATC);
- it must monitor markets for transmission services, ancillary services and bulk power to identify design flaws and potential market power problems and propose appropriate remedial actions; and
- it must be responsible for planning necessary transmission additions and upgrades in coordination with appropriate state authorities.

I favor fewer and larger RTOs so long as they are properly structured; cost benefit analyses are performed prior to their formation; and costs are not shifted from one set of customers to another or from customers of high cost transmission owners to those of low-cost transmission owners. I oppose incentive ratemaking for transmission owners as unnecessary and not cost-effective. This country's transmission system should be regulated as the monopoly it is and should be operated in the public interest.

I believe that the FERC currently has the legal authority to do what it is now doing regarding the creation of four large RTOs and regarding market power mitigation and the imposition of customer refunds on entities that abuse market power. In my view, FERC needs to exercise its power to ensure that markets work efficiently and consumers are protected. FERC does need additional authority over transmission planning and in certain other areas.

If the FERC has any concerns about its authority, I urge this Subcommittee and Congress to give FERC the specific tools it asks for, including:

- specific authority to order the formation of RTOs and to order utilities to join them;
- authority to ensure the adoption of uniform interconnection standards;
- authority to award customer refunds for past periods if the FERC determines the rates charged to be unjust and unreasonable;
- authority to assess civil penalties for market power violations;
- enhanced authority to review and scrutinize mergers;
- clear authority to remedy market power abuse
- authority to mandate reliability standards for bulk power markets and to work with the states to ensure the reliability of electric supply;

—authority to require the development and implementation of demand response/peak sharing programs.

That concludes my prepared remarks. I want again to thank the Sub-committee for this opportunity to appear and to speak on behalf of the residential consumers of Maryland and to express what I believe are the concerns of consumers in general.

Mr. BARTON. Thank you.

The Chair recognizes himself for questions. Just as an aside, the House has finished its business on the floor for the day, so that when this hearing is adjourned, members can go home if they wish. Just put that as a suggestion.

I have a general question. We put out at the staff level a draft RTO proposal late yesterday afternoon. Have any of your groups had a chance to see that and study it? Okay. I don't see.

Mr. ESPOSITO. We've had a chance to see it, but not study it.

Mr. BARTON. Okay.

Mr. TRAVIESO. We've seen it, we haven't studied it yet.

Mr. BARTON. Okay. Well, I would encourage you to study it and get your written comments to the committee staff and the minority staff, and any specific members.

We've had a lot of testimony, a lot of discussion about the number of RTOs. FERC was moving toward four RTOs plus ERCOT. What's the general position of you gentlemen? Is there a magic number and is that magic No. 4 plus one or should we let the market operate and see what seems to make most sense based on the geographic considerations?

Mr. Franklin?

Mr. FRANKLIN. Mr. Chairman, there's certainly not a magic number. I don't think anyone could know what the proper—what the optimum ultimate size should be and what it will be 10 years from now. To my knowledge, no studies have been done.

There are some natural markets that have formed around the country, there's some in the southeast. I think the natural markets that have formed that have some reasonable transmission capability within that region so you can move significant amounts of power within that region is a good start.

Our thought is that forming RTOs that can be formed relatively quickly that meet the needs of a specific region that can get concurrence of State commissions in that region, even if it's somewhat smaller, getting those done quickly but putting them together in a way that they could be merged with larger RTOs later makes a lot of sense.

I think over time if an RTO is too small, it'll become obvious. There'll be demands for lots of transmission between that RTO and the next one and lots of power movements. And over time you can go from smaller RTOs to larger RTOs, but I think the other process is irreversible. I don't see how you form a huge RTO that covers 20 States and later decide that was too big, you can't manage the bureaucracy is out of control. It seems to me it's almost impossible to go in the other direction.

Mr. Bennett, do you have a comment on that since you're representing the NARUC group, plus your State?

Mr. BENNETT. Yes, I would say it's sort of a geographic evolutionary process. As I said in my opening remarks, we see the benefit of a voluntary approach where a region puts something together. But as a practical example, New England, New York and PJM are

working together. And logic dictates that if and when RTOs become the way to go, that would be a region that seems to work together, has worked together and is doing it now.

Mr. BARTON. Okay. You all haven't had a chance to study the RTO draft that we released yesterday afternoon, but it has as a minimum size requirement for an RTO 40,000 megawatts. Would any of you care on the record to comment on the minimum size requirement? Is 40,000 reasonably good or should it be higher, should it be lower, or should there be no minimum requirement in terms of the number of the size of the megawatts in the RTO?

Mr. Esposito?

Mr. ESPOSITO. Mr. Chairman, 40,000 would allow California to remain a single State RTO, and I think we've seen the experience of single State RTOs not being pleasurable, to say the least. So you might want to look at a bigger number.

I think at the end of the day what you really want to look at is where our market's developing, and that's where the physics, not the politics work together. And, you know, 40,000 might be fine somewhere and not good somewhere else. So, it's difficult to just set a number in stone.

Mr. BARTON. Okay. Mr. Gerken?

Mr. GERKEN. What I think is important, I think I commented a little earlier on the first question. I think 4 or 5. The larger the RTOs to us, the better. I think what's more important is—

Mr. BARTON. The larger the size?

Mr. GERKEN. The larger the size of the RTO, less seams issues, but also importantly is that all these are run under one set of rules and guidelines. I think that is the biggest issue right now.

We're stressed to a little point. We happen to fall within the Midwest ISO and the Alliance RTO, and that was formed as a merger, but it's still questionable whether that formation's going to work as what I call, I guess, a subset of one large RTO.

Mr. BARTON. Okay.

Mr. TRAVIESO. Just to follow up, I did say in my testimony that I thought 40,000 was too small.

Mr. BARTON. As a minimal?

Mr. TRAVIESO. As a minimum. Even as a minimum. It seems to me that once you're down to that size, in order for that size of an RTO to work, you'd have to have very vigorous FERC oversight and enforcement against market power abuse.

Mr. BARTON. Okay. My time has expired, but I'm going to ask one more question. Should the FERC be given the authority to force a private entity into a specific RTO? Now the draft mandates that you join an RTO, but it gives the time period and flexibility about creation, but there are those that say we should give the FERC the authority to mandate participation in a specific RTO. Mr. Franklin?

Mr. FRANKLIN. I'd like to answer that, Mr. Chairman, being a private entity. The answer is no.

Mr. BARTON. I am surprised. Shocked, amazed and stunned.

Mr. FRANKLIN. FERC doesn't know any better than any of the rest of us ultimately what size RTOs are going to be best or in which RTO in particular—transmission system should be. I think what needs to be in place is a national policy, which there is, that

RTOs be formed. And I think there needs to be encouragement to get them formed, but the heavy hand of simply dictating arbitrarily not based on cost studies, market studies or anything else that company A needs to be in RTO B without questioning or asking the question of State commissions, utilities, customers or anyone else just seems to me to be arbitrary and will lead to a bad result.

Mr. BARTON. Okay. Mr. Flynn?

Mr. FLYNN. Mr. Chairman, my response to your question would be no, I would be concerned if FERC were in a position where it could dictate join a particular RTO, because I don't think all RTO structures are necessarily equal. I think different structures have the potential for offering different degrees of benefits to market participants, to generators in the region as well as to consumers in the region.

Based on our experience, we believe that there's greater potential for providing consumer benefits from an RTO that has as part of it an investor-owned for-profit independent transmission company. And if one gives FERC the authority to dictate a particular form of RTO, our concern would be that FERC, based on the information that's available, might pick wrong up front and we may be forced into a form of RTO that could be suboptimal.

So we would rather see the flexibility for different structures to develop and then let the market choose which one is providing the highest level of consumer benefits.

Mr. BARTON. Okay. Mr. Johnston, and then Mr. Esposito, and then we're going to go to Mr. Boucher for his questions.

Mr. JOHNSTON. I would agree that—let me say the only time that FERC should be given the authority to force an entity into an RTO is to relieve market abuse as a mechanism of relief of that. Otherwise, I agree with some of the other comments that I don't think there is a perfect size. I think you have to look at markets, you have to look at operational issues in the regions, you have to look at cost benefits; all those play into the RTOs and which is best for me to join or for some other entity to join. But other than the relief of market abuse, I would not agree that FERC should have that authority.

Mr. BARTON. Mr. Esposito?

Mr. ESPOSITO. I agree a lot of points Mr. Flynn made, but at a certain point you can't just have a big hole in the middle of a region. And somebody's got to say you got to be part of the one that surrounds you. And the only entity I can think of to say that is FERC.

Mr. BARTON. Are you aware of a particular company or small group of companies in a particular region that would try to create a hole in the middle of the donut, so to speak?

Mr. ESPOSITO. There's a lot of that going on in the midwest. You can see the maps that are just Swiss cheese, because it does exist.

Mr. BARTON. Mr. Boucher?

Mr. BOUCHER. Well, thank you, Mr. Chairman. Let's continue the discussion with regard to RTOs and, Mr. Franklin, let me begin with you.

I know that when the FERC issued Order 2000 your company expressed support for the basic theory of that order, which is that

utilities would be encouraged to join RTOs, but not required to do so.

This July the FERC has made a somewhat more affirmative statement and has gone beyond Order 2000 by suggesting that if investor owned utilities do not join RTOs, the FERC perhaps would withhold merge authority and might withhold the authority for market based rates. So there's something of a greater encouragement, shall we say, for IOUs to join RTOs than was existent in Order 2000.

So my first question to you is how do you feel about the new order, what is your reaction to that as compared to Order 2000. And if you find that the July order imposes problems for you, what are those problems, if you could precise? Is it higher rates that would be imposed upon transmission sales or is it the inability to reserve sufficient capacity for your native load? I mean, what are the kinds of precise problems that you see stemming from this July order?

Mr. FRANKLIN. Thank you. A very good question, and I'll try to give a fairly short answer.

First of all, the FERC order in July was not helpful. In the southeast, every investor owned utility that I have knowledge of and most all public power groups were working in good faith to form RTOs. So we didn't really need a bigger hammer. We already felt the need to move in that direction.

What FERC has done, in my judgment, first of all has not only expressed an interest in moving faster and more deliberately to RTOs, they're beginning to express a very firm position on the structure for the RTO in the southeast and the size. Well, unfortunately, that was not the structure and the size being pursued throughout the southeast, so it has pretty much thrown those negotiations into turmoil and I think slowed down the process.

No. 2, the States in the southeast are not at all convinced about the direction that RTOs should take. I think FERC generally was going in the right direction with Order 2000, and we were in the process of trying to convince our States that that was a good move. I think the recent approach by FERC has tended to dissuade or increase the concern that the States have about where FERC is ultimately going.

And we can't move into an RTO. With 90 percent of our income regulated by States we cannot move into an RTO structure or size that our State strongly oppose. It would be financial suicide for us. So it's awfully important for us to bring the States along, and I think FERC action has hurt that.

The other point, the very large RTOs I think long term may make sense. I doubt there needs to be four, maybe there needs to be six, maybe there needs to be eight. I don't know. I think time will tell. But with current FERC pricing where you can move within an RTO, where you can move power any distance for the same price you move it one mile, we're going to get huge distortions related to location of generation. And FERC has not been willing to address that.

One of my greatest concerns related to large RTOs is the distortion that we see in the location of generation because of inadequate distance-sensitive pricing.

Let me just mention one other thing since I've got the floor. The chairman's probably about to cut me off.

But a big issue from a corporate standpoint for us is there is not inadequate generation in the southeast. I heard one of the panelists say there was imbalance. There is imbalance; there is way too much generation being built in the southeast. That's probably good for consumers long term, but it's going to require a huge amount of transmission. Ultimately we're going to have to build that transmission and collect the cost of that transmission from our retail customers. Regardless of FERC State jurisdiction the ultimate consumer in our region has to pay for that transmission. And we want to be sure that only the right transmission is built and that our State commissions are willing to allow us to recover that cost. That's a huge financial issue for us.

Mr. BOUCHER. You have mentioned a couple of times in your testimony today this notion of distance-sensitive pricing, and I think it might helpful for us if you were a little more specific about what the problem that you perceive is and how distance-sensitive pricing should properly be structured to address that problem.

Mr. FRANKLIN. Okay. Thank you for this opportunity.

In most any other form of transportation that I'm aware of, the further you move a product the more it cost to move it. So if you're going to build a manufacturing plant, all things equal, you build it closer to the market not a 1,000 miles away.

In electric transmission within a region, within an RTO that's not true. You can build a power plant a mile from the load or 500 miles; the cost to move the power is the same. So there's no incentive to build the generation close to the load. That exacerbates the transmission problem. It's resulting in generation being built by the boatloads down along the Gulf Coast where natural gas is located and shipped to Atlanta, and Charlotte and up the east coast when in fact it should be built close to those load centers, all other things equal.

That causes two problems. It increases the investment in transmission and the ultimate cost to consumers. And No. 2, it makes the system less reliable because you have these massive power flows; the greater the power flow the more bottlenecks are created and the more reliability problems are created.

Mr. BARTON. Will the gentleman yield?

Mr. BOUCHER. Before I yield, Mr. Chairman, ask you one additional question.

You've really defined well, I think, the problem. But what's the answer? I mean, how do we achieve distance-sensitive pricing so as to result in generation being built in a way that is proximate to where electricity is consumed?

Mr. FRANKLIN. It actually is pretty simple. It's been done in the natural gas industry. If you move gas from the Gulf Coast to Atlanta, it cost a whole lot more than moving it just 10 miles inshore from the Gulf Coast. So FERC is very familiar with distance-sensitive pricing.

There can be lots of debates about the exact method where there is zonal. In other words, you have a megawatt mile approach, which offends a lot of people, and I'm not sure it's a great idea either, or do you say you can move power for a price for 100 miles

and when you go the second 100 miles there's another increment? There are lots of methodologies; I think a methodology that can be found that's fair.

I think the problem is the mentality has been at FERC, and our industry too to a degree, that transmission is such a low cost in the total cost of electricity compared to generation that it doesn't matter; that it doesn't matter if you overbuild. It doesn't matter if you build too far from the load center. Well, that's changing.

What we're looking at is tripling our investment in transmission. It's only about 10 percent of our total investment to date. Transmission is about 10 percent. Within the next 5 years it'll go to 20 percent. So investment in transmission does matter and making efficient transmission decisions is just as important as making efficient generation decisions.

Mr. BOUCHER. Well, that's excellent food for thought, and I thank you.

I'd be happy to yield to the chairman with the admonition that I have one additional question I'd like to ask.

Mr. BARTON. I was just going to ask what he answered if there's a way to do distance-sensitive pricing that the industry thinks makes sense, that's all.

Mr. BOUCHER. Mr. Chairman, let me suggest, if I might, Mr. Chairman, that maybe we ask Mr. Franklin and his very excellent staff to enlighten us a little bit further with some written recommendations.

Mr. BARTON. Could the gentleman suspend just a second?

Mr. BOUCHER. I'd be happy to.

Mr. NORWOOD. Are we going to have more than one round?

Mr. BARTON. We're going to have a long one round.

Mr. NORWOOD. I see. So the light's not nearly as important? Okay. No problem.

Mr. BARTON. You'll be on Georgia time when we—

Mr. BOUCHER. And, Mr. Franklin, if you could perhaps send us some written suggestions in the fairly near timeframe about how distance-sensitive pricing might actually work. What kind of formulas would make sense to achieve it?

Mr. FRANKLIN. We will absolutely do that. Thank you.

Mr. BOUCHER. That would be helpful.

Mr. Chairman, the other question I have is this: The Supreme Court had arguments last week in the consolidated cases arising out of the FERC's Order 888. No sooner had the FERC issued Order 888 than it was sued from both directions. Marketers filed suit saying the FERC had not gone far enough to assert jurisdiction over transmission and the States, on the other hand, sued FERC saying that they had done too much and that Order 888 asserting authority over unbundled transactions in States that were open to competition was more than FERC could have done, and that FERC was not empowered to do it. And the Supreme Court heard the arguments on both of those positions last week.

This set of arguments, that case, really goes to the fundamental issues that we have to address in terms of the balance of State and Federal authority over transmission. And I'm wondering if anybody here thinks that this subcommittee ought to wait until the Supreme Court renders its decision, which we could probably expect

in the near term, anywhere from 2 months to 6 months depending on what they get to first, before we legislate on this complex and very difficult subject?

I am agnostic. I'm open to suggestions. I haven't made up my mind about whether it makes sense for us to go forward at this point and begin to tackle these thorny issues, but I would welcome your advise. And so let me offer the opportunity to suggest to us whether it's better to wait or whether it's better to move.

Mr. BARTON. That will have to be the last question.

Mr. BENNETT. I have an easy answer on that, since the State of New York was one of those arguing against the FERC extension of jurisdiction, we think it would be wise to wait.

Mr. BOUCHER. Okay. Anybody disagree? Did I see a hand over here?

Mr. Esposito?

Mr. ESPOSITO. I would just say you might think about somehow encouraging the Supreme Court to act quickly. I don't know what kind of vehicle you have to do that.

Mr. BOUCHER. That's above our pay grade, Mr. Esposito.

Well, maybe if we actually report a bill, that might a signal of some sort.

Well, thank you, Mr. Chairman. And I want to thank these panel members for their helpful testimony.

Mr. BARTON. We do encourage all members to put their written comments in on this distance-sensitive pricing. We understand that Mr. Franklin's position is probably not unanimously accepted by the other members of the panel.

The gentleman from Georgia, Mr. Norwood's recognize for 10 seconds—5 minutes.

Mr. NORWOOD. This is going to be a loud hearing, I can see.

Thank you, Mr. Chairman. And I do thank the panel members.

I find it interesting the ranking member and the chairman, I believe, got right at the heart of the issue and I want to stay on this thing of RTOs just for a little while. And I'm particularly interested, Mr. Johnston and Mr. Mr. Franklin, hearing from you as all panel members, but I want us to say what you said before maybe in maybe some different ways so that it sits very well with this committee and we all have an understanding of it.

It's pretty clear, I think, to all of us that FERC has been moving rapidly trying to get everybody into RTOs. It seems that they like the magic number of four. It seems that they like the thought of large RTOs. And I'm interested in hearing again, first, is this a possibility? Is it technologically possible? Again, how do you feel about that? What if the FERC gets this wrong? What will it do to your customers and my constituents? Have there been studies done so that we can understand, perhaps, if we get it wrong what it might do to our customers?

What's the consequences of us moving too quickly right now? What will it do to your customers and my constituents if we go too fast? Are there ways that the FERC can speed the process along without mandating to our utilities a certain predetermined configuration that you have to sit in stone right now or that perhaps we'll try to sit in stone?

And I'm willing to give up a great deal of time to hear you two gentlemen to discuss that.

Mr. JOHNSTON. We believe that it's a fairly hard sell in a low cost State for RTOs generally, even though I'm speaking here as LPPC and we support the development of RTOs, but reasonable thought out RTOs that we've taken a look at operational issues, we've taken a look at natural markets, we've taken a look at cost benefits.

Frankly, I have not seen—I don't believe there is any cost benefit, comprehensive cost benefit analysis for the southeast United States on the value of RTOs. And I'm not saying that there isn't value, I'm saying there has not been comprehensive studies done or got out.

Mr. NORWOOD. Well, could they be ongoing and we don't know about it? Is somebody looking at that?

Mr. JOHNSTON. Well, maybe they are, but I am not aware of them. But they need to be done and we've stressed that they need to be done, because it's very difficult for us to go to our communities and sell the cost of RTO development, which could be hundreds of millions of dollars, and I have seen very few people say that you're going to lower transmission costs by the creation of RTOs. I think most of us believe you're going to raise the transmission costs. So where's the value going to come from? It's going to come from the generation side.

Well, if it comes from the generation side, and you're already in a low cost State, that's a difficult cost benefit analysis because the chances are what's going to happen to your generation is it's going to get exported, you're not going to import cheaper generation.

So, I'm not saying it can't be done. I'm saying it's a very tough sell in a low cost State. But it needs to be done or it's dead on arrival in my communities when I try to sell the cost of developing an RTO.

So comprehensive cost benefit studies, operational studies. As some have said, these systems that we've built over the last 100 years were never built to be put together, so there has not been an operational study on what happens when you do put them together. And there will be issues, operational issues that come out of that that have not even been studied.

Mr. BARTON. Would the gentleman yield?

Mr. NORWOOD. Yes, sir.

Mr. BARTON. And I'll give you as much time as you need.

Well, I'm a little puzzled. Basically the transmission assets already exist and there are already people operating them. What is the additional cost of creating an RTO if the infrastructure is in place and the personnel's in place, and all we're really doing is setting the ground rules and requiring that there be, for lack of a better word, cooperation and communication? Where is the additional cost in that?

Mr. FRANKLIN. That's a good question, but there's also a very good answer.

Mr. BARTON. Thank you.

Mr. FRANKLIN. An RTO, the primary cost is setting up one very large centralized control system with staff that actually—it's not just a coordination in cooperation. It is replacing a number of smaller control centers and smaller staffs that may be scattered

around several States with one large control center; lots of electronics, lots of computers, lots of screens, lots of telecommunication equipment. The thing in California, as I recall, for the power exchange and the ISO was like \$600 million to set up.

Now, that is an extreme. A lot of things in California was an extreme. It won't cost anywhere near that, but our best estimate for the smaller RTO that we were talking about with the coops in municipalities is probably \$100 million.

Mr. BARTON. But over time if you're going from many to fewer, you know, and from older to newer in terms of equipment it will save money, wouldn't it?

Mr. FRANKLIN. Well, it's a case if somebody would buy those old control centers from you, but you still have the investment in those control centers plus you build a new one.

Now, long term, I think—let me—if I could address maybe both questions sort of.

We haven't done a cost benefit study. We've done a cost study, a rough, very rough cost estimate of what the RTO would cost. Maybe \$100 million, maybe a little more initially to set up.

I've been involved in the industry 30 something years. I've been planning transmission for a big part of that. My gut feeling is that over time with that kind of investment, the size we're talking about, it probably will pay for itself. I couldn't prove it today, but I think it probably would. But when you talk about a much bigger RTO, it's the typical centralization, decentralization question.

You can prove on paper centralizing every decision in a company that the CEO will make it run better, but it doesn't. The same is true in trying to centralize the operation of a huge transmission system in one place as opposed to having maybe 3 or 4 operating centers. Theoretically you get more efficiencies, you have fewer control centers, but what you end up with is more bureaucracy and decisions being made further from consumers and further from the frontlines.

When you say how centralized should a company be, there is no exact answer. How big should an RTO be, there's no exact answer. The bigger it is the more bureaucratic it becomes, the further reliability decisions are made from where the real reliability problems are, but theoretically the more efficient it is. And we think the balance is what's being proposed in the southeast for the SETRANS model.

And let add one other point to Mr. Norwood's question. Another big issue, Congressman, and I'm very concerned about this because we're the most regulated industry in the world and we're one of the most regulated companies in the world.

We're regulated by four State commissions. And if we go into a big RTO and it doesn't work, and we don't have our State commissions on board, it's going to be a disaster just like it's been a disaster in California.

And I don't mean a disaster from a reliability standpoint, I mean a disaster for us. We're going to be punished financially just like the companies in California have been punished.

It's critically important for us to get the States comfortable and onboard with where we're taking RTOs. I think that can be done,

but it can't be done with a heavy hammer mandate from Washington. It's just not going to work.

Mr. BARTON. Of course, I could say you could help in getting the States onboard.

Mr. FRANKLIN. And I will.

Mr. BARTON. Poor little old struggling southern company might have some influence.

Mr. NORWOOD. Reclaiming my time.

Mr. FRANKLIN. I tell you what, if we had had——

Mr. BARTON. It still is Mr. Norwood's time.

Mr. FRANKLIN. If we had had the influence with the State commissions that the chairman gives us credit for, our stock would be selling for 50 bucks a share, not 25.

Mr. NORWOOD. You've made it clear, I think, to the chairman that if we have that RTO there are X amount of new dollars that are going to be spent. And then you said well, we think we can pay for that. Well, I don't have any doubt you're going to pay for that. My question is it's my constituents who are going to pay for that, because that's who you have to pass that on to.

Mr. FRANKLIN. Right.

Mr. NORWOOD. And so the question has to be if we're going to do this, what is that going to do to rates in Georgia?

Mr. FRANKLIN. Congressman, I think initially it's going to raise rates. I don't think there's any question for two reasons. We're going to have an incremental cost of forming the RTO, that's new dollars. We're going to have to build a lot of new transmission; that could be helped if we had FERC transmission pricing right. So I don't think there's any doubt near term the rates are going to go up.

Longer term if these markets operate more efficiently, the generation markets; in other words having a larger region, more efficient generation markets what you would hope is the lower generating costs would offset the higher cost of setting up the RTO. Now, that's a gamble, but I think it's a pretty good gamble for the RTO our size.

Now, if it's start costing \$200 million or \$300 million, I'd be hard pressed to make that representation.

Mr. NORWOOD. Mr. Chairman, I've only got eight more questions, and I'll be brief. But I do have two other little quick things.

And, Mr. Franklin, while we're talking let's finish this.

Mr. SAWYER. With unanimous consent.

Mr. NORWOOD. I didn't notice Mr. Boucher needed it.

I keep hearing over and over again at these hearings this analogy that compares our transmission system to a reservoir. And I can visualize that pretty well where you can put electrons in anywhere along the system and you can take them out anywhere else.

As someone who is regulated by FERC, I've heard the discussion about FERC authority in establishing transmission ratemaking standards. Now, I'd like to hear your view on that situation.

Mr. FRANKLIN. Let me talk about the lake analogy first.

Mr. NORWOOD. Well, tell me about that reservoir.

Mr. FRANKLIN. There is no legitimate analogy between a lake and a transmission system. It's like comparing an airplane to a tugboat. I mean, there is no analogy at all.

In an electric system you have to be very, very careful where you inject power. You can burn the system down if you inject it in the wrong place. You have to be very, very careful where you add demand. And you have to add transmission based on the pattern of growth of generation and demand. So the lake analogy is useless. The highway analogy I would also add is useless.

You can't take shortcuts and pretend the electric system is a lake or a river, or a highway system. It's not. It's an electrical system and it's very much more complicated than static systems like highways or lakes. And, again, I think a little more thought going into that before the California experiment was implemented might have saved a lot of grief.

Mr. NORWOOD. How does this relate to transmission investment and getting a return on the risk associated with that investment? I mean, is this something that FERC has sufficient authority over already or is this something that Congress needs to act on?

Mr. FRANKLIN. I think as far as authority to set wholesale rates for transmission, FERC has authority. What I would like to see FERC do, and they have indicated in the past they would but it doesn't seem to be a priority, is to really focus on transmission pricing to make sure that transmission investment is done efficiently; that is generating plants are located in the right place, and that there is some incentives for building this huge amount of transmission.

I am flabbergasted that people, they believe in competition, somehow don't believe that incentives work in a regulated business. It's just like in a competitive business.

I'm also flabbergasted that utilities and State commissions that offer incentive rates for demand side products to use less energy, to use energy differently, they believe incentive rates for those kind of products, somehow that won't work for transmission investment.

I think it's a very short-sighted approach to simply continue to try to divide up the same amount of transmission among more users as opposed to focusing on getting the right amount of transmission built, and incentives will help that.

Mr. NORWOOD. Mr. Johnston, we probably need to answer quickly here. You know, I realize that the municipals and coops are not regulated by FERC, however, folks around here are talking about changing that. What is your feeling on this and the FERC having jurisdictional control over transmission associated with bundled services to our communities?

Mr. JOHNSTON. Well, we would strongly oppose FERC jurisdiction over bundled retail service to our communities. You know, frankly, it goes back to our obligation to serve and our State mandates. If you take away the tools that we use to carry out that obligation, how can we be expected to accomplish it? Because if you give FERC control over priority and use of that facilities, you in effect are tying our hands and our ability to carry out that obligation to serve. You know, it's kind of a silly statement, but maybe you have to transfer the obligation to serve to FERC, but I'm not sure they care to have it.

Mr. NORWOOD. Well, what happens if we were to do that? I mean, I don't understand what happens back home if FERC were to have that jurisdictional control.

Mr. JOHNSTON. Well, in a plain simple example, if I am moving electrons across the grid in Georgia in order to deliver it to my communities and a constraint occurs in that system and FERC is in control of that system or somebody under FERC's control is in control of that system and they direct the priorities such that they remove my native load to relieve the constraint, that's stripping me of my ability to deliver that obligation to serve that native load.

Mr. BARTON. We're going to have to discourage the gentleman from any further questions.

Mr. NORWOOD. I bow to the chairman.

Mr. BARTON. And we want to announce for the other members about to ask questions, it is acceptable to ask questions of the panel members who are not from the great State of Georgia.

Mr. NORWOOD. But not desirable. Mr. Chairman, I apologize to the other panel members. It's sort of natural for me to ask—

Mr. BARTON. I understand. I understand.

The gentleman from Ohio is recognized for such time as he may consume.

Mr. SAWYER. Thank you, Mr. Chairman.

I just have to observe that there are—I can think of at least a couple of transportation systems that are distant-sensitive. I'm not sure that we want to emulate them in this case, but one is the Postal Service.

Mr. BARTON. Very good point.

Mr. SAWYER. And the other may have some distance-sensitive pricing, but most of us can't discern it, and that's the airlines. There are an awful lot of fees that have no bearing on distance and there are an awful lot of people who are unhappy with that.

I would also suggest that centralized command and control of the kind that you suggested as a hypothetical seems to have been tried in the Soviet Union and fell apart. And my submission is that it would not be useful.

Let me ask one more question of the gentleman from Georgia, and anybody else who would like to answer, and that is the end of year deadline, it seems to me, creates some enormous pressures. Can you tell us your reaction to the feasibility and the result if in fact that's adhered to?

Mr. FRANKLIN. Well, I think the end of your deadline goes back to Order 2000.

Mr. SAWYER. Okay.

Mr. FRANKLIN. We were on a course along with the people from the municipals in Georgia represented by Mr. Johnston and others to move in that direction. I think the recent developments starting back in May and then concluding or being further exacerbated by the FERC order in July have knocked these negotiations off track. I think the end of year deadline does not seem feasible to me at all anymore.

Mr. JOHNSTON. Could I add something there?

Mr. SAWYER. Sure. Sure.

Mr. JOHNSTON. It's important to also recognize that the form of RTO that FERC is leaning toward, which is away from what we've been negotiating, essentially will alienate the vast majority of public power in the southeast, meaning public power is going to walk away from that RTO and has told FERC that. It's not just MEAG,

it's virtually all the major transmission holders, public power transmission holders in the region. You're going to have a huge potholed RTO if FERC does what they have indicated they're going to do, and it will not work very well.

Mr. SAWYER. The whole struggle for competition in your arena for the last 85 years it seems to me, has been a competition for capital. That's been where the real competition has been, and that's where the price advantages have resulted.

Mr. Trabandt, you mentioned that a properly structured transco will be able to access capital markets adequately. Can you give us briefly a sense of what you think is a properly structured transco and if the current access to financing is continued in the future, what will be the prospects for transmission capitalization?

Mr. SAWYER. Congressman, I appreciate the question because I think it's very important for the subcommittee to focus on the notion that these are new business operations. The RTO responsibilities which have been established by FERC in which the various RTOs around the country have been trying to satisfy would require this new business entity to be operating in a circumstance somewhat different from what had been previously contemplated, I think.

When I talk about properly structured, I'm talking about a capitalization that perhaps would be 60 to 70 percent debt with the increment of equity that would go with that, perhaps some preferred that would be structured in a way such that the coverage ratios would ensure that it's investment grade and will stay investment grade, which means it has to be credit worthy itself and it must have credit worthy counterparties for its contracts. That the investment that it's required to make—in many of these RTOs the negotiations have been along the lines of if a new generator—and in fact the chairman's proposed bill addresses this interconnections. We actually looked at all the proposed interconnections of the companies associated with the Alliance RTO. And there are numerous proposed power plants around the country, as you know. Perhaps the slow in the economic will change that, perhaps the uncertainty in regulations as a result of California will change that. But nonetheless, there are lots of proposed power plants, all of those plants have to be interconnected and all of those interconnections are going to have to be paid for. And every new interconnection, as you heard from Mr. Johnston and also from Mr. Franklin, change the flows on the system. And those have to be accommodated as well. And that's going to require substantial upgrade of the existing infrastructure to be able to support the competitive market. That's the reason, I think, that some formulation of an incentive, and as Mr. Vesey testified this morning, whether it's a somewhat higher rate of return because of the increased risk associated with it or whether it's in the form of other features that FERC has already adopted in Order 2000, is appropriate to ensure that in fact we can get the kind of capital to go in assuming the structure, and I described it in my testimony as well.

Mr. SAWYER. Is the traditional notion of "just and reasonable" rate as reflected in comparable kinds of risks in the marketplace, the same risk profile, will that apply effectively in the environment that we're talking about?

Mr. TRABANDT. I'm glad you raised that, because I was interested in Congressman Largent's comment about the FERC Commissioners being here last year and none of them could define "just and reasonable."

The definition of just and reasonable was established by the Supreme Court in a famous case some years ago, and there's not a whole lot of question about that. And I don't think anything that's being discussed in the way of incentives, and I read the chairman's proposal to make this clear, is to suggest anything that's not just and reasonable. But there is a range of reasonableness that's established under the applicable law with regards to what rates can be to take into account, for example, public policy associated with this very specific issue, infrastructure of commitments, to take into account greater risk, to take into account circumstances where the regulators have concluded that their benefits to the public and the consumers from having a different formulation of rate.

It's interesting to my experience, you all are more knowledgeable than I, but the FCC's been doing this for quite some time in telecommunications. When I was at FERC we worked with them when they adopted an incentive rate formulation which you all have long since approved. Most States have incentive rates of one kind or another. They've been wildly successful in reducing congestion in the United Kingdom where there's an incentive that's shared between the customers and between the company in terms of formulating new approaches to the business, which I think Mr. Vesey's testimony clearly looks at.

All of that can be built into a business model with a structure which I think could be highly successful in addressing these issues.

I think the question before you is FERC, as I understand it and all I know is what I've read, has indicated that it doesn't believe that with its new approach, it's new policy, that incentives will any longer be required. And while I don't question for a minute they have the authority, I helped write the incentive policy of FERC in 1991 and believe they did then and believe they did under Order 2000; I think the question is are those going to be available to support these new business structures, which you've heard from others are going to be very, very challenging businesses.

Mr. SAWYER. Are there others who would care to comment? Mr. Flynn?

Mr. FLYNN. Mr. Sawyer, I think the notion of "just and reasonable" certainly accommodates a return on rate base, the traditional rate making that we've had in the industry in the past. And whether the return that FERC sets is just and reasonable, the market will tell us by whether or not investment is forthcoming to go into assets. But I think the notion of just and reasonable can accommodate more than just traditional return on rate bases, as Mr. Trabandt alluded to a minute ago.

National Grid has pending before FERC today what I think is the first incentive rate for transmission that's been proposed in the United States. And it was a joint filing with the New England Power Pool which consists of generators, municipal utilities, marketers as well as transmission companies. Really the cross section of the industry. And the proposal that's before FERC, as I recall,

had over 90 percent approval and it was supported by ISO New England.

What was it? It was an incentive proposal that said we, National Grid, need to do some maintenance on our system. A good utility does maintenance on its transmission system. But to do maintenance the traditional way of working, at least in the northeast, is to take that transmission line out of service while you're doing the work. When you take the line out of service, that path is no longer available for power to get from generation to load. And what you end up doing is adding congestion on the rest of the transmission system.

And we know in New England today congestion costs the consumers are paying are more than \$100 million a year. And doing some studies and working with ISO New England, we did forecasts that taking this line out of service was going to create the potential for significant congestion that consumers would pay.

Well, the first thing we did is move the time of the outage to the fall, so it wasn't during the summer peak. But beyond that, we solved the potential of doing this work live, working the line live, keeping it in service so the power continue to flows to customers while we're doing the required maintenance.

And it appeared to us from our forecasts, and the work with ISO New England, that the savings to customers in terms of lower power costs because of the savings in congestion would more than offset the additional costs of doing the work live.

And so this was a proposal we brought to the New England Power Pool, and it really was a share the savings type of incentive where everybody wins. And the customers who used the system, the generators that used the system all looked at this and said "Yes, this is a good idea." This is the type of thinking we would like to see investor owned transmission companies bring to the management of the grid.

Now, this proposal is pending before the Commission. The work is going on. We're doing it live whether or not we get incentive from FERC. But nonetheless, it took a fair amount of work and study to come up with the idea to do the thinking of how you could save consumers money on the system. And we're really looking at this as a signal from the Commission will this sort of—approval of the incentive will give the signal to the industry that, yes, if you come forward with innovative ways of creating savings for customers, there'll be something in it for shareholders. And I think the concept of just and reasonable rates can accommodate that sort of incentive ratemaking as well as traditional return on rate base.

Mr. BARTON. If the Chair would interrupt. The gentleman from Ohio has had 11, 12, 13 minutes. Now, I said such time as you may consumer, because I gave Mr. Norwood 15 minutes, but—

Mr. SAWYER. Or such time as they may consume?

Mr. BARTON. Yes. But if you could wrap it up in the next 2 minutes, because we need to let Mr. Shimkus and the vice chairman of the full committee, Mr. Burr, have some time. Mr. English has to leave at 3:30, I believe.

Mr. SAWYER. I can wrap it up in the next 2 seconds, Mr. Chairman. I yield back the balance of my time.

Mr. BARTON. Well, if you have another—okay.

Mr. SAWYER. Thank you very much. Appreciate your latitude.

Mr. BARTON. And we're going to go to the gentleman from Illinois, Mr. Shimkus for such time as he may consume, but hopefully shorter road than longer.

Mr. SHIMKUS. As you wish, Mr. Chairman. Thank you for the time.

I'll tell you what I'm struggling with, and we've been in this debate now for 5 years that I've been a Member of Congress. But we do have a new environment today than we had a month ago, and I'm going to give you some examples, and I think we would be remiss if we did not add into this debate the new shift in the world based upon terrorism.

So some of this debate on how we're going to arrange our transmission grid should probably start addressing things like security, redundancy, capital available for repair, which I don't know if we've discussed very much today, and I missed the first panel, and I apologize for that.

The other thing I learned—I've been struggling with is the business model with what we have done, one, as we've addressed the airline industry. There was a time when you went to business classes on developing small business, what did you tell someone who wanted to develop a small business, you'd better have the capital to allow you to survive for 3 years without turning an actual profit in that business. But as we have become leaner and meaner, just in time inventories and stretching the price so thin because we all wanted lower prices in every good and service, we have diminished our ability for the capital reserve to respond to emergencies.

I'm really struggling with this. I see that that has happened in the airline industry and it's costing us a lot of dollars, a lot of tax dollars to keep these industries solvent, which is important for our whole Nation.

The other thing that I'm personally struggling with is, and it does kind of relate to the industry, the—I was at the Verizon headquarters down right across from the World Trade Center on the Telecommunications Subcommittee, Mr. Chairman. I think it's—and it fits into this whole debate about competition. Because here we have a regional Bell company that's supposed to be the big, in essence, regional monopoly that helps put down the competitive local exchanges, but it was big enough to bring a lot of capital to bear to get the connections up rapidly, and their story is monumental what they did at the switching station to get the economy back forward. The little competitors would say, you know, they can't compete but would the little competitors combined be able to provide the response, the emergency response that a regional monopoly, in essence—they don't like that terminology, but in essence the regional Bell was able to bring to the table?

So in this whole debate on addressing the transmission grid, my concern is what about this new environment of having the capital available to respond in case of tragedies and disasters, and the like? And I just want to throw that out. I don't want responses yet, but that's what I'm personally addressing right now, and I think it needs to be part of the debate, Mr. Chairman, especially as we talk about capital available, the redundancy issue and the repair issue and how do we fund the expansion of the transmission grid.

So that's an intro, but I want to ask Mr. Flynn, because you've had some expertise, can you tell me about the National Grid's business operations in Great Britain and are there any lessons that we can learn from the restructuring of England's power industry and things that we should do or things that we should not do?

Mr. FLYNN. I think there are some lessons to be learned. Obviously, you cannot go from one system and just map it to the United States point for point and say well what worked there will work here. But just to set the stage a little bit, back a decade ago all of the industry in the U.K. was government owned. And 11 years ago the U.K. privatized the system and it created an independent transmission company, that is a company that was for-profit investor owned, to manage the transmission grid that had no interest in the generation of power sales business. And that's National Grid. So that's the genesis of our company.

What has occurred in the U.K. over the period of a decade is that National Grid has reduced the controllable costs of operating the transmission system by about 50 percent. And it has reduced congestion costs on the transmission system by about 1 billion pounds. Both of those occurred under a system of incentive rates that the regulator in the U.K. established.

In essence, the regulator said "Look, we want you to manage the system as a business and what we're going to do is work with you up front to set targets with regard to what we think is the right level of costs that a company that's prudently operating the system would incur, and then we're going to set your rates based on those target revenues. You have the incentive and to try to operate the system more efficiently. And to the extent that you do, there will be sayings that your shareholders get to share in. On the other hand, if you're less efficient than we think you should be, then there'll be some shareholder pain and your profits will be less." They also established an incentive with regard to congestion costs on the system. And congestion costs are essentially costs that customers pay for power because generators that bid low, that are low cost, cannot run. They're constrained off by the system operator because there isn't enough transmission capacity to get the power from the low cost generators to the load centers. And because these low cost generators are constrained off, higher cost generators have to run and the difference is called congestion costs.

And when the markets opened in the U.K. congestion costs increased steadily the first few years, the same thing we've seen, quite frankly, when the markets opened in New England. And what the regulator said is we want to give you an incentive to begin to manage the system to control these congestion costs, and to the extent you're able to bring the cost down, your shareholders will be able to share in that.

I think the broad lesson is if you create a rate system with the right financial incentives, then the regulated transmission company will respond. And if you align incentives for shareholders with what's in the interest of customers, then you have a happy situation with the management of the transmission company is trying to create customer benefits and at the same time is adding to shareholder value.

With the right incentive rate structure, you also have a viable business that (a) that's able to raise the capital that's necessary to invest in the system. And, indeed, National Grid has engaged in considerable investment in the U.K. system, most of it not in new transmission lines on virgin right-of-way. Most of it is upgrading the existing system to improve the efficiency of the system, but under a business model a viable business is able to go to the capital markets and get that capital to make the necessary investment.

Mr. SHIMKUS. Thank you. And I know that using that U.K. model is difficult comparing it to the United States with the size and distance and stuff, but I did want to have that answered. And I'm going to finish up with a local general—Illinois has three RTOs. And I'd like to have Mr. Esposito, he talked the seams issue, what are the difficulties you face in a State in which there is actually three different RTOs?

Mr. ESPOSITO. The easy answer, Congressman, is that you know for three RTOs you have at least three seams, and you have to deal with things like scheduling times, being consistent when you go to put your power on the system, and you're going to go across these seams, that everything links up.

You have issues with what they call ramp rates. Some RTOs will look at different ramp rates and some might start at the beginning of the hour, some might start 15 minutes before the hour. These are problems that they've experienced in other places, particularly New England, New York, PJM. And you have to get some entity to say this is going to be the rule. And in the case of natural gas, that became the Gas Industry Standards Boards. It looks like we may have the Electric Industry Standards Board there to do that.

Being able to deal with those important issues that are day-to-day, hour-to-hour issues is critical.

Conversely, three isn't all that bad because you have a situation where you will develop best practices. Now, one of the things we had in the New York/New England PJM area was a situation where one of them required you to schedule your power an hour and a half ahead and the other allowed you to schedule the exact same type of transaction a half hour ahead. So we were able to say "well, they could do it in a half hour, why do you take an hour and a half." And you develop best practices over time.

So I think looking at resolving seams, we shouldn't jump all the way to saying we're going to have a uniform set of rules across the country or a uniform market, because that could be a uniform mistake.

Mr. SHIMKUS. I'll just two bits worth and yield back, Mr. Chairman.

It does tie into my previous comments and the effect, although you may eventually get to best practices there may be some deficiencies initially in the system by which you may not be able to get the return on the investment which addresses the repair and the maintenance and the possible development of redundancies and the things I think, the new environment—in this new environment that we'd better start talking about and considering.

And with that, Mr. Chairman, thank you and I yield back my time.

Mr. BARTON. For our last questions, the gentleman from North Carolina.

Mr. NORWOOD. Could the gentleman respond to that, Mr. Esposito?

Mr. BARTON. I didn't think that was a question. I thought that was a statement. But, sure if he wants to respond.

Mr. ESPOSITO. Yes. I would just respond when you go to a competitive market, you've got people like us who make money finding efficiencies in the system. When people say no, we say why not and try to work around. And I think you end up with the work arounds by having competitors enter the market. These aren't people who make money unless they find a solution.

Mr. GERKEN. Can I answer, add to that? I've got three RTOs.

One of the things that we've got three RTOs and we don't see a real issue of working within those. My issue from a small perspective is being able to move my power on an hour-to-hour basis.

Let's say I'm trying to, for layman's terms, I'm moving from one IOU, IOU-A to IOU-B, and I'm moving 100 megawatts. What happens is during the hour I get a TLR, or transmission line relief that says I have no capacity through that interface. That's physically impossible, but what happens is all the IOUs have reserved all of their native load or all their generation to that capacity that says zero. Well, my problem is if it was an independent system operator, if I said "Okay, I will turn 50 megawatts of peaking generation on in B to unload you 50 megawatts, will you allow me 50 megawatts in," I don't get any justification or satisfaction because they control the rules today.

If an RTO was there independently looking at it, watching the flows, I would actually be giving them benefit as well as my asset benefit. That's all we see is the trouble area right now.

Mr. SHIMKUS. I should ask Mr. Norwood, is that fine? Do you yield back your time?

Mr. NORWOOD. I didn't have to.

Mr. BARTON. All right. Mr. Burr, the last questioner.

Mr. BURR. I thank the chairman. I've enjoyed listening to Mr. Shimkus.

If I cover ground that you've already plowed before me, I apologize.

Mr. BARTON. I would encourage you to plow it quickly.

Mr. BURR. I will plow it extremely quickly.

Mr. BARTON. We've already had one crop harvested today.

Mr. BURR. I won't even plant a second one.

Mr. Franklin, let me ask you, because I think you've covered in some detail in your testimony some concerns that you have about RTO formation specifically how quickly FERC's trying to move. Which speed should they move if they should?

Mr. FRANKLIN. Congressman, my concern is not so much how quickly, it's more a case of how prescriptive FERC apparently intends to be on the size and scope of the RTOs.

I think that, first of all, the RTOs that are formed we're going to be stuck with for a long, long time. And whether it takes 18 months or 2½ years in the long term doesn't make any difference. I mean, it's much better to get it right.

At the same time, I think before this latest order coming out of FERC, we were getting close to a broad agreement in the southeast to form an RTO. Now, once we had the broad agreement to form it, it probably takes a year to 18 months to actually put it in place and have it working. So I don't think under any circumstances we're talking about a long period. The issue is more how prescriptive FERC will be as opposed to letting RTOs evolve in different regions.

Mr. BURR. What experience do we have within FERC today and RTOs at their ability to evaluate the assets?

Mr. FRANKLIN. When you say "evaluate the assets," you mean—

Mr. BURR. Value the assets.

Mr. FRANKLIN. Oh, the value of the assets in an RTO? I first of all wouldn't profess to know what expertise is in—

Mr. BURR. But is the only example that we have up to this time what we did in California? Was it FERC that valued the assets that went into the—

Mr. FRANKLIN. No. No. I don't think so.

Mr. BURR. All right.

Mr. FRANKLIN. Being from Georgia I'm in a perfect position to evaluate and be an expert on California.

Mr. BURR. That's why I asked you.

Mr. FRANKLIN. So take what I say with a grain of salt.

I think the high cost, and I'm going to say this very generally because I don't want to overstate what I really know. The high cost of forming the power exchange and the ISO in California was more a case of the design, how elaborate the computer systems were, the time it took to do it, how many people were involved. It seemed to me it was sort of a design by committee. But it doesn't seem to me that the cost of buying those computer systems, putting the software together, hiring the staff; it doesn't seem to me that that should be related to be the FERC.

Mr. BURR. You, a southern company, to join an RTO would be asked to turn over your transmission grid, correct?

Mr. FRANKLIN. We'd be asked to turn over the control and operation of our transmission grid, not the ownership.

Mr. BURR. The reimbursement that you might receive for the use of that grid would have a significant factor on whether you participate in the upgrade of that grid, would be that be correct?

Mr. FRANKLIN. First of all, we have a—it would have a big factor in whether we were smiling or frowning when we did it.

We have some legal obligations to provide services, Mr. Johnston said about the municipals. So we have an obligation to build transmission. We have an obligation to expand the system as demand grows. But it's awfully hard to build transmission. You got to get siting, you've got to deal with local landowners. It's a very unpopular thing to do locally. And you can do it with a whole lot more enthusiasm and a whole lot more courage in dealing with local problems if you're getting a decent return on that future investment.

Mr. BURR. Is there anybody that believes that we do not need to upgrade our transmission grid in this country?

Mr. Bennett, let me ask you, is it the position of the public utility commissions that FERC has the authority to take a closed State and to require them to open up, to participate in a—

Mr. BENNETT. I'm sorry, what were the last two words?

Mr. BURR. Does FERC have the authority in your estimation to go into a closed State and require them to join an RTO?

Mr. BENNETT. I think that's part of the litigation before the Supreme Court now, I would say it's the position of NARUC and the position of New York State that FERC does not have that authority.

Mr. BURR. I was just trying to get you to stay that.

Mr. BENNETT. And they should proceed on a voluntary basis.

Just a comment. One of the greatest problems, aside from the economic part of it, one of the great problems is how do you get the transmission lines built from one State to another.

I happen to live on Long Island, which is known as a load pocket. We have a need for 5,000 megawatts and we can produce about 5,010 megawatts, so we're right on the line. And we had a plan to bring power across the Sound from Connecticut which was going very well, and then at the last minute we derailed. Now, I'm sure we can work things out with our friends in Connecticut, but it is very, very difficult to get these transmission lines built even within one's State. And if you're going to go from one State to another, the difficulty becomes compounded. But I think that it works—we're going to do a lot better in that situation working with Connecticut than if someone tried to mandate it.

Mr. BURR. It may have been your testimony, Mr. Franklin, and I think we've had it before and I certainly understand it, that the ability to site generation might overcome some of the bottlenecks in transmission grids. And I would also add to that, and I'll be happy for you to comment, that there are many places in the country where, for whatever reasons, we won't build generation facilities where there's a need for power. And the ability to upgrade a transmission grid and put a generation facility in the desert, as advantageous as it is, for somebody else to put a generation facility right next to a high growth area where we can deliver power.

Under the scenario, shouldn't we as a national interest make sure that whatever we do is something that creates the type of incentive that does upgrade our transmission grid where it's needed?

Mr. FRANKLIN. Yes, sir. I think there are two points.

When deciding where to build generation, for example, we don't need to let the cost of transmission or the cost of generation alone dominate that discussion. We need to look at the total cost of both. The real incremental cost; how much more is it going to cost to build a generating plant in location A versus B, and how much new transmission is going to be required. And add the cost up and whichever one is the lowest cost, that's where the generation should be built. And if we get transmission pricing right, that's exactly, in my judgment, that will happen.

So the first issue is to get the pricing right so generation is built where it needs to be built. I think the second component you referenced is to be sure it is a reasonable financial investment to put money in transmission so that the capital is coming into the transmission business.

If we do those two things, I think the market demand will over time make sure we have the right amount of transmission and we'll have generation located in the right place.

Mr. BURR. Is there anybody that would disagree with the statement that Wall Street will be a good indicator as whether we've found the right balance as to how to write a transmission bill? I show that as all yeses.

Thank you, Mr. Chairman. I yield back.

Mr. BARTON. Thank you, gentlemen.

I want to thank this panel. This concludes our series of hearings on the electricity industry. The next step is to put out a second draft after appropriate consideration of the comments on the first draft. I would encourage you to look at our RTO proposal that I authorized the release of yesterday afternoon. Get those comments in writing to us as quickly as possible.

The Senate is attempting to move some sort of energy legislation. If and when that occurs, I would like to be able to go to markup with an electricity bill so I could have the option with Mr. Dingell and Mr. Boucher, and Mr. Tauzin to put it into the comprehensive energy conference if that occurs.

Thank you, gentlemen, for your testimony today.

This hearing is adjourned.

[Whereupon, at 3:45 p.m., the subcommittee was adjourned.]