

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Conference on Competition in Wholesale Power Markets Docket No. AD07-7-000

TESTIMONY OF AUDREY A. ZIBELMAN
ON BEHALF OF
PJM INTERCONNECTION, L.L.C.

May 8, 2007

I am pleased to have the opportunity to address the Commission today on issues of governance and RTO accountability. I am the Executive Vice President and Chief Operating Officer of PJM Interconnection, L.L.C. (“PJM”).

Before responding to the specific Commission questions, I think it is appropriate to first frame the overall issue and provide a decision-making analysis for the Commission’s consideration as it approaches this issue. Without an appropriate focus, one can rapidly get into the weeds of arguing whether this or that particular process or corporate governance practice should be addressed by the Commission. To avoid this conundrum, I think it first appropriate to step back and consider the larger issues. There are two issues at play: what constitutes effective corporate governance practices for an RTO and what role the Commission should have in overseeing RTO and ISO governance. I will address each issue separately.

I. What constitutes effective corporate governance practices?

Effective corporate governance practices are essential to enabling an organization to fulfill its mission by: 1) ensuring fiscal responsibility; 2) establishing clear organizational goals; and 3) meeting the needs of the organization’s stakeholders. In the post-Enron era, a significant amount of attention has been devoted to the issue of corporate governance in order to restore public confidence in corporate behavior. The result included the enactment of the Sarbanes Oxley Act of 2002, as well as the issuance of numerous reports, policies and recommendations by organizations focused on corporate governance practices. In evaluating the governance of RTOs, the inquiry or scope of review cannot and should not be limited to comparisons with their counterparts. Any discussion of corporate governance practices for RTOs should include consideration of governance-related laws and regulations applicable to all corporations, as well as consideration of governance-related recommendations developed by recognized organizations, for example the National Association of Corporate Directors.

Although RTOs have some unique characteristics, many of their governance principles are similar to those of typical corporations. RTOs do not issue stock and do not have shareholders. Yet they are businesses and are subject to corporate laws and standards and remain accountable both to stakeholders and regulators. RTOs are not operated for profit, however they must develop and operate according to budgets. RTOs must establish corporate governance practices similar to their non-RTO counterparts in order to: 1) ensure fiscal responsibility; 2) establish clear organizational goals; and 3) meet the needs of their stakeholders.

In deciding whether RTOs are sufficiently accountable, one needs to first measure RTOs, like any other corporation, against established corporate governance principles. The Commission should recognize that there is no “one size fits all” to corporate governance and refrain from mandating specific governance processes for RTOs. It would be inappropriate for the Commission to create new accountability standards, not otherwise tested for other entities, out of whole cloth or to pit RTO governance practices against one another given the very limited universe of entities involved and their different stages of evolution. By the same token, it is always appropriate to look beyond one’s own industry to avoid a myopic approach. Although there are some issues that are unique to this industry, certainly sound governance is not one of them. Rather, guidance should be obtained from a number of laws and industry standards.

The Sarbanes Oxley Act of 2002 provides useful guidance regarding governance practices that promote fiscal responsibility. Although PJM is not subject to the Act's requirements, PJM believes that many of the requirements represent best practices for fiscal responsibility and as such, PJM has voluntarily adopted numerous Sarbanes Oxley practices. For example,

<i>Sarbanes Oxley Act</i> Requirements	PJM Governance Practice
Audit Committee comprised of independent board members, including one "Financial Expert" Section 301	PJM's Audit Committee Charter requires Committee members to be independent and include one "Financial Expert" as defined by Sarbanes Oxley Act
Certified financial statements by the principal executive officer and principal financial officer Section 302	PJM Annual Financial Statements are certified by the Chief Executive Officer and Chief Financial Officer on a quarterly and annual basis
Disclosure of adoption of Code of Ethics Section 406	PJM has adopted a company-wide Code of Conduct as well as a Board of Managers Code of Conduct
Procedures for anonymous reporting of complaints Section 301	PJM maintains a 24/7 toll-free helpline for employees to report complaints on an anonymous basis
Prohibition of retaliation against informants Section 1107	PJM Code of Conduct prohibits retaliation against individuals who make complaints or act as witnesses
Prohibition of auditors providing non-audit services Section 201	PJM does not engage its auditors to provide any non-audit services
Prohibition of personal loans to executives Section 402	PJM does not permit the granting of loans to executives, other than relocation loans

Additional guidance regarding corporate governance practices can be found in the New York Stock Exchange (NYSE) listing requirements for publicly traded companies. Pursuant to the NYSE Corporate Governance Standards, Section 303A.00, "Listed companies must adopt and disclose corporate governance guidelines." In examining these Governance Standards, PJM

has already adopted several of the governance requirements that the NYSE has established for companies traded on its exchange. For example,

<i>NYSE Listing Rules</i>	<i>PJM Practice</i>
Majority of Independent Directors Section 303A.01	PJM Operating Agreement, Section 7.2 requires all voting Board Members to be independent
Companies are required to adopt and disclose qualification standards for directors. Section 303A.09	PJM Operating Agreement, Section 7.2 contains the qualification requirements for Board Members

Ratings agency evaluations also provide important insight into an organization’s fiscal responsibility. In conducting a risk assessment and assigning a rating to an organization, rating agencies take into consideration both quantitative and qualitative factors of an organization’s operations. Moody's Investors Service has assigned an Aa3 senior unsecured rating to PJM Interconnection, LLC (PJM) which places PJM in the top 3% of all rated utilities. The Aa3 rating reflects investor confidence in PJM and its track record in operating markets and ensuring reliability. The rating also reflects the size, stability, and liquidity of the PJM power market. In addition, the rating considers the stringent credit standards to which all PJM participants are subject.

An organization’s fiscal responsibility is also demonstrated by its implementation of audits in accordance with the Statement of Auditing Standards No. 70 (SAS 70). SAS 70 audits represents that an organization has undergone an in-depth review of its control objectives and activities. PJM’s Market Settlements processes and systems have undergone SAS 70 Type 2 audits since 2000. For the twelve month period ended September 30, 2006, the audit resulted in an unqualified opinion with four minor reportable exceptions. This represents PJM’s sixth consecutive unqualified opinion.

Numerous organizations have conducted extensive reviews of corporate governance practices and have developed recommendations for corporate governance practices. These organizations, such as the National Association of Corporate Directors (NACD), The Business Roundtable and The Conference Board have issued publications and recommendations in the area of corporate governance.

PJM's governance practices include many of the recommendations of these organizations¹, for example:

Majority or substantial majority of independent board members	PJM Operating Agreement, Section 7.2 requires all voting Board Members to be independent
Avoidance of conflicts of interest	PJM Operating Agreement, Section 7.7 requires that the Board ensure that the President, the other officers and the Office of the Interconnection perform their duties and responsibilities in a manner consistent with...the principle that a Member or group of members shall not have undue influence over the operation of the PJM Region. Board of Managers Code of Conduct requires Board members to avoid self-dealing and conflicts of interest and accord PJM's interests over other interests.
Executive Sessions of independent Board Members	PJM's practice is to include scheduled executive sessions for its independent Board Members at every Board of Managers meeting
Independent Board Committees	All of PJM's Board Committees all of which are comprised of independent directors.
Board assessment and evaluation processes	The Board Governance Committee is responsible for periodically assessing the skills, experience and characteristics of PJM Board members. It also manages the process by which the PJM Board annually evaluates its own performance. PJM Governance Committee Charter, Article III
Board access to senior managers	PJM management regularly participates in Board of Managers and committee meetings.
Consultants for compensation should report directly to the Board, not management	The PJM Board Human Resources Committee (HRC) is responsible for retaining an independent consulting firm to perform compensation analyses. This consultant reports directly to the PJM Board HRC.
Executive compensation linked to performance	PJM executive incentive compensation is directly tied to organizational goals which are reviewed and approved annually by the PJM Board.

¹ National Association of Corporate Directors (NACD), Report of the NACD Blue Ribbon Commission Director Professionalism, 2005 Edition. Council of Institutional Investors (CII), Corporate Governance Policies, April 5, 2006. The Conference Board, Corporate Governance Best Practices, 2003. Business Roundtable, Principles of Corporate Governance 2005.

II. What actions should the Commission take, within its jurisdiction, to address the issues? What actions, if any, should others undertake?

The Federal Power Act itself, as well as the recently passed Energy Policy Act of 2005, provide important guidance in answering this question. By requiring that the Commission find that rates are just, reasonable and nondiscriminatory, it is clear that the Congress directed the Commission, at the end of the day, to regulate outcomes not processes. In those specific places where it did set forth certain process expectations, such as in the activities of the ERO, the Congress was clear that the Commission's ultimate task was the adoption and enforcement of reliability standards not the mere creation of an organizational process around development of standards. This Congressional focus is instructive. PJM is not saying that a fair and open governance process is not vitally important to successful results---it clearly is. However, as to corporate governance, the Courts have made clear that the Commission's role is more limited.

As to stakeholder processes, this Commission has stated it cannot accede to a particular proposal merely on a "majority wins" basis---it is required to do its own substantive analysis of whether the proposal is just, reasonable and nondiscriminatory. The same is true for the RTO---a fair process is important as is RTO accountability. However, this cannot substitute for reasoned decision-making by the RTO as to what, in its view and subject to Commission approval, is best for the marketplace as a whole and the reliability of the bulk power grid. As a result, the Commission should resist the temptation to start dictating governance structures, processes or strict requirements from Washington which may not work in Wilmington, Carmel, Indiana or Folsom, California. The Commission's focus on clear enunciation of its policy expectations in key areas such as planning, cost allocation and market monitoring will go much further to ensure that stakeholders remain focused and committed to the important work ahead of us. That being said, PJM recognizes that additional work is needed to ensure further access by its members to the PJM Board. This must be done in a way which is open and transparent and does not violate the principle, embodied in PJM's Operating Agreement, which prohibits undue influence by any stakeholder or group of stakeholders over the Board's decision-making process. The Commission is right to raise these issues in forums such as this one. PJM is proposing additional changes in this area in its Strategic Report and is open to suggestions from stakeholders and others that enable us to provide the access that members seek while still protecting against undue influence and ensuring that the best decision is made that meets the overall needs of the market and reliability.

III. Response to Commission Questions

Stakeholder Processes:

- **Are RTOs and ISOs – and their decision-making mechanisms – designed to address adequately the interests of their customers and other stakeholders?**

This question, as framed, underscores the need for clearly defined policies that recognize the appropriate balance between independence and accountability. It is critical that RTOs have

processes in place that ensure appropriate accountability to the membership. In PJM, accountability occurs in a number of forms including:

- Direct Accountability of the Board to the Members – The PJM Board members have specific terms and are required to be elected by the members. The PJM Nominating Committee is comprised of Member representatives from each Member sector and Board representatives. This allows the Members to play an integral role in the selection of Board candidates.
- Financial Accountability of the RTO to the Members – PJM has also taken proactive steps to improve its accountability to the members who pay the costs of the RTO. PJM has moved from a pass-through formula rate to a stated rate. As part of the stated rate, PJM is required to operate under a cap and excess revenues above a pre-set reserve are refunded to the members. Our stated rate settlement further provides for an enhanced role for the PJM Finance Committee, made up of elected sector representatives to review and comment to the Board upon PJM’s proposed budget. The stated rate settlement did not eliminate any stakeholder’s right to file a complaint with this Commission pursuant to section 206 of the Federal Power Act but provides a clear stated rate that PJM is required to operate within and a level of transparency and dialogue between the members and PJM;
- Substantive Accountability on Market Rule Changes – All of PJM’s market rule changes go through our stakeholder process where specific rules exist concerning the need for advanced posting of information, the openness of meetings and availability of telephonic hook-up as well as strict voting procedures under a hierarchical committee structure.

Although I’ve highlighted some of the aspects of accountability that are inherent to PJM today, I do want to underscore what the Commission should not do in the name of “accountability”. It is important for the stakeholders to have input into tariff rules, the RTO budget and RTO operations. PJM and its Board value that information and input. However, accountability should not mean the RTO always goes with either the majority or the “least common denominator” solution. This is where accountability needs to be balanced with independence. The RTO is one of the only entities (with the exception of the state commissions and this Commission) that does not have a financial stake in the outcome of particular market rules or operations. The RTO, after taking input, should be able to make its own decision consistent with its obligations, which is to ensure the creation and operation of competitive wholesale markets, the operation of a safe and reliable grid without undue influence from any market participant or group of participants. The RTO needs to obtain input from all of its stakeholders. But the exercise of independent judgment, after taking into account all input should not brand one suddenly “not accountable”. In short, the need for accountability is strong but accountability should not become a sword of Damocles that compromises reasoned decision-making.

This Commission has rightly indicated that stakeholder votes are relevant but that, at the end of the day, it must make its own determination whether a particular proposal is just and reasonable. The same holds true for the RTO. It would be no more reasonable to brand this

Commission “unaccountable” when it makes a tough call after taking into account all of the evidence, than it would be to so brand the RTO. As a result, at the end of the day this Commission should judge outcomes---were the proposals that were being presented fair and the process one which allowed adequate participation and transparency? The Commission must resist the temptation, which some might urge, to set forth a “master handbook” of how a particular RTO (or any other utility) should make decisions.

- **Does the representational voting structure of the RTO and ISO stakeholder bodies help to achieve balanced decisions? Is it too cumbersome? Does it lead to inaction? Are customers and other entities adequately represented? Can the RTO decision-making process be improved, especially to overcome deadlocks among stakeholders on important issues?**

Key to a successful stakeholder process is the need for efficient as well as open and transparent decision-making. Stakeholders are not the owners of the enterprise---they are not shareholders. Nevertheless, decisions on market rules can have a profound impact on a market participant’s bottom line and on ultimate consumer rates. As a result, stakeholder input is enormously important to the success and acceptability of the RTO market rules.

PJM has heard its stakeholders desire for more access to the Board. Here too, a balance is needed---stakeholders need to communicate directly with the Board but clearly should not become co-Board members actually running the enterprise. In its recently issued Strategic Report, PJM has addressed this issue by recommending that it 1) arrange for PJM Board members attending Members Committee meetings to participate in luncheon discussions with designated Member representatives on topics identified by the Committee; 2) provide a significant number of additional opportunities for Board members to meet with member representatives at regularly scheduled PJM and industry meetings; and 3) consider changes in voting protocols, including communicating minority positions to the PJM Board in writing and the posting of majority, plurality and minority views on the PJM Web site prior to PJM Board action.

As the markets become more complex, there is no question that the existing stakeholder process can become cumbersome. More complex issues admittedly require more time for education and deliberation by the stakeholders. The key to a successful stakeholder process is an efficient decision-making process, one that doesn’t mix the need for careful deliberation with paralysis of action and inability to reach closure. PJM has seen both. Certain processes such as development of the economic planning protocol represented the best of a stakeholder process. Other difficult matters such as RPM or cost allocation soon fell into the realm of paralysis requiring this Commission to call the “strikes and balls” so as to break logjams.

PJM does not believe the answer is for the Commission to “regulate” stakeholder processes per se---to do so would tax the Commission’s limited resources and divert its attention from addressing key substantive policy issues. Rather, the stakeholder community should realize that, at times, it is acceptable to not reach consensus positions and, instead, to certify difficult decisions to this Commission. Your recent Order addressing the cost allocation issues was just such an example where leadership by this Commission was critical to break a logjam that

threatened new investment in transmission. We recognize that the burden of proof is higher in a section 206 complaint than a section 205 filing. Moreover, PJM is uniquely hamstrung given that many of its fundamental structures and rules are set forth in its Operating Agreement where the members hold the section 205 rights. Nevertheless, when consensus cannot be reached, the RTO should not be charged with failing to be “accountable” when there is an honest difference of opinion after all sides have been heard. In short, the process, although vitally important, should not drive outcomes.

■ **Should RTOs and ISOs consider reforming executive compensation to provide better incentives for management?**

At the outset, this question has two problems: One it incorrectly assumes that executive compensation today is not tied to incentivizing superior performance. In fact, just the opposite is true as I will explain below. Moreover, it assumes that executive compensation is an area that the Commission should regulate. On this issue, we do not believe this is an issue for the Commission to directly regulate. The Commission needs to regulate utilities within its jurisdiction not manage them. *Cal. Indep. Sys. Operator Corp. v. FERC*, 372 F.3d 395 (D.C. Cir. 2004). Although the rates charged by the utility are relevant, there is a difference between ensuring just and reasonable rates and setting and reviewing specific individual compensation plans.

As to the facts, let me start with PJM’s overall compensation structure. *All* PJM employees have a portion of their compensation tied to meeting corporate goals. Those goals are established by the Board and management’s achievement of those goals audited. The Board’s goals are outcome not process-based. The specific areas of operational excellence which are embodied in the goals (operations, markets, customer value, stakeholder relations and workforce capability) are reviewed with stakeholders. Results are audited prior to any pay at risk compensation being awarded. By having each employee’s compensation tied to corporate goals, the drive toward excellence runs throughout the organization.

At the executive level, PJM has adopted a tiered executive incentive compensation program which is directly tied to the organization’s performance as well as the executive’s individual performance. Executives’ incentive compensation is directly linked to the achievement of the company’s organizational and strategic goals, which form the basis for measuring performance. Incentive compensation is structured so that compensation for executives at higher levels is impacted more directly by the company’s performance than lower level employees. This link between organizational performance and compensation at all levels of the organization is an effective incentive and reward for executive performance.

■ **Should RTOs and ISOs consider having hybrid boards that include both independent directors and stakeholder directors?**

The Commission need not look further than past experience to answer this question. In the first place, the Courts have pointed out the limits of the Commission’s overall authority in this area. *Cal. Indep. Sys. Operator Corp. v. FERC*, 372 F. 3d 395 (D.C. Cir 2004). Moreover, the experience during the California energy crisis as well as this Commission’s own precedents

point out that this proposal is unworkable. The California crisis experience painfully illustrated the difficulties of designing markets by committee when each market participant has a financial stake in the outcome. The Commission “got it right” when it made independence a bedrock principle both in Orders 888 and 2000. Despite all the hyperbole, the history shows that the Commission’s instincts were correct and its deviations from the independence principle, as evidenced by the original California ISO stakeholder board, proved to be a costly error.

One of the arguments for a hybrid Board is that the industry Board members would have “real world” experience in the industry. The PJM Operating Agreement requires that Board members have such real world experience with specific experience in fields such as nuclear engineering, utility regulation or familiarity with municipal utilities required of different Board members. An independent search firm is hired to seek out candidates with industry experience and we have been able to attract high caliber candidates to serve on our Board.

Among a Board member’s fiduciary duties is the requirement that he or she act in accordance with the duty of loyalty with regard to the organizations they serve. Stakeholder directors would be caught in the impossible situation of attempting to make decisions that are in the best interests of the RTO without regard as to whether such decisions are in the best interests of their stakeholder organizations. Without doubt, if there were a so-called hybrid board, situations will arise in which a hypothetical stakeholder Board member will be forced to make decisions that may not be in the best interests of his or her own organization. Confidential market sensitive information would have to be masked to prevent giving any particular market participant sitting on an RTO Board an undue advantage. Situations may arise in which a stakeholder Board member would be forced to recuse himself or herself from Board deliberations and decision-making or worse yet, vote their individual pocketbook as opposed to what is best for the market as a whole. Such situations would result in a cumbersome process in which every situation, every bit of data about the market, and every decision being considered by an RTO Board of Directors would have to first be screened to ensure that conveying that information does not create an undue advantage on one market participant.

In response to its stakeholders, PJM has pledged to increase stakeholder access to the Board and through its stated rate settlement, access to greater financial information than any for-profit regulated utility would ever provide to its customers. Through our recently issued Strategic Report, we have pledged to increase the attendance of the Board at stakeholder meetings and promote greater dialogue with stakeholders. The strategic report is still a draft so we welcome other recommendations. The processes arising out of implementation of these Strategic Report reforms in this area should be allowed to work without this Commission prematurely stepping in to dictate a structure assuming it even has the legal authority to do so.

- **Are RTO processes for planning shared expenditures and obtaining customer feedback conducted far enough in advance for stakeholders to provide meaningful input? If not, what should change? What should be the role of market participants in the development of the RTO budget?**

PJM’s governance structure includes a Finance Committee comprised of two representatives from each sector of the PJM Members, one representative of PJM, and two Board

members. Each Board Member and Member representative is entitled to vote on final recommendations to the PJM Board and Members Committee. The purpose of the Finance Committee is to “review PJM’s consolidated financial statements, budgeted and actual capital costs, operating budgets and expenses, and cost management initiatives and in an advisory capacity to submit to the PJM Board its analysis of and recommendations on PJM’s annual budgets...” This joint stakeholder and Board member Committee provides an important opportunity for stakeholders to express their opinions regarding PJM’s financial management.

In early 2006, PJM, the Finance Committee and PJM’s Members agreed on a settlement effective June 1, 2006 that established multi-year stated rates for PJM’s administrative charges and capped formula rates for recovery of PJM’s investment in a second control center. The composite stated rate per megawatt hour of load declines from 33 cents in 2006 to 30 cents from 2011 forward. There are also annual provisions for refunds to PJM’s Members if actual PJM expenses are lower than its revenues by pre-determined thresholds. For example, PJM’s Members will be receiving a 1 cent per megawatt hour refund during 2007 resulting in an effective net composite charge rate of 31 cents per megawatt hour in 2007.

In addition to establishing PJM’s rates, the stated rate settlement enhanced PJM’s financial communications commitments to the Finance Committee through adoption of a Financial Review, Reporting and Communications Protocol. This Protocol explicitly identifies the financial and project information to be discussed with the Finance Committee at least quarterly and the supporting information to be provided to the Finance Committee to assist in their preparation of recommendations to the Board and Members Committee on the annual expense and capital budgets. The stated rate structure and associated financial communications protocol provide PJM’s Members with price predictability and the opportunity for direct feedback to the Board and management on financial matters.

■ **What actions should the Commission take, within its jurisdiction, to address the issues? What actions, if any, should others undertake?**

PJM does not recommend formal generic action by the Commission at this time. However, PJM does listen to its members and this Commission. We do think it important for the Commission, through technical conferences such as this one, to continue to satisfy itself that the appropriate level of both RTO accountability and independence is maintained. We welcome this dialogue and think that constructive ideas and dialogue, rather than pleadings being thrown over the transom, are the best means to meet the needs of stakeholders and the marketplace as a whole as we tackle major issues ahead of us.

Thank you for this opportunity to testify. I look forward to further dialogue on these issues.