EXNET
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"FERC Electricity Policy Developments"

Remarks by
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I. Introduction

Good afternoon. I am honored to speak at this excellent gathering of energy industry analysts and policy makers.

We find ourselves at the beginning of a new year. Starting a new year always is exciting because it gives us a sense of renewal and rededication to purpose. This is especially the case at FERC. Through a series of cases and rulemaking initiatives, 2002 has the potential to be a banner year in which many of the critical pieces for well functioning wholesale electricity markets are placed in the regulatory mosaic. The most important focus of our work will be in ensuring good market structure and design. This is a huge challenge, requiring tough minded decision making. But meeting the challenge now will bring the reliability and efficiency benefits of vibrant wholesale markets to the nation's consumers, and will help to avoid painful remedial decisions when bad markets get out of control.

But before addressing the Commission's efforts to ensure well functioning electricity markets, let me discuss our merger policy.

II. Merger Policy

When I spoke to you a year ago, the big news was the Commission's conditional approval of the merger between American Electric Power Company and Central and Southwest. We had concerns mostly with the potential vertical market power that could be enhanced by consolidating the transmission and generation assets of those two large companies, and so we imposed conditions to mitigate that market power. Less than a week ago, the D.C. Court of Appeals put a cloud over this merger by remanding it to the SEC.

The court questioned the SEC's findings on the interconnection and single region standards of PUHCA. The ball is now in the SEC's court for further decisionmaking.

For several years we at FERC have been developing standards for merger analysis and applying those standards to quite a few merger filings. Some of those mergers presented very challenging issues for the Commission, but I believe we did a good job in balancing the need to give timely and fair decisions to applicants with the need to strongly discourage consolidations that will undercut the competition the Commission has been working hard to nurture in electricity markets.

Our merger policy remains the same. We continue to focus on the effect of a merger on three factors – competition, rates, and regulation. Competition is the issue that receives the most attention and, at times, can be quite contentious. Nevertheless, last year merger policy at FERC was relatively quiet. We acted on only seven merger applications, and processed all of them within our self-imposed 150 day deadline. None presented any particularly novel issues. Competition was not even hotly contested, principally because of the four mergers among vertically integrated utilities, all of them had already placed control of their transmission assets in an ISO. This effectively neutralizes the potential vertical market power issues.

I believe that perhaps one of the reasons that the last year was fairly quiet on the merger front was uncertainty regarding regulatory and legislative policy. Congress is still considering repealing PUHCA, the statute which has put a cloud over the AEP-CSW merger. And there is debate over the FERC's merger authority. Chairman Barton's proposed restructuring bill would strip away FERC's authority to review mergers involving public utilities by repealing section 203 of the Federal Power Act.

I believe a 203 repeal is a bad idea and I have opposed it in testimony before Congress. As we strive to move toward competitive markets and light-handed regulation, the Commission's ability to remedy market power is increasingly important. While mergers can produce efficiencies, they can also increase both horizontal and vertical market power. An agency such as FERC with a broad interstate view must have adequate authority to ensure that market power does not squelch the very competition we are nurturing.

There should be no weakening of the Commission's merger authority. Indeed, to ensure that mergers do not undercut our competitive goals, the Commission's authority over electricity mergers must be strengthened in a number of ways. The Commission should be given direct authority to review mergers that involve generation facilities. The Commission has interpreted the Federal Power Act as excluding generation facilities *per se* from our direct authority, although that interpretation is currently before the courts. It is important that all significant consolidations in electricity markets be subject to Commission review.

I am also concerned that significant vertical mergers can be outside of our merger review authority. Under section 203 of the FPA, our merger jurisdiction is triggered if there is a change in control of jurisdictional assets, such as transmission facilities. Consequently, consolidations can lie outside of the Commission's jurisdiction depending on the way the transactions are structured. For example, a merger of a large fuel supplier and a public utility would not be subject to Commission review if the utility acquires the fuel supplier, because there would be no change in control of the jurisdictional assets of the utility. If the merger transaction were structured the other way, in other words, the fuel supplier acquiring the utility, it would be subject to Commission review. Such vertical consolidations can have significant anticompetitive effects on electricity markets. Since the potential adverse effects do not depend on how merger transactions are structured, neither should our jurisdiction depend on how transactions are structured. The Commission should be given authority to review all consolidations involving electricity market participants regardless of corporate form.

Uncertainty over the Commission's regulatory policies may also have deterred some potential mergers. That may be understandable, given the turbulence in the energy markets and the change in leadership at the Commission in 2001. But the Commission is now stating its objectives more clearly and moving forward aggressively. We have begun to put in place the pieces needed for well functioning electricity markets that will bring benefits to customers and investors alike. I would like to spend the rest of my time this afternoon discussing the Commission's program for getting good markets up and running as quickly as possible.

III. Electric Market Structure

A. RTO Policy

Regional Transmission Organizations are the platform upon which well functioning electricity markets should be structured. Our RTO program has floundered for the two years since it was initiated, partially because it was announced as voluntary and partially because of confusing policy signals emanating from the Commission. I am optimistic that we now have the political will to get the program on track and to insist that a well shaped and structured RTO is functioning in every region of the country.

Last December, the Commission turned an important corner in policy development in deciding the RTO landscape for the Midwest. We approved the Midwest ISO as the RTO for the region and found that the Alliance proposal lacked sufficient scope. In doing so, the

Commission recommitted itself to large well shaped RTOs that eliminate trading seams instead of perpetuating them. I fully supported that decision, and only regret that we failed to reach this conclusion much earlier. Virtually every state commission in the Midwest supported this policy choice.

In the coming months, we must turn our attention to the Northeast, the Southeast, and the West. In the Northeast, several state commissions appear to prefer that we focus on standard market design rather than force a merger among the three ISOs that now function in the region. These states believe that a seamless northeast market is the key to customer benefit. The New York ISO and New England ISO are seriously considering a merger with the Ontario IMO. This would create a single market of roughly 80,000 MW. We are awaiting additional state comment from the Southeast, where support for an RTO is lukewarm in a number of states. With the support of the major transmission owners in the Southeast region, including Entergy and Southern Company, the so called Se-Trans proposal is picking up steam and its features appear to be evolving in a more positive direction. In the Western United States, the Commission's call for a single RTO for the 12 state area, which no doubt would be the best if the goal is economic efficiency, has met a firestorm of political opposition. Getting good RTOs in place in these regions will present us with enormous political and policy challenges.

In addition to scope and governance, the Commission must address issues raised by so called hybrid RTOs. The RTO is responsible for certain market operations, for calculating and posting available transmission capacity, for implementing a regional planning process, and for market monitoring transmission mitigation. The most likely model for a hybrid RTO is where independent transmission companies, or ITCs, own transmission facilities and exist under the umbrella of an RTO. The rationale for ITCs is that the owners of transmission facilities driven by profit motive are in the best position to most efficiently perform certain grid functions. The Commission must decide on the appropriate allocation of RTO functions among the entities that comprise the RTO. This is the so called slicing and dicing of functions debate.

There are two dimensions to this slicing and dicing problem. One of them is geographic. The ITCs are likely to be relatively small and not have sufficiently large regional scope, yet some of them propose to retain substantial operational control. Thus, the issue is which RTO functions may appropriately be performed on a sub-regional level by a smaller ITC. Proposals to retain key functions subregionally must not perpetuate the fractured decision making endemic to the current market and grid management regime. It would be a mistake for a continuation of localized operational control to fail to eliminate grid balkanization.

The second dimension to the function allocation problem is driven by the for-profit nature of ITCs. A major motivation for forming RTOs is removing self dealing incentives from grid operation and market administration. Operating the grid and the markets, and planning, monitoring and mitigation, all have overwhelming public interest considerations.

Transmission competes in the energy market place with other activities, such as traditional generation, load reduction and distributed generation. Thus, we would be very concerned if a transmission entity could skew RTO market operations or RTO decisionmaking to favor its own transmission investments over other transmission investments in the region, or to operate the grid or market to discriminate against particular generation investments.

I feel confident that the Commission can resolve this debate by harnessing the ITC's profit motive to help attain efficiency and reliability objectives while baring opportunities for discrimination. For example, while it would not be appropriate for the ITC to operate either generation or transmission markets, ITCs could have performance based rates and the opportunity to create shareholder value if they exceed specified maintenance or reliability targets. ITCs could be full equal participants in the planning process and make profit-driven system enhancements that are awarded through a competitive bidding process within the RTO. The Commission will ensure that the performance of those activities does not skew competition or any market decisions, or compromise the independence of the RTO, in perception or reality. The Commission wants the transmission business to be a good business that operates efficiently and attracts investment for system expansion.

So, here is where we are on RTO policy. The Commission still must make difficult scope and configuration decisions for the Northeast, the Southeast and the West. Meanwhile, the slicing and dicing of functions debate is still brewing but should be resolved this spring, after a February 19 FERC sponsored technical conference on the issue. My view is that the implementation of our RTO policy has dragged on far too long. The Commission must come to grips with these decisions as soon as possible. I believe that Chairman Pat Wood is committed to moving aggressively in this area to implement our RTO policy. I will support all reasonable decisions to resolve these issues as soon as possible.

B. Market Design

Let me now turn to another important aspect of market structure, and that is market design. We have seen that electricity markets are necessarily based on the complex and unforgiving physics of electricity. As such, these markets are fragile and can be exceptionally volatile. Getting a good market design in place is absolutely essential. I believe that we now have had enough experience to know what works reasonably well and what does not work.

The Commission has recognized this and has initiated a rulemaking process to put in place by this fall a standard market design for the industry. I fully support this initiative. The electricity industry is too important to the economic, health, and safety fabric of our society to continue to let a hundred market design flowers bloom. The Commission recently released a staff paper setting out the parameters of this initiative, and I am in general agreement with the staff paper. And we just held our first two days of public technical conferences, and anticipate having a proposed rule issued by summer.

While I have an open mind on many of the market design issues, there are a few major characteristics that I am pre-disposed toward. For example, the RTO should operate a bid-based real-time market that is based on locational marginal cost pricing and a security constrained unit dispatch. The real time market must have a congestion management protocol that recognizes physical reality, that shows users the economic consequences of their decisions, and sends efficient price signals for future investment.

There should also be a bid based day ahead market operated by the RTO. A day ahead market makes it easier for participants to develop day ahead schedules that in turn make it more likely that the participants <u>and</u> the grid operator can do their jobs successfully in the real time market. A day ahead market would also help facilitate a robust demand side response, by giving buyers time to respond to prices and possibly rearrange their activities.

Each RTO market should also include a comprehensive regional planning function within which all stakeholders have input, but the RTO has ultimate decision making authority. The planning function should identify problem areas on the grid and the most efficient ways to remedy those problems. Those remedies could be transmission, generation or demand response initiatives. It's important that all be considered equally. And where the remedy is transmission, it may be appropriate for the project to be undertaken on a merchant basis, or at least constructed on a lowest-bid basis. Winners and losers in the planning function should be determined as much as possible through competitive processes.

Market design must also include a mechanism to assure that there will be adequate generating capacity to meet load in the future. I have not made up my mind on the best way to assure adequate supply. Some regions now use what is known as ICAP. There may be other ideas. But supply adequacy assurance is very important and should be addressed in some way through market design.

I believe that a common touch and feel for all wholesale power markets will attract new entrants, reduce transaction costs, and eliminate trading seams. Markets would still be encouraged to evolve to incorporate best practices and technological innovations. This is a critically important effort that complements the implementation of the Commission's RTO policy. We are committed to finalizing a market design rulemaking by October of this year.

IV. Infrastructure Issues

Now let me turn to a couple of key infrastructure issues.

Another necessary ingredient for good market operation is sufficient infrastructure. Transmission constraints and tight generation supplies are sources of high prices, market power and reliability problems. Entry in these areas should be as easy as possible. However, the Commission has rather limited jurisdiction to directly resolve infrastructure problems. We have authority to certificate natural gas pipelines that may be needed to fire needed new generators, but beyond that, infrastructure adequacy is largely in the hands of the states.

A. Generation Interconnection

Again, in our commitment to do all that we can, the Commission has ongoing initiatives to help ensure adequate infrastructure. One of them is developing standard interconnection procedures and agreements to smooth the way for new generators to hook up to sell their power. I have long seen the current hodgepodge of voluntary utility specific interconnection procedures as unnecessary entry barriers. Last Fall, the Commission issued an advance NOPR to develop uniform standards for interconnection, and we asked the industry to roll up its sleeves and work toward a consensus document that we could issue as a proposed rule.

The industry took up our challenge and a consensus proposal was filed on January 11. Many difficult interconnection issues have been resolved, among them the types of studies that are needed to complete the interconnection process, protocols for managing the interconnection queue, and defining the circumstances under which generators may have third party contractors perform the needed studies when the transmission provider cannot complete them within the desired time frame. Although there are outstanding issues still unresolved, the industry has make substantial progress. Our goal is to have in place a final interconnection rule by the end of summer.

B. Transmission Siting

In addition, much work is necessary to enhance our nation's inadequate transmission infrastructure. Transmission bottle necks increase consumer costs by billions of dollars annually. Congress could help in this area. I have long advocated that Congress clarify jurisdiction over transmission by placing all of our nation's transmission grid under one set of open access rules, enhancing the Commission's power to ensure that good RTO's are formed in a timely fashion, and transferring transmission siting to the Commission. A state by state approach to transmission siting is proving inadequate to meet market needs. There is a strong argument that the infrastructure necessary for interstate markets to flourish should be certificated by an authority that is focused on interstate and regional issues. At least there should be a federal backstop that can break any siting logjam that arises. I encourage Congress to act in this area.

V. Conclusion

In closing, a brief comment on Enron. Enron's demise is shocking and is highly regrettable for many reasons – among them, employees lost their jobs and retirement and share holders lost their shirts. There are certainly important policy lessons, but based upon what I've seen so far these lessons seem to arise more under retirement, securities or accounting regulations. The entire matter will obviously be thoroughly and painstakingly investigated from every angle, as it should be. If there are lessons for our evolving energy policy, we should certainly heed them. I have seen nothing yet, however, to persuade me that the Commission's general policy direction is unsound. It does not appear that Enron's demise was a result of flawed energy policy or volatility in energy markets. In fact, if Enron had chosen to focus on the energy business in the U.S. markets, had remained reasonably leveraged, and accurately disclosed profits and losses in a timely manner, it might still be in business and perhaps doing reasonably well.

The Commission remains focused on facilitating markets for energy that benefit consumers. Absent Congress telling us to change course, we plan to complete this transition to competitive wholesale markets as soon as possible. We remain convinced that consumers will ultimately benefit, if wholesale markets are efficient and well structured, and that this policy evolution is in the national interest.
That has been my position since coming to the Commission almost nine years ago, and I remain firmly committed to getting the job done.

Thank you.