Testimony of

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on behalf of

Consumers for Fair Competition

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Subcommittee on Energy and Air Quality

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Summary Statement

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Consumers for Fair Competition

Mr. Chairman, much has transpired since this Committee last discussed electricity legislation. CFC believes it is important to reflect on the turmoil that has occurred in the utility industry, revisit the assumptions that underlie last year's conference report, and proceed cautiously. At previous hearings, CFC testified about the difficulties associated with transitioning the wholesale market from cost-of-service rate regulation to reliance on competitive market pressures. Today we are no closer to the goal of market efficiency – and the legislation before you, regrettably, will likely make the situation worse.

As the bill moves through Congress, it is our hope that the "false assumptions" underlying the legislation – which are outlined below – will be reconsidered, and a sound, coherent policy advanced that provides the lower prices, better service and innovation that we all envision.

- **PUHCA inhibits investment.** If by investment we mean building new infrastructure, this assertion is false: under PUHCA, utilities can build new generation, transmission and distribution within their service territory – and build generation anywhere.
- **PUHCA is unnecessary.** A comparison of the financial health of those utilities that are and aren't subject to PUHCA paints a different picture. In a February 2004 report, Standard & Poor's concluded "existing utility credit would be best served from enforcement of PUHCA's provisions and restriction of utility investment in outside businesses."
- **PUHCA repeal won't harm competition.** The utility industry continues to grow increasingly concentrated and a new wave of utility mergers, coupled with likely consolidation and acquisitions

within the merchant generator sector, is on the horizon. With PUHCA repeal, fewer market players will exist to provide competitive power supply alternatives.

- **Markets discipline rates and behavior.** In electricity markets, the theory is not working: in every region wholesale prices are going up and there are fewer – not more – competitive choices.
- **It was only Enron and market rules and monitors are adequate.** Time and again we've seen that clever traders cannot only evade market rules (and, frequently, detection), but that these very rules often create new opportunities for manipulation and abuse.
- **We're creating a free market in electricity.** Yet, recent policies suggest that market-based rate power sales still receive the protection against anti-trust claims that existed under a regulated system.
- **The return on transmission is too low to promote investment.** Utilities and others argue that investment in transmission is low because the rate of return is inadequate to attract capital. On its face this is absurd: guaranteed rates of return of 10 –15 percent are obviously adequate to attract capital.
- **Price signals – like locational marginal pricing (LMP) – will encourage investment.** LMP highlights where transmission congestion and constraints exist, but this is information we already know, and LMP does nothing to relieve the problem.
- **The party requesting new transmission – either generator or load – should pay for it.** This overly simplistic standard ignores the fact that most transmission investments produce broadly distributed benefits, and that these benefits shift over time as the system and use develop.

We are hopeful that significant revisions can be adopted as the process goes forward. However, If Congress cannot include the provisions needed to protect consumers, then CFC would urge deferral of action on electricity legislation until those provisions can be included.

Mr. Chairman, members of the Subcommittee, my name is Marty Kanner; I am testifying today on behalf of the Consumers for Fair Competition (CFC), an ad hoc coalition of small and large electric consumer representatives, small business contractors, public interest groups, consumer owned utilities and others. Consumers for Fair Competition was formed to advance policies necessary to promote effective wholesale competition and has been active in the restructuring debate and efforts to block repeal of the Public Utility Holding Company Act (PUHCA) absent sufficient replacement provisions designed to protect consumers and investors.

Much has transpired since this Committee last discussed electricity legislation. CFC believes it is important to reflect on the turmoil that has occurred in the utility industry over the past few years, revisit the assumptions that underlie last year's energy bill conference report and proceed cautiously.

At previous hearings, CFC testified about the difficulties associated with transitioning the wholesale market from cost-of-service rate regulation to reliance on competitive market pressures. Today we are no closer to the goal of market efficiency and the legislation before you, regrettably, will likely make the situation worse.

To highlight the current disfunctionality of the market, let me share with you an excerpt from a recent filing at the Federal Energy Regulatory Commission (FERC) by various industrial customer groups located in the Midwest. As you recall, it was largely industry that led the charge for greater reliance on markets in the electric industry, and the Midwest is the region that is frequently cited as the poster child of success. Given that background, the picture painted by Midwest industrial customers is a stark warning:

> "While market-based rate authority may produce minor benefits in the form of administrative convenience, the results for customers, many of which are struggling to compete in our global economy, evidence a trend line that is dramatically different than the lower price, better service, and innovation expectations that were created by the Commission and others as a predicate for reform."

Mr. Chairman, I believe that this cutting indictment should cause each of us to pause.

The members of CFC share your desire to craft a comprehensive energy bill. However, as the bill moves through Congress, it is our hope that many of the assumptions – I would argue false assumptions – of the legislation will be reconsidered and a sound, coherent policy advanced that provides the lower prices, better service and innovation that we all envision.

In the remainder of my testimony, I'd like to explore some of these false assumptions, focusing on three topics: the Public Utility Holding Company Act (PUHCA), market manipulation and abuse, and transmission.

The False Assumptions of PUHCA

The bill before the Committee – like bills in each of the last few Congresses – includes repeal of the Public Utility Holding Company Act (PUHCA). Congress enacted PUHCA as a companion statute to the Federal Power Act. PUHCA establishes passive restraints on the structure of the electric utility industry in order to mitigate market power, preclude practices abusive to captive consumers, protect investors from deceptive securities practices, promote the financial integrity of utilities, and facilitate effective regulation. Under the Act:

- Multi-state utility holding companies must be physically and operationally integrated in order to ensure economic benefits and facilitate effective regulation;

- Holding company acquisitions are limited in order to promote economic and operational efficiencies and prevent undue concentration;

- Multi-state utility holding company diversification activities are restricted in order to maintain a focus on the core business of utility service to captive consumers, limit financial risks to ratepayers, and protect businesses in unregulated industries from anti-competitive cross-subsidies;

- Inter-affiliate transactions are limited in order to prevent undue favoritism and self-dealing; and

- Capital structures and holding company investments are regulated in order to protect captive ratepayers and investors from unwarranted financial risk.

So what are the false assumptions underlying PUHCA repeal?

1. **PUHCA inhibits investment.** If by investment we mean building new infrastructure, this assertion is false. Under PUHCA, utilities can build new generation, transmission and distribution within their service territory. Moreover, they can build merchant generation anywhere in the country. PUHCA does limit acquisitions of existing utilities, but I question whether this is properly labeled as "investment" – much less beneficial.

2. **PUHCA is unnecessary.** Repeal proponents claim that financial regulation and investor sophistication have matured since PUHCA was enacted, and that effective state and federal oversight is adequate. However, a comparison of the financial health of those utilities that are and aren't subject to PUHCA paints a different picture. As you may be aware, several rating agencies have issued reports on the beneficial impact of PUHCA and the potential erosion of credit quality that could result from the Act's repeal. In a February 2004 report, Standard & Poor's concluded that "existing utility credit would be best served from enforcement of PUHCA's provisions and restriction of utility investment in outside businesses" and that repeal could precipitate a "deterioration in credit quality for utilities whose corporate parents have an appetite for

great risk if PUHCA is repealed." Similarly, a September 2003 review by FitchRatings determined that, as a result of diversification restrictions, PUHCA-registered companies were less likely to suffer "multicategory" credit downgrades.

3. **PUHCA is only a financial statute.** Many repeal proponents claim that PUHCA is not a consumer protection statute. We need look no closer than the impact of utility diversification on consumers. An analyst with Williams Capital recently noted that "utility investment rarely goes terribly wrong; non-utility investment rarely goes right." But, unlike other industries, it's not just the utility and its investors that suffer from bad investment decisions. As detailed in a December 26, 2002 Wall *St. Journal* front-page article, utility customers suffer the consequences – with utility assets pledged for nonutility ventures, debts from bad investments transferred to utility ratepayers, and utility capital costs rising as a result of failed diversifications.

4. **PUHCA repeal won't harm competition.** The utility industry is growing increasingly concentrated. Industry experts predict that the failure of recent diversifications and foreign investments are likely to push utilities to look closer to home for their next acquisition. A new wave of utility mergers, coupled with likely consolidation and acquisitions within the merchant generator sector, is on the horizon. Fewer market players

will exist to provide competitive power supply alternatives.

5. **PUHCA is irrelevant.** It is frequently asserted that PUHCA is an outdated and antiquated law, but that is hardly the case – and evidence is to the contrary. Indeed, the ongoing CSW-AEP case at the SEC, efforts by the Texas Pacific Group to buy Portland General Electric, and the latest mega-merger where Exelon proposes to buy PSEG seems to indicate that PUHCA is still relevant – and, we would argue, necessary.

Mr. Chairman, as you know, Congress has previously enacted amendments to PUHCA, allowing utility investment in merchant generation and telecommunications services. As I have previously testified, CFC is willing to consider targeted amendments to PUHCA if a clear and discernable problem can be identified and an appropriate solution negotiated.

The False Assumptions of Market Manipulation and Abuse

We are all by now familiar with the callous manipulation, complex schemes and misleading names unleashed by Enron on consumers throughout the West. Some wish to believe that this was merely a growing pain or the actions of a "bad apple". Yet the quote I shared with you at the beginning of my testimony notes that the stated benefits of competitive markets have proved illusive. I believe the assessment is much worse.

So what are the false assumptions about market manipulation and abuse?

1. **Markets discipline rates and behavior.** Economic theory tells us that competitive pressures will drive down prices and check anti-competitive behavior. In electricity markets, the theory is not working. In every region, wholesale prices are going up and there are fewer – not more – competitive choices.

2. **It was only Enron.** Clearly, this statement is false. For months and months, new stories rolled out about various market participants inflating and reporting false price and volume data, intentionally shutting down plants to drive up prices, creating complex schemes to evade price caps, self dealing, and discriminating against competitors. This is not an isolated incident.

3. **Market rules and monitors are adequate.** Time and again we've seen that clever traders cannot only evade market rules (and, frequently, detection), but that these very rules often create new opportunities for manipulation and abuse. A strong, structural solution is needed to prevent and correct market manipulation and abuse.

4. **We're creating a free market in electricity.** Recent policies and decisions suggest that wholesale power sales – made at market rates – still receive the protection against anti-trust claims that existed under a

regulated system. Utilities can have it both ways: the absence of both regulatory scrutiny of costs and rates and insulation from anti-trust laws. No other industry has this hybrid "best of both worlds".

False Assumptions About Transmission

Mr. Chairman, there is no doubt that there is a need for substantial investment in transmission to support wholesale transactions, relieve congestion, and ensure reliability. The bill before the subcommittee includes numerous transmission-related provisions.

However, CFC believes that some of these provisions are based on false assumptions.

1. **The return on transmission is too low to promote investment.** Utilities and others argue that investment in transmission is low because the rate of return is inadequate to attract capital. On its face this is absurd: guaranteed rates of return of 10 –15 percent, for what are usually low-risk investments, are obviously adequate to attract capital. Moreover, stand-alone transmission companies – like ATC and ITC – have been able to attract capital and build transmission without inflated rates of return. This suggests that there are other economic factors at work. First, transmission investment is often dictated by the economics of generation. Second, a constrained transmission system serves the economic interest of large generators that can extract higher prices for power sales and shut out competitors. So-called incentive rates for transmission merely raise

transmission rates without fostering any new construction that wouldn't occur anyway.

2. **Price signals – like locational marginal pricing (LMP) – will encourage investment.** LMP does highlight where transmission congestion and constraints exist. But this is information we already know, and LMP does nothing to relieve the problem or to encourage new investment. Since any new investment (of generation or transmission) could remove the congestion – and the extra profits that LMP creates -- economics encourages the incumbent parties to leave the constraint untouched.

3. **The party requesting new transmission should pay for it.** It sounds simple: the party that causes the transmission to be built should pay the cost of the investment. But this overly simplistic standard ignores the fact that most transmission investments produce broadly distributed benefits in reliability and market liquidity, and that these benefits shift over time as the system and use develop. Moreover, directly assigning new transmission to a small pool of participants creates economic inequity (since there's no assignment of costs for vintage facilities) and creates a barrier for new investment.

<u>CFC Recommendations for Electricity Legislation</u>

Mr. Chairman, we have highlighted the false assumption that are the underpinnings of several significant provisions in the legislation before you. It is our hope that the

Committee will revise the legislation in a number of significant ways. In particular, CFC urges you to:

- **Broadly bar fraudulent and manipulative practices.** Rather than attempting to list specific, abusive transactions that are banned – like round-trip trades – the legislation should recognize that market complexity and participant ingenuity creates an endless series of attempts to evade rules, manipulate operations and prices, and create additional profits. Congress must establish a broad, enforceable ban on fraudulent and manipulative practices.

- **Remove the regulatory shield against anti-trust actions from sales at market rates.** In the absence of active rate regulation, there is no reason for wholesale power sales to be immune from anti-trust action. Removing this shield will treat utility sales like all other provide states and consumers with an enforcement and remedial tool and serve as a powerful deterrent against manipulative practices.

- **Retain PUHCA.** As outlined above, CFC sees no compelling reason to repeal PUHCA. Financial experts conclude that PUHCA serves both utilities and bondholders; consumers realize that PUHCA prevents costly mistakes; and, I submit, many small and medium-sized private utilities welcome the fact that PUHCA keeps them from becoming takeover targets. As noted, above, we are willing to engage in a thoughtful discussion of targeted amendments to PUHCA designed to simultaneously meet legitimate problems and protect consumers and investors. It is noteworthy that no bona fide consumer group supports PUHCA repeal.

- **Review All PUHCA Exemptions**. Enron, after its acquisition of Portland General Electric, self-certified that it qualified for an intrastate exemption under Section 3 of PUHCA. Interestingly, an SEC judge recently ruled that Enron did not qualify for the intrastate exemption based on the percent of revenues Portland General Electric earned from interstate sales. A mandated review of all outstanding Section 3 PUHCA exemptions is needed to ensure that those exemptions are still appropriate and in the public interest.

- **Gaps in the review of utility mergers must be closed.** The weakened financial condition of the merchant generation industry may translate into a significant increase in mergers and acquisitions. Such activities may be economically beneficial – but that can be determined only after careful review. Disposition of generation-only assets may not be subject to review by FERC. Congress must close this gap – not weaken federal review of utility mergers.

- **Congress should resist dictating transmission rate policies.** Establishing rigid, statutory rules will raise consumer rates, stifle competition and inhibit construction of new transmission.

Conclusion

The bill before the Committee is the conference report from last year. While that may suggest to some that it represents broad consensus, it must also be remembered that it did not become law – in part because of controversy surrounding the electricity title. In an effort to reach consensus, we are hopeful that significant revisions can be adopted as the process goes forward. As always, Mr. Chairman, we are committed to working with you, your staff and the members of the Committee. However, we are skeptical that appropriate and beneficial electricity legislation can be negotiated and crafted at this time. If Congress cannot include the provisions needed to protect consumers, then CFC would urge deferral of action on electricity legislation until those provisions can be included.

On behalf of Consumers for Fair Competition, I thank you for this opportunity to testify.