Testimony of
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Overview

I thank the Committee for the honor of testifying here this morning on the various electricity restructuring bills pending before you. In my opinion, Congress should adopt the principle that legislation should remove obstacles to the natural evolution of the industry. FERC does not need more jurisdiction; indeed, we need less. Right now, the generation and transmission businesses are moving in opposite directions. On the wholesale level, FERC has deregulated prices for generation because of the proliferation of independent power and technology that allows plants to come on line in 18 months or so. Transmission, on the other hand, will have to remain regulated for the foreseeable future. Transmission must become a stand-alone business and respond to the market. It must do so, however, within the framework of regulation, though a new form.

Historically, regulation reigned in economic interest for the sake of the public interest. Most people agree that approach failed. From now on, regulation must align economic interest with the public interest. Together, Congress and FERC must act in a way that gives the new model a chance to succeed. What may have worked in the Depression Era no longer works in the Internet Age. In our respective spheres, Congress and the FERC must clear out the underbrush to allow new growth to take over.
FERC and the states can, and, under the right leadership, will remove most regulatory impediments toward efficiency in electricity. Recently, FERC issued Order No. 2000, which flatly states that restructuring will succeed only if transmission becomes a stand-alone business. By unanimous vote, we applied what an economist called a form of performance-based regulation." Rather than write rules and mandate outcomes, Order No. 2000 laid out a business plan – 12 goals, four characteristics and eight functions, for regional transmission organizations to meet.

The Commission opened the door to rate reforms for RTO's to propose as necessary to make the transmission business viable on a stand-alone basis. The Order listed eight, from temporary rate moratoria to performance-based rates. Rather than look at costs, we will focus on value to the customer, as businesses do in the free market. FERC has jurisdiction under current law to approve each of them and many others that RTO's can justify.

People know that about half the States have passed laws opening their retail markets to increased customer choice, to one degree or another. Less well known to most people, some have gone farther. States, such as Wisconsin, have passed laws that require utilities to separate transmission into a separate business. In the case of Wisconsin, the Legislature chose a for-profit company. With transmission as a separate business, FERC has jurisdiction over the wires under current law.

With the right leadership FERC will move forward toward effective restructuring. Incentives and performance-based rates will unleash entrepreneurial initiative. By
aligning the public interest with economic interest, doing the right thing for customers will also result in better earnings for shareholders. Transmission companies will establish a business plan in consultation with customers. Companies that meet or exceed the goals in the business plan will earn profits for shareholders. Those that fail will take the risk, and, ultimately, as in any market, will sell their facilities to more efficient entities. All that can happen under FERC's current jurisdiction, without one word of new legislation.

FERC can go only so far, however. Laws enacted as far back as the Depression and as recently as the Carter Administration, that made sense in their time, now act as a drag on restructuring. These laws have the ironic effect of causing harm to the very consumer they were supposed to protect. In addition, unintended consequences of tax law encrust the status quo, at a time that cries out for change. More than the incentives of Order No. 2000, Federal Marketing Agencies, including Bonneville Power Administration and the Tennessee Valley Authority, need legislation to authorize them to become or join Regional Transmission Organizations. Participants in the discussions in the Northwest agree that Congress should act, whether the RTO takes the form of a for-profit transmission company or a not-for-profit system operator.

Worse than doing nothing, Congress can harm the process of restructuring by taking the wrong road and passing unnecessary legislation or laws that point toward more regulation.
The Need for Legislation

Repeal Outdated Laws

I. PUHCA

The Public Utility Holding Company Act, dating from the Depression, and the Public Utility Regulatory Policies Act, dating from the Carter Administration, act as serious brakes on restructuring. The Holding Company Act requires registered companies to submit to onerous regulation by the Securities and Exchange Commission, including seeking permission for moves that companies make in the ordinary course of their business. Pointedly, the Act exempts utilities operating within one state from registration. The Act also subjects holding companies to requirements that they operate an “integrated” and contiguous system.

Tied to a world in which state commissions, to the extent they existed, operated in isolation, Federal securities laws had just been enacted, power could flow over short distances and designed to combat the effects of stock manipulation during the 1920's, it has outlived its usefulness. As information technology has improved and investors have become more sophisticated, utilities must grow larger and operate beyond the boundaries of single states. Enforcement of securities regulation has eliminated the abuses of the 1920's, in all areas of the stock market. For that reason alone, Congress should repeal the law.

More important, the Holding Company Act has perverse effects. Because of the provisions for foreign utilities, the Act causes foreign companies to buy here and U.S.
companies to invest overseas. Investment in and from overseas help integrate the world economy. The investment should result from economics, not the vestige of a law that outlived its time.

2. PURPA

While not as old as the Holding Company Act, the Public Utility Regulatory Policies Act needs repeal. PURPA, as we call it, forces utilities to buy from alternate energy sources at high prices. Congress passed it at a time when people thought we needed to lessen our dependence on oil for electric generation and that subsidies would help accomplish that result. Now, 22 years later, when we want to bring prices down and when developers can build gas-fired generators in about 18 months and distributed generation lies on the horizon, subsidizing certain types of generation makes no sense. Moreover, experience at FERC shows that the alternate sources PURPA envisioned -- those exclude gas -- have either been fully exploited or (as in the case of municipal waste) have proven infeasible. Several proposals before the Committee this morning would repeal both laws and I support that.

3. Section 203 of the Federal Power Act

The Federal Power Act gives FERC the authority to review electric mergers. FERC has no expertise in the area. FERC enacted a Merger Policy Statement that ignores contemporary economics, such as the Department of Justice and Federal Trade Commission’s practices in making mergers difficult. When utilities should consolidate with neighbors to reflect the growth in the economy, FERC considers those moves anti-
competitive. Also, FERC uses mergers to further policy goals that it has no authority
directly to order.

I offer the AEP-CSW merger case (90 FERC ¶ 61,242 (2000)) as an example. My
dissent pointed to the fact that, without any factual support, the majority overruled the
findings of an Administrative Law Judge who relied on testimony of a former Chief
Economist of the Antitrust Division and the economist at FERC who had a large hand in
our merger policy. In addition, the Department of Justice's International Advisory
Committee recommended repeal of FERC's merger authority. Congress should pass a
law to that effect. Let the Antitrust Division and the Federal Trade Commission, the
expert antitrust agencies, review mergers in the electric industry, as they do for the reset
of the economy (except for communications and railroads).

Public Power

Over the course of the 20th Century, Congress helped create Federal "public
power" marketing agencies, such as the Bonneville Power Administration and the
Tennessee Valley Authority. During the 1930's, both helped bring the blessings of
electricity to remote areas that the power companies could or would not serve. In
addition, thinkers at that time, including Franklin D. Roosevelt, envisioned public
agencies as a competitive spur to private utilities reducing their costs.

On the first objective, the country can proudly say, "Mission accomplished." We,
in this country, have the finest and most extensive electric system in the world. The
second proved disappointing. Both TVA, and to a lesser extent, Bonneville, became
debtladen bureaucracies. To its credit, Bonneville has reformed, but remains burdened with bad debt from nuclear plants. Bonneville has continuing disputes with utilities in the Northwest that claim it uses its transmission (80% of the region) to favor its own generation. The stakeholders in the Northwest, according to my understanding, prefer to separate Bonneville's transmission from generation and to form a for-profit entity, even as a Government corporation. Bonneville has already split its transmission into a separate business line. It needs a separate Board of Directors and a new mandate. This will alleviate preference concerns while not harming the already low rate structure in the Bonneville region.

TVA remains a great problem. Forces in Bonneville want to separate transmission from generation into a stand-alone for-profit business. TVA's transmission has value that, if sold, would help retire its huge debt to the Treasury. While Order No. 2000 created the atmosphere to a separate transmission business, Bonneville and TVA may not legally change. Congress must pass a law. I could support, as a first step, the creation of a for-profit government transmission corporation in the Northwest and another in the Southeast. The program would resemble Conrail, the for-profit stand-alone Federal freight railroad for the Northeast that the Government eventually sold for a good return. States can change their laws regarding locally owned public power.

As a private businesses, Bonneville and TVA would become subject to Order No. 2000. Given the incentives in the Rule, the Federal transmission owners will form into regional transmission organizations. State and local Legislatures have the authority to
allow municipal utilities (and in some cases, cooperatives) to join RTO's. To the extent, state constitutions require amendment, the individual State can use its own procedures to accomplish the goal. I emphasize that, given the economic evolution of the industry and the incentives of Order No. 2000, States will see it in their interest to act. As with retail competition, where the States took the lead, Congress should stay its hand.

Congress has a large role in tax policy. While this area lies outside my expertise, I have heard from many trying to form for-profit transmission companies that spinning off or selling assets creates a tax liability. Turning over operation without ownership does not. Therefore, utilities would find it more difficult to create for-profit transmission companies. Since Congress must deal with the thorny issue of tax exemption for public facilities anyway, I have every confidence that legislation will solve this tax issue also.

What Congress Need Or Should Not Do

I have often said that Alfred Kahn described restructuring when he said that competition is a substitute for regulation and regulation is a substitute for competition. To me, we must choose which direction to move in. We must move away from regulation and toward competition. That requires, in some instances, a new way of thinking. As I discuss next, some issues the market will address that previously regulation addressed. In other instances, we must let go altogether and not fear the unknown.
Reliability

We hear great clamor over possible reliability problems in a restructured market. Many fear for this summer. I think this a legitimate issue for discussion. I think, however, that the solution lies in the market, not in creating an organization, under FERC oversight, with FERC having last-resort authority to impose standards on the industry.

I testified on this question before the House Commerce Committee's Subcommittee on Energy and Power. I said then that I oppose FERC having authority to establish reliability standards. I also think that the current system, involving private regional reliability councils establishing the standards needs reform. I favor injecting reliability standards in the performance based rate plans I advocate for utilities. In particular, each plan for each Regional Transmission Organization would contain a target for reliable performance. I envision interested parties negotiating the issue, along with the other factors in the plan for presentation to FERC. Each RTO's earnings would rise or fall on how well it does.

My suggestion then is to create a climate in which that occurs in transmission. Specifically, tie profits to performance – safe performance and an adequate number of transactions. Give transmission companies business plans to meet. Favorable earnings result from good results, losses from poor management. Clearly, we don't need legislation to do that. FERC has the authority to institute performance based rates. We did it in Mississippi. The Public Service Commission put three criteria into the final plans. Two of them fall directly under the category of reliability, and one indirectly.
Earnings depended on the number and duration of interruptions, customer satisfaction (using actual complaints) and price into which we factored sales transactions. The companies figured out how to set and meet reserve margins, safety standards and capacity goals. We aligned the private economic interest with the public interest. FERC can do that now.

Lastly, I note that, in other industries, such as electric appliances, the market participants established an organization, Underwriter's Laboratory to endorse the safety and reliability of their products. RTO's, especially for-profit companies, have the same incentive to form an organization that will establish proper standards. I will illustrate the problem with a governmental mandate. At the most recent FERC public meeting, we considered in the case New York Reliability Council, whether to allow the New York Council to reduce its reserve margin from 22 to 18 percent. We did. It turns out, however, that the study on which the New York Council relied said that 12 percent would ensure smooth operation, but at maximum, 17 percent would do the job. The New York Council threw in 1 percent for good measure! In economic terms, the New York Council either withheld capacity that belongs on the market or wasted money. A private, for-profit transmission company would have relied on hedging or financial means in case 12 or 17 percent proved too low.

On this issue I think reasonable people can discuss various alternatives.
Market Power Authority

Another area in which we hear much advocacy relates to giving FERC more authority over "market power." Mind you, the antitrust laws would still apply. FERC would have regulatory power in addition to the Antitrust Division and the Federal Trade Commission. Legislation here I consider wrong, in the sense that it moves in the direction of regulation and away from competition. Exercising market power, in the true sense of the term, violates the antitrust laws. What more can FERC guard against?

Proponents give evasive answers. My experience at FERC, however, gives me a clue.

In a number of cases involving price caps for independent system operators in California and New England, the cry of market power arose every time the price rose to a level that the ISO did not like. Without proof of monopoly or collusion, regulators cried market power, when, in fact, prices rose during peak season, when demand rose. The pleadings say that market power occurs every time a price rises above marginal (operating) cost. I called this "capitalism at its best." I also pointed out that prices in the flowers market rise just before February 14, without anyone calling for controls.

Levity aside, legislation here poses a danger. Price caps mask mistakes in market rules or ISO procedures and make reform difficult. When regulators depend on a crutch, they need not undergo painful rehabilitation that would, in the end, allow them maximum mobility. In addition, high prices bring new supplies or decreased demand during peak times. Holding prices at operating costs all the time does not allow sellers to recover

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overhead, let alone earn a profit. Markets require giving sellers the opportunity to earn a profit.

*Interconnection Policy*

Lately, we have heard that Congress must give FERC the mandate of writing rules to allow generators to connect to the grid. Not only that, but a DOE-led task force calls for uniform provisions as well. I find this a waste of time and money. An RTO, especially a for-profit, stand-alone transmission company, would welcome interconnection from generators, as railroads, ships and trucks (and airlines) welcome freight. The problem the DOE addresses results from an alleged bias toward generation. If we separate transmission from generation, we remove the bias.

More important, at a time when FERC and the industry are engaged in collaboration to form stand-alone transmission companies, we must keep our eyes on the forest and off the trees. As with all things, the market knows better and can adapt better than regulators to changes. While Franklin D. Roosevelt advocated trying something else when the original solution fails, how many of us in Government, without pressure of the laws of economics, have the courage to live by his credo? Very few, I am afraid.

I will gladly answer your questions.
Electricity Tax Agreement

LPPC/APPA and EEI

The industry agreement on electricity restructuring tax issues is intended to modify the federal tax laws to remove certain impediments to effective competition in the electric power industry. The agreement is intended to preserve the right to use tax-exempt financing to serve public power systems' own electric load and remove the current tax law impediments to opening up these systems to competition. The agreement preserves public systems' use of tax-exempt bonds to finance distribution facilities, with some limitations. The agreement eliminates taxation of customer contributions in aid of construction for shareholder-owned systems' electric transmission and distribution facilities. The agreement also facilitates FERC's open access transmission policies by allowing public systems to provide open access without violating private use rules and by providing tax relief to shareholder-owned utilities that sell or spin-off transmission facilities to businesses that join independent regional transmission organizations. Last, the agreement is intended to assure adequate financing of nuclear decommissioning activities in a competitive, restructured electric industry.

The provisions of the agreement are described more specifically below.

I. PRIVATE USE

A. Election to Terminate Issuing New Tax-Exempt Bonds

1. Termination Election

Under the agreement, public power systems can elect to permanently terminate issuing most new tax-exempt bonds, in return for an exemption from private use rules for all of their existing tax-exempt bonds issued before date of enactment. However, an electing system may continue to issue certain tax-exempt bonds which are described below.

2. Tax-Exempt Bonds that may be Issued after a Termination Election

Qualified bonds and refunding bonds. — An electing system may continue to issue any qualified bond as defined in Section 141(e) of the tax code. (These are tax-exempt bonds that are currently free of most private use constraints.) An electing system may also issue any eligible refunding bonds. An eligible refunding bond is a state or local bond issued after the system...
makes the election, that directly or indirectly refunds tax-exempt bonds that were issued before the system made the election, provided the weighted average maturity of the refunding bonds does not exceed the remaining average maturity of the refunded bonds.

Qualifying transmission and distribution facilities. -- An electing system may continue to issue bonds to finance a local transmission facility over which the system provides open transmission access (a qualifying transmission facility); and a distribution facility over which the system provides open retail access (a qualifying distribution facility). New transmission and distribution bonds issued under this exception are subject to private use rules, as modified by the agreement.

Repairs. -- An electing system may continue to issue tax-exempt bonds for repair of electric generating facilities that were in service on the date of enactment or construction of which was commenced prior to June 1, 2000. Repair may include replacement of components of the electric generating facilities, but does not include replacement of a major portion of an electric generating facility. The repairs performed with the tax-exempt financing may not increase the capacity of the generating facility by more than 3% of base year capacity.

Environmental. -- An electing system may also continue to issue tax-exempt bonds to meet federal or state environmental requirements applicable to electric generating facilities that were in service on the date of enactment or construction of which was commenced prior to June 1, 2000.\textsuperscript{5}

Renewables. -- An electing system may issue tax-exempt bonds for renewable energy generation facilities during any period in which tax credits for the same type of facility are available to private entities. Tax credits are currently available for solar, wind, geothermal and closed-loop biomass generating facilities.

B. Updated Private Use Rules for Non-electing Systems

Under the agreement, public power systems that do not make the termination election remain subject to private use rules. However, the agreement would modify the private use rules applicable to public power systems that do not make the termination election to permit open access transmission and distribution and to permit public power systems to make certain electric sales not subject to private use rules in order to retain or replace certain load.

\textsuperscript{5} LPPC/APP and EEI jointly express support for the concept that all electric utilities, public and shareholder-owned, be allowed to issue new tax-exempt bonds for air or water-pollution control facilities placed in service after the date of enactment. However, the parties are not going to propose legislative language to cover this concept.
1. Open Access

The following open access transmission and distribution activities do not constitute a private business use: (1) providing non-discriminatory open access transmission service; (2) participation in an ISO, RTO or RTG agreement approved by FERC; (3) providing nondiscriminatory open access to distribution facilities for retail delivery of electricity sold by other suppliers; and (4) other open access transactions as provided by the Secretary. Open access transmission must be provided under a FERC-approved RTO agreement or pursuant to an open access tariff approved by FERC. If the open access tariff has been filed voluntarily, the public power system must comply with requirements of FERC Order No. 2000 concerning reporting its plans for regional transmission organizations. For certain Texas utilities, approvals are by the Public Utility Commission of Texas, rather than by FERC.

2. Sales

Wholesale sales by open access transmission utilities. – Public power systems that do not make the termination election and that provide open access transmission service are permitted to make certain wholesale sales not subject to private use rules from generation facilities in service on the date of enactment or construction of which commenced prior to June 1, 2000. To qualify under this provision, the sale must be to a “wholesale native load purchaser” or a “wholesale stranded cost mitigation sale”.

A wholesale native load purchaser is a wholesale purchaser to whom the public power system had a service obligation in the base year, or an obligation in the base year under a requirements contract or firm sales contract that has been in effect for, or has an initial term of, 10 years or more.

A wholesale stranded cost mitigation sale is a wholesale sale to an existing or new wholesale customer which replaces lost wholesale native load. Lost load is measured by the difference between base year sales to wholesale native load purchasers and the sales to such purchasers during recovery period years. The recovery period is a 7 year period beginning with the start-up year; however, there is a limited one year carry-over to an eighth year. At the election of the public power system, the start-up year is the year the system first offers open transmission access, the first year in which at least 10% of the system’s wholesale customers’ aggregate retail load is open to retail competition or, the year of enactment, if later. The base year is the year of enactment or, at the election of the public power system, one of the two preceding years.

On-system sales by open access transmission and distribution utilities. – Public power systems that do not make the termination election and that provide open access transmission (if the system owns or operates transmission) and open access distribution service may also make sales not subject to private use rules to an “on-system purchaser” from generation facilities in

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service on the date of enactment or construction of which commenced prior to June 1, 2000. An on-system purchaser is specifically defined as one whose facilities or equipment are directly connected with the public power system’s transmission or distribution facilities and who purchases electricity from such system and is either a retail purchaser within the area in which the system provided distribution services in the base year or is one to whom the system has a service obligation, or who is a wholesale native load purchaser from the system.

C. Limits on New Tax-Exempt Financing for Certain Transmission and Distribution Facilities

1. Transmission

Local transmission facilities limitation. — Under the agreement, whether or not they make the termination election described above, public power systems may issue new tax-exempt bonds for transmission facilities only if the facilities are “local transmission facilities.” Local transmission facilities are transmission facilities located in a public power system’s existing distribution area or facilities which are, or will be, necessary to serve its wholesale or retail native load. A system’s retail native load is the load of end-users served by its distribution facilities. A system’s wholesale native load is its wholesale sales to its wholesale native load purchasers (or purchasers under wholesale requirements or other firm contracts that were in effect in the base year), or the electric load of end-users served by any such wholesale purchaser’s distribution facilities. Electric reliability standards of national or regional reliability organizations, or decisions of RTOs or state or federal agencies shall be taken into account in determining whether facilities are or will be necessary to serve wholesale or retail native load. Transmission siting and construction decisions of RTOs and state and federal agencies shall be presumptive evidence as to whether transmission facilities are necessary to serve native load.

Exceptions. — Tax-exempt bonds may also be issued to finance any repair, replacement or qualifying upgrade of an existing transmission facility that is not a local transmission facility or to comply with an obligation under an existing shared transmission agreement. However, repair or replacement may not increase the voltage level nor may it increase thermal load limit by more than 3%. A qualifying upgrade is defined as an improvement to existing transmission facilities ordered or approved by an RTO or ordered by a state or federal regulatory or siting agency.

2. Distribution

As under current law, a public system can use tax-exempt financing to construct distribution facilities to serve its customers or existing customers of other utilities as governed by state law. However, under the agreement, a public power system which begins operation after the date of enactment would be precluded from issuing tax-exempt bonds for distribution facilities until it has been in operation for 10 years. In addition, except for certain voluntary transactions, public power systems could no longer issue tax-exempt bonds under the state volume cap to purchase distribution facilities owned by non-governmental utilities.
II. **SHAREHOLDER-OWNED UTILITY TAX RELIEF**

A. **Contributions in Aid of Construction**

Tax relief for investor owned utilities in the form of contributions in aid of construction (CIAC) would be as proposed in H.R. 2464 (the Watkins bill), but limited to electric distribution and transmission. Contributions in aid of construction (CIACs) for electric transmission and distribution facilities (including contributions for customer connection fees) would be exempt from income tax. However, fees received for starting and stopping service would not be CIACs and would still be subject to income tax. A utility would not obtain basis in property constructed with the proceeds of CIACs (to the extent of the CIAC received).

B. **Transco Tax Relief**

The transco tax relief provision of the agreement would defer taxes attributable to certain gains on sales (IRC Sec. 1033) and would permit tax-free spin-offs (IRC Sec. 355) by a utility of transmission facilities to an entity which FERC determines is not a market participant and which is either a FERC-approved RTO or is part of a FERC-approved RTO, or which a state commission, in ERCOT only, approves as consistent with state law regarding an independent transmission organization. The agreement would permit the deferral of tax on the entire proceeds of sale of transmission facilities to an independent transco; but with a savings provision that makes it clear that the tax treatment of the acquisition is not intended to affect FERC or state policy with respect to the extent to which any acquisition premium paid in connection with the purchase of the facilities can be recovered in the buyer’s rates. FERC’s longstanding policy in the context of facilities that remain under cost of service regulation has been to restrict buyer’s rate base to the seller’s depreciated original cost of the facility unless the buyer shows that the investment decision is prudent and can demonstrate that the acquisition provides measurable net benefits to ratepayers.

C. **Nuclear Decommissioning**

The nuclear decommissioning provisions of the agreement would be identical to the nuclear decommissioning tax provisions found in H.R. 2038 (which was introduced by Rep. Weller). These provisions would eliminate the requirement that amounts contributed to a qualified nuclear decommissioning fund come solely from amounts specifically collected from ratepayers under cost-of-service regulation. The provision would also define nuclear decommissioning costs and acknowledge that all such costs are currently deductible when paid or incurred, allow contributions to a qualified fund on an accelerated basis if such funding is required in connection with the transfer of a nuclear power plant, allow taxpayers to use a qualified fund to accumulate all monies needed for decommissioning irrespective of the age of generating plant and discontinue the requirement that taxpayers obtain a ruling from the Internal Revenue Service before making contributions to a qualified fund.