UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Technical Conference on Public Utility Holding Company Act of 2005 and Federal Power Act Section 203 Issues	**)))**	**Docket No. AD07-2-000**

OUTLINE OF TESTIMONY
<u>OF MIKE NAEVE</u>

I. THE ENERGY POLICY ACT OF 2005 WAS INTENDED TO ENCOURAGE THE CREATION OF OPERATING EFFICIENCIES BY FACILITATING CONSOLIDATION OF A FRAGMENTED INDUSTRY

The Commission should recognize that, notwithstanding some consolidation, a large percentage of U.S. utility services still are delivered by hundreds of small, inefficient utility systems. When compared to most other countries, the U.S. utility industry is highly fragmented and balkanized. There are considerable opportunities for reducing operating costs and improving reliability by consolidating this fragmented system.

Congress has recognized this when it enacted the Energy Policy Act of 2005; it did not tell FERC to limit mergers or to change its no harm standard under FPA Section 203. Instead, Congress largely codified FERC's prior approach to utility mergers.

Indeed, if there was a message in the Energy Policy Act, that message was to eliminate inappropriate barriers to consolidation.

- Congress imposed deadlines on FERC merger review
- Congress repealed the Public Utility Holding Company Act, which had imposed limits both on utility mergers and on diversification by utility holding companies

Thus, Congress took care not to adopt burdensome restrictions on utility consolidation transactions.

II. THE COMMISSION SHOULD GIVE ITS CURRENT CROSS-SUBSIDIZATION RULES A CHANCE TO WORK

At the same time that it acted to encourage beneficial consolidation, Congress also directed the Commission to carefully review proposed mergers to determine whether such proposals would result in cross-subsidization by utilities of non-utility affiliates.

The Commission has required merger applicants to specifically address the most relevant and potentially troublesome areas where cross-subsidization can occur:

- transactions between utilities and their affiliates
- transfers of assets or funds between utilities and affiliates
- pledges or encumbrances of utility assets for the benefit of affiliates
- issuance of utility securities for the benefit of affiliates

These new requirements cover the vast majority of the circumstances under which mergers potentially could result in cross-subsidization.

The Commission now is asking whether the potential benefits will outweigh the costs of imposing additional cross-subsidization restrictions, such as some forms of "ring-fencing." In light of the Section 203 protections the Commission already has adopted, when combined with the numerous protections against cross-subsidization that already are in place (including its code of conduct, standards of conduct, affiliate pricing rules, and *Edgar* standards), my judgment is that additional requirements are not warranted at this time.

III. ANY NEW CROSS-SUBSIDIZATION PROTECTIONS SHOULD NOT BE IMPOSED ON AN AD HOC BASIS

To the extent that the Commission believes that additional cross-subsidization or ring-fencing protections should be added to its Section 203 approval of transactions, the Commission should not impose such protections on an ad hoc, case-by-case basis. Instead, the Commission should either amend its Merger Policy Statement or its regulations to establish clear standards for determining when certain ring-fencing provisions should be adopted and what those provisions should be.

A. Clearly Articulated Standards Should Be Established for Determining Whether to Apply Additional Protection.

The Commission reviews hundreds of Section 203 applications annually. Additional filing burdens or costly commitments could impair the significant majority of these transactions, which present no threat at all, or no material threat, of potential cross-subsidization.

As a result, the Commission should adopt clearly articulated standards for determining whether a transaction should be subject to additional requirements regarding cross-subsidization. While I do not have a specific proposal in that regard, I offer the following observations:

- A great many transactions on their face will not raise potential cross-subsidization issues. For example, no such concerns are raised when a regulated utility acquires from a non-affiliated party additional generation facilities or other assets that will be subject to continued regulation. Similarly, no concerns are raised when neither the acquiring entity nor the acquired entity has affiliated regulated utilities that serve customers under cost-based rates. The Commission should establish clear

"Safe Harbor" criteria for excluding the vast majority of 203 transactions from the need for additional cross-subsidization requirements.

- In deciding what standards or thresholds will cause a transaction to fall outside the Safe Harbor zone, the Commission should consider factors such as:

  - Is the threat of future harm to a regulated utility imminent, or merely a theoretical possibility?
  - Is the level of potential harm material to the cost structure of the regulated utility?
  - Is the likelihood of harm high or low?
  - Does the proposed transaction result in a material increase in potential for harm?
  - What existing protections does the Commission have to reduce the potential for future cross-subsidization?

B. Clear Standards Should Be Established to Identify the Extent of Mitigation that Will Be Required.

Not only is it important for the Commission to establish clear thresholds for imposing additional requirements, but the Commission also should set clear standards for what mitigation requirements should be acceptable. This will allow industry participants to consider the requirements and associated costs that the Commission will impose when evaluating a transaction.

In circumstances where the Commission determines that additional protections are required, the Commission should recognize that no single combination of restrictions will be appropriate for all transactions. The type of restrictions that should be required will depend on the facts and circumstances presented by each particular merger under review. Nonetheless, the Commission should as clearly as possible identify which facts will call for which types of restrictions. This will assist merger applicants in tailoring their merger proposals to meet the Commission's needs.

In addition, just as the Commission proposed in the Merger Policy Statement alternative measures for addressing concerns about the effects of mergers on rates, the Commission should specify alternative approaches for merger applicants to address particular areas of cross-subsidization concerns. This will enable applicants to propose acceptable solutions that are most compatible with their existing financial or state regulatory obligations, and will enable the Commission to rule on transactions without the need for trial-type evidentiary proceedings.

Establishment of clear standards not only will allow industry participants to properly evaluate proposed transactions, it also will help to ensure that transactions presented to the Commission will be structured so as to address cross-subsidization concerns in an adequate fashion, and will prevent transactions that cannot meet the Commission's requirements from being proposed in the first place.

C. Without Clear Standards, Case-by-Case Litigation would be Wasteful and Arbitrary.

A lack of clear standards could recreate the hectic and undisciplined FERC merger review process that existed before the issuance of the Commission's Merger Policy Statement.

Without clear standards, more cases will be set for hearing. Applicants will not know when they need to propose additional protections or what protections to offer. Intervenors likewise will oppose whatever is offered, hoping to increase the risk to applicants that burdensome requirements might be imposed, thereby increasing the incentives for applicants to buy-out the intervenors through individual settlements. Finally, Administrative Law Judges will not know what standards to apply in evaluating merger proposals.

The prospect for lengthy trial-type evidentiary hearings will discourage companies from entering into many efficiency-enhancing transactions. Regulatory delay imposes significant opportunity costs on merging companies and is one of the major contributors to the high failure rate for mergers in the electric power sector.

IV. CONCLUSION

The new requirements imposed on merger applicants by Order 669 address the vast majority of the circumstances under which mergers could result in potential cross-subsidization by utility ratepayers of utility affiliates. When these new requirements are added to the other tools that FERC and state regulators have to protect against cross-subsidization, additional requirements do not appear to be warranted at this time.

If the Commission disagrees with this assessment and concludes that further protections against cross-subsidization in merger cases are appropriate, the Commission should not act on an ad hoc, case-by-case basis but rather should set forth concise thresholds and standards for determining when additional requirements are needed and what those requirements should be.