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UTILITY OVERSIGHT

Recent Changes in Law Call for Improved Vigilance by FERC

Accountability * Integrity * Reliability

GAO-08-289

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Highlights

Highlights of GAO-08-289, a report to congressional requesters.

UTILITY OVERSIGHT

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Why GAO Did This Study

Under the Public Utility Holding Company Act of 1935 (PUHCA 1935) and other laws, federal agencies and state commissions have traditionally regulated utilities to protect consumers from supply disruptions and unfair pricing. The Energy Policy Act of 2005 (EPAct) repealed PUHCA 1935, removing some limitations on the companies that could merge with or invest in utilities, leaving the Federal Energy Regulatory Commission (FERC), which already regulated utilities, with primary federal responsibility for regulating them. Because of the potential for new mergers or acquisitions between utilities and companies previously restricted from investing in utilities, there has been considerable interest in whether cross-subsidization—unfairly passing on to consumers the cost of transactions between utility companies and their "affiliates"—could occur. GAO was asked to (1) examine the extent to which FERC changed its merger and acquisition and post merger review and oversight processes since EPAct to protect against cross-subsidization and (2) survey state utility commissions about their oversight.

What GAO Recommends

GAO recommends that FERC use a risk-based approach to detect cross-subsidization, enhance audit reporting, and reassess resources to demonstrate oversight vigilance. While FERC's Chairman disagreed with GAO's findings and recommendations, GAO maintains they are sound.

For the full product, including scope and methodology, click on GAO-08-289. For the survey results, click on GAO-08-290SP. For more information, contact Mark Gaffigan at (202) 512-3841 or gaffiganm@gao.gov.

What GAO Found

FERC has made few substantive changes to either its merger review process or its postmerger oversight since EPAct and, as a result, does not have a strong basis for ensuring that harmful cross-subsidization does not occur. FERC officials told us that they plan to require merging companies to disclose existing or planned cross-subsidization and to certify in writing that they will not engage in cross-subsidization, but do not plan to independently verify such information. Once mergers have taken place, FERC intends to rely on its existing enforcement mechanisms—primarily companies' self-reporting noncompliance and a limited number of compliance audits—to detect potential cross-subsidization. FERC officials told us that they believe the threat of large fines, as allowed by EPAct, will encourage companies to investigate and self-report any non-compliance. In addition, FERC officials told us that, for 2008, FERC developed its plans to conduct compliance audits of 3 of the 36 holding companies it regulates based on informal discussions between senior agency officials and staffs in key offices. However, FERC does not formally use a risk based approach that considers factors, such as companies' financial condition or history of compliance. A risk-based audit approach is an important consideration in efficiently allocating its limited resources to detect non-compliance. In addition, we found that FERC's public audit reports often lacked a clear description of the audit objectives, scope, methodology, and findings—inhibiting their use in improving transparency with stakeholders or helping FERC staff improve their audit practices.

State utility commissions' views of their oversight capacity varied, but many reported a need for additional resources, such as staff and funding, to respond to changes in their oversight after the repeal of PUHCA 1935. State regulators in all but a few states reported that utilities must seek state approval for proposed mergers. State regulators reported being mostly concerned about the impact of mergers on customer rates, but 25 of 45 reporting states also noted concerns that the resulting, potentially more complex company could be more difficult to regulate. Most states reported having some type of audit authority over the transactions between utilities and their affiliated companies, but many states currently review or audit only a small percentage of these transactions, with 28 of the 49 reporting states auditing 1 percent or less over the last five years. On the other hand, some states reported that they require periodic, specialized audits of affiliate transactions. In addition, although almost all states require financial reports from utilities and report they have access to utility companies' financial books and records, many states reported they do not have such direct access to the books and records of affiliated companies. While EPAct provides state regulators the ability to obtain such information, some states expressed concern that this access is narrow and could require them to be extremely specific in identifying needed information, thus potentially limiting their audit access. From a resources perspective, 22 of the 50 states reporting said that they needed additional staffing and funding to a carry out their oversight responsibilities.

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Abbreviations

EPAct	Energy Policy Act of 2005
FERC	Federal Energy Regulatory Commission
GAGAS	Generally Accepted Government Auditing Standards
NARUC	National Association of Regulatory Utility Commissioners
PUHCA 1935	Public Utility Holding Company Act of 1935
PUHCA 2005	Public Utility Holding Company Act of 2005
SEC	Securities and Exchange Commission

United States Government Accountability Office
Washington, DC 20548

February 25, 2008

The Honorable Jeff Bingaman
Chairman
Committee on Energy and Natural Resources
United States Senate

The Honorable Sam Brownback
United States Senate

The Honorable Russell Feingold
United States Senate

Public electric and natural gas utilities sell about $325 billion worth of electricity and natural gas to more than 140 million customers in U.S. homes and businesses each year. These customers depend on reliable and reasonably priced electricity and natural gas for everything from lighting homes to large-scale manufacturing. Federal and state regulators seek to balance efforts to ensure that these utilities are profitable enough to attract private investment to pay for things such as construction of new power plants with efforts to protect consumers from potential supply disruptions and unfair pricing practices. With the utility industry facing the need to invest potentially hundreds of billions of dollars to expand and upgrade the utility infrastructure over the next 10 years, recent changes in federal laws and regulations have eliminated some limitations on the types of companies that can own and invest in utilities—thereby opening the sector to new investment. These changes, however, have raised considerable interest about whether the remaining laws and regulations strike an appropriate balance between encouraging investment in the utility sector and protecting consumers.

Public electric and natural gas utilities historically operated as state-regulated monopolies, providing electricity and natural gas services to all consumers within a geographic region. For many years, utilities were primarily regulated by the states through state utility commissions, which approved plans for new plants and other infrastructure, examined operating costs such as labor and purchases of fuel, and approved prices—also referred to as "rates"—to allow utility companies the opportunity to recover these costs and make reasonable profits. As regulators, state commissions reviewed proposed mergers or acquisitions involving state-regulated utilities, audited some individual purchases of goods and services for compliance with relevant pricing and other regulatory requirements, and often examined financial records of utilities. In exchange for this regulation, utilities were typically allowed an opportunity to recover costs prudently incurred to provide electricity or natural gas to customers and an opportunity to earn a specified rate of return on their investments. This opportunity to recover costs and a rate of return often meant that utilities were perceived as low-risk investments and were able to obtain money from stock and bond markets at low costs relative to companies in more risky businesses such as energy exploration and development.

Over time, changes occurred in the utility industry that made it more difficult for individual states to regulate utilities. First, the utility industry grew very rapidly during the early part of the 20th century, and utilities that spanned multiple states began to emerge. These multistate utilities shared use of plants and equipment located in different states that often had different rules and jurisdictional authority, making it more difficult for individual state utility commissions to effectively regulate them. Second, by the 1920s, as a result of mergers and acquisitions, utilities were largely controlled by a handful of complex corporations—called holding companies—many of which owned several utilities as well as other companies. In many cases, the companies within these holding companies—called affiliates—sold a wide range of goods and services to utilities, such as fuel for power plants. These transactions between affiliates are generally referred to as affiliate transactions. Some affiliate transactions could benefit utility customers, such as when utilities effectively shared the cost of legal and other administrative services with affiliates instead of each company maintaining staff and other resources to provide these services separately. However, since the rates utility customers pay generally include all of the costs of goods and services bought to serve them, affiliate transactions that were priced unfairly could result in utility customers subsidizing operations outside the utility—called cross-subsidies. When this harmful cross-subsidization occurs, utility rates to electricity and natural gas consumers are inflated, causing them to pay too much and allowing the utility to unfairly compete in other industries. Third, poor disclosure of financial information and limited access to financial records often made it difficult to accurately assess the utilities' financial health. Compounding this, many of these holding companies were involved in risky business ventures outside the utility industry and had pledged utility assets to support those investments. Partly as a result of the poor financial disclosure and the complex web of corporate ownership and affiliate transactions, many utilities went into bankruptcy during the financial collapse followed by the Great Depression of the 1930s, placing at risk the electricity and natural gas services that consumers and businesses relied upon.

To restore public confidence after the Depression, the federal government undertook three efforts to improve the regulation of utilities. First, to protect investors, the federal government created the Securities and Exchange Commission (SEC) to establish rules for the financial markets and publicly traded companies participating in those markets as well as a means to regulate them. Among these were rules focused on improving reporting of financial information to the public. This improved oversight and access to financial information fostered development of publicly held companies and financial markets for timely financial information. For example, credit rating agencies and other financial firms began to track company financial conditions on a regular basis to determine if any changes could pose risks to the company's investors. Second, to protect utility customers, the federal government enacted the Federal Power Act of 1935 which served, and continues to serve today, as the foundation of federal regulatory authority related to regulation of public utilities. Among other things, this law empowered the Federal Energy Regulatory Commission[1] (FERC) to serve as the primary federal regulator of utilities and made it responsible for overseeing interstate transmission of electricity, wholesale sales of electricity to resellers (e.g., sales by utilities to other utilities), and reviewing proposed mergers or acquisitions involving companies it regulates.[2] In its role of regulating interstate transmission and wholesale sales, FERC has been responsible for approving prices (i.e., rates) for the use of transmission lines and the sales of electricity in wholesale markets—also commonly called "rate setting." In recent years, FERC has granted "market-based rates" for wholesale sales to many companies. For the rates that FERC still approves, generally interstate transmission rates, utilities generally initiate these rate-setting procedures—often in order to increase rates to recover rising costs.

[1]The Federal Power Act of 1935 empowered the Federal Power Commission, the predecessor to FERC.

[2]Subsequent to the enactment of the Federal Power Act, FERC was empowered by the Natural Gas Act as the primary federal regulator of natural gas transportation and sales, and was granted similar but not identical authorities. Most of the geographic area of Texas is electrically isolated from the rest of the United States. Electricity flowing within this electrically isolated area is not considered to be interstate in nature and, hence, the utilities that transmit or sell, or both, such electricity are not considered to be subject to FERC rate regulation. FERC does have limited jurisdiction over the facilities that connect the electrically isolated portion of Texas to the rest of the United States.

During such procedures FERC may examine individual costs incurred by utilities to determine whether to allow utilities to recover them in regulated rates. In this way, FERC may determine which costs may lawfully be included in rates charged to customers. However, such reviews may not be done for several years, under some circumstances. To perform its role as federal regulator, FERC has annually collected certain financial and operational data on utilities and more frequently collected other data, such as prices and quantities of sales of electricity to others. While this law created a new layer of federal regulation over certain aspects of the utility industry, state commissions maintain their traditional role as the primary regulator of retail sales—approving many aspects of utility operations, such as the siting and construction of new power plants and approving the rates consumers pay. Third, the federal government enacted the Public Utility Holding Company Act of 1935 (PUHCA 1935) to regulate investment in the utility industry to protect investors and consumers from potential abuses by holding companies and empowered SEC to administer this law. PUHCA 1935 sought to simplify and reorganize existing holding companies' structures, limit the formation of new holding companies that were not physically connected by electric power lines, and prohibited existing holding companies from acquiring more than one utility, unless the utilities were physically connected by power lines. In addition, PUHCA 1935 restricted the ability of companies outside the utility industry to own or control public utilities. In order to maintain control over holding companies, SEC was given responsibility for reviewing mergers or acquisitions involving holding companies, or which could result in the formation of a holding company.

PUHCA 1935 also empowered the SEC to examine utility operations. As such, PUHCA 1935 gave the SEC authority to require more extensive financial reporting than what was previously required and to examine and limit affiliate transactions to ensure that utilities do not purchase goods and services at inflated prices from companies within the same corporation then pass those inflated costs on to utility consumers. In overseeing affiliate transactions in recent years, SEC audited each holding company about every 6 years.

Over time, other statutory and regulatory changes reduced some of the strict limitations PUHCA 1935 initially imposed. For example, PUHCA 1935 was amended in 1978 and 1992 to exempt certain companies that generated electricity but did not sell it directly to consumers. This change allowed companies outside the utility sector to build and operate power plants and sell electricity to utilities and others, but remain outside of the jurisdiction of the SEC. Further, in 1995, to facilitate investment and respond to changes in the utility industry, SEC determined it should interpret PUHCA 1935 more broadly to allow certain mergers and acquisitions by nonutilities. The SEC also allowed some mergers and acquisitions to proceed without becoming subject to SEC oversight if they met certain financial requirements designed to limit control over the utilities.[3] These interpretations allowed some mergers by utilities and nonutilities, holding companies, and other diversified corporations. While allowing these specific transactions to proceed, SEC still placed restrictions on transactions that would result in these new owners owning multiple U.S. utilities.

Over the past two decades, interested parties have advocated repeal or further amendment of PUHCA 1935. The utility industry sought PUHCA 1935's repeal to improve investment in the utility sector, and some believed that this investment could help utilities make needed improvements at a lower cost than on their own. Some advocates also believed that this oversight was no longer needed because several other federal laws had been passed, including antitrust laws requiring the Department of Justice and the Federal Trade Commission to examine large mergers and laws requiring extensive financial disclosure to provide for improved financial oversight of utilities. Furthermore, advocates of repeal argued that federal regulation of utilities by FERC includes extensive oversight of power sales and mergers. Finally, industry has held that state commissions have extensive authority to oversee utilities and limit abusive practices that could affect the rates paid by consumers. On the other hand, opponents of PUHCA 1935's repeal, including some business and consumer representatives, expressed concern that utilities would become too complex to effectively regulate, potentially resulting in higher prices for consumers. Business groups outside the utility industry were also concerned that utilities could use their monopolies in providing electricity and natural gas services to unfairly compete in other businesses—in other words, they could use utility revenues to cross-subsidize investments into other businesses and harm competition and competitors in those other industries. Consumer representatives also expressed concern that, unbound by PUHCA 1935's limitations on the types of companies that could own utilities, utilities could become part of

[3]For a more complete discussion of these financial restrictions, see GAO, *Public Utility Holding Company Act: Opportunities Exist to Strengthen SEC's Administration of the Act*, GAO-05-617 (Washington, D.C.: July 8, 2005).

more risky financial structures, as had been the case in the 1930s, compared to the traditional low-risk utility structure.

Through the Energy Policy Act of 2005 (EPAct), the federal government, among other things, repealed PUHCA 1935, thus eliminating the restrictions on the types of companies that can own utilities, and replaced it with the Public Utility Holding Company Act of 2005 (PUHCA 2005). EPAct also granted FERC enhanced civil penalty authorities. The act did not change the states' overall responsibilities for regulating retail markets, but with the repeal of PUHCA 1935, SEC no longer had an oversight role in regulating utility holding companies or for preventing cross-subsidies.[4] FERC's new authorities under EPAct, to regulate corporate structures and transactions, fell into two broad areas and required FERC to issue regulations that implement these authorities, which it has done.

Merger review. EPAct expanded FERC's merger review to require FERC to ensure that a proposed merger will not result in harmful cross-subsidization. Traditionally, under the authority of the Federal Power Act, FERC determined whether a proposed merger was consistent with the public interest. FERC's 1996 merger review policy statement outlines three primary factors for analysis before approving a merger—the merger's effect on: competition, rates, and regulation. According to FERC officials, although preventing cross-subsidization has been a long-standing responsibility of FERC under its rate-setting authority, preventing it at the point of the merger review is new for FERC.[5]

Postmerger oversight. With the repeal of PUHCA 1935, FERC became the principal federal agency responsible for determining how costs for affiliate transactions should be allocated for all utility holding companies irrespective of when they were formed (i.e., new companies formed through mergers or acquisitions or already existing companies). Traditionally, as part of its review and approval of prices public utilities charge for use of transmission

[4] The SEC will continue enforcing laws and regulations governing the issuance of securities and regular financial reporting by public companies.

[5] Related to mergers, the Department of Justice and the Federal Trade Commission will continue their long-standing enforcement of antitrust laws. These include the premerger provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and Section 7 of the Clayton Act.

lines and wholesale sales of electricity, for companies not overseen by SEC, FERC had the authority to determine whether costs from affiliate transactions between companies in the same holding company were allowed.[6] To help FERC better oversee these transactions, EPAct provided FERC specific postmerger access to the books, accounts, memos, and financial records of utility owners and their affiliates and subsidiaries. The act also granted state utility commissions access to such information subject to some conditions. Furthermore, EPAct gave FERC enhanced civil penalty authority to help it enforce it new requirements, providing the commission the ability to levy penalties of up to $1 million per day per violation.

Business and consumer groups, as well as some state regulators, disagree as to whether the current federal and state legal and regulatory structure imposed by EPAct is sufficient to protect consumers. In the context of this disagreement, we agreed to examine: (1) the extent to which FERC, since EPAct's enactment, has changed its merger or acquisition review process and postmerger or acquisition oversight to ensure that potential harmful cross-subsidization by utilities does not occur; and (2) the views of state utility commissions regarding their current capacity, in terms of regulations and resources, to oversee utilities.

To answer these questions, we reviewed relevant reports, examined existing data, interviewed key officials, and conducted site visits in four states that had strong protections in place for overseeing holding and related affiliate companies or where additional consumer protections were being considered as a direct result of the repeal of PUHCA 1935. In addition, we conducted a detailed survey of state regulators in all 50 states and the District of Columbia. We have provided a copy of our survey and detailed tables showing the staff of the public utility commissions' responses to the questions in a separate report, *Utility Oversight: Survey of State Public Utility Commissions Regarding Utility Commission Authorities and Reporting Responsibilities for Overseeing Utilities Since the Passage of EPAct 2005* (GAO-08-290SP), available on the Internet www.gao.gov/special.pubs/gao-08-290sp. We did not attempt to develop a cost-benefit analysis of the repeal of PUHCA 1935. A detailed description of our methodology is included in appendix I. We performed

[6] According to FERC, its rules governing market-based rates contain specific restrictions on affiliate transactions.

our review from May 2006 through February 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Brief

FERC has made few substantive changes to either its merger review process or its postmerger oversight since EPAct and, as a result, does not have a strong basis for ensuring that harmful cross-subsidization does not occur. With regard to its review of mergers and acquisitions, FERC officials told us that they do not intend to make changes to their process other than to require companies to disclose any existing or planned cross-subsidization and explain why it is in the public interest, and to certify in writing that they will not engage in harmful cross-subsidization. With this disclosure and company attestation, FERC officials review organizational and financial information provided by the companies at the time of the proposed merger and do not take further steps to independently verify such information. With regard to postmerger oversight, including its oversight of already existing companies previously regulated by SEC or FERC, FERC intends to continue to rely on its existing enforcement mechanisms to detect potential cross-subsidies—primarily companies self-reporting noncompliance and a limited number of compliance audits. FERC officials told us that they believe the threat of large fines, as allowed by EPAct, will encourage companies to investigate and self-report noncompliance that they discover. To augment self-reporting, FERC officials told us that they are using an informal plan to reallocate their limited audit staff to conduct affiliate transaction audits of 3 companies in 2008 (of the 36 holding companies it regulates). FERC officials told us that it relies on informal discussions between senior FERC managers and staffs to plan its audits each year, but does not formally consider the risks posed by various companies. A risk assessment, for example, could include developing a risk profile for companies by using data on a company's financial condition and by collaborating with states to consider a company's history of compliance. In contrast to FERC's approach for selecting companies for compliance audits, financial auditors and other experts told us that such a risk-based audit approach is an important consideration in allocating resources to detect noncompliance. Finally, we found that where affiliate transactions were audited, the resulting audit reports often lacked a clear description of the audit objectives, scope, methodology, and findings—thus preventing them from being useful to

FERC staff to build better audit practices or to improve transparency to states and companies policing these transactions or the public more generally.

Although states' views varied on their current regulatory capacities to review utility mergers and acquisitions and oversee affiliate transactions, many states reported the need for additional resources, such as staff and funding, to respond to changes in oversight after the repeal of PUHCA 1935. With regard to the review of mergers, state regulators in all but a few states reported utilities must seek state approval for these proposals. State regulators reported being mostly concerned about the impact of mergers on customer rates, but 25 of 45 reporting states also noted concerns that the resulting potentially more complex company could be more difficult to regulate. In recent years, two state commissions denied mergers, in part, because of these concerns. With regard to affiliate transactions and the potential for cross-subsidies, most states have some type of authority to approve, review, and audit affiliate transactions, but many states currently review or audit only a small percentage of the transactions. For example, over the last 5 years, the majority of states (28 of 49 states reporting) audited 1 percent or less of affiliate transactions. On the other hand, some states reported that they require periodic, specialized audits of affiliate transactions to ensure transactions are consistent with applicable rules. Although almost all states require financial reports from utilities and report they have access to financial books and records from utilities in order to review affiliate transactions, many states reported they do not have such direct access to the books and records of holding or affiliated companies. Some utility experts believe that this lack of authority could prevent some states from linking the financial risks associated with affiliate companies to their regulated utility customers. While EPAct provides state regulators the ability to obtain such information, some states expressed concern that this access is narrow and could require them to be extremely specific in identifying needed information, thus potentially limiting their audit access. From a resources perspective, almost one-half (22 of 50 states reporting) said that with the changes in EPAct they needed additional staffing and funding to a carry out their oversight responsibilities. A commission official told us that examining affiliate transactions can be resource intensive since determining whether a transaction is unfair may require detailed analysis of the transaction and the market for the good or service that was the subject of the transaction.

GAO recommends that the Chairman of FERC develop a risk-based audit approach to detect cross-subsidization, enhance its public audit reporting, and reassess its resources in light of a risk-based audit approach in order to demonstrate that its oversight is sufficiently vigilant. The FERC Chairman disagreed with our report findings and recommendations. We maintain that fully implementing our recommendations would enhance the effectiveness of FERC's oversight.

FERC'S Merger Review and Postmerger Oversight to Prevent Cross-Subsidization in Utility Holding Company Systems Are Limited

FERC has made few substantive changes to either its merger review process or its postmerger oversight as a consequence of its new responsibilities and, as a result, does not have a strong basis for ensuring that harmful cross-subsidization does not occur. To review mergers and acquisitions, FERC officials told us that they do not intend to make changes to their process other than to require companies to disclose any existing or planned cross-subsidization and explain why it is in the public interest, and to certify in writing that they will not engage in harmful cross-subsidization. For postmerger oversight, FERC intends to continue to rely on its existing enforcement mechanisms, as expanded by EPAct, to detect potential cross-subsidies—primarily companies' self-reporting of noncompliance and a limited number of compliance audits. However, FERC does not formally consider the risks posed by various companies in determining which companies to audit—a consideration that financial auditors and other experts told us is important when auditing with limited resources. We also found that where affiliate transactions were audited, the resulting audit reports sometimes lacked clear and useful information.

FERC's Merger and Acquisition Review Relies Primarily on Company Disclosures and Commitments Not to Cross-Subsidize

FERC's merger review process requires companies to submit evidence that a merger or acquisition will not result in unapproved cross-subsidization, and its ability to prevent cross-subsidization depends largely on commitments by the merging parties rather than independent analysis. FERC-regulated companies that are proposing to merge with or acquire a regulated company must submit a public application for FERC to review and approve. As part of its review of these applications, FERC is now responsible for ensuring that mergers do not result in harmful cross-subsidies. To do this, FERC attempts to ensure that mergers will not result in:

- any transfer of facilities between or issuance of securities by a traditionally regulated public utility to an affiliate;[7]

[7]This specifically applies to any "public utility associate company that has captive customers or that owns or provides transmission service over jurisdictional transmission facilities, and an associate company."

- any new financial obligation by a traditionally regulated public utility for the benefit of an affiliate;[8] or
- any new affiliate contract between a nonutility affiliate company and a traditionally regulated public utility company, other than agreements subject to review by FERC under the Federal Power Act.

To fulfill this new responsibility, FERC established an additional requirement that the merging companies submit new information as part of their application for merger or acquisition approval, referred to as "Exhibit M." Exhibit M requires companies to describe organizational and financial information, such as affiliate relationships and any existing or planned cross-subsidies. If cross-subsidies already exist or are planned, companies are required to describe how these are in the public interest by, for example identifying how the planned cross-subsidy benefits utility ratepayers and does not harm others. Further, in FERC's recent supplemental merger policy statement, issued July 20, 2007, FERC provided additional guidance on certain types of transactions that are not likely to raise concerns about cross-subsidization—termed "safe harbors."[9] FERC also requires company officials to attest that they will not engage in unapproved cross-subsidies in the future and specifically requires the merger application, including Exhibit M, to be signed by a person or persons having appropriate knowledge and authority.

FERC's merger or acquisition decision is based on a public record that starts with an initial application. This record includes the filing of the initial application. FERC's review process also allows stakeholders or other interested parties, such as state regulators, consumer advocates, or others to submit information and arguments to this public record for FERC to consider. FERC officials told us that they evaluate the information in the public record for the application and do not separately develop or collect evidence or conduct separate analyses of a proposed

[8]FERC specifically prohibits any new pledge or encumbrance of assets of a traditional public utility associate company that has captive customers or that owns or provides transmission service over jurisdictional transmission facilities, for the benefit of an associate company.

[9]FERC recognizes three types of transactions that are unlikely to raise cross-subsidization concerns, including (1) transactions where the applicant shows that a traditionally regulated utility is not involved so there is no potential harm to utility customers, (2) transactions that are subject to review by a state commission because it has the authority to impose cross-subsidization protections, and (3) transactions that involve only nonaffiliates so that the potential for inappropriate cross-subsidization generally is not present.

merger beyond what is submitted as part of the record. FERC officials told us that they can, and sometimes do, request that applicants provide additional information or conduct additional analysis. In addition, FERC may require a public hearing before making a decision. Whether or not a hearing is held, officials noted that they are required to make their decision based on the evidence that is in the public record. On the basis of this information, FERC officials told us that they will determine which, if any, existing or planned cross-subsidies may be allowed, which is then detailed in the final merger or acquisition order.

According to experts, FERC is generally supportive of mergers. FERC officials largely acknowledged this perspective, telling us that under law and regulation, FERC must approve mergers that are consistent with the public interest. These officials also said that FERC believes it has broad flexibility in determining what is consistent with the public interest, particularly in light of changing conditions in the industry and, as such, it does not read the statute as creating a presumption against mergers.[10] On the other hand, FERC officials said that FERC was not prepared to presume that all mergers were beneficial but that it was the merger applicant's responsibility to demonstrate that the merger was consistent with the public interest by, for example, demonstrating how it improves efficiency or lowers costs while not harming competition.

Between the time EPAct was enacted in 2005 and July 10, 2007, FERC has reviewed or was in the process of reviewing 15 mergers or potential mergers (see table 1).[11] FERC has not rejected any merger applications. In nine cases, FERC approved the merger without condition. In three cases, FERC approved the merger with conditions, for example, requiring the merging parties to provide further evidence of ratepayer protection consistent with FERC-approved "hold harmless" provisions. One merger was withdrawn by the merging parties prior to FERC's decision. The two other applications are still pending.

[10]To the contrary, FERC officials noted that if FERC does not act on an application within 180 days, EPAct states that the application "shall be deemed granted" unless FERC grants itself one 180-day extension.

[11]These data include mergers, acquisitions, or the sales of assets.

Table 1: Merger Proposals Reviewed by FERC since EPAct

Merging parties	Decision date	FERC order
Duke Energy Corp. and Cinergy Corp.	12/20/2005	Approved without conditions
MidAmerican Energy Holding Co., Scottish Power plc, and PacifiCorp Holdings, Inc.	12/20/2005	Approved without conditions
Florida Power & Light and Constellation Energy	Not applicable	Merger was withdrawn prior to FERC decision
Georgia Power Company and Savannah Electric Power Company	3/30/2006	Approved without conditions
ITC Holdings Corp., International Transmission Co., Michigan Transco Holding Limited Partnership, Michigan Electric Transmission Co. LLC and Trans-Elect NTD Path 15, LLC	9/21/2006	Approved subject to conditions
National Grid plc and KeySpan Corp.	10/20/2006	Approved subject to conditions
Boston Edison Co., Cambridge Electric Light Company, Commonwealth Electric Co., and Canal Electric Co.	10/20/2006	Approved subject to conditions
Northwestern Corp. and Babcock & Brown Infrastructure Limited	10/25/2006	Approved without conditions
Green Mountain Power Corp, Northern New England Electric Corp. and Northstars Merger Subsidiary Corp.	12/4/2006	Approved without conditions
WPS Resources Corp. and Peoples Energy Corp.	12/26/2006	Approved without conditions
Duquesne Light Holdings, Inc., DQE Merger Sub, Inc., and DQE Holdings	12/22/2006	Approved without conditions
Dynegy Inc., and LS Power Development, LLC	12/21/2006	Approved without conditions
EBG Holdings LLC, Boston Generating LLC, and Astoria Generating Company Holdings LLC	5/30/2007	Approved without conditions
Oncor Electric Delivery Co., TXU Portfolio Management Co. LP, and Texas Energy Future Holdings Limited Partnership	Not applicable	Not yet decided
ITC Holdings Corp. and Interstate Power and Light Co.	Not applicable	Not yet decided

Source: FERC.

FERC'S Postmerger Oversight Relies on Its Existing Enforcement Mechanisms and Lacks a Risk-Based Approach

FERC officials in the Office of Enforcement intend to use the same tools to enforce prohibitions on cross-subsidization that they currently use for other enforcement actions. In general, the Office of Enforcement relies on two primary tools—self-reporting and a limited number of compliance audits.[12] However, we found that FERC does not use a formal risk-based approach to guide its audit planning—the active portion of its oversight efforts to detect cross-subsidization—or deploy its limited audit resources. As such, FERC's actions do not provide a strong basis for ensuring the detection of potentially harmful cross-subsidization.

The first detection tool that FERC emphasizes is that companies self-police their own affiliate transactions and intercompany relationships and voluntarily self-report instances of harmful cross-subsidization to FERC. FERC's policy statement on enforcement emphasizes such voluntary internal compliance and reporting as well as cooperation with FERC in order to detect and correct violations. A company's actions in following this policy, along with the seriousness of a potential violation, help inform FERC's decision on the appropriate level of potential penalty to impose on violating companies.[13] FERC indicates that it places great importance on company's proactive self-reporting because it believes that companies are in the best position to detect and correct both inadvertent and intentional violations of FERC orders, rules, and regulation. According to FERC officials, companies can actively police their own behavior through a formal program for internal compliance, internal audits, and through annual external financial audits.

[12]FERC officials also told us that in addition to self-reporting and audits of some companies, they also may initiate investigations based on internal and external reports of potential violations. Officials told us that they are able to initiate internal investigations based on referrals from FERC staff such as those monitoring natural gas and electricity trading and markets in the market monitoring center. In addition, FERC officials noted that companies and individuals may report potential violators. Such reports may be made, they said, through their "hotline" reporting system, which allows individuals to anonymously report suspected violations of FERC rules. In addition, individuals knowledgeable of FERC's processes and rules may also report violations as formal or informal complaints that companies are violating the terms and conditions of the detailed FERC-approved tariffs or rates. FERC officials did not tell us how many such reports have been made related to cross-subsidies or how many of such reports resulted in cross-subsidy violations. However, officials noted that all complaints are investigated to determine whether they have merit.

[13]FERC generally plans to retain its flexibility and discretion to decide remedies on a case-by-case basis rather than to prescribe penalties or develop formulas for different violations.

Since the enactment of EPAct,[14] when Congress formally highlighted its concern about cross-subsidization, no companies have self-reported any of these types of violations. FERC officials said that FERC had approved 12 settlements with natural gas and electric entities, none of which involved violations of the PUHCA 2005 provisions in EPAct. In these cases, FERC has assessed civil penalties totaling $39.8 million on the companies.[15] FERC officials told us that because it can now levy much larger fines—up to $1 million per violation per day—they expect companies to become more vigilant in monitoring their behavior.

Regarding FERC's reliance on self-reporting, key stakeholders have raised several concerns about this approach. First, because FERC's rules related to affiliate transactions are broad, company managers may not always be fully aware of how these rules apply to specific affiliate transactions. According to market experts, including a November 2007 report issued by a former FERC Commissioner on behalf of a broad consortium of energy companies, FERC's rules are often written broadly and it is unclear what standards of conduct FERC uses to oversee transactions between companies. This can result in utility managers being unaware that specific transactions may violate current FERC policies. One controller we met with told us that these broad rules can be counterproductive in encouraging company compliance and self-reporting because it is difficult to determine if the rules are actually being violated. Second, internal company audits tend to focus on areas of highest perceived risk and, as a result, may not focus specifically on affiliate transactions. Internal auditors with whom we spoke told us that they have relatively small staffs and are responsible for auditing a wide range of matters within a corporation and, as such, they focus their efforts on areas they believe pose the highest risk to the company. They said this approach means that they rarely focus on affiliate transactions, unless those transactions represent a large financial exposure to the company's potential profitability. Finally, financial audit firms we spoke with told us their work primarily focuses on auditing financial statement balances and related disclosures. These audits focus on providing an opinion about whether the financial statements present fairly, in all material respects, the financial

[14]Subtitle F of EPAct replaced PUHCA 1935 with the "Public Utility Holding Company Act of 2005."

[15]In January 2007, FERC first used the expanded civil penalty authority provided by Congress in the EPAct by assessing total penalties of $22.5 million on SCANA Corp., PacifiCorp, Entergy Corp., Northwestern Energy Corp., and NRG Energy Inc.

position and operations of the company. As such, they said that their work with regard to affiliate transactions is limited to the related disclosures rather than determining if harmful cross-subsidization was occurring. Only in cases where transactions could have a material effect on the overall financial statements of a company would they conduct detailed testing and review pricing arrangements. Compounding these concerns, and FERC's belief that the threat of large fines will encourage companies to self-report, companies expressed uneasiness over FERC's use of its new penalty authority on self-reporting companies. One company official noted that some of the recent penalties for companies that self-reported violations were large and would "chill" companies' willingness to self-report violations. In addition, state commissions expressed concerns about a reliance on self-reporting of cross-subsidies and reported that effective oversight would require regular and rigorous audits of affiliate transactions.

As a second way to detect potential harmful cross-subsidization, FERC plans to conduct a limited number of compliance audits of holding companies each year. Since enactment of PUHCA 2005 provisions in EPAct, FERC has not completed any audits to detect whether cross-subsidization is occurring. In our review of FERC processes for planning these audits, however, officials with the Division of Audits in the Office of Enforcement told us that FERC conducts audit planning for 1 fiscal year at a time. On the basis of this approach, FERC's current audit plan for these matters in 2008 will audit three companies—Exelon Corporation, Allegheny, Inc., and the Southern Company. The overall objective of these audits will be to determine whether these companies are inappropriately cross-subsidizing or granting special preference to affiliates or burdening utility assets for the benefit of nonutility affiliated companies. Such compliance audits, officials told us, will determine whether companies are complying with FERC rules for the pricing of affiliate transactions, among other things. FERC's audit plan is not designed to address the number of audits FERC will conduct beyond 2008, or at what companies it will conduct them since the planning for 2009, for example, will not be done until sometime later in 2008. In addition, based on discussions with FERC officials, the development of its audit plan is informal and developed in an ad hoc manner to address the specific audits for a given year. Specifically, these officials said that the plan is developed through informal discussions between FERC's Office of Enforcement, including its Division of Audits, and relevant FERC offices with related expertise, including the Office of General Counsel, the Office of Energy Markets Regulation, and the new Office of Electric Reliability. FERC officials also told us that the plan is reviewed by top agency officials and approved by the Chairman.

While FERC's audit plan for 2008 reflects insights of key FERC staff, it does not formally consider the risks posed by individual companies, or the overall universe of companies, in determining which companies to audit or how many audit resources to deploy. FERC officials told us that while they do not specifically consider the individual or collective risks posed by companies in a formal manner, they believe that their discussions with knowledgeable staff provide a reasonable picture of risk. However, on the basis of our discussions with FERC staff, this picture of risk may be somewhat limited in that it is informed only by the views of a few key staff and does not seek input from stakeholders, such as the financial community or state commissions, or reflect analysis of key data on risk.

To obtain a more complete picture of risk, FERC could more actively monitor company-specific data to develop a picture of the risks posed by the companies it regulates—something it currently does not do. To partly address this, FERC recently required certain affiliates to begin gathering comprehensive financial information in 2008 and filing the first of what will be annual financial reports by May 2009.[16] According to a FERC audit official, after a year or 2 of data collection, analysis, and conducting audits, it will be in a much better position to plan, conduct, and report the results of its audits of affiliate relationships and potential cross-subsidization.[17] In addition, this official said that FERC does not typically review certain publicly available financial information, such as bond ratings and stock prices for companies that FERC regulates or their affiliates. According to bond rating companies, they actively monitor companies' operating and financial condition to identify the key risks faced by companies and reflect these risks in the ratings they assign to the company's debt. Further, state officials agreed that such information may help provide a view of the financial condition of specific companies, or the overall industry, and how they may be changing. In support of the use of this information, some state regulators told us that such information has been helpful to them in identifying when companies may engage in unlawful cross-subsidies. Finally, some state officials said that because they regulate companies on a day-to-day basis, they have considerable

[16]This requirement affects traditional, centralized service companies (i.e., a company providing services such as administrative, financial, or accounting services, which are provided to other companies in the same holding company system).

[17]FERC officials told us that in addition to these new data, FERC adopted new accounting rules to implement the PUHCA provisions in EPAct and that these rules make certain financial information available to the public, thus improving public transparency of financial accounting for holding and service companies.

expertise and knowledge that may prove useful to FERC. Thus, unless FERC changes its view about the usefulness of such data, it will continue to lack available information that may be potentially useful in assessing risk.

The importance of formally considering risk when carrying out compliance oversight is highlighted by prior GAO reports.[18] In these reports GAO identified instances where other agencies, such as SEC, the Department of Homeland Security, and the Environmental Protection Agency could use and have used risk-based approaches to inspect for compliance with regulations. In some cases, agencies have developed and used statistical models to estimate an entity's (e.g., a company's) risk of a violation and as a means to target limited audit resources. In other cases, we have recommended that agencies continue to devote some resources to auditing entities on a random basis but use the data collected from these random audits to update statistical models so that the agency can continue to identify high-risk entities. Furthermore, according to financial auditors and other experts we spoke with, risk assessments are an important consideration in targeting audits and allocating resources to detect noncompliance. Without a sufficient assessment of risk, it may be difficult for FERC to convince companies, states, and other market stakeholders that it can adequately and consistently detect cross-subsidization.

At present, without a risk-based approach to guide its audit planning and deploy its limited audit resources, FERC may not be effectively allocating its staff to audit the companies it regulates. FERC's Division of Audits currently has a total of 34 full-time staff, including 21 accountants/auditors, 6 energy industry analysts, 3 economists, 2 engineers, 1 attorney, and 1 support staff. FERC has determined that of the 149 companies that have been identified as holding companies, 36 of them are currently subject to its PUHCA 2005 authority and it plans to allocate 9 of its

[18]GAO, *Mutual Fund Industry: SEC's Revised Examination Approach Offers Potential Benefits, but Significant Oversight Challenges Remain*, GAO-05-415 (Washington, D.C.: Aug. 17, 2005); GAO, *Pension Plans: Stronger Labor ERISA Enforcement Should Better Protect Plan Participants* , GAO/HEHS-94-157 (Washington, D.C.: Aug. 8, 1994).

available staff to these audits in 2008.[19] Officials in the Division of Audits told us that they believe a typical audit would involve three to four audit staff—an auditor-in-charge and one or two auditors. Other companies and state auditors involved in auditing affiliate transactions told us that these audits can be difficult and require significant use of auditors with specialized skills and experience. These auditors also told us that examining affiliate transactions can be resource intensive since determining whether a transaction is unfair may require detailed analysis of the transaction and the market for the good or service that was the subject of the transaction. At its planned 2008 audit rate of 3 companies, it would take FERC 12 years to audit each of these companies once. In commenting on the report, FERC noted that the number of audits in future years may change. Nevertheless, FERC may face additional companies, some of which may require more complex audits. According to financial and industry experts we spoke with, the elimination of PUHCA 1935 is likely to attract companies previously restricted from owning utilities to consider mergers or acquisitions. For example, some experts told us that foreign companies, corporate conglomerates, and private equity companies are considering mergers or acquisitions of U.S. utilities. In addition to companies subject to FERC's oversight under the PUHCA 2005 provisions of EPAct, FERC also has audit responsibilities for the electric reliability organization, the North American Electricity Reliability Corporation, which oversees issuing and enforcing rules, such as compliance with reliability standards, focused on ensuring reliable electricity supplies. At present, there are about 4,700 companies that could potentially be audited for compliance with FERC's rules, regulations, and orders regarding reliability, transmission, and electricity pricing rules. FERC officials said some overlap exist between categories, such as investor-owned utilities and electric suppliers with market-based rate authority. In addition, according to FERC, Federal Power Act section 215 companies would initially be audited and overseen by the new Regional Reliability Organization and the related regional entities. FERC officials also said that they intend to audit about 100 of these companies during 2008. The universe of companies that FERC is responsible for auditing is

[19]Initially, FERC officials identified 149 companies that had filed a FERC form 65 (notification of holding company status) with it. Of that total, 113 companies requested and received from FERC an exemption (FERC form 65A exemption notification) or waiver (FERC form 65B waiver notification) from the PUHCA 2005 provisions in EPAct. FERC grants an exemption, for example, if the holding company and its subsidiaries are nontraditional utilities without captive customers. FERC could also grant a waiver, for example, if the company is a holding company in a single state. We did not assess whether these exemptions or waivers were reasonable.

identified in 10 categories in table 2. Because of the magnitude of companies it oversees and the range of rules it enforces, FERC enforcement and audit officials described their offices as resource constrained and acknowledged that the Office of Enforcement has not yet adopted a formal, risk-based approach to target these resources.

Table 2: FERC's Audit Universe by Category of Company

Category of jurisdictional company	Number of companies
Investor-owned utilities	211
Electric suppliers with market-based rate authority	1,304
FPA section 215 (reliability)	1,510
Power marketing agencies	5
Hydroelectric projects	1,022
Liquid natural gas terminals	17
Oil pipelines	199
Interstate natural gas pipelines	159
Natural gas storage facilities	201
Intrastate pipelines (Natural Gas Policy Act, section 311)	68
Total	**4,696**

Source: FERC.

Note: Some overlap exists between categories, such as investor-owned utilities and electric suppliers with market-based rate authority. In addition, according to FERC, Federal Power Act section 215 companies would initially be audited and overseen by its new Regional Reliability Organization and the related regional entities.

FERC's Postmerger Audit Reports on Affiliate Transactions Often Lack Clear Information

FERC's publicly available audit reports pertaining to affiliate transactions are not clear and, thus, their usefulness in terms of public transparency and disclosure is limited. Although FERC has not yet completed any affiliate transaction audits or yet issued any reports under EPAct, officials with the Division of Audits told us that they intend to rely on their existing "exception-based" audit reporting policy. A FERC official told us their "exception-based" audit reporting policy means audit reports would only reflect the audit findings and recommendations associated with the audit issues on which FERC found the company to be out of compliance. In contrast, if an audit does not result in FERC taking an enforcement action due to noncompliance, the audit report does not provide information on the methodology the auditors used nor their findings. Thus, FERC's public audit reports may not always fully reflect key elements such as objectives, scope, methodology, and the specific audit findings. Federal government auditing standards, developed by GAO and referred to as Generally Accepted Government Auditing Standards (GAGAS), stipulate that audit reports contain this basic information, and other information as well, in order to comply with GAGAS. According to FERC officials, they are not required to comply with GAGAS, but “follow the spirit” of these standards because they provide a good framework for performing high-quality audits.[20] In our review of 18 recent FERC audit reports pertaining to affiliate transactions, we found that they did not always identify any findings on affiliate transactions or have any recommendations. Further, the audit reports sometimes lacked key information, such as the type, number, and value of affiliate transactions at the company involved and the percentage of all affiliate transactions tested, or the test results. A FERC official conceded that FERC past audit reports on affiliate transactions do not always meet GAGAS standards because they are not required to do so. However, without this information, it may be difficult for regulated companies to understand the nature of FERC’s oversight concerns and to conduct internal audits to identify potential violations that are consistent with those conducted by FERC—key elements in improving companies’ self-reporting. Further, financial audit firms, internal auditors, and auditors at state commissions told us that they typically review prior related audits, including those done by FERC, as part of their preparation for a new audit. To the extent that FERC audit reports lack information on the work they performed, they limit the usefulness of these audits for future auditors as well as miss an opportunity to improve FERC’s audit practices and transparency to state regulators and other companies and stakeholders. Furthermore, without

[20]FERC is not specifically required to comply with GAGAS. In general, cabinet-level agencies—such as the Department of Energy—and selected other federal agencies and commissions—such as the Nuclear Regulatory Commission—are required to follow GAGAS. The following are among the laws, regulations, and guidelines that require use of GAGAS: (1) The Inspector General Act of 1978, as amended, 5 U.S.C. App. (2000), requires that the statutorily appointed federal inspectors general comply with GAGAS for audits of federal establishments, organizations, programs, activities, and functions. The act further states that the inspectors general shall take appropriate steps to assure that any work performed by nonfederal auditors complies with GAGAS; (2) The Chief Financial Officers Act of 1990 (Pub. L. No. 101-576), as expanded by the Government Management Reform Act of 1994 (Pub. L. No. 103-356), requires that GAGAS be followed in audits of executive branch departments’ and agencies’ financial statements; (3) The Single Audit Act Amendments of 1996 (Pub. L. No. 104-156) require that GAGAS be followed in audits of state and local governments and nonprofit entities that receive federal awards; and (4) The Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, which provides the governmentwide guidelines and policies on performing audits to comply with the Single Audit Act, also requires the use of GAGAS. Even if not required to do so, auditors may find it useful to follow GAGAS. Many audit organizations not formally required to do so, both in the United States and in other countries, voluntarily follow GAGAS.

such information in the audit report, we and other stakeholders, such as state commissions, cannot confidently and credibly determine that the auditor's efforts to detect abusive affiliate transactions and cross-subsidization were sufficient. A recent report prepared by a former FERC Commissioner on behalf of a wide range of industry stakeholders expressed concern that FERC increase the transparency of its audits and investigations in order to, among other things, help individual market participants to improve their internal compliance programs and correct deficiencies before they cause harm to consumers.

States Vary in Their Capacities to Oversee Utilities

States utility commissions' views of their oversight capacities vary, but many states foresee a need for additional resources to respond to changes from EPAct. Almost all states have specific authority to review and either approve or disapprove mergers and acquisitions. Despite this authority, many states' commission staff expressed concern over their ability to regulate the resulting companies. Almost all states report they have some type of authority over affiliate transactions, although many states report reviewing or auditing few of these transactions. Further, although almost all states can access the books and records of the utility to substantiate costs and other relevant data, many states report they cannot obtain such access to these books and records at the holding company or other affiliated nonutility companies. Almost half of the states report they need additional staff and funding to respond to changes stemming from EPAct.

Almost All States Have Merger Approval Authority but Many States Express Concern about Future Regulation of the Resulting Companies after Merger Approval

On the basis of our survey of state commission staff,[21] all but 3 states (out of 50 responses) have authority to review and either approve or disapprove mergers. The types of authority states have vary, however. For example, one state noted that, technically, it could only disapprove a merger and, as such, the state allows a merger by taking no action to disapprove it. Three states noted their state legislatures had not provided them direct merger review authority,[22] but they were able to use other commission authority to conduct such reviews.

[21]Responses to our survey came from 49 states and the District of Columbia. For all references to this survey, we do not distinguish responses for the District of Columbia separately from those of the states.

[22]After completion of our survey, one state subsequently obtained approval from its legislature to review and approve future electric utility mergers.

State commissions responding to our survey noted that the most important factors they consider in evaluating mergers or acquisitions are the effects on regulated rates and the quality of retail service (e.g., no significant problems with service interruptions for consumers). The next most important factors were the commission's ability to regulate the resulting company and the effect on the financial complexity of the company that would result from the merger. Staff from one state told us in additional narrative comments that they were concerned that with the passage of EPAct utilities will become larger, more complex, and located in geographically diverse areas. They specifically expressed concerns over the challenges of allocating costs between various entities due to the potential for centralization of services in these types of resulting companies.

Table 3 below lists the 4 top factors rated as either of very great importance or great importance out of 15 factors we asked states to rate in their evaluation of proposed mergers and acquisitions.[23]

Table 3: Key Factors in Commission Evaluations of Mergers and Acquisitions

Key factors in commission evaluations	Number of states noting these factors as having great or very great importance	Total states responding
Impact of combination on regulated retail rates	44	47
Impact on retail service quality	43	46
Impact on ease or difficulty of regulation of resulting company by commission	25	44
Impact on financial complexity of resulting company	23	44

Source: GAO analysis of state survey of utility commission authorities and reporting responsibilities.

Note: GAO asked commission staff to evaluate the importance of 15 different factors they might consider in evaluating mergers and acquisitions. They were asked to rank these factors on a 5-point scale with the 2 highest points on the scale being very great importance and great importance. The factors listed in the table are the four factors most commonly listed as being of either very great or great importance. Some states did not comment on all factors.

[23]The entire table of all factors can be reviewed in question 6 of our survey at www.gao.gov/special.pubs/gao-08-290sp.

In recent years, the difficulty and increased complexity of regulating merged companies has been cited by two state commissions denying proposed mergers in their states. For example, a state commission official in Montana told us the commission denied a merger in July 2007, between Northwestern Company and Babcock and Brown Infrastructure, an Australian company, even though it had been approved by FERC. This merger involved a Montana regulated utility, whose headquarters was located in South Dakota and was being bought by a foreign-owned holding company. According to this official, the commission denied the merger partly due to concerns about regulating the utility under such a corporate combination. He noted concerns that no top corporate officials would be located in Montana and that the time zone differences with the Australian company made contact with those officials more difficult in dealing with regulatory issues. As a result of the denial by the state commission, the merger was not allowed to proceed. In a different proposed merger in Oregon, state utility commission officials told us they denied the proposed merger in March 2005 between Portland General Electric, one of their regulated utilities and the Texas Pacific Group, a private equity fund company. They noted under their implementation of Oregon's statutes, mergers must meet two standards: (1) they must provide net benefits to consumers and (2) they cannot harm consumers. Officials in Oregon noted that the state commission was concerned that consumers could be harmed because regulating the resulting company would be more difficult due to the financial complexity of the new ownership arrangement. In addition, the commission was concerned that consumers faced potential harm due to risks posed by high levels of debt and the private equity firm's short-term business plan. Although an application had been made for a review at FERC it was withdrawn in April 2005 prior to FERC review.

State commission views regarding potential mergers and acquisitions are of increasing importance in the financial community, as well. Officials from the financial community noted they believe state commissions may be highly suspicious of some of the new corporate structures being proposed, especially the role of private equity firms. They also noted that some commissions have expressed significant concerns over the formation of vast utility companies operating in multiple states. As a result of these and other concerns, these officials reported that some companies potentially interested in merging with or acquiring utilities have been reluctant to propose transactions so far.

Most States Have Authorities over Affiliate Transactions, but Many States Report Auditing Few Transactions

Almost all states report having authorities over affiliate transactions or regular reporting of such transactions, or both. Nationally, 49 states noted they have some type of affiliate transaction authority. These authorities, however, vary from prohibitions against certain types of transactions, or prior approval by the commission for transactions over a certain dollar amount, to less restrictive requirements such as allowance of the transaction without prior review. In some cases state commission authorities permit them to disallow these transactions at a later time if they were inappropriate. In fact more than half the states (27) reported that under their authority, affiliate transactions did not require prior commission approval, but could be reviewed and disallowed later. Such a disallowance would result in the cost of the transaction not being passed on to consumers or being recovered from the company. Only 3 states reported that affiliate transactions always needed prior commission approval.

Nearly all states (41) require utilities to report affiliate transactions at least annually, or more frequently. These reports varied, however, in frequency of reporting, types of transactions requiring reporting, and the detail of reporting. For example, some states required reporting all transactions at least annually, while others required reporting of only certain types of transactions or just reporting the total dollars spent by each affiliate. Several of the state commissions we interviewed noted the importance of strong state authority over affiliate transactions. Staff in one state noted their commission must preapprove any affiliate transactions over $25,000 and conditions for approval were stringent. In some instances the state's attorney general stepped in to stop companies from going ahead with affiliate transactions that had not been preapproved.

Some states are concerned that they may not have sufficient authorities to oversee affiliate transactions, after the repeal of PUHCA 1935. In our survey, some state commissions expressed a need to increase their authority over affiliate transactions. During the course of our work one state took action to increase its authority. In 2006, the California commission strengthened existing affiliate transactions authorities, partly due to concerns related to the repeal of PUHCA 1935. The new rules clarified the scope of allowable utility affiliate transactions and tightened the rules on when and how specific services, such as, legal services could be shared between affiliates and the regulated utility.

Despite various authority governing the prior authorization and disclosure of affiliate transactions, many states responding to our survey reported they audit few if any affiliate transactions or dedicate much staff time to reviewing these transactions. The majority of states reported they have audited 1 percent or less of these transactions over the last 5 years and dedicated no staff time to reviews or audits over the last year. Table 4 shows that many states are not performing reviews or audits of affiliate transactions.

Table 4: State Reviews and Audits of Affiliate Transactions

Limited state reviews or audits conducted	Number of states	Total states responding
Number of states with no staff time dedicated to auditing holding companies and affiliates over last 12 months	24	41
Number of states performing no reviews of affiliate transactions within the last 5 years	18	45
Number of states auditing 1 percent or less of affiliate transactions over the last 5 years	28	49
Number of states that dedicated 1 staff year or less to affiliate transactions over the last 5 years	27	44

Source: GAO analysis of state survey of utility commission authorities and reporting responsibilities.

Since the passage of EPAct several aspects of monitoring of affiliate transactions were raised as key challenges by several state commissions responding to our survey and during our interviews. For example, an attorney from one state utility commission expressed concerns about having enough resources and expertise to enforce existing authorities. He noted that holding company and affiliate transactions can be very complex and time-consuming to review. He noted these reviews are resource intensive, since determining whether a transaction is unfair may require detailed analysis of the transaction and the market for the good or service that was subject of the transaction. Another expert, with extensive experience with FERC and several state public utility commissions noted that on the basis of his experience, states do not generally have the resources to effectively review affiliate transactions, particularly when they are multistate in nature. Similarly, a consultant whose firm does numerous affiliate transaction audits in many states, noted in a March 2007 FERC technical conference on related issues that many states, even when they have significant authority, lack staff to review transactions. Further, he noted that state commissions often lack the staff expertise to adequately address the accounting and financial operations aspects of these affiliate relationships as well as the risks inherent to audits of affiliate transactions

Some states, however, do put special emphasis on auditing affiliate transactions. All four states we visited routinely audit affiliate transactions. Commission officials in one of these states told us they commit the equivalent of 2.5 full time employees to auditing affiliate transactions for reasonableness (e.g., prices appear to be correct). If they find unreasonable transactions the commission can adjust future electricity rates to correct for the problem (e.g., they disallow some or all of the value of the transaction and remove that amount from prices that consumers pay). Their goal is to audit each utility every 2 years and they estimate that over the last 5 years they have audited 100 percent of all utility affiliate transactions. As part of their audits the staff requests SEC filings, monitors credit reports, and reviews other related financial data. However despite this effort, representatives from two consumer groups in this state expressed concerns that affiliate transactions are so complex that the state commission just does not have enough resources to fully audit these transactions. Two additional states commissions we interviewed contract with outside auditors to do specific audits of the affiliate transactions of the state's regulated utilities biennially. State commission staff in one of these states noted their audits review company affiliate transactions for appropriateness and proper pricing. The purpose of the audits is to show the transactions were made fairly to the utility and that ratepayers are not paying more than they should. One auditor who had done affiliate transaction audit work for another state we visited described that state's approach to auditing affiliate transactions as being very aggressive in that their audits involved significant data analysis and the reports contained considerable detail about the findings.

Some States Report Not Having Access to Holding Company Books and Records

All states regularly require financial reports from utilities and are able to obtain access to the financial books and records of these utilities that document costs, but access beyond the utility varies. All 49 states that responded to this survey question, noted that they require utilities to at least provide financial reports. Most states (41) only require such reporting by the utility but 8 states require reports that also include the holding company or both the holding company and the affiliated companies. Of the 48 states that responded to our questions about the frequency of required reporting, 35 require annual reports; 6, quarterly reports; and 7, monthly reports.

Although all states but 1 report having access to the books and records of the utilities in their states, some report they do not have such access to other companies within the holding company.[24] Nearly one-third of the states reporting said they do not have access to the books and records of the utility holding company. Similarly, over 40 percent of the states reporting said they do not have such access to affiliated nonutility companies. Table 5 shows state commission access to different parts of holding companies.

Table 5: State Commissions' Access to Books and Records

Organization	Yes, commission has access	No commission access	Total states responding
Regulated utility	49	1	50
Utility holding company	32	14	46
Affiliated nonutility company	28	20	48

Source: GAO analysis of state survey of utility commission authorities and reporting responsibilities.

Note: Question asked "Excluding the information, if any is provided to the commission through financial reporting by the utilities, does your commission have access to any books and records that document costs and other relevant information for each of the following?"

Utility experts also expressed concerns over state commissions' access to the books and records of holding companies or other affiliate companies either through state authority or through assistance by FERC. Lack of such access, these experts noted, may limit the effectiveness of state commission oversight and result in harmful cross-subsidization because the states cannot link financial risks associated with affiliated companies to their regulated utility customers. Experts expressed concern over state commission authority. For example, the president of an audit company, who currently works with two-thirds of the utility commissions across the country and completed many affiliate audits, noted that there is a lack of clear authority in some states to gain access to the key records in other states, even though the utility shares common services across the states that bear upon the utilities transactions. Similarly, one commission official told us that it is difficult to get access using state authority alone. He noted that holding companies can set up numerous roadblocks for staff to access the records. Consistent with this view, in comments to our survey

[24] PUHCA 2005 provisions in EPAct (section 1265) give state commissions explicit authority to obtain information—including "books, accounts, memoranda and other records"—from utility holding companies and utility associates and affiliated companies "wherever located."

concerning key challenges since the passage of EPAct one state noted a concern about the responsiveness of a parent holding company based out of state to specific in-state inquiries.

While the PUHCA 2005 provisions of EPAct provide states with additional access to books and records, some states expressed reservations relating to the level of protection this offered their states. In response to our survey, 8 states noted that access to books and records, if they had to gain assistance through FERC, offered little or no protection to their states, while another 14 states noted this offered only some protection. In contrast, only 3 states noted that FERC assistance in gaining access offered great protection. Commission staff in one state told us that obtaining such information requires state commissions to be very specific in identifying the necessary information. However, this commission staff noted that it may be difficult to develop such detailed knowledge. According to this state commission staff, such a detailed requirement to access information may limit their ability to conduct adequate and timely affiliate transaction audits. A utility expert who has experience with both FERC and state commissions also noted that states often follow leads and do not always know the specific information to support a detailed request. As a result of the potential need to develop a series of detailed requests, it may take longer to complete an audit. He stated this creates significant risks for states and their ratepayers as the full scope of utility transactions cannot be understood without seeing the entire trail of these transactions through the holding company and affiliate books and records.

States Foresee Needing Additional Resources

States and other officials expressed concerns that the state commissions do not currently have sufficient resources and may need additional resources to respond to the changes from EPAct. Since states have gained over 2 years of experience since EPAct was passed, many believe they now need additional resources to carry out their responsibilities. Specifically, as seen in table 6, 44 percent of the states responded to our survey that they need additional staffing or funding, or both, to deal with the changes from EPAct. Further, 6 out of 30 states raised staffing as a key challenge in overseeing utilities since the passage of EPAct. One state, for example, noted monitoring of affiliate relationships as a key challenge, particularly in light of its current staff and resources. Since the passage of EPAct, 8 states have proposed or actually increased staffing.

Table 6: Some States Foresee Needing Additional Resources Due to EPAct

Type of resource	Yes	No	Total states responding
Additional staffing	22	28	50
Additional funding	22	28	50

Source : GAO analysis of state survey of utility commission authorities and reporting responsibilities.

Note: Survey question asked "Does your commission foresee needing any of the following to deal with the changes from EPAct 2005 concerning holding companies, mergers and various activities previously covered by the Public Utility Holding Company Act of 1935?"

Staffing concerns were also mentioned as problems by officials at the commissions or by representatives of consumer groups in 3 of the 4 states we visited as well others. For example, an official from the one of these state's commissions noted that the state, in response to tighter budgets, had reduced staffing levels across-the-board including the utility commission and that the median age of the commission staff was now 56 and could soon face a wave of retirements. In addition, representatives of two consumer groups in another state expressed concerns that the commission does not have enough resources to oversee or audit affiliate transactions. In addition an official from a national credit-rating agency expressed concern that some state commissions may not fully appreciate the degree of difficulty they could face with existing staffs in the years ahead.

Conclusions

The repeal of PUHCA 1935 further opened the door for new and different corporate combinations, including the ownership of utilities by complex international companies or equity firms, potentially providing needed investment to the utility industry. However, this potential to increase investment comes at the potential cost of making regulation more difficult. Further, the introduction of new types of investors, with incentives that may be at odds with traditional utility company services, could change the utility industry into something quite different than the industry that FERC and the states have overseen for decades. Despite these evolving changes, FERC continues to rely to a considerable degree on companies to self-certify that they will not cross-subsidize and self-report when they do. On the basis of our discussions with industry, state regulators, and audit experts, this reliance on self-enforcement—backed up by a few audits—does little to convince consumers and other market stakeholders that FERC's oversight is sufficiently vigilant.

As FERC and states approve mergers, the responsibility for ensuring that cross-subsidization will not occur shifts to FERC's Office of Enforcement and state commission staffs. However, in the case of FERC this presents a challenge because FERC lacks a formal way of allocating resources to the areas of highest potential risk—leaving audit resources deployed in an ad hoc manner. Without a risk-based audit approach, FERC may not allocate its scarce audit resources to the right areas, potentially allowing cross-subsidization to go undetected. In addition, since states generally review only a very small percent of affiliate transaction to identify potential cross-subsidization and many reported resource constraints, some states' detection of cross-subsidization may be limited.

By reassessing its audit approach, how it shares the results of its audits, and its resources, FERC could take important steps to demonstrate its commitment to ensure that companies are not engaged in cross-subsidization at the expense of consumers. Absent such a reassessment, the potential exists for FERC to approve the formation of companies that are difficult and costly for it and states to oversee and potentially risky for consumers and the broader market.

Recommendations for Executive Action

We recommend that the Chairman of the Federal Energy Regulatory Commission (FERC) take the following actions:

1. Develop a comprehensive, risk-based approach to planning audits of affiliate transactions in holding companies and other corporations that it oversees to more efficiently target its resources to highest priority needs and to address the risk that affiliate transactions pose for utility customers, shareholders, bondholders, and other stakeholders.

2. As an aid to developing this risk-based approach, FERC should develop a better understanding of the risks posed by each company by doing the following:

    a. Monitoring the financial condition of utilities to detect significant changes in the financial health of the utility sector, as some state regulators have found it useful to do. To do this, FERC could leverage analyses done by the financial market and develop a standard set of performance indicators.

    b. Developing a better means of collaborating with state regulators to leverage resources already applied to enforcement efforts and to capitalize on state regulators' unique knowledge. As part of this effort, FERC may want to consider identifying a liaison, or liaisons, for state regulators to contact and to serve as a focal point(s).

3. Develop an audit reporting approach to clearly identify the objectives, scope and methodology, and the specific findings of the audit, irrespective of whether FERC takes an enforcement action, in order to improve public confidence in FERC's enforcement functions and the usefulness of audit reports on affiliate transactions for FERC, state regulators, affected utilities, and others.

4. After developing a more formal risk-based approach, reassess whether it has sufficient audit resources to perform these audits. If FERC believes that it does not have sufficient resources to conduct adequate auditing of the companies that it oversees within its existing staff and budget, FERC should provide this information to Congress and request additional resources.

Agency Comments and Our Evaluation

We provided a draft of our report to FERC for review and comment. We received written comments from FERC's Chairman and that letter and our detailed response is presented in appendix II. In his comments, the Chairman strongly disagreed with the report finding that FERC does not have a strong basis for ensuring that utilities do not engage in harmful cross-subsidization and noted that he believed the report contained inaccuracies and misunderstandings. We disagree with the Chairman's characterization of our report and note that the letter's assertions about some aspects of FERC's operations are, in fact, quite different than the views of numerous commission staff and experts with whom we met over the course of the past year as well as FERC's own Policy Statement on Enforcement. In addition, we believe that the repeal of PUHCA 1935 represents an important change in the context of FERC's regulation of the industry and, in light of this change, FERC should err on the side of a "vigilance first" approach to preventing potential cross-subsidization by enhancing its current approach to audit planning and reevaluating audit resources. Overall, we believe our report presents a fair and balanced presentation of the facts and issues associated with FERC's oversight and, as a result, encourage the Chairman to fully consider our recommendations. FERC also provided technical comments, which we incorporated, as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 14 days from the report date. At that time, we will send copies to the Chairman of the Federal Energy Regulatory Commission (FERC) and other interested parties. We will also make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-3841, or gaffiganm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

Mark Gaffigan
Acting Director, Natural Resources and Environment

Appendix I: Scope and Methodology

In this report, we agreed to determine: (1) the extent to which FERC changed its merger or acquisition review process and postmerger or acquisition oversight to ensure that potential harmful cross-subsidization by utilities does not occur, and (2) the views of state utility commissions regarding their current capacity, in terms of regulations and resources, to oversee utilities.

Overall, to address the objectives we reviewed relevant reports, examined existing data, interviewed key officials and collected new data and information from 49 states and the District of Columbia. We interviewed and obtained documentation, when applicable, from a wide range of stakeholders including federal and state officials, industry officials, and various other special groups and organizations. We interviewed federal agency officials at FERC, the Department of Justice, the Federal Trade Commission, and the Securities and Exchange Commission (SEC). We obtained views from organizations including the National Association of Regulatory Utility Commissioners (NARUC), American Antitrust Institute, National Regulatory Research Institute, American Public Power Association, Electricity Consumers Resource Council, Edison Electric Institute, and Public Citizen. In addition, we obtained information and views on the effects of the Energy Policy Act of 2005 (EPAct) on investment in the utility industry from two national credit reporting agencies, Standard and Poor's and Fitch Ratings, and the investment advisor Goldman Sachs Company.

To specifically determine how FERC has changed its merger review processes and postmerger oversight to prevent cross-subsidization affecting utilities, we reviewed the Energy Policy Act of 2005 and the Public Utility Holding Company Act of 2005 (PUHCA 2005) provisions in EPAct related to FERC's review of mergers and acquisitions, access to the books and records of companies in holding company systems, and assessment of civil penalties on companies that violate its rules. We reviewed information on the number, identity, and outcome of mergers that FERC has reviewed, audits of affiliate transactions that FERC has conducted, and civil penalties that FERC has assessed since passage of the 2005 legislation. We interviewed officials in FERC's Office of Enforcement, Office of Energy Markets and Reliability, and Office of General Counsel concerning their plans to implement the statutory provisions of EPAct, including the PUHCA 2005 provisions and their development or update of new and existing rules, policies, and procedures regarding merger review, law enforcement, and audits. We performed a limited review of selected FERC merger orders and audit reports, including 18 completed audit reports the commission identified as pertaining to affiliate transactions, to assess FERC's practices for reviewing mergers and conducting audits to prevent cross-subsidization.

To address the second objective and gain insight into states' views on their current capacities to oversee utilities, we visited four states, California, New Jersey, Oregon, and Wisconsin and conducted an Internet-based survey with staff from the public utility commissions in the 50 states and District of Columbia. In our site visits we met with officials from the public utility commissions, representatives of two utilities in each state, in some cases the utilities' internal and external audit firms, and we also obtained views from representatives of consumer protection groups. We obtained information on the state's authorities, actions, and resources relating to mergers, affiliate transactions, financial reporting, and access to company records. We gathered opinions relating to the federal regulatory changes and current or planned enforcement by FERC. We selected these states through a literature search, discussions with representatives of NARUC, a national organization representing state utility commissions, and from some initial discussions with selected states. We chose several states to visit that had strong protections related to holding companies/affiliates and utilities prior to the repeal of PUHCA 1935. We also selected two states of the four that were considering additional consumer protections directly due to the repeal of PUHCA 1935. We also discussed key issues with commission officials from Kansas and Montana.

Since little detailed information existed that summarized the authorities, actions, and resources of all the states' regulatory oversight related to utilities and holding companies, we supplemented our audit work with a survey of the staff of the 50 states' and District of Columbia's public utility commissions. The survey was developed between September and December 2006. Because we administered the survey to all of the state public utility commissions, our results are not subject to sampling error. However, the practical difficulties of conducting any survey may introduce other types of errors, commonly referred to as nonsampling errors. For example, differences in how a particular question is interpreted, the sources of information available to respondents in answering a question, or the types of people who do not respond can introduce unwanted variability into the survey results We included steps in the development of the survey to minimize such nonsampling error.

To reduce nonsampling error, we had cognizant officials at NARUC review the survey to make sure they could clearly comprehend the questions. We also pretested the survey with two states to ensure that (1) the questions were clear and unambiguous, (2) terminology was used correctly, (3) the survey did not place an undue burden on commission officials, and (4) the survey was comprehensive and unbiased. In selecting the pretest sites, we sought the advice of NARUC and selected states that had different types of regulatory requirements. We made changes to the content and format of the final survey based on the pretests.

We conducted the survey using a self-administered electronic questionnaire posted to GAO's Web site on the Internet. To ensure that we would obtain information from commission staff most knowledgeable, we first obtained a list of key contacts from NARUC. We sent e-mail notifications to the Chairmen of the public utility commissions informing them of the purpose of our survey and requesting that they make any changes on the contact list provided to us by NARUC that would be most appropriate. After we made changes to our contact list, we sent e-mail notifications to alert the appropriate officials of the forthcoming survey. These were followed by another e-mail containing unique passwords and usernames that enabled officials to access and complete the survey and notifying officials that the survey was activated. Although the survey was available on the Web until June 30, 2007, we followed up with officials first through e-mail reminders and then by telephone to encourage them to respond. We received survey responses from 49 states plus the District of Columbia (each state could only provide one response). One state did not respond due to other high priorities at the time of our survey. We edited all completed surveys for consistency, but it was agreed we would not follow up with states relating to specific responses, but only to encourage them to send us their survey.

Detailed survey results are available at: http://www.gao.gov/special.pubs/gao-08-290sp.

Appendix II: Agency Comments and Our Response

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, DC 20426

January 22, 2008

OFFICE OF THE CHAIRMAN

Mr. Mark Gaffigan
Acting Director, Natural Resources and Environment
United States Government Accountability Office
Room 2T47
441 G Street, NW
Washington, DC 20548

Dear Mr. Gaffigan:

Thank you for the opportunity to comment on the U.S. Government Accountability Office's Draft Report to Congressional Requestors entitled "Utility Oversight: Recent Changes in Law Call for Improved Vigilance by FERC", GAO- 08-289 (Draft GAO Report). My staff received the draft report on December 20, 2007, with a requested response from me as Chairman of the Federal Energy Regulatory Commission (FERC or Commission) by January 22, 2008. This letter contains both general overview comments on the report as well as detailed comments on errors or omissions in the report.

I strongly disagree with the Draft GAO Report's statements and implications that the Commission "does not have a strong basis for ensuring that utilities do not engage in harmful cross-subsidization" and that the Commission has not taken sufficient steps in this area following the passage of the Energy Policy Act of 2005 (EPAct 2005). Further, the Draft GAO Report contains numerous inaccuracies and apparent misunderstandings regarding cross-subsidization, the Commission's historical regulation of jurisdictional utilities with respect to cross-subsidization and the Commission's current regulatory structure, and the Commission's current audit and enforcement process with respect to this discrete area of its enforcement responsibilities. All of these matters are set forth in detail below.

See response 1.

Initially, the introduction of the Draft GAO Report errs in stating that EPAct 2005's repeal of the Public Utility Holding Company Act of 1935 (PUHCA 1935), which removed limitations on the types of companies that could merge with or invest in utilities, "shifted sole responsibility for regulating public utilities from the Securities and Exchange Commission [SEC] to the Federal Energy Regulatory Commission. . . ." The SEC has never had sole responsibility for regulating public utilities. In fact, prior to EPAct 2005, the SEC had very little responsibility for regulating public utilities. While it regulated certain activities of holding companies, with minor exceptions the SEC did not regulate public utilities. Regulation of public utilities (both public utility subsidiaries of

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holding companies and public utilities that were not part of holding companies) has long been the province of this Commission and the states.

See response 4.

Since 1935, this Commission, and not the SEC, has had exclusive responsibility for regulating transmission and wholesale sales of electric energy by public utilities and has had shared responsibility with the SEC with respect to certain other activities (e.g., mergers involving both a public utility and a holding company). With respect to cross-subsidization, in particular, the Draft GAO Report ignores the Commission's extensive ratemaking authority that has been in place since 1935 (Federal Power Act (FPA)) and 1938 (Natural Gas Act) to prevent cross-subsidization, and the Commission's expertise and practices developed over the last 70 years in its exercise of that authority. The importance of the powerful ratemaking tool of disallowing flow-through in rates of costs deemed to represent cross-subsidies, a tool which the SEC never had, cannot be overstated. The draft report also does not reflect an accurate understanding of the Commission's historical and existing review and analysis of proposed mergers. Although our merger review historically overlapped, in part, with merger review by the SEC, the SEC did not undertake the extensive analysis and customer protection oversight performed by the Commission.[1] Similarly, the Draft GAO Report is incorrect in its stated and implied conclusions that the Commission has failed to significantly change its processes since the passage of EPAct 2005 to address the issue of inappropriate cross-subsidization.

See response 1.

See response 3.

See response 2.

Broadly, the Draft GAO Report seems to urge the Commission to resurrect the regulation of holding companies that occurred under PUHCA 1935 on the thin bones of the Public Utility Holding Company Act of 2005 (PUHCA 2005). This would clearly not be appropriate. Notwithstanding its similar title, PUHCA 2005 is primarily an access to book and records statute.[2] It gives the Commission no substantive authority to regulate

[1] A detailed discussion of the Commission's pre-EPAct 2005 merger reviews is provided in Appendix A. As discussed below, following the passage of EPAct 2005, the Commission strengthened its merger oversight review.

[2] PUHCA 2005 did not transfer the SEC's PUHCA 1935 functions to the Commission. Instead, as an "access to books and records" statute, it provides the Commission and states with access to the books and records of holding companies and their members if relevant to jurisdictional rates.

The only provision of PUHCA 2005 that touches on the Commission's substantive authority is a procedural provision that allows multi-state holding companies and state commissions to obtain a determination regarding centralized service company cost allocations for such multi-state holding companies, although the Commission already has substantive authority to do this under the FPA.

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public utilities, it merely supplements the Commission's pre-existing authority to access the books and records of holding companies, public utilities, and other holding company affiliates, and it gives states separate, independent authority to access that information. We have not sought to resurrect PUHCA 1935 for the simple reason that the statute was repealed by Congress after great deliberation and PUHCA 2005 has none of the substantive authority of PUHCA 1935. The heart of the Commission's authority to regulate public utilities remains FPA provisions enacted more than 70 years ago. This authority was expanded by EPAct 2005, primarily through the amendment to FPA section 203 to give the Commission jurisdiction over certain holding company mergers and acquisitions, and we have appropriately exercised this expanded authority over the past two years.

See response 3.

The Draft GAO Report asserts that "FERC has made few substantive changes to … its merger review process … since EPAct [2005]." As discussed below, that is simply incorrect. The Commission has taken a number of significant steps to implement the provisions of revised FPA section 203. We have focused much of our attention on the cross-subsidization provisions because in other respects EPAct 2005 largely codified the merger test used by the Commission for years.

In response to EPAct 2005, which repealed PUHCA 1935, enacted PUHCA 2005and amended section 203 of the FPA to require explicit consideration of cross-subsidization at the time mergers are reviewed and to give the Commission authority over certain holding company mergers and acquisitions of securities, the Commission responded promptly with a series of actions all within the short time frames required by the new laws:

- adopted regulations to implement PUHCA 2005, codified at 18 C.F.R. Part 366;[3]

- adopted detailed accounting, reporting, and record retention requirements for utility holding companies and their service companies;[4]

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[3] *See Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005*, Order No. 667, 70 Fed. Reg. 75,592 (Dec. 20, 2005), FERC Stats. & Regs. ¶ 31,197 (2005), *order on reh'g*, Order No. 667-A, 71 Fed. Reg. 28,446 (May 16, 2006), FERC Stats & Regs. ¶ 31,213 (2006), *order on reh'g*, Order No. 667-B, 71 Fed. Reg. 42,750 (July 28, 2006), FERC Stats. & Regs. ¶ 31,224 (2006), *order on reh'g*, Order No. 667-C, 72 Fed. Reg. 8277 (Feb. 26, 2007), 118 FERC ¶ 61,133 (2007).

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- amended the Commission's regulations governing corporate transactions subject to section 203 of the FPA, 18 C.F.R. § 2.26, to require explicit consideration of whether a proposed merger or other corporate transaction "will result in cross-subsidization";

- adopted FPA section 203 filing requirements to provide the Commission with a record that would allow it to address cross-subsidization; and

- required FPA section 203 applicants to demonstrate that proposed mergers would not result in cross-subsidization or the pledge or encumbrance of utility assets, or explain how the cross-subsidization or pledge or encumbrance would be in the public interest.[5]

Similarly, in the context of a specific merger proposal filed after EPAct 2005 was enacted[6] and later in the Notice of Proposed Rulemaking in *Cross-Subsidization Restrictions on Affiliate Transactions*,[7] the Commission stated that all merger approvals would be conditioned on a "code of conduct" that would govern dealings between franchised public utilities and both market-based rate power sales affiliates and non-utility affiliates, in order to address cross-subsidization concerns involving power and non-power goods and services transactions. The Commission found that, despite the passage of EPAct 2005, imposing such conditions was in the public interest.[8]

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[4] *Financial Accounting, Reporting and Record Retention Requirements Under the Public Utility Holding Company Act of 2005*, Order No. 684, 71 Fed. Reg. 65,200 (Nov. 7, 2006), FERC Stats. & Regs. ¶ 31,229 (2006).

[5] 18 C.F.R. § 33.2(j), adopted in *Transactions Subject to FPA Section 203,* Order No. 669, 71 Fed. Reg. 1348 (Jan. 6, 2006), FERC Stats & Regs. ¶ 31,200 (2005), *order on reh'g,* Order No. 669-A, 71 Fed. Reg. 28422 (May 16, 2006), FERC Stats & Regs. ¶ 31,214 (2006), *order on reh'g,* Order No. 669-B, 71 fed. Reg. 42579 (July 27, 2006), FERC Stats. & Regs. ¶31,225 (2006). Accord, *Cross-Subsidization Restrictions on Affiliate Transactions*, 72 Fed. Reg. 41,644 (July 31, 2007), FERC Stats. & Regs. ¶ 32,618 at P 11-13 (2007).

[6] *National Grid plc*, 117 FERC ¶ 61,080 (2006)

[7] 72 Fed. Reg. 41,644 (July 31, 2007), FERC Stats. & Regs. ¶ 32,618 (2007).

[8] *See National Grid*, 117 FERC ¶ 61,080 at P 66 & n.78; *Cross-Subsidization Restrictions on Affiliate Transactions,* FERC Stats. & Regs. ¶ 32,618 at P 11-13.

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As a foundation for a second round of initiatives following EPAct 2005, on December 7, 2006 and March 8, 2007, the Commission held public conferences regarding section 203 and the newly enacted PUHCA 2005 in which industry participants and state commissioners provided input on key issues including the protection of utility customers from inappropriate cross-subsidization. In particular, the Commission sought input regarding overlaps in state-federal jurisdiction with respect to mergers and various cross-subsidization protections such as "ring-fencing" and other techniques to protect the assets of regulated utilities. One important purpose of these technical conferences was to solicit the views of state regulators on the best way to prevent cross-subsidization, and how to coordinate federal and state merger review to that end. The Commission also sought comment on whether additional measures under the Commission's FPA and NGA authorities were needed to supplement existing protections against cross-subsidization. In response to the input received in those conferences and written comments following the conferences, in July 2007, the Commission took the following actions:

- The Commission approved a Supplemental Merger Policy Statement, in which it provided additional clarification and guidance on, among other things, information that must be provided as part of an application when proposed transactions do not raise cross-subsidization concerns, and as relevant here, the types of commitments applicants could make and the ring-fencing measures applicants could offer to address cross-subsidization concerns when proposed transactions raise cross-subsidization concerns. In response to recommendations by the states, the Policy Statement also stated that the Commission would defer to state ring-fencing measures absent evidence that additional measures were needed to protect wholesale customers. Further, where states have no authority to impose cross-subsidization protections, transactions would not qualify for "safe harbor" protection. *FPA Section 203 Supplemental Policy Statement*, 72 Fed. Reg. 42,277 (Aug. 2, 2007), FERC Stats. & Regs. ¶ 31,253 (2007).

- The Commission issued a Notice of Proposed Rulemaking, proposing to codify restrictions on the pricing of power and non-power goods and services in affiliate transactions between franchised public utilities with captive customers, on the one hand, and their market-regulated power sales affiliates and their non-utility affiliates, on the other hand. These restrictions would apply to all public utilities, not just those proposing a merger. *Cross-*

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Subsidization Restrictions on Affiliate Transactions, 72 Fed. Reg. 41,644 (July 31, 2007), FERC Stats. & Regs. ¶ 32,618 (2007).

- The Commission issued a second Notice of Proposed Rulemaking, proposing to grant limited blanket authorizations for certain jurisdictional corporate transactions that would not be expected to harm either competition or captive customers. *Blanket Authorization under FPA Section 203*, 72 Fed. Reg. 41,640 (July 31, 2007), FERC Stats. & Regs. ¶ 32,619 (2007).

The Commission is currently working on finalizing these important initiatives, which will provide additional cross-subsidization protections and guidance. As this brief discussion demonstrates, the Draft GAO Report's suggestion that the Commission has done little in response to EPAct 2005 and PUHCA 2005 is simply incorrect.

It is important to understand that inappropriate cross-subsidization is a constant concern, which does not arise only in the context of, and following, a merger or other jurisdictional corporate transaction. Cross-subsidies can occur at any time and the Commission has appropriately focused on up-front conditions and mandatory prophylactic rules – like those highlighted above – that, for example, identify pricing standards that must be applied to affiliate transactions should they occur.

Cross-subsidization is primarily a ratemaking concept, one that is very familiar to the Commission. The Commission has developed policies under its rate-setting authority to prevent harmful cross-subsidization over the past 70 years. Not only does the Commission analyze cross-subsidization in the context of a specific rate-setting proceeding and disallow flow-through of inappropriate costs, but it also has generic cross-subsidy restrictions in its regulations.

For instance, the Commission's regulations include a provision expressly prohibiting power sales between a franchised public utility with captive customers and any market-regulated power sales affiliates without first receiving Commission authorization for the transaction under FPA section 205. The Commission reviews such filings to protect against inappropriate cross-subsidization. Similarly, the Commission's regulations require that sales of any non-power goods or services by a market-regulated power sales affiliate to an affiliated franchised public utility with captive customers will not be at a price above market, and any such sales from a franchised utility with captive customers to the market-regulated power sales affiliate must be at the higher of cost or market, unless otherwise authorized by the Commission.

With respect to the Commission's ratemaking responsibilities, the Commission promulgated rules to take advantage of the new access to books and records provisions of PUHCA 2005. The information obtained from holding companies under its new

See response 4.

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regulations enhances the Commission's ability to determine audit candidates and also arms the public with financial information to assist with the filing of formal and informal complaints. In this regard, as noted above, the Commission adopted new standardized accounting regulations in October 2006, and to allow for greater transparency to protect ratepayers from paying improper service company costs, the Commission added a new Uniform System of Accounts for centralized service companies. In addition, the Commission implemented record retention requirements to require holding companies and service companies to retain records consistent with the retention periods for public utilities and natural gas companies, and required centralized service companies to file financial information and information related to providing non-power goods and services to affiliates.[9] Information collected in that form is available electronically to market participants and the public for use in detecting cross-subsidization, affiliate abuse, or other violations of the Commission regulations.

As a further protection, the Commission staff conducts targeted audits as proactive measures to detect and protect against cross-subsidization. Even before PUHCA 1935 was repealed, the Commission had a long-standing practice dating back at least to the 1970s of auditing affiliated transactions as part of its financial audit program. More recently, in November 2003, the Commission began auditing affiliated transactions as part of its multi-scope audits covering its market-based rate program.[10] Specifically, in anticipation of the repeal of PUHCA 1935, the Commission developed and implemented a comprehensive audit program to conduct audits of affiliated transactions to ensure that cross-subsidization does not occur. The audit program reflects the detailed auditing procedures and techniques used to guide the audit team in accomplishing the audit work.

The Draft GAO Report incorrectly concludes in several places that the Commission intends to rely on self-reports as the primary enforcement mechanism to prevent cross-subsidization. The Commission has never relied on self-reports as its primary enforcement mechanism to prevent inappropriate cross-subsidization or assure compliance with other regulatory requirements. Because cross-subsidization is an aspect of ratemaking, by its very nature, it does not lend itself to being self-reported as a violation of the Commission's rules. Ratemaking is a complicated process which relies on the development of an extensive record on costs and revenues, and determination of

[9] *Financial Accounting, Reporting and Records Retention Requirements Under the Public Utility Holding Company Act of 2005*, Order No. 684, 71 Fed. Reg. 65,200 (Nov. 7, 2006).

[10] *See, e.g., Progress Energy*, 111 FERC ¶ 61,243 (2005); *Public Service Company of Colorado*, Docket No. PA05-1-000 (November 28, 2005) (unpublished letter order); *Florida Power & Light,* Docket No. PA05-7-000 (May 12, 2006) (unpublished letter order).

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the proper allocation of costs between jurisdictional and non-jurisdictional operations, the appropriate distribution of costs between and among the various jurisdictional services, and the selection of an appropriate rate of return. Under these circumstances, self-reports would not be an effective method to monitor cross-subsidization. It is possible that the Draft GAO Report may be confusing self-reports regarding standards of conduct violations (pertaining to communications between the transmission and generation functions of a utility) with self-reports regarding cross-subsidization. Moreover, the Draft GAO Report seems unaware that, *prior* to passing through costs in rates, a public utility must request authority to do so and therefore the Commission, at the time of such a request, can determine whether the proposed rate or rate formula permits inappropriate cross-subsidization to occur and, if so, to disallow rate recovery.

See response 5.

Similarly, the Draft GAO Report makes incorrect assertions concerning the universe of companies subject to the Commission's jurisdiction, the number of PUHCA audits the Commission will conduct in the future, and the process used to select the PUHCA audit candidates. With respect to the universe of companies subject to the Commission's jurisdiction, the Draft GAO Report implies that the Commission will audit only 100 companies out of a universe of 4,700 potential audit candidates. The Draft GAO Report fails to take into account the Commission's comprehensive compliance program in its Office of Energy Projects (OEP) for overseeing the jurisdictional operation of 17 LNG terminals and 1,022 hydroelectric projects. In addition, the Draft GAO Report also fails to indicate that the primary audit responsibility for the 1,510 FPA section 215 reliability standards compliance audits falls on the Electric Reliability Organization and the Regional Entities. Aside from these 2,539 audit candidates, there is also significant overlap between the other categories of jurisdictional companies. Thus, the universe of potential audit candidates is significantly below the 4,700 figure cited in the Draft GAO Report.

The Draft GAO Report also is incorrect when it suggests that the Commission will audit holding companies only once every 12 years. The Commission considers a number of factors including the size and complexity of holding companies in determining how many holding company audits the Commission will conduct in a given year. Until the Commission obtains sufficient experience conducting holding company audits pursuant to PUHCA 2005, the Commission cannot correctly estimate how many of these audits will be necessary in the future. The three PUHCA 2005 audits scheduled for FY08 are the initial audits focused on compliance with these requirements, and concentrate on some of the largest utility holding companies. It is inappropriate to assume these PUHCA audits are indicative of the number of audits that the Commission will perform in subsequent years.

See response 6.

The Draft GAO Report incorrectly portrays the Commission's method of selecting audit candidates as informal. The Commission consistently uses a variety of methods to assess risk in order to facilitate the selection of audit candidates. These methods include

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internally developed screens and models, past compliance history, information gleaned from on-going and completed audits, investigations, and complaints, Commission financial forms, SEC filings, websites, rate information gathered from Commission and state rate filings and discussions with the Commission's legal and technical experts.

See response 7.

The Draft GAO Report gives short shrift to a public utility's commitments that are made with respect to cross-subsidization in the context of a merger proceeding and appears to ignore the fact that such commitments are incorporated in the Commission's order as conditions of allowing a merger or other corporate transaction. If those commitments are not adhered to, the public utility will be in violation of a Commission order and subject to sanctions including possible civil penalties. Further, the Commission retains authority under FPA section 203(b) to issue supplemental merger orders as it finds may be necessary or appropriate. The Draft GAO Report also ignores generic rules delineating and proscribing cross-subsidization in power sales and non-power goods and services transactions between affiliates, which are both auditable and enforceable. Continuing rate review by the Commission, and rate complaints by customers, as well as audits provide regulatory tools to identify and disallow inappropriate cost-subsidization and inappropriate cost recovery. Inappropriate costs may be disallowed in rates and/or penalties may be assessed for not complying with such commitments and restrictions. The Commission's audit process and further clarification of apparent misunderstandings regarding the Commission's audit process with respect to cross-subsidies are discussed below.

In the draft report, the GAO makes four recommendations that purportedly would enhance the Commission's ability to detect and prevent harmful cross-subsidization involving public utilities. These recommendations focus primarily on post-merger oversight, in particular with respect to the audit process. In brief, the GAO recommends that the Commission use a risk-based approach to detect cross-subsidization, enhance the agency's audit reporting, and reassess resources to demonstrate that its oversight is sufficiently vigilant.

See response 6.

The Draft GAO Report's first recommendation is that the Commission "[d]evelop a comprehensive, risk-based approach to auditing affiliate transactions in holding companies and other corporations that it oversees to more efficiently target its resources to highest priority needs and to address the risk that affiliate transactions pose for utility customers, shareholders, bondholders, and other stakeholders." Contrary to the premise of this recommendation, the Commission followed a risk-based approach in selecting the FY08 PUHCA audit candidates and will continue to follow a similar approach in the future. The risk-based approach entailed a comprehensive review of audit materials obtained from the SEC; discussions with the SEC; examination of financial information contained in FERC Form No. 60, FERC Form No. 1, and SEC filings; rate information gathered from Commission filings; and discussions with the Commission's legal and technical experts. In addition to the above methods, the Commission audit staff searched

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through 155 boxes of audit materials received from the SEC covering 28 holding companies, participated in several conference calls with the SEC staff responsible for the implementation of PUHCA 1935 and discussed audit practices, processes and procedures, as well as outstanding issues for certain holding companies. Finally, shortly after the audits started, the Commission held discussions with state commission officials in the states of Georgia, Alabama, Mississippi, Florida, Maryland, Virginia, West Virginia, and Pennsylvania.

See response 8.

The second recommendation suggests that the Commission should develop a better understanding of the risks posed by each company.[11] Briefly, the Draft GAO Report suggests monitoring the financial condition of utilities and collaborating with state regulators. Contrary to the Draft GAO Report's assumptions, the Commission audit staff frequently interacts with state regulators during an audit. For example, the Commission's audit staff recently either met or had telephone conversations with eight state regulators regarding the three current FY08 PUHCA 2005 audits. These actions demonstrate that I recognize maintaining contact with state regulators is mutually beneficial to the states and the Commission.

However, the suggestion that the Commission should monitor the financial condition of public utilities fails to appreciate that a company's stock price and bond ratings are typically driven by the company's overall business risks and prospects. Thus, the fact that a company's stocks or bonds are doing well or poorly says little or nothing, standing alone, about whether cross-subsidization is occurring. That is why the Commission's existing method of assessing risk is comprehensive and takes into account both financial and non-financial information rather than solely relying on a public utility's stock prices and bond ratings as indicators of potential cross-subsidization.

See response 9.

The third recommendation is that the Commission "[d]evelop an audit reporting approach to clearly identify the objectives, scope and methodology, and the specific findings of the audit, irrespective of whether FERC takes an enforcement action in order to improve public confidence in FERC's enforcement functions and the usefulness of audit reports on affiliate transactions for FERC, state regulators, affected utilities, and

[11] The Draft GAO Report suggests: (a) monitoring the financial condition of utilities to detect significant changes in the financial health of the utility sector, as some state regulators have found it useful to do. To do this the Commission could leverage analyses done by the financial market and develop a standard set of performance indicators; and (b) developing a better means of collaborating with state regulators to leverage resources already applied to enforcement efforts and to capitalize on state regulators unique knowledge. As part of this effort, the Commission could consider identifying a liaison, or liaisons, for state regulators to contact and to serve as a focal point or points.

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others." The Commission has always strived to clearly identify its objectives and methodologies for all areas of its jurisdictional responsibilities. The Commission is currently implementing this recommendation in the audit context. For example, in November 2007, the Commission's audit staff began the process of including an enhanced audit methodology section in all of its public audit reports.[12] Also, the Commission's public audit reports have always included audit objectives and scope, as well as audit findings, where applicable. In contrast, the SEC previously issued *non-public* audit reports at the completion of its holding company audits. Thus, the Commission's enhanced audit methodology and practice of publicly publishing audit reports provide the public and the regulated community with greater transparency than previously provided by the SEC.

See response 10.

Finally, the Draft GAO Report recommends that the Commission, "[a]fter developing a more factual risk-based approach, reassess whether it has sufficient audit resources to perform these audits" and request additional funds, if necessary. Currently, the Commission continuously reassesses its audit and other resources to achieve its strategic goals. To that end, for each audit cycle, the Commission prepares an annual audit plan that is vetted with senior Commission officials, reviewed and approved by me as Chairman, and shared with all of my fellow Commissioners for their information and input. Needless to say, the Commission will continue to seek additional funds from Congress if it believes it needs more resources to carry out its auditing responsibilities, including PUHCA 2005 audits, just as the Commission recently did when requesting additional funds for transmission system reliability audits.

To summarize, the Commission's auditors already follow a risk-based approach for selecting holding company audit candidates for examination of their affiliated transactions, and the Commission constantly assesses and reassesses its audit resources to carry out the audit priorities in the annual audit plan. Similarly, the Commission continues to collaborate with state regulators to capitalize on their unique knowledge. Interacting with state regulators during the course of an audit is a practice the Commission auditors have followed for a long time. Finally, the Commission continually strives to maintain and improve existing staff practices to ensure that the audit reports include clear audit objectives, scope, and methodologies.

See response 11.

Finally, before turning from these more general comments to more specific comments, I should note that the Draft GAO Report contains considerable discussion regarding states' abilities to protect against cross-subsidization at the retail level. I and my fellow Commissioners have recognized this very important issue in our post-EPAct 2005 actions and it was a topic of lengthy discussion at one of our technical conferences and in our consideration of the Supplemental Policy Statement issued in July 2007 and

[12] *See, e.g., Kansas City Power & Light Co.,* Docket No. PA06-6-000 (Nov. 27, 2007) (unpublished letter order).

referenced above. In fact, we heard feedback from our state colleagues that the Commission should defer to state commissions and state regulatory tools with respect to protecting retail customers. The Draft GAO Report also refers to concerns that state commissions may not be able to obtain books and records of utility holding companies and utility associates and affiliates necessary to assist them in detecting potential cross-subsidization by retail customers and that, under PUHCA 2005's access to books and records provisions, state commissions have to go through this Commission to obtain information. These statements, particularly the statement at page 30 of the Draft GAO Report that refers to developing "a series of detailed requests to FERC," are incorrect. PUHCA section 1265, 42 U.S.C. § 16453, gives state commissions explicit authority to obtain information – including "books, accounts, memoranda and other records" – from utility holding companies and utility associate and affiliate companies "wherever located;" there is no requirement in PUHCA 2005 that state commissions need this Commission's authorization to obtain such information or that they otherwise must go through this Commission.

See response 12.

The Draft GAO Report is also inaccurate in its criticism of mergers approved by the Commission since enactment of EPAct 2005. The report argues these mergers were made possible by repeal of PUHCA 1935. The fact, however, is that the two largest mergers during GAO's study period – Cinergy/Duke and Mid-American/PacifiCorp – were all announced prior to the repeal of PUHCA 1935. The Draft GAO Report asserts that repeal of PUHCA 1935 "opened the door" for ownership of utilities by international companies and "new types of investors." That statement fails to recognize that there were a number of acquisitions of U.S. utilities by international companies before repeal of PUHCA 1935.[13] In addition, there were proposed acquisitions of utilities by equity firms before repeal of PUHCA 1935, some of which were successful.[14]

The Draft GAO Report asserts "FERC is generally supportive of mergers," but cites unnamed "experts" without attribution. The Draft GAO Report implies criticism that the Commission has not conditioned more of the mergers approved since enactment of EPAct 2005. Yet, it makes no effort to analyze any of the approved mergers that were not conditioned. For example, GAO fails to mention that two of these mergers were

[13] *See, e.g., Niagara Mohawk Holdings., Inc.*, 95 FERC ¶ 61,381 (2001); *Bangor Hydro-Electric Company,* 94 FERC ¶ 61,049 (2001); *Louisville Gas & Electric Company,* 91 FERC ¶ 61,321 (2000); *PacifiCorp,* 87 FERC ¶ 61,288 (1999); *New England Power Company,* 87 FERC ¶ 61,287 (1999).

[14] *See, e.g., Tucson Electric Power Co.*, 80 FERC ¶ 62,275 (1997); *Portland General Electric Company*, Docket No. EC04-90 (withdrawn April 8, 2005); *Mid-American Energy Company*, 89 FERC ¶ 62,225 (2000).

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cross-country mergers involving utilities in different regions of the country, and that other mergers involved acquisition of a utility by a new entrant. The Commission conditions mergers as necessary to mitigate merger-related increases in market power, and as a general matter neither of these types of mergers raise market power issues. In my view, it is unfair to criticize the Commission for not conditioning mergers that presented no market power or other issues.

See response 13.

I also take great exception to the Draft GAO Report's characterization of the capacity of state commissions to oversee utilities. The report specifically criticizes state commissions for not auditing more affiliate transactions. I believe this criticism is unfair – my state colleagues are dedicated to protecting retail consumers, and are as committed to preventing cross-subsidization as this Commission. Recognizing the expertise of states in this area, we consulted closely with our state colleagues as we implemented our expanded merger authority.

Turning from my more general concerns with the Draft GAO Report to more specific concerns, let me proceed page-by-page and identify errors or misstatements that I believe need to be corrected:[15]

See response 1.

(1) Introductory Page: As an initial matter, as I noted at the outset, the discussion of "Why GAO Did This Study" errs in stating that EPAct 2005's repeal of PUHCA 1935, which removed limitations on the types of companies that could merge with or invest in utilities, "shifted sole responsibility for regulating public utilities from the Securities and Exchange Commission to the Federal Energy Regulatory Commission. . . ." The SEC never had sole responsibility for regulating public utilities. I discuss this error earlier in this letter, so I will not repeat that discussion here.

See response 14.

(2) Introductory Page: The Draft GAO Report leads with a claim that for 2008 the Commission plans to conduct audits of only 3 of the 149 companies that it regulates. That claim misrepresents the percentage of companies presently planned to be audited. As recognized later in the Draft GAO Report, on page 29, while there are 149 holding companies, only 36 of these holding companies are subject to Commission authority under PUHCA 2005; the other holding companies have received either an exemption or a waiver of all or most of the requirements of PUHCA 2005 and the Commission's implementing regulations. I also note that certain exemptions given under PUHCA 2005 are required by statute.

[15] Appendix B contains staff's detailed rebuttal to the incorrect and misleading audit-related statements contained in the Draft GAO Report.

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See response 15.

(3) Page 3, Footnote 2: The Draft GAO Report incorrectly characterizes the Commission's limited authority with respect to Texas. Much of Texas is the responsibility of the Electric Reliability Council of Texas (ERCOT) and is electrically isolated from the rest of the United States (with the exception of certain direct current ties that are subject to only limited Commission authority); power flowing within ERCOT is not considered to be power flowing in interstate commerce and hence the utilities that transmit and/or sell such power are not considered to be "public utilities" that are subject to Commission rate regulation under Part II of the FPA.

See response 16.

(4) Page 6: The Draft GAO Report suggests that, before the passage of EPAct 2005, the Commission was not concerned with cross-subsidization; the Draft GAO Report states that preventing inappropriate cross-subsidization is a "new" responsibility. As described above, that is incorrect. The Commission has long been concerned with identifying and addressing inappropriate cross-subsidization; all that is new is the explicit statutory directive to consider cross-subsidization at the time a merger's approved.

See response 3.

(5) Page 8: The Draft GAO Report indicates that the Commission has done little in response to the passage of EPAct 2005. As described above, that is incorrect. In the comparatively short time since the passage of EPAct 2005, the Commission has instituted a number of rulemaking proceedings, and issued a number of Final Rules and other documents.

See response 4.

(6) Page 3, 8, 10: The Draft GAO Report implies that the Commission relies largely on self-reporting and a limited number of audits (again citing the incorrect 3 of 149 comparison discussed above). The detailed discussion provided above demonstrates that with respect to cross-subsidization this implication is incorrect. While self-reports are important, they are neither the beginning nor the end of the Commission's efforts. The Draft GAO Report does not, for example, recognize the Commission's ongoing ratemaking authority to ensure inappropriate cost-subsidies are not charged to ratepayers, and does not recognize such customer protections as the restrictions on affiliate transactions that are discussed above.

See response 17.

(7) Pages 10-11: The Draft GAO Report chastises the Commission for not doing an "independent" analysis of proposed mergers. This discussion largely ignores that the Commission makes its decision in each case based on the record developed in that case – a record created not only by the applicants but by the filings of customers, competitors, state

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commissions and attorneys general, and others that may oppose the merger. If the record as developed by the parties through their various filings is not adequate, the Commission can find, for example, that an applicant's filing is "deficient" and direct the applicant to submit additional record evidence; such evidence would, like the original application, be reviewed by and subject to challenge by customers, competitors, state commissions and attorneys general, and others that may oppose the merger. If the record is still inadequate, the Commission can institute so-called paper hearing procedures or even trial-type evidentiary hearing procedures. Once there is sufficient record evidence, the Commission is required to act based on this record evidence. The Commission, like most regulatory agencies, is not permitted to act based on non-record evidence; indeed, its decision will be overturned by a reviewing court if it decides based on non-record evidence. That being said, the Commission is free to independently analyze that record evidence, and does so. The Commission is not bound to follow the analysis of the applicants, and it often does not. Rather, the Commission analyzes the entire record and determines what result is appropriate based on the entire record, and the Commission provides its analysis of the record in the public order that it issues. The Draft GAO Report confuses the record evidence that must form the basis of the Commission's actions with the analysis of that evidence by the Commission, and incorrectly assumes that because the Commission cannot rely on non-record evidence the Commission cannot develop or rely on its own analysis. Finally, I note that EPAct 2005 amended FPA section 203 to require that the Commission expedite review for corporate transactions and to provide that if the Commission does not act within 180 days the application "shall be deemed granted" (unless the Commission for good cause extends the time for not more than an additional 180 days). Thus, the Commission's process as a matter of statute must be streamlined.

See response 16.

(8) Page 11: The Draft GAO Report again suggests that, before the passage of EPAct 2005, the Commission was not concerned with cross-subsidization; the Draft GAO Report states that preventing inappropriate cross-subsidization is a responsibility that the Commission "now" has. As described above, that is incorrect. The Commission has long been concerned with identifying and addressing inappropriate cross-subsidization; what is new is the explicit statutory directive, to address cross-subsidization at the time the merger application is approved.

See response 17.

(9) Page 12: While acknowledging the need for a public record, the Draft GAO Report chastises the Commission for failing to develop its own evidence. Again, as described above, the Draft GAO Report fails to recognize that the Commission is barred from using non-public, extra-

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record evidence; rather, the Commission must decide based on record evidence.

See response 6 & 4.

(10) Page 14: The Draft GAO Report chastises the Commission for not "formally" considering risk, but fails to recognize that the Commission does take risk into account. The Draft GAO Report also ignores the Commission's ongoing ratemaking authority and the ability of customers and competitors, among others, to challenge through formally docketed complaints rates that they believe reflect inappropriate cross-subsidization.

See response 18.

(11) Page 15: The Draft GAO Report takes a November 2007 report submitted "on behalf of a broad consortium of energy companies" and does not consider that the report may not be objective, but rather may reflect the commercial interests of the energy companies that sponsored it. Further, this report did not even directly address the issue of cross-subsidization.

(12) Page 16: The Draft GAO Report references an unidentified "company official" without addressing whether that particular official is objective but whose views instead may reflect the commercial interests of that company. In addition, that official's comments appear to be based on a very limited public data set which, given the newness of the Commission's expanded penalty authority, is necessarily more likely to reflect self-reports. Further, it is not clear that that company official was even addressing the issue of cross-subsidization.

See response 19.

(13) Page 16: The Draft GAO Report refers to the Commission's plan to conduct a "limited number of compliance audits." The Draft GAO Report, however, does not acknowledge that the Commission's PUHCA 2005 books and records authority with respect to holding companies is new, and that the implementing regulations are likewise new. In fact, these are the initial PUHCA 2005 audits. In this same vein, the Draft GAO Report also refers to "compliance with the PUHCA 2005 provisions contained in EPAct [2005]." This implies that PUHCA 2005 has significant substantive requirements; however, it does not. The statute merely supplements our pre-existing authority to access the books and records of public utilities and holding companies.

See response 20.

(14) Page 17: The Draft GAO Report suggests the Commission's audit plan should be developed after "seek[ing] input from stakeholders." This is a course I do not plan to pursue, since I believe it would be inappropriate to consult with non-federal persons, such as regulated companies, on the allocation and deployment of the Commission's

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enforcement resources.

See response 8.

(15) Page 18: The Draft GAO Report suggests that the Commission should consider looking to bond ratings and other public financial data in determining what companies to audit, and that the Commission should look to statistical models in identifying what companies to audit. As to the latter point, in particular, these statistical models are unidentified, and it is unclear whether and to what degree those models may be of value in identifying the companies that should be audited. Similarly, it is unclear whether bond ratings and other similar data are a sound method of identifying, for example, what companies may be engaged in inappropriate cross-subsidization and therefore should be audited.

See response 21.

(16) Page 19: The Draft GAO Report shows no appreciation for the limits on Commission enforcement resources, and that a greater commitment to conducting PUHCA 2005 audits would require a reallocation of enforcement staff from auditing compliance with other regulatory requirements, such as reliability standards, or investigating possible manipulation of power and gas markets.

(17) Page 19: While the Draft GAO Report notes the number of staff members that are at present expected to be assigned to audit holding companies, the Draft GAO Report does not acknowledge that that number represents a quarter of the audit staff and thus, as a percentage, represents a substantial commitment of resources.

See response 19.

(18) Page 19: The Draft GAO Report refers to "companies subject to FERC's oversight under the PUHCA [2005] provisions of EPAct [2005]," which carries with it an implication that PUHCA 2005 contains significant substantive requirements that companies must comply with. That implication is not accurate, as PUHCA 2005 is limited to accessing books and records.

See response 14.

(19) Page 19, Footnote 18: The Draft GAO Report notes that it did not assess whether the exemptions or waivers from PUHCA 2005 and the Commission's implementing regulations "were reasonable." The Draft GAO Report fails to recognize that certain of the exemptions are statutorily mandated by section 1266(a) of PUHCA 2005, 42 U.S.C. § 16454(a), and that the Commission "shall", i.e., must, grant other exemptions if the Commission makes certain findings pursuant to section 1266(b) of PUHCA 2005, 42 U.S.C. § 16454(b).

See response 22.

(20) Pages 20-21: The Draft GAO Report states, on the one hand,

that the Commission has not yet conducted any affiliate transaction audits, but then objects to how the Commission has conducted affiliate transaction audits to date.

See response 18.

(21) Page 22: The Draft GAO Report references a report (presumably the same report referenced on page 15), sponsored by companies benignly described as "a wide range of industry stakeholders." These stakeholders actually represent Commission-regulated companies. More to the point, the Draft GAO Report again takes that report at face value and does not take into account that that report may not be objective, but rather is equally likely to be an advocacy document reflecting the commercial interests of the energy companies that sponsored it. Also, the report does not even directly address the issue of cross-subsidization.

See response 7 & 4.

(22) Page 32: In its conclusions, the Draft GAO Report suggests that all that the Commission does is to "rely" on commitments by merger applicants. That is decidedly not the case. While applicant commitments are certainly important tools in the Commission's toolbox, they are far from the only tools and indeed are not necessarily the best, most useful tools. The Commission has many means by which it can enforce prohibitions on cross-subsidization. As the Draft GAO Report notes on page 6, PUHCA 2005 provided the Commission specific post-merger access to the books, accounts, memos, and financial records of utility owners and their affiliates and subsidiaries to enhance the Commission's traditional review of affiliate transactions in the context of the Commission's review and approval of prices public utilities charge for the use of transmission lines and for wholesale sales of electricity. The Commission will continue to evaluate whether utilities may pass through costs of affiliated transactions in the context of rate reviews prior to accepting the rates utilities charge their customers. That aside, it is unclear why these commitments should be disregarded. These commitments may reflect a careful review of Commission policy, and anticipate merger conditions that would otherwise be imposed by the Commission to prevent cross-subsidization. Further, adherence to those commitments is a condition of the Commission's approval and if public utilities do not adhere to the commitments they are subject to sanctions, including possible civil penalties.

See response 6.

(23) Page 32: In its conclusions, the Draft GAO Report suggests that the Commission should focus on "areas of highest potential risk." This recommendation is reasonable but the Draft GAO Report is vague on how the Commission should do that, beyond general references to unidentified statistical models and to bond ratings and other public financial information. It is uncertain what specific actions the report recommends.

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In conclusion, let me emphasize that, just as the Commission has done since 1935, it will continue to be vigilant to protect customers from inappropriate cross-subsidization through its ratemaking and other regulatory authorities. I believe the rules and policies the Commission has adopted since EPAct 2005 was enacted, and the strengthening of its enforcement function following EPAct 2005, have given the Commission an even stronger foundation to do this. Our existing cross-office approach to regulating utilities allows us to bring to bear all agency expertise necessary to detect potential problems and protect customers. In this regard, I have asked Commission staff to explore what further adjustments might improve our processes based on the Draft GAO Report recommendations. I encourage you to ask your staff to once again meet with my staff to obtain a better understanding of the Commission's implementation of EPAct 2005, PUHCA 2005 and the Commission's post-merger oversight.

I believe the Draft GAO Report suffers from a fundamental misunderstanding of important issues, is based on incomplete information, contains many errors, and demonstrates flawed analysis. Unfortunately, that greatly diminishes the value of the report. Nonetheless, I have directed Commission staff to carefully consider the recommendations in the report.

I regret that it was necessary to submit such a lengthy response. Much of this information has been submitted to your staff previously, in some cases more than once. It is not apparent why this information was not considered. Unfortunately, the Draft GAO Report does not reflect an awareness and an appreciation of essential facts. I thought it necessary to provide a complete response in the hopes your analysis of these important issues would be properly grounded.

Thank you again for the opportunity to comment on the Draft GAO Report.

Sincerely,

Joseph T. Kelliher
Chairman

APPENDIX A

HISTORICAL MERGER AUTHORITY

Section 203 of the Federal Power Act (FPA) long provided (and, even after EPAct 2005, still provides) that proposed mergers and other jurisdictional corporate transactions require Commission authorization, and that such authorization must be granted if the Commission finds that the merger or transaction is "consistent with the public interest." Since 1996, in evaluating proposed mergers and other jurisdictional corporate transactions, the Commission has employed a three-part analysis[1] – looking at the effect of the merger or transaction on rates, competition, and regulation.

Though not expressly stated as a part of the Commission's merger analysis, consideration of cross-subsidization by the Commission is not new. In practice, it has long been an integral part of the Commission's analysis of mergers and other jurisdictional corporate transactions. For example, in January 1996, in considering a proposed merger of Wisconsin Electric Power Company, Northern States Power Company (Minnesota), Northern States Power Company (Wisconsin), and Cenergy, Inc., the Commission noted that "[c]ross-subsidization through inter-affiliate transactions is a major concern of the Commission,"[2] and the Commission further noted that, while the applicants had pledged not to claim that SEC oversight of inter-affiliate transactions was a bar to state utility commission review of the utilities' costs and rates, the applicants had made no similar pledge not to claim that SEC oversight of inter-affiliate transactions was a bar to this Commission's review of the utilities' costs and rates; the Commission set the proposed merger for hearing. *Wisconsin Electric Power Co.*, 74 FERC ¶ 61,069 at 61,191, 61,193 & n.23 (1996), *reh'g denied*, 79 FERC ¶ 61,158 (1997).

[1] *See* 18 C.F.R. § 2.26.

[2] In a similar vein, in 2000, in considering a proposed transaction involving Consolidated Water Power Company, the Commission noted that '[w]hen a public utility is acquired by another company, . . . the Commission's ability to adequately protect public utility ratepayers against inappropriate cross-subsidization may be impaired absent access to the parent companies' books and records," but the Commission also noted that section 301 of the FPA "gives the Commission authority to examine the books and records of any person who controls, directly or indirectly, a jurisdictional public utility insofar as the books and records relate to transactions with or the business of such public utility." *Consolidated Water Power Co.*, 91 FERC ¶ 61,275 at 61,931-32 (2000); *accord E.ON AG*, 97 FERC ¶ 61,049 at 61,284 (2001).

In 1997, in addressing a Boston Edison Company corporate reorganization, the Commission again noted its concern with possible inappropriate cross-subsidization, explaining that the reorganization at issue would, in fact, separate non-utility operations and costs from utility operations and costs which, in turn, "should facilitate regulatory monitoring of possible cross-subsidization between the two lines of business." *Boston Edison Co.*, 80 FERC ¶ 61,274 at 61,992 (1997). The Commission also expressly noted the cross-protections that would be in place – state-established standards of conduct and contractual agreements between the relevant affiliated companies – , and found that these protections would "both act to help protect against cross-subsidization between the utility and non-utility affiliates and ensure comparable treatment between affiliates and non-affiliates as well as arm's-length relationships among affiliates." The Commission thus concluded that the reorganization would "not increase the potential for affiliate abuse or preferential dealings." *Id.* at 61,993-94.

Similarly, in 2000, in the context of a proposed merger between CP&L Holdings, Inc. and Florida Progress Corporation, the Commission found that, while the applicants had included "certain protections against cross-subsidization," the applicants proposed price cap was inadequate[3] – explaining that "[w]ithout an adequate protection method, the danger exists that a negotiated rate that is too high might shift transaction benefits from the ratepayers of one company to the ratepayers of the other" and that "a negotiated rate that is too low might shift transaction benefits as well." Accordingly, the Commission directed the applicants to "incorporate an appropriate pricing safeguard." *CP&L Holdings, Inc.*, 92 FERC ¶ 61,023 at 61,060 (2000), *reh'g denied*, 94 FERC ¶ 61,096 (2001).

As a further illustration of the Commission's longstanding concern with inappropriate cross-subsidization, in 2004, the Commission adopted new guidelines for transactions between affiliates. The Commission explained that acquisitions involving affiliates presented "an inherent potential for discriminatory treatment in favor of the affiliate" and that the Commission, to ensure that proposed transactions are consistent with the public interest, as required by section 203 of the FPA, "must assure that a public utility's acquisition of a plant from an

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[3] The Commission had previously noted that the effect of inappropriate cross-subsidization is felt through a utility's rates. *Boston Edison Co.*, 80 FERC ¶ 61,273 at 61,986 (1997). Thus, it can be addressed at the wholesale level through the Commission's review of the proposed transaction at the outset and through the Commission's continuing review of the utility's wholesale rates, and at the retail level through state regulatory commission review of the utility's retail rates. *Id.*

affiliate is free from preferential treatment" and does not harm to competition and the development of vibrant, fully-competitive generation markets. Accordingly, the Commission found that a proposed transaction "is not consistent with the public interest unless shown not to be the result of affiliate abuse," and required an analysis that would demonstrate a lack of affiliate abuse (based on the so-called *Edgar* standard, referring to *Boston Edison Co. Re: Edgar Electric Energy Co.*, 55 FERC ¶ 61,382 at 62,167-70 (1991)). The Commission also adopted solicitation guidelines intended to demonstrate that affiliates had no undue advantage over non-affiliates, with a showing that (1) the solicitation process was open and fair, (2) the products sought through the solicitation were precisely defined, (3) the evaluation criteria used to evaluate the competing bids were standardized and applied equally to all bids and to all bidders, and (4) the solicitation was overseen by an independent third-party (who designed the solicitation, administered the bidding, and evaluated the bids). *Ameren Energy Generating Co.*, 108 FERC ¶ 61,081 at P 59-84 (2004).

GAO Comments

The following are GAO's responses to the Federal Energy Regulatory Commission's comments on our draft report as outlined in its January 22, 2008, letter.

1. Our statement in the summary Highlights of the draft report referring to Energy Policy Act (EPAct) shifting sole responsibility from the Securities and Exchange Commission (SEC) to Federal Energy Regulatory Commission (FERC) was not intended to imply that, prior to the passage of EPAct, FERC had no role in regulating public utilities. We simply wanted to point out that, after EPAct, sole responsibility for oversight of potential cross-subsidies rested with FERC. We revised the Highlights text to clarify the historical roles of FERC and SEC. Other information in the draft report accurately reflected each agency's role.

2. As a point of clarification, we make no explicit or implicit recommendation regarding "resurrecting" the Public Utility Holding Company Act of 1935 (PUHCA 1935). We share FERC's apparent view that this was not the intent of Congress and the President in repealing PUHCA 1935. Our report focused on FERC's new role as the sole federal agency responsible for enforcing prohibitions against cross-subsidization.

3. We acknowledge that FERC has executed the administrative steps to begin implementing EPAct, made changes such as adding a "code of conduct" for utilities and their affiliates as well as other changes discussed in the letter within the short time frames provided under law—and recognized this in our draft report. However, as we noted in our draft report, our view and the view expressed by FERC staff we met with during our investigation is that FERC's overall merger review process remains largely unchanged except that FERC now requires companies to attest in writing that they will not engage in unauthorized cross-subsidization. We commend FERC for its ongoing outreach efforts, such as conferences to solicit stakeholders' views, but we maintain that those efforts have, so far, resulted in few changes to FERC's merger review process. Accordingly, we made no change to our draft report in response to this comment.

4. The Chairman of FERC said that we incorrectly conclude that the commission intends to rely on self-reporting as the primary enforcement mechanism to prevent cross-subsidization but did not explain what mechanism(s) FERC will use to detect potential cross-subsidization. To be clear, our draft report stated that once a merger

has taken place, FERC intends to rely on its existing enforcement mechanisms—primarily (1) companies' self-reporting and (2) compliance audits—to detect potential cross-subsidization. In addition, the draft report stated that FERC officials also said they used their "hotline" reporting system to identify potential violation of FERC rules. Throughout the course of our audit work, key FERC staff, including those involved in enforcement, noted that self-reporting was a central element in enforcing FERC's overall enforcement approach, including all of the statutes, orders, rules, and regulations the commission enforces. FERC officials also provided a copy of FERC's October 25, 2005, Policy Statement on Enforcement—which prominently features self-reporting—in the context of our discussion of how FERC planned to enforce the prohibitions on cross-subsidization. We share the views of the Chairman that self-reporting is not an effective method to reliably detect cross-subsidization. The Chairman also said that we may be confusing self-reports regarding standards of conduct violations with self-reports regarding cross-subsidization. We have not confused these two distinct reporting mechanisms as our report focuses on concerns related to potential cross-subsidization. As the draft report also discusses, the second key mechanism that FERC intends to use to detect potential cross-subsidization, and its only proactive enforcement component, is a limited number of compliance audits. We believe that audits provide tremendous potential value in enforcing the prohibitions against unauthorized cross-subsidization (delineated in detail by FERC on pages 3 through 7 of the Chairman's letter and addressed in our comment 3), especially in light of FERC's new role as the federal agency primarily responsible for the oversight of public utilities. We believe that audits of companies and transactions should play a key role in the FERC's overall enforcement strategy, particularly in the area of cross-subsidization. With regard to preventing potential cross-subsidization through rate reviews, we are aware of this process and recognized in our draft report that FERC retains a limited ratemaking role and, as such, may have opportunities to establish cost recovery rules prospectively in these proceedings. We added additional language to our draft report to indicate that FERC may examine costs incurred by utilities for rates it still sets and, in so doing, decide which costs may be lawfully included in rates charged to customers. We also recognize that FERC allows third parties to report potential violations using its hotline or by filing a complaint that the terms of the approved rates are being violated. We revised our draft report to better reflect that such reports and complaints may lead to a FERC investigation. However, because we have no way of knowing (1) whether third parties will be a reliable enforcement tool, (2) how likely FERC is to conduct rate setting procedures, and (3) FERC's plans currently reflect only 3 audits, we remain concerned that FERC is overly reliant on self-reporting.

5. We relied on FERC officials to identify the universe of companies it could audit and how many it planned to audit for the information contained in our draft report. In addition, we included suggestions from FERC staff regarding caveats to its audit responsibilities and overlaps raised in the Chairman's letter. For example, the draft report noted that there was overlap between the various categories and that the Regional Reliability Organization, according to FERC, would be responsible for the initial audits of these 1,510 companies. Nonetheless, we moved our table note to the body of the report to emphasize these overlaps and the fact that the number of potential audit candidates could be lower than the universe of 4,700 companies identified by FERC. It is important to note, however, that some of the audits may be quite different and require different resources than audits of affiliate transactions. For example, audits of compliance with reliability rules may focus on whether companies have conducted sufficient training of staff, not addressing the unique accounting issues associated with affiliate transactions. While this change in the text of the report may help the reader better understand overlaps in the universe of companies, it is still not clear from the Chairman's comments how many audits will ultimately be required of these companies, the nature of the audits or the resources needed, and how they would affect the resources available for audits of affiliate transactions. Regarding the frequency of audits, our draft report states, "At its planned 2008 audit rate of 3 companies, it would take FERC 12 years to audit each of these companies once." We recognize that the current audit rate may change since such determinations are made annually, but we use these data—as provided by FERC—as the best available at the time of our review. We added an explicit notation that the number of audits may change to further clarify the statement already in the report.

6. The Chairman stated that the draft report incorrectly portrays FERC's method of selecting audit candidates as informal and that FERC actually uses a variety of methods to assess the individual and collective risks posed by companies it oversees. However, during the course of our year-long engagement, including discussions with key FERC officials, the process was described as informal and did not mention the other mechanisms described in the Chairman's letter. In

addition, FERC staff, when we asked for a record of a risk-based analysis or the criteria FERC would have used to conduct such an analysis, were unable to provide them and told us audit selections were based on informal discussions with knowledgeable senior FERC staff. Although FERC officials may individually consider risk as they discussed audit planning in these informal discussions—and we noted in the draft report these officials believe their judgments provide a reasonable picture of risk—such considerations are not sufficiently formal or systematic and could change as staff in key positions change. In our view, a risk-based audit planning approach should be sufficiently rigorous and systematic to ensure that it reliably and consistently guides FERC in assessing individual company risks and the overall risks posed by the companies collectively and making audit selections accordingly. Furthermore such an approach should be flexible enough to meet FERC's current and expected future auditing demands now that it is solely responsible for detecting potential cross-subsidization. We noted in our draft report that some federal agencies develop their own statistical measures of risk, derived in some cases from models although there are other methods. It may or may not be appropriate for FERC to use this type of tool but we want FERC to be aware that there are other ways of more formally considering risk in agency decision making. In any case, designing a formal risk-based approach will take time and effort and FERC may want to consider consulting with outside experts. It was our intent, by excluding these statistical methods from our recommendation, to provide the Chairman with flexibility on how best to implement a more formal, risk-based approach. With regard to FERC's comment about its outreach to states during audits, we commend FERC for these efforts when conducting compliance audits, but also believe FERC could benefit from the states' expertise and knowledge earlier in the process when determining which companies to audit. We continue to believe that our recommendation, if implemented, would improve the likelihood that the audits will be most effective. As such, we made no change to our draft report in response to these comments.

7. We are aware that FERC has established many expectations and rules—through both the company attestation process and its generic prohibitions on cross-subsidization—but we have concerns as to whether FERC has devoted enough attention to the formidable task of enforcing those rules by detecting violations. We recognize the importance of company attestations that they will not engage in cross-subsidization for use in developing a formal record from which FERC can potentially take enforcement actions. We share FERC's view that

companies should honor their commitments to the federal government, but know that staff turnover at these companies can be high, and that financial and other circumstances of companies can, and do, change. Because of this, and other factors, we believe that it is important to recognize the value of these company attestations in creating a record, but also believe that it is important to be vigilant and proactive in looking for potential violations. As a result, we made no change to the draft report in response to this comment. With regard to the Chairman's related comment about FERC's generic rules, we agree that these rules delineate FERC's expectations for compliance; however, while these rules define potential violations, they do not detect them. Therefore, they must be coupled with vigilant enforcement mechanisms, such as audits to detect potential cross-subsidization. It is these mechanisms that the draft report concludes are inadequate in FERC's approach. We made no change to our draft report for this comment. With regard to the Chairman's comment about rate review, we discuss this point in our response to comment 4.

8. As noted above in comment 6, we are pleased that FERC includes discussions with state regulators when it conducts audits, however we believe FERC could further benefit from their expertise when selecting which companies to audit. With regard to financial indicators, as noted in the draft report, we believe that the deterioration of a company's financial condition may raise the potential for financial abuses. In that regard, how the financial community values a company's stocks or bonds is used as a high-level example of financial indicators that could be helpful to FERC. We do not suggest in our report that FERC should examine only stock and bond values; rather, we suggest that FERC should be gauging risk by, among other things "monitoring the financial condition of utilities." Companies' financial data is a window into their risks and an opportunity to leverage the financial community's research. Such research is not strictly limited to stock and bond prices; it could include other appropriate metrics, such as financial ratios. In implementing our recommendation, FERC may wish to consult with financial experts to develop a set of useful metrics to monitor. We believe, as do others we spoke with in states and the financial community, that such indicators could provide additional insights into the risk posed by individual companies and the financial health of the overall industry. We made no change to our draft report in response to these comments.

9. As the Chairman indicates, FERC is in the process of implementing our recommendation to improve the usefulness of its audit reports. We

discussed the need to improve the transparency of its audit requirements and actions during our discussions with FERC audit officials and encourage FERC to fully implement this recommendation.

10. As noted in the draft report, we believe that FERC should develop a formal risk-based audit planning approach to help inform its decisions about which companies to audit but also to assist it in better leveraging its resources. The development of such an approach could also help FERC determine whether it needs additional audit staff resources to fulfill its oversight responsibilities, particularly given that SEC no longer conducts such audits. We continue to encourage FERC to assess its resources for auditing and enforcement efforts and did not change our recommendation.

11. We agree that the Public Utility Holding Company Act of 2005 (PUHCA 2005) provisions in EPAct grant states the authority to obtain this information directly. Our statements related to state commissions' access to books and records of utilities, holding companies, and affiliate companies was not intended to imply that states must go through FERC for access to this information. However, the draft report points out that this is the perception or experience in some states. For example, in response to our state survey, 14 states reported their state commission did not have access to these records at the holding company and 20 states reported this problem for affiliated nonutility companies. Further, as we reported, officials from companies that conduct audits for the states noted difficulties in obtaining access to out-of-state companies' books and records. We did not evaluate states' reasons for these views. Since there seem to be misunderstandings or misinformation about the access granted under the PUHCA 2005 provisions in EPAct, FERC could play an important role in clarifying these authorities or providing assistance in response to states' concerns, or both. In response to this comment, we clarified the language related to states' access to companies' books and records.

12. The intent of our discussion of mergers in the draft report is not to criticize FERC's merger review decisions or the conditions FERC placed on mergers. Rather, our intent is to provide some perspective on the number and status of FERC's merger reviews and their disposition. Nonetheless, we note that FERC has been supportive of mergers—a point repeated by numerous FERC staff—and that FERC believes that it has certain obligations to approve mergers. Regarding FERC's concern that the draft report does not recognize that "new types of investors" have acquired U.S. utilities before the repeal of

PUHCA 1935, the draft report described such transactions in its discussion of changes to the strict limitations in this act. As such, we recognize that while PUHCA 1935 placed limitations on what types of companies could control utilities, some investors were allowed to invest into the utility industry if they met certain financial requirements (see GAO-05-617). Because these financial requirements placed limits on the companies outside the utility sector, the number of these types of investments was limited. In our discussions with financial experts, we found that, with the repeal of PUHCA 1935, more companies from outside the utility sector are considering utility mergers or acquisitions, or both, which could broaden the pool of potential investors. We revised the text of the report to better reflect these considerations.

13. As a point of clarification, our report conveys the views of state commission staff; we did not analyze state commissions' auditing efforts or other state regulations or responsibilities. As such, we make no criticism of state commissions with regard to auditing, or any other areas of state regulation or responsibility. With this in mind, FERC should be aware that it is the view of state regulators—not based on evaluation by GAO—that state commissions are generally not conducting extensive compliance audits because of limited staff and other factors. On numerous occasions, FERC officials noted that state regulators, outside audit firms, and others are conducting audits of affiliate transactions; however, based on our discussions with each of these groups, we did not find this to be the case. We believe FERC should consider this information as it develops a formal risk-based audit planning approach, therefore we did not change the draft report in response to this comment.

14. With regard to accurately representing the percentage of companies that FERC plans to audit in 2008, FERC determined that 36 of 149 holding companies are subject to its authority under the PUHCA 2005 provisions in EPAct and told us it planned to audit 3. Although we agree that certain exemptions are required by statute, we did not conduct a legal analysis of these exceptions and waivers required by law nor did we review FERC's evaluation of these applications to determine if the 36 holding companies (of the 149) accurately reflect the potential universe of companies to be audited. Because we did not make these evaluations, we revised the Highlights page of the draft report to reflect that FERC said it would audit 3 of the 36 companies it regulates, as we more fully described in the body of the report.

15. We revised footnote number 2 in the draft report to further clarify what authority FERC has with respect to Texas.

16. We disagree that the draft report suggests that, before the passage of EPAct 2005, the commission was not concerned with cross-subsidization. The draft explicitly stated that preventing cross-subsidization has been a long-standing responsibility of FERC and that preventing it at the point of merger review is new. As such, we made no change to the report in response to this comment.

17. We note that our draft report did not have an objective to determine the adequacy of FERC's merger review and, as such, makes no finding regarding the quality of the FERC's review. The draft report describes the record-based analysis noted in the Chairman's comment, and participants' possible roles, and states that FERC does not independently develop such information—a point that was repeatedly noted by FERC officials; rather, its review is limited to reviewing the record. We agree that FERC must make its decisions based on this record, and that it can take additional steps to make sure the evidence provided is sufficient. We clarified the language in the report to note that FERC can request that applicants provide additional information and perform its own independent analysis of record evidence.

18. During our review, we sought input from many stakeholders and involved parties. The report referenced by the Chairman's comments provides one insight as to how industry perceives FERC's actions but does not provide the sole insight, and we disclosed the report's author and interest group affiliation so that the readers are aware of their interests. Similarly, the company official cited in the Chairman's next comment reflects one example of concerns expressed by companies. In either case, we recognize—as should any reader of this report—that stakeholders have specific interests in FERC's decisions and operations. However, it is important to note that some of the industries FERC regulates are expressing opinions similar to views we have developed independently during the course of our work in this area—namely that FERC needs to provide greater transparency of its enforcement functions. Furthermore, it is also worth noting that the need for greater transparency has been a theme over the last several years for GAO's work regarding FERC, which has previously recognized this and made strides toward improving transparency. It is encouraging to point out that the Chairman recently acknowledged a similar view and committed FERC to improving the transparency of its

enforcement functions. We made no change to our draft report in response to these comments.

19. The draft report contained language stating that EPAct provided FERC specific postmerger access to books, accounts, memos, and financial records of utility owners and their affiliates and subsidiaries, therefore we made no change to our draft report in response to this comment. Regarding the comment about "compliance with PUHCA 2005", we deleted the language in the draft report related to company compliance.

20. We are not advocating that FERC allow nonfederal parties, such as FERC-regulated companies, to determine auditing priorities and agree that this would pose significant risks. We believe our recommendation that FERC seek input from stakeholders, such as the financial community and state commissions—many of whom have more frequent or more recent dealings with the utilities, or may have more recent audit experience with these companies, or both—may be an opportunity for FERC to better leverage these resources. Such input, along with the other information sources already at FERC's disposal, could help inform FERC's decisions but should not substitute for the risk-based decision-making criteria that we recommend FERC develop as part of a risk-based audit planning approach. We made no change to our draft report in response to these comments.

21. We recognize that the current FERC staffing choices, as they relate to auditing, leave few resources available to cover a broad range of potentially auditable entities. It is clear that the context within which the FERC audit staff are operating has changed in important ways and may require a reassessment of FERC resources, therefore we recommended that FERC seek additional resources, if needed. It is in this vein that we have outlined a path for FERC to make such a reassessment and to report its results to Congress so that it could potentially consider such a request. In addition, as noted in earlier comments, the development of a risk-based audit planning approach could also help FERC allocate its existing resources most efficiently and effectively. We made no change to our draft report in response to these comments.

22. Our draft report states that FERC has not yet completed any affiliate transaction audits under the PUHCA 2005 provisions of EPAct, but notes that FERC intends to rely on its existing, "exception-based," reporting that it used for other types of audits. As noted in the draft

report, our examination of FERC reports issued under this exception-based reporting policy raised concerns. As a point of clarification, our concern about this policy is meant to provide constructive criticism so that future reports on affiliate transactions could be more transparent and useful to FERC staff, states, and market participants. We made no change to our draft report in response to these comments.

Appendix III: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

In addition to the contact named above, key contributors to this report included Dan Haas, Jon Ludwigson, Randy Jones, and Tony Padilla. Important assistance was also provided by Lee Carroll, Brad Dobbins, Kevin Dooley, Dan Egan, Gloria Hernandez-Saunders, Allison O'Neill, Glenn Slocum, Jay Smale, and Barbara Timmerman.

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