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UTILITY REGULATION

Opportunities Exist to Improve Oversight

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Natural Resources and Environment

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GAO Highlights

Highlights of GAO-08-752T, a testimony before the Committee on Energy and Natural Resources, U.S. Senate

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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 The Energy Policy Act of 2005 (EPAct) repealed PUHCA 1935, removing some limitations on the companies that could merge with or invest in utilities, and leaving the Federal Energy Regulatory Commission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 testify on its February 2008 report, *Utility Oversight: Recent Changes in Law Call for Improved Vigilance by FERC* (GAO-08-289), which (1) examined the extent to which FERC changed its merger review and post merger oversight since EPAct to protect against cross-subsidization and (2) surveyed state utility commissions about their oversight. In this report, GAO recommended that FERC adopt a risk-based approach to auditing and improve its audit reports, among other things. The FERC Chairman disagreed with the need for our recommendations, but GAO maintains that implementing them would improve oversight.

To view the full product, including the scope and methodology, click on GAO-08-752T. For more information, contact Mark Gaffigan at (202) 512-3841 or gaffiganm@gao.gov.

What GAO Found

In its February 2008 report, GAO reported that FERC had made few substantive changes to either its merger review process or its post merger 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 GAO that they plan to require merging companies to disclose any cross-subsidization and to certify in writing that they will not engage in unapproved cross-subsidization. After 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 the large fines allowed under EPAct will encourage companies to investigate and self-report noncompliance. To augment self-reporting, FERC officials told us that, in 2008, they are using an informal plan to reallocate their limited audit staff to audit the affiliate transactions of 3 of the 36 holding companies it regulates. In planning these compliance audits, FERC officials told us that they do not formally consider companies' risk for noncompliance —a factor that financial auditors and other experts told us is an important consideration in allocating audit resources. Rather, they rely on informal discussions between senior FERC managers and staff. Moreover, we found that FERC's audit reporting approach results in audit reports that often lack a clear description of the audit objectives, scope, methodology, and findings—inhibiting their use to stakeholders.

GAO's survey of state utility commissions found that states' views varied on their current regulatory capacities to review utility mergers and acquisitions and oversee affiliate transactions; however many states reported a need for additional resources, such as staff and funding, to respond to changes in oversight after the repeal of PUHCA 1935. All but a few states have the authority to approve mergers, but many states expressed concern about their ability to regulate the resulting companies. In recent years, two state commissions denied mergers, in part because of these concerns. Most states also have some type of authority to approve, review, and audit affiliate transactions, but many states review or audit only a small percentage of the transactions; 28 of the 49 states that responded to our survey question about auditing said they audited 1 percent or fewer transactions over the last five years. In addition, although almost all states reported that they had access to financial books and records from utilities to review affiliate transactions, many states reported they do not have such direct access to the books and records of holding companies or their affiliated companies. While EPAct provides state regulators the ability to obtain such information, some states expressed concern that this access could require them to be extremely specific in identifying needed information, thus potentially limiting their audit access. Finally, 22 of the 50 states that responded to our survey question about resources said that they need additional staffing or funding, or both, to respond to changes that resulted from EPAct, and 8 states have proposed or actually increased staffing since EPAct was enacted.

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to discuss our work on federal and state efforts to protect against potential cross-subsidization in the utility industry after the repeal of the Public Utility Holding Company Act of 1935 (PUHCA 1935). Public 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 utilities may face the need to invest potentially hundreds of billions of dollars to expand and upgrade the utility infrastructure over the next 10 years. Oversight of utilities is carried out by the federal government and state commissions—with the federal role focused on regulation of interstate transmission and wholesale markets and the states' role focused on regulating retail markets. These federal and state regulators seek to balance efforts to protect utility consumers from potential supply disruptions and unfair pricing practices while ensuring that utilities are profitable enough to attract private investment. Traditionally, this regulation took place within the framework of PUHCA 1935 and other federal laws. In 2005, the Energy Policy Act (EPAct) repealed PUHCA 1935, removing some limitations on the companies that could merge with or invest in utilities and opening the sector to new investment. The repeal of PUHCA 1935 has raised concerns about whether the remaining laws and regulations strike an appropriate balance between encouraging investment in the utility sector and protecting consumers.

PUHCA 1935 was a response to the rapid expansion, consolidation, and subsequent bankruptcies in the utility sector during the early part of the 20th century. Prior to its enactment, utilities were regulated by state commissions. As utilities grew, they began to span across multiple states that often had different rules and jurisdictional authority, making it difficult for state utility commissions to effectively regulate them. 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. Since the rates utility customers pay generally include the cost of all the goods and services bought to serve them, some transactions between these affiliates allowed the utilities to take advantage of economies of scale to the benefit of 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, affiliate transactions that were priced unfairly could inflate customers' rates to subsidize operations outside the utility—called cross-subsidization. Compounding this complex web of corporate ownership and affiliate transactions, poor disclosure of financial information and limited access to financial records made it difficult for investors to accurately assess the utilities' financial health. 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.

To restore public confidence after the Depression, the federal government undertook three efforts that influenced the regulation of utilities. First, to protect investors, including utility investors, the federal government created the Securities and Exchange Commission (SEC) in 1934. SEC established rules—including improved financial reporting—for the financial markets and publicly traded companies participating in those markets, as well as a means to regulate them. 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, and empowered the Federal Energy Regulatory Commission (FERC) to serve as the primary federal regulator of utilities.[1] As such, FERC became 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. 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." As part of that process, FERC has determined which costs, including affiliate transaction costs, may be lawfully included in rates. Third, the federal government enacted PUHCA 1935 to regulate investment in the utility industry and protect investors and consumers from potential abuses such as cross-subsidization by holding companies. SEC was responsible for administering PUHCA, including reviewing mergers or acquisitions involving holding companies. To that end, SEC was given primary

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

responsibility for examining and determining how to allocate affiliate transaction costs for holding companies it regulates. Among other things, PUHCA limited 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. Over time, other statutory and regulatory changes reduced some of the strict limitations PUHCA 1935 initially imposed.

Over the past two decades, some interested parties in the utility industry sought repeal of PUHCA 1935, arguing that it was a roadblock to the private investment that could reduce the cost of improvements to the utility infrastructure, and noting that several federal antitrust laws that apply to utility companies have been passed since PUHCA was enacted. Opponents of PUHCA 1935's repeal, including some business and consumer representatives, expressed concern that its repeal would encourage utilities to return to the kinds of risky business ventures that spawned it, and that utilities would again become too complex to effectively regulate, potentially raising prices for consumers. Business groups outside the utility industry were also concerned that utilities could use their monopolies to cross-subsidize investments into other kinds of businesses and harm competition in those industries.

In 2005, EPAct repealed PUHCA 1935—thereby opening the sector to new investment—and replaced it with PUHCA 2005. The repeal of EPAct 1935 eliminated SEC's oversight role in regulating utility holding companies or preventing cross-subsidies, giving FERC new authorities to regulate corporate structures and transactions.[2] FERC's expanded authorities fall into two broad areas: 1) FERC was required to ensure at the point of the merger review that the proposed merger would not result in harmful cross-subsidization, and 2) FERC became the principal federal agency responsible for determining how costs for affiliate transactions should be allocated for all utility holding companies. 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, and granted state utility commissions

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

similar access. Furthermore, EPAct expanded FERC's civil penalty authority to help it enforce its new requirements, providing the commission the ability to levy penalties of up to $1 million per day per violation. After EPAct, states continue to play key roles overseeing utilities and reviewing mergers, including conducting some audits of affiliate transactions.

My testimony today will focus on our February 2008 report, *Utility Oversight: Recent Changes in Law Call for Improved Vigilance by FERC* (GAO-08-289), which examined: (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. For that report, we reviewed relevant reports and data, interviewed key officials, visited four states—California, New Jersey, Oregon, and Wisconsin—that had or were considering implementing strong protections for overseeing holding and related affiliate companies, and surveyed state utility regulators in all 50 states and the District of Columbia. We performed 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.

In summary, we 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 unapproved cross-subsidization. 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 noncompliance. 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 of the 36 holding companies it regulates in 2008. In planning these compliance audits, FERC officials told us that they do not formally consider companies' risk for noncompliance—a factor that financial auditors and other experts told us is an important consideration in allocating audit resources—relying instead on informal discussions between senior FERC managers and staff. Moreover, we found that FERC's audit reporting approach results in audit reports that often lack a clear description of the audit objectives, scope, methodology, and findings—inhibiting their use to stakeholders.

- Although states' views varied on their current regulatory capacities to review utility mergers and acquisitions and oversee affiliate transactions, many states reported a need for additional resources, such as staff and funding, to respond to changes in oversight after the repeal of PUHCA 1935. All but a few states have merger approval authority, but many states expressed concern about their ability to regulate the resulting companies after merger approval. In recent years, two state commissions denied mergers, in part because of these concerns. Most states also have some type of authority to approve, review, and audit affiliate transactions, but many states review or audit only a small percentage of the transactions, with 28 of the 49 reporting states auditing 1 percent or less over the last five years. In addition, although almost all states reported that they had access to financial books and records from utilities to review affiliate transactions, many states reported they do not have such direct access to the books and records of holding companies or their affiliated companies. While EPAct provides state regulators the ability to obtain such information, some states expressed concern that this access could require them to be extremely specific in identifying needed information, thus potentially limiting their audit access. Finally, 22 of the 50 states that responded to our survey question about resources said that they need additional staffing or funding, or both, to respond to changes that resulted from EPAct, and 8 states have proposed or actually increased staffing since EPAct was enacted.

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

In February 2008, we reported that FERC had made few substantive changes to either its merger and acquisition 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. Specifically:

Reviewing mergers and acquisitions. FERC's merger and acquisition review relies primarily on company disclosures and commitments not to cross-subsidize. 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. 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. FERC also requires company officials to attest that they will not engage in unapproved cross-subsidies in the future. This information becomes part of a public record that stakeholders or other interested parties, such as state regulators, consumer advocates, or others may review and comment on, and FERC may hold a public hearing on the merger. FERC officials told us that they evaluate the information in the public record for the application and do not collect evidence or conduct separate analyses of a proposed merger. On the basis of this information, FERC officials told us that they determine which, if any, existing or planned cross-subsidies to allow, then include this information in detail in the final merger or acquisition order. Between the time EPAct was enacted in 2005 and July 10, 2007—when FERC provided detailed information to us—FERC had reviewed or was in the process of reviewing 15 mergers, acquisitions, or sales of assets. FERC had approved 12 mergers, although it approved three of these with conditions––for example, requiring the merging parties to provide further evidence of provisions to protect customers. Of the remaining three applications, one application was withdrawn by the merging parties prior to FERC's decision and the other two were still pending.

Postmerger oversight. FERC's postmerger oversight relies on its existing enforcement mechanisms—primarily self-reporting and a limited number of compliance audits.[3] FERC indicates that it places great importance on self-reporting because it believes companies can actively police their own behavior through internal and external audits, and that the companies are in the best position to detect and correct both inadvertent and intentional noncompliance. FERC officials told us that they expect companies to become more vigilant in monitoring their behavior because FERC can now levy much larger fines—up to $1 million per day per violation—and that a violating company's actions in following this self-reporting policy, along with the seriousness of a potential violation, help inform FERC's decision on the appropriate penalty.[4] Key stakeholders have raised concerns that internal company audits tend to focus on areas of highest risk to the company profits and, as a result, may not focus specifically on affiliate transactions. One company official noted that the threat of large fines may "chill" companies' willingness to self-report violations. Between the enactment of EPAct—when Congress formally highlighted its concern about cross-subsidization—and our February 2008 report, no companies had self-reported any of these types of violations. To augment self-reporting, FERC plans to conduct a limited number of compliance audits of holding companies each year, although at the time of our February 2008 report, it had not completed any audits to detect whether cross-subsidization is occurring. In 2008, FERC's plans to audit 3 of the 36 companies it regulates—Exelon Corporation, Allegheny, Inc., and the Southern Company. If this rate continues, it would take FERC 12 years to audit each of these companies once, although FERC officials noted that they plan audits one year at a time and that the number of audits may change in future years.

[3]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.

[4]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.

We found that FERC does not use a formal risk-based approach to plan its compliance audits—a factor that financial auditors and other experts told us is an important consideration in allocating audit resources. Instead, FERC officials plan audits based on informal discussions between FERC's Office of Enforcement, including its Division of Audits, and relevant FERC offices with related expertise. To obtain a more complete picture of risk, FERC could more actively monitor company-specific data—something it currently does not do. In addition, we found that FERC's postmerger audit reports on affiliate transactions often lack clear information—that they may not always fully reflect key elements such as objectives, scope, methodology, and the specific audit findings, and sometimes lacked key information, such as the type, number, and value of affiliate transactions at the company involved, the percentage of all affiliate transactions tested, and the test results. Without this information, these audit reports are of limited use in assessing the risk that affiliate transactions pose for utility customers, shareholders, bondholders, and other stakeholders.

In our February 2008 report, we recommended that the Chairman of the Federal Energy Regulatory Commission (FERC) develop a comprehensive, risk-based approach to planning audits of affiliate transactions to better target FERC's audit resources to highest priority needs. Specifically, we recommended that FERC monitor the financial condition of utilities, as some state regulators have found useful, by leveraging analyses done by the financial market and developing a standard set of performance indicators. In addition, we recommended that FERC develop a better means of collaborating with state regulators to leverage audit resources states have already applied to enforcement efforts and to capitalize on state regulators' unique knowledge. We also recommended that FERC develop an audit reporting approach to clearly identify the objectives, scope and methodology, and the specific findings of the audit to improve public confidence in FERC's enforcement functions and the usefulness of its audit reports. The Chairman strongly disagreed with our overall findings and the need for our recommendations; nonetheless, we maintain that implementing our recommendations would enhance the effectiveness of FERC's oversight.

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. The survey we conducted for our February 2008 report highlighted the following concerns:

- *Almost all states have merger approval authority, but many states expressed concern about their ability to regulate the resulting companies.* All but 3 states[5] (out of 50 responses) have authority to review and either approve or disapprove mergers, but their authorities varied. For example, one state could only disapprove a merger and, as such, allows a merger by taking no action to disapprove it. 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, the difficulty of regulating merged companies has been cited by two state commissions—one in Montana and one in Oregon—that denied proposed mergers in their states. For example, a state commission official in Montana told us the commission denied a FERC-approved merger in July 2007 that involved a Montana regulated utility, whose headquarters was in South Dakota, which would have been bought by an Australian holding company.

- *Most states have authorities over affiliate transactions, but many states report auditing few transactions.* Nationally, 49 states noted they have some type of affiliate transaction authority, and while some states reported that they require periodic, specialized audits of affiliate transactions, 28 of the 49 reporting states reported auditing 1 percent or fewer over the last five years. Audit authorities vary from prohibitions against certain types of transactions to less restrictive requirements such as allowance of a transaction without prior review, but authority to disallow the transaction at a later time if it was deemed inappropriate. Only 3 states reported that affiliate transactions always needed prior commission approval. One attorney in a state utility commission noted that holding company and affiliate transactions can be very complex and time-consuming to review, and had concerns about having enough resources to do this.

- *Some states report not having access to holding company books and records.* Although almost all states report they have access to financial books and records from utilities to review affiliate transactions, many states reported they do not have such direct access to the books and records of holding companies or their affiliated companies. While EPAct provides state regulators the ability to obtain such information, some states expressed concern that this access could require them to be extremely specific in identifying needed information, which may be

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

difficult. Lack of direct access, 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. All of the 49 states that responded to this survey question noted that they require utilities to provide financial reports, and 8 of these states require reports that also include the holding company or both the holding company and the affiliated companies.

- *States foresee needing additional resources to respond to the changes from EPAct.* Specifically, 22 of the 50 states that responded to our survey said that they need additional staffing or funding, or both, to respond to the changes that resulted from EPAct. Further, 6 out of 30 states raised staffing as a key challenge in overseeing utilities since the passage of EPAct, and 8 states have proposed or actually increased staffing.

In conclusion, the repeal of PUHCA 1935 opened the door for needed investment in the utility industry; however, it comes at the potential cost of complicating regulation of the industry. Further, the introduction of new types of investors and different corporate combinations—including the ownership of utilities by complex international companies, equity firms, or other investors with different incentives than providing 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. In light of these changes, we believe FERC should err on the side of a "vigilance first" approach to preventing potential cross-subsidization. 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. Without a risk-based approach to guide its audit planning—the active portion of its postmerger oversight––FERC may be missing opportunities to demonstrate its commitment to ensuring that companies are not engaged in cross-subsidization at the expense of consumers and may not be using its audit resources in the most efficient and effective manner. Without reassessing its merger review and postmerger oversight, FERC may 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. In addition, the lack of clear information in audit reports not only limits their value to stakeholders, but may undermine regulated companies' efforts 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 their self-reporting. We continue to encourage the FERC Chairman to consider our recommendations.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

GAO Contact and Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. For further information about this testimony, please contact Mark Gaffigan at (202) 512-3841 or at gaffiganm@gao.gov. Individuals who contributed to this statement include Dan Haas, Randy Jones, Jon Ludwigson, Alison O'Neill, Anthony Padilla, and Barbara Timmerman.

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