

United States Senate
Committee on Energy
Committee on Energy and Natural Resources

Testimony of Vincent P. Duane, Vice President & General Counsel
PJM Interconnection, L.L.C.

“Impacts of Potential Financial Markets Reform Legislation
on Organized Wholesale Electricity Markets”

March 9, 2010

My name is Vincent Duane and I serve as the Vice President and General Counsel for PJM Interconnection, L.L.C. (“PJM”). PJM is a FERC-regulated Regional Transmission Organization (“RTO”) responsible for ensuring the reliable and non-discriminatory planning and operation of the transmission grid and the fair and efficient administration of wholesale electric markets. PJM serves 51 million people in an area that includes all or parts of New Jersey, Pennsylvania, Delaware, Maryland, the District of Columbia, Virginia, North Carolina, West Virginia, Kentucky, Ohio, Michigan, Indiana, Illinois and Tennessee – an area representing approximately 19 percent of the nation’s Gross Domestic Product.

Thank you Chairman Bingaman and the Committee for inviting PJM to address this important subject. We recognize this Committee’s key role in considering the impact of proposals to effect regulatory reform of our nation’s financial markets.

Our country’s financial markets are both varied and complex. And while the innovation and evolving sophistication of our financial institutions should be encouraged generally in order to manage risk, spur investment and realize efficiencies, the need for increased supervision over the trading of certain products in certain environments can no longer be doubted. However, let’s keep our “eye on the ball” by recalling why and where we need regulatory reform

Consider those products related to the purchase, sale and transmission of electricity which are undertaken in fully transparent environments administered by the

nation's Regional Transmission Organizations ("RTOs") and Independent System Operators ("ISOs"). The transacting of these products in these environments should *not* be seen as warranting either a new regulator or a new regulatory construct. This is so, quite simply because the RTO/ISO products and their environments are *already* subject to comprehensive and proactive regulation by the Federal Energy Regulatory Commission ("FERC").

With Congress' help, much important work needs to be done by the Commodity Futures Trading Commission ("CFTC") to increase oversight and control and restore to a sounder footing the trading of certain financial products, such as swaps, in certain environments, such as over-the-counter platforms. But to direct the CFTC through the passage of new legislation or enable the CFTC, under an expansive interpretation of the existing Commodity Exchange Act, to assert regulatory jurisdiction in an area already fully occupied by the FERC is wasteful and an unwelcome distraction from the important job of the day: reforming the oversight of those products and trading environments that are unduly opaque and presently are lightly or inadequately supervised.

Although I am testifying solely on behalf of PJM, several of the other RTO/ISOs, including the California ISO (operating in California), the Southwest Power Pool (operating in all or parts of the states of Kansas, Nebraska, Arkansas, Missouri, Oklahoma, New Mexico, Texas, and Louisiana), ERCOT (operating in the state of Texas) and the Midwest ISO (operating in 13 states in the Midwest) have authorized PJM to represent their concurrence in the attached statement reflecting sentiments and concerns similar to those stated in my testimony on behalf of PJM. *See Attachment A, "Joint Statement of Identified RTOs/ISOs"*.

1. What Is PJM?

PJM is a FERC-regulated RTO responsible for ensuring the reliable and non-discriminatory planning and operation of the transmission grid and the fair and efficient administration of wholesale electric markets. The PJM region incorporates 56,000 miles of transmission lines, 1,250 generating plants and 6,000 substations. PJM has 250 intertie points with adjacent systems in the Eastern Interconnection, which means that

along with managing the PJM system, our operators manage the interface between PJM and seven adjacent electric systems.

2. Overview of this Testimony.

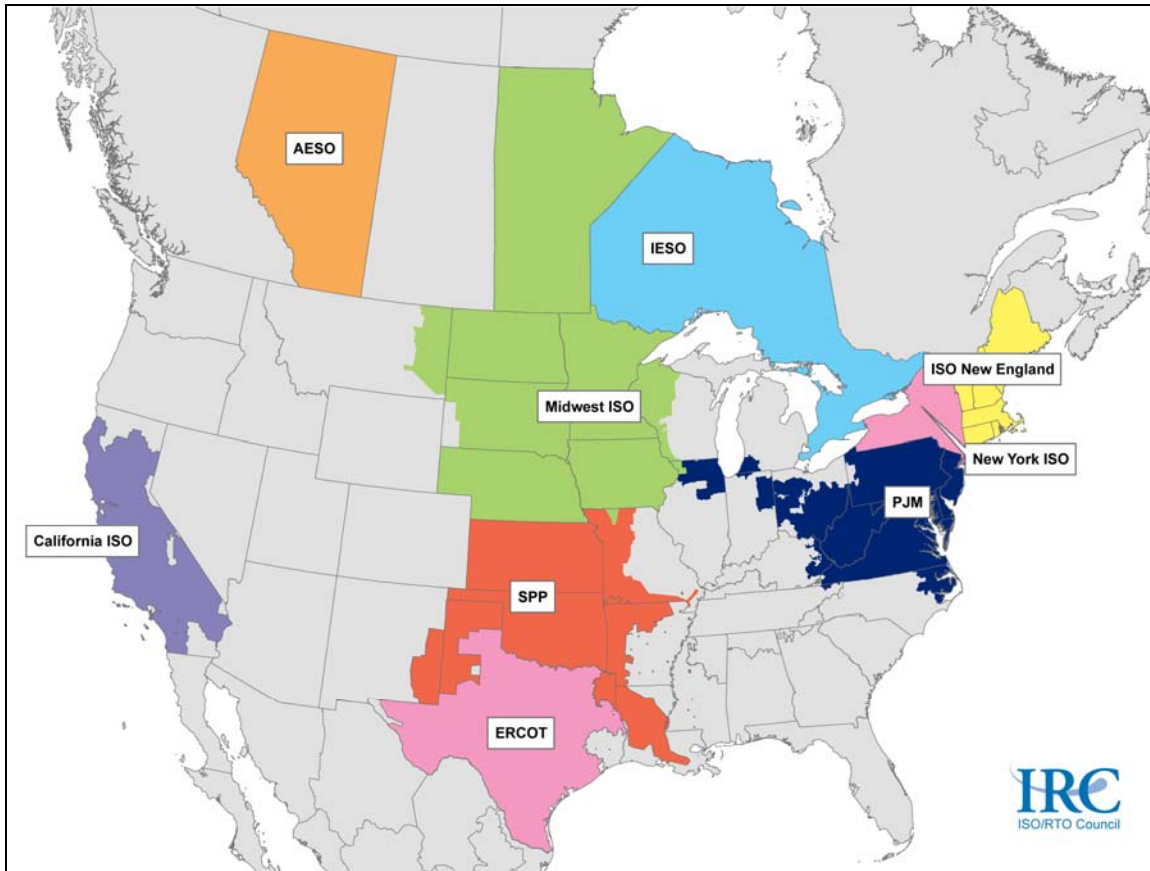
My testimony today will address the following areas:

- An overview of the extensive involvement of FERC in both the creation and oversight of RTO/ISOs;
- A description of certain RTO/ISO forward markets which some contend are subject to oversight by the CFTC;
- The extensive regulation of these RTO/ISO forward markets by FERC and the Congress' authorization of these markets under FERC jurisdiction;
- The incongruity of CFTC regulation if applied to direct how RTOs/ISOs establish their products or perform their services and the problems that would arise from inconsistent, or worse, conflicting regulation should the CFTC seek to apply existing Commodity Exchange Act provisions to these products or functions; and
- A potential legislative path forward that symmetrically defines the exclusive functions belonging to each agency and similarly defines those areas where shared interests and jurisdiction are implicated and thus where inter-agency coordination is warranted.

3. An Overview of FERC Regulation of RTO/ISOs.

PJM is one of seven RTO/ISOs in the United States. Together these entities serve over two-thirds of the nation. The map below depicts the respective operational areas for each of the RTOs.

Regional Electricity Markets



The 9 ISO/RTOs in North America serve two-thirds of electricity consumers in the United States and half of Canada's population.

Source: ISO/RTO Council

RTO/ISOs are a creature of FERC regulation and Congressional pronouncements. These independent electricity grid operators were established to fulfill Congressional policy by introducing competitive forces to liberalize the traditional monopolistic utility industry. The restructuring of the industry began with the Public Utility Regulatory Policies Act of 1978, which introduced nascent competition to the supply (generation) side of the industry. This legislation was followed by a succession of laws, including the Energy Policy Act of 1992, which began efforts to unlock the bulk delivery (transmission) side of the industry. From these beginnings emanated FERC's landmark Orders No. 888 and No. 2000 in 1996 and 1999 respectively. These orders demonstrate FERC's commitment to independent, "open access" operation of the power

grid (not dissimilar from how air traffic controllers operate independently from individual airlines). FERC determined that RTO/ISOs were the best means to effectuate the open access provisions of the Energy Policy Act of 1992. While neither Congress nor FERC has ever compelled transmission owners to cede control over their transmission systems to independent operators, this Committee and Congress affirmatively encouraged this action by instructing FERC, through section 219(c) of the Energy Policy Act of 2005, to offer rate incentives to transmission owners that joined such organizations.¹

This history of Congressional and FERC action introducing competitive forces to the utility industry is sometimes referred to as “deregulation.” But as was often noted by former FERC Chairman Joseph Kelliher, this terminology, particularly when applied to describe the functions of RTO/ISOs, is entirely misleading. In point of fact, FERC’s regulation of RTO/ISOs is pervasive. Moreover, unlike market regulators (such as the Securities and Exchange Commission and the CFTC) whose functions are probably best described as oversight based upon required disclosure, FERC is a traditional “rate regulator” with a mandate grounded in the Federal Power Act of 1935. What distinguishes FERC from those agencies overseeing the financial and commodity markets is its obligation to ensure that prices in wholesale electricity markets, *and* the terms and conditions of the various products and services used to establish prices in these markets, are “just and reasonable.”

Each of the many functions performed by RTOs/ISOs as grid operators and market administrators is measured against this standard. Unlike clearinghouses, exchanges, boards of trade and the like, RTOs and ISOs cannot establish unilaterally their rules of operation provided only that those rules conform to broadly stated principles or best practices. Instead, RTOs/ISOs are subject to a FERC-administered program comprehensively regulating their planning of the transmission grid, their dispatch of generation operation of the grid, their compliance with reliability standards and their administration of the markets they operate. As a consequence, every material

¹ As the majority of the Texas grid is wholly intrastate and not interconnected with the rest of the Eastern Interconnection, the Electric Reliability Council of Texas (ERCOT) operates as an ISO in the state of Texas. Other than for regulation of ERCOT’s compliance with national reliability standards, ERCOT is subject to the regulation of the Public Utility Commission of Texas rather than the FERC.

action taken by an RTO/ISO in performing these functions must be authorized by a rule. Every rule must be embodied in a tariff, which is designed through an open process with active participation by the customers subject to these rules. And every tariff provision must be filed with and adjudicated by the FERC to meet the requirements of the Federal Power Act.²

Moreover, RTOs/ISOs' administration of markets cannot be separated from their operation of the grid. Rather, RTOs/ISOs rely on the markets they operate as tools to more efficiently dispatch generation, manage congestion on the grid and ensure that electricity procured through the RTO and ISO spot markets is provided at the least cost to wholesale customers. RTOs/ISOs operate according to the principle that competitive forces employed in transparent market environments provide price signals that incentivize behavior consistent with the reliable day-to-day operation of grid.

4. Financial Transmission Rights in RTOs/ISOs.

(a) What is An FTR?

I have spoken thus far of “products” and “environments.” The RTO/ISO environments offer a product known as a “financial transmission right” or FTR to ensure “firm” transmission for electric transmission customers. Because this product is integral to the functioning of RTO/ISO markets, it has been in existence in PJM more or less since the inception of our markets. Despite successful operation of the FTR product, under FERC regulation, for more than 10 years in PJM, this product has recently drawn renewed attention from the CFTC.³

The FTR is a forward right or obligation with some attributes seen in swap contracts and other attributes seen in futures contracts.⁴ But several other essential attributes of FTRs are entirely unique so as to strain even the most liberal definition of a swap or futures contract, as those terms are employed, respectively, in the H.R. 3795 and the Commodity Exchange Act. Moreover, as I will explain, the FTR is a necessary

² 16 USC 824d § 205.

³ Certain RTOs and ISOs operate forward capacity markets. These markets have even less of the attributes of a futures product than the FTR referenced herein.

⁴ As noted in the Joint Statement of RTOs/ISOs, Attachment A, other RTOs/ISOs make available similar products to what is known in PJM as a “Financial Transmission Right” or “FTR”. Although the products may have a different name in each RTO or ISO, they all operate essentially the same.

component to the means by which RTOs/ISOs discharge their basic mission in providing open access transmission service and ensuring just and reasonable market outcomes for consumers – a mission whose regulation Congress has squarely entrusted to FERC.

With the establishment by RTOs/ISOs of organized wholesale electricity markets, a system was needed to prioritize equitably firm access to the grid. Transmission customers, typically utilities and competitive suppliers serving retail consumers, pay a priority charge to receive “firm” transmission service. Firm service allows these customers to deliver, with a high degree of certainty, energy from resources located in one place on the grid to meet consumption located in a different place on the grid. Yet the ability of any transmission system to deliver electricity from point A to point B is limited by the physical capability of the system to transfer power within the bounds of the thermal and voltage constraints governing reliable operation of the system.

The electricity markets operated by RTOs/ISOs typically employ a construct known as “locational marginal pricing” or LMP to signal demand for and attract supply of wholesale electricity. This means simply, that the real time price of electricity at point A may differ from the price at point B depending on whether the transmission system can deliver the lowest cost electricity generated by the marginal resource on the system to points A and B. As administered by RTOs/ISOs, LMP reflects the actual cost of delivering electricity from point A to point B in a manner corresponding to the physical flow of electrons on the grid between these two points. As compared to non-RTO/ISO transmission systems, LMP markets allow for a more efficient use of the transmission system by avoiding unnecessary curtailment of service and inaccurate and distorted pricing of transmission service whereby certain customers must subsidize in their rates the service provided to others. The provision of transmission service in LMP markets, however, exposes customers, including firm transmission customers, to price volatility when there is congestion on the grid.

RTOs/ISOs solve this problem by providing firm transmission customers with FTRs. In a nutshell, these financial transmission rights provide the holder a right to deliver power from point A to point B with protection against the risk that prices at point B might be higher than at point A. PJM allocates FTRs principally to utilities that serve

retail customers (including cooperatives, municipal utilities and competitive retail providers in those states with programs to instill competition in retail service). These rights in total reflect the physical capability of the transmission system to deliver electricity; they are finite and their number is determined through analyses conducted by the RTO/ISO. The allocation of these finite rights is made to those transmission customers representing consumers that have paid for the fixed investment in the transmission system and are thus entitled to rights to the electricity transfer capability of this system. The FTR is the means by which RTOs/ISOs in LMP markets assure the provision of “firm transmission,” consistent with FERC’s open access directives, such that these customers are protected against the price volatility associated with multiple transactions occurring through constrained parts of the grid.⁵

As I hope is apparent, the FTR is inextricably linked to both the locational priced energy markets and the provision of firm transmission service by RTOs/ISOs. It is also closely linked to the transmission system planning processes – the means by which the grid is expanded to meet growing need - another set of RTO/ISO functions subject to extensive FERC regulation. In theory, a transmission system could be built to accommodate all desired delivery transactions without congestion – which is to say, without a price difference between points A and B. In this system, FTRs would be unnecessary. In fact, some might comment that the role of the RTO/ISO should be to design, build and operate a transmission system so robust as to eliminate FTRs.⁶ And while it is true that RTO/ISOs look for opportunities on their systems to eliminate points of chronic congestion by expanding transfer capability and thereby reducing the need for FTRs, in reality all transmission planners must strike a balance between the costs and societal tolerance for massive transmission infrastructure versus the costs of congestion.

(b) FERC and Congress’ Historic Oversight of FTRs.

⁵ Pennsylvania-New Jersey-Maryland Interconnection, 81 FERC ¶ 61,257 at ¶ 62,240-241 (1997).

⁶ In this respect, an RTO/ISO and its FTR product is quite distinct from financial institutions and the derivative instruments they design and market. While a financial institution is seeking to expand the market for the instruments it sells, RTOs/ISOs are continuously examining opportunities to enhance the physical capability of the grid so as to reduce the need for FTRs.

FERC Oversight – The FTR is rooted deeply both in FERC regulation as well as in actions of this Committee and the Congress as a whole. For instance, virtually from the inception of PJM’s markets, FERC directed the creation of FTRs as a means to allocate to transmission customers equitable access to the transmission grid. In PJM, the FTR product was approved by the FERC more than a decade ago upon the creation of PJM’s organized markets in 1997. In Pennsylvania-New Jersey-Maryland Interconnection, 81 FERC ¶ 61,257 (1997), FERC found that FTRs “provide an effective method of protecting against incurrence of congestion costs when suppliers engage in transactions that use their firm transmission service reservations.” Id. ¶¶ 62,257, 62,260. FERC also concluded that PJM’s “allocation of FTRs” to transmission providers “to meet native load requirements (i.e. the customers for whom the transmission grid was planned and constructed in the first instance)” was appropriate. Id. ¶ 62,260.

In connection with these approvals, the Commission further found that there needed to be “a process for auctioning FTRs beyond those retained by . . . transmission customers.” Id. ¶ 62,260. Accordingly, in 1999, and after considerable scrutiny, FERC accepted PJM’s design of an FTR auction process that would both (i) provide an efficient means to distribute excess FTRs, and (ii) allow FTR holders the choice to sell those FTRs which they had been allocated and buy FTRs on different pathways that might more effectively hedge their power supply procurements. PJM Interconnection, L.L.C., 87 FERC ¶ 61,054 (1999).

Congress Has Directed FERC In Regulating FTRs – Congress’ recognition of FTRs in organized wholesale electricity markets and its involvement in directing FERC in its regulation of this product is most evident from Section 217 of the Energy Policy Act of 2005 (the “native load” provision). Through Section 217, Congress directed FERC to:

exercise the authority of the Commission under this Act in a manner that . . . enables load-serving entities to secure firm transmission rights (or equivalent tradable or financial transmission rights) on a long term basis for long term power supply arrangements made, or planned, to meet such needs.

This direction to FERC (as well as Congress’ choice of FERC as the implementing agency) shows Congress’ intent to treat FTRs as tools available to load serving entities to meet their power supply needs rather than as another type of

derivative instrument to be regulated separately and, perhaps, inconsistently, by the CFTC, which would claim no expertise or experience regulating the interstate transmission of wholesale electricity.

Congress further underscored the inextricable link of these rights to the underlying physical delivery of power to customers by creating, in Section 217(b) (2), an actual entitlement for load serving entities:

to use the firm transmission rights, or equivalent tradable or financial transmission rights, in order to deliver the output or purchased energy, or the output of other generating facilities or purchased energy to the extent deliverable using the rights, to the extent required to meet the service obligation of the load serving entity.

Congress addressed how such rights are to be transferred by stating in section 217(b) (3) (A) and (B) that:

(A) To the extent that all or a portion of the service obligation covered by the firm transmission rights or equivalent tradable or financial transmission rights is transferred to another load-serving entity, the successor load-serving entity shall be entitled to use the firm transmission rights or equivalent tradable or financial transmission rights associated with the transferred service obligation.

(B) Subsequent transfers to another load-serving entity, or back to the original load-serving entity, shall be entitled to the same rights.

Congress also addressed the disposition of any excess rights not needed to meet an entity's load serving obligation by providing clear authority to FERC to address their disposition:

CERTAIN TRANSMISSION RIGHTS – The Commission may exercise authority under this Act to make transmission rights not used to meet an obligation covered by subsection (b) available to other entities in a manner determined by the Commission to be just, reasonable and not unduly discriminatory or preferential.

Finally, Congress directed FERC to undertake a rulemaking to implement portions of Section 217, a rulemaking that led first to FERC Order No. 681, a 250-page final rule on long term FTRs, followed by FERC Order No. 681-A, a subsequent rehearing Order on the subject, and, finally, compliance filings by the RTO/ISOs.

In summary, through Section 217, Congress stated its intention that FERC regulate FTRs comprehensively, including their formation, initial allocation, and transfer among various entities, as well as the trading of any excess FTR rights available. PJM believes that Section 217 makes clear that the Congress intended for the FERC to act over FTRs because of their inextricable link to the underlying transmission grid and electricity market structure. The plain language of Section 217 indicates, in our opinion, Congress' desire that the FERC's regulation should be pervasive in this area, guided by its expertise in transmission regulation.

As a result, PJM believes clarification is sorely needed given the uncertainties introduced as a result of the potential for an expansive reading of the existing Commodity Exchange Act or potentially from new financial reform legislation to introduce overlapping regulation by two separate agencies.

5. The Problem Of Competing FERC and CFTC Jurisdiction.

As mentioned at the outset of my testimony, the wisdom in holding today's hearing is that it offers an opportunity to confirm whether we are keeping our "eye on the ball" as we develop needed financial market reform regulation. Aside from reasons of inter-agency comity, inefficient duplicative regulation, and distraction, there are immediate and practical reasons to delineate clearly in statute the respective regulatory responsibilities of FERC and the CFTC when it comes to RTO/ISO products and environments.

The notion of dual or overlapping jurisdiction in this area is challenged by the exclusivity of jurisdiction afforded to the CFTC through the Commodity Exchange Act and reinforced through proposed reform legislation. For instance, the existing Commodity Exchange Act states that where a contract falls under provisions of the Commodity Exchange Act, it is subject to the "*exclusive jurisdiction*" of the CFTC. See CEA § 2(a)(1)(A), 7 U.S.C. § 2(a)(1)(A). This grant of exclusive authority raises at least

the potential that FERC could be divested of any jurisdiction over the FTR and any market settlement functions involving FTRs that the CFTC might regard as “clearing.” Yet, as I trust is evident from this testimony, the FTR does not stand in isolation from other market, grid operation and grid planning functions performed by RTOs/ISOs and that are regulated comprehensively by FERC. The FTR is not merely decorative to the architecture of RTO/ISO programs; it plays an integral role in the basic design of these programs.

At least four concerns are apparent.

First, the “exclusivity” provision of the Commodity Exchange Act could cause the FTR and its transaction and settlement functions being subjected to *less* control under CFTC oversight than they are today under FERC rate regulation. FERC’s regulatory paradigm of tariff filings and agency adjudication is considerably more extensive and intrusive than the market oversight performed by the CFTC. Neither the RTOs/ISOs that administer the transacting and settlement of FTRs nor industry participants in the FTR markets support an outcome that would result in less regulation of this product.

Second, if the FTR is subjected to settlement, clearing and credit risk management principles well suited for many financial instruments, but incongruous to FTRs, the future of the FTR in RTO/ISO markets is quite uncertain. Again, this consequence might not be terribly problematic if the FTR could be regarded as a “nice to have” risk management tool, but hardly indispensable to the needs of wholesale customers in managing their power purchases. As this testimony has tried to show, this is not the case. In fact, the FTR is essential to FERC’s policy of ensuring that transmission customers, in RTO/ISO environments, can obtain firm open access service needed to meet the demands of their retail consumers. The FTR’s importance to this objective is underscored by the attention this Committee paid to the product in the Energy Policy Act of 2005.

Third, while the FTR auction markets attract some non-traditional energy market participants, including financial entities, it would be a mistake to therefore assume that these markets can be “cleared” under the Derivative Clearing Organization “core principles” currently in place under the Commodity Exchange Act.⁷ The FTR is

⁷ CEA § 5b(c)(2), 7 U.S.C. § 7a-1(c)(2).

infrequently priced through pre-scheduled auctions that generally occur once a month. Buyers of FTRs are not in any legal sense matched with sellers. While PJM manages the credit risk exposure presented by holders of some FTR positions, these positions are not “marked-to-market” by PJM and there is no workable method for variation margining. Due to these and other attributes unique to FTRs and despite much exploration, PJM has never found a CFTC-registered clearinghouse, including those active in clearing energy commodity transactions, interested in or able to clear the FTR positions of PJM’s market participants. So, assuming that the practical consequences of CFTC oversight do not eliminate outright the FTR as PJM fears, the alternate scenario is one where the CFTC in bringing its expertise in overseeing market clearing and settlement, spends much time and resource requiring registration and reporting, only to find that no change or “improvement” to how our FTRs are transacted, settled and credit risk managed is achievable in a real or practical sense.

Fourth, instruments traded in a manner or in an environment contrary to the requirements of the Commodity Exchange Act are, in a sense, *ultra vires*, and their enforceability is at risk of challenge.⁸ Somewhat ironically, the CFTC’s renewed interest in the established FTR products, motivated presumably by a desire to reduce perceived systemic risk associated with FTR markets, may be having quite the opposite effect. Should the CFTC claim that the FTR is now jurisdictional under the Commodity Exchange Act, the legal integrity of these products becomes less certain and a risk materializes that a counterparty with outstanding obligations under an FTR might assert that the obligation is void and unenforceable. Injecting this risk into the FTR markets is completely unnecessary and easily avoided by Congress drawing clear jurisdictional bounds that recognize FERC’s settled authority in this area.

6. Complications Raised by the Wall Street Reform and Consumer Protection Act of 2009 (HR 4173) and A Proposed Path Forward

In closing, I would like to address the bill that passed the House of Representatives in December, 2009: the Wall Street Reform and Consumer Protection Act of 2009 (HR 4173) and respectfully offer suggestions for an alternate path forward.

⁸ See, e.g., Transnor (Bermuda), Ltd. v. BP North America Petroleum, 738 F. Supp. 1472, 1990 U.S. Dist. LEXIS 4423, Comm. Fut. L. Rep. (CCH) P24829, 1990-1 Trade Cas. (CCH) P68998 (S.D.N.Y. 1990).

The House Bill acknowledges existing and potential future overlapping jurisdiction between the CFTC and FERC in the area of RTO/ISO markets. It does not, however, seek to resolve this overlap; nor does the proposed legislation offer much by way of guidance to the affected agencies in collaborating to ensure RTOs/ISOs face a workable regulatory environment and one that does not afflict these markets with competing and inconsistent regulatory directive from separate agencies. Rather, the House Bill directs the CFTC and FERC to evolve a memorandum of understanding to resolve conflicting regulation and ensure cooperation and coordination where warranted.

PJM believes legislation can, and should, reserve to FERC exclusive jurisdiction over the existing organized wholesale electricity market architecture administered by RTO/ISOs, which has operated effectively under FERC regulation for more than a decade.⁹ Similarly, new legislation offers the opportunity to reaffirm the CFTC's existing exclusive jurisdiction over exchange and clearinghouse environments and provide that agency expanded authority in over the counter energy markets.

This "bright line" would distinguish clearly RTO/ISO environments from other electricity trading environments and would afford market operators, such as PJM, certainty that the products and services they make available under their FERC-accepted tariffs do not need further registration or approval by the CFTC in order to be fully compliant and legally sound. This clarity at the "front end," which is to say with the establishment and definition of the RTO/ISO's products and services and the rules associated with them, will eliminate the potential of irreconcilable direction as to the same subject matter from different regulators.

⁹ Organized wholesale electricity markets have not operated without flaw since their inception – the notable example being a failure in 2001-02 in the western markets, including the market operated by The California ISO. Importantly, this failure had little or nothing to do with credit risk management or market clearing functions where the CFTC's expertise lies. Rather, the problems at the time in that market are generally accepted to have resulted from (i) inadequate design of the complex rules defining the physical marketplace and (ii) actions by certain market participants to exploit these deficiencies. The CFTC would not profess expertise in this first area. And while its investigatory and enforcement expertise is exemplary, (i) effective enforcement in RTO/ISO markets demands a deep understanding of complexities characterizing the physical electricity market that only the FERC possesses, and (ii) since 2001-02, with passage of the Energy Policy Act of 2005, FERC has been vested with significant additional enforcement authorities and resources. In short, reference to the events in the western markets in 2001-02 is not a compelling basis to support the introduction of CFTC regulation to RTO/ISO markets.

While perhaps desirable in theory, carrying forward this clarity beyond “front end” regulation to further define separate and distinct agency duties when it comes to the investigation and enforcement of fraudulent behavior or market manipulation (having “one cop on the beat”) poses different challenges. Some degree of interrelationship among various trading environments is a reality that must be accepted in designing the optimum regulatory construct. A trading firm can put on a position in one market environment hoping to influence the value of other positions it may hold in a distinct market environment. This behavior is not uncommon and may be perfectly acceptable. But under particular circumstances such trading, coupled with fraudulent behavior and viewed holistically, could be manipulative or otherwise present an undesirable distortion of commodity prices. Where a scheme crosses two or more market environments implicating the respective jurisdictions of distinct regulators, inter-agency cooperation is plainly warranted in order to protect market integrity and consumer welfare. Legislation addressing concurrent FERC and CFTC enforcement jurisdiction should borrow from established principles of comity and cooperation that exist today among banking, securities and commodity regulators. By replicating these principles, legislation can either establish for the CFTC and FERC, or direct the agencies to themselves establish, similar protocols as are in place today between the CFTC and the Securities and Exchange Commission that describe shared duties and provide for more robust cooperation, including information sharing, when dealing with investigation and enforcement matters that cross agency boundaries.¹⁰

Finally, PJM is advocating for a “bright line” that would respect the existing FERC regulation of the current architecture of the electricity markets administered by RTOs/ISOs. While this architecture is regularly built out and redesigned by both FERC and the RTOs/ISOs themselves, legislation could anticipate the potential (which seems remote) for the RTO/ISO to develop in the future a wholly new class of products or programs that would be jurisdictional under the Federal Power Act, but also implicate provisions of the Commodity Exchange Act. The “bright line” we urge to protect the existing architecture of RTO/ISO markets from conflicting directives need not apply after

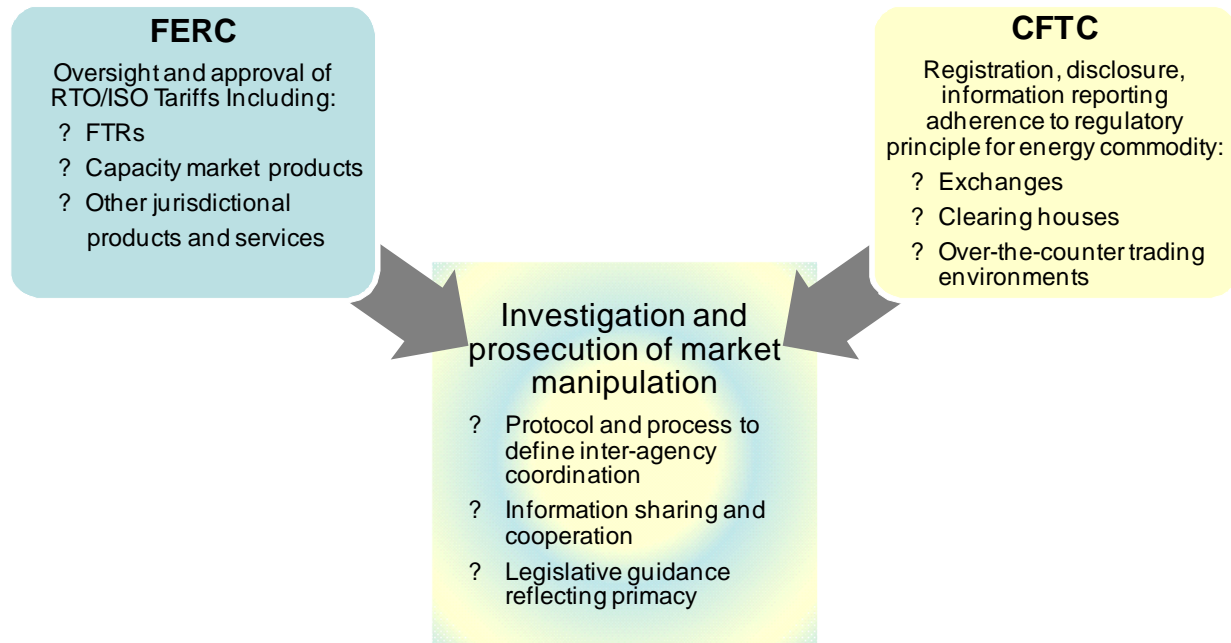
¹⁰ Legislation could offer guidance to the agencies in this area. For instance, Congress could instruct that one enforcement agency defer to the lead of the other in whose jurisdictional area the alleged scheme principally originated.

the effective date of new legislation to wholly new programs – ones that cannot be envisioned today but might possibly evolve in RTO/ISOs at some future date.

The following points and illustration summarize a possible legislative path forward:

- Congress should define the status quo, as of the effective date of new legislation, and plainly state that the *direct* regulation over the products and services provided for by an RTO/ISO under its FERC filed tariff is exclusively the province of FERC.
- Legislation can make equally clear that the *direct* oversight of electricity products (financial swaps, futures contracts, etc) in over-the-counter, exchange or clearinghouse environments is solely the responsibility of the CFTC.
- Legislation can anticipate the possibility that RTOs/ISOs might develop in the future wholly new products or services, that while jurisdictional under the Federal Power Act and therefore offered under FERC-accepted tariffs, still cross into jurisdictional areas for which the CFTC has responsibility. In these cases, directing that the two agencies negotiate a workable sharing of functions could provide a compromise meeting the needs of both agencies.
- Finally, legislation should distinguish between the *direct* regulation, oversight, reporting and rule compliance of market operators, from the important additional responsibility imposed on each agency to investigate and prosecute manipulation and schemes undertaken by market participants that are designed and intended to distort pricing. Given the potential interrelationship among exchange, over-the-counter and RTO/ISO electricity markets, sound public policy warrants a high degree of inter-agency coordination, to allow information sharing and cooperation between the agencies in investigating and prosecuting fraudulent activities that span two or more interrelated market environments.

A “Bright Line” for Direct Regulation/Oversight and Coordination of Enforcement where Schemes Span Across Interrelated Markets



7. Conclusion.

Again, PJM thanks the Committee for the opportunity today to share our thoughts on the potential for FERC and CFTC dual and potentially inconsistent regulation of certain RTO/ISO products essential to load serving entities and thus retail electricity customers. PJM's fellow RTOs/ISOs that have endorsed the statements set forth in Attachment A also appreciate your consideration of their views. We stand ready to offer further assistance as the Committee reviews this important issue.

ATTACHMENT A
JOINT STATEMENT OF CALIFORNIA ISO, ELECTRIC RELIABILITY COUNCIL OF TEXAS (“ERCOT”), MIDWEST ISO, PJM INTERCONNECTION AND THE SOUTHWEST POWER POOL

1. Financial transmission rights (FTRs) are an integral part of the provision of firm transmission service. Although they go by different names in each of the RTOs and ISOs, the products are essentially the same. FTRs are awarded, initially to load serving entities (i.e., providers of electricity to residential, commercial and industrial customers) and others who contribute to the fixed costs of the grid through their payment of transmission rates. These customers have historically shouldered the embedded costs of building and maintaining the transmission system.
2. FTRs are a financial instrument that can be created only by the RTOs/ISOs as their number and composition is determined based upon the transmission system topology and the physics of physical power flows. As such, they differ substantially from standardized, stand-alone derivatives in which parties exchange cash flows based upon price changes tied to a notional quantity of a commodity, but not inextricably tied to the actual delivery of a physical commodity. Moreover, because FTRs are inextricably intertwined with the electricity markets and reliability functions of RTOs and ISOs, it is impractical and inefficient to regulate FTRs separately or differently from the underlying provision of electric transmission service.
3. FTRs have been regulated by the FERC (and in the case of ERCOT, the Public Utility Commission of Texas) since their inception in the PJM market over 10 years ago. In addition, Congress determined in EPACT 2005 that FTRs are integrally tied to meeting the power procurement needs of load serving entities. FERC not only regulates FTRs, but FERC *directed* PJM and other ISOs/RTOs to develop a hedging tool to allow load serving entities to manage congestion risk associated with their longer term power procurements. By the same token, the portion of the Texas grid served by ERCOT is entirely intrastate. As a result, regulation of FTRs in Texas is undertaken by the Public Utility Commission of Texas in a fully integrated manner.
4. Duplicative or conflicting regulation of financial transmission rights is not in the interest of consumers. FERC (and, in the case of ERCOT, the Texas PUC) should be able to maintain their respective roles as the regulators of these products given their pervasive regulation of both ISO/RTO markets and the provision of transmission service by ISOs/RTOs. This regulation comprehensively spans the full span of physical grid operations – from the planning of the transmission grid, to ensuring day to day reliability of the grid, to the dispatch of generation and demand resources to meet consumption in real time. The uncertainty created by the unclear regulation of FTRs under

current law as well as complications created by the provisions of the new legislation should be addressed in the legislation now being considered.

5. Although the RTOs and ISOs do not believe that Congress intended there be two regulators of the FTR product, the RTOs and ISOs do believe that cooperation is needed in areas where activities in a CFTC-regulated market may affect a FERC or Texas PUC- regulated market and vice versa. This is not an area of regulatory overlap, but instead an area where the exercise of the authority of each regulator over their *respective* jurisdictional market should be coordinated and complementary. As a result, cooperation, including data sharing, should be required by this Congress in those areas where FERC's or the Texas PUC's regulation of the RTOs and ISOs has an impact on CFTC's regulation of markets under its jurisdiction and vice versa.