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Federalism and Beyond: The Uncertain Nature of Federal/State Relationships in a Restructuring World

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I. Moderator: Ed Petrini, Christian & Barton, L.L.P.

II. Mark Mathis, Vice President and General Counsel, Bell Atlantic Network Services, Inc.

III. Carrington F. Phillip, Director of State Regulatory Affairs, Cox Communications, Inc.

IV. Ed Brady, Chief Counsel-Regulatory Services, American Electric Power Company

V. Tom Nicholson, Senior Assistant Attorney General, Office of the Attorney General

I. Ed Petrini

Christian & Barton, L.L.P.

{1} Thank you. My name is Ed Petrini of the law firm of Christian Barton. The topic of this last panel of the conference is Federalism and Beyond: the Uncertain Nature of Federal and State Relationships in a Restructuring World.

{2} Federalism in the restructuring context has certainly been controversial and filled with uncertainty -- some would say perilous. Some would say the shifts in jurisdiction between federal and state governments are so serious and of such concern that we should really pause before restructuring the electric industries. Some say we have not done the right thing in the telecommunications industry either. This area is certainly filled with potential for competitors and for lawyers. To help us sort it out, we have four distinguished panelists who are going to identify some of the key state/federal jurisdictional issues in the telecommunications and electric industries - how those issues are being resolved and how they are likely to

be resolved in the future. And because the telecommunications industry is further along than electricity, we are going to start with those panelists first.

{3} First up we have Mark Mathis, group president of the mid-Atlantic states for Bell Atlantic. He has been with Bell Atlantic and its predecessor C&P for more than 20 years. He joined Bell Atlantic as an attorney and worked his way up to positions of increasing responsibility. Mr. Mathis was also a committee staffer in Washington, D.C., and prior to that he was with a law firm in Washington, D.C.

{4} Next we have Cary Phillip, Director of State and Regulatory Affairs for Cox Communications, based in Atlanta. Mr. Phillip was Assistant General Counsel for the California Television Association prior to joining Cox. Prior to that time he served as Assistant Attorney General doing utility work on behalf of the Attorney General of the state of Washington.

{5} Ed Brady is Chief Counsel for Regulatory Services for American Electric Power Service Corporation in Columbus, Ohio. He is responsible for a team of lawyers that represents an American Electric Power (AEP) system of companies for the various federal and state forums. He's been with AEP in various positions of responsibility for more than 20 years. Mr. Brady is a member of the AEP's Task Force on Industry Restructuring. Before joining AEP he was in private practice in Pennsylvania.

{6} Last but not least, we have Tom Nicholson who is currently the Senior Assistant General and Chief of the Insurance Utility Regulatory Section of the Virginia Attorney General's office. He joined the office about a year ago. He is a member of the Electric Committee of the National Association of State Consumer Advocates. Prior to coming to Virginia, Tom was with the Indiana Office of Utility Consumers. He has extensive experience with both the Federal Regulatory Commission, the FCC, and several other federal agencies. He was the Deputy Consumer Counsel for Federal Affairs. Prior to that time he was in private practice in Maine. So with those short introductions I am going to turn it over to Mark.

II. Mark J. Mathis

Vice President and General Counsel, Bell Atlantic Network Services, Inc.

{7} Thank you Ed. Tony Gambredella told me that yesterday Peggy Cummings had some kind things to say about lawyers. I just wanted to say that in my current job as President of Bell Atlantic I stand before you as a recovering lawyer. I also saw yesterday that Dick Blackburn was here. It is not reflected in his biographical material, but Dick started his career with C&P of Virginia, right here in Richmond, and I see that there is hope for us former telephone company lawyers. Someday we can grow up and become electric lawyers.

{8} I know this morning that we are supposed to be here to talk about Federalism, but I understand that yesterday one of the panelists had some strong things to say about protecting markets and doing everything humanly possible to preserve the current situation. When I heard this, frankly I was shocked. I thought he was describing the New York exchange carriers and what they were doing to protect the long distance market -- trying to keep us out. So if anyone wants to talk about that today during questions and answers, I would be happy to do so because we at least think that our friends in the long distance industry are doing everything possible to keep us out of their markets.

{9} Today we want to talk about federal and state relations and because I know many of you are more familiar with electric than you are with telephone, I would like to first, provide a little bit of historical context. In Virginia, I know history is very important and one of my co-panelists went all the way back to the Civil War and the American Revolution. Since the telephone was not invented until after the Civil War, I am going to try to keep it to the 20th century.

{10} You probably know your telephone is now totally deregulated, but the line that comes into your house is used to make both local and long distance calls. The jurisdiction has been divided by Congress between the State Commission, which regulates the rates for local calls, and the FCC, which regulates calls that go between states. The precedent for this structure is the Supreme Court Case of *Smith v. Illinois Bell*, decided in 1930, actually before the famous 1934 Communications Act. What that case said was that when you regulate the rates you cannot just look at the total cost of the line that comes into your house - you have to separate the costs between a portion of it being allocated to the state jurisdiction and a portion being allocated to the interstate jurisdiction-- the state being regulated by the Virginia State Corporation Commission and the interstate part being regulated by the FCC. When the Communications Act of 1934 was enacted, they had some express provisions in there. One was to provide a formal procedure for separating the cost between the states and the FCC. In addition there was a provision of the law, known as Section 2B, which expressly reserved to the states the authority over all intrastate rates, practices, regulations and such.

{11} Let me fast forward to the 1980's. We had a situation where this line coming into your house was sometimes used to make local calls subject to the State Corporation Commission (SCC) jurisdiction, sometimes used to make long distance calls subject to FCC jurisdiction. The costs were allocated between the two jurisdictions and they set the rates to recover those costs. In the case of the FCC it was done through long distance rates, in the case of SCC they have lots of things they set rates for. The SCC set rates for call forwarding, for your basic service, directory assistance and what have you. Until 1984 they even set rates for Princess telephones and things like that. Let me give you an example of the Princess telephone regulatory scheme. By the time it was regulated, a portion of the cost was used for both long distance and local calls, a portion was allocated to the FCC long distance jurisdiction, but there was no interstate rate for the Princess telephone. All the cost of that phone, which was allocated to the interstate jurisdiction, was recovered through long distance rates. So every time you called from Richmond to New York, a portion of that charge was to recover the charge for the Princess telephone. Today, although the telephone itself is no longer regulated, a portion of the cost of the line is recovered through long distance rates.

{12} Now the FCC decided that among the things they needed to do in regulating this competitive market was to set depreciation rates for that line into the house. They traditionally had done this through 3-way meetings and usually the states went along as a result of the 3-way meetings.

{13} But then they decided, because of competition (and this picks up on this morning's discussion) that they needed to have different ways to figure out our depreciation rates. They considered things like remaining life. The life of the plant was going to be much shorter because of technological change, and they wanted to have depreciation rates that conformed to their competition policies. More importantly for purposes of this discussion, they pre-empted the states and said, "Well, you are free to set rates for intrastate service and whatever it's going to be for local service in Richmond, but in figuring out what that rate is going to be in a rate case, you've got to use the depreciation rate we set at the FCC." In doing this they basically said, we want the states to do what we tell them to with respect to depreciation rates.

{14} The Virginia Commission, among others, could not agree with that. They said, "Wait a minute, Section 2B said we had jurisdiction over all intrastate matters," and the appeal went up to the Fourth Circuit and then to the U.S. Supreme Court in a case known as *Louisiana PFC v. FCC*. And in that case the Supreme Court sided with the states. Frankly, the title of my remarks could be called "Confessions of a Reformed Federalist," because in those days we were on the side of the Feds. The Supreme Court told us we were wrong. They told us we were wrong even though, unlike the Federal Power Act and the Natural Gas Act, which has express reservations of state authority over depreciation, there is no such provision in the Communications Act. Because of 2B, the Supreme Court said the state had jurisdiction over all intrastate matters.

{15} Let us fast forward to 1996 when the new Telecommunications Act was passed. Section 2(b) was not changed in any way. But Congress did say we are going to have competition for local service and we are

going to mandate certain ways of doing this; but the states are going to set the rates. And they basically set out 3 ways you can enter the local market. You could be a totally facilities-based competitor -- you could build your own lines, install your own switches and provide service to your customers that way. Or, second, you could resell the telephone company service. If you do, the state commission is going to set a wholesale discount and it is going to be whatever the retail rate is minus the avoided costs. So, for example, we would avoid billing costs, we might avoid marketing costs, and those costs would be used to determine the discount. Then the third way they said you could enter was to require the telephone companies to unbundle their network so you could decide as a new entry into the market to install your own switch and use the telephone company's loops, for example, to provide service. The state commission, again, was given the authority to set those rates. But the standard was different. There, as opposed to the retail standard, the standard was to set the rates at cost. If you wanted the phone company's loop, the cost of the loop is the cost of the switch. And this is a very important distinction in the telephone world because of the way our rates are set -- some rates are set above cost. Call forwarding for example: we charge a rate way above costs on call forwarding because it is a discretionary service. The reason it is set above cost is so we can keep basic service below cost and subsidize those services for rate fares.

{16} I understand some people disagree with me that those rates are below cost, but for these unbundled network elements that a competitor may use, they have to be set at cost, and the competitor has a choice. Do you want to use portions of the network and pay costs or do you just want to resell the phone company service and get a discount from whatever the retail rate is? So, for call forwarding the rate is \$3.50 and the discount in Virginia is 20%. Take 70 cents off and you would be able to get call forwarding at \$2.80 and you would be free to charge whatever you want. On the other hand if you were able to get it for cost it might be pennies. You have to make a choice here.

{17} After the Act was passed, the FCC decided they had 6 months to adopt rules. Even though Section 2(b) was still in place, Section 2(b) gives jurisdiction over rates to the state and the FCC decided that they wanted to promulgate rules that would be binding on the states for setting rates. So, for example, they wanted to prescribe rules for how to calculate resale discount. They wanted to decide "what is an avoidable cost," and they had rules for how to determine the cost for these unbundled networks. Most importantly they decided that they were going to have a way to have even larger discounts than the Telecommunications Act provider. They wanted to require that our competitors be able to take all of these unbundled network elements, have us combine them, and instead of paying a wholesale discount, they would be able to pay rates based upon costs. That is a big difference because if you have something like call forwarding, which is priced way above cost, and you get to get it at cost (as opposed to 20% off the retail rate), that is a big advantage. The states, some of the Bell companies and GTE took the FCC to court. It went to the 8th Circuit, and they agreed with the states. They said the FCC cannot set rules for pricing. They cannot require that we provide to our competitors the combined network elements, totally eviscerating the requirement of the resale discount. The court basically said, in Robert Frost's words, "good fences make good neighbors." They said Section 2(b) was a fence that was hog tight, horse high and bull strong. I guess that means it is a very good fence. Now this is currently before the U.S. Supreme Court and we are going to find out whether the FCC is right or the states are right.

{18} Let me talk a little bit about the implications of this. The reason Congress has traditionally given this to the states is because we are talking about local rates. If you look at the differences between Virginia and the other states, in northern Virginia their business customer cannot get flat rate local calling; whereas in Richmond a business customer can get flat rate local calling. In Manhattan a residential customer cannot get flat rate local calling. In New Jersey where you can get flat rate local calling, you cannot call anyone without making a toll call, because they have very small local calling areas. In Washington, on the other hand, they have huge local calling areas. The question is, who is going to be the one to decide how you are going to have local competition. Is it going to be a bunch of people sitting at the FCC trying to make uniform national rules for Montana, Virginia and Texas? Or is it going to be the people who set the retail rates in the first place? The people who are closest to where the competition is actually going to happen?

{19} Now the FCC thinks they can do it better in Washington. They want to sit there and say, for example, that you are going to have a specified number of zones for your local loop rate. But that does not exactly work. The same rule that would apply to Washington, D.C., which is considered a state, has to also apply in Virginia or Illinois. And it just does not work because in the case of Washington, how are we going to divide it? Are you going to have areas like the Rock Creek Park Zone and the White House Zone and that sort of thing? The FCC just is not in any position to do it. By the same token, you have this very different pattern of flat rate local calling versus paying by the call that varies all over the lot, from state to state. That is why Congress, I think, (and we hope the Supreme Court agrees,) fences this off, and gives jurisdiction to the states. Frankly, maybe some of my colleagues may be able to tell you better than I as to how this applies in the electric industry. But at least in the phone industry, while we have had situations where certainly the feds have been the ones who have promulgated. For example, we are going to have competition for telephone sets and we are going to have competition for local service. I do not know whether that was necessary. The Virginia General Assembly had repealed the Utilities Facilities Act before the 1996 Act ever came about. We were going to have competition anyway, but what really is important is that competition is going to work. It's got to be done under the auspices of the people we think are closest to it.

{20} With that I'll turn it over to the next panel member.

III. Carrington F. Phillip

Director of State Regulatory Affairs, Cox Communications, Inc.

{21} Good morning. My name is Carrington Phillip, and I am an attorney who has practiced for about 12 years. One of the things that always amazes me, regardless of the topic, is that whenever I appear with a regional Bell Operating Company, I am always amazed how they manage to get the dig in about the inter-exchange carriers (ICs). Masterful job!

{22} Having grown up in Canada I think I have seen the best and the worst of federalism. Many of you may not be aware that until the mid 70's, Canada was a country without a constitution. It basically operated under the British America Act, , until then Prime Minister Pierre Trudeau went to London, England to repatriate the Constitution of the British America Act into an Amendment becoming Canada's constitution. Before that event, Canada had a system in place where the federal government absolutely, positively ruled the country. This is demonstrated by the fact that you could not have a more perfect monopoly than the Canadian telephone industry. Interestingly enough, subsequent to Canada adopting this constitution, a number of the provinces then began to demand their provincial rights, which amounted to states rights. I have one interesting story I wanted to share which illustrates why we need to have a balance between the states and the federal government in this country.

{23} I remember in the late 70's or early 80's that the Quebec, specifically certain regions of Quebec, insisted that their local telephone company should not use the RJ-11 Modular Jacks, which many of us enjoyed the convenience of. Instead they had to use what the French used. It was a 4-5 pin jack you stuck into the wall. Obviously this might make no sense because the manufacturer argued that the RJ-11 jacks and phones with modular jacks were prevalent throughout all America and even the Caribbean. What this did was set back the development of telephony in the province of Quebec.

{24} Here in the U.S. with the advent of competition in local exchange markets, I think we should bear in mind the lessons which the situation illustrates, and that is that in certain areas it makes sense to have one regulator, the federal government, at least providing some guidance so you have certain uniform standards across the nation. This obviously benefits the development in terms of equipment, having standards and having some expectations for such companies as Cox to enter the various markets. On the other hand, I do not believe that the FCC and the federal government's role should be dominant or exclusive. I agree with my

colleague that in certain situations the state certainly has a better view of what constitutes a fair price within its boundaries and what constitutes reasonable regulation based on the unique nature of the state.

{25} In 1996, with the advent of the Telecommunications Act, I believe Congress, (after many years of listening to lawyers, lobbyists and constituents,) tried to accomplish the job of providing a balanced act that would hail the advent of competition. I think most commentators would agree that it certainly is not the perfect act. The Act as a political document suffers from some flaws. Its vagueness was illustrated particularly in the discussion about whether the FCC or a state commission would have jurisdiction over deciding rates. Roughly a few months after the Act, very few states actually engaged in the process of trying to determine appropriate interconnection terms, conditions and rates. Virginia was no among them. So I believe at that time the FCC, emboldened by the fact that it was not seeing a rush to adjudicate these issues by the various state commissions, decided to step up to the plate.

{26} I recall reading a quotation from former Chairman Reid Hunt that the Act in his opinion would "toss traditional interstate authority into the trash can of history." I think that quotation demonstrates why he is the chairman. But it also indicates that there was a certain thinking at the FCC that it was fully empowered to step forward and develop national standards. However, despite this thinking, what occurred when the FCC issued its first reported order and its interconnection rules, it really did not come out and say that these shall be the rates terms and conditions. What it really established was a set of proxies from which the states could then make determinations within that range for what would be appropriate rates, terms and conditions. I do not believe that many of the states have serious disagreements with that. I would certainly argue that based on the decision of the Virginia Commission, at least with the cost versus interconnection docket, they seem to appreciate the fact that the FCC had gone through the trouble and analysis of coming up with proxies and they applied their skill, expertise and knowledge of the local market to developing rates within that proxy radius. That was the suggestion of Cox. We thought the proxies were certainly adequate and the Commission could pick within that range. Obviously Bell Atlantic and a number of other incumbents disagreed with that and U.S. West, in particular, seemed to have concerns over the way the FCC approached setting up its rules. As a result, we had the appeal to the 8th Circuit, the so-called highway utilities board case. That case basically requested that the 8th Circuit analyze the Act and make a determination whether the states had full jurisdiction to determine rates, terms and conditions for interconnection. I think it is apparent that the 8th Circuit tended to cite the view that the states did have primary jurisdiction; although, that decision, while certainly helping to clarify things, did issue some additional ambiguities which hopefully will be put to rest by defending before the Supreme Court.

{27} The 8th Circuit decision also seems to suggest, in fact it is their conclusion, that despite the states having primary jurisdiction, they need to follow the pricing standards set forth in the Act. So from Cox's perspective, it is neither a victory nor a defeat. I think we are somewhat grateful for the clarification. We can certainly argue that in many instances the states would probably have a little monopoly because of their closeness to the situation

{28} Again from Cox's perspective we have always believed that the balance between the federal and state jurisdictions is paramount. For example, Cox has a number of operating telephone and cable companies in California. And it has always been a great concern to Cox that the laws of California and appeals from the California Public Utilities Commission go directly to the California Supreme Court. That is not necessarily a bad thing. Unfortunately, the California Supreme Court seems to continually be given the utilities cases and really does not have the resources to take on utilities cases. To my knowledge they have not handled utilities cases in 15 years. So ultimately, once the commission makes a decision, that decision is, for all practical purposes, binding unless you can go on the theory of some type of violation of the federal constitution and get it into federal court. But the result of that is that ,in California, the relative disparity between the power of the incumbents and the companies like Cox have given us some pause. We were very comforted by the fact that the Act suggests strongly that in interconnection matters the federal courts have some jurisdiction.

Nevertheless, here in Virginia, Bell Atlantic and Cox were in dispute over the appropriate characterization of service traffic, and we went to the Commission. Cox was successful and Bell Atlantic appealed to the Virginia Supreme Court. I do not mind telling you there were some heated discussions between Cox's local counsel and corporate counsel as to whether the state had jurisdiction in this matter. We concluded that although not crystal clear, we do see a role for the state courts in this action. As it turns out that case has been dismissed. Bell Atlantic has withdrawn the case and it is fortunate that it did not go to the State Supreme Court despite some reservation by some of the incumbents.

{29} Finally, I wanted to conclude by suggesting that we in the telecommunications industry tend to have very strong and striking positions on one side of the issue or other. In my view the real issue is not the fact that the FCC may step up to the plate occasionally and severely overstep its balance. But the real issue is, in the overall scale of things, does the state commission have a strong role in determining the development of policy within its borders? In my view, it does in Virginia. I guess from my perspective I see a lot that is broken. I think that with both the state and the federal government, in the contest that goes back and forth to determine who has primary jurisdiction, there is a healthy balance and this is absolutely critical to the development of the competition. Thank you very much.

IV. Ed Brady

Chief Counsel-Regulatory Services, American Electric Power Company

(OPENING REMARKS WERE LOST FOR THIS SPEAKER DUE TO TECHNICAL DIFFICULTIES.)

{30} First of all federalism is very easy to define. Mr. Phillip talked about Canada. You are talking about the political science of a delegation of political power from a central government to the state government. Obviously, that is not our system. It is also used as a magic term that embraces many, many political ideas and that runs the spectrum. Let me get to what I think are two critical points and these are some of the critical points you will find in my 2000 articles.

{31} First of all, it is used as a codeword for the shifting of power between the federal government and states, and over time it has gone from the states to the federal government. Today, we are at the point in the process where it is going back to the states. This is a critical idea because what you also find is that in our system, our political leadership is elected independently by both levels of government. That means they have to work together and you find that in the federal domain, many of our existing federal legislators come from the states, so there is a residual respect built into our system.

{32} The other thing you will find if you look at these articles, and where we are today, is that there is a pervasive overlap of state and federal government. We can try to define the bright line in the constitutions that speak to specific statutes but the reality is that the federal government today is into everything. Most of those laws are being passed by people who give great lip service to respecting the rules of the states. For example, if you are talking about crime, taxing, spending money, family care, how we should deal with children, etc.-- the sweep is pervasive. Where does all that take us? Well, the idea is that the legal concept of federalism is a very lasting one and has changed dramatically over time. What it depends on is the areas examined and the questionnaires.

{33} I was told that here, some had come from the Civil War, and that many of you do not remember it. But I do. It was a critical time in our history because there were doubts that really involved states rights in a centralized government. Unfortunately, the way it came out was that, as Justice Holmes said: "the true nationhood of the U. S. was forged not in the words of the Constitution but in the blood of the Civil War."

That is a very dramatic statement. You find that problems developed that the states could not handle, and the federal government stepped in. All of this goes to say that the primary area we are interested in is our economy and commerce. Now, of course, Newt Gingrich is saying we have to return the power to the states. President Clinton calls it a contract *on* America. The critical point is that commerce crosses jurisdictions and has evolved. We as Americans are so concerned about our national economy that it is virtually in the hands of the federal government.

{34} Now, we have this conflict that develops (this is an overview, again, from my 2000 articles). You will find out how we make this division of power. Do we just leave it to the courts? Is it done through the political process, or is it done through the attitude of the public? The answer is that it is all of those. That is why it is a great area and a great topic.

{35} Let me talk to you specifically about electric industry restructuring. We are part of the process that is going on all over the world. Public policy favors competition of free markets and government regulation. The issue specifically is how do you make it work in a history like ours-- in that you have essentially two ideas? One, we currently have vertically integrated generating, transmission and distribution companies providing a single product in a franchised area. What we are talking about is restructuring, and undoing that. We would be moving those components of a single service into its pieces: generation, transmission and distribution. We would take the underlying rate, the single rate that consumers look at, and pulling it apart-- taking what we pay now, the bundle rate, and breaking it into discrete pieces.

{36} Let me show you where that becomes more of an issue. I hate to use numbers, but it will give you a good sense of this concept. With American Electric Power Service Corporation (AEP) Virginia, generation and transmission comprise 66% of the company's investment. I can say the same thing for Virginia Power: 65% for generation and transmission. Why is this significant? 15% of their sales are wholesale. The federal government now provides oversight and rate regulation of that 15%, and the Commonwealth of Virginia and North Carolina provide oversight for the other 85%. There is the tension. For AEP in Virginia, we sell a little bit more at wholesale. We have a little more Federal Energy Regulatory Commission (FERC) oversight. But for AEP total, again, 13%, out of the total revenues of the company, are within the federal domain. What is the significance of that?

{37} As I mentioned before, we are an interstate system. We belong to a grid, and our transmission system and power plants provide power all over our seven state service territory. Not only do we have that, but we also have ECOL. This philosophy is that there is a huge break that extends from the Mississippi out to the Atlantic Ocean, all of it interconnected. What is the point of this? Again, these are only discussion points because I don't have the answers.

{38} You find that the business activity of the electric utility industry has evolved greatly since regulation first began in the 1900's. In addition, the character of the business is inescapably multi-state and regional, yet regulation remains local. That is a very significant point, because restructuring means moving generation and transmission to the federal domain. All the rhetoric that we are talking about, the importance of federalism, the idea of state regulation (which I'm not quarreling with), is important, but recognize that what we are talking about is moving those blocks into the marketplace and under the federal idea.

{39} What else comes from that? Clearly restructuring is a political decision. Some of the questions were asked yesterday. I just addressed what Judge Miller posed because that is the question I get all of the time. When our legislators want to know about deregulation, they want to know: are the rates for my residential customers, the voters, going to go down, and can you guarantee it? The answer to that is no we cannot. It is not a matter of looking for a slight percentage. Yesterday we had the idea: either you believe in competition or you do not. The idea of competition is, for all Americans, the hallmark of our society. The question is, how do you inject it into a regulated industry like ours that has grown up with certain protocols and exists and

operates in a certain way. That is why we have all the questions, and that really gets to the next point: the idea of conflicts we are seeing.

{40} Let me identify some of the restructuring issues we are going to have to deal with. I mentioned rates. The idea of no cost subsidization, well, maybe some people think that might be some but the idea is...

(A PORTION OF THIS DISCUSSION WAS LOST DUE TO TECHNICAL DIFFICULTIES)

{41} Restructuring is going on in every state. It is being studied, and talked about. Every state is looking at it. Coincidentally, one of the ideas mentioned earlier today is that if you are a low cost state, you may be thinking about this slightly differently. Presumably, if you look at where all of the major activity is going, it is in the high cost states. What is the idea there? Is it to get the structure of the industry correct, or is it to lower rates? We talked this morning about California and the artificial lowering of rates. What is the end result of that? As many states continue to move forward there is a slowing of the process. Why is that? Because a lot of the issues we are identifying are being talked about and there are no easy answers.

{42} What does all that mean? It means that as you dig into these things, you find out that details matter. We talk about shutting people off in the winter. It is not like getting a busy signal. If you shut someone's home off in the winter, they die. That's a political issue, you cannot jump over that. Let me tell you something else. Virginia moved forward a seven sentence bill. This is a great political document because it provides guidance. It says we do not know what to do, we can give you milestones. It is a great bill, but the details have to be figured out and we are part of the process. That is one of things I bring up because yesterday someone said "you really want the political process to sort this thing out, you have got to have rocks in your head." The answer is no, that is the way we *have* to do it. If we do not do it that way, I do not know how else we can do it. I can assure you, because I have litigated a lot of cases, the courts are not the place for this.

{43} Finally, let me conclude with this: "All politics are local." Tip O'Neal said that, and he is absolutely right. Where does that leave us in terms of this? I have two points. One, competition for electric service is common, it was launched many years ago. We had Virginia Power start the idea of soliciting generation with bidding. They identified it in the early 1980's and it has been ongoing for a period of time. We cannot do it without a federal/state conflict. The question really becomes: when we have that, how do we sort it out? Everybody has to be sensitive to the other party, and what their viewpoints are.

{44} Two, more critically (and this is something I don't want to take any more time with), we keep passing laws without thinking of how we are going to administer them. I think that this is one of the critical ideas that I hope I can leave you with. The important thing is, as part of your recommendation to the General Assembly, you must ask: how is it going to be administered and how is it going to work. Thank you very much.

V. Thomas B. Nicholson

Senior Assistant Attorney General, Office of the Attorney General

{45} Unfortunately I'm the last guy standing between you and lunch or you and the door. I am pleased to be here today. As much of a challenge as it is to be the last speaker of the last panel on the last day, make no mistake, the last thing state and federal legislators, regulators and other policy makers can afford to do is to lose sight of the ramifications of their decisions. The issues involved in restructuring the electric utilities industry should serve as a wake-up call to those of us who are concerned that the interest of the consumer may become lost in the process. For most of this century, electric power has been supplied to consumers by monopoly utilities, whose rates, terms and conditions of service are largely provided by a structure determined by state regulation. Policy makers at the state and federal levels are considering enormous and wide reaching changes to that structure.

{46} You have already heard the views of some of the other panels, such as the evolving role of state regulatory commissions in the transition to competitive markets, federal efforts to restructure the electric utility industry, and lessons we may learn from the natural gas and telecommunications industries. You have heard about new technology infrastructures and business organizations and, of course, the heavily debated issue of stranded costs. At the heart of these issues a recurring theme of cooperative federalism is often heard and discussed. I would like to put that in context. In May 1995, approximately 2 months after the Federal Energy Regulatory Commission (FERC) announced its notice of proposed rule making that was to become Orders 888 and 889, the California Public Utilities Commission issued its proposed policy decision expressing a policy preference of a majority of city commissioners for the restructuring the industry in California. Throughout its rule making and investigation, the California Commission became convinced that the industry's jurisdictional assumptions have "centered on a model of industry that increasingly fails to mirror reality." In this model, vertically integrated utilities were vested by state governments with exclusive service territory. The federal government has asserted jurisdiction over the high voltage transmission grid, pretending that it has become an instrumentality of interstate commerce. They go on to talk about the introduction of non-utility entrance and a greater quest for economy, which has led to increased incidences of wholesale transactions. Ed Brady's slide, for instance, showed a 38% wholesale activity for the Appalachian Power operating subsidiary of American Electric Power (AEP). All of this has created a dependence on the transmission grid, which has been functionally uniting many of the states, certainly in the west. We are talking about extending to Canada and Mexico as well.

{47} Now we have the ambition, of many, that retail competition be offered as a variant to, or substitution for, the traditional arrangement between utilities and end users. As the California commission put it, "this non-exhaustive list of changes, and calls for change, is fraught with promise as well as peril." According to the California Commission, the promise is of greater efficiency and enhanced levels of service and reliability. Former president Fessler, in testifying before the House Subcommittee on Energy and Power, referred to the peril as this: "I would like to speak to the disturbing possibility that the several states and the federal government are possessed of an ability to frustrate and to distort the development of market institutions, and, in the course of that misguided effort, betray the public trust that each of us diligently seeks to advance."

{48} Such a disagreeable outcome is assured if the private sector genius for innovation and reform is paralleled by a public sector penchant for jurisdictional debates and authority disputation. According to the California commission, they were determined to avoid that result and its inevitable invitation to thwart needed reforms with the uncertainty of protracted litigation. Their strategy was, as they put it, to engage their colleagues on the Federal Energy Commission and other state commissions in a process of cooperative federalism. Taking that first step, their proposed policy decision outlined what was referred to as a scheme of shared responsibility in the context of an articulation of our goals on behalf of the California rate payers and industry participants. In those numerous instances where we acknowledge our authority to be inadequate, we direct our jurisdictional utilities to initiate proceedings at the Federal Energy Regulatory Commission, while providing a clear indication of the steps we will take to follow up on any positive response which they may provide.

{49} My views are not necessarily those of the office of the Attorney General, so I don't mean to interject too much controversy here. I must say as a disclaimer, in the words of that great 20th century philosopher Tim the Tool Man Taylor: "I have no opinion." That being said, while I believe the commission was correct in its observation that the emerging model of the industry increasingly fails to mirror reality, the more fundamental issue is whether this new reality will further what I believe to be the purpose of the public utility industry: reliably served electric customers at reasonable prices, consistent with public interests. The goal should be to advance consumer interest through effective competition and effective regulation. The focus of the debate should be the electric consumer, not jurisdiction.

{50} Unfortunately, if our experience following the passage of the Telecommunications Act of 1996 is any

indication, former President Fessler's prognostication may be correct in that we may be headed toward jurisdiction delegates and authority disputation. If that comes to pass in the electric industry, it's going to be an issue that will preoccupy us for a long time. The introduction of new markets, and new market structures, create new challenges to both the states and the federal government to assure that both the new regulatory structures, and the new reality being created for the electric utility industry, are consistent with the public interest and that regulatory overlaps are minimized and gaps are eliminated.

{51} As I mentioned, the current electric utility structure is largely a creature of state regulatory law. We have an exclusive franchise and the courts have recognized that exclusive franchises may be said to operate in restraint of trade or competition in their assigned territory, as a matter of public policy. In accepting a franchise, the incumbent utility impliedly consents to regulation. As we know from the Supreme Court's 1877 decision in the case of *Mont v. Illinois*, , when private property is devoted to public use it is subject to public regulation, because the property is affected with the public interest.

{52} Against this backdrop of state regulatory law, we also have an overlay of federal regulatory law. Most particularly, I am going to confine my comments to the Federal Power Act of 1935. Section 201B of the Act tells us that the Federal Energy Regulatory Commission has jurisdiction over transmission of electric energy in interstate commerce, and over the sale of energy at wholesale in interstate commerce. Based upon an analysis of relevant legislative history, case law and the Federal Power Act, FERC has also determined that it has exclusive jurisdiction over the rates, terms and conditions of unbundled transmission in interstate commerce by a public utility of electric energy to an end user. What is often glossed over is that, with regard to Section 201A, the Federal Power Act makes clear that such federal regulation extends only to those matters which are not subject to regulation by the states. In the words of Bob Dylan, 'the times they are a'changing' and in the case of federal/state jurisdiction perhaps 'the lines they are a'changing'.

{53} We have already heard about the Clinton Administration proposal, and at last count there were about 10 proposals by House and Senate members to restructure the electric utility industry. I am going to confine my remarks to the FERC, and, in that regard, Orders 888 and 889 are obviously the landmark decisions of recent history coming out of that regulatory body. In essence, Orders 888 and 889 require that all utilities that own, control or operate facilities used for transferring electric energy in interstate commerce, have on file open access nondiscriminatory transmission tariffs. They also permit utilities to seek recovery of legitimate, prudent and verifiable stranded costs associated with providing open access under the Federal Power Act and under Section 211 transmission services. Order 888 defines and identifies the need for a rule requiring open access transmission as resulting from the discriminatory conduct of existing monopoly providers of bundled generation and transmission service. The motivation for this conduct is identified specifically According to FERC, incumbent monopolies, with generation assets whose sum costs materially exceed any reasonable price for power from alternative suppliers, will use their ownership of transmission facilities to deny customers access to those lower price generation supply alternatives.

{54} Well, certainly FERC has set the stage for what they perceive to be as their appropriate role in the restructured electric industry. Ed Brady referred to the fact that in somewhat of a countervailing trend, authority seems to be investing the federal government with even greater responsibility over the electric utility industry than they have enjoyed previously. One of the matters they also address in Order 889 is to articulating a set of principles dealing with independent system operators. There are eleven principles, and FERC has explained that these are applicable only to independent system operators (ISOs) that would be control area operators. However, to the extent that an ISO independently controls the operations and planning of transmission facilities, and the scheduling of power transactions for a regional market, it would provide all power suppliers some measure of nondiscriminatory equal access to the transmission systems. An ISO's control of operations would, among other things, produce the potential for manipulation of firm transmission limits through reported transfer capability and other measures which may also restrict the access of consumers to sources of generation supply.

{55}. . . This is a much different focus than what FERC has been talking about. FERC talks about regional markets. Regional markets are certainly important, but when you talk about what is important for Virginia, the legislature has indicated these industry structures are to serve the public interest of Virginians. This puts up a bit of stress or potential strain between states and the federal government. From what I understand that is not too unusual in the Commonwealth, given its history. As I indicated, not only do we have federal guidance being offered in the form of ISOs but we also now have direction from our General Assembly requiring that utilities work together to put together ISOs and renewable portfolio standards (RPSs) that would serve the public interests of the commonwealth.

{56} As a backdrop, the State Corporation Commission has issued an order establishing investigation, and requiring reports and actions related to independent system operators, regional power exchange, and retail access to pilot programs. This is in response to actions taking place before the General Assembly and in response to comments that it received in its generic docket. It received an incorporated draft working model for restructuring the electric utility industry in Virginia, which was issued to the Senate in Resolution 259 in Joint Subcommittee in November of last year. As the staff recognized in that report, an ISO may be the best way to address bulk power liability issues, promoting effective competition by providing sufficient access to bulk power transmission facilities through the consolidation of individual transmission systems. Against the backdrop of the federal and state activity, we also have individual utility efforts to begin to work on these structures. In December of last year, we had the filing of the FERC by the participants of the Midwest ISO. Originally this group existed of about 25 utilities covering an extended area, bringing it right to the doorstep of Virginia through the AEP company. However, things did not go exactly as planned, because in December another group of utilities announced they were interested in forming an independent transmission entity known as the Alliance. This group included Virginia Power, Allegheny Power Systems, and other utilities. The issues that arise there are going to be of fundamental concern, I think, both to regulators and legislators, as we look at these new market structures, because here in Virginia we have not one ISO proposal but three. We have the PJM ISO up and running, in which Delmarva is participating. Delmarva has a unique position in our Commonwealth because it is not, as I understand, directly interconnected with the other Virginia utilities.

{57} So this leaves the remainder of the Commonwealth. What do we do? Well in response to a commission order coming out of Pennsylvania, we have Allegheny Power (APS) determining that they are going to join the ISO in the Midwest. This presents an interesting challenge given that, to my understanding, APS is not electrically interconnected with the midwest ISO. In addition, we have the issue of the AEP, which has joined unconditionally with the Alliance effort, but is also in the process of trying to reach its hands 'across the water' to join that group with the Midwest ISO.

{58} Why is this important? It is my view that appropriate size and boundaries for ISOs is critical in terms of how markets are going to develop. This echoes the comments of Mr. Bevin yesterday, who indicated that the contour of the grid will largely determine the contour of the market. Issues of ISO topology are going to confront, not only the individual utilities, but our commission and FERC for some time to come. FERC, in recognizing this, has also established its own investigation of ISO policies and initiated a series of regional conferences to be scheduled in late May or early June to address these issues. The important perspective is to make sure an ISO or odd group of ISOs do, in fact, serve the interests of the Commonwealth. For that our State Corporation Commission has primary responsibility. Obviously to make sure this is consistent with the broader regional concerns, the FERC (especially since it will be taking jurisdiction over an ISO) will have things to say about that as well. In these emerging developments it is very clear that we have the distinct possibility for significant federal/state conflicts in the future. The question should not to be focused on who has jurisdiction, but on what is the right answer. Certainly, we need to consider that from a local perspective, but also a regional perspective. Thank you.

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