FERC Buckles Under Pressure, Unveils New Price Mitigation Plan

*By Fereidoon P. Sioshansi**

California's Golden Dream Turns into a Nightmare

The original plan was to let the market forces – not regulations – set electricity prices. To create a competitive wholesale market, California policymakers encouraged incumbent utilities to divest most of their generation. Moreover, they gave the new independent generators near-total freedom on how much they could charge for their energy (in the daily PX auction) and capacity (in the real-time ancillary services market). The critical assumption was that intense competition among rival generators would force prices down and keep them low. This would obviate the need for price regulations.

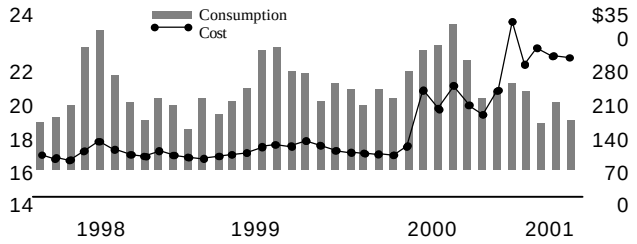
This utopian dream of a self-regulating wholesale market blurred the policymakers' vision and became the fundamental assumption that drove everything else. For example, with low wholesale prices – the argument went – retail rates could be capped. Why bother with long-term, fixed-price contracts – a form of risk insurance – when prices would be stable and low? Similarly, why bother with expensive integral load meters and real-time prices when prices are low around the clock?

Not as Envisioned, Not as Promised

That dream, embodied in the landmark Assembly Bill 1890, passed in 1996, of course, has turned into a nightmare. Prices at the wholesale market began to shoot out of range starting in 2000 (see accompanying graph). In a capacity-constrained market, independent generators gradually learned to drive up prices without braking any laws or engaging in overt price fixing.

California's monthly electricity consumption and average energy price, 1998-2001*

Million MWhs (left scale) and $/MWh (right scale)



Source: Caliornia ISO

* The CA market opened in April, hence there are data for 9 months in 98

While wholesale prices started hovering at levels significantly above 98-99 prices, regulations kept retail rates capped. Since wholesale prices could not be passed on to consumers, there was no effective mechanism for demand to respond to high prices. Consumers continued to use electricity at artificially low prices – significantly lower than what utilities were paying.

Utilities were caught in an awkward and unsustainable predicament. For several months in 2000, they had to buy wholesale power at exorbitantly high prices, selling it at significantly lower levels to their retail customers. Their mounting accumulated debt has sent one, Pacific Gas & Electric Company (PG&E), to seek protection in the bankruptcy courts. The other, Southern California Edison Company (SCE), is in dire financial straits. The state has had to step in to buy power on behalf of the beleaguered utilities since January 2001. The PX market has folded. Retail competition is no more.

The consequences are, of course, dire for the utilities, for the consumers, the California economy, and may ruin the political career of California Governor Gray Davis. His approval rating, for example, has dropped 23 points to 46% since January. The poll was taken before the recent big rate increases approved by the California Public Utilities Commission (CPUC), and before any blackouts. (In May, the CPUC reluctantly approved the largest rate increases in California history, averaging 37-50% for commercial and industrial customers, lesser amounts for residential customers. This on top of an average rate increase of 9%, approved in January). It could get worse with the approach of hot summer months, and expected blackouts.

Moreover, some of the Governor's critics are now saying that the state should not have signed so many long-term power-purchase contracts just at the peak of the crisis. It is not a good idea to go shopping for hurricane insurance just as the hurricane is taking the roof off of one's house. Reportedly, some 38 such contracts with liabilities exceeding $43 billion have been signed, all in great haste and in total secrecy – at the height of the crisis.

What Do We Do Now?

That's all history. The urgent questions now facing California's Governor, state lawmakers, the CPUC, and the hard-pressed grid operator are:

- how to make it through the summer months with demand expected to exceed available capacity for many hours; and
- how to manage the soaring costs of buying power from the independent generators who stand to gain from continued supply shortages.

The former is primarily driven by summer temperatures. If it turns out to be a mild summer, and if the hot temperatures come later in the fall, then California may just make it with few or no rolling blackouts. Several thousand MW of generation are expected to come on line between July tandSeptember. Belatedly, energy conservation and demand responsiveness are also being pushed as far as they can go.

The latter has been the subject of much debate at both the state and national level. Many, including a number of prominent economists who have studied the California market, have reached the obvious conclusion that this is no ordinary market. The very real capacity (and transmission) shortages and the imminent possibility of rolling blackouts gives independent generators an enviable bargaining position. They can literally ask any price they want, and get away with it. That's precisely what they have been doing. Even though none has a dominant market share, each can individually affect prices since there is so little spare capacity in the system.

Given the overwhelming evidence of *price gouging* – the non-technical term for saying that the generators are able to

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collect prices significantly above their generation costs – the debate has focused on what to do to control prices until the market can become competitive again.

With thousands of MW of new capacity under construction or in advanced stages of planning and licensing, normalcy is expected to return to the wholesale power market. In fact, there are predictions of a supply glut in a few years' time. Once there is some excess capacity in the system, competition will force down prices, as California lawmakers had originally envisioned. But what can be done while we await for that wonderful outcome?

FERC: From Cost-based To Market-based

One of the enduring relics of the Roosevelt Administration era is the 1935 Federal Power Act. Its main tenant is that wholesale electricity prices, which are under the jurisdiction of the Federal Energy Regulatory Commission (FERC), should be cost-based. The federal law also requires that prices charged be *just and reasonable*, what ever that means.

Electrifying Milestones
Major Laws with Significant Impact on U.S. Electricity Market

Date	Law	Major intent/impact
1935	Federal Power Act	Created today's FERC and established principles for regulating wholesale electricity pricing
1978	Public Utility Regulatory Policy Act (PURPA)	Allowed independent power producers (IPPs) to flourish and created the QF industry in states such as California
1992	Energy Policy Act (EPAct)	Introduces the premise of a non-discriminatory open access transmission network
1996	FERC Orders 888 and 889	Spelled out FERC's long-standing policy on how an open access transmission system would work in practice; Order 889 spelled out the details of the Open Access Same time Information System (OASIS)
1999	FERC Order 2000	Encourages the establishment of Regional Transmission Organizations or RTOs

A lot has changed in electricity markets since 1935 (see table). The generation market has been opened to competition starting in 1978 with the passage of the Public Utility Regulatory Policy Act (PURPA) which created today's independent generators. Subsequently, the passage of the Energy Policy Act (EPAct) in 1992, and FERC Orders 888 and 889 in 1996, opened the country's high voltage transmission network to third party users, at least in theory. FERC's more recent Order 2000, released in December 1999, encourages the creation of Regional Transmission Organizations or RTO.

Over the years, these laws have led to the emergence of IPPs, power marketers, and traders. Companies like Enron, Dynegy, Williams, Mirant, and Calpine that that did not exist two decades ago, are now major players in the new electricity market. In the process, FERC has assumed a more prominent role in defining, actively promoting – and paradoxically – regulating the nature and level of competition. The agency, for example, must approve the rates and the underlying methodology of power marketers, who are now major players in the U.S. electric power sector.

Since the early 1990s, and with the emergence of competition in wholesale and transmission markets, FERC has gradually shifted from its historical focus on cost-based pricing to what may be called market-based pricing. For example, in the 1990s, FERC has approved applications of 962 power marketers based on this principle. In doing so, it has increasingly taken a laissez faire attitude. If an applicant claims that the market in which it intends to operate is sufficiently open and competitive, FERC is likely to give the benefit of the doubt. Since applications are to be renewed every three years, the agency figures it can catch the mischievous players sooner or later.

These liberal policies generally worked until the California fiasco. With tight supplies and the incredibly lax market rules in effect, private generators and power marketers began to charge prices that are significantly higher than historical cost levels. With bloated operating incomes and high profits, generators and power traders have a hard time denying the fact that they are making super-normal profits. Nor can they deny that these profits are possible due to the tight supplies and the absence of any effective market rules that would restrict what prices may be charged.

These super-normal profits have become a contentious political issue, to put it mildly. With the state of California currently picking up the tab, it infuriates Governor Davis to no end. It is estimated that some $50 billion (based on extrapolating the prices for the first 5 months for all of 2001) may flow from the pockets of California customers and taxpayers to the pockets of a handful of generators and power marketers.

During his meeting with President Bush in May, Governor Davis made a big fuss about this unfair wealth transfer. He has said, time and again, that FERC should fulfill it statutory responsibility, which is to ensure that prices charged are cost-based, just and reasonable. His fellow Democrats in the U.S. Senate held hearings in June, examining FERC's apparent lack of resolve in enforcing the law.

Convincing FERC to Change Course Not Easy

With wholesale prices hovering significantly above normal, what ever normal is in these abnormal times, California has been bleeding at an unsustainable rate. Governor Davis, who had trouble identifying the real villain, has finally found it. And it is none other than the Federal Energy Regulatory Commission (FERC), the agency charged with the task of making sure wholesale prices are cost-based, just, and reasonable.

True, private generators and marketers are pocketing huge sums of money. But they are not the real culprits. These companies are merely profiting from a tight market and lax market rules, as any profit maximizing firm would. It is FERC's duty to police them, and FERC has not been doing its job. Now comes the hard part: forcing FERC to be more diligent in enforcing the law.

In May, California's independent system operator (ISO) filed a petition with FERC requesting that two key players, AES Corp of Arlington, VA and Williams Co of Tulsa, OK be barred from selling power in California at what ever prices the market will bear. Instead, the ISO wants the two companies to be forced

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to sell their output at prices that are tied to the actual cost of production.

In June, the ISO filed a second petition, requesting that FERC revoke the ability of four other mischievous generators from naming the price of the power they sell in California market. The four identified were Reliant Energy Inc., and Dynegy Inc., both Houston, TX based companies, Mirant Corp. (a subsidiary of Southern Company based in Atlanta, GA), and Duke Energy Corp., based in Charlotte, NC. ISO has asked FERC to revoke their licenses to sell power at market-based rates, pointing out that there is no competitive market in California to speak of.

On the surface, this sounds like a convincing argument. But this goes to the heart of a long-standing FERC policy which has gradually shifted from cost-based to market-based. More importantly, it challenges FERC to accept the prevailing view that it should make an exception, at least in the current case of the non-functioning California market. Since California is interconnected to 10 neighboring states, FERC must in effect control prices in all Western states if it is to help California's dysfunctional electricity market. And since there is no effective market in any of these states, this is not as easy as it may sound. The motion, however, has an ardent supporter within FERC, Mr. William Masey, an Arkansas Democrat.

Under increasing pressure, FERC was hard pressed to ignore California's plight. The methodology it has used up to now to determine the presence of market power is outdated and fundamentally flawed. In describing the method to *The Wall Street Journal*, (1 June 01) Mr. Massey said, "*The method we use has a single virtue. It's quick to administer and everyone passes. But it isn't an effective screen in today's market*."

Under Pressure, FERC Changes Course

In view of overwhelming evidence – and political pressure – FERC had to act. And it finally did. In late May, the agency launched a price mitigation plan – avoiding the politically incorrect word price cap. On 18 June, FERC went a significant step further, extending the order to cover the entire Western part of the United States, extending the price mitigation plan to all hours, and closing many remaining loopholes. Governor Davis, sensing that he has finally gained the upper hand, said, "there is much more they (FERC) should do." President Bush and Vice President Cheney, who had both insisted that the markets, given sufficient time, will take care of the problem, had to pretend this was their idea all along.

FERC's initial proposal was to impose a soft and variable benchmark price calculated based on estimated production costs during periods where suppliers are tight. Tight supply was originally defined to include all periods when demand is within 7% of the available reserves. The 18 June decision has extended this to include all hours. All transactions above this benchmark price are treated as *suspect*, and may be subject to review and possible refunds. Moreover, the 18 June decision now covers 11 Western states, an area with a population of 65 million, covering roughly half of the country to the West of Kansas.

FERC's New Game Plan

Main features of FERC's new price mitigation plan:

- Calculate a variable *price benchmark* covering all hours based on estimated production costs;
- Review transactions above benchmark price as suspect; subject to refunds and possible fines;
- Require all generators to offer *all available capacity* into the market;
- Collect and analyze weekly bid data and plant outages; and
- Initiate investigation of *electricity trading practices* throughout the interconnected Western states.

Source: FERC's price mitigation plan, June 2001

A second significant requirement imposed on generators is that they *must* henceforth offer *all* available capacity to the ISO. Previously, there was no such requirement. Generators could offer as little or as much of what they had in the market. According to critics, thus far, it has been easy to manipulate prices by withholding some capacity from the market, further exaggerating the scarcities and artificially jacking up the prices.

This new requirement, however, will be tough to enforce. Short of sending an army of inspectors to each generating plant to make sure that all units are properly maintained and all available units are offered in the market, FERC must rely on generators' words. To monitor and ensure compliance, FERC now requires weekly reports from state officials on bid prices and information on plant outages. To put power traders on guard, FERC has said that it will *initiate investigations into electricity trading* practices across the interconnected Western states.

How's this different than FERC's earlier and largely unsuccessful *soft price cap* of $150/MWh? The previous soft cap only applied to prices during Stage 3 Alerts, when demand is within 1.5% of available capacity. The new initiative applies to all hours. More importantly, the new price mitigation plan calculates a *variable* benchmark price – not a pre-determined soft cap.

In the end, however, this is nothing more than a temporary fix for a wobbly market. The real solution to California's market malaise is to bring back a healthy excess reserve and to create demand elasticity. The former will be solved once more capacity comes on line; the latter once a significant portion of customers are exposed to variable wholesale prices. Until these two conditions are met, FERC must engage in a frustrating and largely futile game of cops and robbers with the generators.