

Restructuring in the Rearview Mirror – a 10-Year Retrospective of California's Doomed Experiment with Electric Deregulation. By The Energy Overseer

First Steps to a Stable Electric Market

More than anything else, California needs to decide exactly what kind of electric power marketplace it wants to have going into the future. To avoid doing so for much longer risks the ad hoc imposition of policies and institutional barriers that will be impossible to untangle later on.

Paul Joskow, director of the Center for Energy and Environmental Policy Research at the Massachusetts Institute of Technology, sees a series of questions that must be asked and answered before a new course of action can be reasonably implemented.

"Going forward," Joskow said, "California really has to decide: Do you want to rely on competitive wholesale markets? Do you want to rely on competitive retail markets? Do you want to go back to a system of regulated vertically integrated monopolies? Those are really fundamental questions that California needs to answer because I think you can't just polish off bits and pieces of the current system and expect it to work without some basic decision about what the future structure of the industry for California will be."

Mark Bernstein, a senior policy analyst at the RAND Corporation, agreed. "I would say we have to rethink what we're trying to achieve, and we have to figure out what the goal is, and when we've decided what the goal is, then we can set up the system to meet that goal. If the goal is to have a functioning market for power in this state, then we need to set up the system to achieve that goal and set up a very different system than what we did set up."

In the aftermath of California's market meltdown and emergency response, most--if not all--of the structures and policies embodied in restructuring law AB 1890 and subsequent transition plans lie in ruins. The California Power Exchange has been out of business for nearly one year and currently resides in a Los Angeles bankruptcy court. Direct access has been suspended, with no restoration in sight. One utility is attempting to impose the burden of its costs for power procurement on all customers, including those who were being sold power by non-utility energy service providers.

Regulatory policy is in complete disarray, with a politically torn California Public Utilities Commission pursuing a vendetta against Pacific Gas & Electric for refusing to settle on the same terms as Southern California Edison and San Diego Gas & Electric. Meanwhile, the CPUC in a series of related but uncoordinated decisions and backroom dealings is trying to reimpose cost-based rates over contract power and tighter controls on power generators that were previously exempted from state regulations.

The California Independent System Operator continues trying to lead market participants into an improved set of wholesale market designs, even as it keeps looking over its shoulder to see whether anyone is following. Working in the shadow of a constant stream of Federal Energy Regulatory Commission rulings, Cal-ISO is also pulled by the political interests of its board, which remains at odds with most of the market participants in decrying "market power" and demanding FERC refunds of past costs.

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Burned out by two extraordinary sessions that pretty much led nowhere, the state Legislature seems to have little appetite for revisiting energy matters and is much more concerned with the state's economy and a looming election.

The governor is already rewriting history to serve the interests of his reelection campaign, while Republican opponents can only cast blame without articulating a clear vision for fixing the problems. And, of course, the state's major response to the emergency--inserting itself into the market as a long-term buyer of energy--has ended up costing more than could have been imagined while threatening the viability of the state's general fund.

Without a clear vision, these disparate threads of energy policy will only continue to unravel--to the detriment of ratepayers and taxpayers alike--and land in the default position of endless litigation.

I'm not recommending another "consensus" effort along the lines of what led to AB 1890. That process has been most charitably characterized as "a Chinese menu approach to restructuring" by Professor Joskow, and worse by many others.

"AB 1890 wasn't a law," reflects Robert Michaels, professor of economics at California State University, Fullerton, and an affiliate consultant with Tabors, Caramanis & Associates. "AB 1890 was a settlement agreement that fell apart partially through the self-interested behavior of people and partially through this year-long force of external events. You could not have the equivalent of the [Steve Peace] 'death march' today. There are too many interested parties. There are too many people with financial exposures that they would not risk in the Legislature, and you have federal and out-of-state interests which have become compellingly important."

That sounds like a recipe for deadlock, but Michaels believes it is necessary to break through the impasse.

"We can't live like this forever. We can't live with a federal presence that we don't understand the implications of, and we can't really go back. There is nothing to go back to," he concluded.

Are there things that can be done to correct the market failures and restore some semblance of competition in the industry, while preserving the public-interest standards of traditional regulation?

In sorting through the ruins of California's market, I recently conducted interviews with a number of economists about this topic. Joskow, Bernstein and Michaels were among the group that also included Severin Borenstein, Frank Wolak, Bill Marcus and, in a limited exchange, Alfred Kahn. While there was nothing like consensus expressed by these thinkers--not surprisingly given their positions across the broad spectrum of economic ideologies--all seem to believe that change is possible but complicated by the continuing politicization of the market.

They also express general or specific concerns about the role of the new California Power Authority--even those who favor its existence are unsure of its direction and wary of establishing another long-term institution that appears to directly conflict with other agencies rather than operating in a coordinated fashion.

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But many discern in the ashes some building blocks for a functional market.

Borenstein, the director of the University of California Energy Institute at UC Berkeley, sees the great failure of California's market less in what was introduced than in what was neglected. "There were two fundamental aspects to this that were ignored. One is the demand side of the market, which was completely left out, so that essentially we were operating a market where all of the adjustment had to occur on the supply side," he said. "On the other side, the supply side, we threw everything into the spot market that wasn't contracted beforehand. We have to understand that for this market to work, we really need to have demand-side responsiveness and we need to have long-term contracting ability."

Included in Borenstein's vision for demand-side response is not only a greater use of real-time meters to provide the kinds of price signals that energy users will respond to, but also a restoration of the direct-access option--at least for larger customers that are better equipped to control their own energy choices than residential or small commercial customers.

Holding direct access hostage to the state's need to pay off the apparently high-priced power contracts signed by the Department of Water Resources would be a mistake, he suggested. Instead, the economist recommends seeing the contracts for what they are: financial liabilities. "We could pay for them by recognizing that there is this loss associated with these contracts, and that we can recover that loss by telling each participant, 'Here's your share of the loss . . . and now you're responsible for that bit of the contract.'"

Of course, he added, "We're not going to do that at the residential level, but we can certainly do that with any customer who wants to go to direct access. If you want to leave the system, you don't just walk away, you leave the system with your share of this contract liability," Borenstein said.

That stands in sharp contrast with the CPUC's knee-jerk policy of terminating choice. "The most antiquated 1960s version of dealing with this is locking everybody into the old utility system, raising flat rates because, again, they're not talking about allowing prices to vary with wholesale or with shortages in the market, and you're just stuck here. It's the innovation-destroying way to deal with this problem," Borenstein concluded.

Restoring direct access is not just a demand-side issue, suggested RAND's Bernstein, but is an integral component of restoring a market for power sellers beyond the state and utilities, while refining the state's role as market monitor and standards setter. "I think we've got to get back to a point where we do create some competition on the generation side. We do let customers choose their provider at some level. And that's only going to happen if we get the real-time pricing or time-of-day pricing. If we get better information out there about how to change your energy use and things like that--which I think the state can do a really good job on and has a role in--that's basically where we should be."

For some, especially Bill Marcus, principal economist at JBS Energy who frequently consults for consumer advocate groups The Utility Reform Network and Utility

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Consumers' Action Network, direct-access availability might be restored on a core/non-core basis as long as those leaving the system cannot escape liabilities.

But Marcus believes there needs to be a much more active effort to bring down the costs entailed in those contracts. "We've got to try to do something to renegotiate some of those DWR contracts," Marcus said with increasing frustration at the inability of the governor to reach agreement with the suppliers.

"I think the focus needs to be on quantity and flexibility rather than price because the worst thing they did with those contracts was to essentially convert gas-fired resources, which are inherently flexible, into 24/7 and 6 x 16 must-take contracts. Essentially, they stood principles of resource planning on their head, made the gas-fired resources inflexible and as a result said, 'Now we have no room for renewables.'" He added, "That's got to be reversed if the state is ever going to do anything reasonable out in the future."

Marcus favors using "pressure points" such as Energy Commission siting rules to persuade suppliers to alter terms. However, it is evident that the current administration effort is not a negotiation at all, but merely an attempt to intimidate power suppliers that entered deals--with terms dictated by the outcome desired by the governor--during the height of an emergency that those particular sellers did not cause. Because the state does not know how to negotiate in good faith, the talks have been unproductive.

"My view is pay them [suppliers] a little bit of money and throw them out," Marcus said. "Reach a settlement. It's cheaper than taking the power."

The entire debate over whether the DWR contracts are "huge losers" or the way that California "tamed the runaway market" is muddled by the fact that the wholesale power market currently does not offer a very good indicator for price transparency. When the Power Exchange went out of business, it took away the main pricing rudder--as controversial as it was, given the state of the market at the time. But even with private pricing surveys or market indexes as carried in this and other trade publications, people must realize that current wholesale trading is very thin, and price indicators going out into the future are unstable and unreliable. Robert McCullough, a Northwest economist and energy consultant, suggests that given the low volume on power futures, almost anyone could manipulate the prices to their advantage--and he cited Enron as a distinct example.

So that means the most important missing piece is the mechanism for establishing price benchmarks--not only as a check against utility purchases (when they return to that function) and a measure of what it might take to buy out uneconomic liabilities, but also to serve as a guideline for determining whether the state's emergency response was a major mistake or just a correctable miscalculation. Currently, that is a matter of vehement conjecture--but only conjecture because in the long run things could look very differently.

There is little chance of restoring the Power Exchange. But Cal-ISO intends to create something of a more functional day-ahead market that can serve as the basis for price transparency today and into the future. Whether that redesign can be put into place in a timely manner is uncertain, however.

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Frank Wolak, the Stanford economist who chairs the Cal-ISO market surveillance committee, sees that as a legitimate role for Cal-ISO, as long as it is not expected to "solve" the problems its systems may reveal. That means the ISO's current proposal to secure capacity might not fit well with its recommended role.

"The ISO should be effectively just a black box through which signals get transmitted," Wolak said. "So, for example, we're short of power, how do we solve that problem? We don't solve that problem by the ISO going out and buying the stuff; we solve the problem by saying, 'Look, we're raising the price of power right now and if you'd like to supply, come supply.'" The same price signal will also trigger demand responses when needed, he said.

"So a lot of it is simply avoiding the tendency to be arbitrary and intervene in the market and just simply use the signals that are already available in the tariff to effectively make this system stay balanced." That is difficult, he acknowledged, because neither engineers nor regulators have much faith that markets can provide appropriate signals.

As the noted business historian John Steele Gordon has accurately observed, "Self-enforcing laws are in everyone's interest except for one group, the people who make and enforce the laws to begin with. Those who work for government---legislators and bureaucrats alike--prefer to manage problems rather than solve them."

So that is the challenge for California, to find ways to solve the problems raised by the electricity market failure--not just manage them by creating costly policies and hurdles that will outlive the problem by decades.

As I said, consensus is elusive, but there are workable ideas that can be pulled together into a new plan for recreating a more workable power marketplace:

- * Avoid arbitrary interventions in markets and be wary of long-term state involvement in purchasing and/or constructing supplies.
- * Restore customer choice for those willing to pay for the privilege.
- * Build demand-responsiveness into the system with new technologies and harness price changes, rather than trying to completely "protect" consumers.
- * Negotiate in good faith--not strong-arm--the DWR power contracts.

But most importantly, California's leaders and market participants must consciously decide which path to pursue.

Paul Joskow said California's failure is not a general indictment of restructuring, which has evolved in England and in other parts of this nation. "I think they should look around the country and around the world to see what others have achieved from various kinds of reforms" **[Arthur O'Donnell]**.

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