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

Requiem for Open Markets

No doubt, some will count the demise of the California Power Exchange as a good thing. My feeling is that the PX was killed because it was the bearer of bad news in the form of high prices.

Those who initially advocated a model of wholesale markets based solely on bilateral spot deals and futures contracts perceived the exchange as a carry-over from centralized regulatory planning regimes.

The so-called "PX mandate" tying California's biggest utilities to the daily auctions for all of their power purchases and sales was creatively likened by rival, non-mandatory exchanges to the Soviet Kremlin.

More recently, the CalPX took harsh criticism for doing the job it was designed to do--conducting its daily auctions without regard for the cost or the outcome. So long as the daily clearing prices were lower than the marginal cost of a brand new, efficient generation unit, as they had been for the first two years of operations, utilities and regulators did not complain too much. The market was a success, they said.

Much of the market analysis of the exchange during its first years concentrated on the unanticipated problem of "negative prices" during periods of low demand and heavy hydroelectricity flows. You might reasonably call those "the good old days" without terribly dating yourself.

Power marketers and energy service providers grumbled but were resigned to the fact that during the transition period they could not expect to beat the CalPX price. Scott Gebhardt, former head of the now-defunct PG&E Energy Services company, once said that everyone had expected the Power Exchange would be inefficient. "The problem is, it's too efficient, and we can't make any money."

The utilities--even Gebhardt's corporate employers--liked this, because it meant that fewer customers would move to direct access, fewer competitors would gain a foothold in the marketplace, and there would be more money collected for stranded-cost recovery.

The almost total reliance on the daily spot market conducted by the CalPX was not simply an oversight by those who designed the system, it was a considered strategy meant to drive prices down and CTC up.

That, of course, changed this year. Beginning in May, the daily clearing prices rose and rose and have never come down to "normal" levels. This was difficult for many to accept, and they struggled to ascribe the outcome to market manipulation or outright criminal collusion by bidders.

The single-price clearing auction that CalPX employed was harshly criticized, and just as widely misunderstood, as a cause of the higher prices. Perhaps ironically, a Blue Ribbon panel of experts under the direction of noted economist Arthur Kahn last week issued its final report on the merits of the single-price auction versus an as-bid payment scheme. The findings were unanimous, Kahn wrote. Any suggestion that switching to the as-bid system would provide relief from soaring electric prices "is simply mistaken. In our view it would do more harm than good."

As the utilities took defensive positions against the daily price tag for energy last summer, they began pulling load away from the Day-Ahead market and deferring it into the Hour-Ahead auction and the California Independent System Operator's real-time imbalance markets. This, possibly more than anything else, weakened the market and caused the system overload that took the form of multiple Stage Two emergencies and power curtailments.

Meanwhile, the direct-access contracts that were tied to PX pricing no longer seemed like much of a bargain, causing customers to return to the utilities. To some extent, the forward contracts promoted by CalPX also caused some major ESPs to abandon the market, because they no longer had a viable gauge of the relationship between the daily market clearing price and the eventual costs of power flowing through Cal-ISO settlements or the PX-credit mechanism.

The California Power Exchange was designed as the linchpin of restructuring. Not only for its key role in determining CTC recovery, but also because everything else was tied to it.

The PX credit, never as easy a concept to understand as the "shopping credit" employed in other states, was essential to the revenue stream of ESPs. Though they never made headlines in the daily newspapers, the regulatory fights over the credit and miniscule PX-adders consumed huge amounts of energy and resources at the California Public Utilities Commission, without ever finding resolution.

With the termination of the exchange, even the last ESP holdouts find they cannot continue, and this week Enron Energy Services and Green Mountain Energy decided to turn back most of their direct-access customers to the utilities.

Restructuring law AB 1890 envisioned the exchange's clearing price as an eventual replacement for the "transitional" short-run avoided cost formula used to determine prices for independent power producers holding QF contracts. Another long and contentious regulatory case has now collapsed in confusion with the demise of the exchange. Perhaps the SRAC formula will be replaced with negotiated prices, perhaps by a figure promoted by CPUC member Carl Wood. The $67.45/MWh price proposed by Wood was not drawn from thin air, but it certainly has no basis in the formal record of the proceeding, bears no relationship to the actual costs of production by QFs, and most importantly, has nothing whatsoever to do with the utilities' avoided costs of energy.

You might say that it is good the PX is gone, because all it did was complicate things. But what do we have in its place?

A secret auction conducted by an agency with so little experience in the energy buying business that it cannot even answer questions about its process and refuses to divulge information about its daily purchases, while burning up $1 billion of public money. Revealing prices paid and volumes purchased will only drive up the market price, state officials contend.

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The results of the recent auction are misrepresented by the Governor's office to seem like the solution to all of California's resource problems, although everyone knows that the submitted bids are inadequate to meet load and irrelevant to a negotiated outcome that we might or might not ever learn.

The new legislation authorizing the Department of Water Resources to become the emergency power procurement arm of the state contains an odd provision, buried deep in Section 80110. It describes the relationship of the CPUC and DWR and the mechanism for the CPUC to set new rates to pay for the power, but it goes much further: "the right of retail end users . . . to acquire service from other providers shall be suspended until the department no longer supplies power hereunder." The provision was inserted to prevent customers from bypassing the inevitable rate surcharges that will result from DWR's purchasing.

Strictly interpreted, that means the termination of direct access in California for two years, or maybe ten. Exactly how the axe will fall seems to be up to the CPUC, but can anyone doubt that the anti-market regulators now in charge will use that new power?

So, this week marks not only the end of the California Power Exchange, but the death of restructuring's promise of consumer choice, lower prices and open markets.

Price transparency has been replaced with secrecy. Markets have been supplanted by arbitrary actions. Customer choice has been substituted by no choice at all except to pay for a market failure that the California Power Exchange did not cause, but only reflected **[Arthur O'Donnell].**

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