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

The Re-Regulation Key Chain

Deregulation is a word that rarely appears in the pages of CALIFORNIA ENERGY MARKETS. As frequently as necessary, I remind our writers that what is happening is not deregulation of the electric utility industry so much as the restructuring and redistribution of its constituent parts.

The regulation of major parts of the system--the transmission grid administered by the Independent System Operator and the buy/sell function performed by the Power Exchange--has passed into federal jurisdiction. Power generation is largely divested from the monopoly utilities to other companies, but their "market-based" rates and services are still certified and monitored by the Federal Energy Regulatory Commission.

It still amazes me that many otherwise intelligent people working at the California Public Utilities Commission and the state Legislature did not realize this was exactly what Professor Dan Fessler had in mind when he intoned the phrase "cooperative federalism" as an underlying concept of the Blue Book restructuring plan.

It is a distant and often unclear kind of regulation, to be sure, as FERC tries to stretch its internally conflicting philosophies across the entire continent. But it is still strong enough to alter market players' behavior or hamstring their activities--just ask the Oversight Board, AES/Williams and Duke Energy. They've all discovered that FERC has the last word, at least until some federal court finds a reason to get involved.

And while the CPUC anticipates loosening its grip over the regulation of the remaining distribution utilities by relying on performance-based ratemaking and by-the-numbers enforcement of its safety rules, it is apparent that what is going on is a transfer of regulatory responsibility from the agency to others.

In some cases, it is to the new market agents. The California ISO, though never intended to be a regulatory substitute, turned into the Big Daddy price regulator last year, when it imposed the $250/MW price cap on its ancillary service markets. Later, when the CPUC attempted to assert authority over Pacific Gas & Electric for the December power outage in San Francisco, it quickly learned from the Legislature that the ISO is the new referee when it comes to deciding which side of the line the reliability ball was dropped.

The ISO itself tries to shrug off any assertion of authority, pointing to FERC or the Oversight Board or its 26-member governing board. Still, it is clear that what FERC wants is a self-policing transmission entity that acts on its behalf to regulate the wholesale marketplace.

In New England, where the local transmission cop is more like a combination PX/ISO, the price regulation function is even more obvious. Twice now, the NE-ISO has called back daily clearing prices for retroactive recalculation based on its judgement that something was amiss.

While such a move by either the ISO or PX would be sure to raise howls from the collective California constituency, there really is nothing that prohibits such an emergency exercise of power. The PX can, and has, rerun daily bidding because of perceived aberrations. The ISO holds mysterious powers through its settlements

process in which daily market clearing prices are tossed into a black box and adjusted before release several months later.

I'm not saying there is anything improper about the way these functions are conducted (though many others have complaints and suspicions). I'm just pointing out that mechanisms exist for the re-regulation of rates in the new market. It is a different form of regulation than the old application/hearings/ALJ opinion/utility *ex parte* contact/revised-order model we've grown used to. But it is still regulation, aimed at eliminating market failures and smoothing out bumps along the way to a free market.

One of the things that market players fear most is that the Powers That Be will someday decide that a temporary price spike, contract delivery failure or other aberrant event will be sufficient cause for an even stronger re-regulatory response. Price caps, forced curtailment and redispatching regimes all loom large as marketplace fears.

An article in this week's *Wall Street Journal* states the concern in headline format: "Soaring Prices in the Electricity Market May Prompt State, Federal Regulation." The story posits that price volatility and power delivery breakdowns during peaks demand periods will eventually cause lawmakers to enact new rules over the wholesale power market.

What would be a sufficient triggering event? The article does not hypothesize, but I'll take a guess: brownouts affecting the financial community or other influential interest group; a "risk-hedging" debacle that brings a major utility to the brink of insolvency; a price spike that passes through to residential consumers directly without the cushioning effect of traditional utility rate regulation.

In other words, just about anything that happens to affect constituents or special interests will cause legislators to second-guess their commitment to open markets.

Earlier this week, the Independent Energy Producers trade association held a telephone news conference to call attention to the re-regulation threat. Honestly, there wasn't much news on the line save some interesting economic analysis from Seabron Adamson, managing director of Frontier Economics. Adamson argued for stakeholders to use a broader analytical framework than marginal costs (i.e.: price spikes in ancillary service markets) to judge whether the new market is working properly or whether somebody is abusing market power.

From experience, I can say that economists do not make for very good copy. They live in an abstract world that is very hard for journalists--even the energy industry reporters who showed up for the IEP conference--to grasp. When asked to cite specific examples or to make the leap to real-world situations, economists tend to roll their eyes and draw a graph.

Still, Adamson is correct to urge that we use a better set of tools to measure success and a more flexible set of standards to adjudge market failure in a competitive energy business. And IEP's concern over the potential for re-regulation is quite real. As IEP executive director Jan Smutny-Jones pointed out, price manipulation by regulators (or others) introduces uncertainty to the market. Uncertainty is an anathema to the investors who are backing all the new merchant generation slated for development in the state.

Another re-regulatory threat exists in the form of legislation to create a new "reliability agency" to combine the Energy Commission, Oversight Board and some CPUC functions. More than anything else, this SB 110 proposal has the potential to create another unwieldy layer of bureaucracy (actually, three layers in the bill's current form) on the new market while trying to wrest some jurisdiction over the system back from the folks in Washington, DC.

From where I stand--admittedly outside the box and frequently out of the loop--it seems that our current marketplace might be likened to a teenager who has just gotten a driver's license and a set of car keys. Big Daddy stands by, with a faint frown and furrowed brow, carefully looking over the fenders for any signs of dents and dings that will serve as evidence that the young driver is not yet responsible enough to be entrusted with the keys.

It's not completely irrational--just the ingrained protectiveness of a parent for a child's safety and wellbeing that manifests as a control issue.

The only way to overcome this stand-off is through the passage of time and the build-up of trust. Trust in the new market, trust in the self-control of market players and trust in the eventual outcome. Otherwise we have the worst of both worlds, abdication of responsibility by state regulators and an arbitrary control exerted by shadow regulators in the state Legislature **[Arthur O'Donnell].**

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