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Where Were the Regulators?

California crunch tests FERC's resolve

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Legal Times

February 28, 2001

For months, members of Congress, consumer advocates, power companies, and local politicians have looked for a quick fix to California's energy crisis.

And for months, they have begged the Federal Energy Regulatory Commission, their would-be rescuer, to step in.

The commission's answer to the state's demands has been succinct: The federal government is not the answer. Markets are.

Although the commission has instituted some changes and new rules for the California electricity market, it has largely steered clear of exercising its broad authority over the market to take command of the crisis. If anything, its new, Bush-appointed chairman seems even more determined to stay out of the fray.

The West "cannot rely on a federal bailout or intervention," new FERC Chairman Curt Hébert Jr. said less than three weeks ago in a news conference. "We remain sympathetic to what is going on out there and hope they can solve most of the problems themselves."

The California energy crisis has been the first hard test of the commission's policy on electricity deregulation, and it has raised questions about what role -- if any -- FERC should play in managing the nation's energy markets.

"They could have said, politically speaking, 'This is a real winner -- we could help out California and be heroes,' " says Scott Spiewak, general counsel of The Power Marketing Association, which represents electricity sellers. "But they have enough common sense to know that comes back to haunt you."

Others, however, see the commission's reticence as an abdication of responsibility.

"They have been fairly absent," says Tyson Slocum, a senior researcher with Public Citizen. "There is no question right now that FERC is being incredibly irresponsible."

THE DEREGULATORS

The FERC commissioners tried to fix that problem with a Dec. 15, 2000, order mandating changes in California's power market. The commission allowed the utilities to hold back 25,000 megawatts from the power exchange and use it for their customers. That released the utilities from having to buy back their own electricity on the high-priced power exchange market.

The commission also lifted California's requirement that electricity be sold only on the spot market and encouraged companies to enter into long-term contracts. It also ordered that the members of a nonprofit board that California created to monitor the electricity flow, which has the authority to buy emergency power for shortages, be replaced with members who do not have ties to the industry.

In addition, the commission put a four-month soft cap in place. It requested that electricity be sold by wholesalers for no more than \$150 per megawatt hour. Prices are allowed to rise above \$150, but bids at prices above this level trigger increased reporting requirements.

But FERC rejected requests for hard price caps, which set an absolute maximum price, for either California or the Western region. Nor did the commission institute cost-based pricing, which limits the selling price to the cost of producing electricity, plus a small amount of profit and other additions such as capital expenditures. The question now is whether that decision is going to kill off California's power market, or save it.

"I think when markets fail you need to go to price-based caps," says Lenny Goldberg, a lobbyist for the Utility Reform Network, a California consumer advocacy group. "This would have never happened had FERC done its job."

But price caps are tricky. Critics charge that price caps cause shortages and create no incentives for companies to build new plants, which they say California needs. Many in the field are dead set against price caps, even as a temporary solution.

"I believe FERC is doing all that it can," says Lynne Church, executive director of the Electric Power Supply Association, which represents power marketers and suppliers. "What essentially California is asking for is for FERC to protect them from themselves instead of dealing with the problems in their system."

While many in California say they assumed that FERC would do everything in its power to save the state in a crisis, the commission has made it clear that it will not play the white knight.

"We were assured by FERC that they would be there," says Michael Shames, executive director of the Utility Consumers' Action Network. "If we had been told that if a competitive wholesale market fails to develop, then we at FERC will not do anything, I can assure you there is no way in heck [California's deregulation bill] would have been passed."

FERC's reluctance has caused clear rage in California. Several California members of Congress have proposed bills to force FERC to put in price caps. The state is moving to grab as much control as possible by trying to create its own state-owned public utility and take over control of the power lines in the state.

The request for price caps, although denied by FERC, is under further review at the request of numerous parties. But some of the spirit of trust and cooperation between California and FERC is lost. And if FERC continues to eschew the role of the regulatory rescuer, it may change the face of deregulation across the country.

"Clearly there could have been more of a safety net than there has been," says J.A. "Lon" Bouknight Jr., chairman of Steptoe & Johnson and head of the firm's electric power practice. "I think so many states are hesitating, at least in part, because if mistakes are made, the safety net they thought was there hasn't been there yet in California."

Although the commission has very broad powers, including the responsibility for ensuring that wholesale electricity prices are just and reasonable, it is an agency that has spent the past few decades pushing for less regulation.

Under a congressional mandate, the commission helped deregulate the natural gas markets, and it has spent the last 10 years mapping out a similar plan for electricity. But it has been a strategy that FERC has had to devise with little guidance.

In 1992, Congress passed the Energy Policy Act, which helped open up wholesale markets and encouraged states to deregulate their retail markets. The commission passed several rules in the 1990s designed to help ease deregulation -- notably one requiring the opening of electricity transmission lines to companies besides the utilities that own them, and another requiring utilities to band together to create regional transmission organizations to manage the movement of electricity within geographic regions.

Since 1992, Congress has held numerous hearings on electricity deregulation and debated dozens of bills, but it hasn't managed to pass anything outlining a uniform national approach to deregulation. Instead, FERC has done this mostly on its own, and some observers say that deregulation has suffered because of it.

"When you start to think about industry restructuring, you should think about what the industry should look like -- that never happened," says Lawrence Spiwak, a former FERC lawyer who is now president of the Phoenix Center for Advanced Legal and Economic Public Policy Studies. "FERC decided they were going to do it on their own. They didn't do the requisite heavy lifting."

FERC Chairman Hébert could not be reached for comment.

What has happened is that FERC has set the broad outlines, then the states have designed their own overhauls.

Until last year, that strategy seemed to be working smoothly.

Then California's energy market spiraled out of control. Prices zoomed, the public utilities started to go bankrupt, and the rolling blackouts began.

California's deregulation scheme is unique. And a confluence of several factors -- high natural gas prices, bad weather, a shortage of power generators, a market that limited long-term energy contracts and exposed utilities to rising prices, but locked in customer's rates -- all worsened the situation.

But the federal government and its energy policy are also factors.

The California crisis has forced FERC to choose between following its free-market philosophy, despite interim pain, or stepping back into California and using the heavy hand of regulation.

TAKING SMALL STEPS

In the wake of the crisis, FERC has backed away from setting prices for California or the entire Western region. Instead, it has preferred to tinker with California's system in the hopes that this will let the market actually work.

All of the power in California is sold through a state power exchange rather than through individual negotiations between companies. The rules of the power exchange force companies to operate on the short term, making them buy their power at the last minute, rather than signing several year-long contracts for their power needs and locking in a price.

But FERC may also feel a little burned. After all, it went out of its way to give the state as much autonomy as possible in designing its own system. Now, it's getting criticized for failing to step in and, essentially, save California from itself.

"When they first OK'd the California system, they were paying deference to California and their prerogative," says Andrew Zausner, a partner at Dickstein, Shapiro, Morin & Oshinsky who represents power suppliers. "In retrospect, they probably paid too much deference, and they would probably agree they paid too much deference."