

BRIEF ANALYSIS

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California's Electrical Mess: The Deregulation That Wasn't

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In 1994 California enacted legislation intended to deregulate the electric power business in the state and establish a competitive market. By January 2001, flaws in the California approach had become evident with the state's utilities driven to the brink of bankruptcy and Californians suffering electricity shortages and blackouts.

Deregulation never really took place in California. Instead, political forces imposed a contrived market structure that made failure almost predictable. California's disaster was of its own making and largely avoidable.

Preparation for Competition. Following the nation's energy crises of the 1970s, the federal Public Utility Regulatory Policies Act (PURPA) of 1978 aimed at improving energy efficiency and increasing the reliability of electric power supplies. It required utilities to purchase power from small, independent generating plants. It also required utilities that owned long-distance, high-voltage power lines connected to the national grid to let other generators send electricity on the lines. This opened the door to competition.

In 1993 the staff of the California Public Utilities Commission issued a remarkable report blaming regulatory micromanagement and centralized planning for rates 50 percent above the national average. The commission recommended radical deregulation, with utilities letting other suppliers have access to consumers on their lines while continuing to sell at regulated rates to consumers who did not choose to switch.

The utilities could price transmission service at regulated rates and could recover an estimated \$27 billion in "stranded costs" through fees to be paid by both customers who switched and those who stayed with the utility. The stranded costs were connected with uneconomic facilities the utilities had built before deregulation.

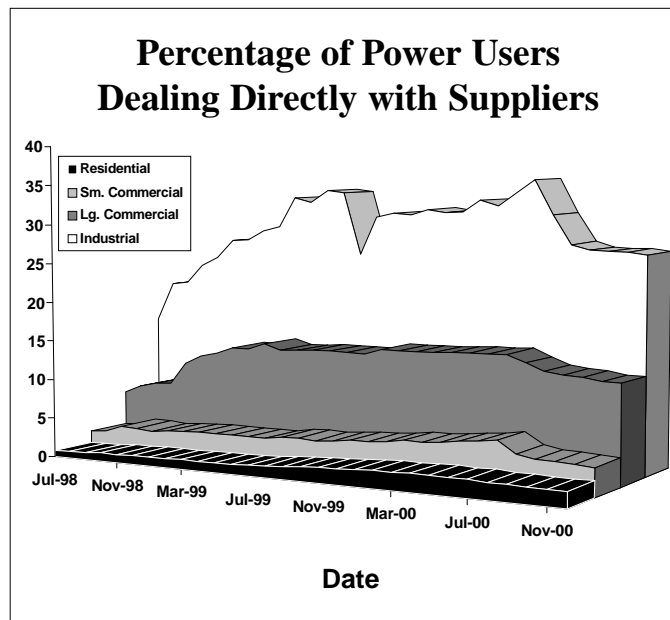
Deregulation Becomes Reregulation. Pacific Gas & Electric, which serves Northern California, accepted the inevitability of competition and offered to phase in direct access if it was allowed to recover its stranded costs. In effect PG&E would get out of the business of producing power and specialize in transmitting power.

In contrast, Southern California Edison and San Diego Gas & Electric proposed setting up "PoolCo," a nearly universal short-term wholesale market covering the entire state. All power producers would bid into PoolCo, and utilities would purchase all their power there. Utilities would pass the price on to customers, who would not be allowed to directly deal with producers.

In September 1996 the legislature unanimously passed a bill embracing a variant of PoolCo. Customers could transact on

their own, but the complicated requirements made this unworkable for all but the largest users. [See the figure.] Electric rates were cut by 10 percent from 1996 levels for existing residential and small business customers and frozen until 2002. But customers saw an *added* monthly charge to pay off \$6 billion in state bonds issued to finance the rate rollback. The utilities were put at some risk for their stranded costs. And they were supposed to collect the difference between the frozen rates and the cost of procuring the power they would resell, but only until March 2002.

The legislation also authorized creation of the California Power Exchange (PX) to operate a statewide



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short-term market, and required utilities to obtain all of their power from it. Another new creation, the Independent System Operator (ISO), would control the prices and terms under which electricity generators could move power across the state grid.

Beginning in 1998, California utilities operated in a system unlike any other in the world. They could buy only on the shortest-term market imaginable, paying prices for their next day's energy that varied hour by hour. They were prohibited from using longer-term contracts or hedging instruments such as options — an odd prohibition, since the price of power is more volatile than that of any other commodity. For other goods (and for electricity outside of California), buyers and sellers meet their needs with a mix of long-term and short-term contracts, hedge their risks and only trade small volumes in the shortest-term markets. California utilities preferred the exclusive reliance on a PX because they forecast a permanent downward trend in short-term prices, which would have made stranded cost recovery more likely. Their forecast proved disastrously incorrect.

Disaster Strikes. For the first two years, low PX prices allowed utilities to collect their stranded costs ahead of schedule. But in the summer of 2000, almost everything that could raise wholesale prices happened at once. Hot weather in the Southwest and low water levels in the Northwest cut importable power. Natural gas prices spiked, and the price of the most important permit in California's pollution-control market rose from \$4 to \$40. (Under California law, businesses receive pollution quotas. Those who pollute less can sell their rights in a market to those who wish to pollute more.) Because of objections to major power plants, none had been built in 15 years, while the growth of the silicon economy had raised demand to levels not expected until 2005.

Although the utilities now faced high wholesale prices, the rates they could charge customers were still frozen. By February, their estimated net cash shortfalls were over \$6 billion and rising, and analysts had downgraded

their bonds to junk status. In mid-January, Southern California Edison failed to pay nearly \$600 million for power purchases and bond interest, and on February 1, PG&E defaulted on \$726 million of commercial paper. Some producers were unwilling to sell in the California market until they had guarantees of payment.

On February 2, Gov. Gray Davis signed legislation authorizing issuance of \$10 billion in state bonds for the purchase of power under long-term contracts. The state will resell this power to customers of the utilities in order to pay off the bonds, which are explicitly not backed by the "full faith and credit" of California. Little has been disclosed about the prices bid for an earlier, smaller set of long-term contracts, but there is general agreement that the governor's target price is extremely low. The governor continues to oppose realistic rate increases needed to maintain the utilities' solvency. Both outgoing and incoming federal energy officials are largely in agreement that California's problems are of its own making, and it is up to California to solve them.

Can California Recover? California's politics aggravate the situation. Rate increases are politically dangerous. And an initiative likely to qualify for the next election proposes state takeover of most utility assets. The first important new power plants in California are scheduled to go on line later this year. State government is attempting to expedite the siting process for generators and transmission, but California allows opponents at lower levels of government considerable leeway to delay construction.

The state confused price controls and artificial markets with competition and is now reaping the consequences. California's trouble stems from many sources, but true deregulation is not one of them.

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