FERC's fixes have fallen short (San Jose Mercury News, June 20, 2001)

BY FRANK WOLAK

On Monday, for the third time in the past eight months, the Federal Energy Regulatory Commission, the agency charged with regulating wholesale electricity prices in California, implemented remedies that it claims will set just and reasonable wholesale electricity prices. This is a case where the third time is unlikely to be a charm.

As chairman of the Market Surveillance Committee of the California Independent System Operator, the independent committee formed by FERC to monitor the California market, I have analyzed the results of FERC's previous attempts. They reveal a misunderstanding of important details of the California electricity market. It is therefore not surprising that they have been ineffective.

Starting in November of 2000, FERC acknowledged that wholesale prices in California during the summer of 2000 were unjust and unreasonable. Its December 2000 order implemented the first set of remedies. Both the California Power Exchange Market Monitoring Committee and the committee I chair pointed out important shortcomings in FERC's analysis of the California market and argued that its remedies would most likely harm, rather than enhance, market performance.

At this time, FERC also did not order refunds for the unjust and unreasonable prices, even though it acknowledged the prices reflected the exercise of market power, which is the ability of a producer to force prices higher. The Federal Power Act requires refunds under these circumstances. But FERC said it was unable to find specific instances of firms exercising market power. This makes no sense. If FERC finds that prices indicate market power, then the generators who bid those prices are exercising market power.

Following the implementation of these remedies, conditions in the California market deteriorated far beyond what had been predicted by the two market monitoring committees. Even though January and February are the lowest demand months of the year, average wholesale electricity prices were almost 10 times higher in 2001 than they were during the same two months of 2000 and almost double the average price during the summer of 2000. In January, March and May, California experienced several days of rolling blackouts and had system emergencies almost every day during January and February of 2001.

In April, FERC made another round of market rule changes designed to lead to just and reasonable prices. However, in response to growing pressure from Congress, less than 10 days after these remedies were implemented, FERC enacted its most recent order.

Before Congress declares victory, it should verify that FERC's most recent plan achieves the following two goals.

First, the plan should guarantee that the average price of wholesale electricity paid by California over the next two years is equal to the average price that would occur in a competitive electricity market, with California's current supply and demand conditions and fuel costs. The Federal Power Act requires not just a high probability of just and reasonable rates; it requires that they occur with certainty.

The second goal is to alter the incentives faced by all market participants so that it will no longer be profit-maximizing for a firm to withhold electricity from the market in order to drive up prices.

FERC's most recently implemented plan does not achieve either of these goals, although it does come closer than any previous attempts.

One solution satisfying both of these goals has been proposed to FERC. In a December report to FERC, the Market Surveillance Committee of the California ISO proposed a one-time regulatory intervention. This intervention would require that each generator serving California sign a forward contract guaranteeing that California consumers can purchase 75 percent of the generator's expected output over the next two years at a specified competitive benchmark price. Once a firm has signed these forward contracts, it is free to sell all remaining energy in the western U.S. wholesale market at whatever price it can obtain.

The obligation to provide power under the contracts, and the incentive to sell 25 percent of power at unrestricted prices, would prevent generators from withholding power.

Unless FERC implements a solution satisfying these two goals, Congress should require FERC to suspend the market-based pricing authority for all suppliers in the Western U.S. for the next two years and order all sales during this period at cost-of-service prices. This will guarantee that FERC meets the statutory mandate of the Federal Power Act in California.