



National Energy Marketers Association

Briefing on Senate Energy Hearing on California Energy Crisis

January 31, 2001

The Senate Committee on Energy and Natural Resources convened an oversight hearing on January 31, 2001, to receive testimony on California's electricity crisis and implications for the West.¹ NEM attended the Hearing to assess the direction of the expert testimony and the current politics of federal legislation².

Set forth below is a brief summary of the verbal comments made by key members of the committee. We will be scanning the testimony onto the NEM Website for member use as soon as possible. **However, in my opinion, the most important expert testimony was submitted into the record by Senator Bingaman very quietly and without being listed on the official witness list.** In my opinion, this testimony will be used to advocate energy restructuring policies that will have an important impact on NEM and its members.

Specifically, *Professor Joskow and Edward Kahn* completed, issued and Senator Bingaman submitted into the record "*A Quantitative Analysis of Pricing Behavior in California's Wholesale Electricity Market During Summer 2000.*" This 37 page document³ performed a sophisticated and very credible quantitative analysis concluding that:

¹ The panels of the hearing were comprised as follows: Panel 1 - Larry Makovich, North American Electric Power, Peter Fox-Penner, Brattle Group, Kit Konolige, Morgan Stanley Dean Witter; Panel 2 - Steve Frank, Southern California Edison, Steven Kline, PG&E Corporation, Fred John, Sempra Energy, Keith Bailey, The Williams Companies, Steve Kean, Enron, Joe Bob Perkins, Reliant Energy Wholesale Group, Curt Hildebrand, Calpine Corporation, Richard Ferreira, Sacramento Municipal Utility District; Panel 3 - Tom Karrier, Northwest Power Planning Council, John Gale, Idaho Power Company, Brett Wilcox, Golden Northwest Aluminum Incorporated, Mark Crisson, Tacoma Public Utilities, Judi Johansen, PacifiCorp.

² NEM's *National Guidelines for Restructuring the Electric Generation, Transmission and Distribution Industries*, the Op-ed on the California Crisis, NEM's press release and the one page summary reprint of the NEM's *National Technology Policy* were distributed to the Senate Energy Committee and the press in attendance.

³ http://www.energymarketers.com/documents/Joskow_Kahn_Quantitative_Analysis.pdf

"The wholesale electricity prices in California far exceeded competitive levels during June, July and August of 2000...that can not be fully explained as a natural outcome of 'market fundamentals,' in competitive markets. Moreover, there is considerable empirical evidence to support a presumption that the high prices reflect the withholding of supplies from the market by suppliers (generators or marketers)." The analysis states that "rational capacity withholding does not require collusion among suppliers." However, on page 19 it states that, "it appears that more than one portfolio player was implementing a withholding strategy."

Chairman Murkowski of Alaska began the hearing by noting that the California crisis highlights the need for a workable energy policy at the federal level. He stated that the purpose of the hearing was to determine what was the legitimate role for FERC and the federal government to play and the hearing was to provide an accounting of what was occurring and what to do to fix it.

It should be noted that Senator Lott has made it known that if there is a need for quick action on federal restructuring legislation, **Senator Murkowski's bill "is ready to go."** A copy of this bill is available on the NEM Website⁴ and there are sections of the bill that are being reviewed for inclusion of NEM positions.

Senator Bingaman of New Mexico argued that the California electric system is inseparable from the West just as the California economy is inseparable from the rest of the country. He said there was an obligation to the nation to put a solution in effect before the situation worsens.

Senator Feinstein of California introduced a letter into the record from California Governor Davis outlining proposed solutions to the crisis including streamlining the certification process, coordinating maintenance schedules, and passing legislation to permit bilateral contracting (the full text of the Governor Davis Letter will be available on the NEM Website). Senator Feinstein argued it was the role of the federal government to provide stability to the marketplace such as was proposed in a bill she introduced requiring FERC to exercise authority to place a cap on unjust and unreasonable rates.

Senator Feinstein also argued that short-term action to stabilize the generation market is needed now because **the California ISO has predicted the state will be short 2000-5000 MWs this summer.** She discussed the Joskow/Kahn Analysis cited above and questioned why FERC found prices were unjust and unreasonable but did not act.

⁴ http://www.energymarketers.com/Documents/Murkowski_bill.pdf

Senator Smith from Oregon made important points that others missed.

Oregon ratepayers are facing 40% increases in electricity prices plus the collateral economic damage while California ratepayers are being protected with only 10% increases in rates. He asked each witness in one word to state whether California's proposed short-term solutions would work. Messrs. Makevich and Konolige both testified no, Fox-Penner said maybe. A discussion ensued that price spikes or price caps set at the wrong level could be classified as economic rents, therefore raised important political and equity issues because they represent major wealth transfers.

Senator Boxer of California argued that it is not the fault of environmentalists that California lacks generation but rather the utilities who did not want to build new generation despite a California PUC Order requiring it. She also stated that the utilities fought at FERC on this issue and won.

Mr. Makovich, of North American Electric Power, testified that serious flaws exist in the California market. Specifically, the market was set up to make it impossible to build new power plants. He stated that the state approval process imposed significant obstacles, and prices were set too low to provide a timely signal. He further explained that the California energy market clears on a short-term basis, and nobody builds plants based on short-term recovery alone. He also testified that another flaw underlying the market was the belief that they could set up market rules designed by stakeholders, as opposed to experts. Mr. Makovich testified that long-term contracts and formal capacity contracts were needed to provide proper price signals.

Mr. Fox-Penner, of the Brattle Group, testified that the solution to the crisis was a combination of federal, state and regional policies designed to allow the evolution of markets. Mr. Fox-Penner described the California situation as a robust economy that spurred demand, growing dependence on imports, lowest gas storage levels in years coupled with high prices, and an overly complex regulatory scheme. He contrasted California to other states that are bringing supply on and where the private sector is doing its job. Mr. Fox-Penner made recommendations for federal action as follows: 1) Congress should engage in examining the jurisdictional structure of utility regulation. Federal legislation should include FERC authority over all transmission and reliability proceedings. There should be a reexamination of PURPA and PUHCA. 2) There should be an expansion of the energy infrastructure, including transmission lines, power plants, and gas pipeline additions. He encouraged maximizing reliance on decentralized sources. 3) Demand side responses are necessary for the electric markets to work properly. 4) The federal Clean Air Act should not be weakened. The lack of generation in

California was not caused by the federal standards, rather California imposes stricter standards than are required under the federal act. 5) To lessen the effects of price volatility, do not isolate consumers from price signals.

Mr. Konolige, of Morgan Stanley Dean Witter, testified about the Wall Street view on a solution to the crisis. He argued that a true supply and demand market is most important for plant investors. Toward that end, price caps and long delays in approval are viewed negatively and long-term contracts and clarity in laws are viewed positively. Mr. Konolige argued that a system is needed whereby consumers pay the true market price for electricity because this will send proper signals to plant builders. He discussed the unique way California markets were interfered with such as: preventing the market from signing long term contracts which drove up spot prices, imposing price caps which were lowered four times last year, and creating a perverse incentive to only sell into the market at what would be considered high returns because there was no long-term stability. Mr. Konolige's solutions to the crisis included making the siting process faster and more transparent and exposing customers to the high prices of electricity.

Senator Bingaman of New Mexico questioned the Expert Panel on the propriety of federal efforts to restrict the wholesale price of power going into California. Mr. Makevich responded that long-term price caps are not a desirable long-term feature of a market. Price caps create distortions because they may be set too low. Price caps also discourage supply additions. Mr. Makevich reasoned that given how short the market will be next summer, the temporary use of price caps may be appropriate. Mr. Fox-Penner pointed out that there are already caps on almost all the markets but that those markets are not trading at that level. He said it is hard to set price caps at a fair level that doesn't squelch investment and that it is very difficult to transition on and off of price caps. He said price caps could be used as a last resort for the summer period. He also argued that long-term contracts could be just as effective of a solution.

Senator Campbell of Colorado, Senator Craig of Idaho, and Senator Burns of Montana voiced concerns that since the western grid is interlocking, the California crisis can spread to the rest of the Northwest and cautioned that it would be a mistake to force the Northwest to solve California's needs.

Senator Cantwell of Washington described the impact of the crisis on the Northwest. Employers at aluminum, steel and timber mills are closing their doors. Also, because California is drawing in power from outside sources it forces prices higher in the Northwest.

Senator Landrieu of Louisiana argued there should be more domestic drilling of natural gas, opening of pipelines, and increased transmission in conformance with

environmental standards. She said every state should assume responsibility for producing what it can, using sources such as nuclear, clean coal, oil, hydro or gas, in conformance with environmental standards. She also cautioned against layering state standards that are overly bureaucratic.

As time permits, NEM will be arranging visits with key legislators over the next few weeks to make our points known. Member comments, political contacts and participation are encouraged and would be appreciated. Please contact headquarters ASAP.

Thank you for your attention to these important matters

Craig Goodman