LESSONS FROM THE CALIFORNIA ENERGY CRISIS

HOW I SPENT MY SUMMER VACATION (2000)

JAN SMUTNY JONES

3 ELEMENTS LEADING TO CRISIS

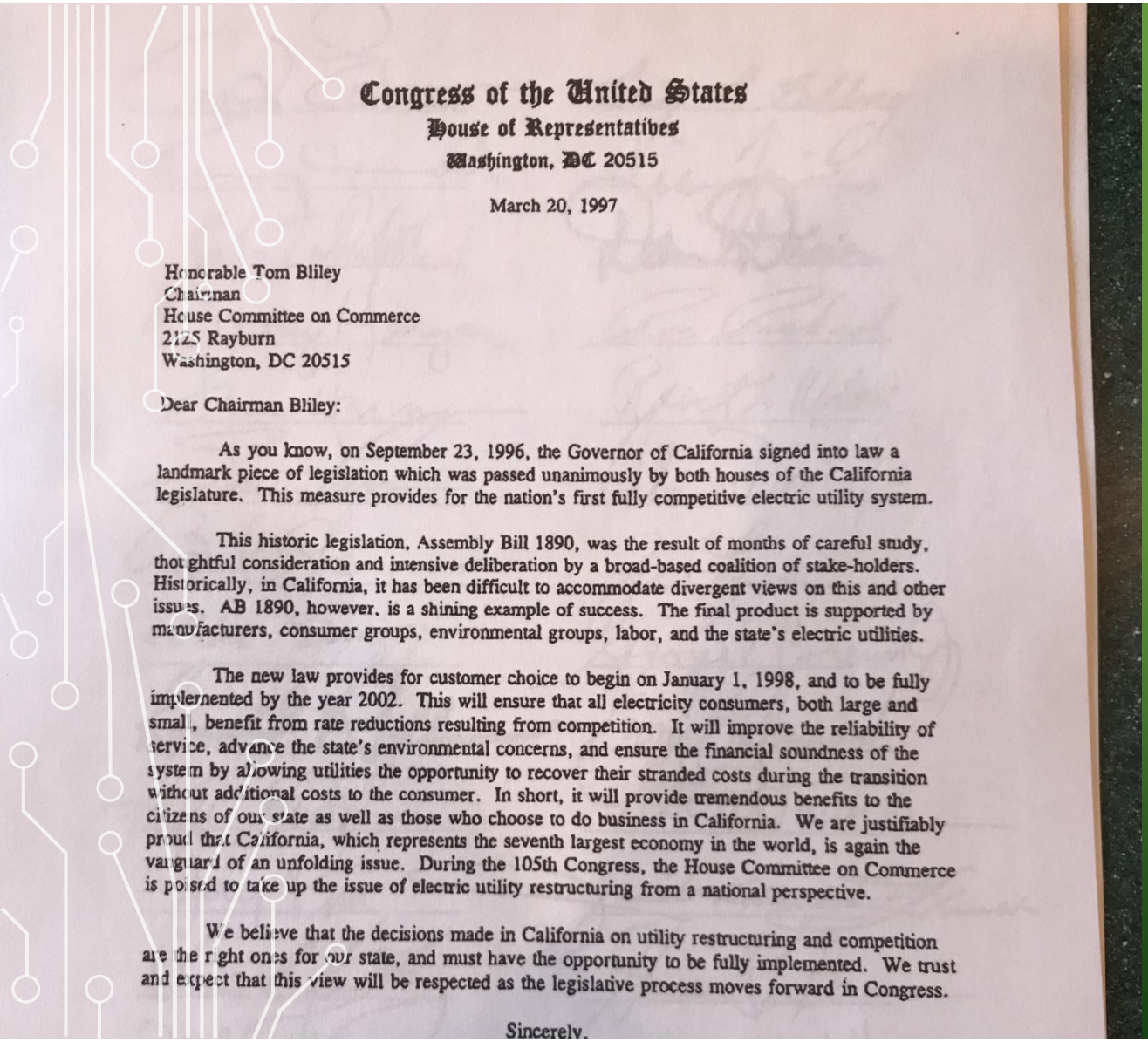
MARKET DESIGN FLAWS

LOW HYDRO CONDITIONS AND GAS DISRUPTIONS

LAG IN PROMPT REGULATORY/POLITICAL ACTION

EXPECTATIONS OF CALIFORNIA RESTRUCTURING

- “Peace is Hell” – Post Cold War and Recession impact California economy
- CPUC investigates regulatory alternatives (Yellow Book)
- CPUC selects Direct Access as viable alternative (Blue Book)
- C&I customers want Direct Access on date certain
- Utilities want ability to recover stranded costs
- Market, not regulatory decisions (Nuke/ QFs)would drive future investments
- Market efficiency would lead to lower prices and innovation



Congress of the United States
House of Representatives
Washington, DC 20515

March 20, 1997

Honorable Tom Bliley
Chairman
House Committee on Commerce
2125 Rayburn
Washington, DC 20515

Dear Chairman Bliley:

As you know, on September 23, 1996, the Governor of California signed into law a landmark piece of legislation which was passed unanimously by both houses of the California legislature. This measure provides for the nation's first fully competitive electric utility system.

This historic legislation, Assembly Bill 1890, was the result of months of careful study, thoughtful consideration and intensive deliberation by a broad-based coalition of stake-holders. Historically, in California, it has been difficult to accommodate divergent views on this and other issues. AB 1890, however, is a shining example of success. The final product is supported by manufacturers, consumer groups, environmental groups, labor, and the state's electric utilities.

The new law provides for customer choice to begin on January 1, 1998, and to be fully implemented by the year 2002. This will ensure that all electricity consumers, both large and small, benefit from rate reductions resulting from competition. It will improve the reliability of service, advance the state's environmental concerns, and ensure the financial soundness of the system by allowing utilities the opportunity to recover their stranded costs during the transition without additional costs to the consumer. In short, it will provide tremendous benefits to the citizens of our state as well as those who choose to do business in California. We are justifiably proud that California, which represents the seventh largest economy in the world, is again the vanguard of an unfolding issue. During the 105th Congress, the House Committee on Commerce is poised to take up the issue of electric utility restructuring from a national perspective.

We believe that the decisions made in California on utility restructuring and competition are the right ones for our state, and must have the opportunity to be fully implemented. We trust and expect that this view will be respected as the legislative process moves forward in Congress.

Sincerely,

THE LETTER

- This letter was signed by the entire California delegation for the purpose of protecting the California restructuring construct from Federal intrusion

AB 1890 (BRULTE) "EVERYBODY IS A WINNER"

- California Legislature Votes unanimously to support Electric Restructuring
- Direct Access by 01/01/98
- IOUs recover Stranded Costs through Competitive Transition Charge (CTC)
- $530 million for renewables
- Money for public purpose expenditures
- Rates reduced/ securitized by 10%
- CAISO created for transmission access
- Power Exchange- IOUs buy/sell into pool per se reasonable

MARKET STRUCTURE

- Power Exchange (PX)- Operates Day-Ahead Market; IOUs sell generation and buy electricity to meet load; All residential customer served through the PX
- C&I customers may purchase DA by 03/31/98, Residential at later date
- CAISO operates transmission system with an hour ahead and real-time market
- CPUC requires IOUs divest at least 50% fossil generation
- New generation expected to be provided by market signals

SUPPLY SQUEEZE

- Low Hydro leads to reduced imports and supply
- Prices move up in the natural gas market
- El Paso Pipeline explosion in July 1998 creates further gas import limitations
- Internal gas fleet runs hard, several IPPs run out of air quality credits
- Accusations of supply withholding
- Market prices rise in PX and CAISO Markets
- Wholesale electricity price rise throughout the West

HITTING THE FAN

- May 1998 SDG&E pays off Stranded Costs, the CTC and rate freeze expire
- SDG&E ratepayers are now fully exposed to market prices
- Early heat wave results in significant rate increases
- Senator Steve Peace, who presided over the AB 1890 Conference Committee, also represented San Diego
- Immediate calls for price freezes
- Price Caps become a major issue

CALIFORNIA RESPONSE SUMMER 2000

- SDG&E requests long term (5 year) contracts from market
- Significant response from IPPs around $50 MW
- PG&E and SCE seek contracts to stabilize price volatility
- CPUC President Lynch discourages contracts, few contracts are signed
- Immediate call for lowering price caps ($750 down to $250)
- Wholesale rates rise while retail rates remain frozen (SDG&E refreezes)

FERC RESPONSE 2000-2001

- July 2000 FERC Staff ordered to investigate the western energy market
- August 2000 SDG&E files formal complaint with FERC asking that price cap be reduced from $500 to $250. (CAISO reduced price cap to $250 independently)
- November: FERC Staff issues report stating that the market structure is seriously flawed leading to unjust and unreasonable short-term rates with the potential for market power abuse; Orders CAISO and PX to replace Stakeholder Boards with Independent Boards
- December: FERC replaces CAISO $250 Price Cap with a $250 "Breakpoint" and requires penalties for generation refusing to run when needed.
- December 2001: FERC eliminates the IOU Must sell/buy into the PX; The PX later goes bankrupt

PEACE TALKS-WASHINGTON

- Dec. 2000 outgoing President Clinton orders Secretary of the Treasury, Secretary of Energy and FERC Chair to hold talks with California leadership and the CEOs of the IOUs, IPPs and QFs
- Governor Davis and the legislative leadership of both parties come to the initial negotiations
- QFs committed not to push involuntary bankruptcy proceeding, structured settlement ensues--everyone eventually gets paid (renewables with no gas exposure help keep the lights on)
- IPPs and IOUs reached a settlement brokered by Secretary of the Treasury (In a bunker under DOE…you can't make this stuff up)
- California orders Dept of Water Resources to procure long-term contracts. Ink dries …litigation ensues…full employment for the D.C. Energy Bar… one case still open.

2001-LET THE FINGER-POINTING BEGIN

- April 2001 PG&E declares bankruptcy
- California passes legislation replacing CAISO Stakeholder Board with a 5- member Board appointed by the Governor and approved by the CA Senate
- FERC adopts "must offer" rules for California and the west
- FERC investigates a number of different market participants with settlements. Process goes on for years
- New leadership at the FERC geared toward correcting the market
- New leadership at the CPUC with actual experience in energy
- Energy Crisis major factor in the recall of Governor Davis

LESSONS LEARNED

- Do not hard-wire economic expectations into legislation
- Expect major new initiatives to run into friction. Do not limit the ability to respond.
- State/Federal regulatory interaction is absolutely necessary, cooperation in the Summer of 2000 would have limited damage
- Going "short" without adequate hedging and long-term planning leads to chaos when market shifts (portfolios are important)
- Suppliers need to be responsive to the political and economic consequences beyond the electricity market
- Hubris is dangerous.