

Watt went wrong?

California's power problems are short-circuiting a switch to electricity restructuring in some states, but others are moving ahead with their plans.

BY ELAINE STUART



Everyone is asking what went wrong with electric restructuring in California. Amid all the finger pointing, most agree demand outstripped supply and the 1996 law to deregulate failed miserably.

California's rolling blackouts and skyrocketing prices have scared off some states, but others well on the path to restructuring are forging ahead. In the past four years, 24 states have moved to transform the electric industry from a regulated monopoly into a competitive market. Most are still in a transition period.

By restructuring, states hope to lower consumers' electric bills, foster economic development and make the market more competitive. States that have moved to restructure generally had higher rates, while those reluctant to switch had lower power costs and thus little to gain. A few low-cost states restructured because they feared federal pre-emption, although this threat has since disappeared. States now are considering what they might have in common with California.

"Most states are not in the same situation as California," said Kenneth Rose, senior economist at the National Regulatory Research Institute at the Ohio State University and a national expert on electric restructuring. "It was like the 'perfect storm' in that everything was lined up to raise prices."

California's sudden economic boom increased demand for electricity at a time when supplies fell. In addition, prices climbed for natural gas, which fuels many of the state's power plants. Flaws in the state's restructuring law contributed to the price jumps.

"I think the people that insisted that we get into deregulation in 1996 made a huge miscalculation," said California Gov. Gray Davis. "They did not anticipate the huge (economic) recovery California experienced and the needs of the tech companies here in Cali-

fornia. Secondly, there was no effort to build new plants to meet the demand.”

In his Jan. 8 address to the Legislature, Davis blamed electricity deregulation for much of the state’s troubles. “California’s deregulation scheme is a colossal and dangerous failure,” he said. “It has not lowered consumer prices. And it has not increased supply. In fact, it has resulted in skyrocketing prices, price-gouging and an unreliable supply of electricity.”

California’s mistakes may seem obvious in retrospect, but in 1996 the Legislature passed the bill to deregulate electricity unanimously, and then Gov. Pete Wilson signed A.B. 1890

into law with fanfare. At the time, three major electric utilities owned most of the power plants in the state and controlled the transmission of power to retail customers. To allow other energy producers into the market and break the monopoly of the three large utilities, the law set up a new nonprofit organization to ensure open access to the utilities’ transmission lines. The Independent System Operator was empowered to buy electricity at whatever price necessary to keep the lights on. The law also required the three major privately owned utilities to buy and sell all their power in the state on the newly created California Power Exchange. To make sure the Power Exchange succeeded as a spot market, utility companies could not sign long-term contracts with power providers to hedge

against rising prices. The idea was to guard against utilities locking up all the cheap electricity and stifling competition. As it worked out, few companies emerged to compete with the big utilities. Moreover, energy producers found they could sell power for higher prices

ceeds to pay off billions of dollars in debt accumulated over past decades, much of it from building expensive nuclear plants and investing in alternative energy. Because utilities had only until 2002 to recover their past investments, they had a strong incentive to sell. The

plants fetched a combined \$3 billion, some \$1 billion more than their book value. However, a small number of energy producers, most from out of state, bought the power plants. The law did not require the new owners to sell their electricity to California utilities at a fixed price.

A taste of the consequences of an unregulated market came last year in San Diego. When San Diego Gas and

Electric’s sale of its assets wiped out its \$2 billion in debt, it triggered a lifting of its rate freeze on July 1, 1999. Within 10 months, San Diego residents’ electric bills soared. In response to a public outcry, the Legislature imposed price caps in August last year.

“The out-of-state generators who bought most of our utilities’ power plants are now charging California several hundred percent more for wholesale electricity than we paid just one year ago,” Davis said in January.

New York and New Hampshire also require utilities to divest to introduce competition into the market. Rose said that California thought that divesting the plants would help utilities recover their old investments faster and place a proper value on power plants. “In ret-



Ten Western governors February 2 recommended steps for a long-term solution for the electric-power system in the West. Shown, left to right, are Idaho Gov. Dirk Kempthorne, CSG president and Western Governors’ Association chairman; Arizona Gov. Jane Dee Hull, WGA vice-chairman, and California Gov. Gray Davis. A.P. photo

on the ISO when an energy crisis loomed, bypassing the competitive price set by the Power Exchange. In sum, California had established a dysfunctional marketplace for power.

The law also provided an immediate 10 percent rate decrease and a rate freeze for retail customers until March 31, 2002, or until the utilities had paid off their past investments, called stranded costs, whichever came first. Stranded costs are past investments a utility could expect to recover in a regulated market, but not in an open market.

Moreover, to curb the market power of existing utilities, the law encouraged investor-owned utilities to sell off their fossil-fuel power plants to unregulated private companies. In return, the state agreed to let the utilities use the pro-

respect some of these measures don't look too bright, but they had their reasons," he said.

As it turned out, however, California lost control over its power supplies. When supplies got tight, utilities were forced to pay higher prices for power, but under the rate freeze they were unable to pass on price hikes to consumers, forcing them into near bankruptcy. Rate freezes for consumers are common in most other deregulating states.

Failure of supply and demand

When California restructured in 1996, the economy was in the doldrums and it looked as if the state had plenty of power. As the state's population and economy grew, however, demand for energy exceeded supplies. From 1996 to 1999, the state added only 672 megawatts of power while peak demand increased by 5,522 megawatts. "For the 12 years before I took office, this state failed to build a single major power plant – not one," Davis said in January.

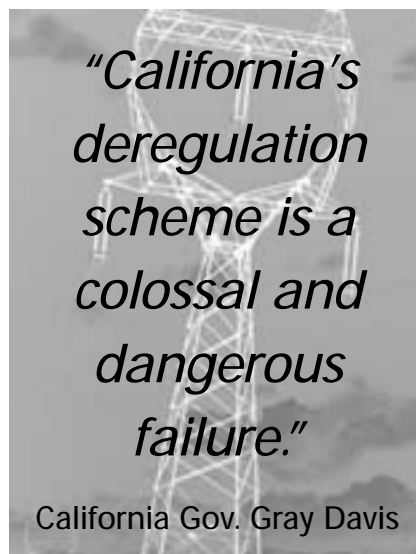
On Feb. 8, Davis announced a plan to boost the state's generating capacity, saying, "We will demonstrate that California can cut red tape, build more power and protect the environment." The plan would cut down on paperwork and streamline the approval process for small natural gas and renewable-fuel power plants to run during peak hours. Davis also ordered changes in air-pollution limits to allow older, dirtier power plants to operate.

Typically it takes a long time for a new power plant to be approved in California. While some point to the state's strict environmental rules, others blame the "Not in My Backyard" syndrome. For example, computer giant Cisco Systems in San Jose blocked construction of a 600-megawatt plant near its corporate campus.

In contrast, Texas, which is restructuring under a 1999 law, has built 22 power plants since 1995, with 15 more under construction. Texas will add

10,000 megawatts by 2002, compared to the 672 megawatts California added in 10 years. Texas also encourages the building of small-scale generators near customers, including fuel cells to power office buildings.

Texas will allow residential customers to choose their power providers starting this June. "Texas is on track



to avert the California train wreck," said Rep. Steve Wolens, co-author of the 1999 deregulation law. As quoted in a Jan. 19 story in *The Dallas Morning News*, Wolens said, "California's experiment was flawed from the beginning. We took every one of those flaws and considered them when we structured our bill."

The area served by the Pennsylvania-Jersey-Maryland power pool also has new plants under construction, as does Ohio.

Weather patterns and a reliance on older plants also contributed to California's problems. In 1999 and 2000, old plants closed for repairs more frequently, while hydropower fell short as reservoirs in the Northwest ran low. In addition, natural gas prices doubled, increasing costs of producing electricity. Transmission capacity in the state also was constrained.

An audit released in February by the Federal Energy Regulatory Commission concluded that weather and en-

ergy policies were partly to blame for rising energy prices in California in November and December. The federal auditors dismissed the governor's charges that power companies shut down plants for maintenance in a bid to raise prices. However, the state is investigating whether generators illegally shut down.

The state passed a series of laws in January and February to keep the power flowing. The Legislature approved a measure to sell \$10 billion in bonds to buy power in the wholesale market and sell it to utility customers. The state also passed legislation to enter into long-term contracts for electricity. The Legislature was considering taking over transmission lines.

Red light, green light?

California is not the only state backtracking on deregulation. In recent months, restructuring efforts have stalled or been declared dead in Arkansas, Louisiana, Minnesota, Montana, Nevada, North Carolina, Oklahoma, Oregon and Vermont. Nevada Gov. Kenny Guinn delayed the state's deregulation scheduled for this fall. "I cannot and will not support deregulation until I am assured that power supplies are secure and those who would be hardest hit by rate increases are protected," he said.

North Carolina Sen. David Hoyle said, "It would be impossible to pass legislation that starts any kind of process to deregulate until we get to the bottom of California's problems."

Other states considered unlikely to restructure include Idaho, Indiana, Kentucky, Nebraska, South Dakota and Utah.

In New Hampshire, however, Gov. Jeanne Shaheen hailed the state Supreme Court's Jan. 16 rejection of challenges to the state's deregulation plan. Public Service Company of New Hampshire seeks to reduce rates by an average of 10 percent for its 430,000 customers, in addition to an earlier reduction of 5 percent under a settle-

ment negotiated with the Legislature in 2000. The deal allows Public Service to refinance up to \$800 million of its debt and requires customers to repay the debt plus interest over 14 years. The debt is the utility's so-called stranded costs from its old power plants, which it might not recover under deregulation. Public Service also agreed to sell off its power plants while keeping its distribution network.

Rose noted that most states where energy is expensive already have moved to restructure. "The whole argument was that lower rates were a way to introduce competition into the market," he said.

Other states should assess their market conditions before restructuring, Rose said. "States should examine how much new supply there is and customer demand," he said. States must have enough suppliers to have real price competition.

Similarities, differences

Many states are looking at how they are similar to and different from California. For example, New York's restructuring plan calls for a statewide wholesale electricity market and for utilities to sell off generation plants. Dave Flanagan, Public Service Commission spokesman, said New York utilities have long-term contracts that insulate them from the price fluctuations experienced in California, and New York does not have the continuous peak demands of California. He said the PSC wants more generating capacity in the state, because the state paid more for power when demand was high last summer.

Illinois has taken a more cautious approach to deregulation, said Rep. John P. Novak, chief sponsor of the 1997 bill that restructured the state's electricity market. The California law's

flaws, Novak said, converged with the state's failure to generate enough power to meet its increased demand for electricity.

Illinois' 362-page law differs from California's plan, Novak said, because "we did not force utilities to sell power plants." Instead, Illinois utilities were allowed to sell their power plants to



Many blame the California Independent System Operator's pricing policies for contributing to price spikes for electricity.

affiliates, which sell power at market rates back to the parent companies and others. As in California, utilities in Illinois will bear the risk of increases in market

prices under a rate freeze to customers. However, the Illinois rate freeze lasts from Jan. 1, 1998 through 2005. "That's a long period, with enough time for new competitors to come in," Novak said. In addition, the utilities can petition for higher rates if needed.

While retail price caps are common in restructuring legislation, California capped consumer rates without allowing utilities to enter long-term contracts to hold down wholesale prices. Illinois utilities can enter long-term contracts and hedge against fluctuations in market prices.

Novak wants Illinois to encourage building more plants and the federal government to issue more emission-trading credits so more coal-fired plants can be built. But he is concerned about the snail's pace of competition in the electricity markets.

Richard Mathias, chairman of the Illinois Commerce Commission, wrote in a Feb. 1 memo to Gov. George Ryan, "Through vigilance and thoughtful initiatives, Illinois can avoid a California-style electricity debacle." He recommended that Illinois encourage conservation, build more power facilities and resolve problems with the regional transmission organization that controls power moving into and out of the state.

A promising start

Pennsylvania's 1996 restructuring plan has received attention for its success. The state produces more power than it consumes and it exports energy. Utilities had the option of selling their plants, and only one, GPU, did. Utilities are free to enter long-term contracts to buffer price spikes in wholesale market. "I assure consumers and legislators that what is happening in California will not happen in our state," Public Utility Commission chairman John M. Quain said in January.

Pennsylvania is getting attention because more than 550,000 customers have switched suppliers. PUC spokesman Kevin Cadden said the choice program has saved Pennsylvania consumers nearly \$2.8 billion.

"We know now that it is hard for new suppliers to come into the market," Rose said. He said Pennsylvania did a good job designing the retail market. Pennsylvania's higher price cap makes retail customers more likely to shop around. In contrast, California set a low price for power, so fewer people switched power suppliers. In neighboring New York, only 3 percent of residential customers have switched electricity providers, or 166,224 of 5.5 million customers as of fall 2000. Critics of the New York program complain customers receive only a small credit for switching.

Pennsylvania is moving fastest toward electricity deregulation, according to a 2001 study by the Center for the Advancement of Energy Markets. The study found that competing suppliers have been slow to arrive in most states that have deregulated, and most

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CSG resources

Restructuring the Electric Industry, by Cindy J. Lackey, P010-9803, 1999, is available by calling CSG's Publications Sales Department, (800) 800-1910, or visiting CSG's online store at www.csg.org.

Women find a home in state government

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ing a young woman, would I be strong enough? And as an African-American, would I represent the entire community, or just the African-American community?"

Walker also said people of color more than others are expected to be from the communities they are running in. "You need to know your community, your geography," she said. "The questions are quick about 'Are you are from the area?' or 'Have you gone through the system?' A white candidate can have moved somewhere three years ago and run."

And Walker said the African-American community does not always put much faith in state government. "I know a lot of people who turn away from the belief that government is the right thing," she said. "I would like to change that, to get people here talking to legislators, or writing, making phone calls, e-mailing. And I want to get information to them so they can identify with what is going on in state government. The community and politics go hand in hand."

Gender-based differences rare

Although women in government are often said to focus on "issues of the

heart," such as health care and education, these women said they care about a wide variety of issues, including budgets.

"I don't find that we are any different from our male counterparts," Everist said. "We are just as fiscally conservative. For example, tobacco prevention is an issue in South Dakota. Both men and women care about this issue, but we are not willing to just throw money at programs that don't work. We have the same philosophy in terms of being prudent."

What female politicians do have in common, these women said, is their style. All said that women in state government work hard, know the issues and collaborate with others.

"The women I've worked with are more consensus-driven, more collegial, less interested in power for its own sake but to achieve policy goals," Alpert said. "This may be because so many women come from nonpartisan local governments, school boards and community associations that got everyone together to work on a problem, where they were used to working by consensus on committees."

And all said that even though their numbers are small, women have changed the nature of state government.

"Government works best when it looks like the people it represents," Alpert said. "By having more women and women in leadership positions, it leads to a balance of issues and brings some issues up to a higher level of importance and concern. And style, the way women tend to run committees and work on problems, it's not the only way, but it's a different way. There's greater strength with different approaches to problems."

Still, while all said women will eventually serve in state government in the same numbers as men, none think that will happen any time soon.

"I think we have to be realistic about what we expect of women," Everist said. "We have to realize that parity has to be reflected in society and then it will be reflected in the political makeup of the Legislature. When you have a part-time legislature, it takes the cooperation of an employer. That's true for both men and women. But when you combine families into that picture, you have to say that even in 2001, women are juggling more balls in the air, and that gives them less flexibility for this endeavor."

Women have come a long way on the road to equal representation, but as the 2000 elections on the state level have shown, the journey is not over yet. ★

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states have little competition or consumer choice. The study ranked the following states as making the most progress in deregulating: New York, Maine, Maryland, Arizona, New Jersey, Washington D.C., Montana, Connecticut and Massachusetts.

Competition and free markets are not guaranteed by electric deregulation. What happened in California is the worst-case scenario, but it shows how the price of electricity will jump

if there are not enough suppliers, Rose said. The usual tenets of free markets do not work in the power industry, Rose said, because consumer demand generally is unresponsive to price for electricity. People "overall are not going to change consumption that much," he said. It also takes time and money to make energy improvements, such as adding insulation, better lighting or more efficient appliances.

Restructuring the Electric Industry, issued by The Council of State Governments in 1999, cautioned state policy-makers that "a dynamic retail market with many competing electricity service providers may take years to evolve."

States still have much to learn from California's failed attempt to deregulate and from promising initiatives in Pennsylvania and elsewhere in moving to competitive markets. ★