A law enforcement perspective of electricity deregulation

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Abstract

In April 2004, the California Attorney General's (AG) office issued a white paper that provided a "law enforcement perspective of the California energy crisis." To complete this special issue's coverage, I summarize three aspects of that paper: notably, the deficiencies in market oversight and enforcement that left the deregulated market prone to potential abuse, the principal *modus operandi* that some market agents used to exploit those deficiencies without fear of retribution, and the AG's "recommendations for improving enforcement and protecting consumers in deregulated energy markets."

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1. Introduction

In 1996, the California legislature enacted Assembly Bill (AB) 1890 under which retail electricity rates would remain subject to regulatory review by the California Public Utilities Commission (CPUC), at least for the foreseeable future, with wholesale rates being determined by market forces [1-3]. To that end, California's three major investor-owned integrated utilities (IOUs) were encouraged to divest themselves of their fossil fuel generating plants. The IOUs turned over control of their transmission lines to an independent system operator (ISO) that would be subject to regulatory oversight by the United States Federal Energy Regulatory Commission (FERC). The ISO was charged with managing the grid's day-to-day operations, which means allocating limited network capacity, and purchasing and selling reserves and real-time energy so as to correct any minor real-time imbalances between loads and resources.

Separately, AB 1890 also created a wholesale spot market in which the IOUs must transact. Established in 1998, the California Power Exchange (PX) served as the central market for some 80% of the state's energy transactions, with the market-clearing prices determined by locational demands and supplies.

The feel-good presumption behind all of this was that consumers would reap the benefits of partial deregulation and competitive spot markets. The reality of May 2000 through June 2001, however, was an energy crisis that manifested itself in soaring wholesale electricity prices far above the capped retail rates, frequent power shortages and consequent rolling blackouts. During November 2000 through May 2001, the coincident dramatic price increases in natural gas exacerbated the electricity problems. The PX closed its doors on February 1, 2001, and the responsibility to ensure competitive electricity prices for transactions other than the bilateral power agreements between LDCs and energy suppliers fell to the ISO. Nevertheless, the soaring wholesale prices and capped retail rates caused financial insolvency of two of the IOUs: Pacific Gas and Electric Company and Southern California Edison. San Diego Gas and Electric was spared because of the removal of capped retail rates in mid-1999 upon its full stranded-cost recovery.

It was apparent that deregulation wasn't working as the California legislature had intended and that something was seriously amiss. It didn't take too long before academics and practitioners alike were offering their explanations and solutions, and for Enron to become a household word - and not just in the United States. One problem in particular was that the IOUs could only transact in spot markets, which might tempt both large-capacity generators to withhold power when supply was tight so as to drive up the wholesale price on a virtually inelastic demand curve, and greedy marketers to devise and implement various short-term market-gaming strategies to pad their pocketbooks, to the ultimate detriment of consumers for whom adequate remedies are unavailable.

In April 2004, the California Attorney General's office (AG) entered the debate through a "white paper" [4] that provided a "law enforcement perspective of the California energy crisis" that plagued California's electricity and natural-gas markets. At the request of this journal's Editor-in-Chief, I summarize three aspects of that paper: notably, the deficiencies in market oversight and enforcement that left the deregulated market prone to potential abuse, the principal *modus operandi* that some market agents used to exploit those deficiencies without fear of retribution, and the AG's "recommendations for improving enforcement and protecting consumers in deregulated energy markets."

2. The deficiencies

The AG identifies and details what boil down to five major failures and deficiencies in market oversight and enforcement.

First, it is left to FERC to determine whether a given generator possesses sufficient market power as to adversely impact price should it choose to do so, say by withholding supply. Once FERC has made a determination that a generator does not possess the requisite power, the generator is free to charge whatever prices buyers are willing to pay, and, FERC insists, the generator is immunized from retroactive refunds and antitrust actions. FERC, however, has limited expertise in antitrust and market-power issues, and has not necessarily devoted the time and effort required to make appropriate determinations in those regards.

Second, although electricity sellers are required to provide FERC with quarterly reports of their business transactions so that it can adequately monitor the energy markets and ensure market-based rates that would approach the competitive norms, the requirement was all too often honored in the breach. By viewing the lapses as "essentially a compliance issue" that an offending generator could rectify by filing an amending report, FERC failed to detect a plethora of instances in which participants manipulated the markets.

Third, generators and traders believe their pricing practices are not subject to judicial review, under the filed-rate doctrine that prevents legal challenges to filed rates that have been approved by administrative agencies such as FERC. Believing that the process of reviewing all rates and terms of sale impeded the competitive process, because it kept sellers from reacting promptly to changing market conditions, FERC in the late 1980s "drastically cut back the filing requirements for sellers transacting at market-based rates." Once a seller demonstrates that it lacks market power or has taken steps to mitigate any power that it might possess, it need only file a "market-based tariff" stating that rates will be determined by agreement of the transacting parties, and it is this tariff to which the filed-rate applies and that earns FERC's blanket authorization.

Fourth, the ISO, the CPUC, and the Electricity Oversight Board (EOB) also failed to exercise adequate market oversight and enforcement of state laws that are themselves of limited enforceability.

Finally, the Security and Exchange Commission (SEC) exempted the IOUs from full scrutiny under the Public Utilities Holding Company Act (PUHCA). Pacific Gas & Electric (PG&E), in particular, took advantage of the situation by diverting $4 billion in earnings to its parent company in the face of large losses and impending bankruptcy.

3. Exploiting the deficiencies

The AG focuses on two very different ways in which the market-oversight-and-enforcement deficiencies were exploited: (1) the raw exercise of undetected and/or undisciplined market power by merchant generators that have no franchised service territories and no legal obligation to serve retail customers; and (2) traders gaming the market through highly complex strategies that are difficult to detect, regulate, or subject to judicial review and consequences..

In the former regard, generators withheld power from California's markets by both reducing production for those markets and simultaneously exporting power to neighboring states, and *then* allowing the law of supply and demand to take effect – as it did and with predictable consequences.

In the latter regard, Enron in particular devised a series of marketing-gaming strategies, four of which take center stage in the AG's report: falsely scheduling power along a congested transmission line in the expectation of being paid to reduce the load; exporting power to a willing accomplice that would resell that power for import at a much higher price; submitting "paper" offers to the ISO in the day-ahead market and covering those offers at the lower capped prices of the real-time market; and scheduling energy in the opposite direction of congestion and then being paid to reduce a load that it had no intention to provide in the first place.

4. The key recommendations

The AG makes four key recommendations, among others, to correct the deficiencies.

First and foremost, there should be a codified statement to the effect that the filed-rate doctrine does not apply to market-based rates and that retroactive refunds, if justified, are available to consumers. Further, and with specific regard to FERC, there should be established "written criteria for market monitoring, identification of gaming, and steps to be taken when markets fail to function properly" and a mechanism should be created "to encourage direct consumer participation" in proceedings before it.

Second, provide the ISO with a "specific and transparent market monitoring system, with specific and enforceable standards for addressing market anomalies and abuses of market power," along with the resources and administrative enforcement authority that would allow it to be an effective enforcer and market monitor.

Third, amend federal law to *require* FERC to cooperate with state and local investigations of any alleged misconduct in the energy markets, and to promote coordination of federal and state enforcement efforts; and consider creating a multi-jurisdictional interagency energy task force.

Fourth, eliminate the intrastate exemption of interstate utility holding companies from the PUHCA, and if the PUHCA is amended or rescinded, retain the oversight-and-review aspects of the law for such holding companies.

5. Conclusion

The notion of deregulated energy markets that are subject only to the discipline of competitive market forces is assuredly appealing, even though the California experience makes evident that it is somewhat naïve. The AG's white paper argues that because such markets are particularly susceptible to market-power abuses as well as obtuse gaming strategies by unscrupulous agents, a critical aspect of the deregulation process should contain the following components: (a) the concurrent establishment of cooperating oversight bodies that have been provided with well-defined responsibilities; (b) the appropriate criteria and analytic frameworks for gauging market performance; (c) the resources to carry out their missions; and (d) the power to enforce their findings. The ultimate end is that the oversight bodies must protect consumers who are compensated for any losses that they may have suffered as the result of non-competitive acts. It is a well taken argument.

Reference

[1] Jurewitz JL. California electricity debacle: a guided tour. Electricity Journal 2002; 15(4):10-29.

[2] Woo CK. What went wrong in California's electricity market? Energy 2001; 26(8):747-758.

[3] Woo CK, Lloyd D, Tishler A. Electricity market reform failures: UK, Norway, Alberta and California. Energy Policy 2003; 31(11):1103-1115.

[4] California Attorney General's Office. Attorney General's energy white paper. Sacramento, CA, 2004. See also: http://caag.state.ca.us/publications/energywhitepaper.pdf.