The California Energy Crisis: Myths and Facts

Causes of the California Energy Crisis

Myth: The energy crisis in California has been caused by demand that outstripped supply. According to Chairman Tauzin, "in California, electric generating capacity dropped 2 percent in the last 10 years. Demand went up 14 percent. . . . When consumers need energy in this economy, this nation needs to respond by making it available."[1] The Washington Times claimed in Insight Magazine that "demand has outpaced supply by a 5-to-1 ratio."[2]

The Facts: Energy supply within California has kept pace with demand. The total amount of electrical energy generated in California increased 19% from 1990 to 1999, from 190 million MWh to 226 million MWh.[3] The increase in generation has exceeded the state's 14% population increase and 11% consumption increase over the same period.[4] However due to drought and other factors, the availability of out-of-state energy supplies is currently reduced.

In 2000 and 2001, when the state began experiencing blackouts, increased demand was not the problem. The key factor in determining whether outages occur is peak demand. In California, peak demand has not increased. In fact, peak demand was lower in 2000 than it was in 1998.[5] See Figure 1.
The real cause of the energy crisis is that energy generators have been holding supply off of the market to drive up prices. In March and April 2001 the outage rates at power generators averaged 14,000 to 15,000 MW, over four times higher than the normal rate. See Figure 2.

Myth: Clean air regulations are to blame. Shortly before his inauguration, President Bush told CNN that "[i]f there's any environmental regulations that's preventing California from having a 100 percent max output at their plants -- as I understand there may be -- then we need to relax those regulations."[6] Subcommittee Chairman Barton stated that "some of the (national clean air health) standards may be too tight."[7]

The Facts: Numerous experts have stated that the Clean Air Act is not interfering with electricity production in California. These experts include Christie Todd Whitman, the Administrator of EPA;[8] Michael Kenny, the Executive Director of the California Air Resources Board;[9] and Carl Wood, a Commissioner on the California Public Utilities Commission.[10]

The Clean Air Act provides sufficient flexibility to allow power plants to run full time when needed to supply California. When generators in California faced limits on their hours of operation, California has acted to expand the number of hours the generators can operate. And in Los Angeles, the South Coast Air Quality Management District has exempted power generators from the RECLAIM program,[11] which was requiring the generators to buy costly emission allowance. California has used innovative approaches, such as requiring mitigation fees, to ensure that these actions do not harm air quality.

Myth: ***California's restrictions on siting power plants are to blame. "The answer to why California doesn't have enough generation is fairly simple," according to Sen. Frank Murkowski. "They have gone out of their way to discourage construction of new powerplants. The permitting of new powerplants has taken forever. They have a severe case of 'not in my backyard' when it comes to new electric powerplants and transmission lines."[12]***

The Facts: Environmental restrictions are not preventing the construction of new power plants. Since the energy crisis began in 2000, 14 major power plants with a generation capacity of over 9,373 MW have received siting approval.[13] Nine of these power plants are currently under construction, and four are scheduled to be on line or partially on line this summer or fall.[14] Moreover, California has also approved nearly 200 small power projects, such as small peaker plants.

It is true that no major power plants were built in California from 1986 to 1998. But this was the result of the investment decisions of California's utilities and independent power generators, not environmental restrictions. The Chairman of the California Energy Commission testified that the failure to build major power plants was attributable to "over-reliance on the market to determine additional need, as well as regulatory uncertainty associated with restructuring and deregulation."[15]

Myth: California Governor Gray Davis is responsible for the California energy crisis. Rep. Radanovich asserted during the Subcommittee's markup of H.R. 1647 that Governor Davis has refused to negotiate long-term contracts for electricity. According to Rep. Radanovich, the marketers are willing to negotiate these contracts but Gov. Davis has not cooperated.

The Facts: California has made every effort to sign long-term contracts for electricity. As of early May, the state had signed 40 long-term contracts and agreements with energy providers, providing a total of over 600 million megawatt hours over the next ten years. The average price is $79 per megawatt hour for the first five years and $61 per megawatt hour for the second five years. These long-term contracts represent a 75%-80% reduction in overall energy expenditures compared to recent spot market prices.[16]

The problem the Governor faces is that many power generators refuse to enter into long-term contracts at reasonable rates. The generators won't enter into these contracts unless they can make as much profit from them as from speculating in the spot market.

Governor Davis has been doing everything in his power to address the energy crisis. He has accelerated the approval of power plants and is spending over $800 million on energy conservation.[17] The root cause of the electricity crisis is the soaring wholesale prices being charged by the generators. By law, Governor Davis cannot control these prices. Only the federal government can.

Myth: California's retail price caps are responsible for the state's problems.

The Facts: California's retail price caps prevented California's two biggest utilities, SoCal Edison and PG&E, from passing on the high wholesale electricity costs to consumers. The caps did contribute significantly to PG&E's bankruptcy. However, the retail price caps did not cause wholesale prices to skyrocket and removing the caps would have done little to have discouraged exorbitant wholesale prices.

The main benefit of higher retail rates is to increase conservation. California recognizes this and is using retail rates to increase conservation. Under the state's voluntary 20/20 Energy Rebate plan, residential, commercial, and industrial customers will receive a 20% rebate on their 2001 summer electric bill if they cut back their electricity use by 20% over last summer's level. In contrast, under the new retail rate structure recently approved by the PUC, residential rates will rise by 47% to 55% for users who significantly increase their consumption.

The Price Gouging and Blackout Prevention Amendment

Myth: Price relief amounts to meddling with a free market. President Bush has dismissed price mitigation, saying "that's not a fix" and "price controls would be a short-term delay of a needed solution."[18] Chairman Tauzin described PG&E's declaration of bankruptcy "as a warning to those who want to manipulate the marketplace through price controls. It simply doesn't work. We remain committed to helping California through this ongoing crisis, but phony politically driven solutions are not the answer."[19] And Vice President Cheney said "price controls do not do anything but hurt when you deal with those kinds of questions" and "price caps don't work."[20]

The Facts: While market intervention may not be appropriate for a functioning, competitive market, California's electricity market is neither functional nor competitive. Generators in California have sufficient market power that they can manipulate prices by withholding energy or bidding far above their actual costs. The only way to prevent these abuses in the short-term is to impose cost-of-service based caps. A market "time out" is desperately needed in California until new supplies can come on line.

Myth: Cost-of-service based rates are too complex to implement. Setting these rates for even one generator would require a voluminous proceeding.

The Facts: FERC can implement cost-of-service rates quickly and simply. FERC can promulgate guidelines that allow generators to make bids based on cost-of-service prices. In essence, the amendment can be implemented through an efficient market where the bids are based on actual generator costs plus a reasonable profit. Then, if there are any disputes, they can be resolved after the fact.

There is no question about FERC's ability to do this. For 20 to 30 years, FERC regulated "coordination transactions" at the wholesale level with filings that were only 4 or 5 pages long. And we heard testimony from Ambassador Sklar that this type of amendment could be implemented in less than a day.

Myth: The Price Gouging and Blackout Prevention Amendment will discourage production and damage the investment climate.

The Facts: In fact, the amendment would increase energy supplies by removing the current incentives for generators to withhold energy. As economist Paul Krugman has stated, "in a market where 'exercise of market power' is a major factor, a wholesale price cap might actually increase supplies because power companies would no longer have an incentive to withhold electricity to drive up the price."[21] This means that the result of adopting the amendment would be to reduce current outage rates to more normal levels.

Moreover, there would be no disincentive for new construction under the amendment because new power plants would be exempted from the cost-of-service rate cap.

Myth: If California adopts cost-of-service based rates, power producers in other states will be deterred from selling needed power to California.

The Facts: Since the amendment applies to the entire Western energy market, it would affect all electricity sales in the West, not just those to California. There is therefore no reason for any generator to withhold power from California. Furthermore, power producers have been willing to sell their output to California in the past when electricity prices were at far more reasonable levels. The argument that California must pay exorbitant wholesale prices resulting from market manipulation in order to attract energy has no historical basis.

Myth: If California adopts price relief, incentives to conserve will be lost.

The Facts: California is the nation's leader in energy conservation. California uses less energy per capita than any other state.[22] Moreover, California is continuing to do all it can to increase conservation. The state is spending over $800 million this year to increase conservation. And since the beginning of the year, energy consumption in the state has dropped by almost 10%.[23] Once the new retail electricity rates hit in June, conservation efforts will increase further, since the rates are specifically designed to reward consumers who conserve and impose higher rates on those who don't.

California already has plenty of incentives to conserve. It doesn't need further incentives. What it desperately needs is relief from the soaring wholesale electricity rates.

Myth: The Price Gouging and Blackout Prevention Amendment won't work because it exempts public power producers. The amendment applies only to private generators, who make up less than 50% of the power generation in the West.

The Facts: The Price Gouging and Blackout Prevention Amendment applies to private power generators and marketers. They make up over 50% of the Western market. Another 19% consists of federal power marketers, whose rates are currently regulated by FERC to prevent price gouging. In total, over 75% of the generation in the West would be subject to cost-based regulation under the amendment and current law.

The only generation that is not covered by the amendment and current law is the 23% of the generation by municipals and cooperatives. These are not big players in the spot market. In fact, most municipal systems buy more power than they sell. Moreover, the municipal generators have voluntarily agreed to comply with cost-of-service rates if the amendment passes.

Myth: At the Subcommittee markup, Chairman Tauzin asserted that California had already tried "price caps" and that they backfired, leading to short supply and rising demand.

The Facts: Cal-ISO did try to institute a "buyer's cap." However, there are two fundamental differences between what California did last summer and the Price Gouging and Blackout Prevention Amendment. First, California's "buyer's cap" was simply a self-imposed limit on what bids Cal-ISO would accept. If the generators didn't want to comply, they could simply refuse to make bids -- and if Cal-ISO needed the energy it had no choice but to agree to pay the generators' asking-price, even if it was above the cap.

Second, the "buyer's cap" was an attempt to impose a traditional price cap. Traditional price caps, which say that electricity cannot be sold or purchased above a fixed price, are very difficult to implement. If you set the price too low, high-cost suppliers that are needed at times of peak demand won't produce electricity. But if you set the price high enough to attract these peaking units, other producers get enormous windfalls and consumers get gouged.

The Price Gouging and Blackout Prevention Amendment is fundamentally different. It uses a cost-of-service based approach. It doesn't set a single price for all sales. Rather, cost-of-service rates produce different rates for different producers, depending on their costs of production. This is the same approach that was used successfully in California for decades prior to the 1996 deregulation law. It worked then -- and it will work now.

Myth: Price caps are a "poison pill." If they are included, the President will veto the bill, killing any chance at relief for California.

The Facts: This is a self-fulfilling prophecy. If members supported and insisted upon reasonable relief, the President would have little choice but to endorse them. Furthermore, since price controls are necessary to help California in the short-term, any legislation that omits them is simply ineffective "window-dressing."

Myth: The amendment is not needed because FERC has already acted.

The Facts: The FERC order is woefully inadequate for three reasons. First, it only applies when California is in an electricity emergency, even though gouging occurs 24 hours a day seven days a week. FERC Commissioner Massey calculated that if this scheme had been in effect last year, it would have excluded 93% of the hours when overcharges occurred.

Second, the FERC order allows megawatt laundering. That is, energy can be sold out of state, and then resold in California at exorbitant profits. The amendment would stop that.

Finally, the FERC order allows enormous windfall profits for generators. It allows the least efficient generator to set the price for all generators. It also allows for generators to get a price based on unrealistic gas prices and inapplicable emissions credits.

In the words of Consumers Union, the FERC order is a "total farce."[24]

Other Myths

Myth: According to Subcommittee Chairman Barton, H.R. 1647 "would cut the number of blackouts in half this summer."[25] According to Rep. Cox, the bill represents an "excellent response (to) California's needs."[26]

The Facts: H.R. 1647, while well-intended, would actually increase energy costs in the West and undermine state efforts to address the electricity crisis. Since the bill fails to address runaway wholesale electricity prices, it would not prevent further gouging of California's consumers. What's more the bill interferes with California's actions to address the electricity crisis by inhibiting the state's ability to acquire and upgrade the state's transmission facilities. It also creates new opportunities for gaming the energy market that directly conflict with California's own demand-reduction programs -- thus making blackouts more, rather than less, likely.

Myth: This is a state problem and there's nothing more the federal government can do. According to White House spokesman Ari Fleischer, "I think all experts agree -- and we concur -- this is predominantly [a state problem] and the solution will be found in California."[27] According to the Vice President, "we have done virtually everything the Governor has asked us to do since we came to office a little over three months ago."[28] Rep. George Radanovich said that "we are taking appropriate measures at the federal level, but Governor Davis has created a catastrophe that must largely be fixed at the state level."[29]

The Facts: The root cause of the California energy crisis is the soaring wholesale rates for electricity. The spot market price of electricity in California has increased from $30 per MWh in 1999 to $300 in 2001. The spot price has gone as high as $1,900 per MWh. See Figure 3. California has no authority over wholesale electricity prices. California would not be in its current predicament if FERC would fulfill its statutory obligation under the Federal Power Act to ensure that wholesale electricity prices are just and reasonable.

Endnotes

1. House Committee on Energy and Commerce, Subcommittee on Energy and Air Quality, *Hearing on Congressional Perspectives on Electricity Markets In California and the West and National Energy Policy*, 107th Cong. (Mar. 6, 2001).

2. *Californians Enter 'In-the-Dark' Age*, Insight Magazine (June 11, 2001).

3. *See* California Energy Commission (on line at http://www.energy.ca.gov/electricity/ electricity_gen_1990-1999.html).

4. *See* California Energy Commission (on line at http://www.energy.ca.gov/electricity/consumption_by_sector.html).

5. *See* California Energy Commission (on line at http://www.energy.ca.gov/electricity/commission_demand_forecast.html).

6. *Bush Suggests Easing Curbs on Pollution*, Los Angeles Times (Jan. 19, 2001).

7. *Showdown likely over Clean Air Act*, Fort Worth Star-Telegram (Jan. 26, 2001).

8. *Crossfire*, CNN (Feb. 26, 2001).

9. Letter from Michael P. Kenny to Rep. Henry A. Waxman (Feb. 14, 2001).

10. Testimony of Carl Wood, House Committee on Energy and Commerce's Subcommittee on Energy and Air Quality, *Hearing on Electricity Markets: Lessons Learned from California*, 107th Cong. (Feb. 15, 2001).

11. South Coast Air Quality Management District, *Proposal to Adopt Proposed Changes to RECLAIM* (agenda no. 35 at May 11, 2001 board meeting) (on line at http:// www.aqmd.gov/hb/010535a.html).

12. Congressional Record, S508 (Jan. 24, 2001).

13. California Energy Commission (on line at http://www.energy.ca.gov/sitingcases/backgrounder.html).

14. Gov. Gray Davis, *More Than California's Problem*, Washington Post (May 16, 2001).

15. Testimony of William Keese, House Committee on Energy and Commerce's Subcommittee on Energy and Air Quality, *Hearing on Electricity Markets: California*, 107th Cong. (Mar. 22, 2001).

16. Testimony of Ambassador Richard Sklar, House Committee on Energy and Commerce's Subcommittee on Energy and Air Quality, *Hearing on Electricity Markets: California* (May 3, 2001).

17. *Id.*

18. *Bush Won't Intervene in Calif. Crisis*, Associated Press (Jan. 18, 2001).

19. House Committee on Energy and Commerce, *Committee News Release: Tauzin, Barton React to Pacific Gas & Electric's Announced Chapter 11 Filing* (Apr. 6, 2001) (on line at http://energycommerce.house.gov/107/news/04062001_169.htm, file: News).

20. *Meet the Press*, NBC (May 20, 2001).

21. Paul Krugman, *The Price of Power*, New York Times (Mar. 25, 2001).

22. According to statistics from the U.S. Department of Energy for 1999, the latest year available, the lowest per capita user is California at 7.085 thousand kilowatt-hours (kwh) per capita. California's use is 42% less than the national average electricity use of 12.146 thousand kwh per capita. State of California, *Press Release: Governor Davis Announces California is Number One in Electricity Conservation Nationwide* (May 16, 2001).

23. *See* California Energy Commission, *Reduction in 2001 Peak Demand* (May 3, 2001) (on line at http://38.144.192.166/electricity/peak_demand_reduction.html).

24. Consumers Union, *News Release: California Electricity Price Cap Inadequate to Protect Consumers from Gouging* (April 26, 2001) (on line at http://www.consumersunion.org/telecom/fercdc401.htm).

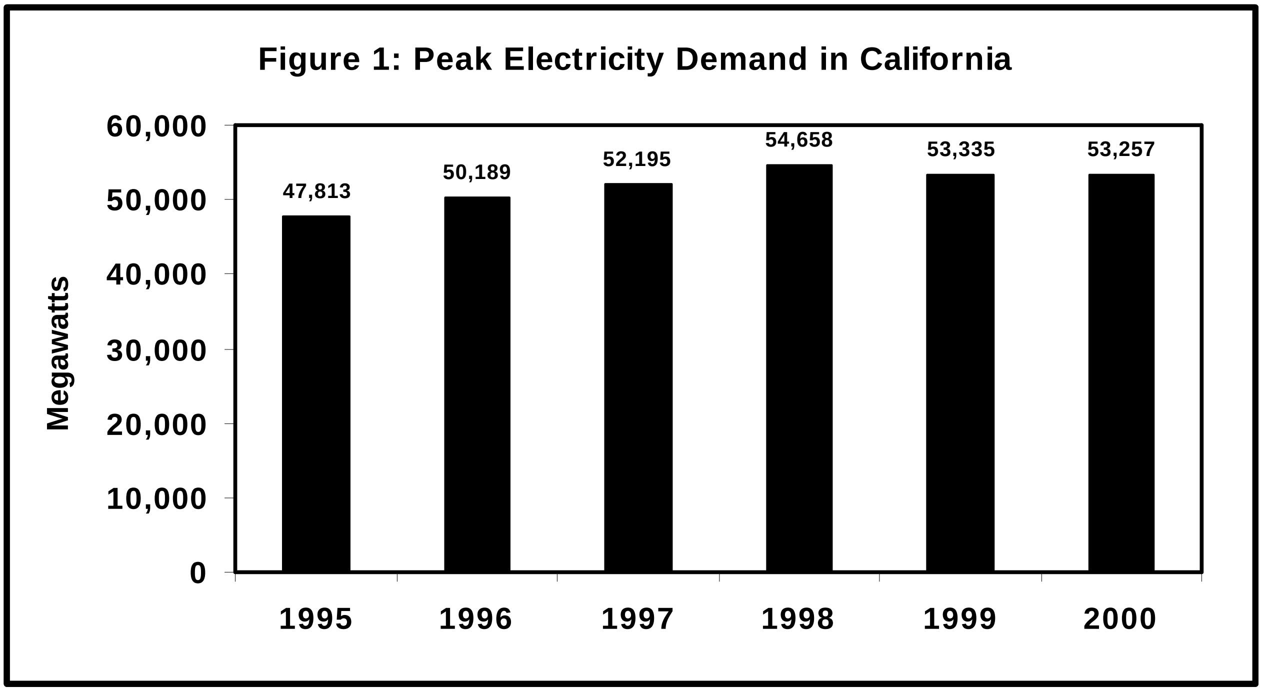
25. *US Rep Barton: Pwr-Relief Bill Will Halve Calif Blackouts,* Dow Jones Energy Service (May 18, 2001).

26. *US Rep Barton: Pwr-Relief Bill Will Halve Calif Blackouts,* Dow Jones Energy Service (May 18, 2001).

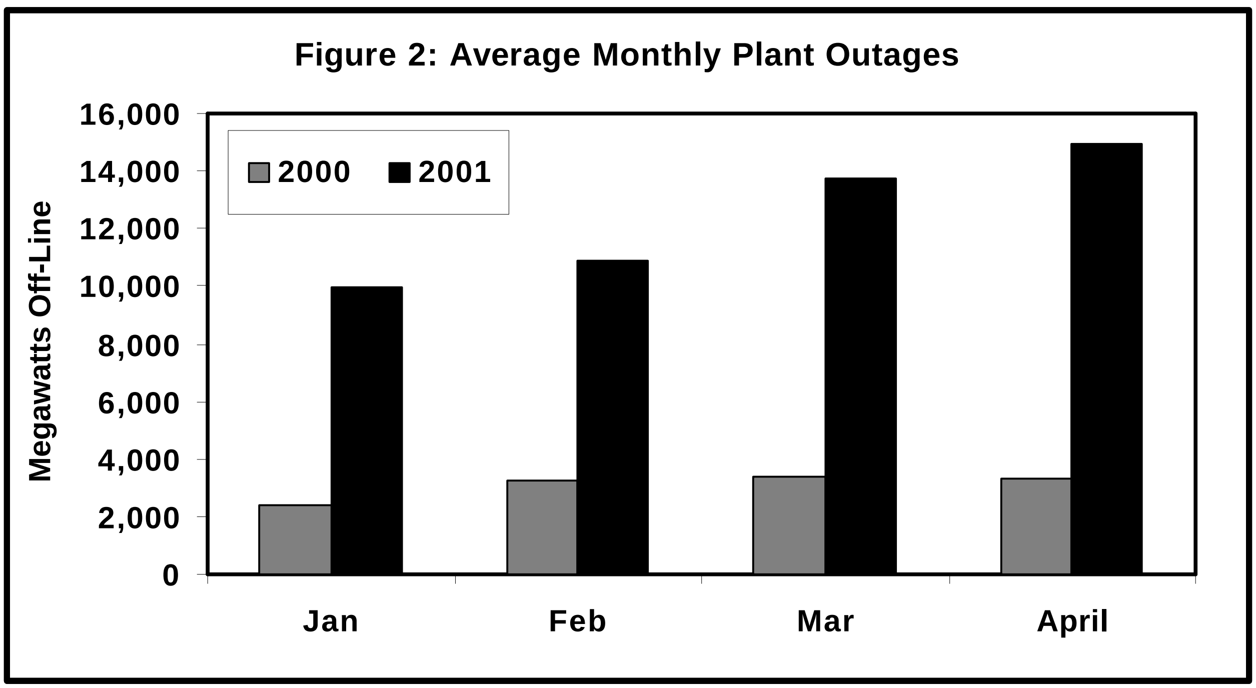
27. *New D.C. Team Not Likely to Play a Major Role in State's Power Woes: Bush Aide Calls It a California Problem*, San Diego Union-Tribune (Jan. 18, 2001).

28. *Meet the Press*, NBC (May 20, 2001).

29. Congressman George Radanovich, *News Release: Energy Subcommittee Passes Emergency Electricity Package* (May 10, 2001) (on line at http://www.house.gov/radanovich/ press/2001/ may01/051001emergencyenergy.htm, file: News Releases).

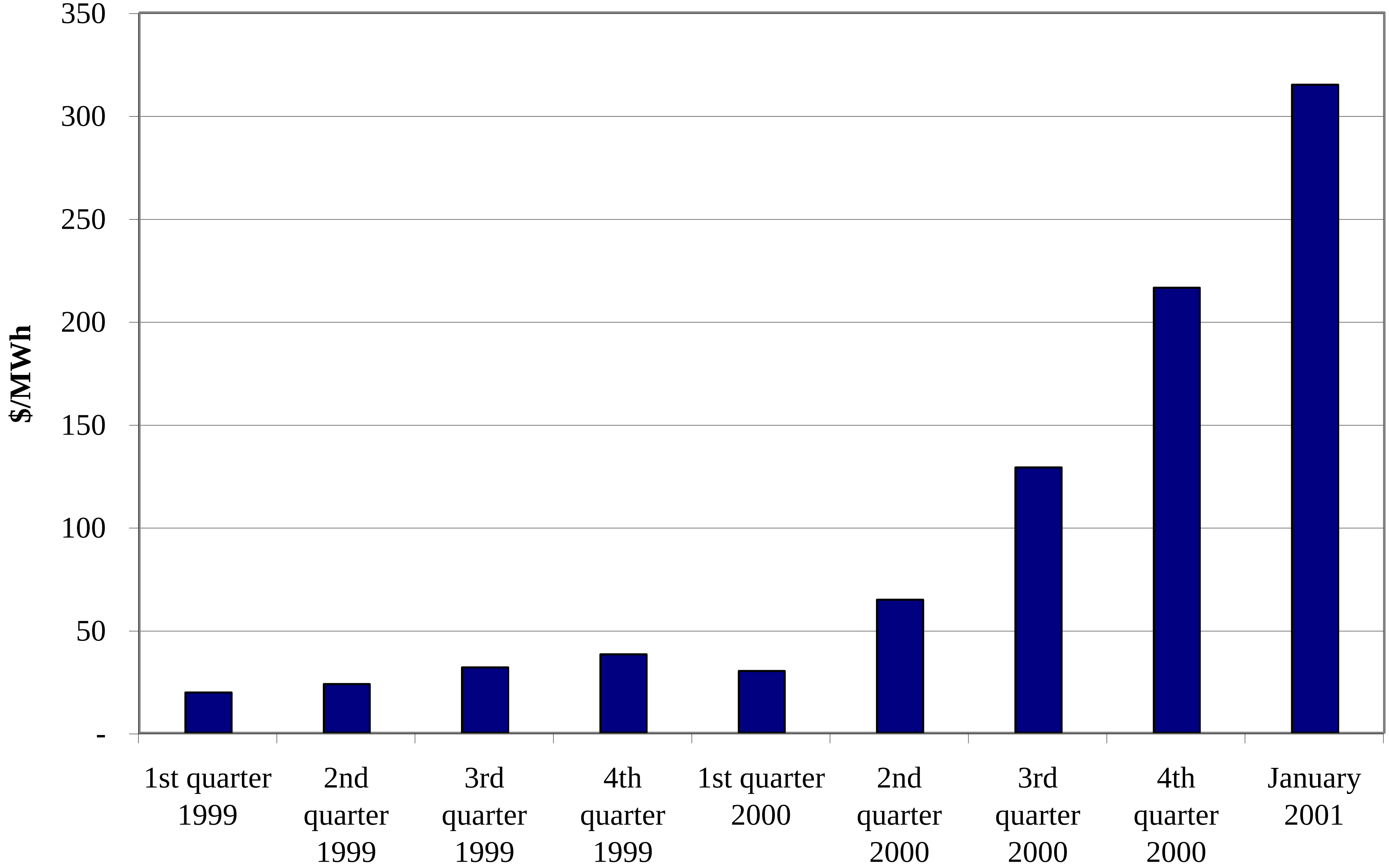


Source: California Electricity Commission



Source: California ISO

Figure 3: Average Spot Prices
1999 - January 2001



Source: California Power Exchange