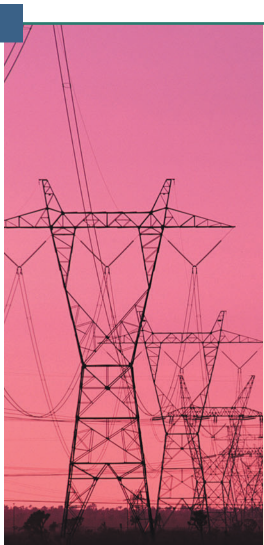

Electricity regulation: How is federal policy changing?

BY DOUGLAS W. SMITH

Prior to the summer of 2000, the public paid scant attention to the often-arcane world of federal electric utility regulation. Over the past two years, however, the California electricity crisis, followed by the Enron bankruptcy, have made electricity regulation front page news.

This article explores how these recent high-profile problems have affected the electricity policy agendas at the Federal Energy Regulatory Commission (FERC) and in Congress.

California crisis

California electricity markets made headlines in 2000 and 2001 when, as a result of a combination of market stresses, spot electricity prices in California increased dramatically. High prices resulted in billions of dollars in unanticipated power purchase costs and pushed the largest California utility into bankruptcy and the second largest to the brink.

The rise in spot prices was caused by a confluence of natural, economic and regulatory factors, including: unusually warm and dry weather, growing electricity demand, stagnant investment in new supply (due in part to regulatory obstacles to building new plants) and restructuring decisions that caused utilities to be almost entirely dependent on spot market purchases. Some argue that less benign forces were also at work – economic withholding, physical withholding and possibly manipulation of the forward markets or collusion among sellers.

The California experience put FERC oversight of wholesale electricity markets into the public eye. It also led to considerable finger-pointing about which market participants and which government institutions bear responsibility for the outcome. Leaving that still-heated discussion aside, it is clear that the California experience has shifted attention and focus at FERC.

Enron bankruptcy

The dramatic collapse of Enron (until last year, the leading U.S. energy trader) is also shaping the current electricity agenda in many ways. Recent allegations that Enron manipulated forward electricity markets led to FERC's continuing investigation of forward markets in the West and to consideration by Congress of reforms to the Commodity Futures Trading Act. Moreover, the cloud of alleged impropriety surrounding Enron's demise has cast a pall over the efforts of competition advocates generally. For many, the "Enron story" confirms that more forceful regulation and oversight is needed to guard against market abuses by bad actors.

FERC

The most direct consequence of these recent high-profile events has been at FERC, as reflected by its expanding and shifting electricity policy agenda. In particular, the California experience has caused FERC to fundamentally revisit its approach to wholesale rate regulation.

For the past decade – with the enactment of the transmission provisions of the 1992 Energy Policy Act, the 1996 promulgation of Order No. 888 open access transmission requirements and the framework for regional transmission organizations (RTOs) established by Order No. 2000 – policymakers at the federal level have focused on fair access and fair pricing for transmission service as the key to supporting competition in wholesale electricity markets.

FERC continues to pursue regulatory changes to address concerns that ownership and operation of the transmission grid is leading to discrimination and inefficiency that is stifling competition in wholesale electricity markets. In particular, FERC is seeking to form RTOs throughout the country.

Until the California experience, however, there was relatively little focus on FERC's market-based rate policy for wholesale sales of electricity. Beginning in the late 1980s, FERC had allowed an ever-growing number of sellers to sell at market-based rates – that is, at prices determined by bilateral negotiation or centralized auction procedures, rather than in FERC-conducted cost-of-service rate proceedings. While the first market-based rates were approved for independent power producers and marketers, by the end of the last decade, market-based wholesale rates were the rule and cost-based rates the exception, even for the vertically integrated utilities and their affiliates.

The first major incident of headline-grabbing price spikes was not in California, but in the Midwest in 1998. While prices rose to exceptionally high levels (up to $7,500/MWh, in contrast to a typical price of $25/MWh), the duration of the high prices was measured in only hours or days. Moreover, the volume of sales at these high prices

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was only a small fraction of the power flowing in the region. FERC attributed these price spikes to the immature market, rather than to market flaws or abuses and did not change its fundamental regulatory approach to market-based rates.

The magnitude of the California pricing problems, however, was vast by comparison – $8.9 billion in increased costs of power by some estimates. High prices persisted for a year and much of the region's power was subject to this pricing. FERC eventually found that the spot markets were dysfunctional and that the resulting market-based rates were unjust and unreasonable. It ordered an array of prospective remedial steps designed to correct market flaws and impose price mitigation until market structure corrections could be made. Litigation over refund liability continues. These FERC proceedings have raised fundamental questions about FERC's market-based rate policy:

• How will FERC judge whether spot markets are producing just and reasonable rates?

• Where markets are not producing just and reasonable prices, what remedial price mitigation will FERC impose from now on?

• What are the limits of FERC's authority to provide retroactive refunds for market-based rates that are determined not to have been just and reasonable?

• Does the practice of relying on quarterly reports of commercial activity satisfy the Federal Power Act's "rate on file" requirements?

The list of questions grew further in March 2002, when FERC set hearings for complaints arguing that long-term bilateral contracts negotiated when California spot market prices were high should be abrogated or reformed. This has caused it to revisit the standards for modifying or terminating bilateral contracts.

As an outgrowth of the Western market experience, FERC is comprehensively reviewing its generic market-based rate policies. Since September 2001, it has initiated the following steps to reshape its wholesale rate policies:

• *New test for market based rates*. FERC has adopted, at least on an interim basis, a new Supply Margin Assessment test for determining eligibility for market-based rates. This test compares the size of the applicant's market share to the amount of excess capacity in the market, to determine whether the applicant is a pivotal supplier. It does not apply in RTOs with FERC-approved market price mitigation in place.

• *Expansion of available refund remedies*. FERC is developing a generic refund condition on market-based rate authorizations that would allow it to provide retroactive refund remedies where the seller is found to have exercised market power.

• *Establishment of ex ante price mitigation rules*. In its "standard market design" rule making scheduled to be completed by the end of 2002, FERC expects to not only establish standard rules for transmission service and rates, but also to institute standard prescriptions on price mitigation in spot power markets. This may include price or bid caps to constrain price spikes, "must offer" requirements under certain market circumstances to guard against withholding or rules about permissible bid prices.

• *More public information*. FERC recently revamped the quarterly filing requirements for all sellers with market-based rates and has inquired whether it should also require such sellers to file annual reports of cost data as well.

• *More active oversight*. The FERC has established a new Office of Market Oversight and Investigation to collect information and analyze the functioning of jurisdictional energy markets.

In sum, FERC is in the midst of retooling its policies on competitive wholesale markets and the pace of activity is fast and furious.

Congress

In April, the Senate passed S. 517, the Energy Policy Act of 2002. The Senate bill will now be conferenced with H.R. 4, the House energy bill. The Senate bill's electricity title was shaped in some respects by the California and Enron experiences. (The House energy bill does not include an electricity title.)

The Senate bill would expressly authorize FERC to approve market-based wholesale rates and would specify factors for consideration by the FERC in making such decisions. It would also adjust the timing of the refund relief authorized by Section 206 of the Federal Power Act, to eliminate the current 60-day delay in the availability of refunds. The bill would require states to consider real-time metering and time-of-use rates as tools to provide for a more robust demand response, which in turn should mitigate price spikes.

In direct response to allegations of Enron misconduct, the Senate gave serious consideration to, but ultimately rejected, an amendment to the energy bill that would have subjected energy derivatives to regulation by the Commodity Futures Trading Commission (CFTC). In May, new revelations about Enron trading practices triggered another round of congressional hearings and may lead to calls for further legislative action.

The experience of the past two years has demonstrated that effective regulation of the transmission system is important, but that it is not a sufficient regulatory predicate to assure competition – and just and reasonable prices – in wholesale markets. However, simply "going back" to cost-of-service rate regulation for wholesale sales has a whole series of problems of its own. That leaves FERC actively laboring to find a new, workable regulatory balance – one that allows markets to work where they can, but provides sufficient oversight and intervention when necessary, to assure that rates remain just and reasonable.