Testimony of
William L. Massey, Commissioner
Federal Energy Regulatory Commission
Before the
Committee on Governmental Affairs
United States Senate

June 20, 2001

Mr. Chairman and members of the Committee:

Thank you for the opportunity to testify about the actions taken by the Commission in response to the western electricity crisis.

The last comprehensive Commission order to address the crisis was issued on April 26, 2001. I dissented in part. In a statement before the Committee on Energy and Natural Resources on May 3, 2001, I outlined the rationale for my dissent. I have attached that statement and request permission to incorporate it in my testimony before this committee.

Throughout this crisis, the Commission's orders have been timid and insufficient to fulfill our statutory duty to ensure just and reasonable prices. The Commission's responses to the crisis, though well intentioned, can be fairly characterized as too little, too late. The crisis began in June, 2000. Electricity prices soared even higher after our December 15, 2000 remedies order, and our refund orders for the months of January

through April, 2001, have been paltry and arbitrary. The April 26 order, though somewhat more aggressive, provided a measure of price protection for consumers only during periods of severe generation reserve deficiencies (so-called stage 1, 2, and 3 alerts). The order also initiated an extraordinarily narrow section 206 investigation into electricity prices in the Western Interconnection.

These measures are insufficient to fulfill our statutory duty to ensure just and reasonable prices. This standard applies 24 hours a day, 7 days a week, not just during reserve deficiencies. The responsibility also applies to all wholesale electricity markets, including the Western Interconnection.

Fortunately, wholesale prices have abated somewhat during June. It is impossible to predict, however, what prices will be next hour, tomorrow or next month. This is still a broken, capacity short market. Based upon our experience with this market, we know that prices can soar at the drop of a hat to unreasonable levels.

Thus, additional steps are necessary to ensure just and reasonable prices. The Commission must impose reasonable price controls throughout the Western Interconnection during all hours. It may be appropriate to exempt new generation

brought on line in the future so that there is no deterrent to entry. There should be no loopholes in these controls, and any form of gaming, manipulation or withholding of capacity (whether physical or economic) should be strictly prohibited. The controls should extend for 18 to 24 months to allow time to fix the broken market and to install necessary power plants.

The Commission has scheduled a special meeting for 1:00 PM on June 18. I will be advocating that the Commission at that meeting address the issues I have raised.

Thank you for this invitation to speak, and I will be pleased to respond to any questions.

Attachment

Testimony of
William L. Massey, Commissioner
Federal Energy Regulatory Commission
Before the
Committee on Energy and Natural Resources

May 3, 2001

The Commission's April 26 order was perhaps the last clear chance to put in place adequate measures to protect consumers in California and other parts of the western market from runaway prices this summer. There are many good features to the order that could prove helpful this summer and beyond. But the order is deficient in critical respects and consequently will fail to achieve our objectives. Because of these restrictions, I dissented in part from the order.

We are now eleven months into the California calamity. It has had a breathtaking and staggering effect on the western economy, and there is no end in sight. Now is not the time for half-a-loaf solutions. I was not willing to compromise my vote so cheaply. Our December 15 remedies order did not contain the effective price relief I championed, or anything close to it. It is now over four months and many billion dollars later. Since then our refund orders have been paltry and, in my opinion, arbitrary. Prices are not just and reasonable now and will not be this summer, and the economic carnage is spreading throughout the western interconnection. For example, four hundred and six workers were put out of work when Georgia Pacific shut a production facility in Bellingham,

Washington, because of skyrocketing electricity bills. The Seattle-Tacoma Airport estimates that this year, its electric bill will triple to $50 million, skyrocketing to 25% of its operating budget. Countless other examples of economic harm throughout the western interconnection could be cited. BPA may increase its rates by a whopping 250%. The point is that now is the time for effective problem solving, and this order, though it has some salutary features, falls far short.

There are four aspects of the order to which I dissented.

First, the price mitigation feature is too restrictive because it is applied only when an operating reserve emergency is called. Effective price mitigation should apply during all hours in California. Such an approach would not be the least bit punitive. It would, in fact, replicate the manner in which the single price auction is supposed to work, that is, the single price auction theoretically provides a powerful incentive for generators to bid their running costs into the market. That is the most effective generator strategy for ensuring dispatch, or so the theory goes.

The problem is that it has not worked that way in the California market. Economic withholding, which is bidding up the price well above costs just because you can, is a pervasive problem, and as a result, high prices that exceed a just and reasonable level are a severe problem in the California market. The record is devoid of any evidence that the

problem is limited to hours when an operating reserve margin alert at stages 1, 2, or 3 is in effect. The evidence is highly persuasive that the problem exists twenty four hours a day, seven days a week. I found the March 21 California ISO study by Dr. Anjali Sheffrin, the ISO's director of market analysis, to be compelling. Dr. Sheffrin concluded that economic withholding is a severe problem in all hours, not simply capacity constrained hours, and I agree. Her analysis concludes that from May to November 2000, withholding that led to inflated market prices in the ISO's real time market occurred in over 98% of hours. According to my calculations, the ISO declared a stage one, stage 2 or stage 3 alert in only 5% of the hours during this period. For Dr. Sheffrin's study period, the price mitigation proposed in our April 26 order would have missed 93% of the hours when market power drove up prices. Similar studies by Dr. Paul Joskow of M.I.T., and by Dr. Frank Wolak of Stanford, provide persuasive evidence of withholding and buttress Dr. Sheffrin's conclusions.

The solution is to require generators to bid their costs in all hours. This replicates the intent of the single price auction concept. What's more, the more efficient generators would still make money under such an approach, perhaps a lot of money, because the market clearing price that all generators get would be set by the highest cost generator, probably an inefficient older gas fired generator with a high heat rate.

Because the price mitigation feature applies only during operating reserve alerts, and not during other periods, I have no confidence that prices will be just and reasonable during all hours. This agency is statutorily required to ensure just and reasonable prices at all times, and this standard in federal law is not limited to stage alert hours.

Today's order also narrows the existing refund condition adopted in the December 15 order. I object to this.

Second, the duration of the monitoring and price mitigation features of this order is too restrictive. Today's order would expire one year from now unless expressly modified by the Commission. This period of time is too short. I would allow the monitoring and price mitigation features to remain in place for at least eighteen months, and perhaps 24 months.

Third, I object to the RTO filing conditions. Under the order, if the California ISO and the three California investor-owned utilities fail to make an RTO filing by June 1, the entire order is of no effect. As I read it, this order becomes null and void. This makes no sense. It seems to stand for the proposition that this agency will make no effort to ensure just and reasonable prices if the California ISO and all three of the California IOUs fail to make an RTO proposal. I cannot support such a condition. The California ISO and the

three utilities must make an RTO filing, but this has no relevance to price mitigation over the next year.

And fourth, the scope of the section 206 investigation that is ordered for the Western Interconnection should be substantially broader. I concurred to our December 15 order, and advocated that the Commission initiate a section 206 investigation into jurisdictional wholesale sales for the entire Western Interconnection, setting a refund effective date 60 days hence. As a legal matter, such an investigation is a necessary predicate to any possible price relief outside of California's spot markets.

This order opens an extraordinarily narrow 206 investigation for the Western Interconnection, and I commend my colleagues for at least going this far, but the approach is much too narrow to hold any promise of effective price relief. I had advocated an investigation, and refund condition, for all transactions of one month or less. The investigation and refund condition set out in this order only apply, however, to transactions of 24 hours or less that occur during a reserve deficiency of 7% or less. The investigation and refund condition are so narrowly circumscribed that they do not hold the potential for meaningful price relief. It is my understanding that many of the transactions that are driving the high prices in Washington, Oregon and other western states are for terms well exceeding 24 hours. This type of transaction would not be subject to this investigation nor to price relief. I object to this omission.

Finally, let me underscore my great concern about the high price of natural gas delivered into California markets. The transportation differential into California often exceeds ten dollars, and is often substantially more at various intrastate delivery points. The transportation differential into other large markets such as New York and Chicago is usually less than a dollar, and sometimes no more than a few cents. The high cost of natural gas delivered into California is then used to justify high wholesale electricity bids into the ISO market. An inefficient, high heat rate, generator using a considerable amount of high priced natural gas then sets the market clearing price that all sellers are paid. Thus, the high transportation differentials into California gas markets have a particularly pernicious effect when coupled with a single price auction for electricity.

I urge this agency to take all available action to mitigate these high transportation differentials. We must actively explore any jurisdiction we may legitimately have that affects the so-called gray market. We must take a second look at whether lifting the price cap for secondary market pipeline capacity was in the public interest. We must vigorously investigate any allegations of withholding or market manipulation or affiliate abuse. We must certificate new interstate capacity that is needed for the markets to function efficiently, and, as Commissioner Breathitt has pointed out on more than one occasion, we must work with the state of California to ensure that there is adequate take away capacity in the intrastate market. I am open to any and all ideas, but my attention was riveted on this issue by our recent staff order setting the so-called proxy price for

electricity for the month of February. The proxy clearing price was $430 per Mwh, and roughly $350 of that amount was the price of natural gas for an inefficient generator. I concluded that electricity prices in California would remain very high if based upon a very high price for natural gas. This issue has not gotten nearly the attention it needs, and I highlight it to urge more forceful Commission action in this area.

Our April 26 order is only the latest in a series of actions the Commission has taken with respect to the problems facing the California and western markets. Despite the hard work of our excellent staff on these matters, the actions of this agency, though well intentioned, have fallen short of ensuring just and reasonable prices. True, we cannot solve all of the west's energy problems. A large share of the responsibility falls on state and local government entities. We can, however, insist that wholesale prices are just and reasonable in all hours. Indeed, we must do so. Under federal law, that is solely our responsibility and no one else's.

We face the second summer of out of control electricity prices out west. This may be our last chance. We should have seized it fully. Because we failed to do so, I dissented.