Loyola University Chicago Law Journal

Volume 33
Issue 4 *Summer 2002*

Article 9

2002

Plunging into Darkness: Energy Deregulation Collides with Scarcity

Robert C. Fellmeth
University of San Diego School of Law

Plunging Into Darkness: Energy Deregulation Collides with Scarcity

*Professor Robert C. Fellmeth**

In 1969, *The Ralph Nader Study Group Report on the Interstate Commerce Commission and Transportation*[1] advocated the substantial deregulation of interstate trucking. The consumer group found that "rate bureaus" of horizontally organized private truckers served as legally authorized cartels to collusively fix shipping rates. The Interstate Commerce Commission (ICC) rubberstamped these regionally formulated industry-set prices. The agency reinforced an anticompetitive structure by issuing narrow licenses of convenience and necessity. These licenses specified the areas a trucker would serve, equipment to be used, commodities to be carried, and even routes to be traversed. A carrier might well have authority to carry photographic film but not developed pictures; rubber hose but not plastic tubing. Common carrier trucking was highly inefficient, with substantial mileage consisting of empty backhauls. And tariffs tended to be set high enough to assure the survival of the most inefficient carriers competing. Nor were assured portions of revenues directed at the "external benefits" often cited to justify industry-dominated public policies, such as safety, reliable availability, or service to rural areas.

Trucking consists of relatively small units of production, which are obviously highly mobile. The barriers to entry to increase supply are

* Price Professor in Public Interest Law, University of San Diego School of Law. Professor Fellmeth is a graduate of Stanford University (A.B. 1967) and Harvard University (J.D. 1970). He is a former state and federal antitrust prosecutor and, in 1979, founded the Center for Public Interest Law (CPIL), a statewide advocacy group centered at the University of San Diego School of Law. CPIL specializes in consumer representation before state agencies, including the Public Utilities Commission (PUC). CPIL publishes the *California Regulatory Law Reporter*. Professor Fellmeth has taught regulatory law (utility regulation), antitrust law, and public interest law since 1977. He has chaired a state agency and served as the State Bar Discipline Monitor for five years. He has also been active in the PUC and legislative advocacy for the consumer and has litigated twenty-five reported appellate cases. Professor Fellmeth has authored thirteen books and treatises, including *California White Collar Crime* (with Thomas A. Papageorge) (Michie, 1998, 2001).

1. *See* ROBERT C. FELLMETH, THE INTERSTATE COMMERCE OMISSION: THE PUBLIC INTEREST AND THE ICC (1970).

low. Capacity can adjust to demand relatively quickly. In other words, it is not a high fixed threshold cost industry and not a natural monopoly that might warrant price regulation to prevent monopoly power pricing.

The *Nader Report* was controversial in its time. Consumerists were considered "standard liberals," backers of government intervention in the marketplace. To that point, they had not supported deregulation, instead recommending additional governmental controls to ameliorate external costs flowing from dangerous products, misleading advertising, or other cited market abuses. A new thesis emerged from this and other work: Government used by commercial interests to restrict competition for private gain and public detriment could be the problem. In contrast, the marketplace could be the consumer's friend.

But here is the problem: It is not always a faithful friend. Indeed, it occasionally needs a chaperone.

I. THE DEREGULATION THEORY

A. Traditional Rationale

The traditional rationale of much deregulation in the modern era is as follows: We engage in maximum price regulation primarily because of natural monopoly problems. An economist might define such a monopoly as an industry in which "economies of scale continue for a single fixed plant structure across the entire range of expected demand."[2] In other words, only one enterprise can operate efficiently. Why build a second set of railroad tracks when all the trains we have can use one track? Such natural monopolies normally exist with a high threshold cost structure, such that we want to maximize the efficiency of that initial capital investment.

But technology can change the economics of an industry. And it is possible to isolate an initial fixed cost part of an industry and regulate just that part, while freeing aspects previously regulated to open competition. That has been the theory of much deregulation. Hence, we have isolated the aspects of telecommunications that remain a natural monopoly (the so-called "loop" which provides the wires into people's homes) and maintained the maximum rate regulation, while freeing up previously regulated ancillary services and long distance transmission for competition. Those aspects were closer to trucking in their economic structure—small and adjustable units of production, low barriers to entry, room for many competitors both to operate efficiently

2. THOMAS D. MORGAN ET AL., ECONOMIC REGULATION OF BUSINESS 15-17 (2d ed. 1985).

and to flourish. And the underlying thesis has merit. Indeed, in the paradigm example of natural monopoly, our railroads, we could theoretically create utilities to own just the track, yards, and switching facilities—the clearest high fixed cost aspect of the enterprise. Then we could leave the trains (engines and cars) to competition, as we have arranged for air travel, with public ownership of its highest threshold cost aspect—our airports.

This basic theory of constricting the area of regulation to the inevitable high threshold cost aspect of an industry and freeing remaining parts for competition is at the heart of the modern deregulation movement. It certainly drives energy deregulation. As energy demand has expanded and generation diversity increased, large numbers of different kinds of generators have been able to "feed the grid." Why not confine price regulation again to the "loop" feeding individual, houses and businesses and allow the generators to compete? Why not bring the magic of the marketplace to this important industry? It brings the "invisible hand"—demand driven from the bottom up, the democratic marketplace, natural selection culling the inefficient, an efficient system, and quickly responsive to informed buyers.

B. The Three Common Historical Flaws of Deregulation Implementation

Notwithstanding its promise, three common flaws of deregulation implementation have repeatedly betrayed it. All three have coalesced to undermine energy deregulation in California. The price now being paid in our largest state for those errors is momentous for small business, consumers, and basic infrastructure. The indirect victims are many and include the children who rely on public investment, now foregone as the state spends billions of dollars for energy purchases at outlandish prices, and where ratepayer repayment will be painful and remains uncertain. New general fund investment in children, badly needed in California, has been substantially stymied.[3]

1. Forgetting the Lesson of Aristotle: The Extreme Pendulum Swing

Aristotle's most famous maxim was "moderation, moderation in all things." We repeatedly forget that simple lesson when we deregulate. Rather, the adherents of deregulation remove state control and, relying on the mirage of the "unfettered marketplace," walk away to allow the

3. For a detailed description of the budgetary shortfall for children, see Children's Advocacy Institute, *California Children's Budget 2001-02*, *at* http://www.sandiego.edu/childrensissues (last visited Apr. 4, 2002).

magic of competition to do its work. But as argued below, competitive markets do not operate in a vacuum. Our underlying commercial sector is subject to far more than the UCC or a civil and criminal justice system, but also to antitrust monitoring and consumer protection statutes.

The deregulation of airlines illustrates the pendulum swing flaw of "walk-away and utopia follows" *ipso facto*. A review of airline fares illustrates what happens with extreme abandonment. One certitude about human behavior perhaps more reliable than greed, lust, or gluttony is the following: An enterprise with monopoly power will use it for advantage in available competitive sectors. And usually that competitive sector will thereby become distorted.[4] Hence, if one wishes to fly from Juneau to Anchorage on Alaska Airlines, one will pay more than three times the per passenger mile fare than the same airline will charge in markets where it is subject to competition. Locational price discrimination patterns become the rule rather than the exception and operate *in extremis*, having little to do with cost. Remember the guidepost: Competition normally drives prices toward cost plus a reasonable rate of return. When that standard is violated, one needs to ask why. Nevertheless, the Robinson-Patman Act[5] is effectively suspended for this industry for reasons traceable to its status as "deregulated."

Nor is price discrimination the only suspicious outcome of deregulation. Would a free market support the current: "If you stay over Saturday, the fare is $300; if you do not, it is $2,000"? Such a policy is common in airline tariffs today. If the cost is $270, in a free market the $2,000 figure will be undercut to obtain business until it is reduced to close to $300. Nor do utilization or other cost- or demand-based factors explain such wide disparities. They rather reflect the kind of price discrimination necessarily exercised by price fixing cartels.[6]

---

4. Instead of a fair contest in which victory is determined by choices made by consumers, prices are based on different variables determined from the top. The degree of monopoly, the nature of the barriers to entry, the size of competitors, and business tactics will determine prices and service, rather than the bottom-driven forces that the ideal market reflects.

5. Robinson-Patman Antidiscrimination Act, 15 U.S.C. § 13 (2000).

6. Price variations normally exist in a perfect free market, usually between marginal cost and fully distributed cost. Hence, a movie theater will charge less for the 6:00 P.M. show to attract an audience otherwise not obtainable and more fully utilize its fixed costs. Similarly, an airline would be expected to lower fares for space available traffic, as they do. But the pattern emerging from the deregulated airlines is a different kind of price discrimination. Prices are not varied down toward marginal cost where there is excess capacity, but up above fully distributed cost to capture business willing to pay more. It is the surcharge of double the regular price to the wealthy albino gentleman for sun tan lotion practice that is here in evidence. This latter form of

In the area of consumer protection, other abuses appear. How many "frequent flyer miles" do you have? After you obtain enough for an award, is your flight available for reservation? Or are the airlines allocating a token number of seats for such flights to effectively bar their use by those promised discount fare benefits? Many of us have sought reservations six months in advance or more, only to be told that the only way to redeem the award is to fly at 1:00 A.M. via Duluth and Fort Lauderdale. If you ask for a full fare reservation, it is immediately forthcoming. When consumer advocates, joined by the Attorneys General of numerous states, attempted to prosecute this and other common airline fare advertising deceptions, the Supreme Court held that the airlines were "preempted." In a baffling decision, the Court found that deregulation conferred exclusive jurisdiction on the now jurisdictionless federal government.[7] The *Morales* case serves as the paradigm illustration of this first flaw in deregulation—the pendulum shift from often excessive regulation to wholesale exception from the basic underlying market rules and interventions generally applicable to all commerce. Deregulation means the removal of an aspect of regulation, not carte blanche immunity from marketplace rules, antitrust law, and fair competition statutes.

Another especially timely example of this consumer protection surrender is the remonstrations of Public Citizen and other consumer advocates over the last twenty years to improve airline safety, especially the security of the doors to the cockpit. Heeding their advice on this simple and oft-reiterated point may have saved many lives on September 11. Instead, the state acceded to the cost-benefit ratios of private calculation, which considered harm to the airline and perhaps recoverable passenger damages, but excluded the damage outside the plane itself.

A newly deregulated industry is particularly vulnerable to competitive market abuses. The market is new and the scramble for business often intense. The field of commerce often involves reliance by third parties on continuity and predictability. And critically, continuing interconnection with a remaining monopoly power sector

---

division of the market to "capture the maximum" that different segments are willing to pay is a reflection not of competition, but of cartel pricing abuse.

7. *Morales v. Trans World Airlines* held that 49 U.S.C. app. 1305(a)(1) prohibits any state enforcement of any law "relating to rates, routes, or services" of any air carrier. Morales v. Trans World Airlines, 504 U.S. 374, 384 (1992). The section is included in the Airline Deregulation Act of 1978, which Justice Scalia's flawed opinion contends not only removes federal jurisdiction, but bars otherwise applicable state deceptive advertising obligation applicable to unregulated business in general. *See id.* at 380-83.

poses the common problem of monopoly power abuse or extension. As noted above, a former monopoly power enterprise will inevitably attempt to leverage its advantage into available competitive areas. It may well obtain advantage not based on bottom up (consumer) choice or efficient performance, but from the mere fact of market power for a related service or product. The extension of AT&T's monopoly into phone equipment dominance was one of the bases for its antitrust dissolution. If you wanted to use a Toshiba speakerphone, barriers were placed in your way to favor the utility's own phone equipment operations at Western Electric. The examples of such distortions are legion in the field of antitrust, so prevalent that they may be anticipated wherever the error is made to allow a remaining monopoly power enterprise to have anything to do with its competitive sector aspect. Such problems remain endemic in telecommunications where the local Bells now seek to compete for long distance and other services while maintaining control of the monopoly loop locally.

2. Failure to Account for External Costs

The second common flaw in deregulation implementation is the failure to maintain external benefits or ameliorate external costs. As noted above, the "free market" does not operate in a vacuum. Human beings decide whether a rule of liability will assess the water pollution costs imposed on fishers downstream, or on non-commercial users of water to a plant causing the pollution. There is no automatic default rule optimally preventing "free ride" profit by way of cost imposition on others. Regulation allows adjustments to be made for overall equity or social benefit. Allowing our poorest citizens to have access to the telephone by charging them only the marginal cost of its provision benefits all of us, making our society more integrated, enhancing communication for overall benefit. Even affirmative cross-subsidies may provide overall advantage—the world is not always a zero-sum game.

Energy deregulation is itself the most important example of such a need. We are using nonrenewable resources at a prodigious rate. We operate a nuclear power plant with a byproduct of dangerously radioactive material with a half-life of more than 100,000 years. We have argued for twenty years over where to put this material. Nobody wants it. The plant itself will have radioactive status for a substantial period. This external cost is generated by a plant that will last perhaps thirty years. What will our legatees in 100 years have to say about resource depletion and radioactive waste as our external cost? What

magical use will oil or natural gas, long since depleted, potentially offer in 100 or 200 years, if we have sacrificed it for ourselves?

Those of us in California live under the most powerful energy source in the universe: The sun. Apart from geothermal, wind, and water resources, the sun could provide adequate power for the twenty million people in Southern California. Beyond photovoltaics, parabolic mirrors the size of a garage roof can generate more energy than any house would ever need, and short-term storage is increasingly feasible by flywheel or battery. The technology to provide ample energy, even as we eschew conservation, has been within our reach for more than twenty years, as Buckminster Fuller instructed us a generation ago.

Will energy deregulation make the kinds of cross-subsidies more likely to keep faith with our intergenerational obligation? Our parents and grandparents sacrificed for us. Are we to be the ones to break the chain of that promise? The evidence regrettably suggests such a breach, whether one looks to investment in higher education capacity, housing prices and property taxation for the young, or a host of other policies. The squandering of our natural resources for the current generation's use was addressed only marginally by energy regulators. But will more responsible legislators be able to correct this continuing failure without the use of regulatory cross-subsidies? Will they be able to compel a politically powerful industry to adopt practices disparate from the "free market" rules they have just conferred and which do not reflect the long-range interests and ethical sensibilities of the citizenry? The record with other deregulated industries is a diminution in external benefit/cost adjustments and increased reliance on the default rules of the marketplace. These rules tend to internalize into the market primarily through tort civil suit where corporate negligence imposes visible, immediate, focused and legally cognizable damage—and then only for a small percentage of such cost imposition.

3. Scarcity

The most obvious flaw in deregulation arises from scarcity defects in the underlying market newly relied upon. Under the ideal market, supply may be increased as demand warrants. Where it is restricted, excess profit from scarcity alone may be obtainable. Although allocation to those able and willing to pay a higher price may be advisable, external costs may be implicated as prices rise. The scarcity problem is not triggered by absolute scarcity, but by a substantial time or cost component required where supply must increase to meet demand.

Energy is the paradigm economic sector where scarcity is concerned. It is one of the few products for which service is provided on a blank check basis. First we use the service, and then we are billed. In the long run price changes may influence demand, but not in the short run. Electricity is also an underlying product. Substantial investment has been made relying on its availability at predicted levels and costs. That investment permeates our society, from refrigeration and indoor ambient temperature to the pizza ovens of the corner restaurant to the lights at intersections, on the streets, and at the public university. It touches virtually every aspect of our lives. Its unexpected unavailability causes a ripple effect of disruption and damage far beyond the energy industry's own domain.

The focus of deregulation has been on the freeing of non-natural monopoly sectors of an industry for competition-driven consumer advantage. Power generation is not a natural monopoly given the huge demand of modern grids. Ten or more separate and competing concerns may well vie in a marketplace for its provision, for the common gain. But deregulation's champions have forgotten that when scarcity occurs—and it need not be permanent scarcity—the external costs may be momentous. Combine that danger with an oligopoly capable of price gaming and market rules that provide a strong incentive to escalate prices parallel to a cartel or monopoly pattern, and the danger is magnified. Remove antitrust monitoring and provide a price "detection" mechanism to allow five market-dominating energy producers to play off each other's prices. Add in the removal of external benefit obligations. Then factor in a class of rate consultants whose task is to predict demand and obtain maximum revenue—each well aware that bidding and pricing can be a non-zero sum game where all involved can profit. Add to the cauldron the characteristics of energy noted above: blank check provision before cost assessment, relatively low elasticity of demand to price changes, and an underlying commodity, and the witches' brew is complete.

Ideally, one might add a final element to make certain that the fatal elixir is sufficiently lethal. Have the utilities that present the bills and actually deliver the energy serve as the pseudo-innocent middle-entity victims. They have to collect the charges imposed by the energy providers. If they do not pay, they must declare bankruptcy and risk energy cut-off by out-of-state energy concerns. Further, they have a constitutionally embedded right to a "fair rate of return" on their investment, including the recovery of all "prudent costs" incurred. These utilities are no longer under substantial state jurisdiction, having been deregulated. The utilities that remain regulated are simply pass-

through collectors with a constitutionally based claim to full compensation. Although utilities are profiting from generation plant sales and some are controlled by parents with natural gas and other energy assets well enriched by the high prices, they all have publicly professed victim status. And at least as the law facially reads, whether disingenuous charade or not, their posture may be legally impregnable. Checkmate.

C. Energy Deregulation in California: The Empirical Record

When the theory met the grid in California, all three deregulation flaws appeared. A consumer-sponsored initiative in 1998 to unwind deregulation was defeated three to one and was outspent by energy providers and utilities by more than twenty to one.[8]

1. The Rigging of the Game: 1996-2000

From the 1990s to the present, California energy rate regulation has proceeded in a time-continuum as follows: (1) traditional "fair rate of return" ratemaking, which allows for prudent costs and a return on capital investment; (2) "performance-based" ratemaking, which takes prior costs and credits the utility with efficiency gains to add profit and incentive (either to supplement fair rate of return ratemaking, or, more ominously, to substantially replace it); (3) "transition" ratesetting for the utility operations which will remain under regulation as assets are sold or released for competition based pricing (such as power generation); and (4) "post-transition" ratesetting for the remaining monopoly power utility.

The progression of regulatory policy through these four stages has created a phalanx of new terms of art, acronyms, agencies, and proceedings that can bewilder those with knowledge of the historical tradition of energy regulation. Included as the Appendix is a brief glossary of new terms that may assist in understanding related regulatory proceedings. The "players" include three major private utilities—Pacific Gas & Electric (PG&E), covering northern California; Southern California Edison (SCE), covering southern California outside of San Diego, and San Diego Gas & Electric (SDG&E), covering San Diego. Five communities have publicly provided power. The five major power generators who have purchased the utility de-commissioned plants are Dynegy, Duke, Mirant, Reliant, and Southern.

---

8. *See* Kenneth Howe, *State Initiatives—Most Costly Campaign Ever*, S.F. CHRON., Nov. 5, 1998, at A19, *available at* 1998 WL 3927011.

California's deregulation experiment formally began with the Public Utilities Commission's December 1995 decision to deregulate the state's $23 billion electricity industry. Under the new regime, the PUC maintains regulation of the power distribution grid (e.g., the rights of way and wiring which bring power into homes and businesses), but subjects power generation to competition.

The Commission's decision required approval by the Federal Energy Regulatory Commission (FERC) which regulates interstate energy matters, including wholesale energy sales. It also required the approval of the state legislature. Legislative approval occurred in 1996 with the confirmation of most of the PUC's initiative through the enactment of A.B. 1890.[9] Effective March 1, 1998, the new law created an "Independent System Operator" (ISO) to assume control of the power grid that transmits electricity statewide between the respective utilities controlling local delivery.[10] It also created a second agency, the Power Exchange (PX), to function as a stock exchange (or a commodities market), enabling sellers and buyers to bargain for electricity price.[11] A.B. 1890 authorized "direct access"—direct transactions can occur between electricity suppliers and end use customers without effective interference from the utility carrying the electricity.[12] A.B. 1890 also outlined a general plan to accomplish the "unbundling," or separation, of the three distinct functions of electricity service: (1) generation, (2) transmission, and (3) distribution (including the unbundling of the maintenance of electricity lines, metering, and billing).[13] Thus, under the new scheme, the traditional local utility—now called a "utility distribution company" (UDC)—continues to transmit electricity to end users, but generation and some aspects of distribution (such as metering and billing) are removed from direct private utility control and placed under a competitive format managed by the ISO or the PUC. Power generators are now called "electricity service providers" (ESPs).

A.B. 1890 also permits utilities to charge ratepayers a "competition transition cost" (CTC) to compensate them for "stranded costs" or "sunk investments" in imprudent power generation facilities; for a time, the CTC appeared as a special itemized cost on energy bills. Further, the utilities were allowed to freeze the price of electricity for residential and small business users at high 1996 levels (about 50% above the

9. A.B. 1890, 1996 Leg. (Cal. 1996) (Brulte).
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*

national average). The new law also required the utilities to give consumers a 10% reduction in electricity rates from those in effect on June 10, 1996. This rate reduction was effective January 1, 1998 and continues until the earlier of March 31, 2002, or such earlier time as each utility fully recovers its transition costs (the "transition period").[14] Finally, the bill promised ratepayers an "anticipated result" of "no less than a 20% reduction" in post-transition rates.[15] As events have unfolded, these mandated savings have also not occurred.

The PUC's implementation of the new scheme has been fraught with problems. Consumer advocates argue that a new and complicated set of terms of art and multi-step proceedings has been created. The current process breaks rate regulation into "transition period" and "post-transition period" phases and separates rules and factors for individual decision making into fragmented hearings not amenable to comprehensive coverage by underfinanced consumer groups. But these complaints have been overshadowed by the underlying flaw in the system—the imposition of "market-based" spot prices to determine final contract price for electricity payable by utilities (UDCs) in a context of supply scarcity.[16]

The "transition" period noted above ends when a utility disposes of all of its power generation assets. SDG&E was the first major utility to do so. Other utilities have followed, and power generating companies

14. However, the rate reduction was accompanied by the issuance of "rate reduction bonds" by the utilities to finance the reduction, and consumers were required to pay the borrowed money back in another specially designated charge on the monthly bill called "trust transfer amount" (TTA). The latter charge is greater than the rate cut (due to interest accumulation). In other words, the rate reduction bonds were secured by a surcharge that substantially offset the facial and advertised rate reduction.

15. A.B. 1890, 1996 Leg. (Cal. 1996) (Brulte).

16. Consumer advocates point to a 1996 decision by FERC as critical to the current conundrum. During 1992–1995, the California Energy Commission had recommended the development and stimulation of substantial alternative energy supply sources. This policy decision was driven by several years of study of future energy supplies and by the long-run advantage of developing renewable energy sources for future consumers in the millennia to come. The recommendation would have produced 1,400 megawatts of power for a capacity cushion which conservationists and consumer advocates argued was prudent. However, the utilities appealed to FERC, arguing that some of the costs of this alternative generation would be higher than the cheapest available power (generally hydro- and gas-powered generators). They contended that utilities had a right to the lowest price sources, indeed, they argued that a failure to pursue the lowest price could be "imprudent" under regulatory law standards and would subject them to liability for the difference. FERC sided with the utilities, and the PUC's intended policy of enhanced alternative generation capacity was substantially abandoned. Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, FERC Order No. 888, 75 F.E.R.C. ¶ 61,080, 1996 FERC LEXIS 777 (1996).

have now sold plants once considered "uneconomic" at an average of three times their book value.[17] The utilities then generally restructured themselves. The UDCs are now generally separate companies and are subsidiaries of "parent companies" which have been allowed to retain substantial interest in the subsidiaries' power-related assets. For example, SDG&E's parent (Sempra Energy) retains substantial interests in natural gas, a major source of electricity generation. SDG&E's rates began to climb precipitously in 2000. As a result, the PUC froze billing at 6.5 cents per kilowatt hour (slightly below the 7.2 cents paid by SCE and 6.7 cents by PG&E). However, the agency pledged that the utility would be able to collect from ratepayers the growing deficit between that charge and the amount paid to generators for electricity. Moreover, the 6.5-cent cap expires on December 31, 2003, and SDG&E is allowed to apply for surcharges above that ceiling in the interim to moderate its growing deficit.[18] That deficit is now substantial, and it appears that the most likely resolution will be the public bailout of this debt and substantial additional debt as described in the chronology below.

- As noted above, the UDCs were subject to state regulation but have a constitutional right to recovery of all "prudent costs." Energy purchases became such a cost with deregulation. Hence, such costs must be passed onto consumers within the state free from in-state regulatory limitation. Only FERC maintained possible controls over excessive maximum rates by power generators at the wholesale level. That control was based on the right of FERC to place ceilings on such rates where it found that "effective competition" did not exist and those resulting rates were arbitrary and excessive. However, as indicated above, FERC declined to impose meaningful limits close to reasonable rate of return levels and only recently imposed a maximum lid (see below).

- Although demand has not increased substantially from prior years, supply contracted slightly during 1999 as utilities transitioned off of power production. So-called "alternative generators" did not

17. Utilities received $28 billion in revenue through the sale of these assets. Note that power generators are likely to recover their full investment in less than two years at current prices.

18. *See* San Diego Gas & Elec. Co., Cal. Pub. Util. Comm'n Decision 99-05-051 (1999), *available at* 1999 WL 1100923; *see also* Pac. Gas & Elec. Co., Cal. Pub. Util. Comm'n Decision 00-08-021 (2000), *available at* 2000 WL 1341115; Order Instituting Investigation into the Functioning of the Wholesale Electric Market, Cal. Pub. Util. Comm'n, Investigation 00-08-002 (2000), *available at* http://www.cpuc.ca.gov. Decision 00-08-021 was then superseded by A.B. 265 signed by the Governor on September 6, 2000, which then led to conforming California Public Utilities Commission Decision 00-12-033 (2000) for industrial and commercial users. *See* http://www.cpuc.ca.gov.

increase as much as was anticipated (see above). A minor drought lessened cheap hydroelectric power supply. Natural gas prices began to climb, particularly after deregulation in California was improvidently accompanied by reliance on monopoly or tight oligopoly pipeline transmission.

- Meanwhile, the new system relied substantially not on long-term contracted power, but on a "commodities market" type of structure, where the ISO and the PX facilitated "spot" prices on a daily basis for power purchased from the generators. The last highest price agreed upon at the end of the day applied to previous "day ahead" transactions. Moreover, little power was purchased in advance, with few long-term contracts. The "day ahead" market yielded to a "real time" market where prices were set hourly—with the last price each hour establishing a "market clearing price" applicable to the previous transactions for that hour. All generators would gain substantially from such high last second prices. Exacerbating the timing gamesmanship was the segmentation of the power purchase "marked" into more than ten separate auctions for different types of power (e.g., RMR or must run, ancillary services, etc.). During this period several things happened. First, about five generators (mostly Texas-based firms with interstate operations) dominated energy production assets. Second, these generators monitored the spot market results instantaneously via the Internet. Third, generators began to take some power off the market, purportedly without clear rationale.

- Due to the nature of the power market and the practices above, spot prices began to climb to five, ten, and even one hundred times the normal market level. Power purchased at $30 per megawatt-hour jumped to $100, $300, and even $1,900. The typical pre-1999 price of 5 cents per kilowatt/hour jumped to 35 cents per kilowatt/hour overall by January of 2001.

- Because of the prior sunk cost investment/low elasticity of demand feature discussed above, and because of the "prior contract" nature of the retail market, energy is purchased and provided based on demand, regardless of the cost. That cost is then *post hoc* imposed on the utilities and passed through to consumers without recourse.[19] The market may respond to high prices, but only after a time lag. That time lag is substantial on the demand side, given the sunk cost already made in electricity, and it is even more substantial on the supply side, given

19. Service has been purchased in advance and is relied upon by the customer. Moreover, the utilities have a "common carrier" type of duty to provide power and are constitutionally entitled to recovery of all prudent costs incurred.

the lag factor in utility plant construction. Hence, the stage was set for excessive prices without practical ceiling or limitation in the provision of a basic and underlying service.

- The utilities publicly bemoaned the high prices, but channeled substantial revenues away from their utility subsidiaries and into competitive sector enterprise.
- The high prices led to enormous paper deficits for utilities, as the rates charged customers had been calculated at previous energy purchase levels and would have to be increased substantially to pay for the debt now owed the power generators.

During and following these developments, public agencies and officials responded. Although somewhat extensive, the full chronology of that response emphasizes the gravity of the disruption and cost flowing from the three deregulation errors cited above, particularly the failure to predict or accommodate scarcity impact. The societal response included legislation and litigation (including several cases contending that the power generators have violated federal antitrust law and committed acts of unfair competition in violation of the state's Unfair Competition Law). It also led to the bankruptcy filing by one utility, conservation incentives, public purchase of power through the Department of Water Resources (at a rate of $50 million per day for a substantial period of time), including long-term contracts to assure supply at a predictable price, the possible public purchase of transmission facilities of two utilities (including SDG&E) the public pay-off of debts to the power generators, and the floating of substantial public revenue bonds (almost $20 billion authorized); belated (limited) rate ceilings imposed by FERC; and hearings on a limited refund due California utilities from generator overcharges.

Most experts place the cost of the overcharges since 1999 at more than $40 billion for each of the years 2000 and 2001, excluding the indirect costs due to the expenditure of budget surpluses and the lack of monies for general fund purposes otherwise available.

2. Post-2000: Who Let the Dogs Out?

The following chronology details the state's response to the energy crisis as energy companies successfully gamed the bidding process to double, and then double again, energy revenues.

1. In May 2000, wholesale prices began a general and steep climb, particularly in San Diego, with SDG&E rates commonly doubling or

tripling. The furor resulted in quick passage of A.B. 265,[20] which capped rates at 6.5 cents but promised later recovery for the utility of deficits, as noted above. In July 2000, PG&E and Edison filed emergency motions with the PUC seeking to sign long-term contracts with power providers—and acknowledging that earlier projections of adequate supply were erroneous.[21]

2. On November 29, 2000, consumer attorney Mike Aguirre filed suit in San Diego Superior Court on behalf of a single ratepayer against 16 power generators (*Hendricks v. Dynegy Power Marketing, Inc.*, GIC758565). Three similar suits were filed by San Diego County Water Districts. These suits alleged violation of federal antitrust law (Sherman Act section 1) prohibiting unreasonable restraints of trade. State legislators subsequently joined these suits. Initial removal to federal court and motions to dismiss based on federal preemption were denied.[22]

3. Through November 2000, Governor Davis and others appeared before FERC, urging wholesale rate price caps. The agency rejected these caps, suggesting instead that California utilities enter into long-term power contracts for price stability.

4. During December 2000, Governor Davis met in Washington, D.C., with federal officials, arguing, once again, for price caps.[23] Energy Secretary Bill Richardson averted imminent rolling blackouts by ordering twelve generating plants to sell power to PG&E and Edison.[24] (Some were refusing on the grounds that previous bills remained unpaid.)

5. On January 4, 2001, PUC President Loretta Lynch reversed direction and announced approval of a 10% rate hike for SCE and PG&E customers.[25]

6. On January 17, 2001, rolling blackouts were ordered in California for the first time (aside from minor Bay Area blackouts in 1998).[26]

---

20. A.B. 265, ch. 328 (Cal. 2000) (Davis).

21. *Citing Crisis, PUC Lets PG&E, SoCal Ed Seek Long-Term, Bilateral Contracts*, ELEC. UTIL. WK., Aug. 14, 2000, at 9, *available at* 2000 WL 13097908.

22. Hendricks v. Dynegy Power Mktg., Inc., 160 F. Supp. 2d 1155 (S.D. Cal. 2001).

23. *See Federal Officials Put Some Electricity Under California's Control*, SAN JOSE MERCURY NEWS, Dec. 16, 2000, *available at* 2000 WL 30572112.

24. Cynthia Berthelsen & Lynda Gledhill, *Energy Chief Steps In*, S.F. CHRON., Dec. 14, 2000, at A1, *available at* 2000 WL 649904.

25. Carrie Peyton, *PG&E Gets Rate Increase: California Regulators to Explore Long-Term Solutions*, SACRAMENTO BEE, Jan. 5, 2001, *available at* 2001 WL 2835826.

26. *See The California Energy Crisis: PG&E History*, L.A. TIMES, Apr. 7, 2001, at A14, *available at* 2001 WL 2476406.

7. Also in January 2001, emergency legislation was enacted to allow the state to purchase electricity through the Department of Water Resources.[27] Meanwhile, natural gas shortages and excessive prices became evident following improvident federal deregulation of natural gas transmission.

8. Starting on January 18, 2001, California began buying power, beginning with an appropriation of $400 million for an initial purchase covering just twelve days.[28] Governor Davis began negotiations with executives of the top four generators—Duke, Southern, Reliant, and Dynegy—for long-term contracts. An auction for "long-term contracts" was announced.[29]

9. Also on January 18, 2001, the City of San Francisco filed suit against the thirteen major power producers, contending that they had unlawfully colluded to manipulate the wholesale market.[30] City Attorney Louise Renne filed the action.[31]

10. In January 2001, SCE and PG&E sued in federal court to compel the PUC to grant them rate increases to pay for the higher energy costs imposed upon them.[32] (On May 4, 2001, the court refused to grant the utility the proposed remedy, instead deferring to other agencies in attempting to address the problem, including a federal bankruptcy judge by then presiding over the PG&E bankruptcy.)

11. On February 5, 2001, Governor Davis seized the existing PG&E and Edison energy contracts held by the California Power Exchange.[33] The Exchange (structured as an independent agency) then presented the Governor with a bill for $1 billion, its valuation of the contracts taken.[34] These contracts provided for energy delivery at lower rates (6 cents to 13 cents per kilowatt/hour).[35]

12. On February 6, the PUC announced that it was investigating whether power utilities had violated Commission rules governing their

---

27. S.B. 7, 2001 Leg., 1st Ex. Sess. (Cal. 2001) (Burton).

28. *See, e.g.*, Ed Mendel, *Blackouts Spread in State: Emergency Aid Ok'd to Keep Utilities Afloat*, SAN DIEGO UNION-TRIB., Jan. 19, 2001, at A1, *available at* 2001 WL 6438167.

29. Ed Mendel, *State Will Take Bids for Electricity, Governor Hopes Web Auction Today Reduces Prices*, SAN DIEGO UNION-TRIB., Jan. 23, 2001, at A1, *available at* 2001 WL 6438901.

30. People v. Dynegy Mktg. Inc., No. SCV318189 (Cal. Super. Ct.) (filed Jan. 18, 2001).

31. *Id.*

32. *See* PG&E v. Lynch, No. CV-01-1083, *available at* 2001 WL 840611 (C.D. Cal. May 4, 2001) (before U.S. District Judge Ronald Lew).

33. Emily Bazar & Dave Kasler, *California Governor Uses Powers to Buy Emergency Electricity*, SACRAMENTO BEE, Feb. 6, 2001, *available at* 2001 WL 12167645.

34. *Id.*

35. *Id.*

diversification into "unregulated" business.[36] All three had formed parent holding companies since 1986 (PG&E formed PG&E Corporation, SCE formed Edison International, and SDG&E formed Sempra Energy).[37] A PUC audit found that almost all of the income of the parents was traceable to utility profit.[38] (Note that utilities are designedly confined to cost recovery plus a "fair rate of return" on "used and useful capital" committed to utility purposes.) The utilities and their parent companies contend that these funds are unavailable to them to pay for allegedly excessive power purchases—all of which must be borne by ratepayers.[39]

13. On February 8, 2001, the Governor announced special incentives to bring new power plants on line.[40] The next day, Duke Energy gave the *Orange County Register* an internal letter dated July 31, 2000 from Duke president James Donnell offering 2,000 megawatts at 5 cents per kilowatt/hour for five years.[41]

14. On February 16, 2001, the Governor unveiled his overall "rescue plan," which included the state purchase of utility transmission lines (to pay off the massive deficits owed the utilities from taxpayer sourced revenues).[42] The price would range from $3 billion to $9 billion, an amount that would be repaid, according to consumer critics, through higher rates in the future. Also on this date, the *Los Angeles Times* revealed that public power agencies had joined in charging wildly excessive rates for the sale of their own excess power.[43]

15. On February 20, 2001, the California Senate approved a measure to create a state public power authority which could generate and sell electricity itself.[44] The measure was thereafter enacted and authorized $5 billion in general obligation revenue bonds to finance such plant investment or conservation incentives.[45]

---

36. Michael A. Hiltzik, *PUC May Probe Utilities' Rule Compliance*, L.A. TIMES, Feb. 6, 2001, at A1, *available at* 2001 WL 2458707.

37. *Id.*

38. *Id.*

39. *See id.*

40. Mark Gladstone & Dion Nissenbaum, *California Governor Speeds Approval Process for New Power Plants*, SAN JOSE MERCURY NEWS, Feb. 9, 2001, *available at* 2001 WL 12168179.

41. Kate Berry, *California Governor Rejected Power-Contract Offer from Duke Energy Last July*, ORANGE COUNTY REG., Feb. 9, 2001, *available at* 2001 WL 12168316.

42. Press Release, Office of the Governor, Governor Davis Announces Recovery Plan for State's Utilities (Feb. 16, 2001), *available at* http://www.governor.ca.gov.

43. Nancy Vogel & Richard Simon, *The California Energy Crisis: DWP Earns Top Dollar Selling Power*, L.A. TIMES, Feb. 16, 2001, at A23, *available at* 2001 WL 2461646.

44. S.B. 6, 2001 Leg., 2d Ex. Sess. (Cal. 2001) (Burton).

45. *Id.*

16. On February 22, 2001, the state announced it needed another $500 million from surplus public funds for another ten days of energy purchases, bringing the total to $2.3 billion in direct public money purchases to that date.[46] This sum does not include the billions of dollars the generators claim they are owed from utilities.

17. On March 5, 2001, Governor Davis announced long-term energy contracts with twenty suppliers.[47] The details were not disclosed. However, a subsequent suit by the media to compel disclosure under the California Public Records Act revealed costs to be at levels double to triple historical prices, and included in some cases additional escalation clauses based on the price of natural gas (which may rise precipitously given evolving federal deregulation).[48]

18. On March 29, 2001, the PUC's Office of Ratepayer Advocates accused SDG&E of padding electricity bills by $170 million.[49] The utility had obtained below-market prices in a contract with Louisville Gas & Electric, and—instead of passing on those reductions—charged ratepayers at market levels and pocketed the difference for its stockholders.[50] Hence, if costs are above established market level, the utility expects ratepayers to pay; if below, it proposes to keep the difference. The charges were made amidst the disclosure of a new compensation package of $7 million for Stephen Baum, chairman of the board of SDG&E's parent Sempra Energy.[51]

19. On April 5, 2001, the PUC's Office of Ratepayer Advocates charged that SDG&E failed to enter into long-term contracts when able to do so during the previous year, costing ratepayers $98 million.[52] The Office noted that SDG&E was in a position to overly rely on the short-term "spot market" which hit extraordinarily high levels in late 2000.[53]

---

46. Jenifer Warren, *Secrecy Cloaks State's Buyers on Their Prowl for Power Electricity*, L.A. TIMES, Feb. 23, 2001, at A1, *available at* 2001 WL 2463953.

47. Dan Morain & Nancy Vogel, *Electricity Deals Could Supply 7 Million Homes, Davis Says*, L.A. TIMES, Mar. 6, 2001, at A1, *available at* 2001 WL 2467355.

48. Dan Morain, *Concern over Price of Long-Term Power Pacts Grows*, L.A. TIMES, July 9, 2001, at B7, *available at* 2001 WL 2501762; *California Officials Release Power Contracts*, GENERATION WK., July 11, 2001, *available at* 2001 WL 8447408.

49. Craig D. Rose, *State Watchdog Accuses SDG&E of Padding Bills*, SAN DIEGO UNION-TRIB., Mar. 29, 2001, at A1, *available at* 2001 WL 6450815.

50. *Id.*

51. *Id.*

52. Craig D. Rose, *Report Faults SDG&E on Contracts*, SAN DIEGO UNION-TRIB., Apr. 6, 2001, at A26, *available at* 2001 WL 6452400.

53. Nancy Vogel, *Cal-ISO Predicts 34 Days of Blackouts*, L.A. TIMES, Apr. 6, 2001, at A26, *available at* 2001 WL 2476067.

20. On April 6, 2001, PG&E surprised public officials by declaring bankruptcy, seeking protection of the federal court and compelling payment from ratepayers of monies allegedly due the power generators.[54]

21. On April 9, 2001, Governor Davis and Southern California Edison agreed in principle on the state purchase of the utility's 32,000 miles of transmission lines for $2.76 billion.[55] As part of the deal, Edison's parent agreed to refund to the utility some $420 million in profit from its plant sales to the power generators to help pay some of the "debt" owed to those generators.[56]

22. On April 21, 2001, the San Diego County Board of Supervisors announced plans for state legislation to authorize a municipal utility district to generate and sell electricity.[57] Los Angeles, Sacramento, and San Francisco currently have such districts. Interestingly, Sempra Energy expressed public support for the concept. On May 22, the measure was killed in an Assembly Committee following intense behind-the-scenes opposition from Sempra Energy.[58]

23. On April 24, 2001, the state announced public expenditures of $5.1 billion for electricity purchases from January to April, all in addition to current amounts allegedly owed energy producers by utilities.[59]

24. On May 1, 2001, FERC ordered a small energy producer (Williams Energy Marketing & Trading of Tulsa) to pay an $8 million refund to the ISO.[60] Williams markets power produced in California by AES Corporation of Arlington, Virginia. The refund was ordered because Williams allegedly took plants off-line improperly, thereby artificially limiting supply resulting in excessive charges. Similar problems were alleged as to other producers who facilitated $550 million in overcharges beyond a $150/mega-watt hours "breakpoint."

---

54. Tim Reiterman, Dan Morain & Mitchell Landsberg, *PG&E Declares Bankruptcy; State's Crisis Plan Collapse*, L.A. TIMES, Apr. 7, 2001, at A1, *available at* 2001 WL 2476433.

55. Miguel Bustillo & Nancy Vogel, *Failure to Buy Entire Network May Doom Davis' Power Deal*, L.A. TIMES, Apr. 12, 2001, at A3, *available at* 2001 WL 2477741.

56. Dan Morain & Robin Fields, *Davis Arranges to Buy Edison's Share of Grid Power*, L.A. TIMES, Apr. 10, 2001, at A1, *available at* 2001 WL 2477198.

57. Ed Mendel, *County Wants to Create Own Utility District*, SAN DIEGO UNION-TRIB., Apr. 21, 2001, at B1, *available at* 2001 WL 6455538.

58. Bill Ainsworth, *Panel Pulls the Plug on County Utility Plan*, SAN DIEGO UNION-TRIB., May 22, 2001, at A1, *available at* 2001 WL 6461964.

59. Miguel Bastillo & Dan Morain, *State Spends $5.1 Billion on Power Budget*, L.A. TIMES, Apr. 24, 2001, at A3, *available at* 2001 WL 2481105.

60. AES Southland, Inc., Docket No. IN01-3-001, 95 F.E.R.C. ¶ 61,167, 2001 FERC LEXIS 973 (2001).

That upper limit is more than ten times wholesale energy prices prior to 2001.[61]

25. On May 2, 2001, Duke Energy proposed a settlement of its financial claims to Governor Davis, including a request to dismiss all pending litigation.[62] In addition to Duke's operation of the South Bay plant in San Diego, it also purchased two large power plants from PG&E at Morro Bay and Moss Landing in 1998 for $611 million and announced its intention to spend another $1.6 billion to expand and modernize them.[63] Duke offered to expand its capacity and accept some discount on monies owed to it if suits were dismissed and investigations terminated.[64]

26. Also on May 2, 2001, Lieutenant Governor Cruz Bustamante filed suit against the major five power producers in Los Angeles Superior Court, contending that they (and fourteen named executives) violated federal and state antitrust laws in conspiring to fix prices and supplies of power for California sale.[65] Duke Energy was among those named.[66] Mike Aguirre of San Diego (who brought *Hendricks*, the consumer class action in San Diego described above[67]) is Bustamante's attorney.

27. On May 13, 2001, a report by FERC staff expert economist Jonathan Ogur found that El Paso Corporation was artificially inflating natural gas prices through its dominance of the only pipeline into Southern California.[68] The report estimated that California had already paid an extra $3.8 billion from March 1, 2000 to March 31, 2001.[69] In testimony on April 19, experts from the Batelle Institute charged that PG&E had mysteriously relinquished its natural gas allocated space on El Paso pipelines into California, which were then relegated back to El Paso, which in turn assigned them to Dynegy, Inc., one of the five major

---

61. San Diego Gas & Elec. Co., Order Directing Sellers to Provide Refunds of Excess Amounts Charged, 94 F.E.R.C. ¶ 61,245 at Attachment A, 2001 FERC LEXIS 463 (2001).

62. Nancy Vogel et al., *Big Energy Firm Seeks Deal with State to End Suits*, L.A. TIMES, May 2, 2001, at A1, *available at* 2001 WL 2483549.

63. *Id.*

64. *Id.*

65. Bustamante v. Dynegy, No. BC249705 (Cal. Super. Ct.) (filed May 2, 2001), *available at* http://www.ltg.ca.gov/newsroom/pressreleases/2001/pr050201.asp.

66. *Id.*

67. *See supra* note 22 and accompanying text.

68. Bernadette Tansey, *Expert Says Market Probably Fixed*, S.F. CHRON., May 15, 2001, at A1, *available at* 2001 WL 3403582.

69. *See id.*

energy producers for California.[70] That capacity is important because a large part of electricity generation comes from natural gas-fired power plants. The experts testified that Dynegy did not use the capacity then assigned to it, foreclosing natural gas supplies from the state's energy producers and driving up gas prices, which in turn artificially drove up spot electricity prices to the massive benefit of the company and its fellow power generators.[71] The manipulation drove natural gas prices to twelve times the price being charged in Texas.[72] Two cases were filed in May and June 2001 against natural gas concerns alleging antitrust violations based on these developments: *Berg v. Southern California Gas Co.* and *City of Los Angeles v. Southern California Gas Co.*[73]

28. On May 15, 2001, the PUC voted three to two to increase rates to residential ratepayers of PG&E by 55%, to 22 cents per kilowatt-hour (from a high 14.3 cents).[74] SCE consumer rates increased by 47% (beyond 130% of the low baseline).[75] Industrial and other rates were raised a similar amount. The total rate hike was calculated to generate an additional $5.7 billion over previous levels.[76]

29. On May 17, 2001, FERC issued an order to help "qualifying facilities" (energy producers that provide power through alternative energy means at somewhat higher prices and account for an important 10% to 15% of energy used).[77] The move was denounced by Governor Davis as undermining his attempt to negotiate a long-term arrangement with the QFs.[78] These producers are allegedly owed $1.5 billion by the utilities and are not being paid.[79] The Governor contended that the policy of FERC will lead California to continue its reliance on spot prices at ten to twenty times otherwise obtainable levels.[80]

---

70. *See* Miguel Bastillo & Julie Tamaki, *Texas Energy Firm Gouged California, Experts Say*, L.A. TIMES, Apr. 19, 2001, at A3, *available at* 2001 WL 2479748.

71. *Id.*

72. *Id.*

73. *In re* California Retail Gas & Elec. Antitrust Litigation, 170 F. Supp. 2d 1052, 1055 (D. Nev. 2001) (consolidating cases originally filed in the California Superior Courts).

74. *See* Press Release, CPUC Sets New Electric Rates for PG&E & Edison Customers, (May 15, 2001), *available at* http://www.cpuc.ca.gov/PUBLISHED/NEWS_RELEASE/7171.htm.

75. *See id.*

76. *See id.*

77. Cogen Lyondell, Inc., 95 F.E.R.C. ¶ 61,243, 2001 FERC LEXIS 1161 (2001).

78. Megan Garvey, *The Energy Crisis: FERC Issues Power Ruling*, L.A. TIMES, May 17, 2001, at A20, *available at* 2001 WL 2487615.

79. *Id.*

80. *Id.*

30. Also on May 17, Attorney General Bill Lockyer filed suit in San Francisco Superior Court to compel three energy companies to produce documents demanded by the Attorney General under his Government Code prefiling Unfair Competition Law powers.[81] Lockyer had asked for ninety-one categories of documents and the out-of-state companies had refused to produce them, objecting to each request as "vague, ambiguous, and unintelligible."[82] They sent some documents to the Attorney General as a show of good faith, but objected to a large proportion of the documents requested.[83] The objecting companies included Reliant, Dynegy, and Mirant.[84] The Attorney General pledged to keep obtained documents "confidential" vis-a-vis the Department of Water Resources, competitors, and entities with which the producers had to negotiate prices or contracts.[85]

31. Also on May 17, the Governor announced the creation of the California Consumer Power and Conservation Financing Authority empowered to float up to $5 billion in general revenue bonds for power generation/conservation purposes.[86] The Authority not only has the authority to build plants, but to seize them where necessary to assure adequate energy (subject to just compensation payment).

32. On May 22, 2001, the PUC announced that it had evidence from service records compiled by the ISO that some generators were withholding power which led to Stage 1, 2, and 3 alerts (as well as extremely high spot prices).[87] General Counsel Gary Cohen indicated that the case was buttressed by three Duke Energy employee whistleblowers.

33. On May 23, 2001, the PG&E bankruptcy judge refused to order rate increases to pay the utility's alleged debt to power generators, instead deferring to the constitutional authority of the PUC.[88] His order became final on June 1, 2001. He also barred representatives of ratepayers from the proceedings as parties or interested creditors.

---

81. *See* Robert Salladay, *Subpoenaed Documents Withheld*, S.F. CHRON., May 17, 2001, at A14, *available at* 2001 WL 3403776.

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.*

86. *See State to Run Power Plants to Ease California Crunch*, SAN ANTONIO EXPRESS-NEWS, May 17, 2001, at A6, *available at* 2001 WL 19786941; *see supra* notes 44-45 and accompanying text (referring to authorizing legislation).

87. Brandon Bailey & Chris O'Brien, *California Regulators Say Companies Pushed Up Price of Power*, SAN JOSE MERCURY NEWS, May 25, 2001, *available at* 2001 WL 21907989.

88. Pac. Gas & Elec. Co. v. Cal. Pub. Util. Comm'n (*In re* Pacific Gas & Elec.), 263 B.R. 306, 309 (Bankr. N.D. Cal. 2001).

34. Also on May 23, legislative Democrats filed suit against FERC to compel the imposition of wholesale price ceilings (contending that FERC's refusal to do so under the existing federal statute constitutes an "abuse of discretion").[89] The suit was filed by well-known plaintiffs' attorney Joseph Cotchett on behalf of Senate President pro tempore John Burton and Assembly Speaker Robert Hertzberg directly before the United States Ninth Circuit Court of Appeals in San Francisco, which has direct jurisdiction over FERC.[90] Joining Cotchett was Clark Kelso, a professor at McGeorge Law School who recently served as interim Insurance Commissioner.[91] On May 30, the Ninth Circuit rejected the suit, declining to hear it.[92] The Federal Power Act requires such challengers to first exhaust administrative remedies, which here would include a request to FERC for reconsideration, which had not been brought.

35. On May 25, 2001, the Governor issued Executive Order D-36-01 instructing the Department of Water Resources (DWR) to implement the conservation measures of then recently enacted SBX1 5 and ABX1 29 and ordering the California Energy Commission to coordinate the permitting, siting, finance, design, and construction of new power plants.[93] The Order authorized spending from the state's Disaster Response-Emergency Order Account for these and related purposes. Under the Order, the contracts entered into by these agencies (including DWR energy purchases) were purportedly exempt from the competitive bidding and other mandatory safeguards normally applicable to public purchasing under the Government Code. The Order also allegedly conferred "retroactive legitimacy" on all such contracts entered into after January 17, 2001 and prior to the Order.

36. On June 1, 2001, the Governor announced his intention to ask FERC to recognize the ISO as a "regional transmission organization" under federal law. That status was required by FERC in order to maintain its limited $250 per megawatt-hour "cap" on wholesale rates, and subjects the state agency to additional federal controls.[94]

---

89. *See* Emily Bazar, *California Loses Round in Fight for Federal Energy-Price Caps*, SACRAMENTO BEE, May 30, 2001, *available at* 2001 WL 21909474.

90. *See* Dan Morain, *Veteran Lawyer Joins Campaign for Price Controls*, L.A. TIMES, May 23, 2001, at B7, *available at* 2001 WL 2489292.

91. *See id.*

92. *See* Bazar, *supra* note 89.

93. S.B. 5, 2001 Gen. Assem., 1st Ex. Sess. (Cal. 2001) (Sher); A.B. 29, 2001 Gen. Assem., 1st Ex. Sess. (Cal. 2001) (Kehoe).

94. *See* San Diego Gas & Elec. Co., Order Establishing Prospective Mitigation and Monitoring Plan, 95 F.E.R.C. ¶ 61,115 (2001).

37. Also on June 1, the Governor announced implementation of his "20-20" incentive plan for conservation. Consumers who reduce power usage by more than 20% from a year ago will receive a 20% reduction on their electricity bill, starting in July.[95]

38. Finally, on June 1, 2001, Duke Energy confirmed that its January 2001 charges for electricity included charges of $3,880 per megawatt-hour, about 100 times normal market levels, and a new record.[96] The sales occurred just before the state stepped in through the DWR to take over energy purchases for the state. On average, Duke charged $136 per megawatt-hour in California during January, just over four times previous market levels.[97] Duke cited the skyrocketing cost of natural gas as a factor.[98] (But those increases accounted for a small portion of the price hikes, and most of Duke's plants can switch within hours from gas to oil.)

39. On June 5, 2001, SDG&E requested substantial rate hikes.[99] (Although rates are theoretically frozen through 2003, it has the right to seek "surcharges for higher electricity prices," as discussed above). It sought to collect $915 million to pay for energy it has used that was purchased after January by the state DWR.[100]

40. Also on June 5, the state Senate Rules Committee issued subpoenas to eight out-of-state power generators and asked for information from DWR and the Los Angeles Department of Water and Power.[101]

41. On June 6, 2001, Williams Energy Services disclosed that it is the target of a United States Department of Justice investigation into possible supply fixing with AES Southland to not build additional power plants in California in order to keep supply diminished.[102]

42. On June 7, 2001, United States Senator Diane Feinstein introduced legislation to re-regulate energy, specifying that wholesale

---

95. *Davis Announces Rebates for Summer Power Savers*, L.A. TIMES, Mar. 14, 2001, at N1, *available at* 2001 WL 6053373.

96. Christian Berthelsen, *Duke Admits Overcharging Utilities*, S.F. CHRON., June 2, 2001, at B1, *available at* 2001 WL 3405252.

97. *Id.*

98. *Id.*

99. *See* Anne C. Mulkern, *SDG&E to Seek Rate Hike to Cover $915 Million Tab*, ORANGE COUNTY REG., June 5, 2001, *available at* 2001 WL 9674714.

100. *See id.*

101. Carl Ingram & Miguel Bustillo, *Panel OKs Subpoenas for Energy Companies*, L.A. TIMES, June 5, 2001, at B1, *available at* 2001 WL 2492815.

102. Peter Behr, *Justice Probes AES's Electricity Deal*, WASH. POST, June 6, 2001, at A11, *available at* 2001 WL 17633741.

rates would be capped at "cost of production plus a fair rate of return" plant by plant.[103] The bill is not expected to pass.

43. By June 8, 2001, spot prices had fallen to a level making the long-term contracts entered into by Governor Davis[104] a costly bargain for ratepayers. Spot prices were then substantially below the price agreed to in 23 of the 38 long-term contracts entered into by the DWR, many negotiated during the height of scarcity pressure and bafflingly applicable for terms of ten years and more. During 1999, prices were in the $40 per megawatt-hour area. During late 2000 and early 2001, they reached extraordinary and extreme levels of over $300 per megawatt-hour. By June 8, peak prices slipped to about $70 per megawatt-hour, with contracts for July delivery at about $175.

44. On June 12, 2001, the Assembly Judiciary Committee passed a bill originally proposed on May 21, 2001 by Assembly member Juan Vargas of San Diego. The bill proposed a partial takeover plan, authorizing state takeover of power plants in the state on a temporary basis, to be returned to previous owners upon payment of a rental charge.[105] After passing through the Assembly Judiciary Committee, it was later sidetracked.[106]

45. On June 13, 2001, Attorney General Bill Lockyer announced via press release the convening of a criminal grand jury to investigate whether power generators were manipulating supply and prices.[107] (It is unclear why a prosecutor would publicly announce the convening of a criminal grand jury, which by its very nature is intended to be a secret proceeding.)

46. On June 18, 2001, the Governor announced a tentative agreement to buy SDG&E's transmission lines for $1 billion, 2.3 times their net book value.[108] The deal would include apparent utility satisfaction of the $750 million claimed by power generators[109] (the difference between SDG&E rates and power purchases over the last year). The

---

103. Richard Simon, *Senator Fires Warning Shot on Power Costs*, L.A. TIMES, June 7, 2001, at A1, *available at* 2001 WL 2493485.

104. *See supra* notes 47-48 and accompanying text.

105. Bill Ainsworth, *Temporary Takeovers to be Spelled Out in Bill*, SAN DIEGO UNION-TRIB., June 12, 2001, at A3, *available at* 2001 WL 6466146.

106. A.B. 35, 2001 Gen. Assem., 2d Ex. Sess. (Cal. 2001) (Vargas).

107. Press Release, Office of the Attorney General, Attorney General Statement on Convening Criminal Grand Jury to Investigate Energy Pricing Practices (June 13, 2001), *at* http://caag.state.ca.us/newsalerts.

108. Press Release, Office of the Governor, Governor Davis Announces Agreement with SDG&E, Sempra Energy (June 18, 2001), *at* http://www.governor.ca.gov.

109. *Id.*

PUC Office of Ratepayer Advocates (ORA) summarized the Memorandum of Understanding's (MOU) key provisions: (a) 100% of the gain on this sale would go to utility stockholders, (b) elimination of the $750 million shortfall account, with SDG&E writing off $319 million, and (c) agreement to price at cost for SDG&E's remaining energy generating facilities for ten years.[110] The ORA openly questioned the wisdom of paying $1 billion in public money to acquire transmission lines. The office argued that these funds would be better spent adding generating capacity—the lack of which results in scarcity and inflated prices.[111] If the state were to ever sell those lines, it would obtain only a fraction of the purchase price, creating a substantial taxpayer loss.[112]

47. On June 19, 2001, FERC announced more extensive price caps on wholesale power sold in California. The caps were set at a level to allow profit for the "least efficient" energy producer in order to "provide incentive to much more efficient producers to expand." The order banned "megawatt laundering" whereby generators had been transmitting power out of state, and then importing it back into California under different auspices to achieve high prices. Importantly, the FERC order required all generators that transmit power to the California grid to "sell what they have available" when the state's ISO requests power. Although this ceiling eliminates the spectacular $1,900 per megawatt-hour charges, it allows overall prices at three to four times historical levels. Moreover, California is assessed, on top of "least efficient plant" ceilings, a 10% surcharge because of the "credit uncertainty" of its utilities.[113]

48. On June 22, 2001, three of the "whistleblowers" who had provided information to the PUC surfaced publicly.[114] All three were Duke Energy employees working at the utility's Chula Vista plant: Glenn Johnson, Jimmy Olkjer, and Ed Edwards.[115] The three testified before the state Senate that they had been ordered to engage in

110. Analysis and Comments of the Office of Ratepayer Advocates on the Memorandum of Understanding by and Among California Department of Water Resources, San Diego Gas & Electric Company and Sempra (July 18, 2001), *at* http://www.ora.ca.gov.

111. *Id.*

112. *Id.*

113. San Diego Gas & Elec. Co., Order on Rehearing of Monitoring and Mitigation Plan, FERC Docket No. EL00-95-031, at 35 (June 19, 2001).

114. Kimberly Kindy, *Three Say Company Purposely Cut Power*, ORANGE COUNTY REG., June 22, 2001, at 1, *available at* 2001 WL 9676471.

115. *See Operation and Maintenance of Generation Facilities, Hearing Before the California Senate Select Committee to Investigate Price Manipulation of the Wholesale Energy Market* (Cal. 2001) *passim.*

unnecessary maintenance and in the ramping down of supply without justification in order to allow Duke to take advantage of high spot prices.[116] The employees contended that the supply diminution included idling some units entirely and throwing away unused equipment that could be used to enhance capacity.[117] They all worked as contract employees until April 2001. The testimony included the presentation of a "control room log" by Olkjer (a former control room operator), indicating the reduction of output minutes before a Stage 3 alert.[118]

49. On June 26 and 27, 2001, Duke Energy purchased full-page newspaper ads disputing the claims of its three former employees. In the ads, Duke Energy contended that the "ramping up and ramping down" supply decisions are made by the ISO, to which the employees complaining were not privy.[119] On July 2, 2001, the ISO confirmed parts of Duke's explanation pertaining to instantaneous ramping up and ramping down.[120] However, the explanation did not address the employees' description of longer-range capacity reduction decisions, including disposal of repair parts capable of generating power and gratuitous removal of equipment from the line for disingenuous "maintenance."

50. On June 26, 2001, California officials asked for $8.9 billion in refunds from energy producers at the first settlement conference on the state's complaint for redress before FERC.[121] The state's ISO presented back-up to justify the refund, claiming the following overcharges:

Williams Cos. – $861 million

Duke Energy – $805 million

Mirant Corp. – $784 million

Reliant Energy – $750 million

Dynegy, Inc. – $530 million.

FERC Chief Judge Curtis Wagner indicated that total refunds would not top $2.5 billion.[122] Note that $3 billion of the claimed overcharges

116. *Id. passim.*

117. *Id. passim.*

118. *Id.* at 115-249.

119. *Duke Places Print Ads to Attack Workers' Allegations*, HOUSTON CHRON., June 27, 2001, at 4, *available at* 2001 WL 23610678.

120. Kate Berry, *ISO: Duke Was Just Following Orders*, ORANGE COUNTY REG., July 2, 2001, at 1, *available at* 2001 WL 9677069.

121. Jim Puzzanghera, *Power Companies Debate Amounts of California Refunds*, SAN JOSE MERCURY NEWS, June 26, 2001, *available at* 2001 WL 23529818.

122. *See id.*

occurred prior to October 1, 2000, which FERC claims is the starting point of its authority to investigate pricing abuses. In response, Senator Barbara Boxer introduced legislation authorizing FERC to order refunds back to July 2000 when the SDG&E rate increases started.[123] Administrative Law Judge Wagner later opined that the refund was unlikely to exceed $1 billion, adopting a set of rules disqualifying 80% of the California claim.[124]

51. On June 26, 2001, two new appointees to FERC—Pat Wood and Nora Brownell—visited California, reiterating confidence in deregulation but promising to have an open mind.[125]

52. On June 26, 2001, the State borrowed $4.3 billion from its own general fund to pay for DWR power purchases, with repayment dependent upon the floating of a mammoth $13.4 billion general revenue bond planned for September.[126] The $4.3 billion brought the general fund draw to $6.2 billion before the end of fiscal year 2000–2001.[127] Virtually all general fund increases, including a "highest priority" Assembly Democrat promise of $330 million for foster care children in need, were suspended. Bills requiring new spending, particularly for children, were terminated by referral to the "suspense files" of the two appropriations committees, allowing their elimination without public negative vote. The bond obligation would be the largest ever floated and will obligate the state to pay interest over the next 15 years,[128] which will affect its general revenue bond capacity and reduce general fund revenues due to the tax exempt status of interest paid out.

53. On July 2, 2001, Governor Davis announced the opening of the 540-megawatt Sutter Energy Project, the largest new power plant since 1976.[129] On the same day, the Senate Rules Committee approved a non-binding resolution supporting a gubernatorial decision to "seize power plants" in California in order to stop pricing abuses by the five out-of-state headquartered generators.[130]

---

123. Richard Simon, *Davis Asks for Energy Refund Help Power*, L.A. TIMES, June 21, 2001, at A1, *available at* 2001 WL 2497185.

124. *See, e.g.*, *California Rate–Refund Request is Curtailed*, N.Y. TIMES, July 13, 2001, at A12, *available at* 2001 WL 24677875.

125. *See* Puzzanghera, *supra* note 121.

126. Ed Mendel, *State Gets $4.3 Billion Loan to Buy Energy*, SAN DIEGO UNION-TRIB., June 27, 2001, at A3, *available at* 2001 WL 6469071.

127. *Id.*

128. *Id.*

129. Jim Herron Zamora, *Scorching Weather Triggers Stage 2 Alert, Price Caps*, S.F. CHRON., July 3, 2001, at A3, *available at* 2001 WL 3408014.

130. Carl Ingram, *Senate Panel's Resolution Backs Power Plant Seizures*, L.A. TIMES,

54. On July 2, 2001, State Controller Kathleen Connell released previously secret elements of the Governor's forty-one long-term electricity contracts, contending that the costs may be substantially higher than the administration's $43 billion estimate.[131] The provisions were released after a media suit resulted in a court order declaring them to be public documents and countermanding the Governor's order to maintain them in confidence.[132] The contracts appear to allow for prices in the $70 to $200 per megawatt-hour range, substantially above previous market levels or prices necessary to provide a fair rate of return.[133] In addition, some contracts included pass-through escalator provisions for natural gas increases.[134] The *Los Angeles Times* reported that the average cost of power under the contracts to July was $173 per megawatt-hour, while recent spot prices were falling to as low as $50.[135] The *Times* also reported that "outside consultants" had been paid $2.8 million by late June to advise the administration and to engage in public relations-related work.[136]

55. On July 18, 2001, a proposed agreement between the PUC and DWR was announced.[137] Under its terms, DWR would be guaranteed full ratepayer recovery of all state power purchases it arranged.[138] The cost of bonds and interest needed to repay the general fund for prior public purchases, and monies still owed and to be owed to the utilities, would be automatically imposed on ratepayers without hearing or further consideration by the PUC.[139] The proposal followed the enactment of AB 1X in February 2001, giving DWR authority to "recover its costs" and directing an agreement between it and the PUC to accomplish that recovery. The new arrangement alters the longstanding state constitutionally specified role of the PUC as the regulator of private utilities. It is unsettled whether the agency can delegate such an exclusive grant of power to another entity. This specific delegation would be not to an independent agency, but to a

---

July 3, 2001, at B10, *available at* 2001 WL 2500510.

131. Rich Connell et al., *The Energy Crisis: Hidden Costs Revealed in Power Pacts*, L.A. TIMES, July 3, 2001, *available at* 2001 WL 2500550.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. Mary Ann Milbourn, *Ratepayers Pay Brunt of PUC Plan*, ORANGE COUNTY REG., July 19, 2001, at K, *available at* 2001 WL 9678790.

138. *Id.*

139. *Id.*

"department" whose director serves at the pleasure of the Governor. Supporters contend that assurance of repayment is needed for bond issuance to repay the general fund and keep utilities solvent and that DWR serves as a public agency check over private utilities in lieu of the PUC.

56. On July 27, 2001, Governor Davis issued a press release reaffirming his commitment to renewable energy, and setting as a goal increasing its share of total energy production from its current 12% to 17% by 2006.[140]

57. On July 28, 2001, The *Los Angeles Times* reported that state spending on consultants was budgeted at $25 million.[141] The Davis administration disclosed that it fired five of its energy consultants for conflicts of interest.[142] A sixth resigned.[143] Four of the consultants served as "traders" facilitating state purchases from energy firms, including Calpine Corporation, a San Jose-based power generator that landed the largest share of the $43 billion in long-term contracts criticized for excessive prices.[144] All four were also Calpine stockholders, some in amounts over $100,000.[145] These dismissals followed asset disclosures required under state law.[146] However, the Governor's advisers include others, including executives Joseph Fichera and Michael Hoffman, who have not disclosed their holdings and who the Governor contends need not do so.[147] California Common Cause Director Jim Knox characterized the Governor's exclusion of these advisers from disclosure obligations as contrary to the law.[148]

The *San Jose Mercury News* revealed the continuing and close relationship between the Governor and John Bryson of Southern California Edison.[149] Edison was a chief backer of the 1996 deregulation scheme and expended more than $31 million in lobbying

140. Press Release, Office of the Governor, Governor Davis Endorses Plan to Increase Renewable Electricity Generation (July 27, 2001), *at* http://www.governor.ca.gov/state/govsite/gov_homepage.jsp.

141. Jeffrey L. Rabin, *5 State Energy Advisors Fired Over Conflict Ethics*, L.A. TIMES, July 28, 2001, at A1, *available at* 2001 WL 2506292.

142. *Id.*; *see also* notes 131-36 and accompanying text.

143. Rabin, *supra* note 141.

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. John Woolfolk et al., *Many of California Governor's Top Hires Have Ties to Utility*, SAN JOSE MERCURY NEWS, Aug. 5, 2001, *available at* 2001 WL 25949835.

and campaign contributions during this period.[150] From 1995 to 2000, Edison contributed more than $350,000 to Davis, more than the $260,000 received from the five power generators or the $290,000 received from the other two utilities: PG&E and SDG&E.[151] The Governor appointed Carl Wood, a former Edison and union official, to the PUC.[152] He used Michael Peevey of Southern California Edison (its president through the early 1990s) as an unpaid consultant to negotiate utility rescue plans.[153] He hired the Electricity Power Group, a consulting firm of former Edison officials, on a $6.2 million contract through 2002 to oversee the state's power purchasing and generation strategy.[154] The *Mercury News* reported that Group director Vikram Budhraja purchased between $10,000 to $100,000 of Edison stock and sold it at a profit at the time his contract started.[155] The Governor also hired Larry Hamlin, who oversaw Edison's power plants, to serve as his "energy construction czar."[156] Hamlin took a "leave of absence" from his Edison position, which he has since rejoined.[157] One of Edison's plants qualified for a $1 million bonus under Hamlin's plan.[158]

The media disclosed that the Governor, in order to sell his plan to the public, also hired public relations firms that had previously worked under contract with Edison, including Mark Fabiani and Chris Lehane.[159]

58. On August 1, 2001, a coalition of consumer groups released a report highly critical of the Davis-Sempra pact to pay off the $750 million in debt claimed by SDG&E from its high energy costs.[160] The groups presented substantial evidence of utility concealment of $450 million in utility profits diverted to its parent. Part of the alleged "accounting evasion" involved $120 million in profits obtained from some generating assets SDG&E had retained post-deregulation. While paying high utility costs, SDG&E also was selling power at the very

150. *Id.*
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.*
155. *Id.*
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. Craig D. Rose, *Customers' Huge 'Debt' to SDG&E Called Sham*, SAN DIEGO UNION-TRIB., July 30, 2001, at A1, *available at* 2001 WL 6475513; *see also* notes 108-12 and accompanying text.

high rates extant. SDG&E contended that the two were separate accounts and it could assess ratepayers the full amount of higher charges paid, while collecting for itself (its stockholders) the full amount of revenues obtained for its power sold at those prices. The consumer groups joined the PUC's Office of Ratepayer Advocates in decrying the purchase of SDG&E transmission lines at 2.3 times book value as a means to "bail out" the utility at taxpayer expense, while burdening the state with transmission line obligations. In addition, the advocates criticized the quid pro quo provision of the MOU that SDG&E would pay $100 million and the state would end its investigation and terminate any further objection to the utility purchasing practices in paying many times previous market levels for power. That concession of over hundreds of millions in purported overcharges was significant because utilities are compensated for only "prudent" costs incurred. Failure to obtain long-term contracts and to otherwise become victims of spot price excess to the degree extant poses a challenge to "prudent purchase" status necessary for ratepayer assessment.

59. On August 9, 2001, the DWR announced its refusal to let energy regulators review its costs.[161] The DWR's July bill for $12.3 billion for energy it had purchased since assuming responsibility was to be recovered by ratepayers. The utilities that had to raise rates for that payment asked the PUC to allow cross-examination and open hearing on the DWR purchases, contending that the PUC is empowered by the state constitution to protect ratepayers.[162] That obligation arguably requires examination of charges to be paid by those ratepayers.

60. On August 13, 2001, the Governor named his four appointees to the new California Power Authority, joining State Treasurer Phil Angelides on the five-person Board (see #31 above).[163]

61. On August 28, 2001, the PUC proposed shifting $500 million of the monies owed by Southern California Edison to PG&E (in bankruptcy) over the next two years.[164] The decision rested on a

161. Michael Bazeley, *California's Power Buyer Refuses to Disclose Costs*, SAN JOSE MERCURY NEWS, Aug. 9, 2001, *available at* 2001 WL 25951152.

162. *Id.*

163. Press Release, Office of the Governor, Governor Davis Appoints Members to the Consumer Power and Conservation Financing Authority Board of Directors (Aug. 13, 2001), *available at* http://www.governor.ca.gov.

164. Nancy Vogel & Tim Reiterman, *The State PG&E's Power Bill May Go Up*, L.A. TIMES, Aug. 28, 2001, at B8, *available at* 2001 WL 2513585.

recalculation of the actual costs incurred by SCE versus PG&E for DWR-purchased power.[165]

The agency also issued a draft decision for another increase for SDG&E ratepayers—at an average of 12%.[166] However, the first small increment of power was increased less; small commercial customers incurred an average 18% hike.[167] The decision was subsequently adopted.[168]

Related orders issued by the PUC acceded to the jurisdiction of DWR to pass through rate increases as necessary to pay for its energy purchases without PUC review. Hence, the bonds to be issued for utility bailout would be marketable given the assured ratepayer assessment for their full cost.

62. On August 29, 2001, consumer advocate Harvey Rosenfield "declared war" on the revised Southern California Edison relief legislation, SBX2 78 (Polanco).[169] Rosenfield rented a suite of rooms at a Sacramento hotel, outfitted his colleagues with yellow "Bailout Watch" armbands, and set up a combat information center "war room" to manage the lobbying against the measure.[170] Declaring his group at "Defcon 1" and prepared "to go to war to protect our pocketbooks," Rosenfield brought additional attention to the issue, and the legislation was subsequently defeated in the state Senate on September 15, 2001.[171]

63. On September 9, 2001, the *San Jose Mercury News* released its own investigation (using outside expert assistance) of the Governor's long-term power purchases, concluding that the prices were substantially above those likely in future years.[172] Quoted experts estimated that peak demand prices would be $36 per megawatt-hour in 2003, while the contracts obligated an average of $81 per megawatt-hour for that year.[173] The state has currently obligated itself to pay an average of $70 per megawatt hour over the next ten years.[174] The long-

165. *Id.*

166. *Id.*

167. *Id.*

168. Kate Berry, *SDG&E Rates Jumping 12%*, ORANGE COUNTY REG., Sept. 21, 2001, *available at* 2001 WL 9684615.

169. Dion Nissenbaum, *Activists, Lobbyists Besiege California Lawmakers over Energy-Rescue Deal*, SAN JOSE MERCURY NEWS, Aug. 28, 2001, *available at* 2001 WL 26628795.

170. *Id.*

171. *Id.*

172. Eric Nalder et al., *Power Deals Under Fire*, SAN JOSE MERCURY NEWS, Sept. 9, 2001, at 1A, *available at* LEXIS, Knight Ridder Tribune News Service.

173. *Id.*

174. *Id.*

term contracts, negotiated at the nadir of state bargaining power, commit the state to spend $43 billion through 2020.[175]

64. On September 14, 2001, the legislature enacted a bill to set aside a portion of existing rate revenues to repay bonds issued by DWR. It would also limit bonds to electricity purchases and related costs, and the claims would be publicly reviewed by the PUC to ensure that incurred costs are "fair and reasonable." However, the PUC review will be primarily cosmetic, bound by an obligation to act within a short (thirty day) period.

65. On September 20, 2001, the United States Ninth Circuit Court of Appeals issued its decision in *Duke Energy Trading & Marketing, L.L.C. v. Davis.*[176] The court held that the Governor's earlier "seizure" of long-term contracts obligating energy companies to provide power at specified prices for state use to mitigate the scarcity problem facing the state was preempted by the statutory authority of the Federal Energy Regulatory Commission.[177] Justice Kozinski's dissent argued unsuccessfully that precedent allows a sovereign state to capture such assets where emergency conditions dictate.[178] The decision, if not altered by the United States Supreme Court, could limit California's options to either control energy prices or restore assured supply, and could place the state at the purportedly untender mercies of FERC.

66. Also on September 20, 2001, PG&E announced its proposed bankruptcy reorganization plan.[179] The proposal would repay energy creditors in full but allow PG&E to escape further regulatory controls.[180] The plan would divide utility operations between PG&E and its parent company, with the latter exempt from regulatory oversight.[181] The parent would assume control of lucrative gas and electricity transmission lines (with their concomitant monopoly power); in addition, hydroelectric facilities and the Diablo Canyon Nuclear Power Plant would move to the unregulated side of the parent's operations. The scheme is designed to satisfy creditors—a traditional prime concern of bankruptcy proceedings. At the same time, it would achieve unregulated status for valuable assets, including much of the

175. *Id.*

176. Duke Energy Trading & Mktg., L.L.C. v. Davis, 267 F.3d 1042 (9th Cir. 2001).

177. *Id.* at 1058.

178. *Id.* at 1059 (Kozinski, J., dissenting) (citing Idaho v. Coeur d'Alene Tribe, 521 U.S. 261 (1997)).

179. Press Release, Pacific Gas & Electric Company and PG&E Corporation File Plan of Reorganization (Sept. 20, 2001), *at* http://www.pge.com/006_news/006a_news_rel/010920.shtml.

180. *See id.*

181. *See id.*

monopoly loop justifying maximum rate regulation. The plan is supported by the energy company creditors who would be paid in full under the plan.[182] It may also be a possible resolution given the primary bankruptcy concern of creditor repayment. However, it is unclear how a regulated monopoly can be removed from PUC jurisdiction without statutory and state constitutional change.

67. On September 21, 2001, the PUC suspended by a three to two vote the "customer choice" element of deregulation.[183] A critical component, such "direct access" choice allows large energy end-users (or small ones who organize to purchase energy) the option of contracting directly with generators. Large users have already signed onto such arrangements with some energy companies at rates reflecting historical market levels and well below recent and current rates. Commissioners supporting suspension have argued that limited numbers of larger end-users would negotiate such terms and add to the burden of debt repayment and higher rate recompense to be carried by those remaining in the system and not striking such deals. Indeed, the rate escalation has led to many large industrial users signing such separate contracts for themselves on advantageous terms. However, the PUC suspension was not applied retroactively, allowing those who entered into such agreements to benefit from them and avoid the higher rates now in place and planned.

The PUC also signaled its opposition to the plan to eliminate its meaningful review of new revenue requirements for utilities arising from DWR energy purchases. Such revenue requirements are passed onto ratepayers and may reflect the now improvident forty-one long-term power contracts entered into by DWR. Further, unlike the PUC, DWR does not conduct public proceedings and is not subject to the hearing, participation, and evidentiary standards of the PUC. DWR is headed not by a commission that must meet publicly to decide policy, but by a single political appointee of the Governor, who serves at his pleasure and who may decide issues in an office without public hearing or disclosure.

The Governor issued an angry press release that a failure to approve assured ratepayer pass-through of these charges jeopardized the security of planned $12.5 billion in state bonds to pay for the $10.4 billion in power bought since January 2001 (and additional sums anticipated for

182. *Id.* (quoting statement of "full support" by Paul Aronzen, legal counsel for the Official Committee of Unsecured Creditors).

183. Carrie Peyton, *California Regulators End "Customer Choice" Option for Buying Power*, SACRAMENTO BEE, Sept. 21, 2001, *available at* 2001 WL 27935950.

the remainder of the year). Failure to issue those bonds would leave the general fund from which these monies have been taken radically short of expected revenue under the 2001–2002 fiscal state budget (at the very time an economic downturn otherwise reduced anticipated revenue).[184] After condemning the failure to approve assured ratepayer pass-through for all prior and future decisions of DWR, the Governor further responded by (a) conceding that some renegotiation of the long-term contracts may be in order, and (b) ordering a statewide hiring freeze.[185]

68. On October 1, 2001, the PUC formally broke ranks with the Governor to argue before FERC that the state's long-term energy contracts imposed excessive prices on California ratepayers and should not be approved.[186] As the argument was presented, California peak prices stood at $30 per megawatt-hour while contracted prices stipulated $69.[187] The agency specifically objected to the high prices agreed to with PacifiCorp Power Marketing Inc., Alliance Colton L.L.C., Sempra Energy, and Calpine Corporation.[188] The last two firms account for about one-half of the volume agreed to among the fifty-three agreements signed as of October, some of which have twenty-year terms.[189]

69. On October 2, 2001, the PUC announced a "settlement" with Southern California Edison in the Filed Rate Doctrine lawsuit that Edison had filed in federal court against the PUC in November 2000.[190] Edison had lost early rounds of the litigation and a similar suit by PG&E in federal court had failed. However, the settlement allowed what consumer advocates termed a "dirty backroom deal" at ratepayer expense after the legislative defeat of a similar scheme.[191] The agreement, reached after secret negotiations and approved by United

184. Press Release, Office of the Governor, Governor Makes Statement on Public Utilities Commission Actions (Oct. 2, 2001), *available at* http://www.governor.ca.gov.

185. *See, e.g.*, George Skelton, *Taking Hits on Energy, Davis Jabs at FERC*, L.A. TIMES, Mar. 4, 2002; Office of the Governor, Executive Orders D-48-01 and D-49-01, Oct. 24, 2001, *available at* http://www.governor.ca.gov.

186. Bernadette Tansey, *State PUC Seeks to Void Davis' Power Contracts*, S.F. CHRON., Oct. 1, 2001, at A1, *available at* 2001 WL 3415856.

187. *Id.*

188. *Id.*

189. *Id.*

190. *See* Jerry Hirsch, *Utility Could Be on its Feet in 6 Months*, L.A. TIMES, Oct. 3, 2001, at A15, *available at* 2001 WL 2522821.

191. *See* Foundation for Taxpayer & Consumer Rights, *Bailout Watch #82*, Oct. 4, 2001, *available at* http://www.consumerwatchdog.org/utilities/st/st002020.php3.

States District Court Judge Ronald S.W. Lew on October 5, 2001,[192] compels SCE customers to pay $3 billion over the next four years. The deal was advertised as involving no rate hikes for consumers and would prohibit common stock utility dividends until 2003. However, SCE customers had been assessed a substantial forty percent rate hike which was advertised as "temporary" but which will now stay in effect at least through 2003. Some commentators predict that rates will then be raised as dividends begin to flow to SCE stockholders, both timed for post-2002 election imposition. More importantly, contrary to the initial PUC press release indicating that only $2.3 billion of the $3.3 billion allegedly owed by the utility to power generators would be paid (with stockholder deferral of dividends making up the $1 billion to be absorbed by the utility), the agreement in fact commits ratepayers to provide the entire $3.3 billion. The agreement does require SCE to cooperate in ongoing FERC and court proceedings to lower or challenge energy company compensation claims, which must be used entirely to reduce the debt owed by ratepayers. However, it removes the PUC as a legal basis for such denial, and essentially adjudicates all of SCE's purchases of power as "prudent" and fully compensable by ratepayers. SCE stock rose fourteen percent on Wall Street.

Consumer advocates immediately appealed to the United States Ninth Circuit Court of Appeals, arguing that the "settlement" arranges a rate matter through the auspices of a federal court proceeding lacking the required open hearing and due process elements applicable to PUC decision making.[193]

Present Status: The state is attempting to float the largest general revenue bond in the state's history at $12.5 billion. As noted above, that issuance involves substantial direct interest expense, reduction of state capacity for other infrastructure and higher education supporting revenue bonds, and general fund reductions as interest payments are deducted by state taxpayers.

Utility rates have already increased substantially, far beyond any cost factor and accomplished rates of return for power generators possible only with monopoly power, horizontal price fixing, or serious scarcity or other market flaw.

192. Nancy Rivera Brooks & David Rosenzweig, *The State Deal OKd to Avert Edison Bankruptcy Courts*, L.A. TIMES, Oct. 6, 2001, at B1, *available at* 2001 WL 28918366.

193. Foundation for Taxpayer & Consumer Rights, *U.S. Court of Appeals Puts Edison Bailout on Hold*, Oct. 30, 2001, *available at* http://www.consumerwatchdog.org/utilities/pr/pr002061.php3.

The overall direct cost may be calculated by taking the cost of energy purchased in 1999, at about $9 billion, and calculating the year 2000 and likely 2001 cost to be paid, the first at close to $50 billion and the latter at around $35 billion. The monies paid constitute substantial excess profits, mostly to out-of-state companies purchasing utility-devolved power plants during deregulation's transition period. The revenues from the year 2000 alone will pay the entire purchase price incurred for most of them. The approximately $55 billion in overcharges (beyond reasonable rates of return) in 2000 and 2001 are reflected in three pots: (a) public monies for purchases at a high price from the general fund and which must be repaid, (b) higher rates the utilities have imposed as outlined in the chronology above, and (c) additional sums from prior energy costs unpaid which they allegedly owe the generators.

The last "debt" category has created the three major arenas for repayment: the PG&E bankruptcy, the Davis-Sempra (SDG&E) MOU, and the Davis-Edison MOU. As discussed above,[194] the last has been altered into a PUC-SCE litigation settlement agreement that approves—without public proceedings—all SCE energy purchasing decisions (implicitly including the DWR purchase portion) and promises payment of the $3.2 billion in energy company claims unless reduced by FERC or ancillary court challenges (which appear to be problematical).

Indirect costs and damage from the debacle recounted above exceed these substantial direct amounts. They include the cost of the new Power Authority. And more significantly, they have effectively suspended substantial new general fund spending, particularly for investment in children (higher education, foster care children, and other accounts, as discussed above). Other costs include the massive consequences arising from the pervasive dependency of the state's economy on energy provision. Those costs include the bankruptcy of numerous small businesses relying on cost-related energy costs in their own equipment investments, from pizza ovens to air conditioning to industrial equipment. They include higher consumer prices for a vast array of products and services where such costs may be passed on due to their industry-wide imposition.

The total price to be paid by California for the deregulation errors may dwarf all prior public purchasing and corruption scandals, including the infamous Teapot Dome scandal of New York, and even

194. *See supra* notes 186-89 and accompanying text.

exceed the California portion of the savings and loan meltdown of the 1980s.

III. CORRECTING THE THREE ERRORS

As acknowledged above, deregulation can benefit consumers. The free market can be the consumer's most precious asset. The praises attributed to deregulation are well in evidence where it functions as intended: It allocates resources efficiently, responds quickly, and is driven by consumer preferences from the bottom. It rewards those who serve the public and penalizes those who fail to do so. But as argued above, it requires preconditions to operate, and it can be corrupted into a top-driven, malevolent, and coercive creature—possessing few of the attributes commending it.

The historic record of deregulation is mixed. It has been driven by some reasonable basis in most cases, a basis usually borne of the possible expansion of market forces into areas previously subject to unnecessary state regulation. However, the three flaws discussed above consistently appear to undercut its promise. Notwithstanding the clichés about "lessons of history" precluding repetition, errors have here been repeated. The architects of deregulation in one industry do not always consult with those experienced in the deregulation of other industries.

Forebodingly, all three of these flaws coalesce to afflict energy deregulation and, if the exercise of these flaws in other industries is a guide, their correction will be difficult to accomplish. Deregulation often releases political forces operating apart from rational argument or real economic justification. The paradigm example of such pessimism can be found in the cable industry—replete with antitrust offenses, unfettered monopoly power without meaningful price regulation, and concentration trends reaching into Internet access to threaten the diversity and competitive future of our most important industry: the world's communication assets. Now the other major underlying industry "affected with the public interest" as the leading case of *Munn v. Illinois*[195] terms it, threatens to follow suit. The stakes in the cases of both of these critical, underlying industries are high. One threatens the future of First Amendment diversity with momentous implications for political democracy, while the other underlies our society from manufacturing to services to virtually everything that can move or make a sound or generate heat or refrigerate food or light a room.

195. Munn v. Illinois, 94 U.S. 113 (1876).

The detailed chronology recounted above outlines the nature of the current struggle, the players, and the manifestation of all three factors underlying deregulation's failures to date.

A. The Extreme Pendulum Swing

As argued above, an industry once deregulated must be subject to competition and consumer protection statutes in the fullest sense. That did not happen in the case of energy deregulation, which failed in the following four respects.

1. Retained Conflicts of Interest

The first non-negotiable element in proper deregulation is the clear separation between the deregulated industry now to be subject to competition and the remaining monopoly power regulated enterprise. The two cannot be mixed. The reason for that separation is well-illustrated by the energy debacle recounted above. But it is more basic. As argued above, those with monopoly power will invariably attempt to use it to gain advantage in competitive markets. This observation of human behavior is supported by the considerable record of reported antitrust cases and by predictable human behavior. Accordingly, the first mistake made in energy deregulation was to allow the parent corporations of those retaining monopoly power to become involved in energy generation or to hold energy-related assets. Ideally, if one operates the loop, one operates the loop. Period. Deregulation assumes that economies-of-scale between the remaining monopoly and newly deregulated sectors are lacking. If the remaining regulated utility wishes to invest in shrimp boats in Louisiana with invested funds, so be it, but not natural gas fields, coal deposits, or pipeline transmission assets.

Such enterprises have a momentous task: They operate a monopoly loop in a manner that must be fair to all users. We do not allow United Airlines to own airports (indeed, when airlines have operated travel agency computer systems, predictable favoritism and problems developed). The monopoly power "wheeling" of any underlying commodity, be it water aqueducts, electricity, natural gas, or telecommunications, must be undertaken by an enterprise lacking any direct or indirect conflict in the judgments it must make about connection, cost, and terms of transport. We not only rely on such facilities to deliver the fruits of free market enterprise, but often to serve as the consumer surrogate in making purchases—certainly that has been the case with energy utilities. Instead of creating a structure amenable

to that end, we have unwisely permitted conflicts of interest to permeate electricity deregulation.

2. Removing the Preconditions for Free Market Pricing

Basic economic doctrine teaches us that free market pricing works optimally where many competitors price independently. That independence is so substantial that a unilateral decision by any one entrepreneur will not affect the equilibrium price. However, energy regulation in California was created in a manner rigged in favor of abusive monopoly power ratesetting by incorporating the following elements: (a) more than fifty percent of energy generation would be devolved to a small group of five providers; (b) those providers each employ professional staff devoted to the common and esoteric function of predicting demand, supply, and optimum bidding strategy; (c) the state-arranged market entities carry with them no mandate to protect the public, but were charged to merely react passively to the bidding and supply decisions made by energy suppliers; (d) the providers each had immediate and detailed information about demand and other bids (what antitrust prosecutors refer to as a "detection mechanism" important to the successful cartel arrangement of collusively arranged prices); (e) almost all sales were to be priced on a "spot market" basis, with very few long-term contracts; (f) capacity expansion has been expensive and has taken substantial time to effectuate; and (g) a final "market clearing price" on the spot market would refer back to and increase previously agreed lower prices over the previous day, giving all participants their own individual incentives to inflate such "real time" pricing where possible. All of these elements were combined in a context of a severe "non-zero sum game" where supply reduction and higher bids have assisted (indeed, enriched) all participants.

All other things being equal, human beings do not always compete. Where common ground can be found, and where practices may be to mutual benefit, cooperation can occur. It often does. Where the alternative is between marginal profits versus $40 billion in profit, one might predict a measure of such cooperative behavior. The trick is to establish preconditions to make such cooperation difficult, to make competition the only feasible alternative. In the case of energy, those preconditions would involve (a) reduced concentration among energy providers (preferably more than ten major corporations providing the energy now provided by the "Big Five"), (b) some determination of meaningful competition (as discussed below), (c) no useful detection mechanism (which facilitates price fixing), and (d) no retroactive

application of spot market prices. California energy deregulation failed to provide all four of these prudent preconditions.

3. Failure to Monitor for / Enforce Price Fixing Offenses

In the case of energy deregulation, a cadre of technical experts engaged in the sophisticated and involved tasks of predicting demand, needed supply, and optimum bids.

To what extent do these experts move between competing firms? To what extent do communications occur? How does this consulting industry use common data? What are the trade associations in this field doing? While a great deal of trade association activity may be immunized from antitrust liability under the *Noerr-Pennington* doctrine,[196] that immunity reach is limited.

In the famous *Container* case,[197] the United States Supreme Court found a combination where participants simply used a common publication to calculate prices, without a common explicit agreement to collude. The prices narrowed after the publication was circulated and used, indicating that a communication was having an "artificial" effect on prices.

Whether the energy firms dominating electricity production in California post-deregulation have committed antitrust offenses is unsettled and may await further litigation. However, it appears that no "antitrust cop" was on the beat in the state, from either state or federal jurisdictions. An active presence in the form of corporate monitoring may by itself impede such combinations. Such monitoring and inquiry did not begin until much damage had been done, and which may not be undone.

4. Removal of the Backstop of "Meaningful Competition" Assurance

The State of California claims that the jurisdiction of the Federal Energy Regulatory Commission includes the obligation to warrant "meaningful competition" in the interstate wholesale provision of electric power. And federal law allows for the imposition of some ceiling on such charges where arbitrary and excessive prices are imposed. As noted above, FERC so acted, but in a limited fashion and only after substantial harm occurred.

196. United Mine Workers of Am. v. Pennington, 381 U.S. 657 (1965); E. R.R. Presidents Conference v. Noerr Motor Freight, Inc., 365 U.S. 127 (1961).

197. United States v. Container Corp. of Am., 393 U.S. 333 (1969).

California erred in relying on FERC as a backstop. It properly establishes its own backstop; an affirmative obligation of its PUC to certify that meaningful competition is in place. Prices in excess of two or three times the normal fair rate of return should constitute a presumption that the market is not properly functioning. Where the PUC cannot affirmatively find continuing competition, it must impose rate ceilings. Such rate ceilings are not intended to reverse deregulation, and—in a proper deregulation setting—might never be invoked. But where needed they must be available.

Nor must such ceilings be at a "fair rate of return" level. The choice of deregulation implies the acceptance that some enterprises may go out of business, and others may make substantial profit. But substantial profit normally implies a premium above fair rate of return levels, perhaps a substantial premium. Profits that are at levels four, five, ten or fifty times fair rate of return levels do not signal a functioning market.

California energy deregulation omitted this critical backstop.

B. External Costs

At least two different types of external costs were inadequately addressed by California energy deregulation. As noted above, the utilities protested the proposed PUC policy to enhance alternative energy supply, arguing that "lowest obtainable" price should be the standard. Regrettably, FERC adopted that position. The decision was wrong not only because it deprived the state of supply it would later need (discussed below), but also because it continues the longstanding pattern of favoritism for nonrenewable energy use.

Our great grandchildren and certainly their great grandchildren are going to be asking how we could ethically use exhaustible resources so wastefully, and how we could impose contaminated waste with thousands of years of radiation hazard on future generations. Deregulation removes the regulatory cross-subsidy handle. While some favoritism for alternative energy remains with California deregulation, it is at a token level in relation to our responsibility to our progeny. Accordingly, deregulation properly involves "depletion" or "contaminated waste" tax imposition, with proceeds properly invested in alternative—renewable energy provisions. The tax should start at a low level, but gradually increase as depletion proceeds.

The market does not gauge the true costs of such depletion given imperfect knowledge, long-term investment in machinery type, and the curvilinear nature of depletion's effect on price in a "natural"

marketplace. Adjustment for those externalities is appropriate. We have not started that process seriously to date.

Related to the nonrenewable resource externality problem is the scarcity flaw that occurs with energy provision, as discussed below.

C. Scarcity

Perhaps the most basic flaw in energy deregulation is the assumption that the only basis for price regulation is a "natural monopoly" structure, and if one simply partitions the monopoly power sector off in a new format, newly freed enterprise will function without further concern. But regulation may also be warranted where there is scarcity, as suggested in the discussion above. Indeed, perhaps no industry imposes more harm than does this one where scarcity occurs.

Electricity provision is one of the few industries where consumers lacking direct contract with providers essentially give a blank check to generators. We use power, the utilities buy what we use, and then we are billed post hoc. Over time, our purchases will be affected by price changes, but not immediately. The elasticity of demand has some important limitations caused by substantial investment in electricity as an underlying energy source, and by its use for basic necessities, such as heat, air conditioning, refrigeration, and light.

Where scarcity occurs, two problems arise under California's deregulation scheme: (1) price hikes driven by "real time" bidding without bargaining power on the purchaser side, and (2) the possibility of rolling blackouts, voltage reduction, or other involuntary and grossly applied cutbacks.

One policy which should have long been in place is the ability of the state to itself provide a three to five percent buffer of power beyond peak need from its own resources as needed. The notion of state intervention to assure needed supply where scarcity interrupts the market or creates external cost is a well-settled policy in many areas. Indeed, it is commonly used where it has no justification. For example, we subsidize milk under the theory that even a temporary shortage would impose grievous external costs (presumably on young children needing formula). While price supports for milk have a dubious connection to that rationale, assurance of an assured surplus to prevent energy scarcity does have merit. That assurance can be provided by a number of means, but the most reliable is a publicly funded and provided capacity.

Meanwhile, the state has a strong interest in lessening the extent of demand variations (the degree of peaking) by educating the public as to

their incidence, and by implementing time-of-day rate variations. A rational market will price peak traffic at a higher rate where it imposes capacity expansion costs. Where energy is used during peak demand conditions, its price should increase, and consumers should be repeatedly so informed. Neither occurs in California.

Time of day rate variation, in addition to the state's own three to five percent reserve capacity, should be accompanied by proper incentives to build and expand capacity as needed. That is now happening, but not on an optimum long-term rational basis. Instead, there is a drive to put plants on line, any plants, many consisting of high cost gas-fired turbines. A system of "peakers" operating with the efficiency of "funny car drag racers" is not the most desirable end result of state energy policy.

D. Immediate: Do Not Pay

California has "unwound" much of its deregulation by direct state intervention in energy purchases. The rationale for the state's approach as recounted in the chronology above is simple. Confronted with cartel-like pricing, the consumers organize through the state to develop a "monopsony" (a buyer's monopoly) to even the playing field. But the results have been mixed. In the short term, the public negotiators appear to have been flamboozled (yet again) by private enterprise into committing the state to long-term purchases of power at two to three times the present and likely future spot price in a properly functioning market. That commitment extends for some contracts over the next twenty years, and totals $43 billion. It is unclear why the state decided to negotiate such prices at a point of apparent bargaining power weakness for such a lengthy term. A more prudent course would have been a three-year commitment until a competitive market can be created, at a level equivalent to anticipated demand plus a reserve at three to five percent beyond that projected demand.

More important are the longer-term implications. Will DWR become the energy purchaser for the state? Why? Under what procedures for public participation (if any)? What will the new Energy Authority really do? What is the PUC's role? Thus far, the state has been putting out a fire, and should be forgiven for its lack of long-term vision. But even short-term fixes may be assisted by such a vision. My own preference will surprise my consumer advocate colleagues—I would not reregulate as before. In particular, such reregulation is likely to be on the post "fair rate of return" basis ("incentive rate regulation") now in vogue, and which has its own considerable flaws and dangers. Moreover, energy provision is an industry that is theoretically amenable

to an enhanced measure of competition. The problem is not with the concept, but with its execution. Unfortunately, the execution has been incompetent in extremis, replete with conflicts of interest, policies ignorant of basic economics and of antitrust history.

So what is the state to do? Ideally, apply a "fair rate of return" standard to energy providers. That rate of return may be enhanced somewhat beyond market levels and may assure such a fair rate of return plant by plant—thus not disadvantaging inefficient energy providers. All sums that are charged beyond those levels are void and uncollectible. Such a prescription does not violate notions that "a deal is a deal." The system theoretically includes a prohibition on collusion and a FERC backstop. It also includes a utility obligation to make prudent purchases properly not influenced by the conflicting holdings of corporate parents. And it operates against a backdrop where energy providers arguably have a common-carrier like obligation to provide available capacity—one that has arguably been violated.

In return for such an agreement (involving the cancellation of about two-thirds of the revenues claimed by energy providers), the state would provide immunity from antitrust prosecution, breach of duty and contract actions, unfair competition actions now pending, and civil actions to compel FERC to fulfill its statutory duty post hoc to bar excessive charges.

Then the state would implement deregulation with the safeguards outlined above.

IV. THE UNDERLYING PROBLEM: THE FREE MARKETEER AS RELIGIOUS ZEALOT

Underlying the three common empirical flaws in deregulation is a philosophical failure, a misunderstanding of the role and nature of the marketplace. Such ignorance is centered among the most faithful disciples of the market, the "University of Chicago" school of economics. Many of its disciples have elevated the concept of the "market" to deity status. The implicit assumption: The "free market" is the ideal economic model. It is an end to itself. Indeed, it has magical properties. It is self-correcting. Most flaws, certainly those that the government tries to address, will be handled by the market's own operation if only left to function of its own accord. Price fixing? It cannot last long; cheaters will be too tempted, for as the excess prices grow higher, the incentive to undercut slightly and capture market share grows as well. As to other alleged antitrust-type abuses, barriers to entry are never very high. In the long run, almost any flaw will correct

itself as demanded by the informed consumer, and in the long run a free democracy assures that the consumer will be, or will become, so informed. Eventually, ashes to ashes, dust to dust. Take the long view and, overall, the market will do what is right. The Soviet fall and the collapse of the planned economies controlled by bureaucratic fiat further demonstrates its merit. Unlike the flawed and inherently uninformed decisions of agencies, the market's hand is more beneficent, more responsive to the popular will, and its rewards are more secure. If the state removes itself, the market will decide production, and allocation, and will assure the elimination of the incompetent and the prosperity of those who serve us well.

Many place the same kind of trust in the market as the religious faithful confer to their respective gods. Voltaire's classic satire *Candide* skewered the so-called "Optimist" view presented through the voice of Pangloss. Pangloss enunciated a still familiar refrain: "God created the universe and is all powerful and all knowing. Anything that happens occurs as part of His grand design, and hence happens for the best because God wills it so." Although providing a measure of needed comfort, this sentiment can also serve as the basis for human abdication. On its own terms, such a God is curious, for He also created the human ability to predict and to apply values to empirical reality. Presumably, His creatures exercise free will within the range of their capacity.

Simply substitute "market" for God as Pangloss speaks, and one is not too far from the implicit view of many "free market" economists. These adherents engage in the same mental process as a religious zealot. Take a means to an end, and make it the end itself. Give an abstraction that inherently stands for pieces of reality its own identity, and regard that abstraction as the goal. This process, called "reification," can transform religious faith into a destructive force of intolerance based on the ephemera of clothing and ritual. In this basic sense, such free market theorists do not have an economic philosophy, but a religion. Reality is to be filtered to accommodate their predetermined commitment to their faith: a God who proves His merit not through incantations and the promise of everlasting life, but through the miracle of the Invisible Hand.

Such a view of the market as an object of irrational obeisance is at the heart of our current problem with deregulation. Let's take the critical recent example: The Federal Energy Regulatory Commission need not limit interstate energy prices because any excess is the product of inadequate supply, and the best way to restore supply is to provide a profit incentive. Limiting that profit impedes the supply increase that is at the heart of the problem. The non sequitur application of this

sentiment is as follows: Allow power generators to charge not merely an incentive premium above cost to stimulate supply, but double, three times, five times, ten times, one hundred times, or more. Never mind the sunk investment of thousands of small businesses now driven out. Never mind the external costs to seniors who can't afford heat or air conditioning, or the crashed budgets of public schools or a thousand other costs borne by others. If energy costs go from $9 billion to $50 billion, so be it. The excess is needed so that the market can self-correct. And eventually it will self-correct. Ashes to ashes, dust to dust.

One has to be an extreme zealot, as FERC has exemplified, to carry fidelity to an abstract concept beyond its rationale, and to such a level of temporal harm. Such a concept must supersede its *raison d'être*. It must be reified into deity status. Its disciples are not genuine public officials imbued with the public trust, but worshipers who rely on faith and who dismiss all empirical consequences. Indeed, human sacrifice is to be tolerated for the larger good, for the longer range. We must do what we must do to pay homage to God, to Allah, to the market. Let the consequences come, they are for the best, for it will eventually make it right.

This current irrationality is exacerbated by an implicit "naturalist" view of the market by its semper fidelis followers. Their market is essentially the natural state of affairs emerging from the removal of hamstringing, red tape-interfering regulatory agencies. A utopian state is achieved with the simple bromide of state withdrawal. The theory: Without interference from government, the magic of the market is assured.

To be sure, the market can be a highly efficient, optimum device for the allocation of production and resources, for immediate responsiveness to demand from the bottom, for natural selection reward of those who perform. But it is not an a priori body or state of being. It is necessarily the product of human interaction, influenced by underlying wealth distribution and inheritance which operate far from egalitarian principles, by common law traditions (when does liability pass in a transaction?), by the culture, education and consumer knowledge, technology and information exchange facility, tort law and assessment, the criminal justice system, and even language. Its performance to accomplish properly cited advantages depends upon preconditions, from traditional Smithsonian theory (e.g., many independent actors) to modern reality (e.g., antitrust enforcement). Its operation can impose external costs that threaten fundamental ethical

imperatives (e.g., leaving behind adequate resources and an environment for our legatees through the millennia to come).

The description offered above of "free market school" myopia is exaggerated, but not by much. Nor is it the product of a "government can do no wrong" counter-school. Far from it. As noted above, this author was among the first to vigorously advocate for deregulation in the case of trucking. This author spent a decade defending and advancing the free market as an antitrust prosecutor. The advantages of an effective market for consumers are substantial. And the errors and omissions of human from-the-top management are too numerous for any human to even catalogue. Accordingly, where the prerequisites for a free market are present, it ought to be more than a mere "tool," and is entitled to presumptive status. But a presumption may be rebutted, not based on the mere incantation of "health and safety," but on demonstrable and serious cost or failure—costs which exceed the price of correction.

Appropriate adjustments, so that a market functions optimally, need not always involve a maximum fair rate of return rate regulation, or even agency licensure or executive branch regulation at all. Preferably, it would be accomplished as a first resort by restoring preconditions needed for an effective market, and in the second resort by change to underlying ground rules (e.g., a rule of liability, or a tax or fee, or an incentive). But intervention is not to be eschewed based on the ethereal "magic" of market reliance, or on ideological zealotry that elevates abstract concept to a false reality and subverts reason to pre-ordained faith.

APPENDIX: A GLOSSARY OF DEREGULATION TERMS

California energy rate regulation has proceeded in a time-continuum from the 1990s to projected post-2002 as follows: (1) traditional "fair rate of return" ratemaking, which allows prudent costs and a return on capital investment; (2) "performance-based" ratemaking, which takes prior costs and credits the utility with efficiency gains to add profit and incentive (either to supplement fair rate of return ratemaking, or more ominously to substantially replace it); (3) "transition" ratesetting for the utility operations which will remain under regulation as assets are sold or released for competition based pricing (such as power generation); and (4) "post-transition" ratesetting for the remaining monopoly power utility.

The progression of regulatory policy through these four stages has created a phalanx of new terms of art, acronyms, agencies and proceedings, which is bewildering even to some informed observers. The following glossary facilitates understanding of the extraordinary developments over the past three years.

- "Revenue Requirement." The estimated amount of money a utility subject to maximum rate regulation should produce. Note that rates are set in advance, before all of the costs incurred to produce energy are precisely known. Hence, ratesetting is analogous to shooting at a moving target. Allowable rates are gauged to achieve "projected revenue requirement" based on cost projections. Adjustments are then made to the next annual "revenue requirement" based on actual costs and performance during the prior year.
- "Unbundling." To separate out a function from maximum rate regulation and other regulatory control in reliance on competition alone.
- "Bundled consumers." Those consumers who do not have a separate contract with an energy source to provide power for them but rely instead on the choices made by the utility to provide energy.
- "Competition Transition Cost" (CTC). A special charge imposed on ratepayers to compensate utilities for a physical plant (e.g., uneconomic power generation) that is being "unbundled" and will not be competitively marketable.
- "Utility Distribution Company" (UDC). The remaining monopoly power utility, which will continue to control the wires routed to homes and businesses carrying power.
- "Electricity Service Providers" (ESPs). The power generators unbundled from utilities and subject to competitive pricing without maximum rate control from the PUC.

APPENDIX

- "Qualifying Facility" (QF) refers to an energy producer qualified by the FERC to distribute wholesale power.
- "Performance-Based Ratemaking" (PBR). Rate setting system under which utilities' rates are set according to an average market price for electricity. If a UDC is able to purchase electricity for less than the benchmark price, the savings are split between the ratepayers and the utility's stockholders. The theory behind PBR is to give the utility an incentive to improve efficiency by allowing it to share in savings, to provide a reward similar to that extant in the free market for improved performance. However, the calculations made under this more nebulous standard lack the reference point of fair rate-of-return analysis that monitors excessive profit.
- "Annual Transition Cost Proceedings" (ATCP). Proceedings to establish utility costs during the transition period of 1998–2002, and upon which performance-based ratemaking calculations will be made.
- "Revenue Adjustment Proceeding" (RAP). The final and comprehensive proceeding to set rates for the UDC (remaining utility subject to rate regulation).
- The "Power Exchange" (PX) functions like a stock exchange, enabling sellers and buyers to bargain for a "spot" or immediate price for electricity.
- The "Independent System Operator" (ISO) is an entity which assumed control of the power grid that transmits electricity statewide between the respective utilities controlling local delivery.
- The "Electricity Oversight Board" oversees the operations of the ISO (above). Its 26 members serve without compensation and include representatives of the three major utilities, the state's four major public utilities, power generators, and consumer representatives.
- "Market Valuation" refers to the determination of "market value" for assets retained by the utilities after power generating assets, *et al.*, are sold and "unbundled" during the "transition" to deregulation. (For purposes of ratesetting during transition, the values of assets being sold are set retrospectively at the sale price that is obtained.)