Office of Gov. Gray Davis | Letter | May 29, 2001

Economists Express 'Deep Concern' over Wholesale Electricity Prices

Cite Government's Failure to Enforce the Federal Power Act

For Immediate Release

LOS ANGELES -- Governor Gray Davis today released a letter from ten top economists who have expressed "deep concern over the failure of the Federal Energy Regulatory Commission (FERC) to act effectively to enforce the provisions of the Federal Power Act that require it to set just and reasonable wholesale prices for electricity in California." The economists warn that "FERC's failure to act now will have dire consequences for the State of California."

"This letter is a very significant validation of what we've been saying," Governor Davis said. The marketplace is not working and FERC has an obligation to act. We're not pleading for relief, we're entitled to it."

The following is the complete text of the economists' letter:

May 25, 2001

The Honorable George W. Bush
The President
The White House
Washington, D.C. 20500

The Honorable J. Dennis Hastert
The Speaker of the House of Representatives
Washington, D.C. 20515

The Honorable Trent Lott
Majority Leader
United States Senate
Washington, D.C. 20510

Dear Mr. President, Mr. Speaker, and Mr. Leader:

We write to express our deep concern about the failure of the Federal Energy Regulatory Commission (FERC) to act effectively to enforce the provisions of the Federal Power Act that require it to set just and reasonable wholesale prices for electricity in California. Under the terms of the Act, FERC is required to ensure that wholesale electricity prices are just and reasonable. FERC historically met this responsibility by approving wholesale prices that were no higher than the total costs suppliers incur to produce electricity. More recently, FERC has given suppliers "market-based pricing authority" in situations where it was able to conclude that market-based pricing would lead to better outcomes than continued cost-based regulation.

FERC retains the responsibility to ensure that wholesale prices are just and reasonable when a state decides to rely on a competitive wholesale electricity market to provide for its citizens' electricity needs. In particular, once FERC has granted suppliers market-based pricing authority it has an ongoing responsibility to ensure that these prices reflect the outcomes of well-functioning competitive markets. If well-functioning competitive markets do not exist and, as a consequence, the resulting prices are not just and reasonable, then FERC should act either to remedy the market failures or to return to cost-based regulation.

In its November 1, 2000 preliminary order and December 15, 2000 final order, FERC stated that wholesale electricity prices in California were unjust and unreasonable. The actions taken by FERC in its December 15, 2000 final order have not remedied the problems. Moreover, as forecast by many parties commenting on the November 1, 2000 preliminary order, these actions resulted in significantly higher wholesale prices and contributed to further degradation of system reliability in California. Our review of FERC's most recent proposals for remedies leads us to conclude that they will be ineffective and unlikely either to enhance system reliability or reduce prices during the summers of 2001 and 2002.

Well-designed competitive wholesale electricity markets can provide long-term benefits to consumers. For sixty years FERC implemented its obligations to set just and reasonable rates under the Federal Power Act by regulating wholesale market prices. During the 1990s, based on the belief that if appropriate criteria were met "market- based rates" could produce lower prices and a more efficient electric power system, FERC changed its policy. It began to allow suppliers to sell wholesale electricity at market- based rates but, consistent with FERC's continuing responsibilities under the Federal Power Act, only if the suppliers could demonstrate that the resulting prices would be just and reasonable. Generally, FERC allowed suppliers to sell at market-based rates if they met a set of specific criteria, including a demonstration that the relevant markets would be characterized by effective competition.

All generators and marketers selling power into California were granted the ability to receive market-based rates rather than cost-of-service rates because they were able to demonstrate to FERC that their participation in the California market would result in market prices reflecting the interplay of supply and demand in well-functioning competitive markets. These showings were based on a variety of market-structure screens adopted by FERC before California's wholesale electricity markets went into operation. Numerous subsequent studies based on actual market behavior and performance have identified a number of serious problems of market design, supplier behavior, and market performance that were not anticipated or considered in FERC's initial market- structure screens.

There are numerous flaws in California's wholesale electricity markets, and their consequences have been significantly exacerbated by the tight supply situation in the Western U.S. We cannot expect a market to operate to benefit consumers or for the resulting wholesale prices to satisfy the requirements of the Federal Power Act if effective competition does not exist.

We strongly advocate that FERC be directed to fulfill its responsibilities and take the actions necessary to alleviate the market-performance problems that have led to unreasonable prices. We are mindful of the potential dangers of applying a simple price cap, the maximum price that all sellers can receive, to a truly competitive market where the interplay of supply and demand happens to yield prices higher than some might like. But California's electricity markets are not characterized by effective competition. In this case, cost-of-service prices are an obvious remedy that satisfies the just and reasonable rate standard. In addition, various parties have submitted proposals to FERC for temporary market interventions that would ensure just and reasonable wholesale electricity prices in California until many of the new power plants currently under construction in California are completed. These proposals do not require price caps on the spot market and thus avoid the problems caused by a simple price cap. However, all of these proposals require FERC to implement market-rule changes that guarantee wholesale prices in California are just and reasonable by setting selling prices for a significant fraction or for all of the output sold by generators and marketers serving California. These proposals have also been very sensitive to ensuring that prices will not be constrained to levels below the costs of new entrants or levels that will discourage sales from existing facilities into California over the next two years.

The events in California during the last year have done serious damage to the evolution of competitive wholesale and retail electricity markets in many parts of the country where electricity industry restructuring and competition have not progressed very far. Several states that had planned to introduce reforms soon are now delaying them. Others will not consider further reforms until FERC demonstrates its ability to identify and its readiness to remedy quickly and effectively serious wholesale market-performance problems.

Creating a well-functioning electricity market in California as soon as possible is the best way to ensure that competition in wholesale electricity will spread throughout the US and provide the greatest possible benefits to consumers.

Designing a well-performing competitive electricity market is an extremely complex evolutionary process. The public must have confidence that the federal government will work cooperatively with the states to establish appropriate restructuring, market-design, and market-monitoring programs so that when market-performance problems emerge FERC will act quickly and effectively to mitigate them. The Federal Power Act gives FERC both the responsibility and the tools to act when wholesale markets produce unjust and unreasonable rates for sustained periods of time. FERC's failure to act now will have dire consequences for the State of California and will setback, potentially fatally, the diffusion of competitive electricity markets across the country. Moreover, this negative experience with electricity re-structuring could delay or reverse current efforts to introduction competition into other formerly regulated industries.

Sincerely,

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