Is energy fox minding the henhouse?

By Sam Kennedy | Of The Morning Call
October 14, 2007

This month, after revealing that electricity rates could surge 35 percent for residents and up to 43 percent for businesses in 2010, PPL Corp. shrugged off responsibility for the looming hike, saying it does not set prices -- the marketplace does.

But the energy industry plays a critical role in policing the power market, which means the fairness of prices depends on the industry's integrity and good faith.

PPL, for example, must make sure that employees who buy electricity and those who sell it do not talk to each other. And it's up to PJM Interconnection, the industry-owned organization that manages the regional power market, to identify and report abuses, such as market manipulation.

At the same time, the Federal Energy Regulatory Commission examines some, but no longer all, wholesale electricity rates to ensure they are ''just and reasonable.''

These are all aspects of the power market that have attracted little scrutiny in Pennsylvania, which has yet to complete the process, begun in 1996, of deregulating its electricity. But in other states, they have become the subject of heated debate, legal action and high-stakes legislation.

Last month, energy companies in Illinois were forced to refund $1 billion to their customers after allegations of price manipulation.

PPL: Buyer and seller

Before PPL EnergyPlus President Joe Hopf makes certain presentations at PPL executive meetings, PPL Electric Utilities President David DeCampli must leave the room and wait in the hallway. Similarly, Hopf must sometimes go outside when DeCampli speaks.

It is an unusual ritual made necessary by the dual roles PPL plays in the power market.

PPL Electric Utilities is the PPL subsidiary that delivers electricity to 1.4 million Pennsylvania customers. It is buying electricity through six auctions to meet its energy needs in 2010, when a cap on what it can charge for electricity expires.

PPL EnergyPlus, another PPL subsidiary, sells electricity generated at PPL's power plants. It won PPL Electric Utilities' first auction in July with an offer to supply the lowest-priced electricity.

PPL's ability to participate in and win a competition to supply itself electricity is a defining characteristic of Pennsylvania's deregulation plan, which was drafted with the help of the energy industry. It permits companies to serve as both deliverers and suppliers of electricity.

Some states do not allow this, fearing a utility might not deliver the cheapest electricity to its customers when it can benefit its shareholders by buying more expensive electricity from another division of its company.

But in Pennsylvania, an auction orchestrated by an independent third party is meant to prevent such self-dealing. And to make sure an electricity supplier such as PPL EnergyPlus doesn't have an unfair advantage over other suppliers, it's not supposed to exchange information with a co-subsidiary like PPL Electric Utilities.

This is the reason for the musical chairs at PPL executive meetings.

''There can't be sharing of market information in either direction,'' PPL spokesman Dan McCarthy said.

Of course, PPL Chief Executive James Miller and up to roughly 20 other company officials in attendance at the meetings may hear from both EnergyPlus president Hopf and Electric Utilities president DeCampli. But McCarthy said everyone understands they must keep what they learn to themselves.

''We train people on this every year,'' he explained. ''We have a policy within the company that lays this out.''

Thus, if Hopf and DeCampli bump into each other elsewhere -- say, the company cafeteria -- they may talk about the weather or sports, but not about market-related matters. The same constraint also applies to the hundreds of people who work under each man.

Asked who is responsible for enforcement, McCarthy responded: "Each individual person…We are all required to report such a problem if we see it."

In Maryland, which modeled its deregulation plan after Pennsylvania's, lawmakers have become increasingly skeptical of such assurances. After electricity rates there soared 72 percent last year, they demanded to know more about the relationship between the state's biggest utility, Baltimore Gas and Electric Company, and its primary electricity supplier, another subsidiary of BGE's parent company, Constellation Energy Group.

In July, the state's Public Service Commission subpoenaed documents from Constellation in an attempt to shed light on the matter.

Market monitor blows whistle

The individual tasked with monitoring the regional power market created an uproar earlier this year when he testified before the Federal Energy Regulatory Commission that his superiors at PJM Interconnection had interfered with his work, blocking him from issuing critical reports and disclosing possible abuses.

On one occasion, PJM market monitor Joseph Bowring said, they did not act on his report that an unnamed power generator had earned $20 million in excess payments as a result of too little competition.

When Pennsylvania deregulated its electric industry, the state took away the Public Utility Commission's authority to set the price of electricity. That function would be henceforth performed by the market.

In its purest form, a market is an actual place a person can step into. The goods being bought and sold, such as groceries, can be seen and touched.

But an electron is unlike any other product, and so is its market. The buying and selling of the tiny particles that give light, heat and cool homes and bring TV screens to life take place out of public view, via sophisticated computer technology.

The nerve center of that operation is in an underground room at an unmarked industrial park building in Valley Forge, Chester County. It is the control room of PJM Interconnection -- the organization, owned collectively by both buyers and sellers of electricity, that manages the regional power market.

PJM likens its role to that of air traffic controller: Air traffic controllers are disinterested parties; they don't own planes, they just tell them where to go. Similarly, PJM directs the electricity generated at 1,200 power plants to utilities and other wholesale customers in parts of 13 states and the District of Columbia.

The testimony of market monitor Bowring, however, raised doubts about PJM's neutrality.

''The market monitor's function is absolutely crucial,'' said Sonny Popowsky, Pennsylvania's official consumer advocate on matters concerning utilities. "We all depend on [him] to ensure the markets are competitive. If he can't make that determination independently…that calls into question the whole basis of the market."

FERC's response to Bowring came last month. It ordered PJM to address concerns about market monitor independence, but rejected calls for public hearings on Bowring's allegations.

The commission said hearings were not necessary because its own investigation found no evidence of wrongdoing.

Federal agency is hands-off

Last month, Illinois' governor signed into law a bill that called for energy companies to refund their customers $1 billion. The same law put an end to an auction process similar to the one PPL is now using to buy electricity for 2010.

In place of the auction, a newly created state agency will negotiate electricity prices on behalf of Illinois residents.

The Federal Energy Regulatory Commission was at the center of the legal action that prompted Illinois' dramatic retreat from deregulated electricity.

After the state's rate caps ended and the price of electricity surged, Attorney General Lisa Madigan filed a complaint to FERC. She claimed to have found evidence of bid-fixing and collusion among 16 energy companies (including PPL EnergyPlus, which does business in Illinois).

But a portion of the document is devoted to the role of FERC.

At issue is what FERC did not do: It didn't approve the contracts between utilities and electricity suppliers.

According to Madigan, the 1935 Federal Power Act required FERC to determine whether the rates were ''just and reasonable.''

''FERC has not even conducted an initial review,'' she said.

FERC, though, has a different interpretation of the law. According to commission's policy, a review of such market-based rates is not necessary. It assumes a rate is just and reasonable because it is market-based.

''It's part of the move toward competition,'' FERC spokeswoman Mary O'Driscoll said.

Experts, however, have put forth a number of reasons why the power market might result in inflated prices:

Insufficient competition, particularly if too few companies are generating and selling electricity.

A lack of transparency, since electricity trading is hidden from the public.

''The secrecy in itself is a big part of the problem,'' said Robert McCullough, an electricity consultant who advised the Illinois attorney general. ''Anytime you do things in a back room, you have created incredible potential for abuse.''

Another key issue is what economists call ''inelasticity.'' Electricity cannot be stored like, say, grain. And it has no substitute. If the price of corn goes up, you can switch to rice. But there's no realistic alternative to electricity when it comes to lighting your home.

But, McCullough said, FERC's faith in markets trumps such concerns.

''There's not a lot of consumer protection,'' he said. ''Victims have to haul (FERC) over to the crime scene.''

FERC spokeswoman O'Driscoll took issue with that characterization. She said today's FERC is different than the one whose hands-off reputation was cemented during the California energy crisis of 2001, when market manipulation by Enron and other energy companies led to electricity price spikes and rolling blackouts. In the wake of those events, Congress gave FERC new enforcement powers, including the ability to levy $1 million-a-day fines, she said.

"FERC is not slow to investigate, nor is it reluctant," O'Driscoll said. "The commission operates a market monitoring center that keeps track of all trades going on in the markets, 24/7…and can look into those it deems worth investigating."

Illinois, nonetheless, took matters into its own hands.

In her complaint to FERC, Attorney General Madigan wrote that she found rates were "40 percent higher than prices in bilateral electricity markets" and "approximately twice the marginal cost."

"They were produced in a highly concentrated market in which there is evidence of price manipulation," she wrote.

In the end, Madigan withdrew her complaint as part of a complicated deal in which energy companies agreed not to challenge the $1 billion refund.

sam.kennedy@mcall.com
610-820-6517