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ELECTRICITY RATES

HEARING

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

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ELECTRICITY RATES

THURSDAY, MARCH 15, 2001

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The committee met, pursuant to notice, at 9:10 a.m., in room SH–216, Hart Senate Office Building, Hon. Frank H. Murkowski, chairman, presiding.

OPENING STATEMENT OF HON. FRANK H. MURKOWSKI, U.S. SENATOR FROM ALASKA

The CHAIRMAN. Good morning, ladies and gentlemen. The Committee on Energy and Natural Resources will convene.

Today we have a very interesting panel led by the Honorable Spence Abraham, one of our own, as Secretary of the U.S. Department of Energy. We were chatting in the back room, and it occurred to me that the responsibilities of the Department of Energy were kind of what we thought the world looked like before Columbus proved it was round: seemingly flat; it has no end. As a consequence, I am not suggesting you are here to end it by any means, Mr. Secretary, but the dimension is beyond comprehension.

On panel 2, we will have the Honorable Curt Hébert, Chairman of the Federal Energy Regulatory Commission, which is expected to solve many of these problems that we are going to hear about today.

We have panel 3: the Honorable Gary Locke, Governor of the State of Washington, and the Honorable Judy Martz, Governor of the State of Montana.

Panel 4: Bruce Worthington, senior vice president and general counsel of PG&E, San Francisco; John Bryson, chairman, CEO, and president of Edison International of Rosemead, California; Steve Baum, chairman, CEO, and president of Sempra Energy, San Diego, California; William Hecht, chairman, CEO, and president of PPL Corporation, Allentown, Pennsylvania; and Steve Fetter, managing director of the Global Power Group at Fitch, New York.

Senator Bingaman and I are going to chair this hearing this morning. About 9:25 I am going to have to go downtown for a few minutes on another matter that was previously scheduled, but I will be rejoining the hearing.

We are having fast-breaking news. I understand that there was a press conference and perhaps some concurrence between two of our members, and they can tell us about that.

I cannot help but note the *Wall Street Journal* this morning makes a rather startling statement that this energy shortage is not unique to California by any means. The *Wall Street Journal* suggests this morning that the New York independent system operators said that 8,600 megawatts of new power capacity, a 25 percent increase from what currently exists, must be constructed by 2006 or shortages will become so pronounced that they will push up prices and raise the specter of blackouts.

Whether we want to adhere to that projection, I think we ought to at least recognize that we have heard these projections at previous times and, unfortunately, we have not taken action. As a consequence, we find ourselves in a rather embarrassing position today, and it appears to be getting worse.

In any event, let me make a brief statement here. Then I will call on Senator Bingaman and then we will go around with the members.

What we have today, at least currently, are three bills by Senator Feinstein and Senator Boxer that attempt to address the California electric supply problem, and the methodology is price controls on wholesale power sold, as I understand it, in all Western States.

Before we proceed, I think we must decide what are we really trying to fix. Are we trying to fix power shortages and price spikes as the fix-all? Or are these symptoms of perhaps deeper problems: inadequate generation, inadequate transmission? Unfortunately, in my opinion, these three bills do not fix the supply problem in California, and I emphasize "supply."

I would note that in the 1970's we did impose price controls on oil and natural gas. We have had some experience with it. At that time it did not work. Those who forget history—we have heard this before—are condemned to repeat it. Simply put, price controls in my opinion will not solve California's supply problem.

Let me point out a couple relevant facts.

First, California is dead last—dead last—in the Nation in terms of electric generation per person. Yet, I believe it ranks sixth in the world economy in comparison.

Second, California has very low monthly electric bills in comparison to other areas. Consumers in 37 other States have higher bills. For example, consumers in Oregon paid about $61.40 per month in 1999, which are the latest available figures from the Secretary's office, as compared with $58.70 per month in California. The nationwide average residential bill is about $70.88.

The staff has prepared a detailed summary of the bills but briefly, as I understand it, S. 287, the Feinstein/Boxer bill, requires FERC to impose cost-of-service price controls on wholesale electricity sold in the West. Cost-of-service price control is the price set on a generator-by-generator basis, calculated by adding the actual cost of generating power plus a rate of return on invested capital.

S. 80, the Boxer/Feinstein bill, requires FERC to impose a price cap on wholesale electricity. Now, the wholesale price cap is a single maximum price which may not be exceeded regardless of the cost of production. I think we have to ask ourselves if that, in fact, stimulates generating capacity coming into California. I think we know what the answer is.

S. 26, the Feinstein/Boxer bill, requires the Secretary of Energy to impose either a price cap or a cost-of-service price control on wholesale electricity. Now, that basically takes the authority from an independent regulatory agency, FERC, which we assume is an objective agency, and gives it to a political appointee. No offense, Mr. Secretary, but the Secretary of Energy is given that authority. I think that is contrary to the object of initially establishing FERC because it sets it in a political arena.

In addition, amendment no. 12 by Senator Smith, as I understand it, would require the States to allow the pass-through of costs to consumers if they are to receive wholesale price controls. I think there is some justification for this, certainly, in ensuring that we have some relief by increasing power generating capacity because unless there is the assurance of a pass-through, I doubt very much if it is going to be economically viable to attract those that want to put in facilities. In my opinion, this would address the problem of California denying the utilities the pass-through of their costs, which I understand is about $13 billion to date.

I am of the opinion that if you receive the power, you are entitled to pay for it. Clearly the California consumers got consideration. They got power. Whether the price was reasonable or unreasonable I think is an obligation of FERC, but the utilities are certainly entitled to payment. The question is, who is going to pay for it? Is it going to be the taxpayer of California or is it going to be the ratepayer of California?

The three price control bills I think raise some policy concerns for the committee.

First, imposing price controls on wholesale power, as I indicated, in my opinion will discourage construction of new generation. Why will investors build powerplants in California subject to price controls if they can build them elsewhere and not be subject to price controls?

Second, it appears that the bills are intended to exempt municipally owned utilities from price controls. If that is true, with only part of the wholesale power market subject to price regulation, loopholes and market distortions certainly could be created. I would note that California ordered its investor-owned utilities to divest their fossil fuel fired generation and to purchase power exclusively from the spot market but, in doing so, exempted or they opted out California's municipally owned utilities from doing the same thing. It is my understanding they were given a choice. The independent utilities could not have that choice.

I think it is interesting to wonder and speculate that the Los Angeles Department of Water, which is owned by the city of Los Angeles, has made hundreds of millions of dollars of profit from selling electricity to the power-short investors and the investor-owned utilities during this crisis. I think there should be some accountability there.

Third, imposing price controls on existing contracts may result in their abrogation. It is my understanding that the Governors of California, Washington, and Oregon support the legislation in general; yet, the Governors of eight other Western States are opposed to price controls. We will hear from some of those Governors today.

So, what is the solution? Well, first and foremost, California itself must act responsibly. We must assist California in every possible way.

But on the supply side, California must get over its aversion to new powerplants and transmission lines. California has not allowed a new major powerplant to be built in almost a decade. California's extremely limited transmission capacity, the so-called Path 15 problem, directly contributes to the shortage problem in California.

On the demand side, California must get over its unwillingness to pass through wholesale costs. As a result, California utilities owe banks some $13 billion, which continues to grow daily. California's legislature has also authorized the issuance of $10 billion in bonds to purchase power, and it has already spent $3 billion before they have even been issued. So, California's taxpayers are certainly at risk.

California is driving independently owned utilities to the brink of bankruptcy. There is a lot of finger-pointing going on, which is understandable. Everybody wants to duck when the flack is flying. They are having the State buy power, take over transmission lines, seize utility assets. I do not think this necessarily resolves the problem of supply and demand. The demand is there; the supply is not. It only prolongs the agony. It reminds me of busily rearranging the deck chairs.

The recent survey, according to I believe the *Washington Post*—so we can all question the accuracy——

[Laughter.]

The CHAIRMAN [continuing]. Allegedly found that two out of three people in California would rather have the lights go out than have any price increase. I will leave it up to the witnesses to comment on that. But in any event, if they continue to oppose powerplants and transmission lines, they might get their wish.

There is no question that California faces serious problems, but we must work together to find a meaningful solution. We do not want a band aid patch that just creates different problems that are going to have to be addressed by different people sitting in this same chair in a different month or a different year.

Last week FERC took action to rein in wholesale prices in California by declaring high prices unjust and unreasonable and ordering millions of dollars in refunds. It may not solve the problem, but it is certainly going to get the attention of those that sold power at extremely high rates.

Likewise, California has taken some tentative steps, I think in the right direction, by trying to expedite powerplant permit approval. But the first real test is the start-up of an existing 450 megawatt gas powerplant for this summer, and I understand it is already encountering several areas of local opposition. If that powerplant is prevented from going on line, I wonder what can save California.

Again, I would encourage that we be sympathetic to recognize that we are all somewhat in this together in the sense that we are intertied, but nevertheless, I think we have to recognize patterns here that suggest that we are not really addressing adequately the issue of supply.

One other thing that occurs to me. We were looking at some matters the other day relative to where is the energy going to come from. If we look at the moratoriums that exist on the east coast, roughly from Maine to Florida, look at the moratoriums that exist on the west coast, roughly from Canada down to the start of Mexico, and the withdrawal of the overthrust belt and the roadless areas in the forests where some 23 trillion cubic feet of commercial gas have been put off limits, I think it is time we came to grips with just where the energy is going to come from.

I look forward to hearing from the witnesses on whether they think this legislation is going to solve California's problems and ensure an adequate and reasonable supply and price of electricity over the long term. I think that is the real question before the committee.

I want to commend my friends from California and Oregon and the other States that have been most affected initially by this, but as the *Wall Street Journal* points out, it is going to move right across the country and do not think New York and the east coast corridor is not going to be exposed to this because it is a reality. It is coming and we better take action.

Senator Bingaman.

STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR FROM NEW MEXICO

Senator BINGAMAN. Thank you very much, Mr. Chairman.

At the last hearing we had on this subject, we learned that there is a variety of suggestions for what has caused the problem in California: structural flaws in the restructuring plan in California, high natural gas prices, hot summers, cold winters, insufficient rainfall, too few powerplants, too few transmission lines, too many environmental laws, and price gouging. Those were all suggested as causes.

But whatever the cause is, the result has been runaway wholesale power rates that have brought the California system to the point of collapse and have driven its largest utilities into debt and is rapidly draining California's State treasury to the tune of some $45 million a day, as I understand it.

The California electricity crisis is, as the Federal Reserve Board Chairman testified 2 months ago, a national concern. Obviously, California represents a very large part of our economy and its problems are the Nation's problems.

The Federal Energy Regulatory Commission and the Bush administration's response to this crisis have been largely to let the market resolve the problem. The senior Senator from California has argued forcefully that the market forces are not solving the problem and that we at the Federal level have an obligation to step in and to fix the problem.

California's wholesale rates first started spiking about 10 months ago in May. The Federal Energy Regulatory Commission, which is the agency charged with regulating those rates, found them to be unjust and unreasonable in November. That was 5 months ago.

The law is quite clear, as I read it, on what the commission is required to do when it finds a wholesale rate to be unjust and unreasonable. The Federal Power Act says the commission must set a just and a reasonable rate. The commission has yet to do so. It has, instead, taken a number of half-hearted actions to try to bring down California's wholesale rates. It is clear that these actions have yet to bring those rates down to a just and reasonable level, as the law requires.

Both the commission and the Bush administration have offered various explanations and excuses for why a rate cap or a cost-of-service rate would not work. They indicate that it would send the wrong signals to generators and consumers. It would discourage generators from building more powerplants and more transmission lines. It would discourage consumers from saving energy. The commission has said that the cost-of-service rates will take too much time and be too difficult to calculate. The commission and the administration embrace an economic theory, the theory that an unregulated, competitive market will cause supply to increase, will cause demand to fall until those two are in balance, and this will necessarily lead to reasonable prices.

But the Federal Power Act does not, obviously, enact an economic theory. It does not provide an exception for administrative difficulty. It simply says if wholesale rates are unjust and unreasonable, the commission is required to make them just and reasonable. This has not been done. To the contrary, by its action last Friday, the commission appears to have given its approval to many millions of dollars of manifestly unjust and unreasonable charges.

Perhaps a cost-of-service rate mandate is not the ideal solution to the problem and perhaps the bills that have been introduced and referred to by Senator Murkowski are not perfectly drawn, but they are a proposed solution. If the administration objects to carrying out its obligations under the Federal Power Act, then I believe it must come forward with a credible alternative solution if it is not anxious to embrace these.

Why do we not go ahead and have short statements from any of the committee members who want to make them, and then we will go to our witnesses. I am advised that according to the order that people arrived here, Senator Campbell is next.

Senator CAMPBELL. Mr. Chairman, I will just introduce a statement for the record. Thank you.

Senator BINGAMAN [presiding]. Very good.

[The prepared statement of Senator Campbell follows:]

PREPARED STATEMENT OF HON. BEN NIGHTHORSE CAMPBELL, U.S. SENATOR FROM COLORADO

Thank you, Mr. Chairman. I would like to thank you for holding this hearing and all of the witnesses here to testify, especially my friend, Secretary Abraham. This hearing will delve into the ongoing problems in California and some of the bills that are attempting to fix portions of the problem. This should be an interesting discussion on how we are going to proceed on the electricity crisis in California, especially since it is affecting the entire West.

As you all know, many Western states are joined together in one enormous power grid. We are so interdependent that the breakdown of a generator in one part of the grid will affect power in another part. The entire Western grid's electric system is under severe stress. High prices and insufficient supplies of energy are likely to burden many Western states for months to come. But, the long-term problem is the supply of electricity which is smaller than the demand in the region. Also, California has not built a new power generation facility in years which would help alleviate the increasing demand for electricity.

The Western power grid is already overworked because of the energy needs created by booming economies and population growth, but not just in California. My home state of Colorado, along with other Western states, has increased demand for electricity as well.

Also, with the soaring price of electricity and the environmental concerns surrounding coal-fired generation plants, natural gas will play a key role in supplying our nation with sufficient power. But, we have certain problems with natural gas as well. In California, they have been experiencing particularly high natural gas prices—more than twice as high as recent national averages.

There are some proposals being offered to help address this power crisis like S. 26, S. 80 and S. 287 which my friends from California have introduced. But, concerns have already been voiced regarding these bills. Regardless of the controversy, whichever way we decide to go, we have to consider all proposals so that the problem can be solved, even if that means consideration of an electricity ballot initiative in California.

I am approaching the California crisis debate very carefully so that the best interests of my home state are not compromised and hurt. I have some questions for the witnesses that I would like them to address so that we can further explore this issue during the time for questions.

Thank you Mr. Chairman.

Senator BINGAMAN. Senator Craig.

STATEMENT OF HON. LARRY E. CRAIG, U.S. SENATOR FROM IDAHO

Senator CRAIG. Mr. Chairman, thank you very much.

Ladies and gentlemen, witness this marvelous act of bipartisanship that the U.S. Senate is now working in. We think it can work. It is working and you are seeing it firsthand this morning, Mr. Chairman.

[Laughter.]

Senator CRAIG. And I appreciate that.

Senator BINGAMAN. I will ask for another 45 minutes I expect. [Laughter.]

Senator CRAIG. But I do want to thank Chairman Murkowski for holding these hearings. I think they are tremendously important to address the current energy crisis that the West is experiencing.

But first, Mr. Chairman, I want to commend Senator Feinstein for her diligence and I believe honest effort to both define and resolve the difficult energy-related problems that are crippling the economies of California and the West. Senator Feinstein I think has been tireless in her search for answers.

I will also say she has been bold against considerable political odds as it relates to rate caps on retail sales to consumers. She has publicly acknowledged the critical need for California to expedite permitting of new powerplants that need to be sited in her State. That goes against some of the political mainstream in her State, but again, when you are in a crisis, it is time to lead.

As she has candidly stated in recent *Investor Daily* articles, without expedited permitting for new powerplants and true market pricing, there is no incentive to conserve. And we are finding in polls coming out of California today that the average California consumer does not recognize that they are in an energy crisis.

Mr. Chairman, these are not easy decisions for a California Senator to make or to acknowledge and the actions she has taken and legislation introduced and these hearings today are important for all of us.

Mr. Chairman, I am sure that it is largely because of her willingness to be honest and openly address these issues that these hearings have been scheduled and that we will move forward as we work on this very difficult problem. I am committed to giving this legislation attention.

However, I hasten to add, Mr. Chairman, that I am fundamentally skeptical of the ability to price cap in any way and to call that a solution to an energy problem in the West. Price caps have not had much economic success in years past. They have always proven to be very difficult to remove once in place. Moreover, they have often proved to be a distraction that creates short-term chaos in balancing load and resources.

Mr. Chairman, I am grateful that our Energy Secretary is here, the Chairman of FERC is here. Clearly, this issue has their attention, as it should. I think we all look forward to their insights in it.

I must say I am also grateful to the Governors who are here today to speak. We in the West are experiencing the California crisis in rather dramatic ways. In fact, rates are going up much faster outside California than inside California. That is true in the State of Oregon. It is true in the State of Washington. It is true in the State of Idaho. It is true in the State of Montana because, as you said, Mr. Chairman, we are all linked together and that grid and wholesale rates and California's inability to get itself under control is driving us into a very real crisis.

Mr. Chairman, let me ask unanimous consent that a letter from my Governor, Governor Dirk Kempthorne of Idaho, become a part of the record, as well as a letter of February 6 from the Governors of Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, and Wyoming, very clearly expressing that price capping is not the issue to solve the problem. It only creates a greater problem. Siting, regulation, getting on with the business of building production capability is the issue. They obviously express concern about California and the decision it is making, but they also recognize the importance of actions taken. This is a letter to Secretary Spence Abraham as a result of his trip out there and his expressions of cooperation of help, but at the same time, a recognition to stand true to the market and let the market forces work. And I ask that those become a part of the record.

Senator BINGAMAN. Those will be included in the record.

Senator Feinstein.

STATEMENT OF HON. DIANNE FEINSTEIN, U.S. SENATOR FROM CALIFORNIA

Senator FEINSTEIN. Thank you very much, Mr. Chairman. Let me thank you and the chairman for holding this hearing. I would also like to thank my colleague from Idaho for his remarks. I appreciate them very much.

Earlier Senator Gordon Smith of Oregon and I held a press availability, and what we announced was essentially agreement on a piece of legislation which would, in essence, say that once the Federal Energy Regulatory Commission finds that rates are unjust and unreasonable, that that commission would be bound to either set a temporary regional wholesale price cap, one, or two, set cost-based rates, provided that the State would then respond and pass on those rates to the consumer.

Now, the State would have the option of setting the timing and the manner in which those rates would be passed on. That could be tiered pricing, real-time pricing. It would include a baseline for those on the lowest part of the economic ladder. It would give the State flexibility in that regard. But it would seek to correct what in California today is a broken market.

That brokenness really came from a bill passed in 1996 which deregulated the wholesale end and yet kept regulated the retail end, which forced California to buy electricity on the day-ahead market, 95 percent of it, and required the utilities to divest themselves of their generating facilities. In hindsight, all of this came together in a catastrophic scenario so that today California buys power at what are, if you look at rates 5 years ago, astronomic prices.

We believe that FERC should act, but we believe that FERC should act in a way that it can be sure that the market also will have a chance of responding correctly.

Let me just quickly take a look at electricity prices in California. In 1998 and 1999, the average energy price for a megawatt of electricity consistently averaged about $30. The green bar is 1999 and the purple bar is 1998. The red bar is the year 2000. You clearly see what happened. The price of electricity jumped to $150 a megawatt hour in the summer, and then in December it increased to over $350 per megawatt hour. The late fall/early winter season is normally the time of the year when demand is low, and California has such an ample supply of electricity, that it usually exports its surplus. This season, however, there were serious shortages of power.

Chart number 2 compares the hourly prices of electricity for two July days in 1999 and 2000. The line graph and the number on the right indicate the available power supply for that day. As you can see, the demand is the same for these two days. However, the purple bar represents the hourly prices for the day in 1999, and the red bar represents the price for 2000. Again, you can look at those price differences.

The discrepancy in price exists in the early morning and it exists late at night. So, even though the supply is the same and we know that there should be ample supply to meet demand late at night, prices for energy still skyrocketed. The only way to explain the differences in price is to conclude that someone is gaming the market and the market is broken.

Now, I am not going to spend a lot of time on natural gas prices. The ranking member and I had the privilege of meeting with El Paso, and I think both of us saw one of the problems and I want to quickly state what it is. The real cost of transporting natural gas is less than $1. Based on cost, when natural gas is selling for $5 in San Juan, New Mexico, directly adjacent to the California border, it should not be selling for anything more than $6 in southern California.

But as you can clearly see from the second spike on the graph, at the end of last year when natural gas was averaging $5 to $7 nationally, it was as much as $37 in southern California. That is additional evidence that the market was not working.

Now, the Federal Power Act gives the exclusive authority to regulate the interstate transmission of power, and I think the statute is pretty clear. Let me quote from it. “Whenever the Commission, after a hearing had upon its own motion or own complaint, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any public utility for any transmission or sale subject to jurisdiction of the Commission, or that any rule, regulation, practice, or contract affected such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order."

Now, I agree California has to fix the brokenness of its market on its own. It has to build additional generation. It is moving in that direction and anticipates at the end of 2002 there should be greatly increased power generation within the State.

So, what is the appropriate Federal role? The appropriate Federal role in my view is, at a time of crisis, to provide a period of reliability and stability in the marketplace. This in my view FERC has refused to do. So, this unusual price market has continued.

The State has spent nearly $4 billion of its surplus to date buying power. It spends about $45 million a day. About $30 million of that is lost forever. That is an extraordinarily difficult situation to sustain into time, and I would suspect that by the end of this year, the State will probably spend close to $10 million buying power. That is gone. It does not buy a school. It does not repair a road. It does not build the water system many of us believe the State needs. As a matter of fact, some of that money has also gone to buy power.

This is one of the reasons that I feel so strongly that any legislation that comes out of this body must also fix the brokenness of that market. Thanks to Senator Smith of Oregon, we have come together I believe now with a bill that says, FERC, do your job but, California, you also must do your job and fix your market. So, we hope that this bill will have favorable consideration by this committee and that we will be able to move it forward. I think long term it is the right thing to do.

There is a program of conservation now asking for 10 percent conservation in the State. But what is the greatest incentive to conservation is if the retail market functions so that when supply is limited, people have incentive to control their use. They can use smart meters. They can buy new refrigerators which save a lot. The computer industry has indicated that if people just take their computers and instead of putting them on sleep, put them on off, that saves totally about 7 percent of the State's supply. That was amazing to me to find out. But people have to respond and the marketplace is one of the ways in which people can respond.

I want to thank Senator Smith. I believe we now have a piece of legislation that can fix the brokenness of the market and also demand, in effect, that FERC provide this period on a temporary basis, a period of reliability and stability in prices which can be a big help.

I would like to take this opportunity just to welcome those people from California who have come a long way, Mr. Chairman, to testify this morning.

Senator BINGAMAN. Thank you very much.

Let me just alert Senators here. We have six more Senators who are here and ready to make statements. I would urge that people keep the statements short so we can get to our witnesses as quickly as possible.

Senator Smith.

STATEMENT OF HON. GORDON SMITH, U.S. SENATOR FROM OREGON

Senator SMITH. Thank you, Mr. Chairman.

Mr. Secretary, welcome. Thank you for being here.

I believe in free markets, but truly we have never had a free market in electricity, not one that is truly free. What we now have is a broken market and a duty to do something.

When this crisis erupted, many rushed to re-regulate. I have withheld any impulse to do that, believing that until California fixed the fundamental flaw in its law, a re-regulation would amount to little more than putting a band aid on cancer.

Senator Feinstein and I have reached a conceptual agreement. We are going to advance it as legislation. We believe the administration should respond and favorably and help us to do this because truly what you have now is converging a perfect storm, both environmentally and economically, for the States in the Western United States.

I think it is important that everyone understand the fundamentals of the agreement that we are going to pursue.

The legislation should direct the Federal Energy Regulatory Commission, FERC, to impose a just and reasonable wholesale cap that could be load-differentiated or cost-of-service based rates in the Western energy market. That market is comprised of the States in the Western Systems Coordinating Council: Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming.

The wholesale price cap or cost-of-service based rate will not apply to wholesale sales for delivery in a State that imposes a price limit on the sale of electric energy at retail that precludes a regulatory utility from recovering costs under the price cap or on a cost-of-service based rate or precludes a regulatory utility from paying its bills.

The ratemaking body of a State can determine, however, would be allowed to determine how and when the wholesale rates will be passed on to ratepayers, including the setting of a tiered pricing, real-time pricing, and baseline rates. With respect to the Bonneville Power Administration, BPA will be encouraged to seek to reduce rate spikes to economically distressed communities, while ensuring costs are recovered by the end of the next contract period in 2006.

Three, the wholesale rate cap or cost-of-service based rates shall remain in effect until such time as the market for electric energy in the western energy market reflects just and reasonable rates, as determined by the Commission, or until March 1, 2003, whichever is earlier.

In addition, as to natural gas transmission costs, the legislation would reimpose FERC tariffs for natural gas transportation into California and require natural gas sellers to declare separately the transportation and commodity components of the bundled rate for gray market transactions.

Additionally, after the date of the enactment of this legislation, utilities should not be ordered to sell electricity or natural gas into a State without a determination by FERC that the seller will be paid.

Finally, in the event that a State in the Western energy market does not meet the criteria described in this agreement, State public utilities commissions in the western energy market should be able to ensure that regulated utilities within their jurisdiction meet demand for electric energy in the utility's service area before making sales into any such State.

Mr. Chairman, I believe that this approach, while temporary, will help us to avert an economic and environmental catastrophe. I hope that we can pass this on a bipartisan basis and I hope the administration will be a party to it because we would be unwise servants if we just sat while Rome got ready to burn.

Thank you.

Senator BINGAMAN. Thank you very much.

Senator Hagel, did you wish to make a statement?

STATEMENT OF HON. CHUCK HAGEL, U.S. SENATOR FROM NEBRASKA

Senator HAGEL. Very briefly, Mr. Chairman. Thank you.

This issue of energy is the most pressing issue America faces, bar none. This is an issue that crosses all boundaries, all walks of life, all socioeconomic dynamics of our country. It affects our national security. It affects our productivity, our economic growth. It affects agriculture. It affects the environment.

I find it a bit ironic, Mr. Chairman, that there are some who are shrieking around America this morning who are concerned that this President has decided not to cap carbon dioxide emissions for utility plants when we are here today about a most urgent issue and that urgent issue is about energy supply. It is not complicated. It is a very clear case of energy demand outstripping energy supply.

As Chairman Murkowski said before Chairman Bingaman took the gavel, we are all in this together. This is a national problem. It is not going to get better. It is only going to get worse. We are here today because of that problem.

We need a national energy policy. We need a short-term and a long-term policy. We need energy supply. We need a broad, deep portfolio of energy supply. That is connected to the environment. It is connected to every part of our lives.

We can talk about amendments to energy legislation and we can talk about quick fixes for particular States, and that is of great importance and great urgency and we understand that. But we must also understand we have an obligation here to take a bigger view and a national responsibility because if we do not, the consequences of this will be catastrophic. We think we have market problems today. It will be nothing compared to the economic downturn that will essentially spread to all of the globe if we do not fix this and we do not have a market that believes we are going to fix it both for the short term and the long term.

So, I am obviously like all of us on this committee, Mr. Chairman, appreciative of the leadership that you are giving and Chairman Murkowski, obviously our colleagues, Senator Feinstein and Senator Smith and others who are grappling with the immediacy of this. It is difficult and we understand that. But my only point is this is a big issue that is going to require big-time, long-term solutions and we should not tinker around or just edge around the bush on this with the American public. We need to tell them straight out we are in trouble.

Thank you.

Senator BINGAMAN. Thank you very much.

Senator Landrieu.

STATEMENT OF HON. MARY L. LANDRIEU, U.S. SENATOR FROM LOUISIANA

Senator LANDRIEU. Thank you. I waive my right to an opening statement because I am anxious to hear the testimony and actually have another hearing in a few minutes. Let me just state this in three questions really.

I commend my colleagues for working together in a bipartisan way to try to address this difficult situation in the West.

My first question would be, what would be the potential effects on prices in other regions of the Nation as a result of this bill?

Second, will we address the authority of FERC to site new powerplants, require the expansion of powerplants and to require transmission lines, possibly even over local opposition, which has been a real stumbling block to any solution to this problem?

Third, would the legislation allow those States that are aggressively pursuing new supplies of energy such as oil and gas and coal, to be compensated for our good efforts in trying to increase the Nation's supply? States such as Louisiana and Texas should be recognized for their efforts.

So, I throw those three questions out for right now and I will have others as we debate this legislation. Thank you.

Senator BINGAMAN. Thank you very much.

Senator Cantwell.

STATEMENT OF HON. MARIA CANTWELL, U.S. SENATOR FROM WASHINGTON

Senator CANTWELL. Thank you, Mr. Chairman, and I would like to thank Chairman Murkowski for holding this hearing.

As stated by my colleague from Idaho, this is truly a bipartisan effort, in the sense of this hearing and the committee working together, the legislation being offered by my colleagues from California and Oregon, and in the testimony that we are going to hear from two Governors from the West.

We in Washington want to make sure that the point is not lost today that we are seeing both economic impacts to industries and to consumers. The Northwest continues to suffer the harsh consequences of this market instability, obviously exacerbated by our below-average rainfall and snowpack. This is the worst drought in our State since 1977, and it is only March. So, there is much to do to address this issue.

BPA is predicting more than a 45 percent water flow shortfall this summer and predicts rate increases of over 200 percent this fall. Rates are already up 43 percent with residential users and 75 percent for some industrial customers in Tacoma, and up 28 percent in Seattle.

Northwest officials and we in the Northwest congressional delegation continue to look for mid- and long-term answers to this problem. I congratulate FERC on their press release yesterday in which they went through a variety of issues that I believe are mid-term and long-term answers to increasing energy supply by expediting processes and procedures.

But I think it is very important that we look at not just the mid-term and long-term solutions to this issue, but the immediate consequences to the economy of the Northwest. We need to stop the bleeding first before we look for a cure for this disease. That is why I join in support of my colleagues from California and Oregon in S. 287, which will try to address these issues.

I cannot emphasize enough—and I am very proud that our Governor, Gary Locke, is here today to talk about these economic consequences to our region. The effect of these energy prices could mean 23,000 fewer jobs in Washington State over the next few years, and that is on top of a 20,000-job loss in water and energy-intensive businesses such as aluminum smelting. This was referred to in a *Wall Street Journal* article that I would like to submit to the record.

I would also like to submit to the record an article that appeared in the *Seattle Post Intelligentser* about the fact that this is not just about California bashing. While there have been problems created by distorted spot market pricing, this is a larger issue that we need to address if we are to help the Northwest economy survive these high prices.

I appreciate the attention of the committee to this issue. I appreciate the fact that our Governor has flown across the country, I think on a red-eye, to be here today to give testimony on this. And I appreciate the Secretary's immediate attention to these Northwest issues.

Senator BINGAMAN. Thank you very much.

Senator Burns, did you have a statement?

STATEMENT OF HON. CONRAD BURNS, U.S. SENATOR FROM MONTANA

Senator BURNS. May I just say to the Senator from California that the last time we sat in these chairs, I said that we have to address this nationally. California's economy is so large—and I think they are still a member of this Union—that it affects all of us. We want to be a part of the solution, not a part of the problem.

I want to congratulate her and Senator Smith for working out this arrangement. It is not a knee-jerk approach to this. It has been given great forethought.

Rather than standing and shouting and worrying—I worried ever since I was in Las Vegas and picked up that newspaper. The *Los Angeles Times* on the front page about a month ago, Senator Feinstein, said 54 percent of the people in California do not believe there is a power shortage. Now, that told me we have got some credibility gaps here. So, we have to address those.

Senator Hagel is right. This is a national problem. It is just not local. But we are situated such in relevancy to the Northwest that it impacts our State of Montana.

I want to congratulate our Governor for being here. And do not worry about Governors taking red-eyes. They are no better than we are. They can take them just like everybody else.

[Laughter.]

Senator BURNS. So, I am not going to feel sorry for Governor Locke because my Governor did the same thing. She is here today and will offer her points.

I want to thank the chairman for calling this hearing. I plan to be part of the solution rather than part of the problem. I congratulate them for it. Thank you.

Senator BINGAMAN. Thank you very much.

Senator Thomas, you are the cleanup hitter here. Do you have a statement?

STATEMENT OF HON. CRAIG THOMAS, U.S. SENATOR FROM WYOMING

Senator THOMAS. Yes, sir, very briefly.

Mr. Secretary, glad to see you. I thought I was going to miss you, but I see you are still here. You have not had a chance yet.

[Laughter.]

Senator THOMAS. What we really need to focus on is our energy policy, and this local thing is a little different. I think we need to deal with it. I am ready to deal with it.

But I have to tell you I want to see from California some decisions made out there, some changes made out there. There were market messages coming out for a number of years. You cannot accept the notion that your use is going up and your production is going down and not know it. So, I am anxious to hear of some of the decisions with regard to caps on retail and so on that have been made out there.

Then we need to move and our emphasis needs to be on the broader emphasis in my view. The national problems are quite different than the California problem. We tend to put them together, but I think there is quite a difference and we need to deal with it that way. So, I am anxious to hear.

Thank you, sir.

Senator BINGAMAN. Thank you very much.

Secretary Abraham, we are glad to have you before the committee today and we look forward to hearing from you.

STATEMENT OF HON. SPENCER ABRAHAM, SECRETARY, DEPARTMENT OF ENERGY

Secretary ABRAHAM. Mr. Chairman, thank you. I could not help but reflect upon my first months in the Senate when, as the most junior member, 100th in seniority, I used to wait at committee hearings to get a chance to make my opening statement, and I see that things have not changed much since I moved from the Senate to the administration.

[Laughter.]

Secretary ABRAHAM. Mr. Chairman and members of the committee, I just want to thank you all for having me here today. I look forward to this testimony and to continuing to work with all of you on the challenges that we face in the energy arena.

I would just say at the outset I agree strongly with the points that have been made that this is not an isolated situation or a short-term challenge. The approach we intend to take as an administration is to look at this in a broad, national, and long-term sense.

However, over the past year, as we know, California has experienced three major blackouts that affected hundreds of thousands of Californians in progressively larger numbers. The problem will get worse and blackouts this summer appear inevitable when peak demand is expected to be about 61,000 megawatts while supplies are anticipated to be only about 56,000 megawatts. Consequently, some analysts project that California may experience up to 20 hours of rolling blackouts this summer, while others project 200 or more hours of blackouts.

The clear cause of this electricity crisis, as has been stated here today, is an imbalance between supply and demand. Over the past 5 years, electricity demand in California grew by 6,300 megawatts while generating capacity has, as a result of regulatory and other impediments, decreased by 1,200 megawatts due to plant retirements and no new sources of power generation.

I believe Governor Davis has acknowledged that California has principal responsibility to address this crisis, and thus, he has taken a variety of actions designed to increase supply and reduce demand. If these measures prove successful, the situation this summer will be improved. In a variety of ways, this administration has been trying to help California in those efforts, as I will later discuss in my testimony.

Unfortunately, the national focus and the focus of this hearing has been diverted away from the challenge of inadequate supply to price controls. Yes, it is true that California is paying high prices for energy, but California is not alone. The rest of the West, as we have heard today, as well as other regions of the country, have also experienced significantly higher energy costs, particularly this winter.

Although other areas of the country are confronting energy supply and pricing challenges, the problems in California are unique because of the aforementioned lack of new generation and the electricity purchasing constraints the State itself applied to its own utilities. By refusing to permit its utilities to buy power except on the spot market, can set into motion the process which drove its costs through the roof.

For example, last summer Duke Energy offered to meet the supply needs of San Diego Electric and Gas Company for 5 years at a price of $55 per megawatt-hour. This is just a fraction of the average price of $376 per hour paid on the spot market in December and $314 paid in January. If the State had approved new generation in a timely manner or had allowed utilities to enter into long-term contracts, such as the one offered by Duke, we would not be here today discussing price caps.

This administration is absolutely and certainly concerned about high energy prices, whether they are in California or anywhere else in the United States. We believe that energy prices should be just and reasonable and we support the recent action by the Federal Energy Regulatory Commission to order refunds to Californians charged unjust and unreasonable rates instead of market rates. And this administration will continue working closely with California and the West to develop measures to help reduce its projected energy shortages.

But let me make one point clear. Any action we take must either help increase supply or reduce demand because that is real challenge. If a proposal does not increase supply or reduce demand, it is not a real solution. If it decreases supply or increases demand, it will only make the current crisis worse, especially as we go into the peak summer season.

And it is within that framework that the administration opposes the imposition of price controls. Price caps will not increase supply or reduce demand. In fact, in our view they will seriously aggravate the supply crisis since they will discourage investment in new generation while eliminating incentives to reduce demand.

Now, this is not a theory. It is the product of experience. Price caps have already been tried and have already failed. California has long had a ceiling price for electricity sales into the State. That price was steadily lowered throughout last year from $750 to $500 to $250 to finally $150 per megawatt-hour. Proponents of price caps then made the same arguments the proponents make today, that price caps will control high prices without diminishing electricity supply.

They were wrong. Price caps failed because some power suppliers were subject to the price cap while others were exempt. The result was market distortion. Price caps gave in-State generators every incentive to sell power out-of-State and power exports from California rose 85 percent. As a consequence, 3,000 megawatts of power were exported.

And what happened to prices? The lower the price cap was set, the higher average electricity prices rose.

Notwithstanding that failure, we are here today discussing price caps for the entire West. However, these proposals I think suffer from the same flaws contained in previous ones.

Regional cost-based price caps will discourage investment in new generation at exactly the time it is needed the most.

Furthermore, imposition of cost-based price caps will also split the electricity market in the West into two markets, one that is subject to price controls and the other which is exempt, much as has been the case in California. This will occur for a very simple reason. FERC only has jurisdiction over 47 percent of the electricity generation in the Western Systems Coordinating Council. The other 53 percent, municipals, cooperatives, and so on, fall outside of the Federal Government's power to regulate.

Now, a cost-based price cap that applies to only half the region has four fundamental flaws.

First, the California experience with price caps, where part of the market was subject to the cap and part was exempt, will be repeated. We believe the result will be the same: distortion of electricity markets, reduction in electricity supply, shifts in electricity supply from capped markets to uncapped markets, and most importantly, failure to control prices.

Second, because of this separation or division, we believe that electricity exports to the United States from Canada and Mexico will almost certainly decrease, since these producers could get a higher price selling electricity within their own countries. And we cannot control the price that it is sold extraterritorially.

Third, a split electricity market would create winners and losers. Winners would be large municipal utilities in the West that have significant surplus generation, since they would be exempt from the price caps, and the losers, of course, would be buyers that cannot purchase electricity from an entity subject to the price caps.

Fourth, a creation of two electricity markets will likely induce cheating and circumvention like that which occurred in the days of oil price controls. That will occur because as the prices in the two markets diverge sharply, prices in the unregulated market will be increasing and rising higher than existing levels, whereas prices in the regulated market will not. Electricity is like oil: it is a fungible commodity. Some unscrupulous parties could easily take advantage of the split markets and sell capped electricity at market-based prices. In fact, that is exactly what Marc Rich's company is accused of doing under oil price controls.

The only way to apply price controls to all generation in the West would be to amend Federal law and grant FERC authority to set rates for wholesale power sales by State and municipal utilities and rural electric cooperatives. However, if we did that, it would be inconsistent with 70 years of Federal electricity legislation, and I would just make it clear that the administration would not support such a proposal.

Finally, I would just like to note that one popular variation on the cost-based price cap idea, which has been espoused by several Governors and a recent FERC chairman, would actually reduce electricity supplies in the most immediate sense. This approach would actually not even guarantee cost recovery because basically it would set a rate at variable cost plus 10 percent or $25 per megawatt-hour, whichever is less. Since powerplants would fix costs in excess of $25 per megawatt-hour, presumably not elect to operate at a lost, the region's electricity supply in those cases would be immediately reduced if we adopted this approach.

Last month, 8 of the 11 Western Governors sent me a letter expressing opposition to price caps. In that letter they stated: "Caps will serve as a severe disincentive to those entities considering the construction of new electric generation at precisely the time all of us, and particularly California, are in need of added plant construction." We share this view and we believe that our responsibility is to help minimize electricity shortages and the blackouts and the resultant economic and security dislocations such shortages produce. So, for those reasons, we do not favor price controls.

Regrettably, I think our opposition to price caps has been claimed by some to suggest that the administration either does not care about California and the West or is doing nothing to help. That is simply untrue.

One day after being sworn into office, President Bush asked me to call Governor Davis to see how we could help address California's power shortages.

Three days after taking office at Governor Davis' request, we extended the emergency electricity and gas orders to give California time to enact reform legislation aimed at maintaining electricity supplies.

Last month, President Bush issued an executive order directing Federal agencies to expedite permits relating to construction of new powerplants in California. The U.S. Environmental Protection Agency has issued air permits for three powerplants in the past 3 weeks.

President Bush and I have engaged in extensive discussions with the Government of Mexico about increasing electricity imports from Mexico to California.

Last week, at the behest of Governor Davis, we sent a letter to FERC asking that the agency act on his request for an extension of the waiver for qualifying facilities from certain fuel requirements. Yesterday that waiver was granted.

Also last week, FERC determined that some suppliers had charged unjust and unreasonable rates and then compelled them to refund those overcharges to California buyers. And new FERC orders, intended I think to again address these issues, were just announced yesterday.

Moreover, today we will be responding favorably to Governor Davis' request that we review his plan for ensuring the financial health of the California utilities.

Mr. Chairman, we are committed to working with California and the West to develop effective solutions to this crisis and we will continue to do so. Moreover, the administration, under the leadership of Vice President Cheney, has embarked on a multi-departmental task force project, much as was recommended by members of this committee to me during my confirmation hearing, to try to look at our energy challenges on a broad, interdepartmental, national, long-term and short-term basis. And as results from that task force effort are completed, we will be taking additional action.

The only action the administration will not take is the implementation of price caps.

In that each of the legislative proposals before this committee today basically are premised on the types of price controls I have just addressed and for the reason which I have just outlined, we do not support them. There are, however, additional concerns which we have with each proposal and I will address those concerns as part of the fuller written testimony which we submit today.

Mr. Chairman, that concludes my testimony. I look forward to answering any questions you or the other members of the committee might have and look forward to working with people as we address these various energy challenges on a very broad-based approach in the future. Thank you very much for having me here today.

[The prepared statement of Secretary Abraham follows:]

PREPARED STATEMENT OF HON. SPENCER ABRAHAM, SECRETARY, DEPARTMENT OF ENERGY

Mr. Chairman and Members of the Committee, I welcome the opportunity to testify before you today on various electricity measures pending before the Committee, namely S. 26, S. 80, S. 287, and the Smith amendment to S. 287.

All of these legislative proposals address the electricity crisis in California and the West. Before I get into the Department's specific comments on these bills, it may be useful to step back and offer our views on how this crisis developed, the real nature of the problem, and an analysis of proposed solutions.

ELECTRICITY CRISIS IN CALIFORNIA AND THE WEST

As everyone knows, California is in the middle of a serious electricity crisis. Over the past year, the State has experienced three major blackouts that have affected hundreds of thousands of Californians in progressively larger numbers. The problem will get worse, and blackouts this summer appear inevitable when peak demand is expected to be 61,125 megawatts, while supplies are anticipated to be only 56,159 megawatts. Consequently, some analysts project California may experience up to 20 hours of rolling blackouts this summer, while others project 200 or more hours of blackouts.

The clear cause of this electricity crisis is an imbalance between supply and demand. Over the past five years, electricity demand in California grew by 6,300 megawatts while generating capacity decreased 1,200 megawatts due to plant retirements. The State siting process constituted a barrier to entry for power producers that sought to build new generation. Over the last four years, independent power producers tried to build new generation, filing applications to build 14,000 megawatts of new generating capacity. None of this new generation is operating yet. Moreover, anticipated political resistance undoubtedly discouraged serious consideration of other new generation options.

Governor Davis understands the nature of the problem and recognizes the State of California has principal responsibility to address this crisis. As the Governor stated in January: "The problem is primarily of California's making, and we will solve the mistakes we made in 1995."

To that end, Governor Davis has taken a variety of actions designed to increase supply and reduce demand. The Governor proposed a series of executive orders intended to increase supply by 5,000 megawatts and reduce demand by 10 percent this summer. If these measures prove successful and the weather is mild the situation this summer will be improved.

We are helping the State in its efforts, and the Administration has taken a number of actions to support the State in recent weeks. I will discuss the actions taken by the Administration later in my testimony.

Mr. Chairman, the national focus, and the focus of this hearing, has unfortunately been diverted from the challenge of inadequate supply to price controls. It is true that California is paying high prices for energy, although, because of retail rate caps, consumers have been largely protected from these price increases. But California is not alone.

The rest of the West and other regions of the country have also experienced higher energy costs, particularly this winter. Unlike in California, where retail rates are frozen, higher wholesale electricity prices have impacted consumers in other Western States. Heating oil prices are at near-record levels, which affect consumers in the Northeast. Regions that rely heavily on natural gas for home heating have also experienced sharp price increases. In every instance, these problems arise from an imbalance between supply and demand triggered by an inadequate development of new generation, unique climate factors and/or higher natural gas prices that have resulted from recent, significant increases in demand for natural gas as a preferred energy source.

Yet, although other areas of the country are confronting energy supply and pricing challenges, the problems in California are unique because of the electricity purchasing constraints the State itself applied to its own utilities. By refusing to permit its utilities to buy power except on the spot market, California set in motion the process that drove its costs through the roof.

For example, last summer, Duke Energy offered to meet the supply needs of San Diego Electric and Gas Company for five years at a price of $55 per megawatt-hour. This is a fraction of the average price of $376 paid on the spot market in December and $314 in January. Even the average $69 per megawatt-hour price of the contracts announced by Governor Davis compares unfavorably to prices available last summer. If the State had approved new generation in a timely manner or allowed utilities to enter into long-term contracts, we would not be here today discussing price caps. Instead, California utilities have until recently been required to buy huge quantities on the spot market, driving up wholesale costs for themselves and others in the West. Hence, the effects have extended beyond California's borders.

This Administration is certainly concerned about high energy prices—whether in California or anywhere else in the United States. We agree that energy prices should be reasonable and support the recent action by the Federal Energy Regulatory Commission (FERC) to order refunds to Californians charged unjust and unreasonable rates. And this Administration will work closely with California and the West to develop measures to help the State and the region meet its projected energy shortage.

The Task Force chaired by Vice President Cheney will soon make a series of recommendations on meeting America's energy demands. In the meantime, we will continue helping expedite California's efforts to increase generation and reduce demand.

But let me be clear on this, any action we take must either help increase supply or reduce demand. If a proposal does not increase supply or reduce demand, it is not a solution. If it decreases supply or increases demand, it will only make the current crisis worse.

It is with that framework in mind that the Administration opposes imposition of price controls such as those proposed in the legislation that is the subject of this hearing. Price caps will not increase supply or reduce demand. In fact, they will aggravate the supply crisis, since they will discourage investment in new generation while eliminating incentives to reduce demand.

This is not theory, but the product of experience. Price caps have already been tried and have already failed. California has long had a price cap that set a ceiling price for electricity sales into the State. That ceiling price was steadily lowered throughout last year, from $750 per megawatt-hour to $500 to $250 to finally $150. Proponents of price caps then made the same arguments that proponents make today: price caps will control high prices, while guaranteeing adequate electricity supply.

They were wrong.

Price caps failed in California in part because they only applied to part of the market—some power suppliers were subject to the price cap, while others were exempt. The result was market distortions. Price caps gave in-State generators every incentive to sell power out-of-State and power exports from California rose 85 percent. Price caps reduced California's electricity supply, since 3,000 megawatts of power were exported. The lesson was clear: price caps on only part of the market will distort the market and drive supply out of markets with price controls into unregulated markets.

And, what happened to prices? The lower the price cap was set, the higher average electricity prices rose.

Notwithstanding that failure, we are here today discussing a different kind of price cap on a broader scale: the entire West. Proponents argue that a price cap that limits power producers to cost-recovery plus a fixed rate of return, if imposed across the entire West, will succeed where price caps that set a ceiling price failed. However, these proposals suffer from the same flaws contained in previous proposals.

First, imposition of cost-based price caps will reduce electricity supplies in the short-term. Governors Davis, Locke and Kitzhaber, along with a former Chairman of FERC, have proposed a version of cost-based price caps that would actually not even guarantee cost recovery, but instead set a cap at variable costs plus ten percent or $25 per megawatt-hour, whichever is less. Since power plants with fixed costs in excess of $25 per megawatt-hour will presumably not elect to operate at a loss, the region's electricity supply will be immediately reduced.

Regional cost-based price caps will also discourage investment in new generation at a time when it is most needed. If cost-based price caps are imposed, independent power producers that are building most of the new power plants will simply decide to build new generation in another region or country.

Imposition of cost-based price caps will also split the electricity market in the West into two markets, one subject to price controls and the other exempt. This will occur because FERC only has jurisdiction over 47 percent of the electricity generation in the Western Systems Coordinating Council. FERC has no jurisdiction over wholesale sales by State and municipal utilities, rural electric cooperatives, and does not have authority to impose cost-based rate on Federal power marketing administrations.

A cost-based price cap that applies to only half the region has four fundamental flaws. First, the California experience with price caps—where part of the market was subject to the cap and part was exempt—will be repeated. The result will be the same: distortion of electricity markets, reduction in electricity supply, shifts in electricity supply from capped markets to uncapped markets, and, most importantly, failure to control prices. Power producers would seek to make sales through entities not subject to price caps and independent power producers would have an incentive to build projects in the service areas of entities not regulated by FERC and make exempt sales through those entities.

Second, electricity exports to the U.S. from Canada and Mexico will almost certainly decrease since these producers could get a higher price selling within their own countries. In short, we would lose supply just when we are encountering shortages.

Third, a split electricity market would create winners and losers. Winners would be large municipal utilities in the West that have significant surplus generation, since they would be exempt from price caps. These utilities have been collecting substantial revenues from sales at market-based levels. Indeed, according to FERC most of the excess power costs that the California Independent System Operator claims were collected in January 2001 were collected by entities not regulated by FERC. These utilities are not subject to refund orders and would be exempt from price caps. Not surprisingly, some of these utilities are advocates of price caps that would apply only to others.

The losers, of course, would be buyers that cannot purchase electricity from an entity subject to the price cap that must resort to the unregulated market where prices will be extremely high.

Fourth, the creation of two electricity markets recalls the days of natural gas price controls—with "old gas" and "new gas." Prices in the two markets will diverge sharply, with prices in the unregulated market rising higher than existing levels. A buyer that needed more power would obviously look first to the market subject to price caps. However, if the buyer could not purchase power in the capped market, he would have to resort to the uncapped market, and pay even higher prices than current market levels. Since electricity is a fungible commodity, some unscrupulous parties would take advantage of the split markets and sell capped electricity at market-based prices, as occurred under oil price controls.

Some advocates of cost-based price caps have proposed exempting new generation from the cap, which implicitly concedes that price caps discourage investment in new generation. A more practical concern, however, is that this scheme would also fail because of the fungible nature of electricity.

Although FERC lacks authority over the Federal power marketing administrations, the Secretary of Energy has authority to impose a cost-based price cap on the Federal power marketing administrations. Such a step would be highly risky. A cost-based price cap would reduce Bonneville's ability to generate revenue through seasonal surplus sales outside the region, since Bonneville would be forced to sell electricity at a rate far below market levels, foregoing revenues that could have been used to defray Bonneville costs and lower rates charged to preference customers.

At the same time, Bonneville must purchase power at certain times of the year. There is no reason to assume that Bonneville will be fortunate enough to purchase power from only those entities subject to the price cap, and Bonneville may well have no choice but to purchase power at extremely high prices from nonjurisdictional entities. Cost-based price caps would thus put Bonneville in a position where it also sells low and buys high, and could force Bonneville to raise wholesale rates charged to regional customers.

The only way to apply price caps to all generation in the West is to amend Federal law and grant FERC authority to set rates for wholesale power sales by State and municipal utilities and rural electric cooperatives. However, doing so would be inconsistent with nearly 70 years of Federal electricity regulation. FERC has never had authority over these sales, and any such proposal would be opposed by many in the West, including presumably members of this Committee. I certainly would not support such a proposal.

These are the reasons for the Administration's opposition to imposition of cost-based price caps in the West. The Administration is not alone in its opposition to price caps. Last month, eight of the eleven Western governors sent me a letter expressing opposition to price caps. In that letter, the eight governors stated "caps will serve as a severe disincentive to those entities considering the construction of new electric generation, at precisely the time all of us—and particularly California—are in need of added plant construction."

By contrast, advocates of price controls have failed to indicate how price caps would increase supply, decrease demand, or prevent blackouts this year.

In that price controls and power shortages are inversely related, the ultimate question thus becomes whether our goal is to control prices or lessen the frequency of blackouts. This Administration believes our responsibility is to help minimize electricity shortages and the blackouts and the economic and public health and safety problems such shortages produce. Therefore, we do not favor price controls.

Regrettably, our well-founded opposition to price caps has been claimed by some to suggest the Administration either does not care about California and the West, or is doing nothing to address the problem. This is simply untrue. One day after being sworn into office, the President directed me to call Governor Davis to discuss the crisis and ask how we could help address the power shortages. Three days after taking office, at Governor Davis' request, we extended the emergency electricity and gas orders to give California time to enact reform legislation aimed at maintaining electricity supplies. Last month, also at the request of Governor Davis, President Bush issued an executive order directing Federal agencies to expedite permits relating to construction of new power plants in California. The U.S. Environmental Protection Agency has issued air permits for three power plants in the past month. President Bush and I have engaged in discussions with the Government of Mexico about increasing electricity imports from Mexico. Last week, at the behest of Governor Davis, I sent a letter to FERC asking that the agency act on his request for an extension of the waiver for qualifying facilities from certain fuel requirements. In response to a request by the State of California, the U.S. Environmental Protection Agency has provided other assistance, clarifying rules relating to operation of backup generators. And FERC recently required suppliers who charged unjust and unreasonable rates to refund those payments to California buyers, as provided by the Federal Power Act. We will continue to work with California and the West to develop effective solutions to this crisis.

In short, the only action the Administration has opposed is price caps.

LEGISLATIVE PROPOSALS

I would like to offer some comments on the legislation that are the subject of this hearing. All of these bills provide for imposition of cost-based rate caps in California and the West, so the general arguments against price caps detailed above apply to all four proposals. Following are our views on the major provisions of these bills:

S. 26

This bill, introduced by Senator Feinstein, would amend the Department of Energy Organization Act to compel the Secretary of Energy to impose price caps on wholesale power sales in the Western Systems Coordinating Council by jurisdictional entities whenever FERC or the Department make certain findings, although the findings the two agencies can make to trigger price caps are entirely different. The Western Systems Coordinating Council is a region composed of eleven Western States (Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming), Baja California, and western Canadian provinces that share an interconnected transmission system.

In effect, the bill directs the Department to take over FERC's ratemaking role, although the Department has no capacity to discharge FERC's responsibilities. Unlike FERC, the Department does not have expertise in ratemaking.

The standards used in S. 26 are unclear. The bill compels the Secretary of Energy to impose price caps whenever he determines rates exceed marginal costs "by a significant amount or for a significant length of time" and continued existence of such rates "threatens public health and safety or the economy of any State or region" and FERC "has otherwise failed to act to improve the situation." None of these terms are defined and none have meaning in Federal electricity law.

The bill would diffuse Federal authority over wholesale power sales, giving both FERC and the Department authority to set wholesale power rates. It would be a mistake to bifurcate Federal authority to establish rates under the Federal Power Act. Under S. 26, both FERC and the Department could set price caps, but under very different statutory standards. FERC would retain its discretion under the Federal Power Act to impose price caps if it finds rates are unjust and unreasonable, a standard that has governed Federal rates for wholesale power sales for nearly 70 years. Under S. 26 the Department would have no discretion, but would be compelled to impose price caps if it finds rates exceed marginal costs, either "by a significant amount" or "by a significant length of time." Since rates can be just and reasonable while exceeding marginal costs the situation could arise where FERC determines rates are just and reasonable and declines to impose price caps, the Department agrees with that determination, but concludes rates exceed marginal cost by an insignificant amount but for a "significant length of time." The Department would have no choice but to impose price caps, since S. 26 affords the agency no discretion. Since electricity is traded in both real-time and hour-ahead markets, a "significant length of time" could be a very short period.

For these reasons, the Department opposes S. 26.

S. 80

This legislation, introduced by Senator Boxer, would require FERC to order refunds of rates and charges for wholesale power sales or transmission if it finds such rates or charges are unjust, unreasonable, unduly discriminatory or preferential. The bill significantly expands FERC's authority to order refunds. Under current law, the effective refund date is limited to no earlier than 60 days after the filing of a complaint. S. 80 provides for retroactive refunds extending back two years.

S. 80 also mandates that FERC establish cost-based price caps in the West—and only the West—if it determines that rates charged for wholesale power sales are unjust, unreasonable, unduly discriminatory or preferential. The bill does not expressly grant FERC authority to remove price caps. S. 80 compels FERC to impose treble penalties on any person who violates these new refund and price cap provisions.

S. 80 would significantly discourage investment in new generation in the West. The independent power producers that are building most generation in the U.S. are unlikely to expose themselves to refunds that stretch back as far as two years. In addition, there is significant uncertainty about the duration of price caps. Since the refund and price cap provisions only apply to the eleven States in the Western Systems Coordinating Council, investment in new generation would shift away from those States and towards the rest of the United States and other countries.

Notably, the refund provisions of the bill are limited to jurisdictional entities. Nonjurisdictional entities such as State and municipal utilities, rural electric cooperatives, and Federal power marketing administrations have also sold power at market-based rates. According to FERC, most of the excess power costs that the California Independent System Operator claims were collected in January 2001 were collected by nonjurisdictional entities. To the extent those entities sold power at market-based rates, they received the same rates as jurisdictional entities. However, they would be exempt from both the refund provisions and price caps. Two classes of wholesale power sellers who made sales under same rates are treated very differently under S. 80.

For these reasons, the Department opposes S. 80.

S. 287

This measure, introduced by Senator Feinstein, directs FERC to impose cost-of-service based rates on wholesale power sales by jurisdictional entities in the "western energy market" within 60 days. The term "western energy market" is defined to include the States of Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming.

Under this bill, the Congress would assume FERC's authority under the Federal Power Act to set "just and reasonable" rates. The bill makes a legislative finding that current wholesale power rates are "unjust and unreasonable" and compels FERC to implement a ratemaking decision made by Congress. With all due respect, Congress has no expertise to make ratemaking decisions. If this bill were to be enacted, we would find ourselves on a slippery slope. Decisions regarding rates would be made in a political environment by a political body, not by an independent regulatory commission that relies on nearly 70 years of experience, is guided by a statute whose meaning is well-understood, and whose decisions are subject to judicial review.

S. 287 will significantly discourage investment in new generation in the West at a time when it is most needed. The duration of the price caps is uncertain, and may be more permanent than temporary. The fact that price caps only apply to the West will likely encourage investment in new generation to shift from the West to other regions of the U.S. and other countries. Moreover, the fact that price caps would apply to only 47 percent of the electricity supply in the West guarantees that price caps will create two electricity markets, distorting the market and driving up prices in the uncapped market even higher than current levels.

For these reasons, the Department opposes S. 287.

Smith Amendment to S. 287

The Smith amendment waives application of price caps imposed by S. 287 on wholesale power sales in States that prohibit public utilities fro m either (1) passing wholesale power costs through to retail consumers or (2) paying for such purchases. Since California has not permitted State-regulated utilities to pass these costs through to retail consumers, the amendment waives price caps on wholesale power sales in California by public utilities. The Smith amendment also prohibits the Department or FERC from ordering electricity and natural gas sales in States that prohibit public utilities from either passing wholesale power costs through to retail consumers or paying for such purchases unless there are guarantees the full purchase price will be paid when due.

The Smith amendment authorizes States in the Western Systems Coordinating Council to prevent public utilities from selling electricity in States that prohibit public utilities from either passing wholesale power costs through to retail consumers or paying for such purchases if a public utility is not meeting electricity demand in its service area. In effect, the amendment authorizes Western States to regulate interstate commerce, a power otherwise reserved to the Congress and the Federal government by the U.S. Constitution. This authorization is inconsistent with nearly 70 years of Federal electricity law.

The Smith amendment reflects the concerns of the Pacific Northwest about the impact that the failure of the California electricity regulatory scheme has had on the region. The impact of this regulatory failure has been felt more in the Pacific Northwest than in California, as a result of the retail rate caps in California. I appreciate these concerns of Senator Smith and his colleagues from the Pacific Northwest.

The Department opposes the Smith amendment, for the reasons stated above.

I appreciate the opportunity to share the Department's views on the legislation, and look forward to responding to your questions.

Senator BINGAMAN. Well, thank you very much for being here.

I think we will have 5-minute rounds of questions, each Senator asking questions for 5 minutes. Let me start.

I take it from your testimony that the bipartisan bill that Senator Feinstein and Senator Smith talked about in their opening statements is something that will not get the support of the administration and is opposed by you in any variation that you can envision.

Secretary ABRAHAM. Mr. Chairman, what I would say is this. I have not, obviously, looked at the new legislation. I heard the report that Senator Smith outlined, and so there seemed to be a lot of components to it. I would not say, without studying it, that every part of the bill would be something we would oppose.

But to the extent, as I have tried to outline in my remarks, that we move in the direction of price controls, then we are going to find ourselves I think in clear opposition to legislation, especially if it is at a time like this where we are trying to deal with shortages that present real immediate crises in terms of blackouts, in terms of resultant economic and other sorts of consequences. That is our view.

Senator BINGAMAN. Let me ask about the real immediate crises that you are referring to. This idea that we are going to resolve this or to some extent resolve it by increasing electricity imports from Mexico. I do not know. I have not made a real study of it, but that is not a solution to an immediate problem, is it? Maybe long term there is some benefit we could gain from increasing imports from Mexico, but there is no infrastructure to accomplish that at the current time.

Secretary ABRAHAM. Actually it is interesting, Mr. Chairman. Right now in the State of California, as I outlined, we are dealing with an immediate challenge for the summer of trying to address an approximately 5,000 megawatt differential between projected peak demand and supply. Every megawatt counts in that kind of setting, or else we will find ourselves with the sort of rolling blackout projections coming through that I mentioned in my statement.

Last week at a hemispheric energy ministers conference in Mexico, I followed up earlier discussions which we have had with the Mexican Government about the possibility, over the next 6 to 9 months, of increasing the possible imports of power generation, electricity generation, from facilities in Baja. The Mexicans and our administration feel there is actually a very significant possibility of increases.

The biggest problem we have with respect to infrastructure is on our side of the border between the border and San Diego where right now we cannot bring very much power beyond what is currently being sent. But there is the potential for some increase. Right now we are looking for every possible way that we can provide assistance to increase California's capabilities for the summer. So, in fact, there is that possibility for the next 6 months that we would see increases.

Senator BINGAMAN. I guess what I am still unclear on is, if the Feinstein and Smith legislation is unacceptable and all of the other proposals that have been developed here are unacceptable, what is the solution that the administration offers for this problem of a $45 million a day cost being charged to the treasury of California? I do not see that coming to an end. If anything, as we get into the summer and electricity use increases, I would expect that the crisis could worsen, and I do not see any solution being offered to deal with it.

Secretary ABRAHAM. Mr. Chairman, let me say this. There are two issues here. As I said in my testimony, I am afraid we have diverted attention away from what I believe to be and what the administration believes to be the central crisis facing California this summer, which is people without power at periods of time when this would have significant lifestyle impact, significant impact in terms of the potential health of residents of the State, impact on the economy of California. That is what we are trying to work on primarily.

Now, I am not in any way suggesting we do not care about higher prices. We do. I believe the action which was taken by FERC last week in its decision to follow up on earlier decisions it had made with respect to the reasonableness and the justness of prices being charged was an important step within the context of Federal actions that can be taken about prices.

But our primary goal right now is to try to make sure that California does not start a wave of blackouts that could reach beyond its borders. What we are doing in that respect, as I outlined, is a variety of things we have been working with the Governor of California on to try to address either an increase in supply or a decrease in demand. I am not saying that people in California do not want lower energy costs, but I know that for sure they do not want to be sitting this summer without electricity at all, and our goal is trying to avoid that as the primary public interest responsibility of this administration.

Senator BINGAMAN. My time is expired. Mr. Chairman, it is your turn I guess.

The CHAIRMAN [presiding]. Thank you, Senator Bingaman.

Mr. Secretary, are you familiar with the situation in Pennsylvania where they have wholesale caps, retail caps, but they are quite high? So, there is a lot of flexibility in there. It is my understanding that in their deregulation plan, they made sure that there was plenty of supply within the State of Pennsylvania before they tied into this. So, unlike California where I understand about 25 percent of the power comes from outside the State, they have a situation that seems to be working, at least in the realm of price caps on wholesale and retail. Is there an application for that concept that would be workable in your opinion?

Secretary ABRAHAM. Well, as I indicated in my opening statement, there has been a soft price cap in California. There was throughout the year 2000. Every time it was brought down, it was allegedly going to lead to lower prices. The average price for electricity actually went up, even as the price cap was reduced.

At the end of the day, the biggest challenge, as I said in my comments, that California faces I think is the decision that was made that did not permit the California utilities to have an ability to diversify the means by which they acquired power which they had to purchase beyond that which they generated themselves. When last summer they had the opportunity to enter into long-term contracts, as I mentioned, for instance, one with Duke power at $55 per megawatt-hour, they were in a situation where they would have been paying a price lower than that which the Governor of California today is able to pay for long-term contracts. Instead, they were forced to buy all of their wholesale power on the spot market without sufficient generation within the State to be able to keep prices under control. But the real escalation in the prices was, in large measure, a result of the unique limitations that were placed on California's utilities with respect to the purchase of power.

The CHAIRMAN. Now, let us follow that through a little bit because, as Senator Bingaman suggested, what we want is a solution, and the long-term solution sought, obviously, is more power availability within the State of California as opposed to outside the State of California. Now that is, of course, a decision that Californians should make as to where they want to get their power. But if they are dependent on outside the State, unless they have long-term contracts, they have some real exposure on price spiraling, which they have already experienced rather dramatically.

My question to you though, is, is there enough available power outside of California that would come in if, if you will pardon the bottom line expression, they were assured they were going to get paid? Right now we have got a difficult time understanding the situation in California because they have not passed on the true cost of that peaking power to the consumer. It has been first the capital of the three major utilities that have basically seen their capital base exhausted, and now it is a combination of loans and bonds that the State is prepared to guarantee.

The question is, of course, is the State going to bear that responsibility, or ultimately are they going to pass it on to the consumer, or is there any difference really between the consumer and the taxpayer? It may be politically a little easier to finesse it off to the taxpayer than the consumer.

But we are looking at trying to address California's need to get through this crisis, and I am wondering what role you might recommend of FERC or whatever agency to ensure that the outside power that has to supply California until they can generate more capacity within the State would come in and what assurances do they need from the standpoint of getting payment? Because when you order payment, what does that really mean? Is that an obligation of the Federal Government ultimately if California ratepayers do not pay or the State of California does not pay the producers of that power? Whose obligation is it?

So, we have got everybody kind of drifting around here trying to look for a solution, but if there is enough power out there to supply California during this interim and they get assurance that they are going to pay for it and the representatives from California know that their consumers are not going to be gouged by necessarily peaking prices, we ought to be able to work through this thing.

Secretary ABRAHAM. Well, Mr. Chairman, we are working with the State of California, as I indicated in my testimony. I called the Governor of California on the Sunday after the inaugural to find out what immediate things we could do. I believe you will recall that one of those actions, which I also mentioned, was to extend for 2 weeks the orders that were in place with respect to the sale of electricity, natural gas because Governor Davis indicated that if he had those 2 weeks and Senator Feinstein and others who talked to me about that indicated that that would give them time to get the State in a position to begin buying on long-term contracts to have the whole faith and credit, if you would, of the State behind the purchases so that out-of-State sellers would have the confidence and assurance they could make those sales.

We have since then worked with the Governor on a variety of other issues that relate to expediting the permitting processes with respect to new power generation to try to find additional sources.

The Governor I know is trying to initiate a variety of conservation measures. Senator Feinstein recently wrote to me with regard to the issue of conservation as it might affect the Federal Government, and the fact that quite a significant amount of Federal Government activity goes on in the State of California at our facilities. We are looking into that as another way to try to make the supply level that will be available at peak points this summer meet the demands that are anticipated.

I cannot tell you today, as I indicated in my testimony, that we are at the point where we can guarantee that there will not be blackouts. There still is a gap. But if the various actions that the Governor is taking are all successful, then that gap can be closed.

The CHAIRMAN. Along with FERC.

Secretary ABRAHAM. Yes, FERC has played a role. In fact, FERC made several decisions last week, which I suspect Chairman Hébert will explain in greater detail, that related both to the prices that had previously been charged in the month of January. I suspect and understand there will be another ruling with respect to prices that were charged in December.

The one thing that I would just note also, because it was touched on by others and in my testimony as well—I believe you also mentioned it—is that many of the very entities which we do not have jurisdiction over are responsible for some of the most excessive charges that have recently been outlined in FERC's rulings. Now, those are State entities.

It would seem to me that as we talk about what the Federal Government should do, it has at least been interesting guidance to me that no efforts have been undertaken to address any changes with respect to the pricing policies of those entities. I am not recommending that. I think it would have the same negative effect to the extent that I have outlined price controls' effects can be. I am just saying I think we need to look at this in a broad context and understand what the Federal Government role can be and what it cannot be.

The CHAIRMAN. But the implication is the power is out there if there is some degree of certainty that they are going to get paid.

Secretary ABRAHAM. We are working with California. I again do not want to make any assertion today that there will not be rolling blackouts this summer. I indicated the difference that exists as we project it today. I saw indications in the California press this morning, in fact, that there may have been an underestimation of the magnitude of the delta between supply and demand. We will continue to monitor it very closely.

The CHAIRMAN. Thank you very much.

In the order of attendance, Senator Craig.

Senator CRAIG. Well, Mr. Chairman, thank you.

Mr. Secretary, first of all, let me congratulate you for the work you have done to come up to speed on this issue very rapidly. Obviously, by your testimony today, you have demonstrated your willingness to do so by the very facts that you put forward and the knowledge you are displaying on this situation.

I am not going to ask a question. I am going to make a statement. You may choose to respond to it.

First of all, I agree if we create an artificial market, we will send the wrong signals without doubt. It has happened in the past. You have cited those situations, and clearly the greatest example is now the catastrophe facing California.

In my State of Idaho, a week ago I suggested to its citizens that they may have to turn off their air conditioners this summer, except for those elderly who truly need a cooler environment in which to live. The reason that message might be heard in Idaho is because most citizens are going to be looking at 25 to 35 percent rate increases, and they can correspondingly react by saying, yes, if I do that, I may save myself some money. Tragically enough in California, that same suggestion probably would not follow through. It will follow through in Oregon if a variety of options are given and citizens are allowed to see how they can effectively conserve and lower or at least sustain the cost of their power bill as prices go up. But again, in a false market, those kinds of signals mean little to nothing, especially if you do not have to make those kinds of choices.

Idaho is not unlike Washington, and we heard those figures this morning. We are going to hear from Governor Locke, who was on national television this morning standing in a middle of a dry lake. There are many dry or drying-up reservoirs in the State of Idaho. Our watershed is at 38 to 50 percent of normal. Our utility people are talking about the rolling brownouts of California being the rolling brownouts of Idaho. And yet, we have got to retain a stable power supply, a quality power supply for some of our industry that cannot afford to shut down or turn off or intermittently bring themselves on line.

If we work together, we can get through this summer, but working together does not mean to send a false signal to the market.

Clearly, our utilities are hustling now to try to see where they can bring additional energy on line in the future. But in the immediate, cooperative actions on the part of both the consumer and the producer are going to have to be, in large part, I believe some of the solution we deal with, Mr. Secretary.

But I would suggest for those of us in the Pacific Northwest—and you have heard from Senator Smith this morning—one of our major players is Bonneville, of course. We will sit with you very quickly to see where we can offer them optimum flexibility to deal with the market. They are doing a reasonable job now as it relates to market pricing and how they handle it and how they respond and what consumer has flexibility to go off line to allow greater use of that resource somewhere else. That will affect Oregon, Washington, Idaho, and part of Montana.

But I do agree with you that to suggest that we just simply fix the market now by freezing the market or shoving it down does not a message send to produce and to solve a problem. So, thank you very much for what I think is an important and direct statement in that regard.

Also, let me thank you and the President for being bold and correcting or clarifying a point that is so essential as it relates to CO_2 and how we deal with that emission. We cannot continue to send false signals to the market. The market deserves stability of decision making at the Federal level. They deserve to know where this Congress and this President will go, as it relates to Federal regulations, so they can adjust and adapt appropriately to it. I think that statement yesterday was key toward heading us in that direction. It is important that the country understand that we are truly, as I think the Senator from Nebraska said, in an energy crisis of substantial proportion, and if we fail to deal with it responsibly, we will fail our country and our country will fail.

Thank you very much, Mr. Secretary.

The CHAIRMAN. Thank you, Senator Craig.

Now we will hear from and be enlightened by the Senator from California, whom we are very pleased to have on the committee. Senator Feinstein.

Senator FEINSTEIN. Thank you very much. Thanks, Mr. Chairman.

Mr. Secretary. I was really surprised by the ideologic hardness of your statement. I must tell you that.

I happen to agree with you that we are going to be about 5,000 megawatts short in California this summer. It is enough power for 5 million homes. It is a lot of shortness.

How do we keep prices down this summer? You addressed supply and demand issues mostly long term. My question is, what do we do right now?

California, as you know, is expediting permits, is expediting peaker plants, is moving as rapidly as it can to build additional power sources. The 5,000 megawatt shortfall is not going to be the only shortfall. They are going to be charging $5,000 a megawatt this summer. What does California do about that if it is not going to get any help to provide that stability and reliability over that period of time?

Secretary ABRAHAM. Let me begin by saying that our position is not a hard ideological position. It is a common sense position I believe.

Let me tell you what I do not think we should do. I do not think that we should impose through FERC or the Federal Government or through congressional action, in the form of a bill that simply mandates it, the kinds of price controls that will make the delta between supply and demand worse. And that is exactly what I think will happen. If we tell people who generate power in Canada that there is going to be a price cap on what they can sell that power for in the United States, then they will not sell it here and your summer differential between supply and demand will get worse. So, then you will be back and we will all be back here talking about what do we say to the people who now are subject to even more energy shortages that we currently contemplate.

Senator FEINSTEIN. But you are sending a signal that it is okay to charge $5,000 a megawatt-hour. We know they charged as much as $3,000 in the past.

Secretary ABRAHAM. Actually I believe the signal that was sent last Friday by FERC is a signal that you cannot charge unjust and excessive rates. I think that as people realize that they are going to be, in fact, forced to respond to FERC orders and to refund those rates that are above market level, that they in fact will respond accordingly.

Now, again, this administration is not for unjust and unreasonable and excessive rates. In fact, we have authority through FERC to address that. They did that last week with respect to January. They will be doing it again, I assume fairly soon, although Chairman Hébert's testimony will probably comment on this more specifically, with respect to December. That is the way to address prices that are excessive and unreasonable.

But in my view to take an action that places an artificial cap in place is going to cause the shortage problem this summer to get worse. Moreover, it is going to send a signal, I think, with respect to new generation that is going to make it much harder for California and the rest of the West to encourage people to develop new generation in that region. Companies who build generation have a choice. They do not have to build it in the West. They can build it anywhere they want, and they are more likely, I would think, to build it in areas where they believe they are not going to be, after they have made major investments, significant changes in policy with regard to what the likely return on their investment is going to be.

At the same time, I would just say this. If we impose a price control that fails to work effectively with respect to the demand side of the equation, right when the goal of the Governor of California is to reduce demand, then I think again you are likely to see the differences between supply and demand even greater at exactly the time the greatest threat is posed to the people of your State.

Senator FEINSTEIN. Let me just say this. The Governor of California is also asking for the help. He is asking for the help to just create a reliable and stable situation for a short period of time so that California can get through this crisis.

Let me put it another way.

Secretary ABRAHAM. Can I just comment on that, though? The Governor of California and I have had a number of meetings and conversations. The first and foremost thing that he has made clear to us I believe that he wishes help with is to try to meet the crisis he sees forthcoming this summer with regard to shortages, blackouts, and the resultant economic and security challenges they pose. That is our top priority. I am not in any way suggesting high prices are a good thing. What I am saying is that our first priority, according to what your Governor have indicated to me, is to try to address the shortages and the blackouts, because I think they would be catastrophic.

I am sorry to have interrupted, but I did want to clarify that.

Senator FEINSTEIN. Let me just put it in another way. I would agree with you that the California Public Utilities Commission was wrong to prohibit long-term contracts. Let me give you an example. In November, Duke was offering power at $50 to $55 for 5 years. Today, 3 months later, the State has had to sign contracts for double that amount and double that length of time. Why in a span of 3 months has this changed so dramatically?

Secretary ABRAHAM. Well, again, I think that is a long-term contract. I do not know whether they were identical contracts, and I am frankly going to have to defer to the experts at FERC to try to distinguish that.

But let me point out just a simple fact which you made. If the State of California had simply allowed its utilities to purchase either last summer or fall contracts at the $55 per hour rate, we would be in a whole different situation. We would not be here today. Again, the question becomes after these consistent decisions that were made that have precipitated and forced the purchase of wholesale power on the spot market that got us into this situation, it is not going to be that easy to get out of it under any condition.

I would just urge everybody to consider what the first challenge we have is. The question is not how do we undo bad contracts that were entered into last year. It ought to be how do we protect the citizens of California this summer from the blackouts and the shortages.

Senator FEINSTEIN. Let me just say one thing.

Secretary ABRAHAM. Maybe that is not important to others. To me it seems to be the primary consideration.

Senator FEINSTEIN. Just one quick comment. I agree with you it is the State's problem to resolve its bad law. I agree with you that the market should be able to fluctuate freely. All we are asking for is help to prevent price gouging.

Secretary ABRAHAM. And I share that view.

Senator FEINSTEIN. And it is taking place.

Secretary ABRAHAM. Senator, I share that view and I believe that FERC has the responsibility and has last Friday demonstrated the willingness to address excessive and unjust prices. That is the proper way to do it.

I do not think the right way to do it is to impose price caps that will exacerbate the problems the State faces. I am telling you, I think this summer, if California has worse blackouts than currently projected, that that would have been a disservice to the people of your State. If the rest of the West finds the Canadian energy providers refusing to sell at the same levels because of price caps and the shortages that are projected in other States are increased because of that, I think that is, in my judgment, an irresponsible carrying out of our public responsibilities here.

So, I just think we have to look at these in terms of priorities. To me our first priority to the American people ought to be to try to ensure that there is a reliable availability of energy this summer when we know there is a crisis for a variety of factors from the climate issues to the issues that relate to supply and demand differentials.

Senator BINGAMAN [presiding]. Senator Smith.

Senator SMITH. Spence, I understand supply and demand very well from many years in a commodity business, but I want to associate myself with Senator Feinstein's questions because I am afraid this summer we are going to be in the middle of a dry lake bed explaining to very angry farmers and homeowners and former factory workers the lessons of supply and demand. I do not think they are going to listen. I think we need to increase our effort to help.

I do not want to send the wrong signals to the marketplace to produce or to conserve. I do not want to send the wrong signals, but I will tell you the wrong signal is a recession. Nobody is going to be investing in an environment when you have not just energy rates going up, but unemployment rates going up.

Let me go to where Senator Feinstein was questioning you as to the ruling that FERC issued in January. It set the just and reasonable rate at $273 per megawatt, but I think you are saying that that will discourage investment. I do not think that will discourage investment. Can we not do that?

We heard lots of economists in an earlier hearing saying that short-term temporary caps at a high enough rate would not retard investment. All I am saying is I think we need to give you more authority and I think you need to use it to mitigate a catastrophe.

The *Wall Street Journal* says Washington State is going to lose 43,000 jobs. My State will not be far behind. I do not want to be seen as giving economics lessons when we have our States heading southward in every direction in every economic indicator.

Can you help me a little more?

Secretary ABRAHAM. Well, of course. Let me just say this. First of all, I know that people who are concerned about economic consequences recognize the relationship between blackouts and economic recessions very clearly. I think that it would be important and I recommend that the members of this committee make it very clear to their constituents what we are trying to make clear, which is that our first goal is to prevent them from seeing their businesses close down because there is no electricity, because we see Canadian imports disappear, because we find, because of price caps, in the long-term sense there is not enough generation being built in your region because people decide they ought to build it in the Southeast.

Now, I am concerned about that. In my judgment there could be immediate economic consequences if a price caps regime is placed in effect that makes the summer's shortages even worse. In my view that should be the primary goal of all of our efforts here, to deal with the summer crisis in terms of power shortages.

Now, what do we do about prices? That is a separate issue. It is not unrelated, but it is a different crisis than the crisis that I think should occupy our primary focus.

With regard to prices, I believe FERC acted properly last week in the decision that it rendered, and I believe it has an ongoing duty to monitor prices to determine if they are unjust and unreasonable. And we will support that effort. The refunds that will be required under their order with respect to January—and I assume there will probably be some kind of decision, as I have said, made fairly soon with respect to December—will be ones that I think send a very strong signal to those who might try to exploit or take advantage of a situation that we all recognize to be a serious one, that they are not going to be allowed to get away with it.

In my judgment, that is a way to balance the issue of making sure prices that are excessive and unjust are not charged with the separate issue of making sure that the power does not go out. In my view we have got to try to make sure, as we approach this, we do it in a way that balances those two considerations. I do not think you want to say to your constituents: Good news, FERC just ordered a price cap; bad news, you are not going to have power for the whole summer. Now, obviously that is an extreme rendition. But our goal is to try to address the power shortage crisis first and foremost.

Senator SMITH. Spence, I think some of the refund you hope will be there will be there too late for a lot of small businesses and a lot of northwesterners. I think we need to show them we are doing more than I am hearing that we are prepared to do.

Many have already rushed out and criticized President Bush to regulate us into safety. I have not done that. I have waited until I got a signal from a California official that said I understand the central problem in California is a law that is broken and it is broken because it caps the retail rate so there is no conservation signal being sent. If you want to send a lot of signals to conserve, Senator Feinstein has just done that or opened up that possibility whereby California, on a rate they determine, can allocate retail rates that will pass through costs. That will conserve power.

I believe the caps—we are literally talking about 20 months—will not discourage incentive if the rate is put high enough and we can go home to very angry people and say we are helping short term and long term the future is very bright.

But the worst signal in the world, in my opinion, is that we are unwilling to exhaust every measure, overturn every stone to try and find a way to help through this crisis because I think it is going to be very serious.

Secretary ABRAHAM. Senator, as you well know, even before I appeared for my confirmation hearing and since, you and I have had numerous conversations with respect specifically to the Northwest about a variety of issues, especially those that relate to the Bonneville Power Administration. We have had meetings with various folks from the region, some of which you and I both participated in, and our office has, on a regular and ongoing basis, been working with BPA to try to address the rate issues that are confronting it as a consequence of a variety of the factors we have talked about today, the climate issue in particular.

We are doing our best to try to address that. We hope to have a plan which will take into account a number of different kinds of ways of trying to focus on the rate issues that are particularly significant and sensitive to you. And your leadership on that in bring these issues to our attention and making sure we keep focused on them is extremely important.

With respect to the broader issue of price caps, I would only say this. It is our view that, in fact, the signals will be very substantial if we move in a direction that suggests that caps are not only in place, but that a regime now exists that will significantly affect future investment decisions. We are trying to look at it for the summer. We are trying to look at it in terms of how to keep prices under FERC's authority within the just and reasonable category. And we are also trying to see how at BPA we can make changes in terms of policy that will address some of the rate increases projected there. We will do our best.

We may have a difference of opinion on the effect of rate caps. Obviously we do, but it is not because of lack of sensitivity about higher prices.

Senator SMITH. Long term we do not. I agree with you completely. Rate caps are the wrong signal long term. But we have a short-term emergency. And if California is willing, under a Federal directive, to change its law, we will conserve more and we will still incentivize producing more, and that is what we have to do. Anything less than that is going to leave the West higher and dryer than it has ever been before.

Senator BINGAMAN. Senator Cantwell.

Senator CANTWELL. Thank you, Senator Bingaman.

I too would like to join my colleagues in encouraging the administration to think more openly about this policy. We seem to be trying to draw a conclusion here today that somehow, by not ensuring that FERC does its job on reasonable rates, that the opportunity to make sure that Californians or others are not left in the dark this summer, that that is the flag that we are waving, when in fact the reality is, with triple digit increases, there will be people in the Northwest sitting in the dark. There will be aluminum facilities that will be shut down. There will be small businesses that will be shut down. So, while we are talking about protecting people from blackouts, the reality of inaction here is going to cost us those same consequences.

I would like to ask a couple of specific questions, and I appreciate your attention and newness to the job. But understanding where the administration is as it relates to the Northwest on a couple of different policies.

First of all, you mentioned the FERC's decision to order power producers to refund millions to utilities. That was directed specifically at California. The Northwest and Washington, even though some of those same providers do business in Washington, was not included. What about including those refunds to the Northwest?

Secretary ABRAHAM. This would be a decision that I think ought to be, obviously, directed at the next witness here who is the Chairman of the Federal Energy Regulatory Commission.

Senator CANTWELL. Do you support including Washington State, Oregon?

Secretary ABRAHAM. I believe that there is a process by which any allegation of unjust rates can be addressed by FERC, and if there is an allegation that that has taken place in any region, I believe that there is a mechanism in place for that to be judged by the agency. If they concluded that with respect to Washington, then they are empowered, as I understand it, to make similar declarations there.

I am not sure what the process has been that has led to the decisions so far in terms of whether or not Washington has sought an appeal or whether or not this was exclusively brought to their attention by the California ISO. I honestly do not know the process enough to tell you whether that is why it was exclusively limited to that one State.

Senator CANTWELL. We will certainly ask the question when he comes up but would seek an opinion from the administration on that as well.

The second issue, you mentioned the Canadians a couple of times. Are you currently engaged in the supply side with the Canadian Government on helping the Northwest on supply?

Secretary ABRAHAM. As a matter of fact, last week in Mexico City at the hemispheric energy ministers meeting, we had the first of what I suspect will be an ongoing and growing trilateral set of meetings with Mexico, Canada, and the United States to discuss a North American energy strategy or initiative. We hope to work more closely with the Canadian and the Mexican Governments with regard to broad continental energy challenges.

Prior to that, I actually had a separate bilateral set of meetings with my counterpart, Ralph Godale, who is the energy minister for Canada. We are in active discussions in terms of future opportunities to expand the relationship between the two countries on a bilateral basis.

Senator CANTWELL. But those are long-term discussions? Nothing for the immediate——

Secretary ABRAHAM. No.

Senator CANTWELL. Do you expect any results out of that on the supply side in the next 6 to 7 months?

Secretary ABRAHAM. Because of the nature of the history of the relationships between Canada and the United States, there have not been quite as many immediate issues as we have had in terms of working with our counterparts in Mexico in terms of power exportation issues. But we intend to continue those discussions with both Canada and Mexico. I am not prepared today to make any prediction with respect to a Canadian/American change in terms of levels of support. That is something still in discussion.

Senator CANTWELL. The third question, if I can. I am running out of time here. The picture of our citizens from Washington and Oregon and other parts of the Northwest standing in dry lakes has been conjured up a couple of times here. I guess the fact that we are facing these triple digit increases brings, I think, a very important point to be put on the table, and that is that sometime this spring we will be facing the choice about what to do about the shortfall in water supply as it relates to the biological opinions about salmon. What is the administration's position on what we should do and options?

Secretary ABRAHAM. At this point, as we examine a variety of options which confront us with regard to BPA, we are still in the policy development stage. We, I think, have made it very clear that the administration does not support the breaching of dams as a solution. We do not believe in foregoing treasury payments from BPA as a way of solving the problem either because I think that would lead to serious reconsideration of the relationship. And we do not support at this time some of the proposals we have had to somehow turn Bonneville into a regional facility.

But we are looking at a variety of other options that range from voluntary conservation, to purchasing load reductions, to other sorts of things, and the use of fish mitigation credits as we try to develop a policy. But when we have a more concrete proposal to offer, we will be submitting it.

Senator CANTWELL. Mr. Chairman, I know my time has run out, but it would just like to leave the point that I think some of these questions show that the problems for the Northwest, without immediate action here, only get worse. So, we are trying to work in a constructive way to give relief to the individuals, businesses, and to the environment in the Northwest.

I would also, at some other point in time, like to ask you about the DOE's proposed cutting on the energy efficiency program and what we need to do to make sure that that investment level gets restored.

Secretary ABRAHAM. I am confident that this committee will have a number of budget related questions to pose to me when we finally release our specific budget information in the next couple of weeks, and I will be glad to try to address all of them.

Senator CANTWELL. Thank you, Mr. Chairman.

The CHAIRMAN [presiding]. Thank you, Senator Cantwell.

Senator Thomas.

Senator THOMAS. Thank you, Mr. Chairman. I know there are many witnesses remaining.

One of the important things if we are to get support for the California idea of some of these kinds of things is I think we need to be more assured that California is doing some of the things that clearly need to be done. I must tell you I am not certain. For instance, the powerplants that are now down could be brought back into service with some repairs and some maintenance. Do you know, is that being done?

Secretary ABRAHAM. Senator, I do not know specifically what might be going on at every facility. I know, as I commented earlier, that Governor Davis understands or has at least reflected in statements he has made that the principal responsibilities with respect to getting California's energy problems resolved lie in California. They are now targeting new generation and conservation as part of that solution. But I am not sure, and I would have to get back to you.

Senator THOMAS. I understand. But I think we need to be a little more assured, if we are going to make some changes and put some impact on some of the rest of us that will be impacted. Implementing emergency demand for reduction in use. Have they done that? I do not know the answer. I do not know what has been done on the retail pricing for sure.

So, I am sympathetic to the problem. I know that it is a very difficult one, and obviously the answer is somewhat over time. But I tell you what. Before I am willing to go ahead with a great deal of support for doing things there, I want some assurance that they are going to do some of the things, that clearly should not have been done in the first place, to find a remedy for those kinds of things. I will not take more time, but I can tell you that I am interested in that response.

Thank you.

The CHAIRMAN. If I may, before I call on Senator Domenici. We got into a situation in the last administration where there were six or seven coal-fired plants that EPA alleged the life was being extended rather than the position of the operators who claimed that they were simply maintaining the plant up to the level of permitting which was required. EPA indicated that they were prepared to file criminal charges against the management if these plants were allowed to continue. Now, I do not know the factual information, but clearly when you are faced with that kind of a threat, it becomes a full employment act for many lawyers to make a determination of was the maintenance done to simply extend the life of the plant or simply to operate.

It seems to me, Mr. Secretary, that these are some areas that we need some enlightenment on because if, indeed, those plants have a capability of producing energy and are not, we ought to be able to settle that differential because they clearly can make a significant difference.

We have seen the administration's position on CO_2 which is pretty definitive. They said it was not a pollutant. Period. I think those of us in the Northwest would encourage the rest of you to go out and grow some trees because that helps too.

Senator Domenici.

Senator DOMENICI. Mr. Secretary, it is good to be with you. First of all, I want to compliment you. I always knew that you were a quick learner and certainly you have learned in this field in enormous leaps. Your statement today is very interesting in terms of its comprehensive nature, and I compliment you.

What I want to talk about here today is I want to tell you a little history. To the Senator from California, I would like to tell you I have been here long enough to where the price of natural gas was 7 cents a million cubic feet. You are talking about $60. Well, that was because the entire natural gas fields of America in production were regulated by a strange interpretation of a case that held that the National Government had authority to regulate, so a group regulated it. We did not have any natural gas, literally none. A trickle.

We started deregulating. The first bill we did we deregulated only new gas, deep gas, and gas in wells that you could easily determine if you put another well in, you do not hurt anything. We eventually deregulated.

The United States does not know how many million cubic feet of gas we have it is so many. But, Mr. Secretary, something is wrong when a producer in New Mexico gets $5 and the gas is sold to somebody at $60. Somebody has to find out what is happening. Since I am not going to be here for the FERC Chairman, I am going to ask the chairman if he could ask him to study that and give us a report as quickly as he can on what is happening.

The CHAIRMAN. Yes.

Senator DOMENICI. Now, this is not just a California problem. So you will know, Mr. Secretary, in Senator Bingaman's and my State, we have 990 workers, the most highly paid workers in one part of New Mexico, working in a copper mine. They may be laid off within the next month because their cost of electricity went from 3 to 4 cents to 21 to 22 cents, and they are not sure they can produce copper and pay the workers. There is another one close at hand with similar proportions. Now, that is on the one hand.

On the other hand, the Senator from California, there are two major, major powerplants being considered in the State of New Mexico. One is already completed and New Mexico has given the go-ahead in a little town of Deming, New Mexico. That is $250 million to $300 million. Over on the east side of the State in the city of Clovis, they are looking at another one and it is bigger.

I get the rumble that the companies that are doing that have every option to go to California, but they are not going to go to California because I would suggest to you that there are still regulations and rules that inhibit the investment as it is being made in other States that have less of that. And that may be California's desire. When you talked to me, it was not. You said we want to build new powerplants in California.

I suggest we ought to find out the reality of it. Is California today really willing, by its regulatory—and this will not solve your temporary problem. I know you would immediately say, Senator, that will not help that. I know that. But I think we ought to find out. The State of California went 12 years without a powerplant, and while demand went up, it peaked out. I think we ought to know as a Nation if they are really ready to let natural gas—that is the simplest one. It is pure white. Are they really letting them come in or are they going to expect powerplants to be built around the country and go in there because they want to keep rules that are harder than other States have and they are still complying with the ambient air standards of America?

So, those are my two observations. One, how come the producer is getting so little and the market is getting so much? Somebody ought to follow that gas from the panhandle in New Mexico and Texas or Wyoming and just see what is happening to it. It comes out at $4, $5 from your field. Where does it get to $60? I think that would be an interesting thing for us to find out.

I also want to say to FERC you have to be concerned. Where is the FERC leader sitting? I cannot be here, but you have got to be concerned. If you have some regulatory power, you have got to say there is a number of States getting hit by this because eventually the price of natural gas in California seeps through the system. It does not get there overnight, so the Northeast is not going to get hit with it yet. But New Mexico may because it is close, and eventually that little piece of gas that has mobility to move around in the system, which needs it, is going to feel this extraordinary price that is being paid in California.

Now, I do not have an answer, Mr. Secretary. But I respect your statement and I truly respect your concern that we do not cut off supply and investment and make things worse. But I do suggest for many States it is pretty bad right now, and can everything stay as it is for the next 3 or 4 years while we finally get some natural gas on board? Long term, it may take 10 years to get the supply up. So, I leave that before you. I say that is a problem. I believe everybody understands that is a problem.

If you care to comment, I would very much appreciate it. The Chairman asked for that study and I would certainly hope that you would pay extra attention to the fact that a number of us are going to get hit by it and what is the solution to that.

Thank you, Mr. Chairman. Thank you, Senator Bingaman.

The CHAIRMAN. Thank you very much, Senator Domenici.

Would you care to respond?

Secretary ABRAHAM. It is obviously an area that we will be glad to work together with you on, Senator.

The CHAIRMAN. In deference to the agenda, I would hope that we could conclude our questioning with one round. But as a consequence of the concern of the Senator from California and the Senator from Oregon, I would be prepared to allow them one question, should they wish. Then I would like to move on to the other panel. As you have observed, you have taken much more time than we thought.

I want to commend you for your forthright answers and I think particularly the lack of equivocation, which we have been exposed to from time to time. You have been very responsive and very knowledgeable, recognizing the fact you have been aboard a very short time. So, I must commend you.

Senator Feinstein, do you have in conclusion one question? I am just extending this courtesy to the two of you.

Senator FEINSTEIN. If I may, I would just like to enter into the record the March 9 letter, signed by the three Governors, Governor Davis, Governor Locke, Governor Kitzhaber, essentially asking FERC to help them with the prices.

The CHAIRMAN. It will be entered into the record.

Senator Smith.

Senator SMITH. Mr. Secretary, would you agree with me that the central problem of our current crisis is the retail cap in California?

Secretary ABRAHAM. I believe that the combination of a half-regulated and half-unregulated California market, combined with the decisions that were made to prevent the utilities in California to diversify the way that they obtain that electricity they needed to purchase beyond what they generated themselves—those two factors combined with one last factor, which I talked about, and that is the fact that over the last 5 years, there has been approximately 6,300 megawatts of new demand in California while simultaneously the total generation in the State declined. Those combined in large measure, I think, to precipitate the crisis.

Senator SMITH. I believe Senator Feinstein and I are working on a bill that fixes those short term without hampering the long-term vision that you and President Bush have for energy in the West and throughout the country. I would just invite you to work with us on this and see if there is not something that we cannot do to fix those two issues short term and long term.

Secretary ABRAHAM. Senator, I would just say that since I took this job, I have spent a substantial amount of every single day working on the issues that confront us in California and the rest of the West, and I do not foresee at least any days in the near future, probably the long term either, where we will not have, as part of our agenda, working with you all on these issues.

Senator SMITH. Thank you.

The CHAIRMAN. Thank you very much. I want to thank you again, Mr. Secretary, and wish you a good day. You have got more than a half a day left.

What I would like to do now is call panel 2 and 3 together to expedite our time sequence. That would be the Honorable Gary Locke, Governor of the State of Washington, along with the Honorable Curt Hébert, Chairman of the FERC, and the Honorable Judy Martz, Governor of the State of Montana. We trust we have got a compatible group here that will proceed as they see fit.

I understand that two of the Governors are catching airplanes. I always thought Governors had their own airplanes. But, nevertheless, if they do not, they ought to, at least from the West. Whoever has the tightest schedule, please respond by going first. You drew the straw. Governor Locke, please proceed.

STATEMENT OF HON. GARY LOCKE, GOVERNOR, STATE OF WASHINGTON

Governor LOCKE. Governor Martz indicates that she has her own airplane.

[Laughter.]

The CHAIRMAN. Good for you.

Governor LOCKE. Chairman Murkowski and members of the committee, I want to thank you very much for the opportunity to address you about an issue that is of fundamental concern to the economic health of the State of Washington and, in fact, all the Western States.

The so-called California energy crisis is really a Western United States crisis, with high energy costs causing serious economic harm to citizens, farmers, businesses, schools, universities, as well as local and State governments. We share the same electric grid which enables us to share power but also each other's misfortunes. Now the crisis is hurting irrigators in Arizona, resort hotels in Nevada, industries in Oregon, and homemakers in Idaho.

In Washington alone, Georgia Pacific, a woods product giant, laid off 850 workers just before Christmas. And just a few days ago, a Tacoma chemical company laid off 80 workers and cut production in half. They make chemicals for hospitals and other institutions.

Last summer, I had to invoke emergency powers to help the State's largest cold storage facility remain open and keep over 1,000 workers employed, as well as to protect frozen fish that had been caught in Alaska and vegetables and fruit harvested in our State of Washington.

Public agencies, hospitals, schools are being forced to cut programs, and homeowners and businesses have experienced in our State increases in their electricity bills of up to 75 percent, with more increases expected.

The Bonneville Power Administration has already announced that it will have to raise rates by at least 100 to 200 percent, and many rural co-ops are 100 percent customers of Bonneville Power and will have to pass on those price increases to irrigators, farmers, and food processing plants in eastern Washington. It will cripple the agricultural economy of our State of Washington.

I have seen estimates that merchant powerplant operators are extracting $1.4 billion per month from the Pacific Northwest economy, $1.4 billion that was not extracted just a year ago because just a year ago wholesale power prices were ranging anywhere from $20 to $40 a megawatt-hour. And now they are in excess of $300 to $400 a megawatt-hour, and a few weeks ago or a few months ago were as much as $2,000 a megawatt-hour.

The situation is untenable and simply cannot continue. It cannot continue without permanent damage to the economies of Washington State and, indeed, the other Western States of America. Our crisis is getting worse in Washington, in fact, the Pacific Northwest, because our hydroelectric dams are threatened by one of the worst droughts in Washington State history.

The drought notwithstanding, the Western energy crisis is a Federal problem, and we in our individual States have been doing all that we can to alleviate the crisis. For example, I have directed Washington agencies and local government agencies to reduce their use of consumption by 10 percent, and our State and local agencies have, in fact, taken up the call and have responded.

We have also asked residents and businesses to reduce energy consumption. We received reports that some of our largest utilities from Seattle to Tacoma have, in fact, cut energy consumption by 6 to 10 percent in just 1 month alone.

I have used the emergency powers to allow utilities and industries to operate diesel engines and other temporary generators to produce the electricity they need.

I have reached agreements that allow operators of older peaking plants to run continuously 24 hours a day, 7 days a week, and we have done it with the cooperation of Region 10 of EPA.

And I have asked the legislature to dedicate funding for low income assistance to augment Federal block grants to help people in eastern Washington pay very, very high utility and electricity bills.

We have a legislative package that offers tax incentives for the cogeneration of electricity, as well as tax incentives for the purchasing of energy efficient appliances and lighting.

We have, in fact, over the last several years, sited, permitted both local and State permits for about a half a dozen powerplants which, when completely completed, will produce electricity that will power some 3.5 million households in the State of Washington. And more are in the process of seeking approval.

But the real key to reducing outrageously high energy costs is for the Federal Government to repair the broken wholesale market structure. We need short-term, temporary wholesale price caps, or the western economy will remain in jeopardy.

The FERC's cautious actions have brought no relief to the State of Washington and the Pacific Northwest. Moreover, FERC is relying on market mechanisms to resolve the problem even though it has formally found that the markets are dysfunctional and unable to produce just and reasonable prices for wholesale energy.

I commend President Bush and the administration for its efforts to produce a national energy policy, a policy which will focus on conservation, renewables, tax incentives for renewables, as well as developing more energy supply.

It is a question of supply and demand, and with a growing population, we must have more supply of energy. But we in the West cannot wait 7 to 10 years until new energy sources are discovered and tapped and brought to market. Washington State's economy and the economies of the other Western States must be stabilized and protected now to prevent permanent, irreparable damage, not in 5, not in 7, not in 10 years.

I believe that we must have short-term, temporary price caps so that California can get its energy house in order and so that other States can get more generation on line. I support cost-of-service based rates, cost-of-service based rates that ensure full reimbursement for both direct and indirect costs of producing power, plus an adequate rate of return. Setting the caps high enough will enable producers to recoup their full cost of producing power, whatever it might be, and a sufficiently high rate of return so that it is also an incentive to continue to pursue additional generation plants.

We simply need a time out. We need a time out for California to correct its flawed deregulation scheme, but a time out to allow other Western States to protect their economies and to get their citizens back to work. We hope that the Senate and this committee will act favorably on the legislation that is before it. Thank you

[The prepared statement of Governor Locke follows:]

PREPARED STATEMENT OF HON. GARY LOCKE, GOVERNOR, STATE OF WASHINGTON

Thank you, Chairman Murkowski, and members of the Committee. I am pleased to be here to speak to you today about the energy situation in the Pacific Northwest and the challenges that are facing the citizens and businesses in my state as the result of continued volatility in the wholesale energy markets.

You have heard a great deal about the "California energy crisis." But by now you know that what some still call the "California energy crisis" is really a region-wide energy crisis, with high energy costs impacting citizens, farms and businesses, schools and universities, and state and local governments throughout the western continental United States.

It impacts irrigators in Arizona, resort hotels in Nevada, industries in Oregon, and residential ratepayers in Idaho.

Let me give you some idea of what is happening in Washington State, where wholesale energy prices have gone up from ten to twenty times the prices of a year ago:

- High energy costs have forced several businesses to curtail operations and lay off hundreds of workers. Georgia Pacific laid off 850 workers in Bellingham just before the Christmas holiday. Pioneer, a chemical manufacturer in Tacoma, has curtailed operations by 50 percent and taken steps to lay off 80 employees. Nine of the ten aluminum plants in the Northwest—and thousands of aluminum workers—are now idle. There are many other examples.
- High energy costs are hurting our agricultural sector. Many farmers worry that they won't be able to afford to pay the pumping costs for irrigation. And last summer, high energy prices forced the state's largest cold storage facility, Bellingham Cold Storage, to curtail operations just as peak harvest season was under way for both berries and ocean fish. Only by invoking emergency powers was my office able to secure an affordable power supply to the facility—not only keeping 1,200 employees at the facility on the job but keeping hundreds of ocean fishers and family farms from bankruptcy due to lack of cold storage for their products.

- Public agencies, schools and universities are faced with the possibility of curtailing programs to meet unexpected energy costs that are double or triple the levels of a year ago.
- And utility ratepayers are now facing surcharges as high as 75 percent of their monthly retail power bills. This is not just a problem for residential customers on a tight budget. For many small and medium-size businesses—restaurants, coin-operated laundries, and retail shops—this can be the difference between profitability and bankruptcy. And the continued high costs of wholesale power threatens the very solvency of some of our utilities.

This situation is untenable. The Pacific Northwest is losing as much as $1.4 billion a month due to high wholesale power costs—money flowing out of our economy into the pockets of merchant power plant operators.

Clearly, high energy costs affect not just individual companies, but all the companies with which they do business. Wood products manufacturers worry that they will no longer have a steady supply of sodium hydroxide. Hospitals worry that they no longer have a steady supply of bottled oxygen and nitrogen. Farmers worry that frozen food processors will not be around to purchase their crops.

And it is not just an economic issue. The high cost of wholesale electricity is forcing many businesses and utilities to look at diesel generation as an alternative source of power. While this may help utilities make it through the winter, it carries an environmental price tag of hundreds of tons of particulates polluting our air. And forcing the Bonneville Power Administration to increase generation to make up for the power being withheld from the market damages our fish runs and undermines federally-mandated salmon recovery efforts.

WASHINGTON STATE'S RESPONSE

Unlike other states, Washington declined to deregulate its energy markets. Yet it has been affected by California's flawed experiment in deregulation as well as the federal wholesale deregulation that severed wholesale power generators from utilities' traditional obligation to serve. The problem's created by these market structures are now compounded by the record low rainfall and snowpack this year in the Pacific Northwest, where we are reliant upon hydropower. So while we did not create the problems with the market structure, we are nonetheless forced to respond to them.

In Washington, we are taking several steps at the state level. First, I have called on the citizens and businesses of my state to reduce energy use by 10 percent. That's an ambitious goal, but citizens are responding to my call and we are nearing that target. I have also directed state agencies and local governments to reduce energy use by 10 percent. By reducing demand, we are doing what we can to put downward pressure on price and help utilities from having to purchase power on the high-priced wholesale spot market.

Second, we are taking steps to increase power generation, both long-term and short-term. In January, I declared an energy alert under state law to allow utilities and industries to install and operate temporary generating facilities this winter. We have also reached agreements with our utilities to allow continual operation of older "peaking plants" that are usually limited to a few hundred hours a year. These actions have brought several hundred megawatts of power on-line to address the immediate need for additional power supplies.

Third, we asked the Washington State Legislature to dedicate funding for low income assistance to augment the federal block grants we currently receive. The demand for assistance this year has far outstripped the federal funding available. The Legislature recognized this need when it passed its first bill of the 2001 session last Saturday.

Fourth, we are continuing to site and approve construction of new power plants, just as we have for the past decade. The state and local authorities have already approved power plants that will produce more than 3,200 megawatts of power. Many of these projects are now under construction or ready to break ground. And the state is in the process of reviewing proposals for plants that can generate another 4,000 megawatts. Clearly, we are taking appropriate steps to increase generating capacity in our region.

But there is only so much a state government can do. The key to reining in energy prices is to fix the wholesale market structure. And that's a federal, not a state, matter. Without federal action to bring high energy costs down to just and reasonable levels, the prosperity we have worked so hard to achieve during the past decade could be undermined in a matter of months.

FEDERAL POLICY MUST ENSURE JUST AND REASONABLE WHOLESALE PRICES

I am pleased that President Bush has appointed Vice President Cheney to chair an energy task force, and I hope that the task force will work with western governors as it develops its strategies. However, based on what I read in the press, I am concerned that the administration's response to the energy crisis so far is simply to focus on the exploration and development of new oil and gas supplies in the Arctic and elsewhere.

Such a strategy ignores our immediate problems. It will take several years before that oil and gas will reach consumers in my state. Because we face potential energy shortages this summer and fall, and because our utilities and businesses and citizens continue to face volatile energy prices, it is imperative that the administration and Congress direct their attention to those actions they can take to bring stability to the wholesale energy market as soon as possible.

I have also been disappointed by the lack of action by the Federal Energy Regulatory Commission (FERC), the federal agency charged with overseeing the wholesale energy markets. FERC is required by law to ensure that prices for the wholesale energy are "just and reasonable." On November 1, 2000, and again on December 15, 2000, FERC found that prices for the sale of short-term energy were unjust and unreasonable. It also found that California's wholesale short-term energy markets were severely flawed, and that those flaws provide sellers both the ability and incentive to exercise undue market power.

Yet, FERC's response has been to rely on market mechanisms to solve the problem, even while acknowledging that the markets themselves were dysfunctional and would not by themselves produce just and reasonable prices.

Indeed, last Friday FERC essentially said that any costs at or below $273 per megawatt hour during a Stage 3 alert would be deemed just and reasonable. In my opinion, prices in this range are exorbitant and clearly unjustified. They have no bearing on the costs of energy production—even with today's high natural gas prices—and are more than ten times the costs of wholesale power from those of a year ago.

Moreover, where FERC has imposed modest price caps, they have done so on wholesale power sales in California only, once again ignoring that the problems of high energy costs are a problem affecting the entire western United States.

Frankly, I think FERC has been asking the wrong questions. The issue is not whether we can make energy deregulation work in the long run. The issue is not whether deregulated markets can be improved. The issue is not whether we should have patience during a long transition to deregulation.

The issue—the only issue which FERC should now be addressing—is how to bring wholesale energy prices down now. We can't afford to wait—not a month, not six months, not a year. We need action now.

It is unfortunate that FERC has resisted calls for direct action to bring price stability to the wholesale energy market. Yet with each passing day, the economy of my state and all of the western states continue to suffer as the result of high energy costs. I am hopeful the new members of FERC less trusting of market mechanisms, and will be more open to taking strong actions to address these adverse economic impacts.

I applaud this Committee for considering strong measures to bring stability to the wholesale energy markets in the months to come. I look forward to working with members of the Committee as it moves forward in its deliberations.

The CHAIRMAN. Thank you very much, Governor Locke.

Governor Martz.

STATEMENT OF HON. JUDY MARTZ, GOVERNOR, STATE OF MONTANA

Governor MARTZ. Thank you, Mr. Chairman and members of the committee. For the record, my name is Judy Martz and I am the Governor of the Big Sky State of Montana.

I appreciate the interest of this committee that you have shown in the struggles of the Western States to deal with this emerging energy crisis.

I would like to frame my testimony around a simple concept which is supply. As you know, the Western United States has experienced substantial growth in population and energy needs in the past decade. While we have seen increasing power needs for economic development and other consumptive uses, we have seen nearly zero development in sources to provide additional power.

The primary reason that we have not seen interest in developing power generation is what we have been living in, the regulated energy market. There have been no incentives to develop additional power, and to make matters worse, while we have not developed additional power generation, there also has been a move to dismantle existing power generating facilities.

Montana entered into deregulation in 1997 in an effort to stay ahead of the curve. Our industrial customers have been deregulated since 1997 and our residential customers will enter into a free market in 2004.

Unforseen circumstances hit the Western States last summer with historically low winter snow packs and drought continuing to present time. This gave us less water to produce electricity through hydroelectric facilities while maintaining stream flows to comply with mandates under the Endangered Species Act.

California compounded our problems, both as the largest user of electricity and as a partially deregulated electricity market. California capped retail prices and did nothing to address wholesale generating prices. Adding to the problem, they had not built a generating plant within the past decade.

With this scenario on place, there was almost no incentive for investment of additional power nor an investment for California consumers to conserve. The result was a power drain from all Northwestern States to meet the demands of the California consumers.

This chain of events has hit Montana hard. Montana industrialists that gambled on declining future power prices have been hurt by the resulting power prices. I could go on over the same litany that Governor Locke has of lost businesses. We have seen several closures in Montana, a State whose economic base cannot afford to lose even one single job.

Montana currently has significant or sufficient energy supplies to meet our own needs. However, because we are tied into the Western grid, any excess energy is pulled to other States. This past summer, industries that chose to shop for energy found their traditionally low rates of about $30 per megawatt rise to about $300. The artificially high prices brought “closed for business” signs to several businesses in Montana.

While Montana is facing one of the biggest challenges we have ever experienced, we are looking at one of the biggest opportunities we have seen for quite some time.

Montana is a resource rich State. From vast super-compliant coal fields to miles of timberland in the west, Montana has the natural resources to quench the thirst for energy across Nation. Montanans are anxious for the opportunity to contribute to the economic health of this country through responsible and environmentally sensible development of these resources.

This Nation has the ability to generate affordable and reliable energy. But we must be careful that we do not stifle the increasing interest to development with additional power caps. An overly heavy-handed Federal Government can stymie efforts to address the long-term solution for our current energy problem. Capping prices regionally will take away individual States' flexibility to address the problem. Capping does not take into consideration the difference in economies or per capita income. A reasonable cap to California may be prohibitive to Montana. And importantly, it extinguishes incentives to invest not only in conservation methods, but also additional generating capabilities.

Just yesterday before coming here, I had a conversation with a representative of an out-of-State interest that is considering investing $200 million in a power generating facility in Montana. Now, $200 million may not be a lot of money to this body because you always talk in billions, but to Montana that is a tremendous investment. And the beauty of this proposal is that it helps address generation concerns not only for Montana and the West, but also helps create good paying jobs.

It is important to note that I had a simple message delivered to me in that very conversation, and it was this. "Just keep government out of the way." They want to compete.

Mr. Chairman and members of this committee, all of us in the Western States are struggling to deal with a situation that has no easy answers. While I recognize the intent of the price caps is to protect the consumers, I believe it will only exacerbate an already difficult situation. We need to address our energy needs for the long run. Short-term responses such as this will only deter serious efforts to come up with long-term solutions. The ultimate long-term solution is the creation of additional power sources and transmission. Capping prices does not provide incentives to conserve. And capping prices does not provide incentives for additional generation.

The Western Governors Association recently reviewed possible solutions to the Western crisis, including capping electricity rates. However, some of the Western Governors, 8 out of 10 that were at the meeting in Portland, voted ultimately and delivered a letter to the President opposing price caps. And as Governor of Montana, I signed that letter, recognizing that capping prices creates disincentives for long-term solutions for our State.

While we do not want the Federal Government to come down on Western States with a heavy regulated hand, we do want to work with the Federal Government to arrive at meaningful solutions. So, I ask you to work with us in an effort to address problems associated with the Western grid straining to keep electricity flowing. Work with us by allowing individual States the flexibility to address the energy shortage by creating new generating facilities and transmission capabilities, and work with us to create incentives to conserve existing resources while developing new resources. Work with us, please, not against us.

Thank you.

The CHAIRMAN. Thank you, Governor.

The hour is about 11:25 and we have got other witnesses. So, I am going to ask you to try to summarize your statement. We will try to be brief with our questions.

The Honorable Curt Hébert of FERC, good morning. Please proceed.

STATEMENT OF CURT L. HÉBERT, JR., CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

Mr. HÉBERT. Good morning, Mr. Chairman. I will certainly do that. I have a brief summary here on a couple of pages. I would ask at the conclusion of that that my summary, as well as my entire statement, be entered into the record, please.

The CHAIRMAN. Without objection.

Mr. HÉBERT. Thank you for the opportunity to appear here today to discuss the topic of Western energy markets and possible legislative reforms.

Wholesale and retail electricity markets in California and throughout much of the West are in a state of stress. Wholesale prices have increased substantially for a variety of reasons. Consumers are implored to conserve as much as possible, and utilities are facing growing financial difficult. As a result, many now argue that we need to return to cost-based regulation instead of relying on market-driven solutions.

First, in my view price caps are not a solution. We need to promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers, at least those not subject to a rate freeze over which the FERC has no control. Market prices will increase supply and reduce demand, thus correcting the current imbalance in the system. A price cap imposed through regulation or legislation will have exactly the opposite effect.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that new generation is built, that the transmission system is upgraded, and that new gas pipelines are built as well.

Finally, we need a regional transmission organization, an RTO for the West. California is not an island. It depends on generation from outside of the State, as the two Governors to my left have made clear. The shortages and the prices in California have affected the supply and prices in the rest of the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Consistent with these three points, the FERC has been aggressively identifying and implementing market-driven solutions to the problems: by stabilizing wholesale energy markets, by identifying additional short-term and long-term measures that will increase supply and delivery infrastructure, as well as decrease demand, by promoting the development of a West-wide regional transmission organization, and by monitoring markets and market conditions.

Let me highlight the commission's most recent actions.

Last Friday, the Commission took further steps to mitigate prices in California, specifically the prices charged in California's spot markets during stage 3 emergencies in January of this year. After examining prices charged in these periods, the Commission identified many transactions that warranted further investigation. The Commission required these sellers to either refund certain amounts or offset these amounts against amounts owed to them or provide additional justification for those prices. Specifically, the Commission required potential refunds or offsets of approximately $69 million based on the market clearing price that would have occurred if sellers had bid their variable costs into a competitive single price auction.

The ISO and the California Electricity Oversight Board asked the Commission to require larger refunds. However, the Commission's order explained the difference between their approach and the FERC's.

First, they include over $170 million for refunds for non-public utility sellers, such as the Los Angeles Department of Water and Power. The Commission has no authority to order any refunds from those sellers.

Second, they include refunds for sales during all hours of January. The Commission limited its approach to stage 3 emergency hours when supply and demand imbalance is most severe and sellers know their power is most needed.

Third, they use a pay-as-bid approach instead of the Commission's proxy market clearing price approach and they use bids only slightly above variable costs.

Finally, they include refunds for December 2000. The Commission will address the December transactions in a separate order. The Commission's approach fully protects consumers from exercises of market power during emergency conditions while still providing clear price signals encouraging sorely needed new generation and load reductions.

Also last Friday, the Commission's staff issued a proposal on how the Commission should monitor and mitigate prices in California's wholesale spot power markets. This proposal is based on monitoring and mitigating prices on a before-the-fact basis instead of through after-the-fact refunds.

After receiving and considering public comment, the Commission intends to implement appropriate changes to its current market monitoring and mitigation requirements by May 1st of this year.

Yesterday, the Commission issued an order seeking to increase energy supplies in California and the West. It is our intention to squeeze absolutely every megawatt out of the California system that is possible for this summer.

The Commission implemented certain measures immediately. For example, the Commission streamlined regulatory procedures for wholesale electric power sales, expedited certification of natural gas pipeline projects in California and the West, and urged all licensees to review their FERC-licensed hydroelectric projects in order to assess the potential for increased generating capacity.

The Commission also proposed and sought comment on other measures such as incentive rates for new transmission facilities and natural gas pipeline facilities completed by certain dates this year or next.

Let me close, Mr. Chairman, by emphasizing that the Commission remains willing to work in a cooperative and constructive manner with other Federal and State agencies. The Commission will continue to take steps that, consistent with its authority, can help to ease the present energy situation without jeopardizing longer-term supply solutions. As long as we keep moving toward competitive and regional markets, I am confident that the present energy problems, while serious, can and will be solved. I am also confident that market-based solutions offer the most efficient way to move beyond the problems confronting California and the West.

I cannot emphasize enough to you, Mr. Chairman and members of this Senate committee, the importance of our RTO process and order 2000 and how we understand what both of these Governors just told us, that in fact we are in this together and that we sink or swim together, that we cannot survive it alone.

We do remain at the Commission vigilant in monitoring the market. Yesterday's show cause order of Williams and AES, which is the first show cause order against generators and marketers in the 3½ years that I have been with the Commission, proves our vigilance and the fact that we do not approve of unjust and unreasonable rates and are willing to look into those.

Mr. Chairman, you, as well as the other members of this committee, know that the Commission is willing to work with you. Senator Feinstein and I had a meeting. Senator Boxer and I have had meetings. And I have heard their approaches and I do have an open mind and the Commission has an open mind. We will continue to be vigilant. We will continue to work and we look forward to your comments and questions.

[The prepared statement of Mr. Hébert follows:]

PREPARED STATEMENT OF CURT L. HÉBERT, JR., CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

Wholesale and retail electricity markets in California and throughout much of the West are in a state of stress. Wholesale prices have increased substantially for a variety of reasons, consumers are constantly implored to conserve as much as possible, and utilities are facing growing financial problems. As a result, many now argue that we need to return to cost-based regulation, instead of relying on market-driven solutions.

First, price caps are not a long-term solution. We need to promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply and reduce demand, thus correcting the current imbalance. Lowering prices through regulation or legislation will have exactly the opposite effect.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that new generation is built, that the transmission system is upgraded and that new gas pipelines are built.

Finally, we need a regional transmission organization (RTO) for the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Consistent with these three points, the Federal Energy Regulatory Commission has been aggressively identifying and implementing market-driven solutions to the problems: (1) by stabilizing wholesale energy markets; (2) by identifying additional short-term and long-term measures that will increase supply and delivery infrastructure, as well as decrease demand; (3) by promoting the development of a West-wide regional transmission organization; and, (4) by monitoring market prices and market conditions.

Other regions that have not adopted California-type restrictions on electricity competition have demonstrated that consumers can and do gain from electricity competition and restructuring. California and Western consumers similarly can share in these gains, once market rules are in place that will make California and other Western states an attractive place for investment.

I. OVERVIEW

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear here today to discuss the topic of Western energy markets and possible legislative reform. Wholesale and retail electricity markets in California and throughout much of the West are in a state of stress. Wholesale prices for electricity have increased substantially for a variety of reasons in the last year. California power consumers face near-daily pleas to conserve. California load-serving utilities are under severe financial stress. Companies supplying wholesale power into California are unsure how much, or even whether, they will be paid for their supplies.

While the situation in California is not representative of other parts of the country that are successfully developing competitive markets, it nevertheless underscores the fundamental infrastructure problems facing the country. The demand for electricity continues to expand while supply fails to keep pace. The development and licensing of new hydroelectric capacity—which provides much of the existing power supply in the West—is nearly exhausted. Very little fossil-fired generation has been added in many regions of the country over the last few years, and in California no major plants have been added in the last decade. And the existing electric transmission grid is often fully loaded and, absent necessary expansion, is often incapable of delivering power to those regions where it is valued the most.

I would like to make three main points with respect to these problems and to identify the steps the Commission is taking to address these problems.

First, price caps are not a long-term solution. We need to promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply and reduce demand, thus correcting the current imbalance. Lowering prices artificially will have exactly the opposite effect.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that new generation is built, that the transmission system is upgraded and that new gas pipelines are built.

Finally, we need a regional transmission organization (RTO) for the West. California is not an island. It depends on generation from outside the State. The shortages and the prices in California have affected the supply and prices in the rest of the West. The Western transmission system is an integrated grid, and buyers and sellers need non-discriminatory access to all transmission facilities in the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Consistent with these three points, the Commission continues aggressively to identify and implement solutions to the problems:

First, in recent months, the Commission has issued a number of orders intended to restore market stability. The Commission has acted to move utilities out of volatile spot markets to enable them to develop a portfolio of risk reducing and credit-worthy contracts.

Second, my fellow Commissioners and I are working to identify and adopt additional measures that will increase supply and delivery infrastructure, as well as reduce demand for electricity in the Western Interconnection.

Third, the Commission is continuing to work with market participants on developing, as quickly as possible, a West-wide regional transmission organization. Such an organization will bring a regional perspective and offer regional solutions to regional problems.

Fourth, the Commission is monitoring market prices and market conditions with the goal of ensuring long-term confidence in Western markets. Moreover, the Commission's staff has proposed a new plan to monitor and, when appropriate, mitigate the price of electric energy sold in California's spot markets on a before-the-fact basis, instead of addressing prices through after-the-fact refunds. The Commission intends to act on this proposal by May 1, 2001.

By itself, however, the Commission can contribute only a small part of the solution to today's energy problems. A more comprehensive and permanent solution requires the involvement of the states and other federal agencies and departments. I am encouraged by all of the hard work and effort undertaken in recent months by the State of California and other Western states. The issues are difficult and the stakes are high. While reasonable minds can differ over the appropriate solutions to these problems, the Commission is committed to resolving these problems deliberatively.

An attachment to my testimony provides an analysis by Commission staff of the specific provisions of pending bills (S. 26, S. 80, S. 287, and amendment No. 12 to S. 287) that are the focus of today's hearing.

II. HOW DID WE GET INTO THIS SITUATION?

A. Legislative Design

The State of California has been widely questioned for its restructuring legislation (A.B. 1890), enacted in 1996. While mistakes were made, California is to be commended for realizing that consumers are better off if supply and pricing decisions are based on market mechanisms, not bureaucratic fiat. The premise of this legislation is that consumers will enjoy lower rates and increased service options, without compromising reliability of service, if electricity providers are motivated to serve by market forces and competitive opportunities.

There were two major flaws in California's market design. First, the three utilities were forced to divest almost half of their own generation, and buy and sell power exclusively through the spot markets of the California Power Exchange (PX). This prevented the utilities from hedging their risks by developing a portfolio of short-term and long-term energy products. Second, the State mandated a retail rate reduction and freeze, eliminating any incentives for demand reduction, discouraging entry by competitors for retail sales and, more recently, threatening the financial health of the three utilities by delaying or denying their recovery of billions of dollars in costs incurred to provide service to retail customers.

However, California's situation does not demonstrate the failure of electricity competition. To the contrary, it demonstrates the need to embrace competition fully, instead of tentatively. Other states, such as Pennsylvania, have been successful in implementing electricity competition. California needs to move forward on the competitive path it has chosen, allow new generation and transmission to be sited and built, and allow its citizens to benefit from the lower rates, higher reliability, and wider variety of service options that a truly competitive marketplace can provide.

B. Other Factors

Until last year, California's spot market prices were substantially lower than even California's mandated rate freeze level. This allowed the California utilities to pay down billions of dollars of costs incurred during cost-of-service regulation. However, several events resulted in higher spot electricity prices beginning last summer. Those events included one of the hottest summers and driest years in history, as well as several years of unexpectedly strong load growth. Other factors influencing prices recently include:

- Unusually cold temperatures earlier this winter in the West and Northwest;
- California generation was unavailable to supply normal winter exports to the Northwest;
- Very little generation was added in the West, particularly in Washington, Oregon and California, during the last decade;
- Environmental restrictions limited the full use of power resources in the region;
- Scheduled and unscheduled outages, particularly at old and inefficient generating units, removed large amounts of capacity from service; and
- Natural gas prices increased significantly, due to higher commodity prices, increased gas demand, low storage, and constraints on the delivery system.

Taken together, these factors demonstrate that the present problems in electricity markets are not just "California" problems. Normal export and import patterns throughout the West have been disrupted. Reserve margins throughout the West are shrinking. Already this winter, when the demand for electricity is relatively low, Stage 3 emergencies in California have become commonplace.

III. THE COMMISSION HAS TAKEN IMPORTANT STEPS TO HELP

These problems require bold and decisive action. Both the federal government and state governments have critical roles to play in promoting additional energy supply and deliverability and decreasing demand. Through its authority to set rates for transmission and wholesale power and to regulate interstate natural gas pipelines and non-federal hydroelectric facilities in interstate commerce, the Commission can take a range of measures to promote a better balance of supply and demand, but its jurisdiction is limited. The Commission can set pricing policies which encourage entry, but it is state regulators that have siting authority for electric generation and transmission facilities, as well as authority over local distribution facilities (both for electricity and natural gas). These authorities can go a long way in improving the grid for both electricity and natural gas. More importantly, state regulators have the most significant authorities to encourage demand reduction measures, which can greatly mitigate the energy problems in California and the West.

A. Promoting Market Stability

In an order issued on December 15, 2000, the Commission adopted a series of remedial measures designed to stabilize wholesale electricity markets in California and to correct wholesale market dysfunctions. The Commission recognized that the primary flaw in the California market design was the requirement for the three California utilities to buy and sell solely in spot markets. The Commission concluded that the foremost remedy was to end this requirement and allow the utilities, first, to use their own remaining generation resources to meet demands and, second, to meet much of their remaining needs for power through forward contract purchases. This measure freed up 25,000 MW of generation that the utilities owned or controlled, which could be used directly to serve their load without having to sell it into the Power Exchange and buy it back at a much higher spot price. Our action returned to California the ability to regulate over one-half of its peak load requirements.

B. The Commission's Latest Efforts

Last Friday, the Commission took further steps to mitigate prices in California, specifically the prices charged in California's spot markets during Stage 3 emergencies in January of this year. After examining prices charged in these periods, the Commission identified many transactions that warranted further investigation. The Commission required these sellers to either refund certain amounts (or offset these amounts against amounts owed to them) or provide additional information justifying their prices. Specifically, the Commission required refunds or offsets of approximately $69 million dollars, or all prices charged during Stage 3 hours in excess of $273 per megawatthour. This analysis seeks to use a proxy price based on the market clearing price that would have occurred had the sellers bid their variable costs into a competitive single price auction.

The ISO and the California Electricity Oversight Board ("California parties") asked the Commission to require larger refunds. However, the Commission explained the difference between their approach and the Commission's. First, they included over $170 million for refunds from non-public utility sellers, such as the Los Angeles Department of Water and Power. The Commission has no authority to order any refunds from these sellers. Second, they included refunds for sales during all hours of January; the Commission limited its approach to Stage 3 Emergency hours, when the supply/demand imbalance is most severe and sellers know their power is most needed. Third, they used a pay-as-bid approach instead of the Commission's proxy market clearing price approach and they used bids only slightly above (10 percent) variable costs. Finally, they included refunds for December 2000; the Commission will address the December transactions in a separate order. In sum, the Commission's approach fully protects consumers from possible exercises of market power during emergency conditions while still providing clear price signals encouraging sorely needed new generation and load reductions.

Also last Friday, the Commission's staff issued a proposal on how the Commission should monitor and mitigate prices in California's wholesale spot power markets. This proposal is based on monitoring and mitigating prices on a before-the-fact basis, instead of through after-the-fact refunds. Comments on the staff's proposal are due on March 22nd. After receiving and considering public comment, the Commission intends to implement appropriate changes to its current market monitoring and mitigation requirements by May 1, 2001.

IV. OTHER WAYS IN WHICH THE COMMISSION CAN HELP

Since the supply of electricity in California and the West this summer may be significantly less than the demand, we must do more than just hope for mild weather and rain. We must focus on measures that will promote electricity supply and deliverability and decrease demand. Such measures are critical if we are to meet our goal of ensuring an adequate supply of power for consumers at reasonable prices.

An important element in this effort is upgrading energy deliverability—through enhancements to electrical transmission and natural gas pipeline systems. Without these upgrades, constraints and bottlenecks increasingly will block energy supplies from reaching load.

With these concerns in mind, the Commission must remove obstacles to increased generation and supply in Western markets. Similarly, the Commission must identify and develop strong incentives to build necessary electric and natural gas infrastructure. The Commission, by itself, cannot solve all of the energy problems facing California and the West. But, we may be able to offer valuable short-term contributions to help ease the current shortages, as well as medium- and long-term contributions to help avert future recurrences. My fellow Commissioners and I have discussed such steps and we hope to implement a wide range of such steps in the near future.

V. PRICE CAPS WOULD MAKE THINGS WORSE

Some advocate price caps or cost-based limitations as a temporary way to protect consumers until longer-term remedies alleviate the supply/demand imbalance. The issue of price caps in the West has been raised on rehearing of the Commission's order of December 15, 2000, and, accordingly, is pending before the Commission. For this reason, I cannot debate the specific merits of price caps for California or the West. However, I will reiterate briefly the views I have stated publicly on this issue.

As a general matter, I do not believe that price caps promote long-term consumer welfare. Price caps will not increase energy supply and deliverability or decrease demand. Instead, price caps will deter supply and discourage conservation. At this critical time, legislators and regulators need to do everything they can to promote supply and conservation, not discourage them.

My belief is based on experience, not just economic theory. The summer of 1998 demonstrates my point. Then, wholesale electricity prices in the Midwest spiked up significantly. The Commission resisted pleas for immediate constraining action, such as price caps. Subsequently, suppliers responded to the market-driven price signals, and today the Midwest is not experiencing supply deficiencies.

In short, price caps can have long-term harmful effects because they do not provide appropriate price signals and may exacerbate supply deficiencies. Supply and demand cannot balance in the long-term if prices are capped.

With respect to the bills that are the subject of today's hearing, I do not believe Congress should mandate specific ratemaking standards for the Commission to carry out. The Commission already has sufficient authority to implement price caps if the Commission determined they were needed.

S. 26 and S. 287 would require "cost-of-service based rates," while S. 80 would require "cost-based rates." Either of these "cost" standards likely would require on-the-record, trial-type procedures which would be lengthy, costly and contentious. Litigating such a rate case for one seller requires a significant commitment of resources. Concurrently litigating such cases for scores of sellers in the West would be overwhelming both for the Commission and the industry. Moreover, neither buyers nor sellers would be sure of the prices until the conclusion of this litigation. This delay in price certainty would be unfair to customers and discourage new investments by suppliers.

Many leaders share these views. In a letter to the Secretary of Energy, dated February 6, 2001, eight Western governors expressed their opposition to regional price caps. They explained that "[t]hese caps will serve as a severe disincentive to those entities considering the construction of new electric generation, at precisely the time all of us—and particularly California—are in need of added plant construction."

In the face of the current challenges, we all must have an open mind to any proposals that may mitigate the energy problems in the West. I remain unconvinced that price caps will help solve the problems and I do not believe they are in the long-term interest of consumers.

VI. CONCLUSION

The Commission remains willing to work in a cooperative and constructive manner with other federal and state agencies. The Commission will continue to take steps that, consistent with its authority, can help to ease the present energy situation without jeopardizing longer-term supply solutions. As long as we keep moving toward competitive and regional markets, I am confident that the present energy problems, while serious, can be solved. I am also confident that market-based solutions offer the most efficient way to move beyond the problems confronting California and the West. Thank you.

The CHAIRMAN. Thank you, Chairman Hébert.

Let me ask you just very briefly on your show cause investigation on the peaking power price that you just mentioned. What is your specific authority if you find, indeed, that these are deemed to be unrealistic peak prices that were charged? On the other hand, you offset that with whatever the traffic will bear, which may be the case and may not. What enforcement authority do you have? Do you have authority for refunds, penalties, fines?

Mr. HÉBERT. As you know, the penalties themselves are not something that we possess. We do have market-base rate authority. We do have the ability to issue refunds. This matter itself, Mr. Chairman, to be clear, is a non-public matter and is something that I am not at liberty to discuss. The record will speak for itself.

The CHAIRMAN. Do you have authority to do it?

Mr. HÉBERT. Yes, sir.

The CHAIRMAN. Why have you not moved on it sooner?

Mr. HÉBERT. Well, we just issued the order yesterday, Mr. Chairman.

The CHAIRMAN. I know but this has been around for a while. We have heard from our California friends about the tremendous price of this peak power once they deregulated and the shortage became evident.

Mr. HÉBERT. As you know, Mr. Chairman, I have been Chairman for about 6 weeks and that is about as quickly as I could move.

The CHAIRMAN. That is a good answer. You better quit there.

[Laughter.]

The CHAIRMAN. Governor Locke, you talk about the conservation, the emergency orders, the other aspects of action that have to be taken, including the increase in the supply. From the standpoint of one unique case that I have always kind of wondered about, the theory of Bonneville was to recognize the tremendous hydroelectric resource that you had there for the region, to serve the region. It was paid for by all the taxpayers of the United States, but it benefits primarily your State, Oregon, to a degree Idaho and a few other States. But over the period of time we have seen Bonneville go down, say, to California. It benefits California. It does not benefit Washington.

A case in point is your municipal utility, Seattle Power and Light. It contracts with Bonneville because they can buy long term and then they wheel down to southern California and contract with the Nordstrom stores and displace investor-owned power in California. That causes a shortage in the Pacific Northwest and higher rates. Is that, in your opinion, appropriate procedure for Bonneville to follow? Or does charity begin at home?

Governor LOCKE. Some of this is beyond my expertise, but let me just say that Bonneville has always been part of a region-wide system. Bonneville has sold electricity and produced electricity normally in the wintertime for California when the needs of electricity are very low for our customers. Excuse me. In the wintertime, we normally receive power from California because our nights are longer and it is a colder temperature. So, we normally receive power from California in the wintertime, and then when our days are warmer in the summer and the days are longer, we use that water from the reservoirs and the runoff from the snow to supply electricity to California as they experience heat waves and need air conditioning and so forth. We have always had this exchange.

The CHAIRMAN. Are you buying power from California now?

Governor LOCKE. Except this time, this winter we had to send California electricity and we had to really conserve as much as possible to free up that electricity to help California avoid the rolling blackouts.

The CHAIRMAN. But as you help California, you do so at the expense of your own constituents.

Governor LOCKE. Many of our utilities, private-owned utilities, investor-owned utilities, have sold power to California without any guarantee of repayment. Our utilities are owed tens of millions of dollars. Now, Bonneville has been able to ship electricity down to California, but actually has gotten that electricity back on an exchange basis. But because we are not receiving that electricity that we normally do in the wintertime, it has caused considerable angst amongst our citizens because it is otherwise power that we could be using for ourselves. But we realize that we are part of the grid and we have to help each other out.

The CHAIRMAN. This is a parallel and it is a little closer to home, but in view of the limited time and the fact that we only get one round, I want to present you with a parallel that I think affects your State, Washington, of course, Oregon and California to a degree. The parallel is this. California has found itself dependent on outside energy by about 25 percent of what it consumes. As a consequence, because of that shortage, they have had to buy outside and prices have spiraled.

The entire west coast is dependent on Alaskan oil. Washington. Oregon does not have any refineries. Certainly California. As our oil production declines, if it is allowed to decline, these three States particularly are going to get their oil anyway. They are going to get it from foreign sources in foreign tankers. It does not create the jobs or the U.S. flag vessels that carry Alaskan oil from my State to your State or the State of California.

I just wonder if the residents of those areas really care where their oil comes from, whether it comes from the scorched earth of a Columbian rain forest where there is no environmental oversight. There just does not seem to be a conscious awareness, Governor, of whether or not they care where their oil comes from or what environmental sensitivity is associated with the development of that.

As you know, you have been to Alaska. You know that Prudhoe Bay has supplied this Nation with about 20 percent of the total crude oil for the last 27 years. It is in decline. We have opportunities to open other areas. The question is can we do it safely.

But there does not seem to be much awareness or consideration as to where the oil comes from, as long as it comes. My point in making this statement is if you do not get it from us, you are going to get it. And you are going to be dependent not on a neighboring State; you are going to be dependent on the whims of foreign governments and foreign parts of the world. So, I would encourage the ladies from Washington and California, as well as the Governor and others, to spend a little time and consideration of the merits of where you want it to come from.

My time is up. Senator Bingaman.

Senator BINGAMAN. Thank you very much. Let me ask Commissioner Hébert a couple of questions.

As I understand it, the commission last fall set $150 per megawatt-hour as a so-called breakpoint or a benchmark for wholesale rates. I believe that was agreed to by the commission. Then last Friday, you came out with the decision that charges in excess of $273 per megawatt-hour would be unjust and unreasonable or would be required to be refunded.

I guess I am having trouble figuring out how this calculation is made. Is it just every month or every few weeks? How do you make the decision as to what is unjust and unreasonable?

Governor Locke made, I thought, a pretty good point where he said that your decision Friday essentially said that any costs at or below $273 per megawatt-hour during a stage 3 alert would be deemed just and reasonable. Is that what you decided on Friday?

Mr. HÉBERT. Senator, what we decided, consistent with what I believe to be the December 15 order, was that the $150 breakpoint was never intended to set a proxy price. It was in fact to set the bid at which anything above that, reporting information would be required to the FERC on a weekly basis. We envisioned an opportunity to use those reportings that were made to the FERC so if we did see problems in the market breaking down at some point.

What we deemed necessary with the $273, which is a separate order, which we had the opportunity to look at those reporting requirements that were brought to us, is that the proxy of the $273 is what we believe to be an accurate reflection of a clearing price under competitive conditions. And that is how we came up with that amount.

So, the $150 and the $273 are not inconsistent. If anything, they are very consistent with each other.

Senator BINGAMAN. So, your idea of just and reasonable is that you look at essentially what the market will pay for the power, and that is the price. Is that how you determine what is just and reasonable? You say if there is a competitive market, the market will pay the $273 and so that is all we are going to allow people to charge.

Mr. HÉBERT. What we said, Senator, is anything over the $273, that we would require them either to refund those amounts or explain to us why and how they can cost justify those amounts.

Senator BINGAMAN. There is some cost determination in your calculation, though.

Mr. HÉBERT. Absolutely. The $273 indicates what we believe the amount to be, what the staff believes the amount would have been had there been a competitive market. And we are going to look at anything above that.

Senator BINGAMAN. It is not tied to the cost of providing the power. It is tied, instead, to what the market will pay for the power at that time and place.

Mr. HÉBERT. What it accurately reflects is an inefficient, high-cost generating unit on the margin in California. It is tied to cost——

Senator BINGAMAN. You think it is tied to the cost.

Mr. HÉBERT. It is tied to the cost of the generation of that unit.

Senator BINGAMAN. Why did the Commission limit the refunds to sales during stage 3 alerts? Last November, the Commission said prices were unjust and unreasonable. That was before there were any stage 3 alerts. So, why did you limit the refunds to the stage 3 alert?

Mr. HÉBERT. The Commission wanted to make certain that, as we move down this road of trying to correct this market in California, that we distinguish between scarcity and high prices and a point at which supply would end and the lights would go out. In doing that, when the margins get at around 1.5 percent at a stage 3, we deem that is the point that the FERC should inject itself into the process.

I know it leads into a conversation, Senator Bingaman, about how far do we go here. How much farther are you willing to go in coming in and injecting yourself into price mitigation? We have to be very careful through this process because, quite frankly, the one thing that we must give to this industry is certainty.

Senator BINGAMAN. Which industry is that?

Mr. HÉBERT. The energy industry. We have got to give certainty because it is only fair to give certainty so that the consumers in the end can get not only the supply they deserve but the supply at a cost that they deserve to receive it at. If we get this out of balance and if we start injecting ourselves anytime prices might get high, we are going to cut off any conservation measures, we are going to cut off price indications which, quite frankly, would bring in needed infrastructure to regions like California.

Senator BINGAMAN. Why did you limit your order to January? Do you intend to address other months?

Mr. HÉBERT. We are addressing February by the end of the week.

Senator BINGAMAN. But you are not going to address anything prior to January?

Mr. HÉBERT. Well, we are. The problem that we are running into right now, as far as turning it around as quickly as we did January, when we set the December 15 order into motion, when we issued it, the $150 breakpoint which required the reporting requirements, which this will prove the necessity of that and the benefit of it, did not kick in until January 1. So, we did not automatically get the information that is required to make that type of decision. We are gathering that now. I have instructed the staff to move at all deliberate speed and we are going to turn this around quickly I assure you. So, we are looking at December as well and we are looking at the other months.

Senator BINGAMAN. The other months being prior to December.

Mr. HÉBERT. Forward. The other months are subject to rehearing at this point and we will rule on that later.

Senator BINGAMAN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Bingaman, we have got a vote on. We have two votes, as I understand it. I believe you have agreed to be kind enough to come back after the votes. I have an annual commitment that occurs today beginning at noon. So, I would encourage the Senators to probably recess and come back and catch both votes. I was under the impression that there was one vote, but now there are two.

Senator CRAIG. Mr. Chairman, you have got a time crunch with these Governors.

The CHAIRMAN. I understand. Let us go ahead and ask a question. Perhaps we can conclude with the Governors at least. I do not know how else to play it.

Senator FEINSTEIN. Mr. Chairman, I think it is extraordinarily important to hear from the utilities. That is where there is $13 billion of debt.

The CHAIRMAN. We will ensure that. Let us finish with the Governors.

Senator Craig.

Senator CRAIG. Thank you, Mr. Chairman. I will be brief. I appreciate our circumstance and the circumstance of the Governors.

Governors, as a neighboring State, do not think I am not sensitive to this problem. Oregon and Washington quite often get mentioned in this. Idaho is under the same circumstance, as is Montana, at this moment. We are all inside that market and we are at the headwaters of the problem, if you will. At the same time, it is a very similar situation.

Obviously, you two are at conflict as to how we approach this short term as it relates to price caps. I have already entered into the record the statement of my Governor, Mr. Chairman, Governor Kempthorne as it relates to his agreeing with the Governor from Montana and other Governors of the West that price caps send a wrong signal.

At the same time, Governor Locke, I do not dispute the immediacy that obviously the Senator from Oregon is attempting to respond to at this moment, as is the Senator from California. My guess is, absent price caps, that we have got to come together on a short-term approach toward this difficulty. My guess is that we have to send some pretty bold signals to the consumer out there to get them to do some things for us, including reduce their power usage substantially so we can keep our industries operating.

It is unique that we have industries in your State whose employees often live in my State. Industries have put their folks on furlough and turned their pots off—and I am talking about the aluminum industry—and are selling the power and making more money than operating their industry. That is a tragedy in the making. Soon those contracts will no longer be in existence, and that will have to change dramatically.

So, I hear you. I have no questions for you, but we must get this resolved short term, at least to get us through the summer. I flew out of Boise the other day and the tops of our mountains are brown. That means there is no snow on them. When there should be 10 and 12 feet of snow, there is no snow. Therefore, our runoff this spring at the headwaters of the Columbia is going to be very, very sparse. As a result, there will be little hydro or less hydro.

Commissioner Hébert, let me thank you very much for the leadership that is emerging out of the FERC at this moment to deal head on with this within the confines of the Federal law that you have to deal with and the decision making that you are moving on. We appreciate that.

I guess it is a request more than it is a question because we have got 4 minutes left in this vote and we have all got to get there to vote.

We have got a crisis in the West. Let me suggest to you that you bring the Commission West. Sit down and listen to our people and listen to our utilities. Get out there on the ground with us and see where we are. I think it would be extremely valuable, and I would recommend you do it sooner than later. Within the confines of your authority, I think that would be extremely valuable. We understand the California situation: You can deal with 50 percent of it but you cannot deal with the other 50 percent. We understand that. But there is a great deal you can deal with, and I think it can be very helpful. You can send the right signals to the market, absent the kind of capping that could go on at the request of some that might send the wrong signals. So, would you consider that in behalf of us westerners? We think it would be extremely valuable to have you and your other commissioners on the ground.

Mr. HÉBERT. I would do that, Senator Craig. What I will make certain and do as well, because as a part of our E-1 docket that we issued yesterday in trying to come up with some short-term remedies, as well as some long- and medium-term remedies, one of the things that we discussed in there was having a conference of some type, a Commission conference, in the Northwest. I will make certain that it is understood that it would be your request that we do so quicker rather than later, and at the same time, I am assuming that that would be an invitation to have it in Idaho.

Senator CRAIG. Well, it certainly is. We would be more than proud to facilitate that. I am not quite sure, but we could probably open up one of our rodeo stadiums. The crowds will be rather large.

[Laughter.]

The CHAIRMAN. Let me call on Senator Feinstein, followed by Senator Cantwell. We are basically out of time. I apologize, ladies, and I apologize to the two Governors and the Commissioner, but that is just the way it is. So, please proceed.

When you leave, the hearing will be recessed until Senator Bingaman comes back and we will start on the last panel.

Senator FEINSTEIN. Excellent. Thank you very much.

Mr. Hébert, I have real differences with your commission. I do not think the commission's responsibility is only to provide certainty for the industry. I think it is also to provide certainty to the people that they can afford electricity.

I would like to get your explanation of this chart. This chart shows that in the last 2 years in California demand has remained essentially the same. Here there is a 4 percent differential between lines. Also during this period, natural gas prices were low. Look over the 2-year period. This is November 1999 into the year 2000. Look at the price spike. What is your explanation for that price spike?

Mr. HÉBERT. Well, I think there can be a lot of different reasons for it. If you understand—and I know we do—that certainly supply was tight during that time period, demand was high——

Senator FEINSTEIN. Demand was the same over the 2-year period.

Mr. HÉBERT. Show me your demand curve. I am sorry.

Senator FEINSTEIN. This is the demand curve between the 2 years. Right in here there is a 4 percent differential. That is all.

Mr. HÉBERT. Could I read the bottom of the chart, please? I am sorry.

Senator FEINSTEIN. What it says is: "Markets do not produce competitive prices. Under similar medium load conditions, 2000 prices have increased 700 percent over 1999 levels."

Mr. HÉBERT. I think it is clear that the market was working in 1999. I think that is probably the first assumption we could make. I guess the question that we come up with is what is broken about the market. Why is it not at competitive levels? Or is it, in fact, at competitive levels for 2000?

Senator FEINSTEIN. This has nothing to do with putting price on consumers. This is just straight demand and price.

Mr. HÉBERT. I am sorry. I thought he was saying something.

Senator FEINSTEIN. No. Well, clearly there is no fast explanation. This is a 700 percent increase in electricity wholesale prices during that period of time. That is what we are trying to get FERC to address, to not have this happen this summer because I believe it will happen absent some control. I can relate this directly. I do not begrudge anybody making a profit, but the profit is extraordinary.

Mr. HÉBERT. Let me say this. I will be glad to give you a formal answer, as I have done on some other measures that you have requested, on this chart.

Let me just say I do want to make it clear obviously to you and for the record itself, I have never felt like, nor do I currently feel, that we should not be very clear in what we are trying to do for consumers as well. Actually my comment a moment ago said that. Give certainty to the industry and consumers as well when it comes to not only getting adequate supply and having it delivered, but having it delivered at a reasonable price.

Now, we are moving forward with measures right now—I know you have seen the orders. I have forwarded them to your office—where the staff is recommending market mitigation. It will be ex ante mitigation, so we will do it immediately as opposed to coming back and dealing with refunds. It would certainly give the type of certainty that you are looking for I believe.

I do not think there is any question. I think you and I agree we had a great conversation in your office. The market has problems certainly during periods. We have seen some price volatility. We are going to figure out a way to get through that. I think we are doing that right now.

I know that you know the commitment of the Commission and that the Commission is working very hard to respond to these problems. We have almost issued something on a weekly basis in trying to respond and correct this. I will give you a further comment on it, but I want you to know we are resolving it.

Senator CANTWELL. I want to thank the panel as well, and I think I will submit my question in writing, Mr. Hébert, about your decision as it relates to last Friday on power producers, on refunds, and specifically consideration of Washington State and the Northwest.

Unfortunately, we have to go and vote and I want to make sure our Governor has a chance to talk to some of the Northwest folks who are here before adjourning. We will be back and would love to, if you are still available, either individually respond to some of these questions. But I do want to thank the Governors for being here as well.

Notwithstanding the previous comment about the red-eye, I want to thank Governor Locke. Given that our State's earthquake has caused significant damage to the State capital, your office is not without a home but is not in the State capital right now and we have been greatly displaced. So, your time and focus on this issue, as well as that, is much appreciated. Thank you.

[Recess.]

Senator BINGAMAN [presiding]. Could we find the witnesses and we will go ahead with this next final panel.

[Pause.]

Senator BINGAMAN. Why do we not go ahead. What we would like to do, if we could, on this panel is to have everybody summarize their statement, make the points that they believe are most essential, and we will try to limit every witness to about 5 minutes here in summarizing their statement. We will have this light to indicate when your 5 minutes are up. Then Senator Feinstein and I and any other Senators who have shown up will have a few questions.

So, why do we not start with you, John Bryson with Edison? Please go right ahead. Welcome. Welcome to all of you. We are glad you are here. Sorry it has taken so long to get to this panel.

STATEMENT OF JOHN E. BRYSON, CHAIRMAN, PRESIDENT AND CEO, EDISON INTERNATIONAL, ROSEMEAD, CA

Mr. BRYSON. Senator Bingaman, Senator Feinstein, thank you very much for this opportunity and thanks also to the other members of the panel.

I actually will not summarize my statement at all because there is something that I think is more striking, more important, and more promising. I did not know that Senator Feinstein and Senator Smith this morning would come together with a joint conceptual proposal for how to deal with this problem. This has been a very, very difficult 10 months in California. There have not been many heartening moments. The proposal, Senator Feinstein, that you and Senator Smith propose to jointly co-author is one of the few heartening moments we have had.

It seems to me the kind of practical, problem-solving leadership approach that we need at a point of urgent crisis. One of the big challenges that we have faced in seeking practically at the point, frankly, where the rubber hits the road, at the point of buying power and serving it to consumers—one of the few practical approaches to bring together the core problem—and the core problem has been a large and vastly growing gap between retail prices under the jurisdiction of the California regulators and wholesale prices under the jurisdiction of the Federal regulators.

We at Southern California Edison and others in California have been in a position for a long time where in retail rates we receive only 6 cents to 7 cents a kilowatt hour. I think PG&E actually slightly less. But at the wholesale level, the prices being paid are steadily rising and, in the last month, have been about 35 cents a kilowatt hour. So, the multiple of the wholesale rate to the retail rate is something like 10 times, and it is likely to be yet higher this summer.

In the wake of the FERC decision just this last week, the so-called refund decision that has been discussed this morning, the forward price at Palo Verde, one of the gate points to California, was in excess of 50 cents a kilowatt hour, 53 cents to be specific.

The FERC refund decision, because it was so limited and so narrow and so unexpected, has been reacted to in the market as a kind of further pass on disciplines in the market. It was limited to only stage 3. Senator Bingaman, you addressed that point. It did not bear at all on the previously set $150 per megawatt hour cap. It appeared not to discipline the market but, rather, to further open the door in an already broken market.

So, the notion that a bipartisan approach, one that addresses both Federal regulation and State regulation, one that would establish a kind of halt on the broken market in a period of what Senator Feinstein described as stability and reliability, to bring together all the pieces towards a practical solution so that we can get through this summer and beyond at lower cost than likely otherwise will prevail, is extremely important. I hope the committee and ultimately the Senate and other public leaders will see the practical elements of that approach and move towards it.

I want to underscore just how intense the situation is in closing. We are in a situation now in which Southern California Edison and Pacific Gas & Electric have borrowed to the limit of their borrowing ability. We have no further credit worthiness. We are, in a practical sense, substantially insolvent unless a practical solution is found.

Most of the focus now is on providing adequate supply of generation power. That is an appropriate focus. There is nothing about $500 per megawatt prices that will bring more power on this summer. Nothing whatsoever.

It, I believe, is a mistake to reach the conclusion that somehow prices at this level are essential to bring new supply on. They simply are not. Competitive markets are a desirable approach to bringing electricity supply to customers, but those markets have to be competitive and they have to work. And these are broken markets; they are not working.

So, we need a kind of temporary time out and that is what has been proposed by many this morning. We need the regulators to act on that.

Because of the lack of credit worthiness now of Southern California Edison and Pacific Gas & Electric, we can no longer procure power for customers. In fact, for some period of time, there has been a kind of risk premium on the part of generators that had to sell into California, and the State had to take up procurement. That is not a good step. The State has no experience in it. The *Wall Street Journal* now reports that the State itself at these high prices has gone through 64 percent of California's very considerable budget surplus just to buy power on an interim basis.

So, we cannot allow to continue this gap between the State on the one hand, where there is a preference that the Federal regulators act, and the Federal regulators who prefer that the State regulators act. There needs to be a coming together.

So, I confine my remarks entirely to what seems to me the promising and practical step that is being proposed by Senator Feinstein and Senator Smith and that seems, judging by the panel's reaction, to be endorsed by others on the panel. I think it is extremely important.

Thank you very much.

[The prepared statement of Mr. Bryson follows:]

PREPARED STATEMENT OF JOHN E. BRYSON, CHAIRMAN, PRESIDENT, AND CEO, EDISON INTERNATIONAL, ROSEMEAD, CA

Good morning Mr. Chairman and Senators. I am John E. Bryson, Chairman, President, and CEO of Edison International, parent company of Southern California Edison. I appreciate the opportunity to testify before you on federal legislation to address the crisis in electricity supply and prices now affecting California and the Western United States. I use the word "crisis" deliberately. There is no other word for California's experience with electricity markets since last May. And there is no other word for what is facing California and the entire West in the months ahead.

On January 31, 2001, my colleague, Steve Frank, President and CEO of Southern California Edison, testified before you on the very serious problems threatening Southern California Edison, California and the West. A month and a half later, the same threats remain, becoming more immediate with every passing day. I will not repeat Mr. Frank's testimony, but some review is necessary.

As of the end of January of this year, after nine months of buying wholesale electricity at unjust and unreasonable prices and reselling at artificially low prices, Southern California Edison incurred $5.5 billion in undercollections. We financed the shortfall by borrowing in unprecedented amounts until we exhausted our credit. To preserve our limited cash reserves we suspended payment for power and some of our outstanding debts. Our creditors have been extraordinarily patient, largely because everyone realizes that there are no real winners in a bankruptcy and because we and the state are taking steps to address this crisis. Southern California Edison has implemented major cost reduction measures including reduced capital expenditures and layoffs. And we eliminated common dividend payments for the first time in our 100-year history. Now, we are essentially out of the power procurement business, although it remains somewhat uncertain whether we will be expected to pay for power that the state is procuring through the Department of Water Resources.

Since January, the Department of Water Resources has been the major buyer of electricity in the state. It is spending $45 million or more per day to keep the lights on. To date, the state has spent approximately $3 billion in power procurement costs, quickly going through its reserves. Although the state is attempting to reduce its reliance on the spot market by entering into long-term contracts with generators, this has been a difficult task because prices for the near-term remain extraordinarily high throughout the West.

The Governor and the state legislature have also been working to return Southern California Edison and Pacific Gas & Electric to some semblance of fiscal health. A key feature of the Governor's plan is the purchase of the utilities' transmission systems by the state. I understand that some in Washington have reservations about this. Certainly, we would have preferred not to do this. We would have preferred to obtain gradual retail rate increases and meaningful federal action to reform a broken wholesale electricity market. Our countless efforts to this end—in the courts, at FERC and elsewhere—have met with no success. Indeed, many of the people who have been most critical of the state's purchase of our transmission have opposed an affirmative federal role in addressing this crisis and have told California to solve this problem itself. I ask them to put themselves in our position. What choice do we have? What better alternative do you offer?

We continue to negotiate the details with the state. However, nothing we, or the state, can do will adequately address the broken wholesale market. Make no mistake, this broken market continues to guarantee unjust and unreasonable prices that are a principal impediment to a realistic solution to this crisis.

The Federal Energy Regulatory Commission (FERC) is obligated under the Federal Power Act to ensure just and reasonable rates. FERC found wholesale rates in California to be unjust and unreasonable on November 1, 2000. FERC reiterated this finding in its December 15, 2000 order when it imposed a "soft cap" of $150. Since then, and possibly as a result of FERC's order, wholesale prices have climbed and have stayed at levels more than twice the soft price cap. As illustrated in the chart attached to my testimony, prices before the FERC finding averaged up to as much as $152.65/MWh in August 2000. After the FERC finding on November 1, prices continued to rise to $219.28/MWh in December and reached $260.23 in January 2001 after the FERC order imposed the "soft cap".

After months of complaints and literally thousands of pages of pleadings, reports and evidence establishing that California's wholesale electricity market is broken, FERC at long last issued an order on March 9 that might require 13 California power sellers to refund $69 million for sales in January 2001. Even if FERC actually orders such refunds, this would be less than one and one-half days' worth of state spending on power. In contrast, the Independent System Operator (ISO) petitioned FERC for refunds totaling $315 million in January.

FERC ruled that prices up to and including $273 per megawatt hour were acceptable for January, and apparently that any prices charged at times other than periods of Stage 3 emergencies are acceptable also. There is good reason to question the economic assumptions underlying FERC's order. I will note one of those concerns here.

$273 per MWh is nearly ten times higher than the average wholesale price in January 2000 of $30 per MWh. A more legitimate definition of "just and reasonable" rates would have resulted in refunds for January five times higher. And what about preceding months? FERC itself found wholesale prices in California to be unjust and unreasonable long before any Stage 3 emergencies were ever declared.

Of additional concern is the FERC staff Recommendation on Prospective Market Monitoring and Mitigation, also issued on March 9 of this year. Under this proposal, the soft caps will end on May 1, 2001, and a limit on real time market prices equal to the highest-cost generator will be put in place only during emergency conditions such as Stage 3 alerts. At other times, no market power mitigation will exist whatsoever for California's dysfunctional market. If adopted, this proposal would leave California at a much greater risk of market power exploitation than during 2000.

FERC's "too little, too late" attempt to address this crisis makes it all the more important to adopt Senator Feinstein's bill, S. 287. Only temporary cost-plus wholesale caps will adequately address the problems in our broken market. Without federal action compelling it to do so, it is clear that FERC will not act to ensure just and reasonable wholesale rates in California or the rest of the West.

Those who argue against such intervention should be aware that FERC, itself, has now imposed a cost cap (at least for January), but one that appears to us to be too high and too selectively applied to be useful. Moreover, it is established after-the-fact. This means that those selling into California do not know at the time they sell what price will be deemed acceptable by FERC. I would suggest that establishing, for some limited period of time, a system of cost-plus regulation for all WSCC generators, as Senator Feinstein's bill would do, is far preferable to FERC's after-the-fact caps. I emphasize here that this is a remedy for the West.

If wholesale prices are not comprehensively, though temporarily, regulated it will not matter what the state does. The extraordinary transfer of wealth from California and the West to power generators will continue to benefit only a handful of companies at the expense of the economies of the entire region.

Were there mistakes in how California designed and implemented its restructuring? Absolutely. But, as I think is now apparent to this Committee, this is not only "a California problem," and California alone cannot resolve it. Other states in the West are already feeling the effects of unprecedented growth and a tight supply of electricity. Many states have raised rates and imposed strict conservation measures. Others, including California, have acted to expedite siting and construction of new generation. While these actions will help address the long-term problems in a manner that may ultimately produce a workably competitive wholesale electricity market in the West, we will never get there if the short-term crisis is not addressed.

For this reason, we urge prompt passage of S. 287. It provides for temporary imposition of cost-plus rates similar to those with which FERC has ample experience. It offers generators a healthy return on their investment, especially when you consider that some generators in the California market have already recovered all of their initial investment in the plants they bought.

We understand Senator Gordon Smith's concerns in wanting California to raise retail rates in line with increasing wholesale electricity prices. We, after all, have borne directly the brunt of California's failure to do this, and have done everything we know, from litigation to negotiation, to obtain an increase in the costs we may recover from retail consumers. We agree that an increase in retail rates is long overdue, but such action must be complemented by federal action on cost-plus wholesale rates to bring this market under control. Senator Smith's amendment acknowledges the need for action at both the state and federal levels, and we appreciate that acknowledgement.

Some argue that cost-plus profit caps will discourage additional generation, but: 1) it should not take exorbitant profits to encourage entry into the California market; 2) much generation is being planned elsewhere in the country where electricity prices are far lower; and finally, 3) if a generator's costs are covered and they are assured of earning a reasonable profit, this will be an attractive proposition.

Some may also argue that this regulation will be too difficult to implement and too burdensome. Let's all remember that before FERC authorized market-based rates for this generation, all except the newest of this generation was subject to cost-of service regulation. It has been done. It can be done again. There is nothing novel or unduly complicated about this.

Let there be no misunderstanding about the absolute necessity of federal action here. Average prices per KWh have increased from 5 or 6 cents to as high as $1.80. If consumers were exposed to all of these price increases, it would be analogous to paying $20 for a gallon of milk or a gallon of gasoline. If this were any other product, continued federal inaction would be intolerable. It should not be different just because we are talking about electricity. If anything, the case is more compelling because electricity is not a luxury; it is an essential service. And no one can afford the luxury of waiting any longer for federal action.

Finally, let there be no doubt that continued inaction will only serve to further erode trust in our governmental institutions' ability to respond adequately to economic crises. Throughout this crisis and our efforts to work our way out of it, we have heard plenty on the principles of a free market. But a workable free market in California does not exist. California may have been the first to restructure, admittedly with disastrous results, but it is also clear that state and federal agencies have shown themselves incapable of responding efficiently to a very dynamic situation. The California Public Utilities Commission failed to provide timely authority for power contracting and failed to affirm our right under federal law to recover our wholesale procurement costs in retail rates. The FERC has been similarly slow to act to ensure just and reasonable wholesale rates or to deal adequately with this crisis. For example, we are still being fined by FERC for not scheduling load in a day-ahead market that has been non-existent for two months.

California's mistakes aside, we can understand other states stepping back from deregulation until they develop more generation and receive stronger signals that our governmental institutions are up to the task and can be trusted to respond efficiently to avoid results diametrically opposed to the consumer benefits sought by deregulation.

Thank you.

Senator BINGAMAN. Thank you very much.

Steve Baum, who is chairman, CEO and president of Sempra. Glad to have you here.

STATEMENT OF STEPHEN L. BAUM, CHAIRMAN, PRESIDENT AND CEO, SEMPRA ENERGY, SAN DIEGO, CA

Mr. BAUM. Thank you very much for the opportunity to address this panel, and thank you, Senator Feinstein, and thanks to Senator Smith for their leadership in putting forth S. 287.

I would like to echo what John Bryson said, and I do not want to repeat it. But I would like to bring up a couple of other items and to emphasize some items.

I do believe we face, at the root of the problem in the West, a serious supply and demand problem. There has not been an adequate number of new generating plants built nor have there been an adequate number of new transmission facilities sited to meet the rising demand not only in California, but also in the surrounding States. I do not think it is lost on anyone that California has, in the past, depended upon neighboring States to supply its energy, its excess needs, and those States themselves have now grown dramatically, at rates exceeding those of California. So, we really do have a supply and demand problem that has to be addressed.

One of the things that is a characteristic of the broken market in California and in the West that I would like to emphasize—and it is something that John Bryson and others have mentioned—and that is the lack of demand-side response that exists in California because of the retail price caps. Any attempt to cap wholesale prices needs absolutely to be accompanied by an easing of retail price caps. I believe it would be a serious error to continue with those caps because there would not be the response necessary to the price signals that we need to have to have conservation. California does make a large, kind of sucking noise in the West and brings in energy from surrounding States because it has not curbed its own demand. And I believe that is absolutely a necessary concomitant to wholesale price caps.

We endorse temporary, targeted, cost-based caps for old generation in the West for a medium period, as contained in S. 287, in order to carry us through to a time when the coming construction will bring new generation. I completely agree with John Bryson that there is adequate price stimulation currently and with these proposed caps to have that generation come on line, particularly since new generation would not be subject to those caps.

Affiliates of my company are building in excess of 2,500 megawatts of new power both in Arizona and northern New Mexico and in California. I can tell you directly that we will continue to do that to meet the needs of California regardless of price caps being put in place.

I would also like to address another issue and that is the interplay of natural gas prices with generation in the West. I know that witnesses that have come before this panel in previous hearings have suggested that the price of power in the West is largely driven by high natural gas prices. Well, I think there is a relationship between high fuel costs and high generation costs. I do not believe there is a correlation between the spikes we see in electric costs and rising natural gas prices. One can see that through the comparison of natural gas prices last summer to natural gas prices today and the price of power last summer, as well shown in Senator Feinstein's chart, and the price of power today. There were price spikes that went to $2,000 a megawatt-hour last summer when natural gas prices were still quite low.

That is not to say that there is not an issue with natural gas prices and, in particular, an issue with the transportation costs to California for natural gas. When prices spiked up into the $50 range for delivered gas at the California border, the basin prices were still under $10. So, that transportation differential is caused by a squeeze in that market and it is an area that I think FERC ought to address.

We think two things ought to happen. Our company has filed a complaint at the FERC asking the FERC to look into transportation costs. We believe that is an area that ought to be investigated. But also we believe there should be an order unbundling the cost to the commodity—that is, the natural gas—from the cost of transportation so that customers and the market can distinguish those costs.

But in summary, I would like to say that we fully endorse temporary, targeted, cost-based price caps for old generation in the West. We believe that will cause California to be able to remedy its problems. We are encouraged by the conservation efforts that Governor Davis has recently come out with. For example, it is a bid to consumers who are willing to reduce their demand by up to 20 percent to get paid for that. That I think will help. We would encourage him also to raise residential rates.

[The prepared statement of Mr. Baum follows:]

PREPARED STATEMENT OF STEPHEN L. BAUM, CHAIRMAN, PRESIDENT & CEO, SEMPRA ENERGY, SAN DIEGO, CA

Good morning. I am Steve Baum, Chairman, President & Chief Executive Officer of Sempra Energy. Sempra Energy is a Fortune 500 energy services holding company whose subsidiaries provide electricity and natural gas services. Sempra Energy's two California regulated subsidiaries are San Diego Gas & Electric (SDG&E) and Southern California Gas Company (SoCalGas). I want to thank you for the opportunity to provide input on S. 287, and to discuss events in the California electricity marketplace.

Let me begin by commending you, Mr. Chairman, and Senator Feinstein, for working toward helping to solve the ongoing energy crisis. Sempra Energy recently testified before this Committee regarding actions that we believe the federal government must take to stabilize the chaotic energy marketplace, actions that only the federal government can take because it pre-empts state action in this wholesale market. We are pleased that Senator Feinstein's bill, S. 287, seeks to implement "Cost of Service Plus" electric energy rates, an action that we have advocated as a necessary, near term step in solving the energy crisis.

First, I would like to speak to a question I have heard regarding whether the order issued by the Federal Energy Regulatory Commission (FERC) last Friday, March 9, addresses the problems in the western market. Let me be very clear about our assessment of that order. In that order, the FERC drastically limited potential refunds for sales into the electricity market during January. After numerous FERC pronouncements on the California electricity crisis, the Commission has crafted a strange, new, one-price-fits-all cut off point for reviews of transactions that does not appear to be based upon any of its preceding work. While after many months of inaction we are heartened by FERC's attention to this crisis, the Commission's action is far too little and far too late. As noted in the dissent, "this order, limiting the potential for refunds to transactions that occurred during State 3 alert hours and bids in excess of a $273 proxy market clearing price, is arbitrary, capricious and an abuse of discretion." This order will do little to discipline the wholesale electricity market. If anything, this order solidifies my support for S. 287.

S. 287

S. 287 takes a critical step toward instituting a much needed cooling-off period for California's chaotic energy market by imposing "Cost of Service Plus" rates. Under "Cost of Service Plus" rates, each existing generator would provide to FERC the unit cost per kwh to operate its plants. FERC would then include a profit margin to the price per kwh that is high enough to provide generators with an incentive to continue producing energy but low enough to meet consumers' concerns regarding energy prices. It is important to note that nothing in this proposal should be viewed as a disincentive to new construction. I strongly believe that new generation facilities should not be subject to such a cap. To stimulate additional investment in needed generation facilities in the West, new construction should be rewarded by being permitted to charge market rates.

Other market participants involved in the energy crisis have testified before this Committee and have argued that the cause of high electric commodity prices is the high cost of natural gas and the high cost of environmental compliance. They have pointed out that the costs of operating the different types of generation facilities vary widely, and that a flat cap would be a disincentive to supply. These arguments are all addressed by the proposal in S. 287, as the actual costs of operating each plant would be accounted for in the price that could be charged. By avoiding the implementation of a "one size fits all" price cap, "Cost of Service Plus" rates would protect both consumers, by providing price stability, and generators, by assuring that plant costs, including a profit, will be fully covered.

I endorse this concept with the understanding that price caps are clearly not a long-term solution to the energy crisis. However, when a market is as broken as the western region is today, failure to protect consumers from runaway prices while the market is being fixed is simply not an acceptable alternative. When astronomically high prices were passed directly through to consumers in San Diego over the summer of 2000, the economic shock was severe. In fact, in California we experienced a reality that some economists are ignoring in this situation: there is also an issue of "political elasticity;" which is that consumers will not long tolerate prices that are so completely disconnected from actual costs. The magnitude of the crisis requires an immediate tempering of the market to reach a solution that is fair and reasonable to both electric producers and consumers. "Cost of Service Plus" rates offer that solution.

At the same time, I would be remiss if I did not mention efforts undertaken by me and others at Sempra Energy to argue strenuously before Governor Davis, the California Public Utilities Commission, and the Legislature for a demand side response to help solve this crisis. I believe that an orderly and predictable relaxation of the retail price caps will provide appropriate incentives for consumers to reduce their energy consumption. We expect that a demand response to incrementally increased retail rates will enable California to avoid blackouts during the upcoming summer months. We would also expect that reduced demand would place downward pressure on the wholesale price of electricity. Demand can be also reduced if rate designs are developed to charge more for increased use of electricity and if customers had energy meters that allowed them to see on a real time basis the impact of higher usage on the price they will pay for electricity.

Because Senator Feinstein's proposal addresses a dysfunctional market, I strongly agree with the concept in S. 287 that the caps must only be a temporary provision. Some opponents have argued that there is no such thing as a temporary cap. I disagree. Building into the authorization a sunset provision, whether a date certain or, as in this bill, a change in condition in the marketplace, fully addresses this argument.

Another argument used against caps is the pragmatic one: that they simply don't work. Opponents have pointed to the caps in California to show that caps failed to control prices. Indeed, caps triggered actions to circumvent them. The major way to circumvent them was to move into the broader western regional market instead of the one-state market of California. Again, S. 287 addresses that problem by imposing a cap that is region wide, protecting all of the consumers in the western states.

HIGH GAS PRICES IN CALIFORNIA

As I have already stated, the approach to price caps proposed in this bill addresses the impact of natural gas costs on the costs of generation. Nonetheless I would like to take a moment to address that particular question.

First, I do not concede the statement that some witnesses have made before this Committee that natural gas prices of themselves explain the explosion in electricity prices in California. That is simply an oversimplification of natural gas supply and demand, which I will discuss later in my testimony. Rather, while there is limited cost-of-service justification for the astronomically high price of electric energy that has been seen over the past nine months in California, the interrelationship between the price of natural gas and the magnitude of change in electric commodity prices is terribly out of alignment. For example, in the summer of 2000, the price of natural gas was $3.50 per mcf, yet the electric commodity price was as high as $2,000 per MWh. To me, these numbers provide little justification for the skyrocketing electric prices that have been charged in the wholesale market, contrary to what has been argued.

A good example of this argument can be found in the letter sent to this Committee by Mr. Keith Bailey, CEO of the Williams Company on February 14, 2001. In his letter, Mr. Bailey concluded that the cost of electrical generation in California is high, largely due to the high cost of natural gas. We have reviewed that letter and rebutted some of its conclusions in a letter that we have sent to the Committee under separate cover.

In short, I have heard no explanation that adequately or reasonably correlates high electric prices with the increased cost of natural gas. While it is fair to suggest that there has been upward pressure on electric rates as a result of increased natural gas prices (resulting from year round rather than cyclical demand and storage shortages), I have seen no evidence suggesting that high natural gas prices justify the skyrocketing electricity prices we have seen recently.

However, we do believe that the recent escalation in natural gas prices at the California border has made it exceptionally difficult to negotiate with sellers of electricity for reasonably priced power, has led to extremely adverse impacts on the California economy, and has rendered largely meaningless FERC's "soft cap" on wholesale electric prices. On February 6, 2000, FERC issued Order No. 637 on an experimental basis. In that order the Commission waived its regulations that had capped capacity release transaction rates at the interstate pipeline's maximum firm transportation rate. The result of this failed experiment has been a substantial increase in the price of natural gas at the border of California—not because of an increase in the cost of the commodity, but because of vast increases in the imputed value of using the pipe.

While well intentioned, eliminating the cap did not achieve the objective of a more transparent and liquid market, and in fact had the unintended consequence of increasing the price of delivered gas at the California border to levels far beyond what the market had experienced to that point. For example, at one point last December the average daily cost of gas delivered to California shot up to $59.42/mmBtu (with some purchases at the $70.00 level), while the cost of the gas itself was around $10.00/mmBtu. Thus the imputed value of delivery to the California border, which under regulation was $0.67/mmBtu, rose to S49.00/mmBtu.

If Congress were to address this problem in conjunction with the electricity "Cost of Service Plus" price cap under consideration in S. 287, the combined impact could help lower the ultimate price of electricity throughout the western region. This is the case because the cost-of-service cap would make wholesale electricity sales reflective of the actual cost-of-service, and reinstatement of the cap on pipeline capacity transactions would help limit the input costs of generators and eliminate demands for pricing premiums based on stated concerns over the delivered price of natural gas.

Furthermore, the price of gas in California has compounded the price impact of electricity for residential consumers and businesses, some of whom are seeing price spikes for both commodities at the same time. If the Congress were to require FERC to terminate the ill-fated experiment in waiving the cap on the secondary market, we would anticipate a substantial reduction in the average price and volatility of delivered natural gas prices at the California border.

Congress should also require FERC to develop regulations that require interstate shippers to disclose separately the cost of the gas and the cost of the transportation of the natural gas when selling bundled gas and transportation services. Such a provision will clearly identify to natural gas market participants the key components of pricing of natural gas and, by leading to greater price transparency, would provide FERC the tools it needs to enforce the cap. By clearly delineating pricing information, market participants can make better decisions about their gas purchases, and regulators will be better equipped to enforce their regulations and understand the economic drivers in the current natural gas marketplace.

I would reiterate that the provision for a "Cost of Service Plus" electricity price cap in S. 287 already addresses any impact of natural gas prices on electric generation costs, by factoring them into the allowable charges for each facility. But these prices themselves exhibit problems that must be addressed. As a result, it is imperative that FERC be required to re-impose caps on interstate natural gas transportation services.

CONCLUSION

Nationally, we are confronted with a need to develop our overall energy infrastructure. We have, in part, turned to the market to guide this transition. What we are confronting now are problems that arise as we make the transition, and in particular, we are confronting the question of how we assure some economic stability while still allowing the market signals that will guide our investment.

S. 287 offers both near and long-term solutions to alleviating the current energy crisis. The bill takes into account the need to create a temporary "time out" to bring market participants to the table today so that a lasting long-term solution can be reached. We strongly urge the Committee to quickly pass S. 287, and send the bill to the Senate floor as soon as possible. Federal legislative action is urgently needed to fix the wholesale market, and S. 287 takes the necessary steps to achieve this objective.

There is clear and compelling evidence that the electric wholesale market is not working in the western region, and that without "Cost of Service Plus" rates, it will continue to flounder and spread economic harm. The states in the region are moving aggressively to address the disastrous impacts of the existing market structure, and to expand the supply. Senator Feinstein's bill, S. 287, offers a much needed "cooling off" period to protect consumers, and our economy, as we resolve this critical situation.

Thank you again for the opportunity to testify today. I appreciate your interest in this important issue, and am available to answer questions,

Senator BINGAMAN. Thank you very much.

Next would be Bruce Worthington, who is senior VP and general counsel with PG&E Corporation.

STATEMENT OF BRUCE WORTHINGTON, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, PG&E CORPORATION, SAN FRANCISCO, CA

Mr. WORTHINGTON. Thank you very much, Senator Bingaman and Senator Feinstein, as well. I appreciate the opportunity to be here to talk about this. I am a substitute for Bob Glynn, and his comments I would like to have submitted to the record of this proceeding.

Senator BINGAMAN. They will be included in the record.

Mr. WORTHINGTON. Thank you.

Senator Feinstein, I want to really acknowledge your concern and help and involvement and fortitude for persisting in this crisis in California and in the West.

I echo the comments of the other two California-based utilities in the urgency in which this needs to be addressed. We have talked about long-term and medium-term solutions for this, but for the upcoming summer, the proposal embedded in S. 287, I think, is absolutely necessary. We do not normally think that the sort of market-distorting caps or cost-based rates are a good thing, but in California for the summer, I am not aware of any other measure that is going to do it. We are going to do all we can to reduce demand. There are short-term peaking supplies that I know the Governor in permitting is trying to get on line faster, but that is not going to bridge the gap. If the Secretary was right this morning that there is a 5,000 megawatt gap, I do not understand how that is going to otherwise be met.

So, in order to avoid that chart that you showed us this morning being duplicated again in the summer or 2001, I do think we need either the Secretary or the FERC to exercise their wholesale price controls. The market, where it is clearly broken, where you can set short-term temporal limits on it and apply it to existing generation so we do not discourage the siting and development of new generation, which we absolutely need for the long run, I think is an appropriate mechanism to control the prices.

With that summary, I will finish. Thank you.

[The prepared statement of Mr. Glynn follows:]

PREPARED STATEMENT OF ROBERT D. GLYNN, JR., CHAIRMAN, CEO AND PRESIDENT, PG&E CORPORATION

Good morning, Chairman Murkowski, Senator Bingaman, and members of the committee. I'm Robert D. Glynn, Chairman, CEO and President of PG&E Corporation. Thank you for the opportunity to appear before you today, as you continue your examination of California's electricity shortages and related price impacts across the West. Let me also acknowledge my own Senator from California, Senator Feinstein, and thank her for her interest and fortitude in helping find solutions to these difficult problems.

As you know, wholesale electricity prices in California and the West remain at unprecedented levels—the estimated average price for February in California was $228 per megawatt hour, with no relief in sight for consumers or the utilities and retail energy providers serving them. Supply, both in terms of available megawatts and the natural gas used to produce electricity, is extraordinarily tight. Hydropower, in particular, continues to be short. At this point, it appears certain that the availability of hydropower across California and the Pacific Northwest will be substantially below normal. Recent storms have improved the California hydro outlook slightly from as recently as a month ago, and our utility currently forecasts hydro availability of about 70 percent of normal. The Northwest outlook however, is unchanged: BPA continues to forecast hydro at just over 60 percent of normal.

As we look to the peak usage summer season, the dire predictions you heard at the last hearing on this subject seem, if anything, to be optimistic now. At best, according to the California ISO, the state will be short 2 to 3 thousand megawatts for the summer, and that forecast may not fully reflect current hydro conditions in the Northwest.

In that context, the implicit theme of your hearing today, "How can we moderate or limit electricity price impacts this summer, while simultaneously sending the correct market signals to promote supply-demand equilibrium?" is precisely the correct short-term question. Given the fact that broad resolution of the supply problem is necessarily a longer-term activity, the immediate answer to the price impact component of the question in the short time frame between now and summer is that California and the West will be scrambling to use all tools currently available to address the problem: 1) bringing power plants now down for maintenance and repairs back on line; 2) siting and building new "peaking" power plants in an expeditious manner; and 3) implementing emergency demand reduction efforts. All three of these measures are the best mechanisms available to address the very top of the demand peaks that will occur—and to help mitigate prices without exacerbating the supply problem.

In short, we must act immediately to provide market-oriented solutions that attack the supply problem first and encourage fast-track supply projects, such as is being done now with peaking units. In the interim, a combination of supply and demand initiatives is imperative—everything from the longer-term bilateral contracts being implemented now between the state of California and suppliers, as well as demand-reduction incentives comparable to those that were initiated last summer. We also believe that prices at the retail level in California need to be adjusted further to better reflect the true cost of electricity so that adequate signals can be sent to encourage more responsible electricity use.

Even then, given the extent of the expected supply/demand imbalance for this summer, it is not clear that these tools will fully mitigate the potential economic impact this summer. This leads us to the pieces of legislation before you today that address price caps in one way or another.

Historically, PG&E Corporation has not supported price caps; over the long term, they create market distortions and have unanticipated and perverse consequences. In a functional market, they mask the peak price signals that spur conservation, changes in usage patterns, investment in energy efficiency and in new supply. Often, they make matters worse. That said, in June of last year we recognized that in circumstances where power markets are not fully competitive, short-term implementation of price caps might be necessary.

We adopted a corporate policy statement (attached) that addressed those circumstances, which can be summarized as follows: where markets are clearly broken, for example, where FERC has determined that prices are not "just and reasonable," short-term offer caps may be warranted.

This was not an easy decision on our part, because in addition to Pacific Gas and Electric Company, the utility that serves much of northern and central California, we also own the National Energy Group, which builds, owns and operates power plants across the country. So, as you might anticipate, there was a fair amount of discussion and thought in the process that led to our corporate policy.

With that process in mind, I'd like to address regional price caps for the West, for the summer of 2001. Based on what we know today, there is a very good chance that the West is heading for a meltdown where—due to short supplies—the price of power could increase from today's already historically-high levels to sustained stratospheric levels for the summer. That would inflict severe hardship on households and the economies of the Western states to no good end; prices are already high enough to incent new generation, which is being built as fast as it can be permitted and constructed.

In order to avoid that meltdown, policy makers should create a mechanism, which would allow either the Secretary of Energy or the FERC to implement temporary price caps, should our worst fears be realized. It seems only prudent to create the policy tool and carefully describe the circumstances under which the tool can be used, including the duration of use. For example, any price cap should have an explicit start and sunset date, for instance, May 1 and September 30 of this year. And in order not to inadvertently discourage new, badly needed power plants, the price cap should apply only to existing generation.

With respect to setting a price cap, it must be simple enough to be easily administered, and it should allow suppliers to make a reasonable profit. Most options being given serious consideration involve benchmark rates that build up from a cost basis. Frequently discussed are technology-specific caps that would cover suppliers' costs plus a stipulated profit margin. Under this approach, caps would be set at different levels based on the type of generating resource—natural gas, coal, hydro, etc. Other options include fixed price caps at levels high enough to accommodate input price fluctuations, such as variations in the price of natural gas, or indexed caps equal to some multiple of current input prices.

I strongly believe in markets; if I didn't, we would not have invested money in building power plants across the United States to participate in competitive wholesale power markets. A meltdown in the Western power market this summer would be a huge setback to the development of a national wholesale power market, and markets in general.

Mr. Chairman, I would be pleased to answer any questions.

Senator BINGAMAN. Thank you very much.

Next is William Hecht, who is the chairman and CEO and president of PPL Corporation in Allentown, Pennsylvania. Thank you for being here.

STATEMENT OF WILLIAM F. HECHT, CHAIRMAN, PRESIDENT AND CEO, PPL CORPORATION, ALLENTOWN, PA

Mr. HECHT. Thank you, Senator.

PPL Corporation is an energy company that markets electricity in 42 States and Canada and operates about 10,000 megawatts of generating capacity in Pennsylvania, Montana, and Maine and delivers electricity to about 6 million customers on three continents.

In addition to representing the views of PPL, I am also appearing on behalf of the Electric Power Supply Association, a national trade association representing competitive suppliers.

While there are many contributing factors to the electricity supply crisis in the West, the underlying problem is that California does not have enough electricity supply. The State has an electricity load of about 48,000 megawatts and in-State generating resources of only about 38,000 megawatts.

The real solution to the problem is not in artificial price controls but in a focus on the forces of supply and demand which will both discourage consumption and encourage production. Reflecting actual current economic value of electricity through retail prices in some form for at least some users would exert downward pressure on consumption, immediately helping to reduce the mismatch between supply and demand. This in itself would help reduce wholesale prices.

Even more importantly, prices set by supply and demand will send the proper price signals to investors, encouraging the construction of new generating facilities.

Price caps would, on the other hand, reduce the incentive to invest in new production and unnecessarily prolong and exacerbate the existing supply and demand imbalance. This free market lesson is one that we have learned elsewhere in the U.S. energy industry as a failed experiment with natural gas price controls would attest. Allowing the free market to function and to send the right price signals will result in the significant capital investments that are needed to build the next generation of American powerplants.

There is ample evidence that such a process is working in places other than California. Across the country, more than 125,000 megawatts of generating capacity are under construction or in advanced development in markets where investors believe they can successfully site plants and receive a fair return on their investment.

My company is but one example of this process at work. PPL has explored acquisition and development of power generating facilities at more than 100 locations in the United States and even overseas. In each case, we carefully study available supplies in the region, our estimate of future marketplace prices, the likelihood of success in constructing a facility, and a host of other factors. This very selective process has resulted in our acquisition of about $1 billion in generating assets, principally in the State of Montana, and PPL is developing plants in eastern Pennsylvania, Eastern United States, and in Western U.S. markets that could result in an investment of approximately $2 billion more. As I speak today, we are developing powerplants in Connecticut, on Long Island, in Pennsylvania, in Washington State, and in Arizona.

It goes without saying, of course, that we are developing these plants, which will add more than 4,000 megawatts of supply, because they are located in key markets where the power is needed and that offer long-term opportunities for our shareowners. Put another way, if the wholesale markets in these regions were not sending the appropriate price signals, we could not justify building the plants there.

I am convinced that there is only one way to ensure adequate supplies of electricity for the people of California and the rest of the country: We must encourage the building of new powerplants. These new supplies, however, will be put at risk if we begin to artificially manipulate or threaten to artificially manipulate the wholesale markets. For the reasons I have detailed in my written testimony, imposition of price caps or a return to cost-based rates would actually result in two very problematic, unintended results: reduced likelihood of new powerplant construction and, ironically, over time higher average prices for electricity.

The bills before you also propose refund requirements on companies that own generating facilities, essentially rewriting the rules under which the transactions were made. These interventions in the market not only would hurt the very companies that are part of the potential solution, they would also discourage those who are considering such development.

Some say that the building of new powerplants is too complicated, too environmentally threatening, and too time consuming to address the current situation. This is simply not true. New generation can be installed rapidly in compliance with existing laws and regulations that fully protect environmental quality.

Further, modern electric generation technologies are cleaner and more efficient than those in use only a few years ago. Higher efficiencies mean that less fuel is used to produce each kilowatt hour of electricity and cleaner technologies mean that even the fuel that is burned produces fewer emissions.

There are some steps that the Federal and State governments can take to ensure that new generating units can be built quickly and efficiently.

For instance, environmental review can be accelerated procedurally without reducing the participation of knowledgeable intervenors or compromising the quality of the outcome. Government can also make sure that the electric transmission system is fully open and accessible to all market participants. Such enhancements, combined with the time-proven forces of supply and demand, can result in new supplies being available in as little as 24 months for conventional generation and sooner for distributed generation which has higher cost.

In conclusion, I believe that the California experience underscores the need for a renewed commitment to competitive electricity markets.

Thank you very much.

[The prepared statement of Mr. Hecht follows:]

PREPATRD STATEMENT WILLIAM F. HECHT, CHAIRMAN, PRESIDENT AND CEO, PPL CORPORATION, ALLENTOWN, PA

I am William F. Hecht, chairman, president and chief executive officer of PPL Corporation. Thank you for the opportunity to appear before this Committee to share my views on S. 26, S. 80 and S. 287.

These legislative proposals raise issues that are central to the future of the nation's energy supply.

In addition to representing the views of PPL, I am also appearing on behalf of the Electric Power Supply Association, a national trade association representing competitive suppliers, including independent power producers, merchant generators and power marketers.

PPL, with headquarters in Allentown, Pa., is a rapidly growing international energy company with revenues of nearly $5.7 billion.

We operate four principal subsidiaries:

- PPL EnergyPlus markets wholesale electricity in 42 states and Canada and markets competitively priced retail electricity in several Eastern and Western states. PPL EnergyPlus also provides energy services in the Mid-Atlantic and New England regions.
- PPL Generation owns and operates U.S. power plants. Its portfolio includes nearly 10,000 megawatts of generating capacity in Pennsylvania, Maine and Montana. In the East, our 8,500 megawatts areis primarily coal-fired and nuclear generation. In Montana, our 1,150 megawatts are coal-fired and hydro generation. Our Montana plants were acquired from The Montana Power Company in late 1999, and since that time have been used primarily to serve Montana electricity customers under a wholesale agreement that we signed with Montana Power at the time of the purchase. We have sold a limited amount of wholesale power into the California market since acquiring the plants.
- PPL Electric Utilities delivers electricity to 1.3 million customers in eastern and central Pennsylvania.
- PPL Global owns distribution businesses in the United Kingdom and Latin America that deliver electricity to 4.4 million customers. The company also develops and acquires generation in key U.S. markets. It now has more than 4,000 megawatts of capacity under active development.

THE SOLUTION FOR THE CALIFORNIA MARKET IS NEW GENERATION

The electric supply situation in California has reached nearly crisis proportions. California and other Western states now face economic dislocations due to the high cost of electric power, and California itself also faces a fundamental reliability problem.

There are many reasons for the current economic and reliability problems. Gas prices increased. Electricity demand increased rapidly. It was a "low-water" year for hydroelectric generation. The West Coast experienced a heat wave.

However, the underlying problem in the Western System Coordinating Council—the interconnected system of which California is a part—is that there simply is not enough generating capacity to meet load requirements. This generating capacity shortfall is directly traceable to California, which has a load of about 48,000 megawatts and in-state generating resources of only about 38,000 megawatts.

This means that California must import large quantities of electricity to satisfy its demand. And, much of the in-state generation is old and inefficient. California has not built a significant generating facility in more than 10 years. Further, transmission limitations sometimes exacerbate the generation shortfall.

The solution to this problem is to permit the forces of supply and demand to set prices, and to allow those prices to both discourage consumption and encourage production.

Reflecting the actual economic value of electricity through higher retail prices—in some form for at least some users—will cut consumption, immediately reducing the mismatch between supply and demand. This, in itself, would help reduce wholesale prices.

Even more importantly, prices set by supply and demand will send the proper price signals to investors, encouraging the construction of new generating facilities. And, additional generation is the solution to the root problem.

This additional generation can be installed rapidly, with existing laws and regulations fully protecting environmental quality. Further, modern electric-generation technologies are cleaner and more efficient than those in use only a few years ago. Higher efficiencies mean that less fuel is used to produce each kilowatt-hour of electricity. And, cleaner technologies mean that even the fuel that is burned produces fewer emissions.

There are a number of steps that federal and state governments can take to ensure that new generating units can be built quickly and efficiently. For instance, environmental review can be accelerated procedurally, without reducing the participation of knowledgeable intervenors or compromising the quality of the outcome. Government also can make sure that the electric transmission system is fully open and accessible to all market participants, especially new generators.

Even with such enhancements, however, new generation will be developed only if we allow the forces of supply and demand to operate unencumbered, to freely set the price of electricity. Price caps would, on the other hand, reduce the incentive to invest in new production and unnecessarily both prolong and exacerbate the current supply and demand mismatch.

This free-market lesson is one we have learned elsewhere in the energy industry. When the federal government limited the wellhead prices of natural gas, producers had no incentives to develop wells, resulting in severe supply shortages and restrictions of customer hook-ups. As soon as the price caps were lifted, drilling activity expanded, resulting in ample supplies and lower prices for customers.

DEREGULATION

Under the regulated structure of the past, public utilities operated in franchised service territories and had mandatory obligations to serve customers. As part of this obligation, the utilities were required to build capacity to meet load requirements.

This structure, which proved to be inefficient, has been replaced with a deregulated marketplace in which generation is built based on the forces of supply and demand. Power plants are now built in response to price signals with increasing prices signaling the need for new capacity. Over the long-term, this deregulated marketplace will lead to prices for end-users that are lower than they otherwise would have been under regulation.

In a deregulated energy marketplace, the mere existence of high prices does not necessarily mean that a market is dysfunctional. In fact, in any correctly functioning market, high prices are simply a proper and normal signal of demand outpacing available supply.

This is not to suggest that we should—in any way—tolerate market power abuse or collusion. In cases where there are proven instances of abuse of market power, the Federal Energy Regulatory Commission has adequate powers to correct those abuses. Certainly, the Justice Department and state agencies also will address any issues of collusion or anti-competitive behavior.

Allowing the free market to send the right price signals except in the case of illegal activities will encourage the capital investment that we need to build the next generation of American power plants. There is ample evidence that such a process is working in places other than California. Across the country, more than 125,000 megawatts of generating capacity are under construction or in advanced development.

My company is a good example of this process at work.

PPL has explored acquisition and development of power generation facilities at more than 100 locations in the United States—and even some overseas. In each case, we carefully studied available supplies in the region, our estimate of future marketplace prices, the likelihood of success in siting and constructing a facility and a host of other factors.

This very selective process has resulted in our acquisition of about $1 billion in generating assets, principally in the state of Montana. And, PPL is developing plants in key Eastern and Western U.S. markets that could result in additional investment of approximately $2 billion.

As I speak here today, we are developing power plants in Connecticut, on Long Island, in Pennsylvania, in Washington state and in Arizona. It goes without saying, of course, that we are developing these plants—which will add more than 4,000 megawatts of supply in these key regions—because we believe they will benefit our shareowners.

Put another way: If the wholesale markets in these regions were not sending the appropriate price signals, we could not justify building plants there.

I am absolutely convinced that there is only one way to ensure adequate supplies of electricity for the people of California and the rest of the country:

We must encourage the building of new power plants.

PRICE CAPS

These new supplies, however, will be put at risk if we begin to artificially manipulate the wholesale markets. Imposition of price caps, or a return to cost-based rates, actually will lead to decreased supplies—and thus, higher prices.

Price caps interfere with the most important part of any functional market—the price signal.

Caps are designed to clip the peaks of price movement in the market, with the goal of thereby reducing average prices. The California experience itself has shown that price caps tend to encourage higher average prices, which could actually lead to an increase in costs to consumers. Caps also can result in a transfer of capacity to higher value markets. That will surely happen in the West, as resources seek higher-priced markets elsewhere or even, in certain circumstances, shut down if they cannot achieve sufficient revenues for operation.

Second, the caps signal developers to go elsewhere. Developers of generation look for the best returns they can find, on a risk-weighted basis. They are not limited to California, the Western United States or even the United States as a whole. Putting a cap in place will send a strong signal to developers that the western United States is coming more and more under price controls and government interference. Developers will respond to that signal by avoiding those markets. Moreover, the history of price caps so far in California has been one of change. Price caps in California last year changed regularly between $150 and $750 per MWh. Such uncertainty and changeability produces additional caution, leading to higher required returns for project development, eventually resulting in higher prices for consumers. In the extreme, price caps, along with their variability and lack of predictability, may lead to generation development being canceled in favor of projects elsewhere.

Third, a cap tends to reduce the volatility of a market, which can lead to reduced trading and hedging instruments. A critical part of evaluating any market is understanding the volatility of that market. Volatility is the tendency of prices to move up or down—higher volatility means that prices change more often and to a greater degree. A price fixed by government fiat has essentially zero volatility. By limiting the upper range of price spikes, prices will change less often and by not as much. Since energy traders make their money on price changes, a less volatile market will have fewer traders in it providing liquidity. Reduced liquidity results in less price discovery—the knowledge about what the price of electricity may be in the future. Developers need as much knowledge of future prices as possible to make informed decisions about investments. Traders, generators and consumers also need the forward market to allow for the hedging through long-term contracts that has been touted as a short-run solution to California's woes.

There is a fourth harm from caps that also stems from the loss of volatility—developers will make the wrong decisions. A volatile market is sending out a price signal for peaking generation. Prices occasionally spike upwards (or downwards); the appropriate generation response to such spikes is a peaking unit that only runs occasionally. The peaking unit will pick-off the higher prices, thereby reducing them. Alternatively, if there is lower volatility and higher average prices, the appropriate business decision is to build baseload plants that are designed to run relatively cheaply and all the time. This takes advantage of higher average prices and does not really address price peaks.

Caps tend to distort the market signal in favor of baseload generation. With the scarcity problem in California, that may not seem like an important problem right now since any generation would be helpful. However, baseload plants can cost several times as much as peaking units and take considerably longer to construct. The market will either pay to recover those costs or those plants may go bankrupt and cease operations in the future. Regardless, efficient economic decision-making by developers requires the correct price signal coming from the market.

For all these reasons—higher average prices, reduced development, reduced forward liquidity and inefficient price signals—price caps are inappropriate and dangerous for California and the Western United States.

The legislation before you also proposes refund requirements on companies that own generating facilities, essentially rewriting the rules under which the transactions were made. These interventions in the market not only would hurt the very companies that currently are part of the potential solution to the supply crisis, they would discourage those who are considering such development.

Returning to cost-based rates can be a particular problem. Under regulation, vertically integrated public utility companies had mandatory obligations to serve within their franchised territories. This meant they were required by state regulators to build whatever capacity was required to meet demand.

Because of the mandatory obligations to serve, regulated companies had to build whatever capacity was needed even though rates were capped or cost-based. Today, however, that archaic system is gone in many parts of the country. In California, Pennsylvania and many other states, independent generating companies, not regulated public utilities, now build generation. Local electric distribution companies no longer have an obligation to build generating facilities, and the generation function has been deregulated.

If rates for generation are "capped" or returned to old "cost-based" structures or if other economic restrictions are placed on these new unregulated generating companies, they simply will not build the facilities needed to serve the public because they will have no incentive to build and there is no obligation to construct plants. The capital with which those plants would have been built will go elsewhere.

Ironically, price caps may actually serve to benefit companies such as PPL, which currently own significant amounts of low-cost, efficient generation—our Montana power plants, for example.

The reason for this benefit to companies like PPL is straightforward. Price caps would have the effect of prolonging the time before new, efficient generation is constructed. Prices that otherwise would have declined with added generation will remain at capped levels for a longer time—and for more hours—than would have been the case. Existing generation would remain more valuable than otherwise would have been the case.

CONCLUSION

The real solution to the long-term supply issues in California and the West is inescapable: We need to build new power plants. And, those new plants will be built only if we allow the competitive market to do its job.

If we use the California experience to further improve our commitment to truly competitive electricity markets, then our nation's energy supply future can be a bright one.

And, I am confident that—after considering all the facts—we will reach the conclusion that electricity deregulation not only is sound public policy . . . it is the only way that we will be able to ensure adequate electricity supplies at fair prices.

Senator BINGAMAN. Thank you very much.

Our final witness is Steve Fetter, who is the managing director of the Global Power Group with Fitch. Welcome.

STATEMENT OF STEVEN M. FETTER, MANAGING DIRECTOR, GLOBAL POWER GROUP, FITCH, INC., NEW YORK, NY

Mr. FETTER. Thank you, Mr. Chairman and Senator Feinstein. I appreciate the opportunity to offer my views with regard to the important issue of Federal price caps or controls for the protection of consumers.

I note that in some ways, though, you have presented me with my own worst nightmare. I am surrounded on this panel with Fitch bond rating clients and they have taken positions on all sides of this issue.

Senator BINGAMAN. Now you know how all of us in politics feel. [Laughter.]

Mr. FETTER. Yes, exactly. So, now you have asked me, Mr. Fetter, so what do you really believe? So, I guess the only path I can take is to offer my sincere thoughts.

As a former State regulator, I see nothing wrong with continued cost-based regulation for service obligations that the traditional utilities are still mandated to provide for core customers who have chosen not to receive alternative competitive supply from a third party provider.

At the same time, from my vantage point on Wall Street, I believe that if you are going to have competition, policy makers have a duty to let markets operate.

To the extent possible, under a competitive framework, it is important to reduce the role of government. I have long adhered to the controversial view offered years ago by then California PUC president Greg Conlon who said that divestiture of transmission was the best model for dealing with market power concerns and ensuring non-discriminatory market access for new energy providers. It could even reduce or even eliminate the need for quasi-governmental organizations, such as the California ISO and the Power Exchange and similar entities elsewhere. But divestiture of transmission was never ordered due to political concerns and timeliness issues at that time.

Instead, California took the flawed path of encouraging, virtually to the point of mandating, utility divestiture of most of their generating capacity. California government also placed strict limitations on a utility's ability to procure electricity supply for its core residential customers. We are all familiar with the sad results of that strategy.

So, from where we find ourselves now, can price caps help the situation?

I am willing to go so far as to admit that Federal enactment of a uniform price cap at a high level—let us say $1,000 per megawatt-hour—might serve a useful purpose. It could operate as a circuit breaker or safety valve to cap wholesale prices during the brief periods of time when extremely volatile circumstances result in a market that cannot be contained by any manner of competitive forces. It also probably would not interfere with strategic decision making by generation suppliers because prices at the $1,000 per megawatt-hour level do not enter into their financing models.

However, to go below that level, indeed to go anywhere near the $250 per megawatt-hour or even $150 levels that proved ineffective in California would in my opinion slow the Nation's movement towards an efficient, competitive wholesale market. Suppliers would seek alternative market outlets or slow their production of electricity and they certainly would reassess further investment in the generation sector where such price caps were in place.

I would also not be surprised to see litigation brought by those who purchased generation assets at very high prices based on reliance on State legislative enactment of laws defining the new competitive market orientation, the theory being an unconstitutional taking of private property in the form of decreased valuations without fair compensation.

I offer further thoughts in my written testimony that the ongoing negotiations over sale of the three California utilities' transmission assets could conceivably provide a second chance to take the road not taken several years ago.

I would be happy to respond to any questions that you may have. Thank you.

[The prepared statement of Mr. Fetter follows:]

PREPARED STATEMENT OF STEVEN M. FETTER, MANAGING DIRECTOR, GLOBAL POWER GROUP, FITCH, INC., NEW YORK, NY

I appreciate the opportunity to testify before the Committee on Energy and Natural Resources to offer the views of Fitch on S. 26, a bill to amend the Department of Energy Authorization Act to authorize the Secretary of Energy to impose interim limitations on the cost of electric energy to protect consumers from unjust and unreasonable prices in the electric energy market; S. 80, the California Electricity Consumers Relief Act of 2001; and S. 287, a bill to direct the Federal Energy Regulatory Commission to impose cost-of-service based rates on sales by public utilities of electric energy at wholesale in the western energy market, and amendment No. 12 to S. 287. I will speak from the perspective of a member of the financial community as well as former Chairman of the Michigan Public Service Commission.

In 1995, Fitch formulated an Electric Industry Time Line (see attachment) that forecast the general evolution of power markets within the United States. I am happy to say that restructuring activities across the country have to a large degree tracked Fitch's predictions. However, substantial divestiture of generation assets in many states, most notably California, left the endpoint of the analysis—that utilities would be operating under regulated and competitive supply models concurrently—in question.

Fitch's conclusions were based on the belief that when competition was in place after 2000, utilities would be operating under a bifurcated structure: a lower risk regulated market and a higher risk competitive market. Within the lower risk regulated market, integrated utilities would generate or purchase power to meet an obligation to serve core residential customers, much as they have under the traditional system of cost-of-service-based regulation. But in addition to that familiar framework, there would be a competitive market under which utility generation subsidiaries, independent power producers, and power marketers could compete to supply electricity to industrial and large commercial users, and aggregated smaller customers (both small commercial and residential). This half of the model, by its very nature, would be a higher risk undertaking for both seller and purchaser.

California's restructuring plan encouraged utility divestiture of generation and substantial government involvement in the operation of the transmission grid (through an independent system operator, or ISO) and the power market (through a power exchange, or PX). For those who believe that the catastrophic events in California in late December and early January came without warning, I invite attention to "Procuring Power in California: A Potential Stranded Cost," a September 2000 Fitch report by Lori Woodland, detailing the pressures soon to be faced by California's three investor-owned electric utilities, Pacific Gas & Electric (PG&E), Southern California Edison (SCE), and San Diego Gas & Electric (SDG&E). A copy is attached.

California's restructuring model called for a high proportion of customer demand being met by spot market supply from day-ahead or hourly transactions. This exposed the state's three investor-owned utilities, which were operating under retail price caps, to extreme financial risks due to wholesale market volatility. By contrast, in more rational market structures for electricity and other energy commodities, approximately 85-90% of demand is normally provided through long-term contracts, with at most only 15% subject to spot market fluctuations. The extreme volatility of price at the wholesale level has given rise to urgent calls for a "fix" in the form of lower and lower price caps.

So will price caps provide the solution?

I am willing to go so far as to admit that federal enactment of a uniform price cap at a high level—such as $1000 per mwh—might serve a useful purpose. It could operate as a circuit breaker to cap wholesale prices during the brief periods when extremely volatile circumstances result in a market that cannot be contained by any manner of competitive forces. It also probably would not interfere with any strategic decision making by industry participants since builders of new generation or transmission would not employ prices at that level (or higher) in their financing models.

However, to go lower than such a safety valve-type level would undoubtedly slow the nation's movement toward an efficient competitive wholesale market. We have already seen that imposition of a low price cap, such $250 per mwh or even $150 per mwh, can have the negative effect of encouraging suppliers to seek alternative market outlets or even to slow production. Continued tinkering with market rules, especially if at the macro federal level, is sure to create uncertainty among energy investors and delay implementation of their business plans, especially in light of recent ambiguous economic signs.

A further concern for market participants is that major investments have been made in California and other states based on the particular competitive frameworks mandated by state legislatures. Price levels for generation asset auctions were driven by the new market orientation; a retrenchment by state policymakers back to a form of cost-of-service regulation could be challenged as an unconstitutional taking of private property without fair compensation. Below-market price caps would contribute to this situation and could conceivably result in the government being ordered to pay the difference between the market value of assets in a competitive environment versus in a newly-tariffed regime.

Interestingly, the ongoing negotiations about sale of the California transmission grid to the state hearkens back to a controversial point of view then-California Public Utilities Commission (CPUC) President Greg Conlon espoused during the early stages of implementation of electricity industry competition. Speaking to the National Association of Regulatory Utility Commissioners Electricity Committee in July 1997, Conlon explained that an ISO was not the first choice of the CPUC for controlling the market power of utilities owning transmission lines. Rather, Conlon said, the statewide ISO was a compromise; the best model he believed for dealing with market power concerns and ensuring nondiscriminatory market access for new entrants was divestiture of transmission to third parties. That action was never taken because of political concerns and timeliness issues. (See attached Fitch report, "Divestiture Gets A Boost," August 18, 1997.)

Now it appears California will revisit the question of divestiture of transmission through its negotiations to sustain the financial viability of its state's utilities. However, early signs are that a purchase of the transmission systems from PG&E, SCE, and SDG&E may be followed by the leasing of the assets back to the utilities to operate. Instead, the state might want to consider seizing this new opportunity to create an independent owner or, at least, operator of the state's transmission grid. Such a step would allow the state to remove itself from amidst the electricity supply morass and reduce its activities to the more appropriate role of facilitating private sector investment in enhancing the state's energy infrastructure. This of course could include increased generation investment by the three California investor-owned utilities without fear of creating competitive conflict. Breaking the tie between generation and transmission would allow the state's utilities and third-party players to compete on a level playing field with minimal state interference.

I continue to believe that the bifurcated utility structure described above creates the proper balance between retail choice and customer protection. In the final analysis, policymakers who thought retail choice could only be a win-win proposition need to reassess their stance. There are customers who believe themselves savvy enough to participate in energy markets in an attempt to improve their financial situation while bearing the risk that they will not. They should be given that option. At the same time, there is another group of consumers the vast majority of residential users who never wanted things to change. For them, the provision of a cost-of-service regulated alternative is a necessity.

Senator BINGAMAN. Thank you very much. Thanks to all of you for your very good testimony.

Let me ask Mr. Hecht. I am concerned. I guess I am still confused. In order to incentivize companies like yourself, your own company and others, to generate power for sale in the California market, why is it essential that you allow prices to go as high as they have gone? I can understand how you would want to have a good return on your investment, but why do you need prices in the ranges that they have been? Why should we be concerned about protecting the ability of people to charge prices in those ranges, on the theory that they are going to lose interest in producing power, if we do not protect those rights?

Mr. HECHT. There are several good examples that I will give you.

First of all, fuel cost alone in a few cases has exceeded $500 a megawatt-hour. In a few cases, delivered price of natural gas has been in the range of $50 a million Btu's. And a good round number for some gas turbine generators is 10,000 Btu's per megawatt-hour. Simple arithmetic: $500 a megawatt-hour.

Some other examples. There are some things that can be done in the near term to increase supply even for this summer. For example, it is true that installing conventional generation can take 24 months and longer. But installing some forms of distributed generation can be done much more quickly but at much higher cost. Sending the right price signal to the end user will give that end user the economic incentive to install, even for this summer, some distributed generation, which can be done in that time frame.

So, there are some important reasons why prices should be allowed to follow the market.

The prices are high. The market has been called dysfunctional. I do not think that there is evidence that the market is dysfunctional. Those high prices are telling you something, telling you that there is a dramatic mismatch, not a mild mismatch, between supply and demand. And we ignore that signal at some peril.

Senator BINGAMAN. We have this chart that Senator Feinstein has got up there. Could you put that one up? The way I read that is the two lines that run across there show the power generation in 2000 and the power generation in 1999.

Mr. HECHT. Yes.

Senator BINGAMAN. And the gap between those is modest.

Mr. HECHT. Yes.

Senator BINGAMAN. And you are saying that the mismatch is so enormous that that explains the prices that are reflected on the chart. The truth is the mismatch is pretty minimal compared to the price changes that have been observed.

Mr. HECHT. Yes. I saw that chart this morning, and I am anxious to speak to it because that chart just plots price against time. If you were to plot price against demand, at periods of low demand, periods when there is a surplus of generation, the curve would be relatively flat, plotting price against demand. At periods of high demand, periods when demand and supply are almost matched, when demand is on the verge of exceeding supply, as it has in California during the stage 3 alerts, the price/demand curve gets very steep. So, modest increases in demand or even small reductions in supply can produce dramatic changes in price. If you were to look behind the numbers on that simplistic chart, I think you would see that.

What that chart does not reflect is the example I gave earlier of $50 a million Btu gas resulting in a fuel price alone of $500 a megawatt-hour for a 10,000 Btu per kilowatt hour plant.

It also does not reflect reductions in capacity which occurred in California. Some small power generators actually shut down because they were not paid. Some hydro facilities were less available because it was a low hydro year. There was also a reduction in capacity resulting from other forces as well.

Senator BINGAMAN. You are saying that that much was not generated. Basically you are saying that that red line there that shows how much was generated in the year 2000 is wrong.

Mr. HECHT. No. The generation matches load on an hour-to-hour, minute-to-minute basis, but the generation that was called for approached the absolute capability of the system. In fact, that is the definition of the stage 3 alerts that have happened in California that we have all read about. And during those periods, it is perfectly expected for prices to get high.

I can give you some other examples as well. This is not unique. Those prices are in the several hundred dollars a megawatt-hour range. As early as 1998 in the Ohio region, the so-called east-central area reliability region, during a period of a number of nuclear plants being forced out of service, prices hit $3,500 a megawatt-hour and higher. So, that is not unprecedented.

In PJM in the Eastern part of the country, prices have hit $1,000 a megawatt-hour during short periods.

Senator BINGAMAN. Let me give you my lay person's view of why prices may be hitting these very high levels, and then I will defer to Senator Feinstein because my time is up here.

What you have here is a requirement on the utilities, the certificated utilities, in the area to provide power, and they are required by the commissions in their respective States, in this case California, to provide that power in whatever way they can. So, when they see a shortage, they will pay whatever they have to pay to obtain that power. So, in a lot of ways, it is not a traditional market where you can either buy or not buy depending on whether the price is to your suiting.

Mr. HECHT. That is correct.

Senator BINGAMAN. In this case, you have got utilities that are under legal obligation to buy that power at whatever price they have to pay and continue to buy that power at that price until they themselves go bankrupt.

Mr. HECHT. You make a very good point. The forces of supply and demand in most markets are allowed to act not only on the supply side of the equation but also on the demand side of the equation. And because retail prices are fixed in California, there has been no demand response. You are absolutely right. That has increased the volatility of those markets.

Senator BINGAMAN. Yes, and the legislation that Senator Feinstein and Senator Smith have put together would try to address both, as I understand it.

Senator Feinstein.

Senator FEINSTEIN. Thanks very much, Mr. Chairman.

Mr. Baum, do you remember our conversation in San Diego and you told me that when Sempra had to purchase power in the middle of the night, it was 500 times higher in cost?

Mr. BAUM. Yes, I do.

Senator, I would like to, if I may, make a comment about your chart and respond to some of the things that have been said.

Senator FEINSTEIN. I would appreciate it.

Mr. BAUM. First of all, I think we could correct the record that during the period of time shown in that chart, at least through the summer spike period, I do not believe California had a stage 3. The stage 3's have come up subsequently. So, the assumption that we actually had a shortfall of whatever—I think it is once they go below a 1.5 percent reserve, that it is stage 3—did not occur.

Furthermore, natural gas prices remained fairly steady during that period. They have recently spiked, particularly through the transportation costs.

So, neither of those factors in this picture that is portrayed on this chart—and it defies any reason to believe that in the nighttime hours, when demand is actually quite low, that prices would have remained at very, very high levels, above $100 a megawatt-hour quite often during that summer period and even higher today in the nighttime hours. That can only be accounted by market distortions or irregularities in my opinion.

Senator FEINSTEIN. Thank you very much.

PG&E, Edison, and Sempra together sell power to how many customers? Mr. Bryson?

Mr. BRYSON. The number would be about 10 million customers, approximately. It is the largest part of the State of California. 10 million customers would probably mean 25 million people, something like that.

Mr. BAUM. I think that is about right. I think there are about 12 million meters in the State, something like that. The other two would be with the municipalities.

Mr. WORTHINGTON. We have 4.8 million meters and a lot more people represented by that.

Senator FEINSTEIN. So, these are, in effect, the largest distributors of power in our State.

Now, one of the things that was pointed out and is very much correct is that the 1996 law forced these utilities to divest themselves of their generation facilities. I wanted to ask this question. When you generated electricity, what was your megawatt cost?

Mr. BRYSON. Our cost for a long period of time had been on the order of $35 a megawatt or 3.5 cents a kilowatt hour.

Senator FEINSTEIN. PG&E, could you respond?

Mr. WORTHINGTON. I am not exactly sure of the number but I believe that is the order of magnitude for our historic cost-based rates as well.

Senator FEINSTEIN. Mr. Baum.

Mr. BAUM. Yes. That is about correct, depending on which of the generating units, whether they were nuclear or gas fired units.

I would comment too that those very plants that produced that electricity at those costs were the plants that were bought by the generators when we divested.

I wanted to go to one of the points about the targeted caps and whether that would be an ex post facto taking or somehow unfair. Those very generators that bought those plants made a filing at the FERC, not long after they had acquired them, asking the FERC to recognize that the costs that they had paid the utilities for those plants were to be considered, should cost-based rates be put in place, the cost that they should have in their rate base. As I recall, the FERC said no, that it should be the book cost that existed on the books of the utilities at the time those plants were acquired. So, I would dispense immediately with any notion that there was some unfairness or lack of notice or taking that would occur should cost-based rates be imposed on an old plant that was acquired, which is all I believe targeted caps would do.

Senator FEINSTEIN. Thank you. That is very helpful.

The point I am trying to make, Mr. Chairman, is they were able to generate power at $35 a megawatt hour. A year or so later, the people that bought those same facilities were charging these same people up to what a megawatt-hour? Mr. Bryson?

Mr. BRYSON. Certainly the market at times has gone—there was one case when it went to $800 a megawatt-hour. That is not standard. But if you take again the Wall Street source 2 days ago for the entire market—so that would include these people that bought our plants—$353 a megawatt-hour I believe was the number. So, approximately 10 times what the prior cost-based pricing had been.

Now, an important reality addressed today is that natural gas prices in that period had gone up. Some underlying costs had gone up. So, cost-based pricing would be substantially higher than the traditional $35 a megawatt-hour, but we do not believe it would be anywhere near the 10 times that.

If I could, there has been much reference this morning, including on the part of Mr. Hecht whose views I respect, that the price of current wholesale cost needs to be seen by the retail consumer. But as a practical matter, increasing utility rates by 10 times overnight would have such enormously dislocating and disruptive consequences that it just is not a practical or desirable thing to do.

What I am concerned about is when people address this problem strictly as a matter of theory, they come to nice solutions that in practical effect would hurt deeply lots and lots of people and already have hurt badly the California utilities and California customers. We have this theory competition between those who say rates ought to not go up at all, that current rates were fine a year ago so do not raise them, and those that say current price signals ought to be put into retail rates all the time. That theory competition has led to an absence of real action and real practical problem solving. We have to get urgently now the practical problem solving, and that will mean, unavoidably, some increase in retail rates. I believe it absolutely will require, to be practical, some controls on a fundamentally broken market that is vividly demonstrated by that chart.

Senator FEINSTEIN. Mr. Baum, could you comment on the highest prices you paid on a generation of $35 a megawatt-hour? What prices were you required to pay?

Mr. BAUM. Well, SDG&E would have paid similar prices to Edison because we were mandated to make all of our purchases from PX and/or whatever was passed through from the ISO, which was common essentially to the utilities. So, the answer would be very similar.

I would like to make a comment about what Mr. Bryson just said. San Diego was the first to pass through real-time prices, which it did during that time last summer, and it caused what I call a French Revolution syndrome that people were looking for heads to cut off not only of politicians but of utility executives. I believe, just as John Bryson has said, that it is impossible or impracticable to pass through prices that are 10 times what people are paying. But I do believe that prices should be passed through in an orderly and predictable fashion.

Let me say that what we saw during that time in San Diego was an immediate drop in consumption of about 10 percent. I do not believe—and I think there is ample evidence and research at the Electric Power Research Institute—that one needs to have double or triple the bill to get a 10 percent reduction. There is some significant elasticity of demand even at lower price increases.

But there is a secondary effect too if price increases are predictable and come in over time, and that is that then consumers and businesses can take the time to plan and can justify capital expenditures as against these higher prices for energy efficiency in their operations. So, I think there is reason to believe that as much as a 20 percent reduction can be achieved over a longer period of time.

So, I fully endorse the notion that at both ends, both the supply and the demand side, we need to be orderly in what we do. We need to raise prices in an orderly, predictable fashion, but we also need to cap them temporarily.

Senator FEINSTEIN. Yes.

Mr. Worthington, could you respond to my question as well? And my question is, when you were generating at $35 a megawatt-hour and you then sold that facility, what was that facility then charging you for power at its most?

Mr. WORTHINGTON. Much like was just said. When we first sold them, the prices remained near the price that we had encountered when we owned them. It was only really later, starting about June 2000, that the prices from those very same facilities started skyrocketing in price. In fact, in that one month of June 2000, we under-recovered from our customers $700 million compared to what was embedded in the rates that we were entitled to charge under the retail frozen rates. To give you just an order of magnitude, in one month it popped up $700 million and that was the delta over what was embedded in our rates, and that was more than enough to cover the cost of those plants ahead of time.

Senator FEINSTEIN. My concern is how do we get through this summer. Respectfully, Mr. Hecht—I listened very closely—I do not think your solution would get us through this summer——

Mr. HECHT. May I give you some suggestions for the summer?

Senator FEINSTEIN. Can I just finish? Let me just make my point. I will be happy to listen to you.

Mr. HECHT. Sure.

Senator FEINSTEIN. We are building power. Powerplants are being fast-tracked. As a matter of fact, I have a list of nine plants due to go on line with about 7,000 megawatt-hours of capacity. That is happening. I mentioned earlier the peaker plants. Just as fast as the Government can process them. They are not going to be there this summer. Ergo, this summer is going to be the same situation. You have got the major utilities close to bankruptcy right now. What would you advise?

Mr. HECHT. Let me make a number of suggestions. I, in fact, thought about the short-term issues and what might be done.

I already mentioned increasing retail prices, not by a factor of 10, carefully explained, merely for at least some consumers in some fashion. As Mr. Baum pointed out, sometimes even modest increases in price do constrain demand.

Secondly, the installation of new capacity in small amounts in certain ways can be accomplished for this summer, particularly if the end user sees a higher price. Distributed generation, small powerplants, micro-turbines, fuel cells can be installed for this summer and can be done if the consumer has the right pricing because they are more costly per kilowatt-hour than larger generating plants that take longer to install.

Thirdly, I would suggest that the State closely examine all environmental regulations that may impede or inhibit the utilization of existing facilities, existing generation. Might there not be at least some regulations that could be amended at least temporarily in some minor way that would increase production capability? Some production was off line during periods of very high prices during this past year because they ran out of NO_X emission allowances.

Another thing that might be considered—and I do not mean this facetiously—is that the utilities and the State pay for the energy that has been used but not paid for. Energy marketers and producers do have choices. Opposite party credit risk is one of the factors influencing that choice. To the extent that they have choices, producers and energy marketers will sell energy elsewhere than California where they perceive the opposite party credit risk to be less. It has been commented that these high prices are unjust and unreasonable. Prices set by supply and demand, reflecting the actual imbalance between the two, may well be one definition in competitive markets of just and reasonable. I would submit that paying zero for energy which has been consumed is, in fact, unjust and unreasonable.

I also think that even the conversations about price controls can reduce new production, even for this summer. Let me give you one very small example.

My company, jointly with Duke, is constructing a powerplant now in Kingman, Arizona which will be part of the Western market. That plant is due to come on line this summer. Each company has put more than a million dollars additional into incentive awards for the contractors working on the facility to get the facility in service merely 4 weeks early. That is a multi-million dollar commitment that must be recovered in a matter of weeks.

So, there are things that can be done for this summer. I do respect the fact that a lot has been done for this summer. I do not believe this summer need be the crisis that it is shaping up to be.

Senator FEINSTEIN. Mr. Bryson, Mr. Baum, Mr. Worthington, would you respond?

Mr. BRYSON. I would be pleased to. I think much of what Mr. Hecht presents is old history and out-of-date and does not apply in a practical way to the urgent and difficult situation we face in California. Part of the problem that we face here is that so much time is spent on theory and in pointing at the past and mistakes made or allegedly made in the past.

The reality is that in a practical way California now is doing every practical thing that I know that can be done to site powerplants, to allow existing plants to produce and produce at full capacity, to allow existing facilities to go beyond contracts and nameplate and produce more, to site small facilities, to waive or change environmental requirements that might restrict production.

Believe me, as utilities we believe and would want nothing more than the ability to pay for past incurred power. We simply do not have the capacity to do that, and now the State is taking that up.

Practical steps are being taken, but they are not much solved by application of pure theory and old bromides.

With all due respect, I have just been handed a note that I think puts an accent on this. The reason that I try to get concrete and use numbers is to get away from theory. That is textbook.

I am told that this morning, I believe, the California Independent Operators Market Surveillance Committee—now, that is an independent group of primarily economists that were established with the adoption of the California deregulation to review the competitiveness of the market and make judgments about it. As perhaps you are aware, they have repeatedly concluded—and these are people who have no commercial stake. These are a combination of academics and other independent close observers—that regrettably the wholesale market in California is not competitive.

Here is the practical situation we are facing. They are projecting, as of today, a 10-fold increase in the price of power in the aggregate to California, from $7 billion in 1999—and 1999 is a benchmark because it was prior to any of the run-up in prices that began last May—all the way up to $70 billion projected for year 2001. The number in 2000 was $28 billion.

So, this is a terrible problem. And just the experience of 8 months in the year 2000 put us into practical near insolvency. Projecting, going forward, for 2001, current year, is more than double the cost of last year.

So, something absolutely has to be done, and it does not do, in my judgment, to say just let markets go forward. The markets are not working. I believe in competitive markets. I believe that competitive markets can work in electricity, but they are not working now and we have a terrible crisis and we need a practical solution. Imposition of cost-based rates in my judgment ought to be temporary. It ought to be short. It ought to exist only under clear parameters. The proposed legislation, Senator, offered by you is clear on that point. All the comments I have heard this morning have been clear on that point, but we simply cannot go forth with inaction on the part of either the State or the Federal Government.

Mr. BAUM. Let me say that in my opinion there is little that can be done that has not already been done or is in the works for the supply side for this summer. I think we are pretty much baked as far as that is concerned. There are plants in the works and there are some peaking turbines and a variety of other efforts that are underway.

But I do think there is a lot that can be done with respect to price. Mr. Hecht does have a point in bringing up the credit issue. I believe that built into the prices that we are seeing currently is a significant portion of the price that relates to the uncertain credit worthiness of the ISO, of the utilities themselves, and frankly, unfortunately, even the State of California. Mr. Fetter may want to comment on what Fitch's view of California's continuing credit worthiness may be at these prices. But I believe that unless we do something to stabilize the price, to stabilize the ability of the market participants to pay, that we will see that continuing credit component appearing.

But last, I think the main thing that can be done for the summer, apart from this bill that you have put forth, is to work on the demand side of the equation. I think much can be done in that area.

Mr. WORTHINGTON. I would concur with the comments that I think the State and we have done what we can with respect to the supply side for this coming summer. It is mid-March already. Not many months left.

On the demand side, I know the Governor about a day and a half ago came out with his proposal to provide an additional 20 percent rebate to customers who save 20 percent of energy usage over this coming summer. I think that type of proposal does need to get attention and other demand-side management. But I do not think even with an aggressive demand-side management program, as fully implemented as we could for this summer, will meet the gap that we are going to have.

That is why I fully endorse the temporary limits of price caps or cost-based rates for existing generation. I do not see any other way that we are going to otherwise avoid those very startling numbers that we just heard of what the estimate for the total California energy cost could be for the year 2001.

Senator FEINSTEIN. Mr. Fetter, and then I will conclude. I think if you could comment on what might happen to the State's credit rating as well.

Mr. FETTER. I would say the expectation of everyone on Wall Street, not only on the credit rating side, but on the equity side as well, from the start of this crisis would be that rates would go up. Rates going up would improve the credit profiles of the three companies represented here. In fact, all four companies would be strengthened if rates came closer to what the market structure was intended to be.

As far as the State's credit rating, we recently reaffirmed it at AA. We are in the process of reviewing bridge financing which will fill the gap until the $10 billion bond issuance occurs later this year.

But one question that has come up on the generator side is the Division of Water Resources which is an agency of the State and so is not backed by the State's full faith and credit. It is making certain purchases where the generators are not sure what is backing those purchases and whether, at a later time, that agency may say that the prices they agreed to purchase power at were unjust and unreasonable, so we do not intend to pay those prices. And that I think is chilling some of the interest on the part of generators, both in State and out of State, and their willingness to supply power to California.

Senator FEINSTEIN. Let me just thank you all very much. I appreciate your coming so far for this. Thank you.

Senator BINGAMAN. I also wish to thank all the witnesses. I think it has been a useful hearing. We will try to get a consensus to move ahead. Thank you very much.

[Whereupon, at 1:26 p.m., the hearing was adjourned.]

APPENDIXES

APPENDIX I

Responses to Additional Questions

FEDERAL ENERGY REGULATORY COMMISSION,
Washington, DC, April 17, 2001.

Hon. FRANK H. MURKOWSKI,
Chairman, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

DEAR SENATOR MURKOWSKI: Thank you for your letter of March 26, 2001. In that letter, you requested that I provide responses to questions from Senators Cantwell and Wyden that arose following my March 15, 2001 testimony before your Committee. Please find enclosed my responses to these questions.

If I may be of further assistance, please let me know.

Sincerely,

CURT L. HÉBERT, JR.,
Chairman.

[Enclosures]

RESPONSES TO QUESTIONS FROM SENATOR WYDEN

Question 1. California is trying to work out a deal to sell 26,000 miles of transmission lines now owned by private utilities to the State. This sale is one of the key components of a deal to help bail out California utilities and pay back those who are owed for power sold to the utilities. Does the Commission have jurisdiction to review this deal?

Answer. Yes. The Commission has jurisdiction to review the sale of jurisdictional transmission assets owned by public utilities and also review any transfer of operational control of jurisdictional facilities by a public utility. Section 203 of the Federal Power Act requires the Commission to review sales, leases or other dispositions of transmission facilities owned by public utilities, when such facilities have a value over $50,000 and they are used for transmission in interstate commerce.

Question 2. If a deal goes through that involves the State of California acquiring transmission lines, won't this raise regulatory concerns with the Commission? For example, FERC Order 2000 requires participants in a Regional Transmission Organization (RTO) to give up operational control of those transmission lines. Regulatory concerns have been raised about how the Bonneville Power Administration (BPA) could participate in an RTO without giving up control of the transmission lines it owns. Won't state ownership of transmission lines raise the same regulatory issues as have been raised by the BPA? How would this regulatory concern be addressed in the case of California? Would the State have to give up control of the lines it acquires from private utilities?

Answer. Yes, state ownership of transmission lines could raise regulatory concerns similar to those raised with respect to BPA and other non-public utilities. Non-discriminatory open access to transmission service in interstate commerce and the formation of Regional Transmission Organizations (RTOs) are crucial to achieving competitive markets in electric power. California transmission lines are an integral part of the western interstate transmission grid.

If the sale of transmission lines to the State of California occurs, the Commission would need to decide whether the transaction is consistent with the public interest, based on all relevant considerations. The need for a non-discriminatory transmission grid and coordinated, efficient markets in the West could be undermined if California acquires the transmission facilities of the public utilities in California, but chooses not to apply or follow the same non-discriminatory transmission rules as public utility transmission owners regulated by the Commission. Similar concerns could be implicated if California chooses not to include those transmission facilities as part of a west-wide RTO. While there are various means the Commission could use to attempt to address these interstate concerns, it is not possible to comment in detail without knowing more about California's proposal to acquire and own transmission lines.

RESPONSES TO QUESTIONS FROM SENATOR CANTWELL

Question 1. With Washington State as the backdrop—with surcharges and rate increases now approaching triple digits—what new supply do you expect to see triggered between now and summer by the kind of price increases we've seen? Are we really dealing with a market signal here or are we burdening consumers with price signals that cannot work?

Answer. The Commission is doing everything within its powers to promote new supply and conservation and thereby bring back down, as quickly as possible, the price increases to which you refer. As for this summer, higher than normal prices experienced in the West during the summers of 1999 and 2000 will permit and encourage more generation, and thereby enhance reserve margins, whereas low prices may leave some generation idle. Furthermore, higher prices may provide the financial wherewithal needed to adequately maintain these older plants and thereby preserve the reliability of electrical grid operations. I would also note that an appropriate price signal may prompt additional supply over the long term and help to ensure adequate generation in the summer of 2002 and beyond. Finally, as you know, approximately 50 percent of the generation in the West is not jurisdictional to the Commission.

More importantly, on the demand side, an appropriate price signal will encourage conservation, both in terms of consumers using less electricity, and consumers making investments in more efficient electricity-consuming appliances. Although I am not aware of estimates of the conservation potential in Washington State, I do know that estimates of the conservation potential in California are significant. Conservation has the effect of lowering prices for all consumers by balancing supply and demand at a lower level of demand.

Question 2. Washington state has price increases far larger than those that have shown up in California. Demand reduction is running about 6% overall. However, the major reason is that industry shuts down and lays off workers. Is that kind of price signal desirable? Would you not agree that the reason for this response—shut downs and layoffs—is that price signals are not meant to be effective in short-term, crisis situations? Can we expect market signals to work when there's an incomplete or ineffective market?

Answer. We recognize the importance of an effective, well-functioning bulk power market which can send appropriate price signals to consumers to reduce demand and to generators to increase supply. It is regrettable that high prices have caused industrial shut-downs, worker layoffs, and other economic dislocations. But it is to be expected that some industrial firms, being the most price sensitive sector of the economy, will respond first. Some industrial firms have benefitted from purchasing a significant amount of their energy needs at low spot market prices for several years, and are only now feeling the effects of high spot market prices.

However, I understand your concerns about high Western power prices and the implications for Western electricity consumers. While there are no easy answers to these problems, it is my belief that market-based solutions offer the most efficient way to move beyond the severe energy shortages confronting California and the West.

In fact, appropriate prices, even high ones, can and do elicit some very potent short-term effects that work to lessen the impact of supply shortfalls. The fact that industrial electricity consumers shut down in some cases due to high electricity prices allows the electricity they would have consumed to be used by others, including hospitals, schools, and public safety consumers such as police and fire safety. In that event, all purchasers of electricity should pay lower prices, and actual shortages (blackouts) ought to be reduced in scope and duration.

In the future, industrial firms may begin to choose differently than they have in the past when purchasing their energy services. In light of the experience of the last year, industrial firms may choose among the number of strategies available to address the risk of volatile spot market prices including the choice of maintaining a more diversified supply portfolio so that they purchase more energy in long-term markets where prices are likely to be more stable.

Question 3. Your press release on March 14 encompasses a lot of FERC activity in an effort to respond to criticism that you have not adequately addressed the Western electricity crisis. I commend the effort, but question the scope. Why does your proposal not address prices? How much energy will this proposal add to the grid and on what timeline? When fully implemented, how many megawatts are you expecting to produce with these supply initiatives? What effect on rates would you estimate from this increased supply?

Answer. The Commission's March 14 order was issued to increase energy supplies and reduce energy demand in California and the West. The Commission implemented certain measures immediately, including: (1) streamlining regulatory procedures for various types of wholesale electric sales (including sales of backup or on-site generation and sales of demand reductions); (2) expediting the certification of natural gas pipeline projects into California and the West; and (3) urging licensees of hydroelectric projects to assess the potential to increase the generating capacity of FERC-licensed projects. The order was issued after taking a broad look at the Commission's regulatory responsibilities and addressing measures the Commission can implement immediately. The Commission also proposed, and sought comment on, other longer-term measures (such as incentive rates for transmission or pipeline construction completed by specified dates).

The March 14 order does not directly address prices because pricing issues are being addressed in other dockets and orders, in particular the Commission's December 15 order, which created a $150 breakpoint and directed Commission staff to propose market mitigation to be put in effect as of May 1, 2001. On March 9, and 16, the Commission issued orders requiring California power sellers to make refunds or offsets of approximately $124 million for January and February 2001 transactions or provide further justification of their prices. In addition, the Commission held a conference in Boise, Idaho on April 10 addressing price volatility throughout the West.

Where the Commission can act to enhance the energy infrastructure in the West it has done so. On April 6, 2001, the Commission issued a certificate of public convenience and necessity authorizing the construction of 135,000 Mcf per day of new natural gas pipeline capacity to California by the Kern River Transmission Company. This authorization issued within three weeks of Kern River's application to the Commission.

In my judgment, the most effective way to lower Western energy prices in all time periods, and to keep them low, is to increase Western energy supplies. By way of example, I offer the summer of 1998, when wholesale electricity prices in the Midwest increased significantly. The Commission resisted pleas for price caps or other constraints. Subsequently, suppliers responded to the market-driven price signals and today the Midwest is not experiencing supply deficiencies. In the West today, we have market prices and barely adequate supplies. If we reduce prices below market levels, supplies will go elsewhere, risking greater reliability problems.

The Commission's March 14 order was intended to increase energy supplies in the West. Although it is not clear how much additional energy will be available this summer or the effect it will have on rates, we believe that the Commission's order will permit many existing sources of energy to operate more efficiently. For example, of the 326 hydroelectric projects licensed by the Commission within the WSCC, 200 have provisions that limit operational flexibility. These 200 projects represent a total capacity of 21,000 megawatts. Greater flexibility in the dispatch of this capacity, consistent with protecting environmental resources, could provide additional energy to enhance the reliability of the system.

Commission staff held two conferences, on April 9 and 10 in Portland and Sacramento, to discuss with agencies, licensees, and others, ways of expediting proposals to increase power generation at existing licensed hydroelectric power projects. The conferences were attended by representatives of the hydropower industry as well as resource agencies and nongovernmental organizations. In general, industry representatives set forth proposals for increasing electrical generation that ranged from modifying minimum flows and reservoir elevations to installing additional generating units and enhancing the efficiency of existing facilities. The resource agencies and nongovernmental organizations expressed a willingness to expedite processing of such proposals. Commission staff urged all of the industry representatives to comprehensively review their projects, in partnership with the resource agencies and other interests, to find ways of increasing power generation while preserving environmental resources.

I find another example of a positive response to the Commission's March 14 order in a press release issued by Avista Utilities just last Friday, on April 13. In that announcement, Avista states that it has filed with the Washington and Idaho public utility commissions to implement an all-customer electric energy buy-back program.

Specifically, Avista would offer a credit of five cents per kilowatt-hour for each customer which reduces electric use by more than five percent. This is precisely the type of demand reduction program the Commission has encouraged, and represents the type of cooperative relationship between federal and state agencies that is necessary to make it through this difficult summer.

Question 4. A possible variation on cost-based rates could be to exempt new generation from the cost-based requirement. Would you support this approach?

Answer. While I have strong reservations about returning to cost-based regulation, I agree that it is very important that market forces be allowed to work in ways that encourage investment in new generation. I have an open mind to pricing approaches that ensure this result.

However, it is difficult to design and police a tiered system in which pricing policies are different for existing and new generators. Existing generators will have an incentive to sell power through intermediaries whose power sales are either not subject to the Commission's jurisdiction, or are outside of the scope of any cost-based regulatory rule. (Past experience with vintage rate setting schemes in the pricing of natural gas suggests that it may be impossible to craft rules which are not subject to circumvention and arbitrage, or lead to other unintended undesirable consequences.) Accounting for the components of the sale to ultimate consumers may require significant transaction tracking and auditing activity.

Some may also be concerned with the disturbing precedent of a boom-bust regulatory cycle: deregulation, followed by re-regulation. Following deregulation, some utilities sold off their generation assets, either voluntarily or pursuant to state directive. The companies acquiring these assets did so based on the knowledge and belief that their future sales would be made at market prices, and set acquisition prices (often at levels far in excess of book value) based on those beliefs. Subsequent re-regulation of these assets, could create further regulatory uncertainty in the future as for-profit companies consider whether to invest in the electric power industry in general, or in Western electricity markets in particular, unless such re-regulation were known to be of limited duration during extraordinary circumstances. Ultimately, I believe that market certainty is one of the most important goals we can seek to achieve for electricity producers and consumers alike.

Question 5. In your March 14 press release, about the order regarding ways to increase the supply of electricity in the West, you say that: many hydro projects have the potential to more fully use their available water resources to increase generation. This may be done through additional capacity units, generator and/or turbine upgrading and other operational improvements. The Commission asks that all licensees immediately examine their projects and propose and efficiency modifications that may contribute to increased power supplies.

(a) How fast is FERC prepared to act on efficiency modifications proposed by hydro licensees? Can you commit to a specific number of days? My concern is that summer is fast approaching, and we need to get the most out of our hydro system to keep the lights on in the West. If FERC does not act promptly on these proposals, it will be too late to do us any good.

(b) Your press release also mentions the need to expedite the Endangered Species Act consultation process. Specifically, how do you plan to do that? Will you work with the resource agencies (e.g., the Fish and Wildlife Service) to assure that endangered species are protected during this process?

Answer. In its March 14, 2001 order, the Commission ordered the removal of obstacles to increased electric generation and natural gas supply in the Western United States. The Commission will act on any efficiency modifications as promptly as possible. Where there is broad support for an amendment and the environment, including endangered species, is adequately protected, we would expect to act on a proposal in a matter of days. As I noted in my response to Question 3, Commission staff has held two conferences in the WSSC region. As stated above, the conferences revealed a commitment of the industry and other participants to identify proposals that would provide for additional power generation that are consistent with environmental protection.

Question 6. On March 9, you issued an order regarding potential refunds for California electric power sales. Why was that order restricted to California when it is clear that much of the Northwest is paying as much or more for electricity on the current distorted market? Why does the "justness and reasonableness" evaluation only apply to transactions that took place during Stage 3 conditions? One could make the case that higher prices are more nearly warranted when a Stage 3 emergency is declared because they are just trying to keep the lights on. The price gouging that is of most concern is at Stage 1 and Stage 2. The limited time period and limited conditions under your refund order are inconsistent with FERC's authority to look at just and reasonable rates. How can consumers be protected if you don't use your delegated authority?

Answer. The Commission's March 9, 2001 order put 13 California power sellers on notice that they must either make refunds for certain power sales or provide further justification of their prices. This order followed the Commission's December 15, 2000 order adopting specific remedies to address dysfunctions in California's wholesale bulk power markets and to ensure just and reasonable wholesale power rates by public utility sellers in California.

The December 15 order found that California's flawed market rules caused rates that were unjust and unreasonable during certain periods. The order addresses specific market flaws in California wholesale electricity markets and made public utility sellers that bid above $150/MWh subject to weekly reporting requirements to ensure just and reasonable rates. The sales of all public utility sellers into the ISO and PX markets were also made subject to potential refund. Under the conditions in the December 15 order, the Commission must issue written notification to a public utility seller within 60 days of each weekly reporting filing that the seller's transactions are still under review or refund liability for those transactions will automatically cease.

In the March 9 order, the Commission established a proxy price screen applied to transactions that are above $150/MWh breakpoint and that take place during Stage 3 emergencies. The Commission reasoned that the potential for market power abuse is most likely to occur during periods of severe supply deficiency. The Commission limited its approach to Stage 3 emergency hours, when the supply/demand imbalance is the most severe and sellers know their power is most needed.

The Commission has considerable discretion in establishing just and reasonable rates under the Federal Power Act. In setting rates, the Commission may take into account non-cost factors, including the need to encourage new supply. See *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). In the refund order at issue, the Commission's focus only on the highest stage of emergency serves to target the Commission's intervention where it is needed most. Stage 3 emergencies (when reserve margins dip below 1.5%) are the periods when supply and demand are on the verge of imbalance. As the March 9th order reasoned, at Stage 3, the least efficient simple-cycle combustion turbine unit (CT) would be the marginal source of power, and therefore represented a reasonable point for developing a proxy price screen. The Commission's order did not want to mask scarcity costs because doing so will blunt the price signals needed to induce supply entry. And because current technology is much more efficient than marginal CT units, the proxy price leaves room for price signals to stimulate market entry. I would note, however, that these issues are subject to rehearing.

Others have suggested, as you do, that the Commission should extend its approach in California to other parts of the Western markets. While I have an open mind on this issue, there are certain fundamental differences between California's centralized market design and the bilateral contract regime that exists elsewhere in the West. As a result, our approach in California does not adapt readily to other parts of the West.

THE SECRETARY OF ENERGY,
Washington, DC, April 10, 2001.

Hon. FRANK H. MURKOWSKI,
U.S. Senate, Washington, DC.

DEAR SENATOR MURKOWSKI: In response to a number of inquiries from Members of Congress, and in light of recent discussions of possible legislation addressing energy issues in the West, and particularly California, I thought it would be helpful to provide you with an update on the crisis.

First, it is important to note that this crisis is a supply crisis. Simply put, the principal problem—and thus the proper focus of our attention—should be on the problems of the blackouts and shortages. Proposed solutions that do not either lead to increased supply or reduced demand will not address the core problems confronted in the West.

Thus, the Administration has taken a number of actions to support California in its efforts to address critical supply issues.

- One day after being sworn into office, the President directed me to call Governor Davis to discuss the crisis and ask how we could help address the power shortages.

- Three days after taking office, at Governor Davis' request, we extended the emergency electricity and gas orders to give California time to develop legislation aimed at maintaining electricity supplies.
- In February, also at the request of Governor Davis, President Bush issued an executive order directing Federal agencies to expedite permits relating to construction of new power plants in California. The U.S. Environmental Protection Agency has issued air permits for three power plants in the past month.
- President Bush and I have engaged in discussions with the Government of Mexico about increasing electricity imports from Mexico. DOE is also working expeditiously to approve two cross-border electricity expansions between California and Mexico that should be approved later this year.
- In early March, at the behest of Governor Davis, I sent a letter to the Federal Energy Regulatory Commission (FERC) asking that the agency act on his request for an extension of the waiver for qualifying facilities from certain fuel requirements.
- In response to a request from the State of California, the U.S. Environmental Protection Agency has provided other assistance, clarifying rules relating to operation of backup generators.
- While the imbalance between supply and demand is the reason for high energy costs and power shortages, the Bush Administration was the first to take action on overcharges. FERC took unprecedented action and ordered the first-ever refunds to address overcharges by generators on market-based rates after we took office and after a Republican took over as Chairman.
- On March 14, FERC issued a series of orders designed to expedite energy supplies to California, including streamlining regulatory procedures for wholesale power sales, expediting natural gas pipelines, and urging hydropower licensees to assess the potential for increased hydropower generation.
- As follow up to a meeting with Governor Davis, I issued a letter indicating that the Administration did not oppose the State's proposed purchase of the California utility transmission systems, conditioned on the adherence to open access requirements.
- Just two weeks ago, I met with a group of California energy suppliers to impress upon them that the next several months should not be viewed as "business as usual," and to ask for their help to avoid foreseeable disruptions in supply.
- Last week, I met with a group of electricity experts to discuss the California electricity crisis and to explore actions that could be taken by the Federal Government and State to increase supply or reduce demand.

As you can see, the Administration has taken constructive action from its first day to help California deal with its electricity crisis. Governor Davis has expressed his appreciation to both the President and me for this help.

Regrettably, our well-founded opposition to price caps has been claimed by some to suggest the Administration either does not care about California and the West or is doing nothing to address the problem. Certainly, the actions described in this letter show this is simply untrue.

The only thing we have opposed has been the imposition of price controls because they would not prevent blackouts and would drive away the new supply California and the West so badly need. The Administration is not alone in its opposition to price caps. In February, eight of the eleven Western Governors sent me a letter expressing their opposition to price caps. Those eight governors reiterated their opposition in an April 6 letter to FERC Chairman Curt Hébert, calling them "penny wise and pound foolish."

By contrast, advocates of price controls have failed to indicate how price caps would increase supply, decrease demand or prevent blackouts this year.

I appreciate the opportunity to brief you on the numerous actions the Administration has taken since our first day to support California. Please be assured that we will continue to look for constructive ways to remove obstacles to new electricity supply in California and the West.

Sincerely,

SPENCER ABRAHAM.

FEDERAL ENERGY REGULATORY COMMISSION,
Washington, DC, April 3, 2001.

Hon. FRANK MURKOWSKI,
Chairman, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: At your Committee's March 15, 2001 hearing on Western Energy Problems, Senator Pete Domenici asked that the Federal Energy Regulatory Commission report on the reasons for the significant differential between wellhead prices for natural gas produced in New Mexico and the delivered price of gas at the California border. Specifically, Senator Domenici questioned why producers in New Mexico were receiving $5 for natural gas while natural gas was being sold for $60 at the California border.

I have attached a Staff paper discussing the operation of natural gas markets. I hope these answers are helpful to you. If I can be of any further assistance in this, or any other matter, please do not hesitate to contact me.

Sincerely,

CURT L. HÉBERT, JR.,
Chairman.

[Enclosure]

STAFF PAPER ON NATURAL GAS MARKETS

There are various ways in which a natural gas buyer in California (or elsewhere), whether it is a local distribution company (LDC), industrial customer, or electric generator, can get gas to the state border. First, the customer can buy gas in the various producing basins, either on the spot market or through a long-term gas supply contract, and transport the gas on an interstate natural gas pipeline using capacity that it has purchased directly from an interstate pipeline serving California. In that circumstance, the customer would pay the interstate pipeline's tariff rate, which is regulated by the Commission, plus the price of gas at the wellhead.

A second option would be for the customer to purchase gas in the producing basins and transport the gas to the state border using capacity that was released to it by an entity holding interstate capacity. If the customer purchased released capacity, the price the customer pays for the interstate capacity could exceed the pipeline's maximum tariff rate because, pursuant to Section 284.8(i) of the Commission's regulations, "[u]ntil September 30, 2002, the maximum rate ceiling does not apply to capacity release transactions of less than one year." Under this option, the customer would still pay the congressionally deregulated price of natural gas at the wellhead. However, while the price paid for the interstate capacity could exceed the pipeline's maximum tariff rate, capacity release transactions do not appear to be causing the $60 gas prices. Capacity release data received by the Commission for November and December 2000 show that there were relatively few short-term capacity release transactions and nearly all of those transactions were small volumes priced at the interstate pipelines' maximum tariff rates.

The final way in which the customer could get gas would be to buy it in a bundled sales transaction. In that circumstance, the customer does not contract for its own interstate capacity and has not purchased released capacity. Nor has it entered into any long-term gas supply contracts. The customer would enter into a contract with another entity who would make arrangements to deliver the gas at the California border for an agreed upon price. The entity would have its own gas supply or purchase gas on the spot market in the producing basins. The gas would be transported using the entity's own interstate capacity as described in the first option or firm capacity that it obtained through a capacity release arrangement as described in the second option. While these transactions appear to account for the $60 natural gas prices at the California border, a review of *Gas Daily* index prices for December indicates that the price spikes of $60 occurred only for a few days.

The price that producers receive for their natural gas at the wellhead reflects the value of the natural gas in the production area, while the higher price received at the California border appears to reflect the value a natural gas customer without interstate pipeline capacity places on having gas delivered to the California border. Any entity who has both gas supplies and interstate capacity is able to capture this value. In order for producers, including producers in New Mexico, to sell natural gas at the California border, they can elect to secure any available transportation capacity directly from the interstate pipelines or through capacity release transactions. In doing so, however, the producers would bear the cost responsibility of retaining interstate capacity.

The Commission's jurisdiction over bundled sales transactions is limited. The Commission retains jurisdiction to regulate sales for resale by interstate pipelines, intrastate pipelines, LDCs and their affiliates, except when they produce the gas that they sell. The Commission also does not have jurisdiction over bundled sales transactions that are direct sales. In addition, the Commission cannot regulate the price of gas imported from countries with free trade agreements, including Canada and Mexico. Based on information contained in the California Energy Commission's November 2000 report entitled *California Gas Analysis and Issues*, the Commission estimates that between 12 and 17 percent, but no more than 35 percent, of gas sales into California would be subject to the Commission's jurisdiction. The percentage of gas subject to the Commission's jurisdiction could change daily depending on a number of factors including the seller of the gas, the buyer of the gas, the source of the gas and how the transaction is structured. Any reregulation of the price of natural gas could bifurcate that natural gas market into jurisdictional and nonjurisdictional elements. This bifurcation could send inaccurate price signals to gas consumers and could cause distortions in the natural gas markets, similar to those that occurred in the 1970s, when interstate natural gas sales were subject to federal regulation and price controls.

APPENDIX II

Additional Material Submitted for the Record

THE STELLA GROUP, LTD.,
Washington, DC, February 20, 2001.

Hon. FRANK MURKOWSKI,
Chairman, Committee on Energy & Natural Resources, U.S. Senate, Washington, DC.

DEAR SENATOR MURKOWSKI: As a leading firm in the marketing of distributed renewable energy technologies, I would like the opportunity to testify before the Committee on the following Department of Energy renewable energy programs relating to solar energy, distributed energy, combined heat and power, and energy storage. Particularly on how it relates to electricity reliability and price stability.

The Stella Group, Ltd, is a strategic consulting firm to the distributed power industry founded in 1995. The firm receives no federal funding or subcontracting. Previously, I served 14 years concurrently as Executive Director of both the Solar Energy industries Association and the National BioEnergy Industries Association.

I hope for the opportunity to provide short testimony in regard to these important programs.

Sincerely,

SCOTT SKLAR,
President.

MORRISON & FOERSTER, LLP,
ATTORNEYS AT LAW,
Washington, DC, February 21, 2001.

Hon. FRANK MURKOWSKI,
Chairman, Senate Committee on Energy and Natural Resources, Washington, DC.

DEAR SENATOR MURKOWSKI: We are submitting two news articles for inclusion into the record of your Committee's hearings on the California Energy Crisis.* These articles are from the Wall Street Journal, California Edition, and the Los Angeles Times, Orange County, regarding AES' efforts to restart two mothballed units in Huntington Beach, California. If the necessary permits can be secured, AES would bring on line 450 megawatts of generation to help meet next summer's energy needs in California. We also enclose AES' recent firm announcement on its plans to reactivate the Huntington Beach units.

AES is the world's largest global power company, which 19 years ago began developing, building and owning cogeneration plants in the U.S. AES' experience includes owning generation businesses in competitive markets in Australia, Argentina and England and Wales. In California, AES has owned and operated a 125 MW combined cycle power plant in Santa Clarita since 1988. Ten years later, we purchased from Southern California Edison power plants in Redondo Beach, Huntington Beach, and Long Beach representing 4000 MW.

Please let us know if you have any questions.

Sincerely yours,

ROBERT H. LOEFFLER,
Attorney for AES.

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* Attachments have been retained in committee files.

STATE CAPITOL,
Boise, ID, March 14, 2001.

Hon. CURT HÉBERT, JR., *Chairman,*
Hon. WILLIAM MASSEY, *Commissioner,*
Hon. LINDA BREATHITT, *Commissioner,*
Washington, DC.

DEAR CHAIRMAN AND COMMISSIONERS: You are aware of the energy challenges confronting my state of Idaho and other Western states this year due to historically low water levels. We face a critical imbalance between the demand for energy and the supply of energy.

Some have offered temporary solutions for a long-term problem. Of those solutions, price caps have been discussed as a possible remedy. You may recall that on February 6 of this year, eight western governors, including myself, asked Secretary Abraham not to impose price caps on electricity and natural gas. Just as I opposed price caps then, I oppose price caps now.

Although price caps are intuitively appealing in our current situation they may ultimately undermine our efforts to offset the energy situation that we are experiencing. One of the major drawbacks to price caps is that it discourages investment in new generation facilities. That is something that we cannot afford to do. Instead, bringing new facilities on-line is a long-term solution to this problem. Another issue surrounding price caps is that they jeopardize current short-term and long-term energy contracts that are already in place. This would exacerbate the problem for the entire region.

We have seen the devastating effects price caps have had on California. We do not want that to spread into the other western states that are proactively seeking real solutions to this real situation.

In a September 11, 2000 speech before the Senate Energy and Natural Resources Committee, then Commissioner Hébert stated the following:

> "In a report dated September 6, 2000, the Market Surveillance Committee of the California ISO concludes that price caps have little ability to constrain prices . . . If the FERC is serious about increasing generation supply, it should act immediately to withdraw all price caps in generation markets. They distort price signals and inhibit entry into competitive markets."

Furthermore, it was concluded in a September 24, 1998 report from the FERC staff to the Commissioners on Midwest electricity price spikes the following:

> ". . . The team believes that price caps, whether they are applied generally of intended for specific, emergency situations, create a situation in which prices are not allowed to perform their rationing function. In addition, they can distort market signals and prevent the efficient allocation of resources resulting in shortages."

As I have already stated, we must have long-term solutions to this situation. Price caps only offer a false sense of security and do nothing to remedy the problem. Common sense approaches such as reducing demand and increasing supply and siting new generation facilities is the only sure way of solving the problem. These are the discussions that we should be engaged in that will offer real solutions, and I am hopeful that the Commission understands that.

I appreciate this opportunity to share my concerns with you about price caps. The economy of our region depends upon successfully managing this energy challenge that we are facing. With your help, we can do that.

Sincerely,

DIRK KEMPTHORNE,
Governor.

STATE CAPITOL,
Sacramento, CA, March 15, 2001.

Hon. FRANK MURKOWSKI,
Chairman, Senate Energy and Natural Resources Committee, U.S. Senate, Washington, DC.

Hon. JEFF BINGAMAN,
Ranking Member, Senate Energy and Natural Resources Committee, U.S. Senate, Washington, DC.

DEAR CHAIRMAN MURKOWSKI AND RANKING MEMBER BINGAMAN: Thank you for convening today's hearing to discuss legislation introduced in the U.S. Senate to address the problem of high prices and shortages of electricity in the West. This is an issue that affects the citizens in all of our states to varying degrees.

I want to commend Senators Feinstein and Boxer for their leadership in advancing these proposals. Their legislation makes a clear and compelling case for greater levels of intervention by the Federal Energy Regulatory Commission (FERC) in responding appropriately to California's electricity situation. I appreciate the Committee's willingness to hear testimony on these measures, and I urge the Committee to seek ways to advance the underlying goals of the legislation.

Since my January 30, 2001 letter to you we have made significant progress in our comprehensive strategy to tackle the myriad issues before us. We are maintaining our aggressive efforts to increase new generation, decrease demand, reduce our reliance on the spot market through long-term contracting, stabilize the financial viability of our utilities, and plan for electricity and natural gas transmission improvements, Attached for your information is a more detailed discussion of recent developments in California.*

I want to assure you that my Administration continues to pursue this course of action with spirit and determination. We are doing everything humanly possible to meet this challenge. However, the federal government has an obligation and responsibility to take corrective and decisive action on one issue that falls squarely on the shoulders of Washington—excessively high wholesale energy prices.

In the near term, these wholesale prices—which have been found by the Independent System Operator (ISO) to greatly exceed the actual cost of production—need to be brought down to reasonable levels. The excessive charges levied by generators have brought California's two largest utilities—Pacific Gas & Electric and Southern California Edison—to the edge of bankruptcy. Last week the FERC itself found that 13 generating companies may have to refund $69 million for overcharging on power sales in January alone.

Earlier this week, Governor Locke of Washington, Governor Kitzhaber of Oregon and I formally requested that the FERC take steps on an interim basis to restrain the unreasonably high wholesale costs in our region. We specifically suggested that the FERC give serious consideration to a plan proposed by Commissioner William Massey. The essence of the plan centers around a temporary cost-based price cap on spot market sales in the western interconnection. The price cap could be calculated on a generator-by-generator basis at each generator's variable operating costs plus a reasonable rate of return in the range of $25/MWh.

As a purely temporary measure that enables generators to recover all of their operating costs and receive a return, this proposal would not discourage the development of new generation. In addition, federal power marketing agencies that are not controlled by the FERC, such as the Bonneville Power Administration, would agree to adhere to such a plan if adopted by the FERC.

S. 287, S. 26, and S. 80 before you today are all reasonable approaches in pursuit of just and reasonable wholesale electricity prices. I urge the Committee to carefully review the situation we face in the West with respect to current wholesale prices. Any objective review will adequately justify congressional action to implement a cost plus pricing strategy.

Mr. Chairman, it is clear that this market has become dysfunctional. Nothing less than the nation's economy and the economies of all of our states are at stake. Federal action to enact a temporary cost-based price cap is necessary and warranted in order to protect consumers and businesses in the West from the vagaries of this dysfunctional market. If the FERC refuses to exercise its full authority under the law to restore price stability, I believe it is appropriate for the Congress to do it for them.

Thank you again for holding today's hearing and for the opportunity to share my thoughts with you.

Sincerely,

GRAY DAVIS,
Governor.

STATEMENT OF THE AMERICAN PUBLIC POWER ASSOCIATION

The American Public Power Association (APPA) is pleased to present this written statement for the record to the Senate Energy and Natural Resources Committee for their March 15 hearing, "Western Energy Problems." APPA is the national service organization representing the interests of over 2,000 municipal and other state and local community-owned utilities throughout the U.S. APPA member utilities in-

*Attachments have been retained in committee files.

clude state public power agencies, and serve many of the nation's largest cities, but the majority of our members are located in small and medium-sized communities in 49 states, all but Hawaii. In fact, 75 percent of our members are located in cities with populations of 10,000 people or less. APPA members serve about 14 percent of all kilowatt-hour sales to ultimate consumers throughout the United States.

We share many of the energy policy objectives held by President Bush and members of the Committee. Chief among these are developing a balanced national energy policy that emphasizes fuel diversity, appropriately integrating energy and environmental issues, and resolving problems in the wholesale markets for electricity. Congress and the Administration must focus on creating a more competitive market for wholesale sales of electricity in order to protect consumers from wildly fluctuating prices and ensure reliability. Recent developments across the country, but especially on the West Coast, reinforce the fact that wholesale electricity markets (and wholesale energy markets in general) are interstate in nature and disturbances in the market cut across all industry segments. The Committee's hearing is timely because solutions to the problems in the Western electricity market and heading off similar problems in other regions require quick and coordinated action at federal, state, and local levels. Moreover, these policies should recognize the problems that ensued when federal and state policymakers ignored the cautions raised about market structure and instead put blind faith in the ideology of open markets and made inaccurate assumptions about competitive market forces.

In this statement APPA outlines some of the root causes of—and possible solutions to—the Western energy crisis, and emphasizes that the "California problem" is not exclusive to that state alone.

THERE ARE THREE ISSUES TO ADDRESS: SCARCITY, STRUCTURE, AND SKEPTICISM

The problems encountered in the Western electric market, and new problems beginning to be seen in other regions, have three distinct characteristics: scarcity of supply, generation capacity and transmission; imperfect, or dysfunctional, market structure at the wholesale level; and consumer skepticism that market participants are capitalizing on scarcity and imperfect markets. Each of these problems must be addressed as Congress, the White House, and the Federal Energy Regulatory Commission (FERC) develop and implement a cohesive set of policies applicable to all regions of the nation.

SCARCITY

Lack of generation capacity has contributed to California's failed electricity experiment. But that is just part of the equation. Lack of sufficient transmission capacity, scarcity of fuels, particularly natural gas, low water levels, and few serious conservation efforts are other factors. To address these scarcity issues, APPA recommends that federal policies incorporate the following principles:

- The use of all types and sources of electricity production must be encouraged while maintaining our national commitment to a clean environment.
- Production incentives for both renewable energy as well as environmentally acceptable means of using fossil fuels should be provided, and such incentives must be available to all entities, including not-for-profit publicly owned utilities.
- Regulatory policies, including but not limited to the hydroelectric relicensing process, that reduce the capacity of existing generating facilities without ensuring an appropriate balance of both energy and environmental needs, must be reviewed and modified as necessary.
- Our nation's dormant commitment to efficient use of energy must be renewed, and conservation must become an essential component of the solution.

IMPERFECT MARKET STRUCTURE

Many of the market problems in California can be attributed to policymakers; both at the state and federal level assuming that market forces alone would be sufficient to forge competition out of an industry structure that had been monopolistic in nature since inception. Consumers have paid the price for the consequences of premature decisions by federal regulators to allow a transition to market-based rates without first requiring the existence of a competitive wholesale market structure. The California experience makes clear that FERC should permit wholesale sales at market rates only in regional markets that meet predetermined criteria that clearly define the characteristics of workable competitive wholesale markets. These and other market structure issues need to be addressed in any federal policy, including the following principles:

- Transmission is an interstate commerce matter within the jurisdiction of Congress. Regionally integrated planning and expansion of the grid is essential to create and maintain a structure that can sustain regional reliability and wholesale competition. Federal eminent domain authority to ensure reliability and competitive wholesale markets must be provided for construction of new transmission facilities, either to properly structured, independent RTOs, Regional Transmission Organizations, or in their absence to transmission builders pursuant to a FERC issued certificate of public convenience and necessity.
- The lack of effective RTOs that can ensure truly neutral management of the nation's transmission facilities is the single biggest obstacle to a properly functioning interstate electricity market. Private utilities that control vast amounts of the nation's transmission systems have a long history of denying access to their systems, or providing access at highly discriminatory rates and unfair terms. It is vitally important that federal policies encourage the development of independent, properly configured RTOs.
- Wholesale sales at market rates into improperly structured and dysfunctional markets will not produce just and reasonable rates for consumers. Congress must clearly define the fundamental characteristics of workable competitive wholesale markets, and FERC should permit wholesale sales at market rates in regional markets that are consistent with these characteristics and require sales at cost-based rates in those that are not. Senator Feinstein's bill, S. 287, directs the FERC to do just that.
- Repeal of the Public Utility Holding Company Act (PUHCA) prior to the creation of a new market structure that can sustain effective competition would only make a bad situation worse and should not occur. Indeed, numerous parallels can be drawn between the market conditions that existed in 1935 which led to the enactment of PUHCA, and the market conditions that exist today. These parallels highlight its continued importance. For example, the number of registered holding companies has expanded from 14 to 30 in the last eight years. In addition, today's 150 registered and unregistered holding companies have a combined total of 240 utility subsidiaries and 4,200 non-utility subsidiaries. And, the ongoing rapid consolidation of the marketplace has seen 54 mergers completed or announced during the past two years alone—in addition to 24 mergers of U.S. utilities with foreign companies over the same period of time. This consolidation limits the number of potential competitors, and requires additional oversight to prevent market power abuses that put consumers at risk.

CONSUMER SKEPTICISM

With postings of enormous profits, billions of dollars changing hands, and cries of market manipulation, it is easy to understand the level of skepticism held by California officials and consumers. APPA believes we all have a responsibility to rebuild consumer confidence as soon as possible, and we urge Congress to adhere to several principles when developing federal policy:

- A national reliability organization with the authority to establish and enforce reliability standards, assure adequate generating capacity reserves in each relevant wholesale market, and oversee and coordinate maintenance outages, must be created.
- Complete and timely market information on capacity, transactions and prices must be available to regulatory agencies, public officials and all market participants.
- The FERC must be directed to monitor the wholesale market, and given the resources necessary to do so. It must also be delegated the authority to provide remedies and impose penalties as appropriate.

CALIFORNIA IS NEITHER AN ABERRATION NOR EXCLUSIVELY A STATE PROBLEM

The failure of electric utility industry restructuring in California has had and continues to have broad and far-reaching adverse effects throughout the Western States Coordinating Council region. Electric utilities and their consumers in Western states are experiencing unprecedented volatility of electricity prices. Utilities, both public and private, are near the financial edge and some are threatened by bankruptcy. The collapse of these utilities would challenge the financial stability of major banks, energy producers and marketers, as well as businesses and industries that provide products and services (and credit for such products and services) to the electric utility industry throughout the region.

As Federal Reserve Board Chairman Greenspan has noted, the magnitude of the current electricity problem is sufficient to disrupt the economy of the entire country.

If left unchecked, the problems will become more severe. If addressed, this near brush with disaster should provide a sobering message that such problems cannot be allowed to arise in other regions.

There are two critical lessons that must be understood from California's crisis. First, electricity is the oxygen of our economy. While lip-service has been paid to this fact in the past, the reality of this proposition is now being driven home with frightening force. The electric utility industry is simply too important to the well-being of the entire nation to permit hasty "experiments" and unquestioning and untested reliance on the ability of "deregulated" retail markets without viable wholesale electric markets to provide reliable and adequate supplies (and sufficient reserves) of electric energy and capacity to all consumers at reasonable rates.

Second, and equally important, wholesale electric markets are interstate in nature. What is happening today is not simply a "California problem"—consumers in Arizona, Utah, Idaho, Montana, Oregon and Washington are directly affected, and there will be ripple effects throughout the economy. Regardless of its origin or cause, this is a national problem and the solution requires federal action.

The failure of California's electricity plan has made clear the important role that wholesale markets have in determining the effectiveness of the retail competition plans enacted by the states. For several years, APPA and other organizations have emphasized that state objectives for retail competition will only succeed if supported by a workable wholesale marketplace. While many factors have contributed to the rolling blackouts and high prices in California's electricity market, it is apparent that improvements in the structure of the interstate electricity marketplace would go a long way toward helping to avoid such problems in the future.

Congress must finish the job it started with the Energy Policy Act in 1992, the first major step in creating competitive wholesale markets. It must take further steps to strengthen the electricity market. This can be accomplished, as outlined above, by ensuring consumer protection and by eliminating the problems caused by market abuses.

With regard to the specific issue of today's hearing, we support Senator Feinstein's legislation, S. 287, calling on the FERC to impose cost-based rates in the Western energy market on an interim basis. While we support this legislation, we believe FERC must enforce the statutory standard of just and reasonable rates in all wholesale markets that fail to provide just and reasonable rates through competition and market forces.

Senator Feinstein's bill, S. 26, is a viable option. S. 26 would amend the Department of Energy Authorization Act, to authorize the Secretary of Energy to impose interim limitations, or price caps, on the cost of electric energy. However, because it allows for individual states to opt out and because price caps inevitably allow the price to rise to that cap, we believe S. 287 is a better alternative.

Attached you will find APPA's recently adopted policy resolution calling on FERC to enforce the Federal Power Act by taking action to prevent wholesale sales of electricity at costs that exceed just and reasonable rates. As you know, FERC has already acknowledged that rates in the Western market have not met the just and reasonable standard—yet it has failed to fulfill its obligation under the Act to remedy this situation.

CONCLUSION

The essential purpose of federal initiatives should be to establish a structure for interstate commerce in electricity that promotes effective wholesale competition in order to reduce rates and improve service. Despite California's failed experiment, APPA still believes truly effective wholesale competition can benefit every consumer in America, and this is the responsibility of the federal government. If properly exercised, all may benefit. If not, all will suffer.

Statement of Hon. Anna G. Eshoo, U.S. Representative From California

Chairman Murkowski, Senator Bingaman, thank you for the opportunity to share my views with the Energy Committee. I want to thank Senator Feinstein for her important leadership in the Senate. She has been a great advocate for the State of California, particularly during this energy crisis.

In January, Representative Duncan Hunter and I introduced H.R. 238, the House companion bill to S. 26, introduced by Senator Feinstein. Since January, over half of the California Congressional delegation has joined us in cosponsoring this legislation, and many more share our view that federal intervention is needed to stabilize the western energy market.

Simply put, the Feinstein-Hunter-Eshoo bill would allow the Secretary of Energy to set temporary cost-of-service based rates or regional price caps for wholesale electricity in the West. This authority parallels what the Federal Energy Regulatory Commission (FERC) already has; however, we need this legislation because FERC has failed to adequately protect consumers in California and the West.

FERC's decision last Friday to order generators selling into California to refund $69 million for overcharges stemming from transactions made this January was a positive first step. Although many believe that this figure is on the low side, FERC has sent an important message to power generators—that they can't continue to gouge consumers without repercussions. While the Commission's order moves ahead, we must anticipate the future. We need prompt and prudent federal action to preempt current and future overcharges as we head into summer.

Much has been written about the failure of electricity deregulation in California and the state's failure to invest in new generation. As Californians, we accept our share of the blame for the energy crisis, and we are doing everything within our power to correct the problem. California now ranks second in the nation in energy conservation, with per capita energy use at 37 percent below the national average. Business and residential consumers have taken steps to reduce their energy consumption even more—eight percent in February alone. [Governor Davis has announced incentives for consumers who cut their energy use by 20 percent during this summer.] It's estimated that this initiative could save 2,200 megawatts per day. The Governor and the California Energy Commission are also working to expedite the review of new power plants and expect to have more than 2,300 megawatts of new capacity on-line by the end of the year.

The effects of the energy crisis reach beyond California's borders. So do the causes. While California failed to increase production during the 1990's, so did its neighbors to the north. According to the Northwest Power Planning Council, demand in the northwest increased 24% in the last decade while generation has only grown 4%.

Whatever the causes, the reality is that the western electricity market is dysfunctional due to a growing imbalance between electricity supply and demand. With regional demand expected to increase this summer, political leaders outside California are recognizing that their constituents will also experience acute electricity shortfalls. Oregon Governor Kitzhaber and Washington Governor Locke have been calling for federal intervention since January. Most recently, these governors joined Governor Davis in a March 12, 2001, letter to FERC requesting that the Commission impose cost-service-based rates for the region.

Mr. Chairman, the scarcity of supply today is allowing generators to exert tremendous influence over wholesale electricity rates in the region. By withholding even marginal amounts of power, generators have successfully driven prices to unprecedented levels.

Despite the accusations that "greedy" California consumers are gobbling up every megawatt they can, the facts tell a different story. The demand this winter has not been great in comparison to previous winters or peak summertime periods. A March 11, 2001 *San Francisco Chronicle* review of California Energy Commission data demonstrated that December 2000 demand was actually lower than December 1999 demand. The real difference was in the supply.

FERC has reported that in December between 6,000 and 11,000 megawatts of power were not available, guaranteeing that supply barely met demand. Meanwhile, generators were able to charge investor-owned utilities an average price of more than $400 per megawatt, compared to approximately $30 per megawatt one year earlier. With rates this high, generators have no financial incentive to build new capacity. Instead, they have a strong incentive to cut supplies and charge higher rates.

Critics of federal intervention, including FERC Chair Curt Hébert, have said that consumers should absorb the cost of these outrageous wholesale rates. Only then, they argue, will consumers receive the proper market "signals," adjust their consumption, and prompt generators to build more capacity. Unfortunately, the West's up-side-down electricity market has said to generators, lower production leads to higher profits. Higher consumer rates will not change that reality.

This is why we need temporary federal intervention. There's a substantial difference of opinion within FERC itself. Commissioner William L. Massey wrote to me on February 21, 2001, telling me of his support for aggressive federal intervention in the western energy market, and I'm enclosing, for the record, a copy of Commissioner Massey's letter. Separately, the *Seattle Times* reported on March 3, 2001 that Commissioner Massey said, "A federal hands-off approach, in my judgment, is absolutely unlawful. It is an abdication of our responsibility under the [Federal Power] act."

I'm a believer in free-markets. Period. The western wholesale electricity market is not free. Consumers and utilities have no choice about where they buy their power because there is not enough supply to foster competition among generators. Chairman Hébert's views notwithstanding, regulators and market observers agree that consumers need protection until there is sufficient generation capacity for a truly competitive marketplace.

Mr. Chairman, Senator Bingaman, and Senator Feinstein, thank you for holding this essential hearing. I look forward to working with you to address the western energy crisis, and I believe that Senator Feinstein's bill is a good place to start.

STATEMENT OF TERRY SMITH, CHAIRMAN OF THE CALIFORNIA INDEPENDENT PETROLEUM ASSOCIATION

Mr. Chairman, distinguished members of the committee, thank you for allowing me the opportunity to participate in this proceeding to share our thoughts on this issue of critical importance to California's economic health and well-being.

I am submitting testimony on behalf of the California Independent Petroleum Association—a non-profit trade association representing over 450 independent producers of oil and natural gas, service companies, and royalty owners. California produces about 40% of the oil it needs, the remainder comes from Alaska and foreign producers. California is the fourth largest producing state behind only Alaska, Texas and Louisiana and has the largest untapped reserve base for oil production in the lower 48 states. We believe that given the right conditions, we could produce more.

California's petroleum industry finds itself in the same circumstance as many of the state's other large power consumers—stung by high electricity costs. Continued high electricity costs could potentially make a large portion of the state's oil production uneconomic, however, given the proper incentives, CIPA and our member companies can be part of the solution to the energy supply problem facing California energy consumers.

There are two basic ways to help ease the energy supply crisis faced by California:

The first is to increase energy production. Policy makers must recognize the geographical advantage of in-state oil, natural gas and energy production and develop incentives to identify additional energy supplies that already exist in California. Laws and regulations that target and stimulate these critical resources and move energy supplies to the consumer quickly must be adopted. The siting of new in-state power plants of all sizes should be encouraged and expedited.

The second way to ease the crisis is to reduce energy consumption. Innovative financial, tax and regulatory solutions to reduce energy consumption that benefit both energy users and consumers should be made available. Examples of additional incentives to encourage business owners to shift electric load are interruptible tariffs, demand side management programs and demand side bidding. The ability of oil and natural gas producers to utilize distributed generation, self-generation and co-generation technologies should also be facilitated.

CALIFORNIA OIL AND NATURAL GAS PRODUCERS PERSPECTIVE ON THE ENERGY SUPPLY CRISIS

I've chosen to contribute to this dialogue because today's topic is of critical importance to the members of my association. For most independent producers in California, electricity accounts for up to 60% of the cost of doing business. California oil is costly to produce because it requires steam injection driven by natural gas to get it out of the ground. California producers also use a lot of electricity to pump the oil out of the ground. Environmental rules prevent them from using crude oil to make electricity so they use natural gas. High natural gas prices and unreliable supplies of electricity have resulted in making California crude costly to produce—and are threatening to severely curtail the amount of oil we produce on an annual basis.

CIPA has placed an extraordinary priority on assuring that it has access to a reliable and economic supply of electricity and on ensuring the state's private utilities are kept viable and solvent. 1ndependent oil and natural gas producers are some of the largest electricity consumers in the state, and are economically vulnerable to unreliable, high-priced electricity supplies.

Disruption in electricity supplies can result in reduced production of indigenous oil, natural gas and energy supplies produced by CIPA members. Almost all of the oil and natural gas produced in California is consumed in California.

What happened to California's electrical system that has resulted in the problems we see today? As someone representing large consumers of electricity, I would offer the following insights.

The problem, in essence, comes down to exceptionally stringent environmental siting guidelines and a low return on investment that kept new power plants from being built in California during the past twelve years. Over the past ten years, few people anticipated the strong demand for electricity brought about by a surging economy and technology infrastructure. California policymakers thought that other neighboring western states would sell us their excess power if we couldn't keep up with our own demand. They didn't anticipate the growth of our neighboring states' economies and the fact that they might want to keep that power for their own use.

In 1996, when the California Legislature passed legislation deregulating California's electrical market, it did so only partially. Not all of the market was deregulated, just the generation portion. Investor owned utilities like PG&E were required to sell their generation so they wouldn't be seen as competing with independent power producers or holding back the new electricity market. In addition, the law imposed a mandatory rate freeze that had been in effect during the past couple of years. The rate freeze was intended to allow the utilities to recover, from businesses and consumers like you and me, all the past costs of purchasing infrastructure and facilities. This also shielded ratepayers from the true cost of providing electricity.

This arrangement worked great as long as wholesale power costs were lower than the rates utilities were allowed to collect from customers. But, when wholesale power costs rose, the utilities tried to get the rate freeze removed by the California Public Utilities Commission and be allowed to pass along the true cost of wholesale power to their customers. To date, the Governor, Legislature, and the CPUC have all said 'no' thereby forcing the utilities to continue assuming the price differential of how much they purchase power for and how much they can recover.

To compound the problem, the new regulatory structure set up by AB 1890—the legislation that created the deregulated market—put a price cap on what independent power producers could charge for their power and restricted the ability of these same producers and the utilities to enter into long term contracts.

Finally, all of these factors converged at the same time natural gas prices began reaching historically high levels. Higher than expected demand throughout the west, reduced supplies, and disruptions on major pipelines serving California all served to drive prices up, thereby further exacerbating the generators' cost of producing electricity.

All of these trends have manifested themselves into the current crisis facing the committee today.

Having identified the problem as we see it, where do we go from here? California's independent producers believe we can be part of the solution if allowed the proper opportunities. As companies based and operating in California, we believe we are uniquely situated to mitigate the strains that are being placed on the supply side of the energy equation. Given the proper combination of regulatory relief and incentives, we believe we can increase our levels of both oil and natural gas production beyond their current levels.

ADDING IN STATE NATURAL GAS SUPPLY

According to the California Division of Oil and Gas, California continues to have some of the largest proved reserves of oil and natural gas anywhere in the United States. Proved reserves of over 21 trillion cubic feet (tcf) have been identified along the West Coast of the United States while over 3 tcf of proved onshore reserves have been identified to date. With the advent of new, increasingly accurate technology, new reserves of oil and gas are being found throughout the state in areas previously thought to be barren.

Despite the presence of such substantial reserves, and the state's rapidly growing demand for increased supplies of natural gas, in-state production in California today accounts for only 10–15% of the state's total annual natural gas needs. In the past, California production has accounted for as much 25% of the state's total needs.

Although much of this trend can be contributed to some of the same factors I referenced earlier—stringent environmental laws, high drilling costs, historically low gas prices throughout the 1990's and labor shortages—many experts believe a large part of decline can be tied directly to the policies of the state's major gas utilities.

Existing law provides the utilities with almost exclusive authority in setting the terms and conditions under which pipeline connections for new natural gas wells are accommodated. Historically, many producers have felt that the utilities have used this authority to stifle California production and limit competition in favor of taking larger supplies of gas from out of state sources such as Canada, the Rocky Mountains, and the Southwest.

For the past ten years, independent producers throughout the state report experiencing delays of six months to a year before receiving utility approval to install a new pipeline interconnect for newly completed wells. Overly burdensome and expensive terms of conditions imposed by the utilities as a condition of new interconnections are now thought to be the rule rather than the exception. In many cases, producers have elected to simply abandon new exploratory projects rather than try to meet the demands being imposed by the utilities.

One of the largest impediments to increasing gas production in California are the utility's own management policies relative to its existing pipeline infrastructure. Representatives from PG&E recently announced that the company would no longer be adding any new metering systems along its pipeline system in Northern California. If enacted, the new PG&E policy would require all new wells to be connected through an existing metering site along the pipeline—requiring in some cases miles and miles of new pipelines to be constructed in order to connect a remote exploratory well. Given such terms and conditions, most exploratory projects would become automatically unfeasible. In an related move, PG&E has also recently embarked on an ambitious plan of "retiring" large sections of its pipeline gathering and delivery systems—further limiting the potential points of interconnection for new gas wells. Many of the sections being targeted by the utility continue to remain in operational condition. The hardest by these new policies would be the Northern Sacramento Basin—one of the most proliferate dry gas fields in the United States and the source of over one-third of all the natural gas produced in California.

Significant evidence suggests that much of California's long-term gas needs could be addressed be expanding production, and reforming the regulatory relationship between the independent producers and the utilities. Suggested reforms that could help accomplish this goal include:

- Establishing mandatory timeframes under which a utility must respond to a producer's request for a pipeline interconnection.
- Encouraging new exploration activity by requiring the utility to install new metering sites, rather than requiring producers to construct miles of new pipeline for every exploratory well.
- Allowing producers to expedite the installation of new interconnects by authoring them shoulder costs such as pipeline construction and labor costs if the utility's workforce is already overburdened.
- Facilitating the development of new pipeline gathering infrastructure that enables more gas to get to market.
- Requiring the utility's to sell off its existing gathering systems to interested producers and co-ops, and provide the producers the authority to maintain and service the gathering systems.

By making some of these minor changes, and facilitating the ability of California producers to get their gas to market, we believe we can begin to help mitigate at least one element of the problems driving our state's current crisis.

IN-STATE GENERATION OPTIONS

On a related note, CIPA believes that Federal policymakers must act to eliminate federal policies that discourage co-generation, self-generation and distributed generation. Many California oil and gas producers are uniquely situated to generate their own electricity. Some have excess supply which could be sold to other consumers if reasonable utility connection, siting and standby policies were in place. We encourage you to examine the ways in which FERC, the DOE and other agencies of the federal government could encourage and incentivize utilities, and the regulatory community in California, to act to approve new facilities.

In closing, independent oil and gas producers are price takers and have no ability to set the price of crude at the wellhead where we produce it. Independent oil and natural gas producers are like energy farmers. We take our commodity out of the ground and sell it for the market price set by OPEC and other producing countries, usually to an independent refiner or integrated oil company who then refines it into products like gasoline. As such, our members are extremely vulnerable and can be dramatically impacted by any combination of events that force their costs to rise suddenly. We appreciate the committee's attention to this extremely serious matter and stand ready to work with you in finding the proper solutions.

STATEMENT OF MARCIA MERRY BAKER, EIR NEWS SERVICE

Dear Chairman Murkowski, members of the Committee, and Senator Boxer: The draft Federal energy bills now before you—S. 26, S. 80 (both introduced Jan. 22), and S. 287 (Feb. 8), by the California Senators, deserve full support for the policy direction they propose. Namely, they are a move toward Federal government regulation of the vital service of electric power, for the interest of the general public. The limitations—which we address below, are not as important as the fact that these two bills, and very few others (one is that of Rep. Peter DeFazio, D-Oregon), favor serving the general welfare, and go against the Administration's crazed continuance of deregulation, which is equivalent to throwing gasoline on a burning house.

Moreover, the additional danger at present, is the political fact that, without such measures, the process of worsening energy emergencies—for the Northwestern states, and New York, as well as California, can be taken by the Administration as the pretext for "rule-by-decree," on exactly same principle as in Hitler's 1933 takeover. We do not exaggerate. This prospect was the inherent danger in the confirmation of John Ashcroft for Attorney-General, who ideologically opposes Federal government measures to protect and advance the General Welfare. Without reregulation, however, the crisis will worsen to the point of creating a national emergency.

In opposition to the mantra of "free markets," there are moves now in all states, to delay, roll-back or reconsider energy deregulation, to prevent economic destruction, and the threat of chaos or dictatorship. In particular, the emergency policy proposals made by economist Lyndon LaRouche—contributing editor to EIR News Service, are under review at town meetings, lobbying days, and policy sessions in dozens of states.

In brief, LaRouche's proposals call for re-regulation of energy, and Ch. 11 Bankruptcy for the California utilities, and others in the same position. These are traditional precedents from the FDR era.

LaRouche, who forewarned decades ago, of the consequences of deregulation, and allowing a "casino" economy of speculation and concentrated ownership, has released on Feb. 6 a policy document on the "California Energy Crisis, As Seen and Heard on the Salton Sea," 400,000 copies of which are circulating in the form of a mass pamphlet, through the LaRouche-in-2004 Democratic Presidential campaign. Excerpts of this document were provided to the Committee in EIR testimony to the Jan. 31 hearing on the California crisis.

We remind you of what it means to continue to back deregulation. In data tables below, we provide the statistics of the 30% to 200% profit rates for Y2000, made by Bush Administration-aligned Enron and the new energy "merchant" and speculation companies, off California and other power crises; these companies also made mega-donations to elected officials. However, beyond simple corruption, the point shown is that any expectation that the financial and economic system which is based on this level of hyperinflation, and cartel control, can continue, is insane.

Either you start to think, as implied in the Feinstein/Boxer bills, that something can and must be done to set controls on the markets, or you are on the side of chaos and destruction. First, we provide the Committee the economic assessment given by Lyndon LaRouche at an international policy conference President's Day weekend in Reston, Virginia; and then some documentation of the nature of crisis, and why there is no other policy direction than what LaRouche proposes, like it or not.

LaROUCHE'S ASSESSMENT: HYPERINFLATION

On Feb. 17, in an address titled, "A Branch in the Road of History," LaRouche said, "What you're seeing in the energy prices, what you're seeing in the costs of supplies—manufacturers' supplies—combined with what you're seeing in the collapse of retail sales, what you're seeing in terms of the mass lay-offs, in one industry after another, which is now building up into an international chain-reaction, is a process of a depression, caused like that of Weimar Germany in 1923—worldwide—caused by the collapse of a financial bubble, which has gone into a hyperinflationary phase.

"That's why Alan Greenspan has lost his marbles. He probably didn't have too many to begin with, but whatever he had, he's lost.

"So, we are now at the point, where it is impossible, by the present methods, to keep this system going. It is in the process of going into a deep depression. And nothing that these guys are proposing, or will accept, will work. The idea of more deregulation, the idea of tax reductions, all these kinds of things—cutting down the role of government, opposing re-regulation—all of these things ensure nothing but the greatest depression in world history. Globally.

"Because, what happens is, the U.S. is the importer of last resort, nations all over the world have been depending on dumping cheap-labor products on the U.S. market, for the products we no longer produce. As our market declines, as you saw in the last-quarter retail sales, which is the big Christmas retail business, from the last quarter of the year: That collapse set into motion a chain-reaction collapse around the world, which, together with the financial collapse, caused by the hyperinflation, has sunk the world economy. We can no longer finance that kind of subsidy for imports, as we were doing before; therefore, we can't do that. Therefore, our suppliers, who have used us as a market, are now being shut down.

"For example, Mexico can expect, 20, 30, 40% of its exports into the United States to be wiped out, very soon. One of the biggest. Canada is already suffering, as you've seen from some reports recently from there. This is a global process."

REQUIRED: REREGULATION AND CH. 11 BANKRUPTCY

LaRouche continued, by describing what is required. "Take the California energy crisis. We have a worldwide energy crisis, and especially a West Coast energy crisis. There's only one way you can deal with that energy crisis: You've got to go back to regulation. Use what we prepared in the 1930s—Chapter 11 bankruptcy protection for the entire industry. You see, in this kind of Chapter 11 bankruptcy, you protect, not only the creditors and debtors; you protect the general public. You see, because the people of California, for example, have to be defended. The interests of the firms of California, the farms, have to be defended. Whether or not they're involved in the relationship between the creditors and debtors, is irrelevant.

"The fundamental interest of the United States, is that our people have electricity! That our firms have the power to operate on. That our hospitals function. That our farms function. When we go into court with a Chapter 11 bankruptcy, these interests come on the table, and actually have the greatest say, in how the bankruptcy will be renegotiated. The creditors and the debtors go into a second tier. What comes up front, is the interest of the nation; the interest of the people; the interest of the economy.

"So, we need Chapter 11 protection, for all the imperiled sections of vital infrastructure for our national economy.

"Secondly, we can not do this, without both a combination of Federal and state re-regulation.

"If we do that, we have enough energy available to manage this crisis, and can manage this at prices, at charges to people who are using electricity, to ensure the electricity they require, and to ensure that it's delivered to them, regularly, at a decent price. We can guarantee that.

"If we do that, the energy crisis is brought under control."

WHO OPPOSES CONTROLLING ENERGY PRICES?

LaRouche then turned to, who would oppose solving the energy crisis, asking, "But, what does that mean? That's in the interest of the nation. How can any patriot oppose that? George Bush has to be opposed to it. If you look at the combination of financial interests, which is represented by the people that gave the money to make Bush President: These guys would be wiped out, by an honest deal. Because they make their money by looting; they bid up the price. The reason that the prices go up, is purely that these fellows are looting the United States, as well as other countries. Therefore, the interest, the reaction, the response of these people, is against the interest of the people of the United States; against the national security interests."

The following two tables,* reproduced here from the March 2 issue of EIR, "Energy Crisis Update, Feb. 22" give data analyzed on the energy cartel mega-profits, and mega-donations to political campaigns.

NOT A "SUPPLY AND DEMAND" PROBLEM

The tables above, listing the companies making hyper-profits off hyperinflationary energy prices, also raise the point that the problem in run-away energy prices is emphatically not a "supply-and-demand" issue. While the energy infrastructure and resource base of the United States has been degraded (from aging transmission lines, to the lack of new nuclear plants) over the last 30 years, today's energy price spikes are clearly speculation and gouging.

The graphs below, for three power commodities—oil, natural gas and electricity (California), all show that while supplies (and correspondingly, use) remain almost level, prices soared over Y2000. During this same time, demand did not jump. The price take-off came directly from deregulated energy "markets" and speculation.

Two more points should be brought out in this respect. Natural gas, because it is federally deregulated, is soaring in price (from speculation and gouging) all across the continent, with terrible economic dislocation and financial chaos. Where natural gas is part of the electricity generation, a double whammy is hitting the locale. Sec-

* All tables have been retained in committee files.

ondly, price rises for petroleum, do not correspond with non-existent swings in supply or demand for oil. Prices soar from speculation and gouging.

In the best estimates of financial analysts, every barrel of oil entering world exports, is traded up to 15 times over on the London and New York commodities' futures exchanges. This is called, "paper oil." Natural gas is traded on the New York Stock Exchange 8 or 10 times more than the volume that exists. Electricity futures are traded many times over the actual unit volume and production costs.

"GO THE WHOLE WAY"

These few facts demonstrate that only policy that will "go the whole way" with energy price re-regulation, and Ch. 11 bankruptcy protection of the public interest, is appropriate to the nature of the crisis we now face. Half-way measures, or partial "bail-outs" are doomed, along with the economy, if we don't take an across-the-board reregulation approach.

Thus, from this point of view, the principle of public interest embodied in the Feinstein/Boxer bills is in the right direction, but too limited, given the reality of the depression.

S. 26—"To impose interim limitations on the cost of electric energy to protect consumers from unjust and unreasonable prices in the electric market; and

S. 80—"To require the Federal Energy Regulatory Commission to order refunds of unjust, unreasonable, unduly discriminatory or preferential rates and charges for electricity, to establish cost-based rates for electricity sold at wholesale in the Western Systems Coordinating Council . . ."

S. 287—"To impose cost-of-service based rates [meaning, to cover cost of production, and a reasonable return on invested capital] on sales by public utilities of electric energy at wholesale in the western market."

[The states covered by the bills are defined as the "Western Energy Market"—Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming."]

It is in the best interests of the nation, that these draft bills be expanded to cover all power modes, be nationwide, re-instate regulation, and facilitate Ch. 11 Bankruptcy actions where needed.

STATEMENT OF GEORGE FRASER, GENERAL MANAGER, NORTHERN CALIFORNIA POWER AGENCY

The Northern California Power Agency[1] (NCPA), urges the Committee to adopt legislation implementing cost-based wholesale power rates in California and the other Western States on an interim basis. We do not currently enjoy a truly competitive market for electricity in California at this time, and consumers cannot wait for a competitive market to materialize.

Today, in California, we are struggling to develop solutions that will get us beyond the mistakes that have been made in restructuring that market. It will take some time to develop and implement the best solutions. But even if we knew today the exact recipe for creating a workably competitive market, those changes would take time to implement. Without cost-based rates, unfettered prices for electricity will continue to create disincentives for correcting the flaws in the market and impose significant societal and economic harm.

California's municipal utilities were not required to participate in the state's retail, choice program and largely remain vertically integrated utilities that retain an obligation to serve their retail consumers. NCPA members generally have sufficient generation resources to meet their consumers' electricity needs. At times, NCPA has excess generation that we sell into the market and, at other times, we must also occasionally purchase power on the market. On aggregate, NCPA members are net market purchasers.

NCPA has long supported steps to foster and promote sustainable and effective competition in the wholesale electricity market. Regrettably, the market conditions needed to sustain effective wholesale market competition are not present in Califor-

[1] NCPA is a nonprofit California joint powers agency established in 1968 to generate, transmit, and distribute electric power to and on behalf of its fourteen members: cities of Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alto, Redding, Roseville. Santa Clara, Ukiah, the Port of Oakland, the Truckee Donner Public Utility District, and the Turlock Irrigation District and seven associate members: cities of Davis, Santa Barbara, ABAG Power, Bay Area Rapid Transit District. Lassen Municipal Utility District, Placer County Water Agency, and the Plumas-Sierra Rural Electric Cooperative serving nearly 700,000 c1cctric consumers in central and northern California.

nia today. Consequently, NCPA supports efforts to re-impose cost-based rates as a temporary measure until such time as competitive market conditions exist.

CAUSES OF THE CURRENT CRISIS

While there is no value in finger pointing, it is clear that many factors contributed to the current crisis—a crisis that spills beyond California's borders and infects the regional power market. At its core, the California and associated Western power market lacks the conditions necessary for a competitive market: multiple sellers, ease of entry, free flow of commerce and price transparency. In California:

- There is a shortage of installed and operable generation in California. This shortage has allowed market participants to withhold generation, strategically bid and game the system to maximize profits.
- There is a shortage of transmission capacity within the State. Alleviating current transmission constraints between northern and southern California would have avoided the recent rolling blackouts. However, no party has both the responsibility and authority to relieve such constraints.
- There is a shortage of transmission capacity to import generation products from outside California.
- The absence of a seamless, independent regional transmission system impedes commerce and narrows the relevant market.
- From its inception, the Cal-ISO and PX lacked proper rules, procedures and mechanisms to promote competition, monitor market conditions and take corrective action.

Market forces can only serve to check prices when competitive market conditions exist. In the absence of such conditions, sellers are able to dictate prices without suffering competitive responses that reduce sales and revenue. Although the Federal Energy Regulatory Commission (FERC) should only approve market based rates when competitive market conditions exist, FERC approved the California restructuring plan and the use of market based rates.

CALIFORNIA MUNICIPAL UTILITIES HARMED BY DYSFUNCTIONAL MARKET

The general perception is that California's municipal utilities have been insulated from the volatile market. While it is true that California's municipal utilities retained the generation assets needed to serve load, our consumers have been far from insulated from the dysfunctional market. NCPA and its members:

- Voluntarily participated in the Cal-ISO load curtailment programs and have been subject to rolling blackouts—even though we had sufficient resources to meet our load.
- Have drawn down the reservoirs at our hydro projects to help meet the electricity demands of the state, putting at risk our ability to generate power at these projects during the critical peak Summer months.
- Operated gas-fired combustion turbines at the sole direction of the Cal-ISO, using 20 percent of available air emissions in the first 20 days of January (at a time when the plants would usually not operate)—again reducing our ability to operate the plants during the Summer.
- Purchased power on the market at rates above what would exist in a truly competitive market.
- Sold power to the Cal-ISO, for service to the state's investor-owned utilities, for which we've since been told we will not be paid.

As consumer-owned utilities, the effects of these developments will be felt directly and exclusively by our consumers. We have no stockholders to "share" in the pain.

PRICE CAPS AND COST-BASED RATES

NCPA recognizes the shortcomings of hard price caps. The level may be arbitrarily set too high or too low, either unnecessarily enriching low-cost producers or preventing marginal generators from economically operating. While a $250 price cap seemed more than adequate one year ago, natural gas prices and emission credits—not to mention opportunity costs—combine, at times, to make the cost of operating one of NCPA's gas-fired combustion turbines more than $800 per megawatt. It is clearly difficult to divine a single number to impose as a cost cap throughout the west.

It is equally clear that failure to impose regulatory cost discipline—in the absence of effective market discipline—will cause excessive and unacceptable burdens on residential consumers, businesses and the California, regional and national economies. Just as the stock markets employ "circuit breakers" to halt trading when the market rises or falls too precipitously, so too must we call a "time out" in the western wholesale electricity market.

Ultimately, additional infrastructure—both generation and transmission—is needed to restore supply-demand equilibrium and enable markets to function competitively. NCPA strongly supports such investments and is aggressively pursuing generation and transmission additions. However, the most critical transmission addition will take at least two years to complete and generation projects will take even longer. Consumers in California and neighboring states cannot wait that long.

To protect consumers during this intervening period, NCPA supports a temporary re-imposition of cost-based rates and supports the intent of the legislation pending before the Committee. We commend Senators Feinstein and Boxer for recognizing the need to act and for pursuing the temporary re-imposition of cost-based rates.

NCPA understands that there are differing opinions on the need for and design of any regulation of the regional power market. While we are willing to work with the Committee, the Administration and other market participants on the design of the effort, we believe expeditious action is imperative.

Issues that the Committee might consider include:

- "cost plus" rates in which higher than normal profits would be temporarily allowed to ensure operation of existing generation;
- exempting generation additions from cost-based rates as a means of encouraging new plant construction;
- the types of transactions subject to the cost-based rate requirement (e.g., all transactions or only short-term transactions); and
- the "trigger" for when the cost-based rate requirement would be lifted.

At a minimum, Congress should ensure that the current "soft cap" imposed by FERC is properly enforced. As intended, power sales at prices above the FERC-imposed "soft cap" would be allowed but reviewed to ensure that they were cost-justified. It is unclear whether FERC is adequately collecting and reviewing the cost data needed to determine whether above-cap bids are in fact cost-justified. Congress must ensure that this minimal protection is, in fact, operating.

LONG-TERM MARKET REFORMS NEEDED

Re-imposing cost-based rates is merely regulatory triage, temporarily treating the problem. It is not a long-term solution, and it is equally important that Congress and FERC use the time afforded by this temporary "band aid" to address the systemic issues and provide long-term solutions.

The recent California experience has taught us a number of critical lessons:

- Without clear authority on RTOS, FERC accepted inadequate, inferior and flawed filings from the Cal-ISO. FERC needs clear authority and direction on RTOs to promote truly effective, regional and independent transmission management.
- While California would be the 6th largest country in the world based on GDP, it is not big enough to serve as a stand-alone energy market. Markets are regional, and the transmission system must be run in a manner that supports interstate commerce.
- There are numerous transmission constraints in California that have contributed to the rolling blackouts and locational market power. While the Cal-ISO identifies these constraints, it has no authority to take corrective action. Current transmission constraints—like Path 15—must be eliminated and immediate federal funding assistance, through the Western Area Power Administration (WAPA), for environmental, engineering and rights-of-way acquisition is needed. Ultimately, RTOs should have clear authority and responsibility to plan and expand the transmission grid. Federal transmission siting authority is also needed.
- Creation of contrived markets—within the PX and ISO—don't work and exacerbate market problems. While there is a need for institutions to ensure independent grid management, these institutions should have minimal market involvement.
- Markets do not work well when there are too few market participants and scarcity of supply. FERC must establish clear and effective rules to promote sustainable competitive markets prior to granting authority for market-based rates.
- While there are conflicting accounts on whether generators have exercised market power, manipulated supply and bids, taken advantage of poorly designed market rules or simply profited from scarcity, it is clear that there is little public confidence in the current system. Reformatting FERC's role so that it is an

effective market monitor, with clear authority and direction to detect and correct market manipulation or abuse, is needed.

Congress and FERC have exclusive authority over inter-state commerce in the sale of electricity. The interstate market is not currently working and will not sustain effective competition. It is critical that the structure and mechanisms necessary for a competitive market be established.

NCPA is a participant in the Electricity Stakeholders—a diverse coalition supporting wholesale market reforms—and urges the Committee to adopt legislation consistent with the Stakeholder principles.

CONCLUSION

NCPA remains committed in its belief that an effectively competitive market is beneficial to all consumers. However, such a market will not miraculously appear simply by declaring markets deregulated. As California has demonstrated, deregulated markets that lack the structure to support effective competition will simply cause consumer and economic hardship.

As a first-step, FERC must re-impose regulatory discipline in the uncompetitive western power markets. The pending legislation is a critical step in achieving this necessary relief. But we cannot stop there. Congress must also provide FERC with necessary guidance and authority to promote and monitor effective competition in the wholesale market.

NCPA looks forward to working with Senator Feinstein and the Committee in promoting both of these objectives.

STATEMENT OF PHILLIP H. TOLLEFSON, EXECUTIVE DIRECTOR, COLORADO SPRINGS UTILITIES

Mr. Chairman and members of the Senate Energy and Natural Resources Committee: My name is Phillip H. Tollefson and I am the Executive Director of Colorado Springs Utilities (CSU). I appreciate this opportunity to submit testimony for the record on behalf of Colorado Springs Utilities and in support of legislation that is intended to address recent, dramatic increases in the price of wholesale electricity in the West. I also want to thank each of you for your willingness to consider this statement as you look for interim solutions to address the dramatic increases in electrical bills that western consumers have faced as a direct result of rapidly rising wholesale electricity costs.

Colorado Springs Utilities is a municipally owned utility which provides water, wastewater, gas and electric services to the citizens of Colorado Springs. We generate 82% of the City's electric power needs (approximately 623 megawatts) and we purchase an additional 11% from the Western Area Power Administration and through other long term contracts. Only 7% of our annual requirements are purchased on the "spot" wholesale market. CSU currently provides electric service to approximately 417,000 people.

While a great deal of attention has been focused on the State of California in recent months, I want to make it very clear that the rising price of wholesale electricity is not just a California issue. Since the summer of 2000, the wholesale price of electricity all over the West, including Colorado, has been rising precipitously. For example, in 1998 the average price of a megawatt hour of electricity on the wholesale market in Colorado was approximately $30. In 2001, we estimate that we will pay $130, over four times what we paid in 1998, per megawatt hour. Seasonal and monthly variations are even worse; prices this coming August are expected to approach $400 per megawatt hour. The price of power on the spot market far exceeds the actual costs of generation as is demonstrated by the fact that CSU expects that the 7% of power we anticipate buying on the spot market will account for 43% of our total annual electric supply costs!

It is an unfortunate fact of life that even the most well maintained power plant will occasionally be forced out of service unexpectedly. Up until last year, it was generally possible to purchase necessary replacement power on the "spot" wholesale market at reasonable costs. Last summer, a cracked steam header at one of our plants took a week to repair. Replacement power cost us $11 million, or about six times what it would have cost us to generate the power ourselves. The current futures markets suggest a similar incident this summer could well cost us over $30 million for a single week. This is not a functional wholesale market.

As a result of these unreasonable wholesale increases, electric consumers in Colorado and throughout the West face skyrocketing utility bills. Further, we believe that the economy of our city, our state, our region and even our entire nation will feel its effects. This situation has reached a crisis level and calls for the involvement of the federal government.

Many theories exist to explain the specific reasons that wholesale prices have increased so dramatically. Generally however, the consensus seems to be that the problem is a result of a combination of factors, including: scarcity in terms of generation capacity due to aging facilities; transmission delivery systems with inadequate capacity and the existence of bottlenecks; imperfect market structure at the wholesale level and, in the case of California, the retail level, and; market abuses by energy providers who have taken advantage of narrow supply margins to "price gouge" consumers. Certainly one could argue about the relative weight and impact of each of those factors and there are, no doubt, other factors here left unmentioned. What is important however, is that the price increases have resulted in consumers being forced to pay unjust and unreasonable amounts for electricity. Those who are low income or on fixed incomes, the elderly, and non-profit organizations and small businesses with narrow operating margins have been particularly hard hit. If nothing is done, the situation will grow far worse this summer.

The legislation being considered today is crucial precisely because it can provide some measure of relief to those consumers. By granting to regulators the authority to implement rate caps on the wholesale price of electricity, the dramatic fluctuations we have seen recently in wholesale electricity prices can be mitigated. That "leveling off" of wholesale prices that is the desired result of the legislation will, in turn, lead to some relief for the retail consumers. Opponents of rate caps may argue that such caps could serve as a disincentive to the construction of new generation. However, I believe the proposed legislation addresses that argument by expressly allowing the rate caps to include a reasonable rate of return that would continue to provide an incentive for the construction of new generation capacity. Only unjust and unreasonable rates would be affected by this legislation. In fact, many companies that saw fit to add generation in the past made healthy profits for decades at prices far below current levels.

The rate caps proposed in this legislation are being advocated precisely because electric wholesale prices in the West have become unreasonable and unjust and it is clear that consumer price gouging is occurring. In fact, the Federal Energy Regulatory Commission has previously concluded, in an order issued on November 1, 2000, that prices in California and the western energy market were "unjust and unreasonable." In the short term, the only means available to protect consumers from price gouging is to implement rate caps. Ultimately, additional generation and transmission capacity will have to be developed to bring stability to the wholesale market, but today's prices are not necessary to justify such construction.

Another issue I would like to briefly address is reliability. It is critical that in addressing the pricing problems of the wholesale electricity market, Congress not inadvertently impair electric reliability. Congress should ensure that any measures it implements for the purpose of solving the electric wholesale problems not create conditions which would result in a reduction in the availability of power in the West. The laws of physics do not necessarily recognize state boundaries. Imposition of a cap in one part of the Western grid but not in others could have severe unintended operational consequences.

Colorado Springs Utilities supports the concept of temporary electric wholesale rate caps as a means to protect consumers from market abuses and bring prices under control. I urge the Committee to act quickly in moving legislation to address the current wholesale crisis.

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