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WHOLESALE ELECTRICITY PRICES IN CALIFORNIA AND THE WESTERN UNITED STATES

HEARING

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

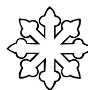
ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

FERC'S APRIL 26, 2001, ORDER ADDRESSING WHOLESALE ELECTRICITY PRICES IN CALIFORNIA AND THE WESTERN UNITED STATES

MAY 3, 2001



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WHOLESALE ELECTRICITY PRICES IN CALIFORNIA AND THE WESTERN UNITED STATES

THURSDAY, MAY 3, 2001

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

The committee met, pursuant to notice, at 2:31 p.m. in room SD–366, Dirksen Senate Office Building, Hon. Frank H. Murkowski, chairman, presiding.

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

The CHAIRMAN. Good afternoon, ladies and gentlemen. I want to thank you for coming. I notice that a good deal of interest from interested parties within the beltway on the topic of this hearing. It's an oversight hearing on FERC's April 26 order addressing wholesale electric prices in California in the Western United States.

The purpose of the hearing is to give us, the committee, an opportunity to be educated. I use the word loosely because sometimes our span of attention is a bit limited.

Anyway, this is your opportunity to educate us on FERC's recent order regarding wholesale electric prices in California and the Western United States.

Now, Senator Bingaman and I have had a number of conversations on the procedure here, and I was of the opinion that we had an order. And the order came out from FERC, and it came out 2 to 1. But, nevertheless, it was an order. To me an order stands as just that, an order.

As a consequence, I feel very strongly we should limit the presentation to an explanation of the order by the chairman.

Senator Bingaman felt otherwise. He felt that since it was disputed, we could learn more on the basis of the internal evaluation of what went into the order, and I don't necessarily dispute that. But I don't think it's in the intention of either one of us to stage a debate here on who's right and who's wrong. We respect the individual opinions of the commissioners, as we should. They make their decisions based on what they believe is best for the country, and we hold them accountable.

But, in any event, I did want to clarify, so there was no misunderstanding, the discussion I had. And Senator Bingaman obviously can speak on this as well from his point of view.

Now, I think it's fair to also annunciate that what we understand is the intention to bring the spot California power market under control for the summer was the charge of FERC. Further, it was questionable whether this should go beyond California into conditions in the rest of the west.

Maybe that's a broader obligation, but I'm certain that there will be those who say FERC's order goes too far. Others say it doesn't go far enough. But, nevertheless, we have an order. And if we don't like the order, we have a legislative alternative, or FERC can come up with another order.

Now, we have a difficult situation in California. I'm told that in 1998 prices for energy in California ran about $9 billion. I was told in 2000 they ran about $28 billion. I'm told this year they're going to run somewhere between $60 and $70 billion.

Now, that will get anybody's attention, and the justification for that may be supply and demand. Nevertheless, FERC has an obligation to address, if you will, inconsistencies associated with the marketplace.

Now, I'm not here to blame California, but I think we have to be very candid in expressing, to the best of our ability and understanding, that price spikes are not the cause of California's problems. They're the symptoms of a deeper, deeper, deeper problem that cannot be fixed by price controls.

In this connection, I don't think we can lose sight it was California, to a large degree, that made a decision a long time ago that it was cheaper to buy power outside the State than it was to develop within the State of California adequate power generation capabilities.

So a little history I think is in order as we go back and recognize it was California that ordered its investor-owned utilities to divest their fossil generation.

What did they do with that money? They gave it back to the shareholders. A lot of criticism for that, but if you're going to be ordered to divest and you divest your fixed assets, who does it belong to other than the shareholders? It was California that required its investor-owned utilities to drop long-term contracts and instead require all of their power supply from the volatile spot market.

It was California that decided to treat its investor-owned utilities differently than it's public-owned utilities. The investor owned didn't have an opportunity to opt out. And, of course, the public-owned utilities basically did.

It was California that chose to create a dysfunctional retail competition plan, forcing utilities to buy high and sell low, which you can only do that so long before you go into bankruptcy and we've seen that with PG&E.

Most importantly, it was California that chose to forgo construction of new generation and transmission, instead placing reliance on power-generated neighboring States to the tune of about 25 percent of the power that's consumed in California.

Now, you might not think those statements are representative of a sympathetic chairman, but they are in my sense of how you go about fixing it. You recognize you have a problem. And you recog-

nize truly what caused the problem, and then fairly decide on what we can do to help. That's the spirit we bring to this hearing today.

We have a problem in California, but FERC has been trying to address through its April 26 order and other orders. Some will criticize FERC and say where's FERC been? Well, I think we've seen a change of administration, and we can go back, if you want. But I don't think it serves a purpose and point the finger why hadn't FERC done this earlier or something else earlier.

Some don't think FERC has gone far enough. They're calling for even more regulation by FERC. But more regulation doesn't necessarily build new powerplants, new power lines, or new transmission lines. Whether it be gas or electricity. Instead, more regulation, in my opinion, will discourage investment, further worsening California's problem.

I would implore those of us who are searching for an answer to not be misled by the number of permits that are being issued out of California. That's got nothing to do with the reality of whether you're going to have more power generation. That power generation is only going to come about if indeed the investment community is satisfied that they can get a fair return on investment and want to go into California and provide those generating facilities. So that's one of the real concerns you have to watch when you consider wholesale price caps.

We've seen what retail caps have done to California. They've taken care, to some extent, of the consumer, and put the burden on the taxpayer. And it's beyond me to try to differentiate the difference between the taxpayer and the consumer when it comes to the liability that the State of California is picking up. But that's hindsight.

Ultimately, FERC's order is, in effect, an effort to try to strike a balance between the need for dampening of prices and the need for incentives to build new facilities. Whether it's adequate or not, it's not my job to make that determination. But the order dampens prices but does not eliminate market pricing.

Now, it's rather interesting to note that within California there's an extraordinary process going on now where utilities are, in effect, making deals to settle disputes with the State of California on pricing.

I assume many of you have read the *New York Times* article yesterday, "Power Concerns Offer California a Secret Deal." The Governor and Duke and a political intrigue associated with it.

But I think it's important to point out one thing. The FERC recently ordered generators to justify high prices in California this year or pay $125 million in refunds. Those companies, including Duke, rely on—Dinergy, Williams, et cetera, deny any wrongdoing and so forth. To suggest FERC isn't doing anything is a bit misleading as well.

For those of you that don't know what I'm talking about, I suggest you take a look at the *New York Times* because it's an extraordinary article, and you can read anything you want into it, relative to the implications.

There's one thing I read into it. There is a process within California addressing these alleged spike hikes. And how it will come out, in any event, remains to be seen.

In any event, in the connection that I noted, I think we should also reflect on a letter that we have by nine Western Governors to the FERC Chairman Hébert, which reiterates their opposition to price controls.

Just let me read the paragraph. "Your resistance to the considerable pressures to impose penny pies and pound-foolish rate controls has served the long-term interest of our region by allowing California to work its way out of this difficult situation.

"Likewise, your recent actions to streamline electric sales in the West have been valuable and appreciative."

I want to commend the FERC Commissioners because we have them all here. I look forward, after my colleagues speak, of hearing an explanation on the FERC order, and I'm sure that the members here will have many questions relative to the adequacy or inadequacy of that. But I would hope that out of this we could continue to build a case for real relief for California, not perceived or cosmetic relief, because we can all go out of this process feeling very good that we've done something.

But if capital doesn't go into California, and have a market for the investment necessary, California isn't going to get the relief it needs.

Senator Bingaman.

[A prepared statement from Senator Campbell and Senator Smith follow:]

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 regarding the ongoing problems in California and how the FERC is going to deal with wholesale electricity prices. 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.

I am skeptical of price caps and am leery of the these orders. Many say they are likely a disincentive to investment in new generation. This can be a dangerous course we are taking, especially since these rules are limited. There is only so much the Federal Government can and should do to affect local electric power issues.

Still, the long-term problem is the supply of electricity which is smaller than the demand in the region. And, California and other Western states have not built new power generation facilities sufficient enough to 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.

All of the proposals being offered to help address this power crisis, regardless of the controversy, have to be considered so that the problem can be solved.

I am approaching the California crisis debate very carefully so that the best interests of my home state are taken into consideration. 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.

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

Mr. Chairman, I appreciate your willingness to schedule this hearing in such a timely manner on the April 26, 2001 Mitigation Order issued by the Federal Energy Regulatory Commission concerning wholesale electricity sales into California, and instituting an investigation of public utility rates in wholesale Western energy markets. I want to welcome the FERC Commissioners here today, and appreciate your willingness to appear before the Committee to discuss this order.

You almost need a scorecard to keep track of the energy situation on the West Coast. We are having a severe drought in the northwest, blackouts in California,

huge price spikes for electricity on the entire West coast, and a utility bankruptcy that will keep lawyers employed for years. And it's only May.

As you know, I am the principle cosponsor of S. 764, the Feinstein-Smith bill to impose some form of price caps or price mitigation on the entire Western energy market. I agreed to support price caps or price mitigation at the wholesale level only on the condition that states, particularly California, institute retail prices that allow utilities to recover costs, and that send the right price signals to encourage conservation.

Prices in the Northwest for spot power in April were 10 to 12 times their historic levels. This is unsustainable for those living on fixed incomes, for small businesses, for school districts and small towns. And the situation is only going to get worse in the Northwest this summer, and possibly into next winter as well. The flow of the Columbia River at The Dalles was 40 percent of the historic average, taking storage into account.

I am very concerned that this order will not do enough for California, will not encourage conservation in California, and will actually have unintended negative consequences for states like Oregon when demand greatly exceeds supply this summer in the Western energy market.

While I'm glad that the FERC is instituting an investigation of public utility rates in wholesale Western energy markets, and am very concerned that it has taken so long to get to this point. It is my understanding that this means that—if FERC finds there are unjust and unreasonable rates for spot sales in the Western energy market—the earliest any customers outside of California could request refunds on electricity prices will be for spot sales after July 11 of this year. This is very disconcerting to me, and leaves utilities in the Northwest with fewer avenues of relief for the high prices they have paid to date. I will be pursuing this issue further in my line of questioning.

I think everyone realizes that the West is in for a long, hot summer. In the Northwest, however, we're also concerned about making it through next winter. Even if we have normal precipitation levels next winter, our reservoirs won't refill until next spring when the snowpack melts. We need to make certain that senior citizens, low-income families, and small businesses can all survive, both physically and economically.

I want to help lead a bipartisan solution that will restore some stability to the Western energy market, and will avoid outrageous prices for a commodity so necessary to public health and safety. I look forward to hearing from the Commissioner today.

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

Senator BINGAMAN. Thank you, Mr. Chairman, for holding the hearing. Thank you for inviting all of the Commissioners. There are really two broad questions I think we need to delve into. One is what does this new order do? How is it going to work as implemented?

The second big question is: is the order adequate to solve the problem that needs to be solved and to carry out the responsibilities of FERC under the Federal Power Act? Those seem to me to be the essential questions. And I know there's a difference of opinion on the commission, and I think it's useful for the committee to understand that difference of opinion.

I've supported Senator Feinstein Senator Smith's legislative initiative to direct FERC to go ahead and carry out what I believe is FERC's responsibility already to set just and reasonable rates for wholesale power going into California. But I am anxious to hear from the witnesses who understand the issue better. And I hope that's the result of our hearing today. Thank you very much.

The CHAIRMAN. My understanding we agreed there would be no opening statements today other than yours and mine. Do you mind?

Senator FEINSTEIN. I'd like to have an opportunity to answer the comments that you made, at some point, Mr. Chairman.

The CHAIRMAN. Go ahead.

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

Senator FEINSTEIN. Because I differ with them, and I would like the opportunity.

Mr. Chairman, let me thank you, and I do appreciate it. And I thank the ranking member for insisting that Commissioner Massey be here as well.

Mr. Chairman, I don't think that anybody debates the fact that the 1996 deregulation bill was badly flawed. As such, it created a broken market. Deregulated on the wholesale end, left regulated the retail end. Required 95 percent of the power to be bought on the spot market. That's great if prices are low and supply is great.

It wasn't. Prices jumped. Utilities had to pay the pay the price. They couldn't recover it from the consumer, so they go into—one goes into bankruptcy and one is close behind it.

The requirement that they divest of their generating facilities perhaps was the first real indication of what was going to come.

I was sitting right over there when John Bryson testified. And I asked him this question: When you divested of your first generating facility, what were you selling power at? He said $30 a megawatt hour. I said when the generator that bought that facility sold it back to you, what did they sell it back to you at? He said $300 a megawatt hour. So right away the price jumped.

Mr. Chairman, you said that you did not know whether facilities were going to come on line. One of the things I believe California has done right is fast tracked additional supply. I'd like to add to the record 350—3,572 megawatts, mainly peakers, half are peakers that will be on-line by the end of the summer. And an additional 6,900 megawatts that will be on-line from November 2001 to July of 2003. That's a total of 10,495 megawatts, or enough power for almost 10½ million households.

I would like to put that list in the record, if I may.*

The CHAIRMAN. Without objection.

Senator FEINSTEIN. Now, I would like to address myself to the FERC order for just a moment, if I can. Because I find it flawed on a number of accounts. The first is the order is limited to only stage one, two, or three emergencies. And I would suspect that stage one, two, or three emergencies, the number of purchases are not great during that period of time. All other areas are left out.

Behind me is a chart I showed to Chairman Hébert at our last hearing. And I want to apply that chart to the FERC order. I think it's interesting. The horizontal line is demand in 1999 and 2000. The black bars are prices in 1999 and the red bars are prices in 2000. This is a Sunday, not a high use day. But a Sunday in July 1999 and July 2000. You see the inordinate price spike. Not at a peak time, not in a stage one, two, or three emergency.

So the way I understand the FERC order, it would do nothing to address the situation that most of the power is bought—is not

*The list has been retained in committee files.

bought during a stage one, two, or three emergency but at other times. This does nothing to deal with that spike.

The second point is the order does not address natural gas. As far as I'm concerned, if FERC is not going to address natural gas, you are not going to be able to help California. The price of natural gas in southern California is still three times higher than the rest of the country. California transports natural gas from San Juan, New Mexico, where it sells at less than $5 a decatherm. When it gets to California, the price becomes $15, when the actual cap price of transportation is 70 cents.

I do not see how you can address that crisis without addressing natural gas. Order 637 from February 2000, the Commission for a 2-year period, essentially abrogated its responsibility to see that natural gas transportation costs have been reasonable. This has been a disaster for California.

I just want quickly to indicate to you, so you don't think this is esoteric, a couple of situations. Let me give you the only sugar refinery on the west coast. Steam costs average $450,000 a month for years. Since October 2000, the cost of our steam has spiked to over $2 million a month, a 500 percent increase. This is CNA sugar. They had a thousand employees. They shut down in March. They're trying to get a bridge loan. If they don't get a bridge loan, they go out of business because of natural gas costs.

Atlas Pacific Corporation, as we've written to you previously, our natural gas costs have gone up six fold. $15,000 to $90,000 a month. We ask for help.

California steel industries, our historical gas bill was $12 million annually. With the price gouging going on in California, that bill will rise to $40 million or even $50 million this year.

For electricity we historically paid about $15 million a year. That number will double this year due to increased retail rates. They're in trouble.

The dairy coalition, the largest dairy State in the union, between December 1999 and December 2000, the cost of gas to dairy plants increased 4,000 percent. And loss average paper and box, board mills, companies closing down, I would like to put these in the record.

The CHAIRMAN. Without objection.

[The information referred to follows:]

CALIFORNIA DAIRY COALITION OF
CONCERNED ENERGY CONSUMERS,
Sacramento, CA, February 16, 2001.

Hon. DIANNE FEINSTEIN,
U.S. Senate, Hart Senate Office Building, Washington, DC.

DEAR SENATOR FEINSTEIN: On behalf of the California Dairy Coalition of Concerned Energy Consumers, I would like to thank you for all of your activities to date directed to resolving the energy crisis in California.

The Dairy Coalition was formed recently due to the supply problems and dramatic price increases seen for both electricity and natural gas in California in late 2000. The Coalition represents all of the major dairy producer co-operatives in California, as well as the major proprietary processing companies.

As the number one-ranking dairy producing state in the nation, the California dairy industry uses substantial quantities of natural gas to run its processing plants. Between December 1999 and December 2000 the cost of gas to dairy plants in California increased 4,000%. Our paramount concern is the dramatic increase in the non-commodity portion of the price of gas.

Again, the Dairy Coalition greatly appreciates your attention to this critical issue.
Sincerely,

JIM GOMES,
Executive Vice President,
California Dairies, Inc.

Senator FEINSTEIN. My point is this order does nothing about natural gas. If you don't do something about transportation costs of natural gas, if they're at $15, electricity is going to sell for $300 to $500 dollars per megawatt hour because of the cost of natural gas.

Your final point is your order lasts for only one year. This is not enough time to get all the needed power on-line and operating. I pointed out the additional megawatts. Mr. Chairman, you pointed out how much California is paying for power. What the State has asked for, and it has fallen on a deaf ear back in Washington, is a period of price reliability and price stability.

FERC has found the prices to be unjust and unreasonable. Individual generators are coming to agreements and making payments to the State and to FERC. They know they've been price gouging. We just ask FERC to do your job. Stop it until we can get enough power on-line and the market can function. Supply and demand, the prices will be passed through to the consumer, and we can have a properly functioning market.

Absent that, the probabilities of California getting through the next two summers without major blackout are very remote. I thank you.

The CHAIRMAN. Thank you. I would respond very briefly to the article that appeared Sunday in the *Los Angeles Times*, April 15. I think, Senator Feinstein, we both want the same thing to happen, and that's relief for California. But the question is how we get there from here.

What concerns me, as evidenced in this statement, and I'll just read this one paragraph, an effort began last year to issue plant permits within 4 months led to approval of only one 50-megawatt plant at San Francisco International Airport. Officials say the deal is collapsing. Half a dozen other plant applications were withdrawn, due to site problems, including pollution.

California Energy Commission approved two projects and five more are being reviewed for a total of about 500 megawatts. State officials concede that not all the power will be available the entire summer because developers have until September 30 to get these plants on-line.

So my concern, as evidenced in my statement, was that these plants that are receiving certifications also receive the assurance of being financed. And that's the problem you run into if you don't have a climate that will encourage that investment. I know the senator from California agrees with me on that.

Senator FEINSTEIN. Just so you know, Mr. Chairman, the list I gave you are approved, they're moving. There is nothing that's going to stop any of the projects on this list. I hope.

The CHAIRMAN. Well, I hope you're right. You have a good deal more optimism on that than the information that I've been given by people in the financing community who are yet to give commitments on a good portion of these plants. Because they're waiting

for some degree of certainty associated with their ability to amortize those investments.

If we put wholesale caps that don't fit, then the question I think we have to ask ourselves are we relieving the pressure on California? What we want to do is create an investment environment that will work and relieve California.

With that I would encourage us to take the opportunity we have, evidently, to hear from our panel, relative to a FERC order. And I guess in the interest of comity, we'll start with the chairman and move right down the line with Mr. Massey and Ms. Breathitt. Please proceed. 10 minutes is enough, can you—okay, fair enough, thank you.

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

Mr. HÉBERT. Thank you, Mr. Chairman, for the opportunity to appear here today. Electricity markets in California and the Western United States are faced with a substantial imbalance of supply and demand. While no one can build generating capacity fast enough to eliminate the imbalance this summer, the commission is taking appropriate action within its jurisdiction to help mitigate problems in those markets.

For example, in December the commission issued a major order requiring changes in California's wholesale power markets to ensure that rates charged to buyers are just and reasonable.

Last month, a Federal appeals court rejected the first challenges to the Commission's orders, stating that the Commission had adopted a reasonable middle ground between the need for temporary price mitigation and the realization that competition must exist for the California energy market to survive in the long run.

The Commission continues to balance competing interests and to strive to reach that reasonable middle ground in the dozens of orders issued in recent months addressing California and the Western electricity markets.

Last week, as promised in the December order, the Commission adopted a new market monitoring and a mitigation plan in California. The plan packages together a number of related measures intended to help remedy California's dysfunctional electricity market in order to offer immediate relief to consumers, including price mitigation, a demand-response mechanism, coordination of planned outages, and steps to prevent economic or physical withholding of power.

The elements of the Commission's plan must be viewed as an integral package. The price mitigation cannot be evaluated in isolation. The other elements of the Commission's plan are equally vital to the success of the price mitigation in the plan as a whole.

Last week's order will help ensure that customers are adequately protected against unjust and unreasonable prices, while also providing a market-oriented price for California generators.

Starting in late May, a market driven price for real-time electricity will be determined each day based on market costs for electricity inputs, natural gas, and emission allowances. And the fuel usage ratio or heat or the heat rate and emission rate for the least efficient generator needed to meet demand on that day. All Califor-

nia generators bidding at or below this market-driven price will be paid the market price.

Any California generator bidding above this price and selected to run by the ISO will be paid its price, subject to refund and justification. But its bidding will not, I repeat will not raise the market price.

This price mitigation approach reflects the way pricing works in competitive markets. As in a competitive market, the prices are set by the highest price supply needed to meet the demand. This approach encourages development of new efficient supplies by anyone who can build and operate a facility that costs less than the existing price.

The new facilities will then reduce the need to rely on the inefficient facilities setting today's prices. The alternative approach of paying generators only what they bid will likely cause their bids to increase. Ultimately raising prices to consumers.

The Commission's price mitigation approach fulfills the requirements of the Federal Power Act. The Commission has broad discretion in setting rates and is not required to use cost base rates or any other specific methodology, so long as the end result of its rate making is within a zone of reasonableness.

The courts have held that the Commission's rate making can reflect non-cost factors such as the need to promote development, induce supplies or transportation capacity, or to increase market efficiency.

The Commission also required that all jurisdictional sellers with participating generating agreements or PGAs with the California ISO must offer all power that is available in real time, not already scheduled or committed by contract. This includes marketers who would control generation.

This must-sell requirement applies to all California sellers who own or control generation, even if they are not jurisdictional public utilities. If they sell in the ISO's markets or use the ISO's transmission facilities, the only exception is for hydroelectric facilities because of their multipurpose characteristics.

Also, all public utilities buying from the ISO must submit demand bids identifying the price at which they are willing to curtail power purchases if prices exceed the amount. The requirement will help the ISO's real-time market behave more like a competitive market where increases in price reduce demand.

The plan enhances the ISO's ability to coordinate and control planned outages. The ISO must submit weekly reports to the Commission on outages so that the Commission staff can continue monitoring outages.

Further, the Commission modified the market-based rate authority of the public utility sellers to prohibit anticompetitive behavior bidding in the ISO's real-time market.

All elements of the plan, except for price mitigation, operate 24 hours a day, 7 days a week. The price mitigation applies when California reaches a stage one emergency. In other words, when generating reserves are at or below 7½ percent.

The threshold is based on the fact that the critical problem is a lack of supply. And a stage one emergency signals when the supply is nearing the point of being insufficient in real time.

The Commission's plan terminates not later than one year from now. The Commission also instituted an investigation into wholesale prices in other parts of the West. The Commission is seeking comment on what forms of price relief and market monitoring are appropriate for Western sales outside of the California ISO.

The Commission stated that its intent is to mirror its approach in the ISO's real-time market to the extent possible. And the Commission is also addressing natural gas prices in California. Senator Feinstein, I agree. This is a gas situation as well, and we do need to look into that and we are.

For example, the Commission has expedited the issuance of natural gas pipeline certificates into California. Recently, the Commission processed in only 21 days an application for a major expansion of the Kern River gas system.

The Commission has also ordered an expedited hearing on whether El Paso Natural Gas Company and its marketing affiliate exercise market power involving El Paso's pipeline and thus increase California gas prices.

The Commission also is reviewing comments it saw on additional actions to increase gas supplies to California, and I expect the Commission to act soon on those comments.

And today the Commission issued a notice of a technical conference to be held on May 24 of this year on current and projected pipeline capacity to California, including the interconnections between the interstate and intrastate systems.

Let me mention one other issue that the Commission is working on involving, qualifying facilities under PURPA. According to the California ISO, 1000 to 3000 megawatts of QF generation in California is not running because of financial issues, Mr. Chairman. Those issues are pending before the Commission. That's enough to supply between 1 and 3 million homes.

The CHAIRMAN. Is not being——

Mr. HÉBERT. Is not being used right now or run due to financial difficulty. Those issues are pending before the Commission in several proceedings. So I cannot comment on the merits of the issues at this time.

However, I believe that prompt resolution of these issues is critical to freeing up this capacity for sale in California this summer. And I expect the Commission to resolve these proceedings quickly.

A couple of closing comments. Senator Smith, I've heard your concerns and have read your concerns, and I think they're appropriate.

Senator Feinstein, I've obviously read yours and heard yours as well and had conversations. And I want you to know that this committee has made it clear, certainly the chairman has made it clear to me that this Commission is to act and act appropriately in following the Federal Power Act. And we are doing that.

I will tell you that in the 3 months that this Commission has been working together, we have issued some 40 different orders and implementations in dealing with California in the West.

At the same time, as you know, we've testified at quite a few hearings, and we're glad to shed light on that and make sure that the American public and those in California and the West understand your concerns and ours.

But I will tell you that we have talked about and issued orders that bring more supply and lower prices to California and the West to looking at hydro facilities on a temporary basis.

But what we read about in the press and what we hear people saying is, in fact, what you're doing is creating loopholes there. We've also issued refunds, something that wasn't done before. Something that we've done in the last 90 days. And we've got price mitigation.

But then again when we read in the press, we hear about gouging, and we don't hear about how we're moving forward.

Again, we've said that, in fact, California, you, and the rest of the United States of America understand the importance for regional transmission organization, but, in fact, when we ask them to file one and they're the only State that hasn't, the answer is how dare you tell us what to do in California.

We've also said, in fact, there is a need for additional generation. There are generators that you can get on-line. Some of them burn diesel, and their action is don't tell us what we can burn here. We'll decide whether or not we burn it. And I will tell you, Mr. Chairman, back to your question about the megawatts that are available, we look at the purpose, the QFs, if you will. And under those estimated as much as 3000 megawatts out there are not being used.

Now, the estimates that come from the California Energy Council suggest that they are only 3,800 megawatts short for the summer. Some suggest as high as 6,800. It depends on who you're going to listen to. But we've got around 3,000 there that people are talking about. With reductions in aggregation of load that we've talked about, we're estimating around 1,000 there.

Producers who came and communicated to me, in fact, they are flaring gas. They could hook up systems that could produce 1,000 megawatts. Flaring the gas and could produce a thousand megawatts.

If I could be given one more minute, Mr. Chairman.

Also, the demand, a 5 percent demand reduction of the 26,000 load we're talking about in California, that will bring around 2,300 more megawatts on-line. That together is 7,300 megawatts.

Now, that doesn't include capacity added by must-sell requirements that this order has that we didn't have before. That doesn't include bidding and outage requirements that this order has that the previous order didn't have. This does not include the price mitigation and what it will do.

Now, I will tell you, Mr. Chairman, I want to tell members of this committee, FERC has acted. FERC is acting responsibly, but the one thing we cannot do is go to California and build generators and build electric transmission lines and build intrastate capacity on pipes and build intrastate pipelines.

We can certificate them quickly, and we have done that. Three weeks with Kern River, unheard of historically, even got a letter from the Governor commending us saying that we acted appropriately and they appreciate it. We're doing what we can do. But California has got to do some things as well.

I look forward to your questions. Thank you.

[The prepared statement of Mr. Hébert follows:]

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

I. OVERVIEW

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear here today. Electricity markets in California and the Western United States face a substantial imbalance of supply and demand. While no one can build generating capacity fast enough to eliminate the imbalance this summer, the Commission is taking all appropriate action within its jurisdiction to help mitigate the problems in these markets. The Commission's actions center on three critical needs.

First, we need to encourage 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 efficiency, promote delivery, enhance infrastructure and reduce demand, thus correcting the current imbalance. Last week, as described below, the Commission adopted a market monitoring and mitigation plan for California consistent with these principles. Among the provisions of that plan, the Commission adopted a price mitigation approach that will ensure for real-time sales, in emergency hours, that customers are adequately protected against unjust and unreasonable rates, while also providing a market-oriented price for California generators. California generators will be allowed to sell above that price if they can justify their costs. Other provisions of last week's order, applicable during all hours, improve the Commission's ability to detect and remedy anticompetitive bidding behavior by electricity suppliers in California. The Commission also instituted an investigation into wholesale rates in Western states outside California, and is seeking comment on what other relief may be necessary.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that the transmission system is upgraded and that new natural gas pipelines are built. The Commission has taken action on these issues recently, and is considering additional action.

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 Westwide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West. As described below, the Commission took important steps last week to promote RTO formation in the West.

II. MARKET MONITORING AND MITIGATION

A. Action to Help California

In the past few months, the Commission has issued dozens of orders to address dysfunctional wholesale energy markets in California and the West. Last week, the Commission adopted an innovative plan, which packages together a number of related measures, for market monitoring and mitigation in California. *San Diego Gas & Electric Co.* v. *Sellers of Energy and Ancillary Service, et al.*, 95 FERC ¶61,115 (2001). This plan strikes an appropriate balance by bringing market-oriented price relief to the California electric market, providing greater price certainty to buyers and sellers of electric energy, promoting conservation, and—importantly—simultaneously encouraging investment in efficient generation and transmission.

The Commission established price mitigation for the real-time market run by the California Independent System Operator Corporation (ISO). However, the price mitigation, based on a price determined from a market-oriented formula, applies only when California reaches a Stage 1 emergency, i.e., when generating reserves are at or below 7.5 percent. (In all hours, as explained further below, the Commission remains vigilant in detecting and remedying anticompetitive bidding behavior by electricity suppliers.)

The price mitigation simulates the price a competitive market would produce. Under the price mitigation, a market-driven price for real-time electricity would be determined each day based on market costs for electricity inputs (natural gas and emission allowances), and the fuel usage ratio ("heat rate") and emission rate for the least efficient generator needed to meet demand that day. All California generators bidding at or below this market-driven price would be paid the market-driven price. Any California generator bidding above this market price and selected to run by the ISO would be paid its price, subject to cost justification and potential refunds, but its bid would not raise the market price. Non-California generators would

be paid the market price or the bid price, but would not be subject to price justification or potential refunds.

The price mitigation would apply to marketers as well. A marketer could accept the market-driven price or specify its own price. If its price exceeds the market price, the marketer would be required to justify its price based on the amount it paid for power. However, marketers (and generators) are not allowed to include extra cost components for scarcity rents or opportunity costs.

This price mitigation plan reflects the way pricing works in competitive markets. As in a competitive market, the price is set by the highest priced supply needed to meet demand. The plan also provides certainty to the market. All bidders at or below the market price are paid the market price, and need not provide subsequent justification.

The plan provides incentives for investments in efficient generation. The market price under this plan is set by the price of the least efficient generating facility used each day. Any new facility will receive this same price. Thus, the more efficient the new facility is, the more it will earn. Conversely, the plan provides incentives for retiring or replacing inefficient, dirtier facilities.

The plan does not set price caps. A price cap is a fixed limit on sellers' prices that does not change over time, i.e., a snapshot. By contrast, the Commission's price mitigation allows prices to vary each day based on market changes in the cost of electricity inputs (fuel and emission allowances). Moreover, each generator can bid any amount it chooses, so long as the generator can justify any bid above the announced market price. For example, if a seller's own gas costs exceed the gas costs used in determining the market-driven price, the seller can seek to justify the higher costs.

Nor does the plan discourage the sale of generation into California from facilities located outside of California. Out-of-state facilities have no obligation to sell into California. If they do, they can recover any bid, even if in excess of the market-driven price, that is accepted by the ISO; they do not have to justify prices in excess of the market-driven price.

The price mitigation fulfills the requirements of the Federal Power Act. The Commission has broad discretion in setting rates, and is not required to use cost-based rates or any other specific methodology so long as the end result of its ratemaking is within a zone of reasonableness. The Commission's ratemaking can reflect non-cost factors such as the need to promote development of new supplies or transportation capacity or to increase market efficiency.

The plan contains several other important elements. For example, all jurisdictional sellers with "participating generator agreements" (PGAs) with the ISO must offer all power that is available in real-time and not already scheduled or committed by contract. This includes marketers who control generation that is subject to a PGA. In addition, all sellers that own or control generation in California, including non-public utilities, and sell in the ISO's markets or use the ISO's transmission facilities must do the same as a condition of being able to participate in ISO markets and also as a condition of using Commission jurisdictional transmission facilities. In addition, these sellers must agree to abide by the same price mitigation and monitoring that applies to the other generators. These conditions were put in place by the Commission so that all generators—even those that are not otherwise subject to the Commission's jurisdiction—participate in helping to solve California's problems. The only exception to the "must-offer" requirement is for hydroelectric facilities because of their multi-purpose characteristics (e.g., irrigation, recreation and power production).

Also, all public utilities buying from the ISO must submit "demand bids" identifying the price they are willing to pay for power and the load to curtail if prices exceed that amount. This requirement will help the ISO's real-time market behave more like a competitive market, where increases in price reduce demand.

The plan enhances the ISO's ability to coordinate and control planned outages. The ISO must submit weekly reports to the Commission on outages and bid data, so that the Commission staff can continue to monitor the market. Further, the Commission modified the market-based rate authority of public utility sellers to prohibit anticompetitive bidding behavior in the ISO's real-time market.

All of the elements of the plan, with the exception of the price mitigation, operate 24 hours a day, seven days a week, during the specified duration of the plan. Any effort to engage in physical or economic withholding of scarce electric capacity, to the detriment of California consumers, will be met with a vigorous and appropriate remedy.

The various elements of the Commission's market monitoring and mitigation plan should be viewed, as they were intended by the Commission, as an integral package. The price mitigation cannot be evaluated in isolation. The other elements of the

Commission's plan (outage coordination and monitoring, demand bids, the "must-offer" requirement and the change in market-based rate authority to bar anti-competitive bidding behavior) are vital to the success of the price mitigation and the plan as a whole.

Finally, the Commission imposed two important limits on its plan. First, all of the mitigation terminates not later than one year from now, so that California cannot rely indefinitely on mitigation in lieu of new generation and conservation. Second, all mitigation is conditioned on the ISO and California's three investor-owned utilities filing an acceptable RTO proposal by June 1, 2001. An RTO is an essential tool in improving transmission reliability and addressing the transmission bottlenecks contributing to the market dysfunctions in California (and the West).

B. Investigation of Other Real-Time Western Sales

As part of the same order last week, the Commission opened a formal investigation into prices charged by public utilities for real-time wholesale power sales (i.e., up to 24 hours in advance) throughout the West (other than sales through the ISO). The Commission proposed: (1) to mitigate prices charged by all public utilities; and, (2) to impose mitigation as a condition on all non-public utilities using the interstate transmission facilities of public utilities. Similar to the Commission's approach for the ISO's market, price mitigation here would apply only when contingency reserves fall below 7.0 percent in any control area in the WSCC. The Commission sought comments on what the price mitigation for these sales should be, stating that its intent is to mirror its approach in the ISO's real-time market to the extent possible. The Commission also proposed, as it required in the ISO's market, that generators should have to offer all energy available in real-time. As above, hydroelectric generation would be exempt from the "must-offer" requirement but not from the price mitigation rules.

After receiving and reviewing public comment on its proposal, the Commission will determine the market monitoring and mitigation plan for real-time wholesale sales in the West other than sales through the ISO.

III. OTHER COMMISSION EFFORTS TO INCREASE SUPPLY AND REDUCE DEMAND

Six weeks ago, the Commission issued an order seeking to increase energy supplies and reduce energy demand in California and the West. *Removing Obstacles to Increased Electric Generation and Natural Gas Supply in the Western United States*, 94 FERC ¶61,272 (2001) ("Order Removing Obstacles"). The Commission implemented several measures immediately, including:

- streamlining filing and notice requirements for various types of wholesale electric sales, including sales of on-site or backup generation and sales of demand reduction;
- extending (through December 31, 2001) and broadening regulatory waivers for Qualifying Facilities under the Public Utility Regulatory Policies Act of 1978, enabling those facilities to generate more electricity;
- expediting the certification of natural gas pipeline projects into California and the West; and,
- urging 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 and accelerated depreciation for new transmission facilities and natural gas pipeline facilities completed by specified dates, blanket certificates authorizing construction of certain types of natural gas facilities, and greater operating flexibility at hydroelectric projects to increase generation while protecting environmental resources.

The Commission received many comments on these proposals. I expect the Commission to complete its review of these comments and finalize its actions on these issues soon. In addition, the Commission already is acting on many of the initiatives it announced in its *Order Removing Obstacles.* For example, in the month of April, the Commission significantly expedited its processing of applications—approved in a mere three or four weeks—to add significant amounts of natural gas pipeline capacity to California.

IV. A WEST-WIDE RTO

The development of a West-wide RTO is vital to preventing future problems in the West. Market conditions in California have affected markets throughout the West because the Western transmission system is an integrated grid. A West-wide RTO is critical to support a stable interstate electricity market that will provide buyers and sellers the needed 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.

Last week, the Commission took major steps toward RTO formation in the West. First, the Commission accepted key parts of a proposal for an RTO that will span eight Western states, RTO West. RTO West will operate (but not own) more than 90 percent of the high voltage transmission facilities from the U.S.-Canadian border to southern Nevada. The Commission said RTO West can serve as a platform for the ultimate formation of a West-wide RTO.

In the same order, the Commission accepted a proposal for an independent transmission company within the RTO West structure, TransConnect. TransConnect will own and operate the transmission facilities of six utilities in the region.

Finally, as noted above, the Commission conditioned its price mitigation in the California ISO's real-time market on the ISO and California's three investor-owned utilities filing an RTO proposal by June 1, 2001, consistent with the characteristics and functions set forth in the Commission's Order No. 2000. As the Commission stated, this condition "recognizes that the only real solution to supply problems that affect the western United States is to create a regional response." By letter dated May 1, 2001, the Commission's General Counsel and the Director of the Commission's Office of Markets, Tariffs and Rates, wrote to the ISO and the three utilities, and offered to make the Commission's staff available to assist them in completing the application.

V. CONCLUSION

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. We'll hear now from the Honorable William L. Massey. Mr. Massey, good afternoon.

STATEMENT OF WILLIAM L. MASSEY, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. MASSEY. Thank you, Mr. Chairman, members of the committee. The Commission's April 26 order was perhaps the last clear chance to put in place adequate measures to protect consumers in California and other parts of the western market from runaway prices this summer. There are good features in the order that could provide some help for this summer and beyond.

But the order is deficient in critical respects. And, consequently, will fail to achieve our objectives. And because of these deficiencies, I dissented in part from the order. We're now 11 months into this absolute calamity out West. It has had a staggering effect on the economy. There is no end in sight.

Now is not the time for half-a-loaf solutions. I was not willing to compromise my vote so cheaply. Our December 15 remedy's order did not contain the effective price relief I championed or anything close to it. It is now over 4 months, 4 months and many million dollars later. Our refund orders have been paltry and, in my opinion, arbitrary.

In fact, of the $124 million and potential refunds that were in order, $100 million of that has been challenged by the sellers.

Prices are not just and reasonable now and will not be just and reasonable this summer. The economic carnage is spreading to other States in the Western interconnection. 406 Workers were put out of work when Georgia Pacific shut a production facility in Bellingham, Washington, because of skyrocketing electricity bills.

The Seattle Tacoma Airport has estimated that this year its electric bill will triple, triple to $50 million. That's 25 percent of its budget. Countless other examples of economic harm throughout the Western economic connection could be cited. Bonneville Power may increase its rates by a whopping 250 percent this fall.

The point is now is not the time for half-a-loaf solutions. Now is the time to solve this problem. And this order falls short.

There are four aspects of this order to which I dissented. First, the price mitigation feature is much too restrictive because it is applied only when a operating reserve emergency is called, so-called stages one, two and three. Effective price mitigation should apply during all hours in California. Period.

Such an approach would not be the least bit punitive. It would, in fact, replicate the manner which the single-price auction is supposed to work. That is the single-price auction theoretically provides a powerful incentive for generators to bid their running costs into the market. That is the most effective generator strategy for insuring dispatch, or so the theory goes.

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

The record is absolutely devoid of any evidence that the problem is limited to stages one, two, and three hours. The evidence is highly persuasive that the problem exists 24 hours a day, 7 days a week.

I found the March 21 California ISO study by Dr. Angelie Sheffrin, the ISO's director of market analysis, to be compelling. She concluded that economic withholding is a severe problem in all hours, not just capacity-constrained hours. Her analysis concluded that from May through November of last year withholding that led to inflated market prices in the ISO's real-time market occurred in over 98 percent of the hours.

According to my calculations, the ISO had declared a stage one, stage two, or stage three alert in only 5 percent of the hours during that period.

For Dr. Sheffrin's study period, the price mitigation proposed in our new order would have missed 93 percent of the hours when market power drove up prices beyond just and reasonable levels.

Let me quote from Dr. Paul Jowskow, a very distinguished professor of economics at MIT. Quote, "There is considerable imperical evidence to support a presumption that the high prices experienced in the summer of 2000 were the product of deliberate actions on the part of generators or marketers controlling the dispatch of generating capacity to withhold supply and increase market prices."

I could quote from a number of studies by Dr. Frank Wolak of Stanford, the ISO's independent market monitor.

The solution is to require generators to bid their costs in all hours. Our order could have done that. What's more, the more efficient generators would still make money under such an approach, perhaps a lot of money because the market-clearing price that all generators would get would be set by the highest cost generators, probably an inefficient older gas fire generators with a high heat

rate. I have no confidence that prices will be just and reasonable during all hours this summer.

This agency is statutorily required to assure just and reasonable prices at all times. This standard in Federal law is not limited to stage alert hours.

The order also narrowed the existing refund condition adopted in our earlier December 15 order. And I object to that as well. A large part of the market this summer in California will not be subject to any refund condition whatsoever.

Second, the duration of the monitoring and price mitigation features of this order are too restrictive. They would expire one year from now, unless expressly modified by the commission. This period of time is too short. I would allow the monitoring and price mitigation features to remain in place for at least 18 months and perhaps 24 months.

Third, I object to the RTO filing conditions. Under this order, if—this is the condition. If the California ISO and the three California investor-owned utilities failed to make an RTO filing by June 1, the entire order is of no effect. As I read it, the order becomes null and void.

Now this makes no sense. It seems to stand for the proposition that this Federal agency will make no effort to ensure just and reasonable prices if the California ISO and the three California IOUs failed to make an RTO proposal. We let them decide for us whether we're willing to do our job. I cannot support such a condition. I urge them to make such a filing, but this has no relevance to price mitigation over the next year.

And, fourth, the scope of the section 206 investigation that is ordered for the Western interconnection must be substantially broader to do any good whatsoever.

This order opens an extraordinarily narrow section 206 investigation for the Western interconnection. I commend my colleagues for at least going this far. It's something I've been championing for months, but the approach is much too narrow to hold any promise of effective price relief.

I had advocated an investigation and refund condition for all transactions of one month or less. The investigation refund condition set out in our order apply, however, only to transactions of 24 hours or less that occurred during a reserve deficiency of 7 percent or less.

It is my understanding that many of the transactions that are driving the high prices in Washington, Oregon, and other Western States are for terms well exceeding 24 hours. This type of transaction would not be subject to this investigation nor to price relief. I strongly object to this omission.

Now, finally, let me express my concern about the high price of natural gas delivered into California markets, which also is not dealt with in our order. The transportation differential in California often exceeds $10 and is often substantially more at various intrastate delivery points. The transportation differential into other large markets, such as New York and Chicago, is usually less than a dollar.

The other day from Henry hub to Chicago was 9 cents and from Henry hub in Louisiana to New York City was 47 cents. On that same day it was over $10 into California.

The high cost of natural gas delivered into California is then used to justify high wholesale electric bids into the ISO market. An inefficient high heat rate generator using a considerable amount of high-priced natural gas then sets the market clear in price that all sellers in the market are paid.

Thus, the high transportation differentials into California gas markets have a particularly pernicious effect when coupled with a single-priced option for electricity.

May I have one more minute, Mr. Chairman?

The CHAIRMAN. Sure.

Mr. MASSEY. I urge of my agency to take all available action to mitigate these high transportation differentials. We must actively explore any jurisdiction we may legitimately have that affects the so-called gray market. We must take a second look if lifting the price cap for secondary market pipeline capacity a year ago was actually in the public interest.

We must vigorously investigate any allegations of withholding of market affiliation or affiliate abuse. We must certificate new interstate pipeline capacity. And as Commissioner Breathitt has pointed out on more than one occasion, we must work with the State of California to make sure there is adequate take away capacity in the intrastate capacity.

I'm open to any and all ideas, but my attention is riveted on this issue by a recent staff order setting the so-called proxy price for electricity for the California market for the month of February. The order set a proxy clearing price should be $430 per megawatt hour. In other words, we're concerned about prices above that if they occurred during stage three. We weren't concerned below that.

$350 of that amount was the price of natural gas for an inefficient generator. I've concluded that we'll never get a handle on electricity prices unless we get a handle on gas prices.

In conclusion—10 seconds—despite the work of the commission, our hard working staff, we have not solved these problems. And we must do so. Our order fell short, and I dissented in part.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Massey. Our last witness this afternoon, the Honorable Linda K. Breathitt, Commissioner.

STATEMENT OF LINDA K. BREATHITT, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Ms. BREATHITT. Thank you, Mr. Chairman, Senator Bingaman, Senator Feinstein, and other Senators representing Western States here this afternoon. I am pleased to be here today to answer questions on FERC's order of April the 26.

The development of a price mitigation and monitoring plan for California wholesale electric markets has raised contentious and difficult issues that go to the heart of each commissioner's philosophy of public utility regulation.

Our deliberations on this issue have been the subject of intense and unprecedented scrutiny by an increasingly sophisticated public. And that's a good thing.

I hope that that public will be well served by the actions that we took last Wednesday evening, and I believe that they will be.

I emphasize the complexity and difficulty of the decisions we made because I believe there is considerable danger in oversimplifying the problems facing California and western markets, as well as the solutions this commission and other State and Federal bodies have sought.

That danger is in the misconception that the issue is simply whether or not price mitigation in California should occur. And further, that the answer is going to be either a simple "yes" or a "no". To present the matter in such a way it is not recognized that the Commission has reached a consensus that price mitigation should occur. And, yes, we did reach that consensus. The real issues have been what form price mitigation should take.

For several years now this Commission has focused its attention on finding market solutions to problems confronting the wholesale electricity sector. I believe that such a market approach will achieved the best long term result for the public, and that our specific mitigation plan addresses the short-term situation.

While the situation in California has certainly challenged this resolve, I remain steadfast in my belief that market-oriented solutions are preferable to those which might further hinder the evolution towards efficient and workable competitive wholesale electricity markets that will deliver lower prices.

That said, however, the flawed electricity markets that exist in California and elsewhere are not at all what proponents of restructuring had in mind when this process was initiated at both the Federal levels and State levels in the past decade.

Over the past months, I have made a point to emphasize my belief that it is imperative for regulators to take firm steps to improve markets in California, so that the present turmoil will not cause to us abandon or retreat from the paramount objectives of opening the transmission system to fair and non-discriminatory access in making the wholesale electricity markets more competitive.

In light of the predictions for prolonged blackouts, supply shortages, and even higher prices, I am convinced of the need to implement the structural and regulatory remedies required to stabilize California and the Western markets.

In developing a price-mitigation procedure for California, I had several objectives that I wanted to accomplish. And primary among those was that the plan we ultimately adopt must address price volatility in California's real-time energy markets. It shouldn't discourage necessary investment in California's generation infrastructure, and it should be market oriented. And I believe our plan meets those objectives.

The hallmark of the order we issued last Wednesday is its price mitigation plan, which establishes a single market clearing price auction for the real-time market during reserved deficiencies. Price mitigation will be required for all generators with an available capacity when reserves are at 7.5 percent or less.

During those periods, a proxy price will be in effect. That is a marginal cost based on heat rate, gas cost, and emissions cost, and that will be calculated for each generator. The calculated marginal

costs of the unit that clears the market will determine the market clearing price.

This price mitigation mechanism will not operate on an after-the-fact basis as does our current methodology. Instead, the ISO publishes the gas index and the emission information to be used in the formula on a daily basis.

And if mitigation applies, when stage one is called by the ISO, that will trigger the price mitigation plan. And, Senator Feinstein, I believe we may likely be in the stages a lot of the summer. Our mitigation plan will be in effect a lot of those hours.

I want to highlight the fact that our April 26 order also contains a number of measures that address California market issues from the demand side as well as the supply side. And these measures will be in effect for all hours and are in addition to ongoing enforcement and monitoring that the commission is undertaking.

On the supply side, our order requires that the ISO propose a mechanism for the coordination and control of outages. The order also requires the ISO to submit weekly reports on the schedule, the outage, and the bid data for all hours, 24/7, so that the Commission staff can monitor generating unit outages and real-time prices.

Another important supply measure in the order is the imposition of a must offer obligation on all the generators that have participating generator agreements with the ISO in real time. And these features that I've just talked about address economic withholding and physical withholding, and they speak to enforcement and monitoring on a 24 hour basis, 7 days a week.

Also, non-public utility sellers must abide by the same must offer obligation. In other words, if they use interstate transmission, they must offer any available capacity that they have to sell into the California ISO in the real time.

In addition to the price mitigation, the order institutes requirements that should result in demand-side responsiveness. Specifically, the order requires all entities purchasing electricity in the real-time market to submit demand-side bids that establish the price at which their load will be curtailed. And they need to identify the load to be curtailed.

This action should help mitigate market power and lessen the severity of price spikes. It also makes more megawatts available in times of shortage.

As the order points out, when demand responds to price, suppliers have more incentive to keep their bids close to marginal cost because high bids are more likely to reduce the bidder's energy sales.

So in addition to monitoring, the Commission staff has initiated the following daily reports from the ISO on plant outages. We're going to be reviewing bids and bidding patterns into the ISO real-time markets, and we're going to be doing ongoing financial audits of selected sellers of electricity power into California.

Finally, I would like to comment on the order's institution of an investigation under section 206 of the Federal Power Act into the rates, terms, and conditions of sales in the Western States Coordinating Council.

The feature of this order was important to me because it appropriately reflects the regional nature of the wholesale electricity

market and the problems being faced in the West. This investigation will target the transactions and prices in the WSCC in a manner that is consistent with our actions in California.

I am pleased that also the commission issued an order today establishing a technical conference looking into natural gas issues in California. An issue I have been speaking about for several months, and I don't know the exact date of the technical conference, Mr. Chairman, but it will be designed to look into the interstate natural gas market and how it fits in with the intrastate natural gas market.

It will seek to determine why prices are higher in some of the market hubs in California—Topac, Wheeler Ridge, and others—and we will hopefully begin to sort out what is driving some of the high prices of natural gas in California.

Thank you. That concludes my statement. I will enter it into the record upon permission, Mr. Chairman, and I am available to answer questions.

The CHAIRMAN. Thank you very much, Madam Commissioner. Before we go into the questions, I know the members have many. Let me remind all of us that what we have here before us to consider is an order. That order was voted on by democratic process within the Commissioners two to one. So I think we have to question the adequacy of the order and indeed the remedy if we feel the order is inadequate.

Now, those remedies or another order which would have to be initiated, of course, by FERC over legislation. It's rare that you have an opportunity to revisit a dissent. But, nevertheless, I think in spite of my concern, Mr. Massey's rationale has certainly been helpful to the members to understand and appreciate.

But I would hope members as they question will direct their questions to the adequacy of the order, which is what we're going to have to live with unless, again, they change the order or, again, we want to introduce legislation to the contrary.

I think it is also noteworthy to recognize the point that Chairman Hébert had made regarding the volume of paperwork that's associated with this cost of production cost.

Senator Bingaman, I understand we have a voted for. I think we should proceed as best we can limit the members. But we've been asked to allow a visual of this volume of paperwork. So if whoever has a strong back and wants to bring it in, maybe as we begin to question the witnesses, you can explain what's in these so-called orders.

So if the officer would allow the material to come in, and if we've got any volunteers with a strong back to bring it in, well, you make your point.

I think Senator Smith has to chair at 4. I have another 5 minutes, then I'm going to come back. Senator Bingaman, you can work it any way you want. I'll defer my questions at this time in order to accommodate Senator Smith, if that's all right with you.

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

Senator BINGAMAN. May—is this stuff coming in now or—Mr. Chairman, what is this stuff again?

The CHAIRMAN. Well, it's the stuff that he referred to. Go ahead and tell us what it is.

Senator BINGAMAN. What is this stuff?

Mr. HÉBERT. Mr. Chairman, what certainly we are considering here is the ability for this Commission to turn the clock back, the ability for this Commission to go back and do cost base for cost-of-service regulation.

The CHAIRMAN. Come on, bring it up.

Mr. HÉBERT. It has certainly been the position of the majority of this Commission consistently that we can't go back, and that it is impractical for us to go back to cost base or cost of service.

The reason for that is demonstrated by this case, which is a Florida Power & Light case which goes back to 1993, which has yet to be finalized.

And what these represent is even—not even a complete list of the filings which is 15 boxes.

Now, these 15 boxes again represent the complexity of rate cases. This is not to represent what is the oldest cases that FERC has dealt with historically. We've had cases go back 15 and 20 years.

The point that these 15 boxes will represent, through this Florida Power & Light case, which is a rate case, is that California nor the West can wait eight years, nor can we wait 20.

The CHAIRMAN. This is one case before FERC?

Mr. HÉBERT. That's correct, Mr. Chairman.

The CHAIRMAN. And what's in the boxes?

Mr. HÉBERT. The filings of the case, and it's not complete.

The CHAIRMAN. Somebody open the top of one of those.

Mr. HÉBERT. Some will get out.

The CHAIRMAN. Put it back on, quick. How do you relate this to, you know, a rate-based case? In other words, each rate has to be examined individually what the production costs are and——

Mr. HÉBERT. Again, this is one case. If we're talking about cost-based cost of service, we're talking some hundreds, as many as some as 500 generators that we would have to go back and establish their cost, subject to litigation, subject to rehearing of this commission and appellate procedures beyond that. It's just not an answer.

Senator DORGAN. Mr. Chairman, I'm apparently missing the message. If the message is we can't regulate because there's too much paper, that's not a message I understand or accept. The IRS.

The CHAIRMAN. Just a minute, just a minute, just a minute. I don't think we need any more—we believe there's 15. Is that fair enough, Senator Dorgan? I think the point has been made that when you talk about cost base, you're talking about a great deal of detail because it comes in on various types of formulas that are applicable. You have to go through them all.

Mr. HÉBERT. Mr. Chairman, I don't want Senator Dorgan to misunderstand me. It's not about the magnitude of the paper. It is the time span of the paper which creates the magnitude. The 8-year period.

Senator DORGAN. I don't want to take other's time, but Senator Burns and I have been talking about a complaint against railroad rates that lasted 15 years. But that's the agency's fault. If these things drag on and can't get done, that says a lot about the agency.

The CHAIRMAN. It says a lot about both sides because obviously each side wants to make a case and each side gets good legal——

Mr. MASSEY. May I make a comment, Mr. Chairman?

The CHAIRMAN. The point is we've got an emergency here. We can't wait 8 years or California will burn out all of its candles.

Mr. MASSEY. May I make a comment?

The CHAIRMAN. No. I'm going to call on Senator Smith because he's under a time constraint.

Senator SMITH. Thank you, Mr. Chairman.

Mr. Hébert, are you aware that in the bill Senator Feinstein and I have we could relieve you of this problem? We give you a choice of imposing just and reasonable load-differentiated demand rates or cost-of-service service base rates. So you don't have to go through all of this. You set them. You don't have to do this facility by facility. Are aware of that and why isn't that a reasonable option?

Mr. HÉBERT. I understand, Senator Smith, that the legislation does address that. What I'm concerned about and what I've not quite figured out through the legislation is how we get beyond the due process of law. How we get beyond the Administrative Procedures Act which I don't believe the legislation would be able to override. Which then again would bring us right back here.

Senator SMITH. One of the concerns I have for the energy industry, which seems fairly unanimous in wanting to go to a deregulated free market, is the presumption that we even have a free market. It seems to me what we're in the middle of a process and a ways away from it.

And for a number of reasons of another nature, California's difficulties with their law have magnified the problem so incredibly that some are allowed to gain in the system. What I fear is happening is we're going to set back deregulation for a generation or more.

And people who are trying to put up plants or think that there's a future in this are going to be sorely disappointed when the public outcry is so loud this summer that there's going to be little to hold back the dam that's going to break on energy companies if they keep this up. Are they aware of that?

Mr. HÉBERT. They being the commission itself, are we aware of it?

Senator SMITH. Are you aware of it? Are the people you deal with, do you go to these boxes with, do they have a clue about the kind of—the head of steam that's building up against them?

Mr. HÉBERT. Well, part of the problem, as you know, Senator Smith, and you and I have had had conversations and I know you're sincere as to wanting to correct the problem, and I commend you for attempting to do that, but these boxes do not represent two parties. They're not just two parties and two sides. There are many sides to this. Which is the complexity of it.

But I will tell you that FERC is acting in a way that we think is reasonable. And I totally agree with you that the market is dysfunctional. FERC agrees with you that the market is dysfunctional. That is, in fact, why you have the price mitigation plan.

But we have a tender balance in trying to correct the marketplace and get the marketplace on its feet and get adequate generation, which means adequate supply.

At the same time, you can't separate out deliverability of that supply as well. In other words, the transmission side of that is important too. Because quite frankly whereas some people want to

say, you know, why do you tie the RTO filing that California should have made 16 months ago? They were put on notice. Why do you tie that to the mitigation measures? It doesn't have anything do with mitigation.

Well, quite frankly it has everything to do with mitigation. Because if someone tells you that transmission system, especially Path 15 which is not set up correctly which needs to be improved, that the people have been debating since 1985. At least if they're going to tell you that's not part of the solution, then what they're doing is putting their thumb in the eye of every other State but California.

Because what they're going to say is we don't care about the transmission system and what it does with the other States and whether or not it sucks your energy dry. What we care about is just taking care of California, and we have to represent the entire 50 States of the United States of America. It is about transmission, it is about generation, it is about supply. It's a tender balance, and we're trying to provide that.

Senator SMITH. It seems to me those boxes are Exhibit A that we have a functional market, a broken market, and FERC needs to take a different course.

But I do want to commend you at least for the direction you're headed. I think it's welcome. I wish you had gone a bit farther, and I frankly wonder why you didn't include the other Northwest States on the grid.

Mr. HÉBERT. Well, we have a section 206 which we're seeking comment on that comment period. We're hoping to get information that is somewhat going to be similar and mirror what we've done in California. That is what we're looking for. So we haven't ordered it, but we are in a comment period which would end next week. It is a 10-day comment period, which I think is the quickest comment period we've ever had.

Ms. BREATHITT. Senator, may I add we're legally constrained to address this situation and the other Western States without first instituting what we first call section 206 of the Federal Power Act provision.

Senator SMITH. And you have that investigation going now; is that correct?

Ms. BREATHITT. It begins immediately upon publishing in the Federal Register which should be, hopefully, this week.

Mr. MASSEY. Senator, may I comment on that? That investigation is so narrow it holds almost no hope for any price relief for your State whatsoever. We're only investigating transactions of 24 hours or less that occur during reserve deficiencies. All the transactions that are driving prices very high in your State, pretty much all of them I would say are excluded.

Senator SMITH. My concern is just by including California, you leave Oregon, Washington, and others more vulnerable to some of this abuse.

Ms. BREATHITT. In 60 days after it is published in the Federal Register, which should be this week, we will be able to, upon a finding from our investigation, that we can address high prices in the other Western States, including yours, Senator. We just have to go through this important legal step first.

Senator SMITH. I understand, and I know you can't look backwards. But I tell you looking backwards I'm looking at differences in pricing of 10 to 12 times what they were just a year ago. If that isn't unjust and unreasonable I don't know what is.

And I would just plead for you all to continue to exercise all of the powers you have. And if you need some more, we'll get you some because this is unsustainable politically for this commission, for this administration, for this Congress. And so tell us what you need and with all delivered speed help.

Mr. HÉBERT. Commissioner Smith, if I could be clear—Commissioner Smith, I apologize.

Senator SMITH. I've been called worse.

Mr. HÉBERT. No, you have not been called worse. Senator Smith, let me clear up one inaccuracy. The price mitigation does not just apply during the contingency reserve. The price mitigation we're looking at through the 206, as I said, we're looking at mirroring California, the must sell, the bid requirements, the outages, and the reporting, 24 hours a day, 7 days a week. And that will mitigate prices. So I wanted to clear that inaccuracy up. That is 24 hours a day, 7 days a week.

Mr. MASSEY. There's no need to clear up what I said. What I said was absolutely accurate. The investigation is so narrow that it holds almost no hope for any price relief in other States.

Senator SMITH. Thank you.

Mr. HÉBERT. Thank you very much.

Senator BURNS [presiding]. Senator Bingaman.

Senator BINGAMAN. Thank you very much, Mr. Chairman. One of the confusions I've got about this is whether or not this mitigation plan that has been implemented or proposed here, I guess adopted here, whether this can be evaded. Are there sellers outside of California not subject to this proxy system who can find a way to get a higher price for the power and the higher price power wind up getting into California? Is that a legitimate concern, in your opinion—I'll ask the chairman first, then the Commissioner Massey.

Mr. HÉBERT. If you have a concern, Senator Bingaman, it's legitimate. But I will tell you it is not a concern that I have. One of those issues will be subject to rehearing and certainly pending the comment period in the 206 proceeding.

But I will tell you any bid that comes from out of the State into the State of California is not subject to the mitigation at this point. But we will get comments on that.

Senator BINGAMAN. Commissioner Massey, do you have any thoughts on whether this mitigation plan could be evaded?

Mr. MASSEY. Oh, I've heard one comment that it is a Swiss cheese mitigation plan, which I think is true. I expect prices to go up outside of stage one, two, and three hours.

No. 2, the out-of-State generators that bid into the market are not subject to the market clearing price and are not subject to a refund obligation under the order as it's drafted right now. So, yes, I think that there are several ways that even the limited mitigation in this order can be evaded.

Ms. BREATHITT. Senator, may I respond also?

Senator BINGAMAN. Yes, sure, please go ahead.

Ms. BREATHITT. I'm going to read one sentence from our order. And it says during mitigation when the stage one triggers our price mitigation plan, marketers and I don't know if you're speaking to marketers, but marketers can accept the market clearing proxy price that is set by the ISO or submit their own bid.

If their bid exceeds the market clearing price, they would be required to justify the bid based on the prices they pay for the power. So our order does seek to include sellers selling into the ISO and the real-time market.

Mr. MASSEY. But the out-of-State generators are exempted from that at-risk condition by the order.

Senator BINGAMAN. Right. That was my concern that out-of-State generators could sell to parties also outside the State at a higher price, and then those parties could sell into California at whatever they wanted, whatever the market would bear. But you don't think that's a real problem, Mr. Chairman?

Mr. HÉBERT. I don't think it's a real problem, and I would suggest to you, Senator Bingaman, that, in fact, this commission is going to remain vigilant to look at manipulation. We have done that. If we find market power manipulation that we think merits moving forward with and having discouragement, we will, in fact, do that 24 hours a day, 7 days a week.

Senator BINGAMAN. Does California have to file a proposal that incorporates it into a West-wide RTO in order to be consistent with this order 2000?

Mr. HÉBERT. It is conditioned. The RTO is a condition as to their necessity to file with the mitigation plan.

Senator BINGAMAN. What does that mean?

Mr. HÉBERT. It is conditioned, and I'll be fair with you. I would love to have mandated it. If we would have had the votes to mandate it, I would have mandated it.

Senator BINGAMAN. You would have mandated that California file a proposal that incorporated it into a West-wide RTO?

Mr. HÉBERT. That they file an RTO with us. The provision within our order does not say West-wide RTO, it says RTO. You see, some 16 months ago the Commission unanimously, at that point, ordered all States to file with us regional transmission organization plans. And, in fact, California has yet to do it.

But what people don't understand is if you're trying to mitigate prices, which means in the end you're trying to get more supply delivered so you can bring down those prices, the transmission system has everything to do with that. That is, in fact, what order 2000 was about.

And every other State has complied. But if we're going to get California and the West on its feet, the RTO proposal is part of that and must be filed. You can't separate it.

Senator BINGAMAN. But now you're saying that is not required in this order, but it is conditioned? What does that mean? What does that mean?

Mr. HÉBERT. Well, it's obviously subject to rehearing, and this Commission will speak to that. But I will tell you the condition is that they must file an RTO with this Commission.

Senator BINGAMAN. Well, then it's required. If that's a condition, then it's required. Let me ask the other two commissioners.

Ms. BREATHITT. Senator, the way I read that section in the order, which I did vote for, let me say that it's not one of my favorite features of the order, but I did vote for it.

Senator BINGAMAN. I'm supposed to be the one reading the order, you're supposed to be the one writing it.

Ms. BREATHITT. I know, I'm just explaining it's not my favorite feature. But notwithstanding, I don't think it will be difficult for the California ISO to file an RTO plan as every other jurisdictional transmission-owning entity in the United States has last October. It does not ask them to join with any other surrounding RTO.

Senator BINGAMAN. So you agree they have to file a plan, but you don't think it will be difficult to do?

Ms. BREATHITT. I do not.

Senator BINGAMAN. Commissioner Massey, did you have any comment on that?

Mr. MASSEY. Under this order they don't have to file a plan. If they don't file a plan, the order self-destructs. That's the way it works. This Commission has said in this order if California doesn't file an RTO plan, even the meager steps that we took here to ensure just and reasonable prices evaporate.

Ms. BREATHITT. Senator, Bill is right, but I don't think it will be difficult for them to comply.

Mr. HÉBERT. Senator Bingaman, if I might just add, we have provided the State of California, the IOUs, and the ISO three of FERC's brightest and best to help them. We've exchanged phone numbers. We have three individuals helping with them. We're doing everything we can. But the RTO is an integral part of bringing prices down. There's no question about that.

Mr. MASSEY. May I say one thing? If Chairman Hébert wants to send a separate order up to mandate this, I will vote for it. There's two votes right there. So I—but I would not vote for it as a condition in this order of our commission carrying out its responsibility to insure just and reasonable prices.

Senator BINGAMAN. Mr. Chairman, I've used all my time. Thank you very much.

Senator BURNS. Senator Feinstein.

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

Mr. Chairman, someone just handed me an interesting document. It's entitled, "Megawatt Laundering Under FERC's Mitigation Plan or a Primer on How to Gouge California." And it actually described how to use this order to price gouge.

And it's got a step-by-step primer in it that goes on and says exactly how to do it. I find that very interesting.

But I sent down to Mr. Hébert a letter dated April 30 from Southern California Edison, and I would like to enter this letter into the record because it documents that there are not 3,000 megawatts of QF-generating capacity off line in California due to financial concerns.

The total includes 320 megawatts of generation under contract with Southern California and 400 under contract to PG&E.

What this letter points out is that the payment system is in the process of being worked out, and in light of these payments made and offered by Southern California Edison, no financial hardship will result from continued sales by QFs pursuant to their existing

contracts with utilities. And I would hope that if there are any QFs here, they would make themselves available of that.

[The letter follows:]

SOUTHERN CALIFORNIA EDISON,
Rosemead, CA, April 30, 2001.

THE VICE PRESIDENT,
The White House, Eisenhower Executive Office Building, Washington, DC.

DEAR MR. VICE PRESIDENT: Southern California Edison Company (SCE) is deeply concerned that some in the Administration and Congress apparently have come to believe that the abrogation of existing contracts between investor-owned utilities in California and qualifying facility (QF) power suppliers offers a means to increase the amount of electricity available in California. This position appears to be based on misinformation about the amount of QF power that is currently off-line in California, the reasons that generation is off-line, and the implications for California consumers if QF power is sold outside of these existing contracts at higher, market-based prices. Questions regarding the government's legal authority to abrogate these binding contracts aside, it is vitally important to set the record straight before the government takes precipitous action that will only worsen the California electricity crisis.

It has been asserted that 3,000 MW of QF generating capacity is off-line in California due to financial concerns including nonpayment by SCE and Pacific Gas & Electric (PG&E) for past power deliveries. The facts, however, show otherwise.

Only 1,200 MW of otherwise dependable QF resources contractually committed to SCE and PG&E are off-line. (QFs under contract to San Diego Gas & Electric, which has not missed payments under its contracts, are not included in this total.) Of this 1,200 MW that are off-line, approximately 500 MW are off-line due to scheduled maintenance or equipment failures. Thus, only approximately 700 MW has been taken out of service due to financial concerns. This total includes 320 MW of generation under contract to SCE and approximately 400 MW under contract to PG&E.

While there remains a past delivery payment issue that must still be resolved, going-forward payments for QF power will be made on a timely basis, as required pursuant to the March 27 decision of the California Public Utilities Commission (CPUC). SCE will make energy and capacity payments to all QF generators for power deliveries made on and after March 27, 2001. The first such payment for April's deliveries was made by SCE to its QFs on April 13, 2001. We understand that PG&E also paid its QFs in accordance with the CPUC's March 27 order.

The same CPUC order requiring payments going-forward also modified the pricing formula that applies to the vast majority of SCE's QF contracts. Certain gas-fired cogeneration facilities have claimed that this modification (which ties QF electricity prices to a natural gas spot market index at the California/Oregon border rather than the previous, typically higher, index prices at the California/Arizona border) has caused a financial dislocation while such cogenerators find ways of transitioning from purchasing natural gas at Arizona spot border prices to lower priced alternatives. SCE believes that the financial strain resulting from this change in the price formula is directly responsible for most, if not all, of the QFs under contract to SCE being taken off-line.

To ease the effects of the natural gas price change on this limited class of QF suppliers, and to ensure that all available resources continue to operate during this crisis, SCE made a proposal last week to affected cogenerators, subject to the concurrence of the CPUC, to make a supplemental monthly payment to gas-fired cogenerators during the calendar months of May 2001 through April 2002. The proposed supplemental payment would assure that the total energy payment received would be equal to the amount that would have been paid using the previously effective Arizona border gas index.

SCE also has offered to prepay the affected cogenerators for the first full delivery month following the effective date of the agreement proposed above, in a further effort to assure that there are no financial obstacles standing in the way of full production by these facilities. We believe that this package should be effective in bringing back on-line that limited amount of generation currently off-line due to financial concerns. We are very encouraged by the favorable initial reaction of the cogenerators to our proposal and are hopeful that all of these small generators will be back on-line as early as this week.

In light of these payments made and offered by SCE, no financial hardship will result from continued sales by QFs pursuant to their existing contracts with utilities. The legitimate financial issues facing these generators are being addressed. Al-

lowing QFs to abrogate their contract obligations would do nothing to resolve the issue of past debts.

If QFs are permitted to break their contracts and sell their generation on the open market, there is no guarantee that this much needed power will stay in the state of California. What is more, the government is proposing to abrogate the very type of forward contract that the Federal Energy Regulatory Commission and others repeatedly have claimed is necessary to reduce the price volatility in the California energy market. While the result will be a windfall for QFs and power marketers selling at market-based prices that are today roughly four times higher than existing contract prices, the result for the state will be to make the power supply and price situation worse, not better. Allowing a QFs to sell all their generation outside their existing contracts in order to bring back on-line the limited amount of generation that is off-line due to financial concerns will roughly double the amount of power that the state must purchase (the "net short") with disastrous financial consequences.

California consumers have paid dearly for the right to finally reap the benefits of QF contracts that have for years saddled utilities and their customers with the obligation to pay far in excess of market prices for QF power. Prior to 2001, SCE had paid its QFs atotal of $27.9 billion for electricity, approximately $15.8 billion of which exceeded the prevailing market rate. As the CPUC has acknowledged, QF contracts were heavily front loaded in order to encourage the financial community's support for QF development. When consumers are now finally poised to receive some of the promised benefit of the QF program, that benefit would also turn out to be illusory if the QFs are permitted to abrogate their agreements in order to pursue greater profits in a dysfunctional spot market.

Federal action is not needed here. The CPUC has authority in this matter, and has recently instituted an investigation regarding the performance of QFs under their existing contracts. As the CPUC observed in its Order Instituting Investigation, "this Commission, like other state regulatory agencies, has the primary role in calculating payments to a QF . . . and in overseeing the contractual relationship between QFs and utilities operating under our rules and regulations." There is no compelling justification for the Federal government to intrude into this matter at this time.

For all these reasons, we urge you to disavow any intent to abrogate existing QF contracts. Such a step would be ineffective in increasing the availability of power in California, and would only aggravate the substantial burdens being borne by the state and its residents as a consequence of the broken wholesale electricity market.

Sincerely,

STEPHEN E. FRANK,
Chairman, President & CEO.

Senator FEINSTEIN. But if I could, I would like to ask Mr. Massey a couple of questions. Mr. Massey, what percentage of transactions from January to March where FERC ordered refunds because they found prices were unjust and unreasonable were in stage three or one or two?

Mr. MASSEY. It depends on the month. I have the numbers for stage three. Let me give you an example. For the month of March, the proxy clearing price was $300. And we said in an order if generators during stage three bid $300 or above, they're subject to refund. That only captured 220 out of 9,000 transactions that were above $300.

So 98 percent of the transactions that were above $300 were for megawatt hour during the month of March were essentially given a free and clear by our order. I don't have the numbers for stages two and one.

I have them for last year. From June until December of last year, only about 5 percent of the transactions occurred during stages one, two, and three. So if the price mitigation in this order had been applied then, only about 5 percent of the transactions would have even been covered by it.

What will happen this summer, what percentage of the transactions will be in stages one, two, and three it's anyone's guess. But

one estimate I have heard is in the range of 40 to 45 percent. Which may mean that 60 percent of the transactions will not be subject to price mitigation this summer.

Senator FEINSTEIN. And therefore very likely will have prices go up?

Mr. MASSEY. I expect the prices outside the mitigation periods to go up.

Senator FEINSTEIN. Can you give us any estimate of how high you believe they will?

Mr. MASSEY. You know, I really do not know, but I do know that the order the way it's drafted right now, if it's purely economic withholding, a generator simply bidding a $1,000, $1,500, just because it can and it's outside of stages one, two, and three, there's no relief and no at-risk condition.

Senator FEINSTEIN. Well, you know, I think in a sense it makes the order next to worthless in terms of real impact and——

Mr. HÉBERT. Senator Feinstein, I would love to comment on a couple of things. One, there is not going to be physical or economic withholding because the must-sell requirement which, by the way, doesn't have anything to do with the stage. It is 24 hours a day, 7 days a week. It's important you understand that.

The must-sell requirement was not in the December 15 order. Actually, you and I have had some exchanges, and that is one of the things we agreed that probably was important. I think it was important, and that is why it's in there. The bidding requirements are additional, so are the outage requirements. In the reporting requirements they were going to happen on a weekly basis. So I don't want you to think those transactions are not going to be looked at.

Nor do I want you to think that this commission, if it comes to market manipulation, is not going to act. We are going to act.

A couple of other things that are very important too. Commissioner Massey so clearly pointed out a little while ago the fact that when you had the megawatt rate at around I think it was $430, that the gas cost itself was around $380. Yet somehow somewhere in this conversation we talk about capping at rates such as $150.

Now, I'm not sure how that helps me help you get supply to the consumers of California, and quite frankly it doesn't. But a couple of other things. One as to the letter, and I do appreciate you giving me this, I haven't read it. I will read it. But I will tell you that we have pleadings that were filed before us from the ISO in California. And others that do suggest that there are 3,000 megawatts out there with the QFs.

Not to mention I always find it interesting when I read letters as to who is copied. This has everything to do with FERC, and I do notice that we're not copied.

I also note that this letter was sent to the House when the House was having their hearings, and that Mr. Frank was to testify and then declined to testify for some reason. So, Mr. Frank could certainly prove this out by testifying as to the matter. But I certainly find it interesting that I was not provided a copy other than by you, and I'm thankful.

Senator FEINSTEIN. Well, the letter was sent to the Vice President, just so the record is clear.

Ms. BREATHITT. Senator, may I add one point? Commissioner Massey had heard an estimate that the transactions are likely to be 40 to 45 percent in stages one, two, and three this summer. I had heard estimates that they will be as high as 80 to 85 percent in stages one, two, and three. We don't know, but I think the likelihood because of the summer heat of being in the stages most of the summer is very high.

Senator FEINSTEIN. Yes, let me just ask one last question because my time is almost up. The just and reasonable provision of the Federal Power Act applies only to stage one, two, or three emergencies or all the time? I understand it applies all the time.

Now, your board applies just to stage one, two, or three emergencies. Why doesn't the price mitigation apply all of the time? Why do you select just that one period and do it on the basis of the least efficient megawatt when you know that this can be manipulated?

Mr. HÉBERT. Several reasons. One, inefficiency does set market prices. Two, by focusing on inefficiency, we'll get those dirty dog units that burn some 40,000 heat rates and others out of the State of California because the more efficient units will come in and they'll clean up——

Senator FEINSTEIN. Why if you get more money for a dirty unit, why not have a dirty unit?

Mr. HÉBERT. You're not going to get more money with a dirty unit. You're going to get more money with an efficient unit. Because it's an efficient unit. Let's say that unit clearing price is, let's just pick a number, $175. If that is the proxy price, if you have an efficient unit that can produce it for $25, you're going to try to build as many of those efficient units as you can because, quite frankly, that's where your profit is. Your profit is not here.

You're on a cost line here, and you're very tight. It's going to bring efficiency. Understand that and I would like to take more time to explain it to you further but let me tell you my colleague, Commissioner Breathitt, I thought did a very good job of explaining as well that this summer, probably most of the summer you're going to be in a stage one, two, or three.

And I think we did a very good job of balancing two things. One, the need to get in when we think market power might be at an extreme, while there might be illegal conduct. While at the same time providing an opportunity for there to be new investment in California so that people of California can get more supply and can keep their lights on and can have better prices.

Mr. MASSEY. Senator, may I make a comment on that point, please? It may be that if I owned several generators, I would want to have a bunch of efficient ones and at least one highly inefficient one. It seems to me that's the point you're making because that unit could set the market cleaning price. And I think that is a very valuable point to make.

But your other question is why not apply this 24/7? It seems to me that the argument that you're going to be in stages one, two, and three 85 percent of the time anyway is a powerful argument for going ahead and applying it all the time. Why exempt that 15 percent, assuming it's that small, which I don't believe it.

The truth is we don't know when they will be in stages one, two, and three alerts for the summer, but we do now know that the Federal Power Act says there shall be just and reasonable prices in all hours.

Senator FEINSTEIN. Thank you, thank you.

Senator BURNS. Senator Cantwell.

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

Senator CANTWELL. Thank you, Mr. Chairman. I appreciate this opportunity. I know we're here to discuss the FERC order of April 26 and obviously some of your testimony was broader about the larger issues.

From the Washington State perspective, while we can have a lot of discussion about lack of generation or planning or the amount that's on the books to produce a greater deal of capacity in future years, I'm most interested in the next 24 months and what we can do for the people of Washington State. Hand out all the criticism you want about the past or what is going to happen in the future, but the next 24 months is critical to our economy and to the people of our State.

I have some basic questions regarding your actions. Because we're limited on time, and I believe we have a vote here, if you could just answer yes or no to these, that would be very helpful.

First of all, do you believe that the energy prices in Washington State represent reasonable rates?

Mr. HÉBERT. Are you asking me?

Senator CANTWELL. Yes.

Mr. HÉBERT. I understand, but if I may ask permission of the chair, I would certainly like to answer yes or no with the request of the Senator, but I would like to back that up in writing with a further comment and explanation.

Senator BURNS. Without objection.

Mr. HÉBERT. Thank you.

Senator BURNS. Without further investigation, which is what the 206 is about, I can't answer that.

Senator CANTWELL. So you don't know today whether you think there are reasonable rates being charged when they are 11 times what they were a year ago?

Mr. HÉBERT. That is what the 206 investigation of the period is about.

Mr. MASSEY. It actually isn't. It's about a very narrow investigation aimed at a very narrow part of the market. And based on what I've seen, BPA has to increase its prices by 250 percent. Is that just and reasonable? I don't think so.

Mr. HÉBERT. I am concerned about the prices.

Senator CANTWELL. Yes, but I'm asking you whether you think— well, let me get to the second question. Do you believe there should be price mitigation in Washington State, yes or no? And Commissioner Breathitt, I didn't mean to cut you out of the last round, so if you want to jump in too . . .

Ms. BREATHITT. I can't prejudge what the 206 will find, but if it finds that there are prices that need to be mitigated, I would agree with that.

Senator CANTWELL. Well, the reason I'm asking is because I'm going to see constituents this weekend, and I'll share with you some of their thoughts. Our prices first spiked in June 2000. If we're going to talk about 206 and what an important act it is, I would like to point out that we should have done that a year ago. So telling us today that you don't want to comment on whether there is a need for——

Ms. BREATHITT. I'm legally constrained, I'm sorry.

Senator CANTWELL. This was an important action that should have been taken a year ago if that's the case. If you couldn't talk about it when we started seeing spike increases, we should have started having discussions then about investigations. But now it's a year later and you don't even want to talk about whether you think that these are reasonable rates?

Mr. MASSEY. I think you're absolutely right. We've been too little too late. We should have gotten on this a year ago. And they don't sound reasonable to me.

Mr. HÉBERT. Senator Cantwell, if I may add to this, this commission, through the 206, has stated, which I think is what you're after, that at certain times and at certain conditions rates may not be just and reasonable. That is what the 206 is about. We're not trying to evade you.

As you know, we're quasi-judicial. We're in a comment period. We made that very clear to the staff. We're in a situation where if one of us gets conflicted out, we can't make a decision.

But to answer the June question, I've been chairman of this agency for 90 days, and we have acted and we've acted quickly. We were made to be vigilant. That is what the 206 is about.

Ms. BREATHITT. Senator, I went to the meeting in Portland and heard from the Governor in your State and received correspondence from him. And I do very much share your concerns and your Governor's concerns. And I've talked to members of your State commission. And I do believe that the process we're going through will produce some beneficial results.

Senator CANTWELL. So you do think we'll see price mitigation in Washington State?

Ms. BREATHITT. I can't legally say that or I might have to recuse myself, then we wouldn't be able to move forward.

Senator CANTWELL. Well, I would just remind the Commission of the dates the prices first spiked, and if it was a limitation on your discussions, we should have invoked 206 a long time ago, given the increases that people have seen.

Mr. Chairman, if I could, this is still being discussed as somewhat of a California issue. And yet I very much appreciate Commissioner Massey's comments about plants and facilities being shut down in Washington State: Georgia Pacific and Birmingham have been affected, pulp and paper companies in Steilacoom, Washington, a chemical company in Tacoma. These are layoffs that are early indicators of real problems in our Washington economy.

I have an emotional letter from an 11-year-old whose mother works in an aluminum facility. He said, "This is the first house we've ever lived in. And it's really important for me to live in a house. And we might not have this house."

And I hear from senior citizens in eastern Washington who are saying "Next winter, if this 200 percent rate increase is actually implemented, we don't know whether we're going to be able to pay the bills."

So this is an emergency now. We can talk all we want about what is going to happen 2 years from now in generation or criticize other activities. But FERC has very clear legal responsibilities under the Federal Power Act of 206, that whenever the Commission, after a hearing or upon its motion or upon a complaint, finds that any rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate charge classification rule and then enforce it.

And I think what we're saying, Senator Feinstein, Senator Smith, and myself is that if you're not going to do that, the Congress is going to act in pushing that to happen. Because it is an emergency in our State, citizens are being impacted—to the degree that they are going to be without house or home or jobs. Remember that the western economy is 1/3 of the national GDP. So this is an issue that we must deal with in an expeditious fashion.

Thank you, Mr. Chairman.

Senator BURNS. Thank you Senator.

Senator Dorgan.

STATEMENT BY HON. BYRON L. DORGAN, U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. Mr. Chairman, thank you. You all aren't going to like what I'm going to have to say and I'm sorry about that, but frankly there's not a free market in the power supply in California. You're phasing an illusion if you're talking about free markets, number one.

No. 2, the reason I came today is I have been distressed for some long while. I see regulatory agencies that won't regulate. I think during the last couple of years you've done a wonderful imitation of a potted plant. You have not done what you ought to do. If we're going to spend money for FERC, then let's have an agency that's going to crank up an effort to do the right thing at the right time.

You talk about the market system. The market system is a wonderful thing. I used to teach a little economics, and I deeply admire the market system. I don't worship it. It needs a reform from time to time in certain areas. Cranky little Judge Judy on television, you know how much she makes in the market system? $7 million is her salary. Judge Rehnquist is $180,000. So that's the market.

Shortstop for the Rangers is $250 some million in the market system. Well, the market system sometimes gets out of whack, and we have regulatory agencies that ought to have the energy to go right at it, hard and on a timely basis.

And I tell you I'm just not impressed by the paper. Look, I know that regulating is a tough job, but regulating is not a four-letter word and not a dirty word. It's what FERC is all about.

When you see what's happening in California, $7 million to I think $26 million then nearly to $70 billion this year, let me make sure we've got it right. Billions, with a B. When you increase the

cost of power tenfold, something is haywire someplace, and this is not about philosophy I would say, Commissioner Breathitt.

It's about a lot of folks getting their back broke by energy prices they can't afford. And I just, you know, I was listening to this, a couple of observations. One, you all don't get along very well.

The CHAIRMAN. We're going to change that in a few days. We have a couple more commissioners coming on so that will help.

Senator DORGAN. Well, we'll see.

The CHAIRMAN. It depends on your point of view, whether you want to get something done around here or not.

Senator DORGAN. Well, that's what I'm hoping. I'm hoping that FERC will decide to saddle up and move out in the right direction here.

The CHAIRMAN. Can't blame this group, you know. They just got together and it's amazing what they've been able to do in the last 90 days compared to what's been done in FERC in the last couple of years.

Senator DORGAN. I understand that. I'm asking the questions at the moment here.

The CHAIRMAN. I understand that. I'm just telling you the other side of it. Please proceed.

Senator DORGAN. I understand the other side. The point is we have a regulatory agency, no matter who is in charge, hasn't been regulating very effectively. And I think it's pretty hard to make the case, Mr. Chairman, that that which has been done recently can be called anything other than inching——

The CHAIRMAN. Better than nothing, and that's what we had before.

Senator DORGAN. I will tell you what. If I lived in California and were subject to the kind of price increases that they've been subject to, I guess I wouldn't want better than nothing regulatory——

The CHAIRMAN. I believe that charity begins at home, and I think that's certainly true in California.

Senator DORGAN. Well, better than nothing is not something that's a standard I relate to in this issue. My hope is whatever FERC decides it's going to do and whoever is engaged in this issue down at FERC, you'll decide you're a regulatory body. And in circumstances where regulation is required, that you'll step up and move on briskly in the right direction and provide some help to people.

I tell you I'm just unimpressed and I've been unimpressed under the previous administration as well. And now too.

It is not about philosophy. There is no free market there. If you continue to chase that illusion, you're never—you're never going to solve this issue.

Ms. BREATHITT. Senator, I agree with you that there's not a free market in California.

Senator DORGAN. Well, we keep talking about trying to find the free market to deal with the efficiencies here. Seems to me this needs a dose of regulation at this point, effective regulation. And there are ways for you to deal with that paper there. Are ways for you to deal with that as a regulatory body.

And so, you know, I understand the differences that you've expressed here with this particular order, and I know the chairman

asked us to focus on this order, but frankly I just want you to act like a regulatory body that wants to be aggressive in pursuit of the right policies, and I don't see that. Thanks, Mr. Chairman.

Mr. HÉBERT. Mr. Chairman, if I may——

The CHAIRMAN. Thank you very much. Before you do, I think we all are striving for the same thing, Senator Dorgan. The question is how do we get there? There is no free market in California. There used to be. Is it FERC's fault that it isn't? We can go through that exercise for a long time. Effective regulations suggest different things to different people. You're tempting to try and instill in California what has been lost. And that has created an environment where investment will come in and put in facilities.

Now, California discouraged that. There's absolutely no question about it. They discourage it as evidenced by their purchase outside the State. That was a matter of choice. Now, I'm not suggesting, and I'm not standing here defending FERC. And this is one of the things that concerned me about this type of hearing. We got an order here. We can either live with that order. You folks are going to come together and change it, but we're going to legislate something to the contrary. The focus should be on the adequacy of the order. This is turning into a debate between the minority and the majority within FERC.

It's a fine democratic process, but it's an exercise that doesn't address the bottom line. How do you encourage private sector investment to come into California and create, not necessarily a surplus but create an environment where they can meet the increasing demand? First of all, they have to ensure that they get paid. How much is outstanding, Mr. Hébert?

Mr. HÉBERT. I think around $13 billion.

The CHAIRMAN. For power that's been provided. Would you agree with that Mr. Massey?

Mr. MASSEY. Yes, but my view is——

The CHAIRMAN. Just a minute. That's the question I asked. So we got $13 billion out there that hasn't been paid for. Before other folks are going to be anxious to come into California, they are going to want to have had some assurance that they're going to be paid. That's a reasonable assumption.

Those people in California, they got power. Now whether that power was unreasonably priced is another matter and an appropriate matter, but they got consideration. They haven't been paid for it. That has got to be addressed by California and Californians, whether they're rate payers or taxpayers.

Otherwise what we're talking about here is an exercise of cosmetics. If we don't encourage investment to come into California, this whole thing isn't going to work. My question is whether you can have wholesale caps and still bring in investment into California. I see people out there shaking their head both ways. I don't know what to believe, but that's the crucial thing.

Mr. Massey, you wanted to make a point?

Mr. MASSEY. Senator, I would not agree that all of that $13 billion represents a just and reasonable——

The CHAIRMAN. I didn't say it did, but it's out there and somebody is making a case that they haven't been paid. And I assume

the lawyers are going to be able to get a little work out of this deal and so forth.

But, in any event, you know, when I look at this volume associated with one case and recognize that's part of your job, but nevertheless we like to have timely decisions based on reasonable research. You can research to the end of the moon if you want to. You have to make a decision at some point in time based on a degree of satisfaction.

So while, you know, I can appreciate some of the comments of my colleagues here relative to, well, this is your job anyway, the point is if we magnify this by causing an evaluation into all—how many rate cases could there be relative to cost of production? I mean, everybody has a different cost of production. So you have to look at a practical aspect of how you're going to measure this in some way that's responsive to the needs of the people.

And I think your effort here in this evidence is to simply show that cost of production puts a hell of a load. It's not impossible but don't expect quick and timely reviews unless you want to increase your staff tenfold. Enough of that. California hydro projects are regarded by FERC order to spill water for fish habitat starting now and through the summer.

I'm curious to know if relief in this order would require whether FERC would issue an order suspending this bill for a year after an endangered species section 7 consultation with national marine fisheries service. I'm told that there's about 2,700 megawatts of additional power per month could be generated for the region if the spill order could be suspended. I gather this would almost meet the 3,000 megawatt per month California has estimated to be short this summer.

Bonneville Power Authority, which is not subject to FERC, right, just received—a waiver from National Marine Fisheries to allow it to suspend its planned spill from the Federal hydro facilities. Are you aware of that?

Mr. HÉBERT. I just got news of that, Mr. Chairman, on my way in. And I heard that is several thousand megawatts.

The CHAIRMAN. So the Northwest Power Planning Council, which is an agency created by Congress, just concluded a meeting I'm told in Spokane to consider requesting relief from FERC and has put its intention to request relief out for public comment. The Northwest Power Planning Council analysis of a 1-year suspension of the FERC's bill order shows a negligible impact on fish populations.

Now, this conclusion evidently is consistent with the no-jeopardy opinion of Bonneville Power received from NMPS allowing it to suspend spills from the Federal hydro project.

Now, are you folks looking into this matter, and are you going to determine how FERC can expedite the process to suspend spills from the mid Columbia hydro facilities? And, in conclusion, this would appear to be an extremely important source of power that perhaps could be available to the West during the summer.

Mr. HÉBERT. Obviously we are looking into every opportunity to squeeze every available megawatt out of the West. We would have to cooperate with other agencies. We're more than willing to do that.

That is something we actually did with Kern River in trying to move that process ahead and got it out in 3 weeks. Obviously not a hydro, but we are willing to do that in looking for any and all opportunities, and I appreciate you bringing that before our attention.

The CHAIRMAN. Now, are you satisfied with the contention of the Planning Council's analysis that this suspension would have little impact on fish populations, or do you depend on other agencies like Fish & Wildlife?

Mr. HÉBERT. We have other agencies that would have to make comments on that, and we would have to comply with that.

The CHAIRMAN. You have not had any feedback from the Fish & Wildlife Service at this time?

Mr. HÉBERT. On this, no. I just heard about it.

The CHAIRMAN. What if indeed this would potentially provide you with 3,000 megawatts per month or thereabouts? I guess it's 2,700 megawatts that we're looking at here potentially, would that pretty much alleviate the California situation?

Mr. HÉBERT. With the demand management techniques, with our mitigation plan, the must sell, the bidding requirements, everything taken in context, I believe it would make California very close, yes.

The CHAIRMAN. Are we likely to have a negative reaction based on the fisheries issue and the escapement issue, and what it would do to the levels of maintaining an adequate level for the salmon?

Mr. HÉBERT. My educated guess would be probably. Based on past experiences.

The CHAIRMAN. At least this is one of the more positive potential availabilities that is attainable and has some immediate——

Mr. HÉBERT. I agree.

The CHAIRMAN [continuing]. Capability of making a significant contribution. That's what we're really looking form. We're looking for immediate relief here. Go ahead. You were going to add something else.

Mr. HÉBERT. I had a couple of things, yes, I wanted to add one to the record, then answer your price cap question. This is basically a list of what FERC has done. I would like to enter it as Exhibit 1.

The CHAIRMAN. Without objection.

Mr. HÉBERT. Thank you. It would provide you and the committee members with some opportunity to understand what we have been doing.

Price caps for the West and price caps for California, Mr. Chairman, when you look at a hard cap, that is what I think is the beauty of the mitigation plan which looks at prices, which looks at bidding, and must sell and outages. I think that's the beauty of it in that it is a tender balance in that it is going to get the supply that is necessary into California and the West.

And if you want to look at temporary price caps and understand what temporary price caps can do to you, you don't have to go far to get the answer. You can ask California. They have temporary retail caps for about 2½ years, and it absolutely destroyed their market. And they have now confessed to that and reversed that.

The other thing price caps, when they had them in California, what did they do? They went out of market for those. The other thing that price caps does it sets a price at which we in Washington might tell the people in California and the West, Mr. Chairman, that they should turn out their lights.

Now, I agree with you that we don't condone high prices. We want prices to be reasonable but at the same time I think it's important to keep the lights on. And I guarantee you the people of California are smart people, and they know when to turn down and turn over and they will, in fact, do that.

But if we set price caps in California a hard cap at X price, then we set a hard cap in the Northwest, which is naturally what comes next in the entire West. I'm not sure how we keep the power from escaping the United States of America and going to Mexico and going to Canada. And for those who think we can do that, there's this little thing we have a problem with called the free trade agreement. I think we'd have a problem with that.

And the last thing, if they want a price cap in California, there's an opportunity. The Governor can say there's a price at which we're not going to pay. The Governor of California can stand up and say we're not going to pay this price, we're going to turn the lights out in California when the price goes that high. FERC doesn't have to do it, the U.S. Senate doesn't have to do it, the President and the House don't have to do it.

The CHAIRMAN. And the Governor chose not to do it.

Mr. HÉBERT. Correct.

The CHAIRMAN. Look, I want to thank you all three of you for making your time available to the committee. It has been very gratifying, and I would admonish whatever segment of the financial community is here for not giving us some better guidelines on what you will or won't do under the theoretical wholesale price cap.

We can't hold you accountable, but I've been around long enough to know what happens. Either incentive is there for an investment and you go in and invest or it isn't. From we're sitting here is obviously not with the expertise in the area the financial community has nor that you commissioners have trying to make a determination of how we're going to get out of this mess.

But I can tell you the bottom line that the financial community will come in and say these are the terms and conditions we have to have to come into California. We can cut through this chaff and get down to whether or not we're going to put in more generating facilities in California.

Now, that's not quite that simple because we have transmission, consider ourself with, but that's certainly where you start. I would suggest we duck out of here now other. This thing could go on at great length. Mr. Massey, you have the last word and I don't mean plural.

Mr. MASSEY. 10 seconds. May I even send a follow-up letter? I have six compelling reasons how a price cap would bring power into the California market.

The CHAIRMAN. What I would like you to do with that letter is have a few people that we can ask that are in the financial community that will give us the terms and conditions under which they will come in and finance generating facilities in California. And I

want substantial people that have a little meat on their bones. Thank you, gentlemen. Thank you, lady.

[Whereupon, at 4:32 p.m., the hearing was adjourned.]

APPENDIX

Responses to Additional Questions

Federal Energy Regulatory Commission,
Office of the Commissioner,
Washington, DC, June 14, 2001.

Hon. Frank Murkowski,
Ranking Member, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

Dear Senator Murkowski: I appreciate the opportunity to respond to follow-up questions from you, Chairman Bingaman and Senator Campbell pertaining to the Federal Energy Regulatory Commission's recent actions related to energy markets in California and the West. I am pleased to offer you my thoughts on these matters.

Attached you will find my responses to the questions contained in your letter dated May 16, 2001, to be included in the hearing record. I look forward to working with you and other members on these important issues. If you have any additional questions, please do not hesitate to contact me.

Sincerely,

Linda K. Breathitt,
Commissioner.

[Attachment]

Responses to Questions From Senator Murkowski

Question 1. As I see it, the fundamental problem in California isn't a lack of regulation, it is a lack of generation and transmission. What are your views?

Answer. I agree that a lack of generation and transmission infrastructure is a fundamental problem in California. But there are other problems, as well. The Commission's investigations of California's electricity markets have identified several factors that have contributed to high prices and uncertain market conditions. First, a combination of market forces, including increased power production costs, increased demand for electricity, and a scarcity of electric generation in the West, led to price volatility. Second, flaws in the current market design and rules in California, such as a lack of forward contracting, mandatory buy-sell requirements for investor-owned utilities, and a lack of demand responsiveness, magnified the effects of higher prices. Third, the California market structure provided the opportunity for sellers to exercise market power, especially during periods when supply is tight. While these are the factors that have contributed to high prices in California's electric market, please see my response to Question No. 3 with regard to natural gas issues. That said, strong regulatory action is imperative in an energy crisis such as we are experiencing.

Question 2. Is it correct that a large share of California's price volatility problems can be attributed to the State's insistence that investor-owned utilities divest their generation and acquire all of their power from the spot market instead of through self-generation and long-term contracts?

Answer. I adopt Chairman Hébert's response to this question.

Question 3. There are a lot of complaints that the price of natural gas at the border of California is too high. Has the California public utility commission opposed new pipelines and expansion of existing pipelines? What about California's local distribution companies?

Answer. I adopt Chairman Hébert's response to this question. Further, I would like to add that I do not believe the expansion of interstate capacity, by itself, represents the solution to high gas prices at the California border. As shippers and local distribution companies have pointed out in comments to interstate pipeline expansion proposals, there may not be adequate intrastate capacity at the California border to take away additional volumes that might flow through new or expanded

interstate pipeline facilities. Without adequate takeaway capacity, actions on FERC's part to approve additional interstate pipeline facilities may not have the desired effect of increasing natural gas supplies in the California markets where they are needed. Indeed, uncoordinated interstate pipeline expansions could serve to exacerbate congestion at the border and result in even higher prices to consumers.

In this regard, I am attaching my separate statement in *Kern River Gas Transmission Company* (*Kern River*), Docket No. CP01-106-000, in which I called for a coordinated approach to resolving California's natural gas pipeline infrastructure needs. Subsequent to the issuance of the order in *Kern River* the Commission established a proceeding in *California Natural Gas Transportation Infrastructure*, Docket No. PL01-4-000, and directed the Commission's staff to hold a technical conference. At that conference, which was held on May 24, 2001, representatives of all industry sectors, including California regulators, discussed both physical constraints and regulatory impediments to natural gas transportation into and within California. Comments on the issues raised by the conference are due June 25, 2001.

Apart from the issue of take-away capacity at the California border, there are other pipeline issues about which I have recently expressed concern: (1) the high level of spot market purchases of natural gas in California (as opposed to longer-term contractual arrangements); (2) the low levels of working gas storage inventories last year; (3) the lack of firm capacity rights on some intrastate pipelines in California; (4) the appropriateness of continuing the waiver of the price cap on short-term secondary market pipeline capacity transactions; and (5) allegations of the exercise of market power by interstate pipelines, affiliate preference, and the withholding of interstate pipeline capacity. While I recognize that some of these matters are not within FERC's jurisdiction, I believe they are all relevant to the objective of stable natural gas prices in California.

Question 4. Am I also not correct that the State of California has steadfastly insisted that all interstate pipelines end at the border of California, with interstate pipelines inside the border being subject to State jurisdiction? Isn't the net effect of this to deny California consumers the benefits of FERC's open access transportation program, which has saved consumers elsewhere in the U.S. billions of dollars?

Answer. I adopt Chairman Hébert's response to this question.

RESPONSES TO QUESTIONS FROM SENATOR BINGAMAN

THE CALIFORNIA MITIGATION PLAN

Question 1a. How easy or hard is the mitigation plan to implement?

The ISO is charged with developing a proxy price for every gas plant in California for every hour. Is that a huge burden, or something they already have the capacity to do?

Answer. The actual calculation by the ISO of the proxy marginal cost for each generator should not be unduly burdensome. The data inputs necessary to compute the proxy price are straightforward and easily accessible. These include heat rates and emission rates filed by each California generator, proxy gas costs and emission costs published each day by the ISO, and a $2.00/MWh adder for operation and maintenance expenses.

Question 1b. Does the after-the-fact justification of bids that are above the proxy price impose a huge burden on the Commission?

Answer. Generators that submit bids higher than the proxy market clearing price must file at the end of each month a complete justification of their bids, including a detailed breakdown of all component costs. A refund obligation will end 60 days from the date the information is filed, unless the Commission, within that period, notifies the seller otherwise. Reviewing this cost justification data will obviously be time consuming for the Commission, but I expect it to be a manageable. I'm sure that appropriate resources will be assigned to this task and that we will process this information in a timely fashion.

Question 1c. Would a pre-set price cap be easy to administer while getting a similar result?

Answer. Whether or not a pre-set price cap would be easy to administer or would produce results similar to the Commission's price mitigation plan depends entirely on the specific design of the price cap mechanism. For example, a cost-based price cap set for individual sellers would likely be administratively burdensome and costly for the Commission, as well as other parties, since the process would be litigation-intensive and time-consuming. A single price cap for the entire market would be less administratively burdensome.

Question 1d. How accurate is the information that is used? In other words, will lots of plants have gas prices above the average that the ISO will use, so that all

of them will be trying to justify prices above the proxy price, or will it just be a few? Does the use of an average gas price guarantee a lot of prices above the proxy price? Is there a similar problem with the emissions prices?

Answer. The Commission's price mitigation plan uses proxy costs for natural gas and emissions. The gas cost proxy to be used in the mitigation plan is the average of the daily prices published in *Gas Daily* for all California delivery points. Because the plan uses an average of gas prices, some generators will be paying gas prices that are lower than the average proxy cost and some will be paying prices higher that the average. Each generator has the choice of either electing the proxy price or submitting a bid greater than the proxy price. Whether or not a generator chooses to bid higher than the market clearing price will depend on many factors, including the extent to which its actual gas costs are higher than the average proxy cost published by the ISO. But just because a generator's actual gas cost is higher than the proxy cost does not mean that it will always choose to bid a higher amount. It is not possible to predict, at this time, how generators will bid in this regard.

The proxy emission cost is an index published by Cantor Fitzgerald Environmental Brokerage Services. Just as in the case of the proxy gas cost, whether or not a generator will bid a price based on actual emission costs that are higher that the Cantor Fitzgerald index will depend on numerous factors. It is not possible to predict, at this time, how generators will bid in this regard.

Question 2a. Does the mitigation plan actually result in lower prices?

The proxy system is similar to the system you used to develop the refund numbers for the last few months. Have you looked at the market to determine whether prices outside the time that you applied the proxy price were higher or lower? Do you intend to do so in the future? It seems that this would help determine whether the plan is being applied broadly enough or not. Do you intend to use some kind of measuring stick like this to keep a check on the effectiveness of this system?

Answer. I adopt Chairman Hébert's response to this question.

Question 2b. How does the spot market mitigation plan result in lower prices in other markets, such as the futures market or the long-term firm contracting market?

Answer. I adopt Chairman Hébert's response to this question.

Question 2c. Does the fact that sellers outside of California are not subject to the proxy price and refunds mean that the market may clear well above the proxy price because of outside bids, so that the real effect is that prices in the spot market are still high?

Answer. I adopt Chairman Hébert's response to this question.

Question 3a. Can the mitigation plan be evaded?

The sellers outside California are not subject to the proxy system. What is to prevent generators inside California from selling to parties outside the state at a high price, then those parties selling back into California above the proxy price?

Answer. I adopt Chairman Hébert's response to this question.

Question 3b. Marketers are required to show the price they paid for electricity in order to justify a bid above the proxy price. What is to prevent marketers from selling to one another at high prices then bidding into the market at that high price and so evading the proxy price?

Answer. I adopt Chairman Hébert's response to this question.

THE RTO CONDITION

Question 1. You have conditioned implementation of the mitigation plan on California's utilities filing a regional transmission organization proposal that is consistent with the requirements of Order No. 2000. What does "consistent with" mean? If CA files a plan that you reject or modify will you withdraw the plan? If they file a proposal that you accept conditionally will you withhold implementation until they meet the conditions?

Answer. The California ISO and public utilities were directed to make a compliance filing pursuant to Order No. 2000. Such a filing should fully address, among other things, the Commission's required RTO functions and characteristics. Compliance filings were made by these entities on June 1, 2001 as required by the April 26, 2001 order. As the RTO compliance filings are presently before us, I am not able to discuss what we might or might not do with respect to either the RTO compliance filings or the price mitigation plan. I will add, however, that I am very pleased that the RTO compliance filings were made.

Question 2. Does California have to file a proposal that incorporates it into a West-wide RTO in order to be consistent with Order No. 2000?

Answer. No. As stated above, the California parties were directed to make an RTO compliance filing that fully addresses the requirements established in Order

No. 2000, including the Commission's required RTO functions and characteristics. A commitment to join a West-wide RTO is not a specific requirement. While I believe larger RTOs are the best, longer term result, I think RTOs will need time to develop into large regional entities.

Question 3. If so, what is the likelihood of other states coming to an agreement with California? I know my home state of New Mexico at one point was considering joining together with the CA ISO, but has changed their minds about that as a result of the troubles in California markets. What can California do about that?

Answer. As stated above, California is not being required at this time to join a West-wide RTO.

THE 206 INVESTIGATION

Question 1. Why is the investigation into markets in the rest of the West limited to spot markets and those periods when reserves are below 7 percent?

Answer. The Commission instituted a 206 investigation into the rates, terms and conditions of service in the WSCC for sales for resale into real-time spot markets that take place during periods of reserve deficiencies. The Commission believes that currently such rates, terms and conditions for these sales may not be just and reasonable. The limitations placed on the investigation reflect the Commission's general view that real-time spot markets, not longer-term bilateral contracts, are the primary source of price volatility and that the exercise of market power is most likely to occur during periods of severe supply/demand imbalance, such as those in which contingency reserves (as defined by the WSCC) fall below 7 percent. Comments on this issue are currently pending Commission review.

Question 2. Do you know without investigation that the long-term firm contract market, for example, is producing prices that are just and reasonable?

Answer. I adopt Chairman Hébert's response to this question.

THE PROPOSED MITIGATION FOR THE REST OF THE WEST

Question 1. You have proposed that a plan somewhat similar to that ordered for California might be useful in the rest of the West. How would such a plan work, given that there are no clearly defined spot market institutions elsewhere to play the role that the CA ISO is playing in California?

Answer. I adopt Chairman Hébert's response to this question.

Question 2. You suggest that a plan would be in effect for the West in any time that reserves fall below 7 percent in any control area. Does that mean that an implementation plan will be in effect for the whole West if reserves are low in a single small area?

Answer. I adopt Chairman Hébert's response to this question.

THE DEMAND RESPONSE PROPOSAL

Question 1. You order that California utilities state a price at which they will curtail load. How might this mechanism work? Will customers have to tell the utilities their curtailment price, so that the utilities can assemble a collective demand response, or will the utilities make this judgment on their own?

Answer. I adopt Chairman Hébert's response to this question.

Question 2. You suggest that a West-wide clearing-house for demand response might be instituted. Would this interfere with already existing state programs? Are there issues in state law that would have to be dealt with before implementation of such a plan?

Answer. I adopt Chairman Hébert's response to this question.

Question 3. You do not have jurisdiction over behavior by retail customers, which is what demand response ultimately comes to. Is there something we need to do in Federal Law that would allow you to consider demand response?

Answer. I adopt Chairman Hébert's response to this question.

RESPONSES TO QUESTIONS FROM SENATOR CAMPBELL

Question 1. Why have a single market clearing price, especially since this will probably cost California more money?

Answer. I adopt Chairman Héert's response to this question.

*Question 2.*Could this possibly drive up prices in the West?

Answer. I adopt Chairman Hébert's response to this question.

Question 3. I am skeptical of price caps. Many say they are likely a disincentive to investment in new generation. Won't they hurt in the long run?

Answer. I have been on record supporting price caps in prior California orders and in other parts of the country. I agree that price caps could deter new investment.

That is why price caps should be implemented only after careful consideration and for a short duration.

Question 4. What does the FERC see as the best means to fix this problem?

Answer. I believe the orders this Commission has issued over the past several months on the California and Western energy situation (well over 50) have begun to address the problems being experienced in those markets. I believe we need to stay the course of market oriented solutions combined with strong regulatory oversight and enforcement of market rules and behavior. For a discussion of natural gas issues, please see my response to Senator Murkowski's Question No. 3.

Question 5. How will your new orders affect the rural electric associations, the coops?

Answer. I adopt Chairman Hébert's response to this question.

Question 6. What can we all do to ensure that the rest of the Western region is minimally affected by the crisis in California, because I don't want my home state of Colorado's resources and consumers hit by these problems?

Answer. In our April 26, 2001 order we instituted a Federal Power Act Section 206 investigation into the rates, terms and conditions of service in the WSCC for sales for resale into real-time spot markets that take place during periods of reserve deficiencies. Comments on this issue are currently pending Commission review.

ATTACHMENT

UNITED STATES OF AMERICA FEDERAL ENERGY REGULATORY COMMISSION

Kern River Gas Transmission Company Docket No. CP01-106-000

(Issued April 6, 2001)

BREATHITT, Commissioner, dissenting in part, concurring in part:

This protested filing has raised difficult issues for me that today's order does not resolve to my satisfaction. As I will explain in greater detail below, I believe that the parties have raised valid concerns that require further exploration. Specifically, Southern California Gas Company (SoCal Gas) requested that the Commission establish a technical conference in this proceeding, on a compressed schedule, in order for the Commission and the parties to approach Kern River's filing in a more orderly and informed fashion. Pacific Gas & Electric Company also sought further information about this project, either through a technical conference or additional written data. In addition, Kern River's Firm Customers sought a coordinated approach to expansion of capacity on Kern River. I would have granted these requests by either: (1) establishing a conference before issuance of the certificate, or (2) conditioning the certificate we are issuing today on the outcome of a conference. I am disappointed that my colleagues fail to see the value of granting this request. Therefore, I am issuing this partial dissent. However, for reasons I will delineate below, I am concurring on other aspects of the order.

Each of us seeks to use FERC's regulatory authority in a positive way to alleviate the energy market disruptions being experienced by California consumers. I strongly believe that the Commission must act within the limits of its jurisdiction, to ensure that additional natural gas supplies reach the California markets to curb the shortage of electric generation in that state. I do have serious reservations about this project and about the Commission's general direction with respect to capacity expansions into California; however, I find on balance that it is in the public interest to certificate this project.

I share the hope that this action today represents a step in the right direction. However, it has been somewhat difficult for me to view Kern River's "California Action" project as being one that necessarily merits the kind of extraordinary regulatory treatment that we have granted the applicant in this case. My hesitation does not come only from the fact that Kern River has pending before this Commission a very similar proposal in which the parties have raised valid concerns that would pertain to any expansion of Kern River. I believe that it would have made more sense for the Commission to have considered the merits of that proposal at the same time we deliberated the merits of the instant expansion. It is my understanding that such consideration would have been possible and timely; and in my opinion, it would have given us a more complete picture to consider. However, the relationship between Kern River's two proposals is not my main concern.

The intervenors, who themselves represent the intended beneficiaries of this expansion of interstate capacity, point out the primary problem: Kern River's application does not demonstrate—or even assert—that any more gas will flow through the Wheeler Ridge interconnection than currently flows. This is due to congestion at

that point that could prevent additional supplies from reaching the intended markets and, importantly, providing natural gas that is needed for electric generation.[1] Furthermore, the record of this proceeding is inadequate for the Commission to independently assess the congestion issues at Wheeler Ridge. I am very uncomfortable that this order does not take the opportunity for a fuller airing of this issue.

This order acknowledges, in dismissing claims that existing shippers will be negatively affected by the project, that "the delivery point capacity at Wheeler Ridge will be greater than the sum of the combined Kern River and Mojave volumes" that must pass through that point, but that "this does not factor in the volumes attributable to both PG&E and local production that are also delivered to Wheeler Ridge." In other words, Kern River's expansion could result in the displacement, by interstate natural gas, of gas that is already available, such as natural gas produced within California. But it will not necessarily result in any net increase of natural gas in the California marketplace. This makes it difficult to understand just how our approval of Kern River's proposal is going to assist in increasing electric generation in California this summer.

But beyond questioning whether we are doing any good by certificating this project, I am even more concerned that our approval of it could make the situation in California even worse by exacerbating the congestion problem at Wheeler Ridge. And this is exactly what the intervenors have alleged: that insufficient take-away capacity at Wheeler Ridge and the resulting degradation of firm shippers' rights will place them in a situation analogous to the type of capacity rights controversy that we recently addressed with respect to the Topock delivery point.[2] Today's order gives little weight to these claims on the speculation that future expansion of intrastate capacity will occur. I hope it does; but I am wary of the potential for creating congestion and future capacity turn-back problems without firm assurance that sufficient additional capacity downstream of Wheeler Ridge will materialize.

While I do not question that additional interstate natural gas pipeline capacity to California may be needed, we at the Commission are tasked with acting on individual projects and their effects on specific markets. I strongly believe that the California situation warrants a thoughtful and coordinated approach to interstate pipeline expansion. This case has raised issues that will likely continue to appear as we analyze other expansion projects on an expedited schedule. It would be counterproductive for this Commission to act precipitously on projects related to California without ensuring that they will, in reality, benefit specific markets—and more importantly, that they will cause no further harm. There appears to be great uncertainty about exactly what interstate capacity is needed to assist California in alleviating its energy crisis; and the information available to us is, at times, confusing. For example, while we have been urged to take extraordinary measures and expend considerable resources to process this application on an emergency basis, the California Gas Utilities, in their 2000 California Gas Report, state that Southern California continues to operate in an environment of excess interstate pipeline capacity.[3] In addition, the California Energy Commission's report on siting peaking plants for the summer of 2001[4] establishes that the 32 potential sites for this summer's "peaker project" were chosen, in part, because of the existing availability of natural gas supplies at those sites. The report does not call for additional interstate capacity to effectuate the program. It is obvious to me that FERC must work in tandem with California officials to establish common goals and understanding, since the primary

[1] In an April 5, 2001 pleading, the Kern River Firm Customers emphasized the need for the Commission to address the Wheeler Ridge situation. As a result of an alert issued on March 30, 2001, by SoCal Gas, nominations allowed by SoCal Gas for the Wheeler Ridge receipt point were 600 times the available capacity of 518,500 dth. The Firm Customers allege that such "'gaming' demonstrates that the situation at Wheeler Ridge is out of control" and that this situation "will only further deteriorate under Kern River's proposal." The Firm Customers contend that such data pertaining to recent developments at Wheeler Ridge reinforce their claims that while Kern River may be able to implement its expansion very quickly, the gas cannot be delivered to the markets needing gas.

[2] *Amoco Energy Trading Corp., et al.*, v. *El Paso Natural Gas Co.*, 93 FERC ¶61,060 (2000).

[3] California Gas Utilities, 2000 California Gas Report, http://www.pge.com/pipeline/news/ (2000) (prepared at the direction of the California Public Utilities Commission). In addition, the California Energy Commission's November 2000 staff analysis concludes that while local constraints can be a problem, the physical capacity of interstate pipelines appears adequate, when used in conjunction with in-state storage capacity. California Energy Commission, Staff Report: California Natural Gas Analysis and Issues, http://www.energy.ca.gov/naturalgas/ (November 2000).

[4] California Energy Commission Fuels Office, Staff White Paper: Natural Gas Issues That May Affect Siting New Power Plants in California, http://www.energy.ca.gov/naturalgas/ (January 25, 2001).

responsibility for take-away capacity belongs to intrastate pipelines and state regulators.

It is not good public policy, in my view, for the Commission to encourage interstate capacity to California that does not have the desired effect of bringing additional supplies into the areas where they are needed. As the parties argue in their comments, a coordinated approach could avoid pipeline expansions that (1) would not match up with downstream capacity; (2) could not be used by the markets and end-users that require additional supplies; or (3) would degrade the service of existing firm shippers. It is regrettable that we must act on Kern River's proposal without the benefit of such coordination. I hope that FERC will seek a collaborative resolution to the broader California expansion issues, and I suggest that the Commission's inquiry in Docket No. EL01-47-000 provides a suitable forum for such discussion.[5] We have other proposals in-house for which the applicants are seeking expedited action. It is simple common sense that more coordination should take place so that additional interstate pipeline capacity can be targeted to areas where it will represent a positive response to California's energy needs.

The speed with which the Commission has acted in this proceeding is something which will no doubt be touted as a great effort. And it has been. The staff responsible for processing this application has put in countless overtime hours to meet compressed deadlines. The precedent we have created could be a double-edged sword. What signals does this order really send? Will the Commission be able to keep up this pace on other pending "emergency" expansion applications? Is there sufficient time built into the process for the Commission and staff to fully analyze the issues? Should we be willing to sacrifice careful review for speedy action? Will we be overlooking significant issues? It would certainly be helpful for the Commission to have a plan of action before embarking on this course. I would also like to point out that if the Commission is to act within weeks of receiving certificate applications, I have been told that there could be more prefiling involvement of Commission staff than we are all accustomed to. The extent of such involvement is a matter about which I hope the Commission can reach a comfortable agreement. Meanwhile, I feel it necessary to caution the public and other agencies that staff's role is not to advocate or support individual projects. Each agency must use its own discretion to determine the urgency of any application.

I fully support the Commission's overarching goal of finding solutions to the energy problems facing California, and I am voting to issue the certificate.

LINDA K. BREATHITT,
Commissioner.

FEDERAL ENERGY REGULATORY COMMISSION,
OFFICE OF THE COMMISSIONER,
Washington, DC, June 14, 2001.

Hon. FRANK H. MURKOWSKI,
Ranking Member, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

DEAR SENATOR MURKOWSKI: Enclosed herewith are my responses to the questions asked by you and by Chairman Bingaman, and Senator Campbell.

If you have further questions or need additional information, please let me know.

Sincerely,

WILLIAM L. MASSEY,
Commissioner.

[Enclosure]

RESPONSES TO QUESTIONS FROM SENATOR MURKOWSKI

Question 1. As I see it, the fundamental problem in California isn't a lack of regulation, it is a lack of generation and transmission. What are your views?

Answer. I agree that the lack of adequate generation capacity and the presence of transmission constraints that keep power from reaching certain areas are fundamental problems that need to be addressed. These fundamental problems allow the exercise of market power that results in wholesale prices that are not just and

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[5] Removing Obstacles to Increased Electric Generation and Natural Gas Supply in the Western United States, Order Removing Obstacles to Increased Electric Generation and Natural Gas Supply in the Western United States and Requesting Comments on Further Actions to Increase Energy Supply and Decrease Energy Consumption, 94 FERC ¶61,270 (2001).

reasonable. Effective short term price mitigation is needed to ensure prices are just and reasonable until the fundamental problems are resolved.

Question 2. Is it correct that a large share of California's price volatility problems can be attributed to the State's insistence that investor-owned utilities divest their generation and acquire all of their power from the spot market instead of through self-generation and long-term contracts?

Answer. The lack of adequate forward contracting contributed to the recent high prices. However, generation and transmission facility inadequacy and the lack of demand side price responsiveness has allowed sellers to exercise market power and drive up prices.

Question 3. There are a lot of complaints that the price of natural gas at the border of California is too high. Has the California public utility commission opposed new pipelines and expansion of existing pipelines? What about California's local distribution companies?

Answer. Please see Chairman Hébert's response to this question.

Question 4. Am I also not correct that the State of California has steadfastly insisted that all interstate pipelines end at the border of California, with interstate pipelines inside the border being subject to State jurisdiction? Isn't the net effect of this to deny California consumers the benefits of FERC's open access transportation program, which has saved consumers elsewhere in the U.S. billions of dollars?

Answer. Please see Chairman Hébert's response to this question.

Third, a price cap would restore investors' confidence in the Western market. I do not believe that investors take much comfort from a wildly volatile market. And finally, a price cap would restore both consumers' and state regulators' confidence in the wholesale market that is needed to facilitate effective retail market restructuring.

Question 5. How will your new orders affect the rural electric associations, the co-ops?

Answer. Please see Chairman Hébert's response to this question.

Question 6. What can we all do to ensure that the rest of the Western region is minimally affected by the crisis in California, because I don't want my home state of Colorado's resources and consumers hit by these problems?

Answer. Please see my response to question 4.

Responses to Questions From Senator Bingaman

THE CALIFORNIA MITIGATION PLAN

Question 1a. How easy or hard is the mitigation plan to implement?

The ISO is charged with developing a proxy price for every gas plant in California for every hour. Is that a huge burden, or something that they already have the capacity to do?

Answer. Under the mitigation plan in the Commission's April 26, 2001 order, the ISO is charged with calculating a mitigated proxy bid from each gas generator. The heat rate of each unit is supplied to the ISO by the generator, and the mitigated bid for each unit is calculated daily using published prices for gas and NO_X emission credit costs. This would not seem to be much of a burden for the ISO. I objected to this mitigation plan because it is effective only during stage 1, 2, or 3 emergencies. There is no basis to conclude market power cannot be exercised at other times. Indeed, the record in the Commission's proceeding indicates otherwise. However, I believe the mitigation plan, although inadequate, is administratively feasible.

Question 1b. Does the after-the-fact justification of bids that are above the proxy price impose a huge burden on the Commission?

Answer. No.

Question 1c. Would a pre-set price cap be easy to administer, while getting a similar result?

Answer. Yes. One type of pre-set cap is to limit prices to the variable costs of each generator plus an adder to allow a reasonable profit. Administering such a generator-specific price cap would not be administratively difficult. Before the Commission allowed market-based pricing, the many inter-utility coordination transactions were regulated in a similar way and resulted in mostly short, ministerial filings. Generally, variable costs were specified in, and recovered by, a formula so that extensive cost data did not have to be filed but adherence to the formula could be verified in audits. A cost-based adder to recover fixed costs was derived based on depreciation rates, rate of return, and annual operation and maintenance costs. Such factors are generally not controversial. But to avoid any controversy over the profit factor, the Commission could simply specify a profit adder, say in the range of $25/mwh.

Thus, I do not believe administering a fixed price cap, even one that varied by generator, would be burdensome.

An important consideration in administering any price cap is that it be applied to all markets where the targeted sellers can transact. Otherwise, when the price cap might be constraining, sellers will sell in the markets where the cap is not applied. The ISO's price caps were ineffective last summer because they applied only in California.

Question 1d. How accurate is the information that is used? In other words, will lots of plants have gas prices above the average that the ISO will use, so that all of them will be trying to justify prices above the proxy price, or will it be just a few? Does the use of an average gas price guarantee a lot of prices above the proxy price? Is there a similar problem with the emissions prices?

Answer. I do not have the information needed to answer the question. However, it is likely that there will be many instances where a generator's actual gas costs will be different (higher or lower) than the published index used in the Commission's formula.

Question 2a. Does the mitigation plan actually result in lower prices?

The proxy price system is similar to the system you used to develop the refund numbers for the last few months. Have you looked at the market to determine whether prices outside the time that you applied the proxy price were higher or lower? Do you intend to do so in the future? It seems that this would help determine whether the plan is being applied broadly enough or not. Do you intend to use some kind of measuring stick like this to keep a check on the effectiveness of this system?

Answer. I do not believe that the proxy price system used for refunds was effective price mitigation because it was applied only during stage 3 emergencies and was based on a very high proxy price. Because the only transactions that were questioned were those that occurred during stage 3 emergencies, there were many sales that were made above the proxy price were not questioned. During January, 14% of the transactions reported above the $150 breakpoint were also above the $273 proxy price but were not subject to refund because they were made outside of stage 3 hours. For February, 56% of reported transactions were above the $430 proxy price but made outside of stage 3 hours. And for March, 97% of the reported transactions were above the $300 proxy price but made outside of stage 3 hours. For April, the figure was 100% because there were no stage 3 emergencies. I would also point out that to my knowledge, most of the refunds identified have been contested by the sellers.

The price mitigation plan now in effect is effective in stage 1, 2, and 3 hours, but I am concerned even that expanded coverage will not ensure just and reasonable prices. There is persuasive evidence that the problem exists twenty-four hours a day, seven days a week. I found the California ISO March 21, 2001 study by Anjali Sheffrin, the ISO's director of market analysis, to be compelling. Dr. Sheffrin concluded that economic withholding is a severe problem in all hours, not simply capacity constrained hours, and I agree. Her analysis concludes that from May to November 2000, withholding that led to inflated market prices in the ISO's real time market occurred in over 98% of hours. According to my calculations, the ISO declared a stage one or higher alert in only 5% of the hours during this period. For Dr. Sheffrin's study period, the price mitigation in place now would have missed the great bulk of the hours when market power drove up prices.

Question 2b. How does the spot market mitigation plan result in lower prices in other markets, such as the futures market or the long-term contract market?

Answer. Forward and futures contract prices are based on expectations of spot market pries in the future. To the extent that spot prices are expected to be reasonable, prices forward and futures contract prices will be reasonable. Thus, an effective spot market price mitigation program will result in reasonable forward contract prices. However, because I question the effectiveness of the mitigation program announced in the April 26th order, I have no basis to expect lower forward contract prices as a consequence of the program.

Question 2c. Does the fact that sellers outside California are not subject to the proxy price and refunds mean that the market may clear well above the proxy because of outside bids, so that the real effect is that prices in the spot market are still high?

Answer. The Commission's mitigation program applies only to the California ISO's real time and ancillary services markets and only during stage 1, 2, or 3 emergencies. During emergency conditions, prices in those markets will not "clear" at prices higher than the mitigated bid levels because sellers that bid above the mitigated bid levels and are dispatched will be paid only their bid. Those bids will not set the market clearing price. Paying those higher bids, however, will increase cus-

tomer bills. There is no limit to bids or prices when a stage 1, 2, or 3 emergency has not been declared by the ISO.

Question 3a. Can the mitigation plan be evaded?

The sellers outside California are not subject to the proxy system. What is to prevent generators inside California from selling to parties outside the state at a high price, then those parties selling back into California above the proxy price?

Answer. There is nothing in the Commission's mitigation program to prevent this evasive behavior as long as the sales to parties outside the state are contracted for ahead of time. The Commission's program requires California generators to make available to the ISO's real time market any power not previously contracted. But power may be committed to sellers outside of California in transactions made before the real time market hour. Those outside sellers could then resell the power into California. A uniform price mitigation program applied across the entire western interconnection would prevent such evasive behavior.

Question 3b. Marketers are required to show the price they paid for electricity in order to justify a bid above the proxy price. What is to prevent marketers from selling to one another at high prices then bidding into the market at that high price and so evading the proxy price?

Answer. There is nothing in the Commission mitigation program to prevent this type of evasive behavior. Again, a uniform price mitigation program applied across the entire western interconnection would prevent such behavior.

THE RTO CONDITION

Question 1. You have conditioned implementation of the mitigation plan on California's utilities filing a regional transmission organization proposal that is consistent with the requirements of Order No. 2000. What does "consistent with" mean? If CA files a plan that you reject or modify will you withdraw the plan? If they file a proposal that you accept conditionally will you withhold implementation until they meet the conditions?

Question 2. Does California have to file a proposal that incorporates it into a West-wide RTO in order to be consistent with Order No. 2000?

Question 3. If so, what is the likelihood of other states coming to an agreement with California? I know my home state of New Mexico at one point was considering joining together with the CA ISO, but has changed their minds about that as a result of the troubles in California markets. What can California do about that?

Answer. I dissented to the RTO filing condition in the April 26 order. The RTO filing condition stands for the proposition that the Commission will not fulfill its statutory obligation to ensure just and reasonable prices if the California ISO and all three California IOUs fail to make an RTO proposal. This condition is unlawful. We must fulfill our statutory obligations.

THE 206 INVESTIGATION

Question 1. Why is the investigation into markets in the rest of the West limited to spot markets and those periods when reserves are below 7 percent?

Answer. There is no reasonable rationale for limiting the western investigation to conditions when operating reserves fall below 7%. I dissented from the Commission's decision to so limit the investigation. The Commission should investigate the potential for market power to be exercised and unjust and unreasonable prices to be charged regardless of generation conditions.

Question 2. Do you know without investigation that the long-term firm contract market, for example, is producing prices that are just and reasonable?

Answer. No. There is no way to reach a rational conclusion regarding the reasonableness of contract prices without an investigation.

THE PROPOSED MITIGATION FOR THE REST OF THE WEST

Question 1. You have proposed that a plan somewhat similar to that ordered for California might be useful in the rest of the West. How would such a plan work, give that there are no clearly defined spot market institutions elsewhere to play the role that the CA ISO is playing in California?

Answer. The aspect of the Commission's California mitigation program that depends on a single market clearing price based on mitigated bids could not be applied to the rest of the west to develop non-California market clearing prices because there is no other centralized bid-based market in the west. Some means of capping or otherwise mitigating prices (instead of bids) would have to be developed. Another idea would be to simply extend the California mitigated market clearing price as a ceiling to the rest of the West. I have not given adequate thought to this last idea.

Question 2. You suggest that a plan would be in effect for the West in any time that reserves fall below 7 per cent in any control area. Does that mean that an implementation plan will be in effect for the whole West if reserves are low in a single small area?

Answer. I dissented from this limitation on when mitigation would be implemented. However, it is my understanding that mitigation would be implemented on a control area by control area basis. Prices would be mitigated on a sale made into a control area where reserves in that control area are below 7%.

THE DEMAND RESPONSE PROPOSAL

Question 1. You order that California utilities state a price at which they will curtail load. How might this mechanism work? Will customers have to tell the utilities their curtailment price, so that the utilities can assemble a collective demand response, or will the utilities make this judgment on their own?

Answer. Please see Chairman Hébert's response to this question.

Question 2. You suggest that a West-wide clearing-house for demand response might be instituted. Would this interfere with already existing state program? Are there issues in state law that would need to be dealt with before implementation of such a plan?

Answer. Please see Chairman Hébert's response to this question.

Question 3. You do not have jurisdiction over behavior by retail customers, which is what demand response ultimately comes to. Is there something we need to do in Federal Law that would allow you to consider demand response?

Answer. Please see Chairman Hébert's response to this question.

RESPONSES TO QUESTIONS FROM SENATOR CAMPBELL

Question 1. Why have a single market clearing price, especially since this will probably cost California more money?

Answer. Economists believe that in a centralized bid based market that is functioning well, a single market clearing price will keep costs down. A single market clearing price encourages sellers to bid something very close to their costs to ensure that they are dispatched. There is no reason to bid higher because sellers get paid the market clearing price if dispatched. Encouraging sellers to bid close the their costs helps ensure that the plants with the lowest costs are picked before more expensive ones. However, if seller's are able to exercise market power due to shortages or the ability to withhold plants, that market power must be mitigated directly.

Because I remain concerned about the California market, I still have an open mind on the single market clearing price. So far, however, the Commission has not dealt with the seller's market power directly.

Question 2. Could this possibly drive up prices in the West?

Answer. It is my view that prices throughout the West have been correlated with prices in California. To the extent prices are driven up in California for whatever reason, it is likely that prices will also rise in the rest of the West.

Question 3. I am skeptical of price caps. Many say they are likely a disincentive to investment in new generation. Won't they hurt in the long run?

Answer. Yes, price caps applied over the long term may act as a disincentive to new generation investment. I do not believe, however, that some type of price mitigation in the short term will result in such a disincentive. The price signal for new investment in the West has been sent many times over. The continued high prices in the West no longer are needed to signal the need for new generation.

Question 4. What does the FERC see as the best means to fix this problem?

Answer. My views on this question differ from those of the other Commissioners. I believe that an effective short term price cap applied to the entire western interconnection would achieve the following goals. First, it would remove the incentive for generators to withhold power from the market in order to drive up prices. Second, limiting prices would stop the economic bleeding in the region that is serving no legitimate economic purpose.

FEDERAL ENERGY REGULATORY COMMISSION,
OFFICE OF THE CHAIRMAN,
Washington, DC, June 14, 2001.

Hon. FRANK H. MURKOWSKI,
Ranking Member, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

DEAR SENATOR MURKOWSKI: Thank you again for giving me the opportunity to testify at the Committee's May 3, 2001, oversight hearing reviewing the Federal Energy Regulatory Commission's recent order addressing wholesale electricity prices in California and the Western United States.

On May 29, 2001, subsequent to the May 3, 2001 hearing, the Commission's mitigation plan became effective. Experience so far has been positive. Price mitigation has been triggered twice, on May 30 and 31, 2001, and prices fell during those events. In fact, electricity prices in California and throughout the West have trended significantly lower since May 29, 2001.

As you know, the Commission has taken and continues to take a number of actions to address the energy market situation in the West. These steps are detailed in the enclosed responses. Attached you will find answers prepared by the Commission's staff to the additional questions from yourself and Chairman Bingaman, and Senators Campbell, Cantwell, Craig, Thomas, and Dorgan, to be included in the hearing record.

Sincerely,

CURT L. HÉBERT, JR.,
Chairman.

[Enclosures]

RESPONSES TO QUESTIONS FROM SENATOR MURKOWSKI

Question 1. As I see it, the fundamental problem in California isn't a lack of regulation, it is a lack of generation and transmission. What are your views?

Answer. I agree with you. California's rolling blackouts are not caused by high wholesale prices in the West, but are caused by shortages of generation and insufficient transmission investment. These infrastructure shortages are the root cause of both rolling blackouts and high prices. More generation and transmission are greatly needed throughout the West and especially in California. We must ensure that new generation is built, that the transmission system is upgraded, that hydroelectric projects are licensed, and that new gas pipelines are built. We must also recognize that in the short-run there will be shortages of electricity during peak periods. Market-responsive wholesale and retail prices may offer the best, if not only, way of both minimizing blackouts in the short run, and maximizing the incentives to add the necessary new generation and transmission investment to secure California's long-term reliability.

The FERC continues to do what it can to encourage increases in generation and transmission in the West. The Commission recently streamlined regulatory procedures for wholesale electric power sales, expedited the certification of natural gas pipeline projects into California and the West, and urged licensees to review their Commission-licensed hydroelectric projects in order to assess the potential for increased generating capacity.

In addition to increased generation, a key element for stability in the western markets is investment in transmission facilities. The Commission recently approved a series of economic incentives aimed at ensuring upgrades to the western transmission grid. For projects that significantly increase transmission and can be in service by November 1, 2001, these incentives include increased rates of return on equity invested and accelerated depreciation rates.

The Commission's efforts alone will not solve the electricity crisis in California. However, together with state-level action within California to facilitate the siting of generation and transmission facilities, and to ensure more market-responsive retail pricing, our actions will provide additional incentives to increase power supplies in the western markets in the long run. Markets will do the rest—by providing clear price signals to stimulate the necessary new investment. While the Commission has found it necessary to impose price mitigation to protect consumers in the short-term, consumers will best be protected in the long-term if market forces are allowed to work.

Question 2. Is it correct that a large share of California's price volatility problems can be attributed to the State's insistence that investor-owned utilities divest their generation and acquire all of their power from the spot market instead of through self-generation and long-term contracts?

Answer. Yes. California, unlike most states, required investor-owned utilities to divest substantial generating assets and to sell all of their generation into and buy all of their energy needs from the California Power Exchange (PX), which resulted in total reliance on spot market purchases. The Commission, in its December 15 Order, eliminated the mandatory PX buy-sell requirement, which allowed the three investor-owned utilities to self supply about 25,000 MW subject to state regulation. The Commission encouraged market participants to develop long-term contracts for power, and required California market participants to preschedule all resources and loads with the ISO and limit their real-time energy purchases to no more than five percent of their load. In a key decision, issued on April 11, 2001, the United States Court of Appeals for the Ninth Circuit refused to disturb the Commission's approach to remedying the dysfunctional California electricity market structures.

Question 3. There are a lot of complaints that the price of natural gas at the border of California is too high. Has the California public utility commission opposed new pipelines and expansion of existing pipelines? What about California's local distribution companies?

Answer. In the past, the Public Utilities Commission of the State of California (CPUC) and the California local distribution companies frequently opposed interstate pipeline projects in California. However, in light of recent events in California's energy markets, California authorities are updating their knowledge of California's natural gas infrastructure, and may be more receptive to new pipeline proposals which enhance interstate natural gas deliveries to the state.

As recently as a year ago, the CPUC and Southern California Gas Company opposed a certificate authorizing Questar Southern Trails Pipeline Company to convert and operate an oil pipeline to provide open access gas service from the Four Corners area of Utah, Arizona, Colorado, and New Mexico into Southern California. (*Questar Southern Trails Pipeline Company*, 89 FERC ¶61,050 (1999); 92 FERC ¶61,110 (2000).) (At present, the Questar Southern Trails Pipeline is not operating.) In May, 2001, the staff of the California Energy Commission (CEC) issued a staff draft report on "Natural Gas Infrastructure Issues," examining the adequacy of California's natural gas delivery infrastructure. On June 5, 2001, the CEC held a public conference on these issues.

Question 4. Am I also not correct that the State of California has steadfastly insisted that all interstate pipelines end at the border of California, with interstate pipelines inside the border being subject to State jurisdiction? Isn't the net effect of this to deny California consumers the benefits of FERC's open access transportation program, which has saved consumers elsewhere in the U.S. billions of dollars?

Answer. Yes. In the Commission's proceedings authorizing the Kern River Gas Transmission Company, Mojave Pipeline Company, and Wyoming-California Pipeline Company systems, as well as the northward expansion of the Mojave system, the CPUC argued that it would have jurisdiction over those companies within California because they would be performing local distribution and would be exempt from Commission jurisdiction and subject to State regulation under both sections 1(b) and 1(c) of the Natural Gas Act. The Commission rejected this argument. (See, e.g., *Mojave Pipeline Company*, 41 FERC ¶61,040 at page 61,117 (1987). See also *Public Utilities Commission of the State of California* v. *FERC*, 900 F. 2d 269 (D.C. Cir. 1990) (affirming Commission certification of interstate pipeline into California).

RESPONSES TO QUESTIONS FROM SENATOR BINGAMAN

THE CALIFORNIA MITIGATION PLAN

Question 1a. How easy or hard is the mitigation plan to implement?

The ISO is charged with developing a proxy price for every gas plant in California for every hour. Is that a huge burden, or something they already have the capacity to do?

Answer. The ISO, in its May 18, 2001 status report, stated that it was actively working towards implementing the Commission's plan. The ISO reported that it would have in place by May 29, 2001, a manual process for implementing mitigation. The ISO has since done so. The ISO also stated in its May 18 status report that it will have an electronic version fully operational by July 1, 2001. The ISO should be able to use a computer formula to generate the proxy rate.

Question 1b. Does the after-the-fact justification of bids that are above the proxy price impose a huge burden on the Commission?

Answer. Evaluating the justification for bids imposes a burden on the Commission, but one that should not be extreme, depending on how many bids are above the proxy price. Under the price mitigation approach in effect from January until recently, the number of hourly transactions requiring justification was 69,522 in

January; 71,890 in February; 34,488 in March; and 15,057 in April. While I cannot predict the number of bids that will be above the proxy price under the new price mitigation approach imposed by the Commission effective May 29, the *ex ante* nature of the new proxy price mechanism will provide advance price certainty to the market, which should lead to fewer transactions requiring justification.

Question 1c. Would a pre-set price cap be easy to administer while getting a similar result?

Answer. Setting seller-specific price caps based on each seller's own costs would be difficult administratively, because the Commission would have to gather extensive cost data and make separate findings for each seller. Such a process would be time- and litigation-intensive. Setting a single cap for all sellers would be easier to administer but would raise the problem that, on some days, the price cap could be lower than the costs incurred by sellers for fuel and emission allowances, while on other days, the price cap could be too high. In contrast, the Commission's mitigation plan is based on the prices generators would be expected to bid on a daily basis based on current costs.

A price cap also would have adverse effects compared to the Commission's approach. Price caps would discourage investment in new generation which California desperately needs and can create incentives for suppliers to sell their power in markets without price ceilings, creating greater shortages of power. Indeed, when price caps have been tried before in California, the ISO was forced to petition the Commission for emergency relief from the caps in order to enable it to avoid shortages and obtain the power it needed. (See California Independent System Operator Corporation, 93 FERC ¶61,239 (2000).) Price caps also can discourage investment in technology that will make generating units more efficient. Instead of using inflexible price caps, the Commission's market mitigation plan seeks to replicate competitive markets and maintain incentives to supply California as well as increase investment in making generating units more efficient and environmentally friendly.

Question 1d. How accurate is the information that is used? In other words, will lots of plants have gas prices above the average that the ISO will use, so that all of them will be trying to justify prices above the proxy price, or will it just be a few? Does the use of an average gas price guarantee a lot of prices above the proxy price? Is there a similar problem with the emissions prices?

Answer. The proxy price is recalculated each day based on current market costs for natural gas and emission allowances. Individual sellers may have higher costs on a given day depending upon their contractual arrangements for buying these inputs. I cannot predict how many sellers will be in those circumstances on any given day. However, those sellers will be required to justify any sale of power above the proxy price.

Question 2a. Does the mitigation plan actually result in lower prices?

The proxy system is similar to the system you used to develop the refund numbers for the last few months. Have you looked at the market to determine whether prices outside the time that you applied the proxy price were higher or lower? Do you intend to do so in the future? It seems that this would help determine whether the plan is being applied broadly enough or not. Do you intend to use some kind of measuring stick like this to keep a check on the effectiveness of this system?

Answer. The Commission's market monitoring and price mitigation plan took effect only recently, on May 29. The Commission will be receiving bid data for all hours (i.e., not simply during system emergencies) and will monitor that data to determine the effectiveness of its price mitigation approach. The Commission's price mitigation plan seeks to replicate the prices that would occur in a competitive market. By doing so, the plan will ensure that prices are just and reasonable.

Experience so far has been positive. Although the Commission's mitigation plan went into effect in California on Tuesday, May 29, 2001, there were no alerts, and hence no price mitigation occurring on that day. Price mitigation was triggered during portions of the day on Wednesday, May 30, 2001, and Thursday, May 31, 2001, when the California ISO called Stage I emergencies. As a result, prices for hourly imbalance energy, which had risen to around $299 per MWh before the emergency alert on Wednesday, fell to $120, and rose no higher than $135 per MWh during the rest of the day. On Thursday prices rose to $130 per MWh prior to the emergency, but fell to $109 per MWh when mitigation began, and fell further to $64 per MWh. Although no emergencies nor price mitigation occurred during the period from June 1 to June 4, 2001, prices remained relatively modest, not exceeding $150 per MWh, and generally trending below $100 per MWh for most hours.

The Commission's market monitoring and price mitigation plan took effect on May 29, 2001. The following table (Table 1) shows Western electricity spot prices before and after mitigation:

Table 1.—WESTERN ELECTRICITY PRICES ($/MWh)

Date	COB	Mid-Columbia	NPIS	Palo Verde	SPIS
Mid-Week Daily Spot Prices					
4-Apr	$314	$316	$267	$237	$237
11-Apr	$388	$383	$347	$181	$178
18-Apr	$262	$271	$258	$230	$224
25-Apr	$318	$313	$296	$292	$281
2-May	$246	$252	$225	$220	$212
9-May	$443	$438	$476	$455	$479
16-May	$247	$247	$235	$222	$211
23-May	$419	$415	$410	$385	$381
Daily Spot Prices Following Mitigation					
29-May	$165	$161	$163	$153	$130
30-May	$127	$122	$128	$129	$117
31-May	$180	$177	$175	$176	$151
1-Jun	$153	$151	$156	$165	$150
4-Jun	$167	$160	$163	$178	$153
6-Jun	$102	$100	$114	$118	$105
6-Jun	$ 62	$ 60	$ 75	$ 90	$ 75

Price Chart Labels: "COB" is the California-0regon Border price. Mid- Columbia is a market pricing point located in the Pacific Northwest. "NP15" is north of Path 15, and represents prices in northern California. "SP15" is south of Path 15, and represents prices in southern California. Palo Verde is located in Arizona near the California border, and represents prices in the Southwestern United States.

Question 2b. How does the spot market mitigation plan result in lower prices in other markets, such as the futures market or the long-term firm contracting market?

Answer. In fashioning its market mitigation plan for California in the April 26, 2001 order, the Commission carefully considered the supply and demand circumstances faced during all periods in the marketplace. Prices in the daily spot market, the day ahead market, and longer term bilateral contracts are strongly interrelated. In the long term, each represents an alternative to the other, as long as they are available. However, as the time between commitment and consumption shortens, alternatives become fewer. Buyers and sellers price electricity sales to reflect, among other factors such as demand, the opportunities available in these different products. Futures prices are related to physical products in a similar manner. Although electricity futures are not themselves substitutes for the physical product, the open expiration of a futures contract results in the requirement for physical delivery, which provides an ultimate linkage back to spot market sales, prices.

Given these linkages, the lowest priced service generally sets the value basis for all services. To the extent the Commission can succeed in crafting a well-functioning short-term electricity market in California without barriers which might prevent purchasers from using these services as one of many alternative energy supplies, long-term firm contracts, and futures prices should also be beneficially affected.

Question 2c. Does the fact that sellers outside of California are not subject to the proxy price and refunds mean that the market may clear well above the proxy price because of outside bids, so that the real effect is that prices in the spot market are still high.

Answer. No. Under the mitigation plan, generators outside of California can accept the market clearing price determined by the proxy methodology (in which case, their bid will not affect the price) or submit their own bid. If they submit a separate bid, that bid will be paid (if they are dispatched), but the bid will not affect the market clearing price in the ISO's real-time market.

Question 3a. Can the mitigation plan be evaded?

The sellers outside California are not subject to the proxy system. What is to prevent generators inside California from selling to parties outside the state at a high price, then those parties selling back into California above the proxy price?

Answer. Your question raises an issue commonly referred to as "megawatt laundering." The April 26, 2001 order, at p. 12, acknowledged concerns regarding "megawatt laundering." In response, the order recognized that the California market is integrated with those of other states and, for that reason, FERC is instituting a West-wide, Federal Power Act Section 206 investigation into public utility sales for resale. The order solicited public comment on the proposed West-wide investigation. This issue is pending before the Commission on rehearing of its April 26 Order.

Thus, I cannot comment on the merits of this issue. However, I recognize that the issue is an important one and warrants careful consideration by the Commission on rehearing. The Commission's price mitigation plan just became effective on May 29, 2001, and experience to date has been very good. But, if this concern about "laundering" is realized, I would consider modifying the Commission's approach to ensure the effectiveness of its price mitigation mechanism.

Question 3b. Marketers are required to show the price they paid for electricity in order to justify a bid above the proxy price. What is to prevent marketers from selling to one another at high prices then bidding into the market at that high price and so evading the proxy price?

Answer. This issue is pending before the Commission on rehearing of its April 26 Order. Thus, I cannot comment on the merits of this issue. However, this issue also will receive careful consideration by the Commission on rehearing.

THE RTO CONDITION

Question 1. You have conditioned implementation of the mitigation plan on California's utilities filing a regional transmission organization proposal that is consistent with the requirements of Order No. 2000. What does "consistent with" mean? If CA files a plan that you reject or modify will you withdraw the plan? If they file a proposal that you accept conditionally will you withhold implementation until they meet the conditions?

Answer. Order No. 2000 set forth the essential characteristics and functions required of regional transmission organizations (RTOs) but also left significant flexibility to adapt to regional needs. RTO filings were made by the California ISO and the three California investor-owned utilities on June 1, 2001. The Commission currently is reviewing the merits of the filings and I cannot prejudge the Commission's response to them.

Question 2. Does California have to file a proposal that incorporates it into a West-wide RTO in order to be consistent with Order No. 2000?

Answer. I cannot comment upon or prejudge the acceptability of the RTO filings made on June 1. However, the Commission's April 26, 2001 Order on RTO West made it clear that a West-wide RTO was a long-term goal—not a requirement for filing.

Question 3. If so, what is the likelihood of other states coming to an agreement with California? I know my home state of New Mexico at one point was considering joining together with the CA ISO, but has changed their minds about that as a result of the troubles in California markets. What can California do about that?

Answer. As noted above, a West-wide RTO is not a requirement for filing. I cannot assess the likelihood of other western states joining with California, especially during these difficult times. However, the western states have an excellent history of acting cooperatively in electric industry coordination. Regional coordination has been taking place through the Western Governor's Association, the Western Systems Coordinating Council, the Western Regional Transmission Association, the Committee on Regional Electric Power Cooperation and other groups. In addition, the CA ISO and RTO West have created a joint technical group to work on interregional coordination issues.

It is important for California to work with other states within the Western region to stabilize the energy markets in the west. I expect RTO West, as well as participants in other RTO efforts under consideration in the West, to work cooperatively with the California ISO to develop comprehensive solutions to the problems confronting western markets.

THE 206 INVESTIGATION

Question 1. Why is the investigation into markets in the rest of the West limited to spot markets and those periods when reserves are below 7 percent?

Answer. The Commission proposed to adopt mitigation measures in the West that, to the extent possible, mirror those being applied in California. The California investigation (which was initiated in August 2000) was limited to the markets operated by the California ISO and PX, i.e., spot energy and ancillary services markets. In addition, the price mitigation in those markets applies to spot markets when reserves are deficient. I note that parties in both proceedings have filed comments asking the Commission to expand the scope of the West-wide investigation and the scope of the mitigation. Thus, I cannot comment further on these pending issues.

Question 2. Do you know without investigation that the long-term firm contract market, for example, is producing prices that are just and reasonable?

Answer. The allegations in recent months regarding unjust and unreasonable prices in California and the West have focused on spot market prices. These mar-

kets are the closest in time to when load must be met and therefore can exhibit the highest prices in times of shortage. Forward markets, on the other hand, present buyers with more time and options, and offer greater rate stability and certainty. Pursuant to its authority under section 206 of the Federal Power Act, the Commission will investigate any complaints that prices in long-term contracts are unjust and unreasonable. (See, *San Diego Gas and Electric Company* v. *Alamito Company*, 46 FERC ¶61,363, at p. 62,125 (1989).) In doing so, the Commission must consider all of the rates, terms and conditions of a long-term contract for the full duration of the contract, instead of merely a "snapshot" of the contract at one time.

The Commission's market monitoring and price mitigation plan took effect on May 29 of this year. Since this plan has been in effect, electricity prices in California have fallen sharply as illustrated in Table 1, presented earlier within these responses.

THE PROPOSED MITIGATION FOR THE REST OF THE WEST

Question 1. You have proposed that a plan somewhat similar to that ordered for California might be useful in the rest of the West. How would such a plan work, given that there are no clearly defined spot market institutions elsewhere to play the role that the CA ISO is playing in California?

Answer. As your question recognizes, the goal of the West-wide investigation initiated in the April 26, 2001 order is to mirror the California mitigation plan. The order instituted a Federal Power Act section 206 investigation into the rates, terms and conditions of public utility sales for resale of electric energy in interstate commerce in the WSCC other than sales through the California ISO markets, to the extent that such sales for resale involve: (1) electric energy sold in spot markets (i.e., up to 24 hours in advance); and (2) take place during conditions when reserves (as defined by the WSCC) for any control area fall below 7 percent. The order proposed that all non-hydroelectric generators and marketers in the WSCC with energy operationally and contractually available in real-time (public utilities and non-public utilities) would be required to offer that real-time energy for sale at that time. The generators would not be required to sell that energy into California; they would only have to offer the power for sale in any location. Any sales made in other (non-California) spot markets in the WSCC would also be subject to price mitigation, but that mitigation would be limited to system conditions when contingency reserves (as defined by the WSCC) for any control area fall below 7 percent. The order sought comment on what this price mitigation should be.

As FERC established proceedings which purposely invited comment on this and other aspects of the West-wide mitigation proposal, and those comments are currently before the Commission, I am unable to comment further on the issues raised by this question.

Question 2. You suggest that a plan would be in effect for the West in any time that reserves fall below 7 percent in any control area. Does that mean that an implementation plan will be in effect for the whole West if reserves are low in a single small area?

Answer. The April 26, 2001 order instituting the West-wide investigation, at p. 30, states that any sales made in other (non-California) spot markets in the WSCC would be subject to price mitigation, but that mitigation would be limited to system conditions when reserves for any control area fall below 7 percent. The order requested comments on the details of this price mitigation.

As FERC established proceedings which purposely invited comment on this and other aspects of the West-wide mitigation proposal, and those comments are currently before the Commission, I am unable to comment further on the issues raised by this question.

THE DEMAND RESPONSE PROPOSAL

Question 1. You order that California utilities state a price at which they will curtail load. How might this mechanism work? Will customers have to tell the utilities their curtailment price, so that the utilities can assemble a collective demand response, or will the utilities make this judgment on their own?

Answer. The Commission did not impose a "one-size-fits-all" approach on how utilities should implement demand-side bidding. Thus, each utility may implement an approach that fits its circumstances, including any contracts it may have with retail customers and any programs it may have for implementing retail load reduction. Generally, I would expect the utility's demand-side bids to reflect the expressed willingness of its customers to reduce load at certain prices. Thus, if 20 percent of a utility's customers indicate their desire to curtail usage when prices reach a specific

level, and its other customers indicate a desire to continue consuming power, the utility could submit a demand-side bid corresponding with this consumption pattern.

Question 2. You suggest that a West-wide clearing-house for demand response might be instituted. Would this interfere with already existing state programs? Are there issues in state law that would have to be dealt with before implementation of such a plan?

Answer. The Commission wishes to do what it can to promote demand reductions as a means of alleviating the supply/demand imbalances in Western markets, and does not want to interfere with existing state programs aimed at achieving demand reductions. As the Commission recently stated in its Order Removing Obstacles in Docket No. EL01-47-000, the Commission is promoting wholesale programs that complement existing state demand-side management programs, and our goal is not to supersede state authority over retail customers, but to work cooperatively with the states to achieve a common good.

Question 3. You do not have jurisdiction over behavior by retail customers, which is what demand response ultimately comes to. Is there something we need to do in Federal Law that would allow you to consider demand response?

Answer. See the answer to question 2 above. I believe that the combination of existing state and Federal authority is currently sufficient.

RESPONSES TO QUESTIONS FROM SENATOR CAMPBELL

Question 1. Why have a single market clearing price, especially since this will probably cost California more money?

Answer. As explained by economist Alfred E. Kahn and other notable economists in a study by the Blue Ribbon Panel Commissioned by the California Power Exchange on January 23, 2001, an auction that pays all accepted sellers a single, market-clearing price will, in practice, generally result in lower prices than an as-bid auction. Moreover, a single clearing price auction offers the following advantages over as-bid auctions. First, a single market clearing price auction encourages construction of efficient, new generation. Generators that can build and operate at a cost less than the expected future market clearing price will see that they can profit by entering the market. The additional, more efficient supply will lower prices and benefit consumers.

A single price auction also encourages all generators to reduce their costs and their bids. All generators, including the least efficient generators, have an incentive to reduce their costs. All generators will attempt to come in below the clearing price so they can profit. Bids above the clearing price will result in no sales and, therefore, no revenues. Lower bids mean lower prices for consumers.

Finally, a single price auction encourages the lowest bids. When the price is set by a single price auction, competitive generators have an incentive to bid their running costs, because they know that they will make a profit by being paid the clearing price. But when there is no single price auction, generators will bid above their running costs, because this is the only way they can be sure they will make a profit. As they guess at the potential market clearing price, they could end up bidding higher than what a single market clearing price would have been. As a result, pay-as-bid auctions are not as likely to result in lower prices for consumers.

Question 2. Could this possibly drive up prices in the West?

Answer. No, that is not likely. As noted above, an auction that pays all accepted sellers a single, market-clearing price will, in practice, generally result in lower prices than an as-bid auction. However, there are many factors underlying high prices recently experienced by California and the West, most notably insufficient supply and inadequate transmission capacity.

The Commission's market monitoring and price mitigation plan took effect on May 29, 2001. Table 1, presented earlier within these responses, shows Western electricity spot prices before and after mitigation.

Question 3. I am skeptical of price caps. Many say they are likely a disincentive to investment in new generation. Won't they hurt in the long run?

Answer. Price caps are not the long-term solution and would only make the situation worse. They do not promote long-term consumer welfare as they will not increase energy supply or encourage conservation.

Question 4. What does the FERC see as the best means to fix this problem?

Answer. In general, market-based solutions offer the most efficient solution to the problems confronting California and the west. Infrastructure improvements are greatly needed throughout the West and especially in California. Appropriate financial incentives are needed to ensure that new generation is built, that the transmission system is upgraded, that hydroelectric projects are licensed, and that new gas pipelines are built. Without these upgrades, constraints and bottlenecks increas-

ingly will block energy supplies from reaching load. In addition, purchasers must also have the ability to reduce load in response to high prices.

The Commission has ordered a range of measures to promote a better balance of supply and demand, but its jurisdiction is limited. The Commission can and has 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. State regulators also have the most significant authorities to encourage demand reduction measures, which can greatly mitigate the energy problems in California and the West.

Question 5. How will your new orders affect the rural electric associations, the co-ops?

Answer. Sales by co-ops (and other non-public utilities such as municipal utilities) under bilateral agreements will not be affected by the Commission's April 26 Order. Co-ops in California that voluntarily use the ISO's transmission facilities or sell into the ISO's markets are subject to the same price mitigation as other utilities and the same requirement to offer available power for sale in real-time, but only for electric energy that is available in real-time and not already scheduled to run under a bilateral arrangement. It is my understanding that very few co-ops sell into the California ISO spot market. Absent this approach, the Commission could not fulfill its statutory duty to ensure the justness and reasonableness of jurisdictional prices. For sales in Western States other than California, the Commission proposed to adopt a similar approach to co-ops and other non-public utilities; the Commission has received comments on this proposal and intends to issue an order in the near future. Throughout the West, co-ops are typically wholesale power purchasers, and our price mitigation should help them.

Question 6. What can we all do to ensure that the rest of the Western region is minimally affected by the crisis in California, because I don't want my home state of Colorado's resources and consumers hit by these problems?

Answer. The most important measure is to ensure that infrastructure (generating facilities, transmission lines and natural gas pipelines) can be built when and where needed, without unreasonable impediments. Another important step is to provide price signals for new supplies and conservation by not capping prices artificially. Finally, utilities should be allowed to purchase needed power under long-term arrangements when it is economical, instead of being forced to buy power only in spot markets.

Responses to Questions From Senator Cantwell

Question 1. Consider the situation in Washington state. We've already experienced retail rate increases in the high double-digits, suffered plant closures and job loss as a result of skyrocketing electricity costs, and are facing the prospect of a BPA rate increase this fall that threatens to further undermine the economic health of the entire region. Do you believe prices in the Pacific Northwest are just and reasonable?

Answer. Prices in the Pacific Northwest may not be just and reasonable under certain conditions. For this reason, the Commission recently instituted an investigation into the rates, terms and conditions of certain wholesale sales by public utilities within the Western Systems Coordinating Council. The Commission has received comments in this investigation and will address the issues in the near future.

The Commission's market monitoring and price mitigation plan took effect on May 29, 2001. Table 1, presented earlier within these responses, shows Western electricity spot prices before and after mitigation.

Question 2. How do you make the case that FERC has upheld its statutory mandate to ensure just and reasonable rates at all times and in all markets?

Answer. Under the Federal Power Act, the Commission can order changes to existing rates, and practices and contracts affecting those rates, only upon finding those rates to be unjust and unreasonable. In its December 15, 2000 order, the Commission found that, under prior market rules and under certain conditions, prices in spot markets in California were not just and reasonable. Consistent with the Federal Power Act, the Commission ordered changes to the market rules governing California's spot markets and also ordered additional market monitoring and price mitigation. On March 9, 2001, the Commission implemented the price mitigation that was ordered in the December 15 order. A federal appeals court recently rejected challenges to the primary remedy adopted by the Commission in the December 15 order, characterizing the Commission's approach as a "middle ground between the need for temporary price mitigation and the realization that competition must exist for the California energy market to survive in the long run." *California Power Exchange Corp.* v. *FERC*, No. 01-70031, 2001 U.S. App. LEXIS 6153 (9th Cir. April

11, 2001). The same court recently rejected another challenge to the Commission's actions. *John L. Burton, et al.* v. *FERC*, No. 01-70812 (9th Cir. May 29, 2001).

In its April 26, 2001 order, the Commission adopted a new approach to price mitigation for the California ISO's spot markets, and proposed to adopt a similar approach for spot markets throughout the West, to ensure that rates are just and reasonable. The Commission will act on its proposals for Western States other than California in the near future.

The Commission has not found that rates are unjust and unreasonable at all times and in all markets. Unless such a claim is supported on the record, the Commission has no authority under the Federal Power Act to impose a remedy applicable at all times and in all markets. That said, prices in the spot markets and in more forward markets are influenced by each other and a decline in spot prices should result in lower prices generally.

Question 3. What specific elements of this order promise relief for Washington state consumers?

Answer. The April 26, 2001 order's most direct means of short-term relief for Washington state consumers is its Federal Power Act Section 206 investigation into the rates, terms and conditions of public utility sales for resale of electric energy in spot markets in the Western Systems Coordinating Council (WSCC) (order at p. 30-31). The investigation portion of the order seeks comment on the Commission's proposal to require all non-hydro-electric generators and marketers in the WSCC to offer all available energy in the spot market at any non-California location; and to subject any sales made in non-California spot markets in the WSCC to price mitigation, with the form of that price mitigation to be determined following review of comments. The proposed mitigation would be limited to system conditions when reserves for any control area fall below 7 percent; and condition the market-based rate authority of public utility sellers selling in the WSCC region to ensure that they do not engage in anti-competitive behavior.

The April 26, 2001 order recognizes that FERC is limited in its ability to solve all of the problems facing California and the West. However, the order, coupled with previous orders addressing California and the West, seeks to remove regulatory obstacles and provide incentives to increase investment in needed infrastructure, including ensuring that new generation is built, that the transmission system is upgraded, and that new gas pipelines are built. FERC has also sought to get California's market situation under control through, among other things, moving electricity purchases to serve load from the spot market to long-term contracts.

In addition, the April 26, 2001 order included a number of conditions which were designed to prevent anti-competitive behavior during all hours and not just during hours when emergencies are declared by the ISO. Among the measures is the conditioning of market-based rate authority on not withholding available supply and not engaging in other anti-competitive behaviors; the coordination of planned outages by the California ISO; FERC's monitoring of unplanned outages; requiring all generators with Participating Generator Agreements (PGAs), as well as all non-public utility generators in California which sell through the ISO markets or currently use the ISO's interstate grid, to sell all available supply into the ISO's spot market; requiring ISO buyers to submit demand reduction bids by hour, amount, and customer; and the monitoring of all bids in all hours by the ISO and FERC through an ISO weekly report. Removing the volatility of prices in California through price mitigation should have a beneficial effect on prices in the West. This is evinced by Table 1, presented earlier within these responses.

Question 4. I do appreciate that your April 26 order institutes an investigation into wholesale prices throughout the West. As I've tried to illustrate in my remarks, this is a crisis that is having profound effects throughout the Northwest and promises to reverberate throughout the nation if left unchecked. I'm concerned, however, about the scope of this Section 206 proceeding. The investigation will only take up transactions that occur up to 24-hours in advance on the spot market, and only during California emergencies. This includes very few hours, particularly in the Northwest where most of our transactions are done under longer-term contracts. Shouldn't you be investigating the broader issue of why prices remain extremely high (and very much above costs) for all types of transactions across the entire West Coast?

Answer. As part of its investigation into California's spot markets, the Commission also received information about the circumstances in spot markets in other parts of the West. Based on this information, the Commission concluded that rates, terms and conditions for sales in spot markets in these areas may not, under current market rules and under certain conditions, be just and reasonable and should be modified. On this basis, the Commission instituted its West-wide investigation in the April 26 Order. The information available to the Commission did not warrant

a finding that rates, terms and conditions are unjust and unreasonable for all types of transactions. However, I note that parties in the proceeding have filed comments on both the scope of the investigation and the scope of the proposed mitigation and therefore I cannot comment further on these pending issues.

Pursuant to its authority under section 206 of the Federal Power Act, the Commission will investigate any complaints that prices in long-term contracts are unjust and unreasonable. (See, *San Diego Gas and Electric Company* v. *Alamito Company*, 46 FERC ¶61,363, at p. 62,125 (1989).) In doing so, the Commission must consider all of the rates, terms and conditions of a long-term contract for the full duration of the contract, instead of merely a "snapshot" of the contract at one time.

Question 5. As you may recall, I submitted to you a question at our March 15 hearing about why FERC's order regarding potential refunds for California did not include the Northwest. I appreciated receiving your written response, but based on your answer, I am not fully satisfied that Northwest ratepayers will eventually receive the refunds they may very well deserve. You cited the Commission's considerable discretion in establishing "just and reasonable rates," that FERC did not want to "blunt the price signals needed to induce supply entry," and that "fundamental differences" in the structure of the markets would make it difficult to adapt the approach the Commission has used for California to the Northwest. Now, in your April 26 order and as you've testified today, the Commission has solicited 10 days' worth of comments on putting in a price mitigation plan for the entire WSCC that would resemble the one you're putting in place for California. The order also makes mention of potential refunds. The language, however seems a bit ambiguous. Could you please more fully articulate what, precisely, FERC is proposing West-wide, and how/if this relates to the Section 206 investigation and potential refunds?

Answer. The Commission's April 26, 2001 order established an investigation into the rates, terms and conditions of public utility sales for resale of electric energy in interstate commerce in the Western Systems Coordinating Council (WSCC) other than sales through the California ISO markets. This investigation applies to sales for resale that involve electric energy sold in spot markets (up to 24 hours in advance), and which take place when contingency reserves fall below 7 percent.

The Commission is proposing three measures in connection with the WSCC investigation. The three measures are:

(1) requiring all non-hydroelectric generators and marketers in the WSCC to offer for sale any available electric energy not scheduled in real-time pursuant to a bilateral arrangement;

(2) instituting price mitigation when reserves fall below 7 percent; and

(3) prohibiting public utility sellers selling in the WSCC region from engaging in anti-competitive behavior discussed in the April 26 order.

The April 26 order also established the earliest refund effective date permitted by section 206 of the Federal Power Act with respect to the West-wide investigation, which is 60 days after publication in the Federal Register. This means that the Commission will have the discretion to order any unjust and unreasonable amounts to be refunded for rates charged in the WSCC spot markets other than California beginning July 2, 2001, through a period 15 months thereafter. (See section 206(d) of the Federal Power Act (as amended by P.L. 100-473, October 6, 1988).) Please note that the refund effective date and therefore the Commission's refund authority, associated with the West-wide investigation differs from that in the California investigation. The refund effective date with respect to the California investigation is October 2, 2000.

Question 6. Aside from my vigorous insistence that FERC recognize and address the situation in the Northwest, I also have a number of qualms about the technical elements of this order and how well its price mitigation mechanism will actually work in California. I agree with Senator Feinstein's assessment that this order doesn't go nearly far enough. And to the extent it does attempt to moderate prices, I'm afraid it is so riddled with potential loopholes as to be ineffective. I'm concerned about unintended consequences in California—and especially if you intend to export the mechanics of this model to the rest of the West. Specifically, the order requires California generators to offer the ISO all of their capacity in real time, during all hours, if it is available and not scheduled to run through bilateral contracts. The thinking, according to the order, is that a generator "should be willing to sell that energy at a price that covers its marginal costs, since it has no alternative purchaser at that time." Is it true then, that as long as the ISO has not declared an alert, generators can demand as high a price as possible—one far exceeding marginal costs?

Answer. It is true that there is no price mitigation during periods when no emergency has been declared by the ISO. This is premised on there being sufficient supply during non-emergency hours to discipline price. However, the Commission made

clear that it would revoke the market-based rate authority of any seller, or take other appropriate action against any seller, which withholds available supply or engages in other anticompetitive behaviors in any hour. In addition, the order required the ISO to monitor all bids in all hours and file with FERC a weekly report, which will enable FERC to monitor for any anticompetitive behavior. Moreover, all public utility generators, as well as all non-public utility generators, in California which sell through the ISO markets or currently use the ISO's interstate grid, must sell all available supply into the ISO's spot markets during all hours.

Thus, the Commission's market monitoring and price mitigation plan operates during all hours of the day, not simply during those hours when the ISO has declared a system emergency. I note that, although the Commission's mitigation plan went into effect in California on Tuesday, May 29, 2001, there were no alerts, and hence no price mitigation occurring on that day. Price mitigation was triggered during portions of the day on Wednesday, May 30, 2001, and Thursday, May 31, 2001, when the California ISO called Stage I emergencies. As a result, prices for hourly imbalance energy, which had risen to around $299 per MWh before the emergency alert on Wednesday, fell to $120, and rose no higher than $135 per MWh during the rest of the day. On Thursday prices rose to $130 per MWh prior to the emergency, but fell to $108 per MWh when mitigation began, and fell further to $64 per MWh. Although no emergencies nor price mitigation occurred during the period from June 1 to June 4, 2001, prices remained relatively modest, not exceeding $150 per MWh, and generally trending below $100 per MWh for most hours.

The Commission's market monitoring and price mitigation plan took effect on May 29, 2001. Table 1, presented earlier within these responses, shows Western electricity spot prices before and after mitigation.

Question 7. What prevents California generators from entering into bilateral agreements with marketers at high, uncapped prices?

Answer. See answer to question number 8 below.

Question 8. Further, during ISO emergency conditions, marketers bidding higher than the market clearing price would, according to the order, "be required to justify the bid based on the prices they paid for power." What prevents marketers from paying high prices to generators, and then passing those costs on to the ISO?

Answer. Power sellers and purchasers are free to enter into bilateral contracts at terms agreeable to both entities. In fact, FERC has encouraged and continues to encourage sellers and purchasers to enter into mutually agreeable, long-term bilateral contracts.

Your question raises an issue commonly referred to as "megawatt laundering." The April 26, 2001 order, at p. 12, acknowledged concerns regarding "megawatt laundering." In response, the order recognized that the California market is integrated with those of other states and, for that reason, FERC is instituting a West-wide, Federal Power Act Section 206 investigation into public utility sales for resale. The order solicited public comment on the proposed West-wide investigation. This issue is pending before the Commission on rehearing of its April 26 Order. Thus, I cannot comment on the merits of this issue. However, I recognize that the issue is an important one and warrants careful consideration by the Commission on rehearing. The Commission's price mitigation plan just became effective on May 29, 2001, and experience to date has been very good.

Question 9. So if the ISO rejects a marketer's bid because the price is too high, how does the order assure that the generator will be made available to sell to the ISO? After all, as the order notes, "Marketers generally have a portfolio of energy supplies and often sell energy numerous times. It, therefore, would be exceedingly difficult to try and trace energy back to the generating source . . ."

Answer. First of all, the April 26, 2001 order's must-sell requirement is independent of price mitigation, and operates during all hours. Under the scenario you describe, the marketer's bid would have been rejected because the ISO determined that it had sufficient resources at a lower price than that offered by the marketer to meet expected load. At that point, the marketer could seek to sell elsewhere. However, if it had no alternative market in which to sell its power, and the ISO later determined that the marketer's supply was needed to meet load, the April 26, 2001 order's must-sell requirement would obligate the marketer to offer its supply to the ISO. Second, all California generation and all sales by marketers in California spot ISO markets are subject to price mitigation. Thus to the extent the marketer sought a price in excess of the market clearing price, such a bid must be justified. Thus, if the ISO requires the supply but the marketer's bid exceeds the proxy price, the ISO will accept the bid subject to justification and refund.

Question 10. Several parties have raised concerns, as noted in the order, about so-called "megawatt laundering," where a supplier schedules supply out-of-state and then reimports that power to avoid a mitigated price. Doesn't all this assume that

marketers can't game the system, including by selling outside the state of California?

Answer. The April 26, 2001 order, at p. 12, acknowledged concerns regarding "megawatt laundering." In response, the order recognized that the California market is integrated with those of other states and, for that reason, FERC is instituting a West-wide, Federal Power Act Section 206 investigation into public utility sales for resale. The order solicited public comment on the proposed West-wide investigation.

As FERC established proceedings which purposely invited comment on this and other aspects of the West-wide mitigation proposal, and those comments are currently before the Commission, I am unable to comment further on the issues raised by this question.

*Question 11.*These technical issues illustrate a simple point: we need a common-sense, consistent solution throughout the West that will restore rationality to the market over the next two years. You have repeatedly questioned how a simple price cap could be effective. About a decade ago, I understand that the WSCC had a short-term wholesale power tariff—cost of generation, plus 28 mills—that applied to all systems. At the time, if you wanted to buy power at a certain price, you had to be willing to sell at that same price. This seems like a simple, common-sense model, relative to the one you have proposed here. Please explain why the price mitigation mechanism proposed in your order is preferable.

Answer. The program you describe allowed voluntary sales at prices below the costs of a hypothetical average utility (based on data filed by the FERC-regulated participants). This approach was preferable to seller-specific rates based on each seller's costs because it allowed efficient trading by willing sellers and buyers when both were able to benefit at prices higher than seller-specific cost-based rates but lower than the prices calculated from the aggregated cost data. Mandating such an approach now would require abrogating voluntary contracts, which would most likely create more uncertainty in the marketplace.

The Commission's price mitigation mechanism seeks to replicate pricing in a competitive market. I believe the power generation industry will better meet the needs of consumers if prices are allowed to balance supply and demand. When prices increase, suppliers will build more and consumers will conserve more, thus driving prices down. This is exactly what has happened in recent weeks. Price caps reduce the incentive for suppliers to produce and consumers to conserve.

Question 12. The order also conditions implementation of California's market mitigation plan on the California ISO and the three investor-owned utilities filing a regional transmission organization (RTO) proposal by June 1, 2001. Setting aside for today the debate about merits of Western RTOs, my question is how can you make exercise of your statutory mandate to ensure just and reasonable rates contingent upon something altogether unrelated—namely RTO development? Further, does the Commission have a back-up plan if California doesn't file a proposal?

Answer. I do not see price mitigation and formation of RTOs as unrelated. The West is a single market without the regional institutions to support it. An RTO is vital to removing impediments and inefficiencies in California and the West. An RTO will allow power to be traded across a broader area, thus expanding trading opportunities for all buyers and sellers. An RTO will allow for improved transmission infrastructure by alleviating bottlenecks. This, in turn, should dampen generation prices.

On June 1, 2001, the Commission received RTO filings by the California ISO and the three California investor-owned utilities. The Commission will address the merits of the RTO filings in a future order. I cannot prejudge the Commission's response to the RTO filings.

Question 13. Why do you think expanding the role of the ISO into an RTO will help?

Answer. In Order No. 2000, the Commission established specific characteristics and functions for a regional transmission organization that the Commission believed would result in independent and efficient management of the transmission grid, which would in turn foster competitive electricity markets over a broad region. An RTO meeting the Commission's Order No. 2000 requirements should facilitate improved competitive markets within California. In addition, it would establish a platform for cooperation or integration of California's investor-owned utilities with other utilities in California and with other RTOs in the Western interconnection, which should add stability to the markets.

Question 14. You have asked for load curtailment options in your ISO real time market proposal. Are you aware that load curtailment programs have now been adopted throughout the Pacific Northwest, but not in California?

Answer. The Commission's April 26 order directed each public utility purchasing electricity in the ISO's real-time market to submit demand-side bids that will indicate the price at which each load will be curtailed. Also, the Commission has authorized market-based sales for resale of retail load reductions when consistent with state law. (See *Further Order on Removing Obstacles to Increased Energy Supply and Reduced Demand in the Western United States*, 95 FERC ¶61,225 (2001).). This is in addition to other demand relief programs that are already in place or will be in place for the upcoming summer months in California. The Commission understands that each California local service entity has interruptible or curtailable load programs. Entities not participating in such programs may qualify to bid into (or be bid into by aggregators) the ISO's Discretionary Load Curtailment Program (DLCP) or its Demand Relief Program (DRP). According to ISO documents, the DLCP has already been implemented and will continue through March 31, 2002, and DRP resources will be available for ISO operations for the period June 1, 2001 to September 31, 2001.

Question 15. I am also concerned because the California ISO has a reputation for poor operational performance—not refilling pumped storage units, announcing Path 15 problems while capacity was available on the Pacific Northwest Intertie, derating the power system in California for communications and forecasting problems. Have you directed your staff to investigate these ISO problems?

Answer. Contrary to the statement in your question, Commission staff's general impression from on-site visits and what they have heard from NERC, WSCC and other operators, is that the ISO staff is competent and has performed very well under very difficult circumstances. The pumped storage units are owned by the California investor-owned utilities. Refill decisions are theirs, not the ISO's. It is likely that the CA ISO, the operator and security coordinator for the California transmission system, is in a better position to judge Path 15 problems than utilities in the Northwest. I would hope that the ISO takes precautions, such as derating the power system, if they experience communication and forecasting problems.

The Commission is not able to investigate every unsubstantiated claim we might read in the press. If neighboring utilities believe that these problems are serious, they will bring specifics to our attention as an informal or formal complaint. The Commission will seriously investigate such complaints as they arrive.

Question 16. Are you aware that in March the ISO announced that it was derating the 8,500 MW of Qualifying Facility capacity to 5,500 MW because they were unable to communicate with or forecast the operations of these generators? Are you investigating this report?

Answer. In March 2001, the ISO announced a reduction in its expected available capacity from Qualifying Facilities (QFs) from 8,500 to 5,500 MW. This was not a surprise. Commission staff discussed with ISO staff their experience with QF suppliers during our Bulk Power Market investigation in the fall of 2000. Staff's understanding is that the 8,500 MW number is total nameplate capacity of the QF units. Nameplate ratings do not provide an accurate measure of dependable output. The 5,500 MW reflects the amount of capacity the ISO believes it can depend on from QFs.

It is important to remember that the ISO does not have a direct relationship with or control over the QFs. QFs have supply contracts with the three investor-owned utilities. These contracts and the Commission's rules with respect to QFs may inhibit full use of QF capacity in California. This is why on May 16, 2001 the Commission allowed QFs in California to sell excess power they generate into the wholesale market and to arrange for necessary transmission and interconnection service, to the extent permitted by a court after review of QF contracts.

Question 17. Some Pacific Northwest utilities have had their schedules cut without warning by the ISO. This threatens the stability of the entire system. Are you investigating these failures?

Answer. The Commission has not been informed of schedule cuts by the California ISO. If Pacific Northwest utilities can show that these cuts have taken place and believe they are a serious threat to the stability of the Western Interconnection, they should bring specifics to our attention in the form of an informal and formal complaint.

Question 18. The ISO has stated repeatedly that the WSCC reliability guidelines do not apply to California. Have you considered how we should evaluate ISO reliability if they no longer operate by traditional utility rules pertaining to reliability?

Answer. The Commission is not aware of the California ISO making any declarations regarding the applicability of WSCC reliability guidelines to California. The Commission expects the ISO to comply with established practices as a member of the WSCC and as a signatory to the WSCC's Reliability Management System—a voluntary contract-based program designed to preserve reliability with sanctions for

noncompliance with established reliability criteria. Further, under FERC's Order No. 888 and the pro forma tariff requirements issued in 1996, a transmission provider, including the Cal ISO and the three major California utilities, has the responsibility to plan, construct, operate and maintain its transmission system in accordance with good utility practice.

While the Commission does not have direct responsibility over electric reliability matters, its policies have always been directed toward ensuring the continued reliability of the systems. The Commission has encouraged California utilities to participate in the development of a Regional Transmission Organization (RTO) that would meet the Commission's Order No. 2000 requirements. The Commission concluded in Order No. 2000 that the RTO must have exclusive authority for maintaining the short-term reliability of the transmission grid under its control. The RTO must perform its short-term reliability functions consistent with established NERC (or its successor) reliability standards and notify the Commission immediately if implementation of these or any other externally established reliability standards would prevent it from meeting its obligation to provide reliable, non-discriminatory transmission service.

Question 19. The ISO Management has told entities in the Northwest that they sometimes declare system emergencies for the legal powers this confers on the agency, instead of a legitimate reserves deficiency. Have you investigated this?

Answer. The Commission has received formal complaints from Reliant and Dynegy alleging that the ISO misused its emergency powers and caused economic harm. The complaints are still pending. I am unable to comment further on the issues raised by this question.

Question 20. Have you had your staff check out the outages announced by Duke, Dynegy, Reliant, Mirant, and Williams against the data on comparable units at the North American Reliability Council? How do you explain the fact that the outages at the plants owned by these marketers are twice as high as those experienced by similar units of the same age?

Answer. The Commission staff investigated unit outages in California and issued a report on February 1, 2001. The investigation included site visits to the generating units and the owners' corporate headquarters to obtain: (1) a further understanding of the outages, (2) information of how these outages correlate to scheduling practices, maintenance and capital programs, and (3) an understanding of the relationship between the plant manager and individuals that makes daily marketing and commercial decisions. Among other things, the outage report found that these units are generally old peaking plants that in recent years had only run for very few hours during the year. Last summer, these units were run many more hours than usual because of California's short supply situation. These units had much higher capacity factors than similar units of the same age. One downside of running the units more is that they have more opportunity to break down. Thus, a higher reported outage rate is not unexpected.

Although the Commission staff did not find evidence of physical withholding of capacity through manipulation of outages, the staff is coordinating its efforts with the California ISO to monitor unit outages. Additionally, the staff will conduct more site visits, and is continuing to investigate past and present outages. Recently, we received OMB approval to receive outage incident reports from California generators which they will submit within 24 hours of their occurrence and conclusion. (Note that this is a voluntary submission for non-jurisdictional generators.)

However, in a case involving AES and Williams, the Commission found serious questions about whether physical withholding of capacity occurred through manipulation of outages in April and May of 2000. Williams agreed to refund $8 million to the California ISO, to accept for one year the financial risk of a forced outage at a reliability must run unit and to provide replacement power at the same price.

Question 21. Thermal plants north of the California border, regardless of age or fuel type, ran at close to their theoretical maximums since May 2000. Have you investigated why the plants owned by the big five generators/marketers (Duke, Dynegy, Reliant, Mirant, Williams) averaged only 50% operations in 2000? Do you plan to do so?

Answer. As noted above, the Commission staff is investigating both historical outage patterns and current outage patterns, including the derating of thermal units in California as part of its on-going outage investigation. A small part of the outages were attributable to discrepancies in the ratings of the units in the ISO's records and the plant owners' reports. Commission staff has been working with the ISO and the plant owners and has largely resolved those rating discrepancies. As for operating practices in the past year, staff is still collecting data to evaluate those operations.

RESPONSES TO QUESTIONS FROM SENATOR CRAIG

Question 1. There has been considerable discussion and debate as to the obligation of the Commission to ensure "just and reasonable" rates in California and the rest of the West in light of its finding that Western markets are dysfunctional and that market power may be exercised in some hours under some conditions. Please explain how the courts have construed the Commission's obligation to ensure just and reasonable rates under the Federal Power Act. In particular, please explain whether the courts have imposed on the Commission an obligation to balance consumer and investor interests, and whether the Commission may consider other factors (such as the need to induce capital investment).

Answer. The Federal Power Act does not define the phrase "just and reasonable." The courts have said the Commission has broad discretion on ratemaking methods, so long as the end result is that rates are within a zone of reasonableness and are neither confiscatory (to the detriment of investors) nor excessive (to the detriment of consumers). *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). The Commission is not required to use any particular ratemaking method. *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). The Commission can set rates based on non-cost factors such as encouraging greater production of energy supplies or construction of transportation facilities. Id.

A federal appeals court recently rejected challenges to the primary remedy adopted by the Commission in December 2000 for California's spot markets, characterizing the Commission's approach as a "middle ground between the need for temporary price mitigation and the realization that competition must exist for the California energy market to survive in the long run." *California Power Exchange Corp.* v. *FERC*, No. 01-70031, 2001 U.S. App. LEXIS 6153 (9th Cir. April 11, 2001). Recently, the same court rejected another challenge to the Commission's actions. *John L. Burton, et al.* v. *FERC*, No. 01-70812 (9th Cir. May 29, 2001).

Question 2. In its April 26 order, the Commission has linked its market monitoring and mitigation plan with the imperative for California to file for a regional transmission organization (RTO). Please explain how RTO development is, in your opinion, necessary or helpful in overcoming current market defects and improving market conditions in California and throughout the West.

Answer. In Order No. 2000, the Commission established specific characteristics and functions for a regional transmission organization that the Commission believed would result in independent and efficient management of the transmission grid, which would in turn foster competitive electricity markets over a broad region. An RTO meeting the Commission's Order No. 2000 requirements should facilitate improved competitive markets within California. In addition, it would establish a platform for cooperation or integration of California's investor-owned utilities with other utilities in California and with other RTOs in the Western interconnection, which should add stability to the markets. At present, the West is a single market without the regional institutions to support it.

Question 3. Much of the testimony at the May 3 hearing focused on the hours during which the Commission's market monitoring and mitigation plan will be in effect. Please explain which provisions of the Commission's plan will be in effect at all times, and please explain their effectiveness in protecting consumers against the possible exercise of market power.

Answer. The following aspects of the plan are in effect for all hours: coordination and control of outages; must-offer obligation; and demand response. Only the price mitigation component is limited to reserve deficiencies.

The ability of the ISO to coordinate and control outages will help ensure that there is sufficient generation available to meet demand. The must-offer obligation ensures that generation is not withheld from the market in order to raise prices. The requirement for demand responses will apply downward market pressure on prices.

I note that, although the Commission's mitigation plan went into effect in California on Tuesday, May 29, 2001, there were no alerts, and hence no price mitigation occurring on that day. Price mitigation was triggered during portions of the day on Wednesday, May 30, 2001, and Thursday, May 31, 2001, when the California ISO called Stage I emergencies. As a result, prices for hourly imbalance energy, which had risen to around $299 per MWh before the emergency alert on Wednesday, fell to $120, and rose no higher than $135 per MWh during the rest of the day. On Thursday prices rose to $130 per MWh prior to the emergency, but fell to $108 per MWh when mitigation began, and fell further to $64 per MWh. Although no emergencies nor price mitigation occurred during the period from June 1 to June 4, 2001, prices remained relatively modest, not exceeding $150 per MWh, and generally trending below $100 per MWh for most hours.

The Commission's market monitoring and price mitigation plan took effect on May 29, 2001. Table 1, presented earlier within these responses, shows Western electricity spot prices before and after mitigation.

RESPONSES TO QUESTIONS FROM SENATOR THOMAS

Question 1. Electricity rates in Wyoming have been going up, as much as 100 percent in the Cheyenne area. What does your Order of last week do to mitigate this kind of drastic rate increase?

Answer. The Commission's April 26, 2001 order established an investigation into the rates, terms and conditions of public utility sales for resale of electric energy in interstate commerce in the WSCC other than sales through the California ISO markets. This investigation applies to sales for resale that involve electric energy sold in spot markets (up to 24 hours in advance), and which take place when contingency reserves fall below 7 percent.

The Commission is proposing three measures in connection with the WSCC investigation. The three measures are:

(1) requiring all non-hydroelectric generators and marketers in the WSCC to offer for sale any available electric energy not scheduled in real-time pursuant to a bilateral arrangement;

(2) instituting price mitigation when reserves fall below 7 percent; and

(3) prohibiting public utility sellers selling in the WSCC region from engaging in anti-competitive behavior discussed in the April 26 order.

The remedies proposed for the WSCC region are intended, to the extent possible, to mirror those being applied to sales in the California ISO's spot markets. The Commission has received comments on these proposals and intends to act on these proposals in the near future.

The Commission's market monitoring and price mitigation plan took effect on May 29, 2001. Table 1, presented earlier within these responses, shows Western electricity spot prices before and after mitigation.

Question 2. You state in your testimony that, "Electricity markets in California and the Western United States face a substantial imbalance of supply and demand." But, as I understand it, the order that you issued last week would provide a measure of price mitigation only for California. Is that correct? If so, why shouldn't this same level of mitigation be provided throughout the West?

Answer. I agree with you that a similar type of mitigation may be warranted for the WSCC outside of California, and the Commission has proposed to adopt Mitigation mirroring its approach in California. However, the Commission cannot immediately impose mitigation without following the requirements of the FPA to change rates. For that reason, in the April 26, 2001 order, the Commission instituted an investigation into the rates, terms and conditions of service in the WSCC outside of California in Docket No. EL01-68-000. The Commission intends to act on these matters in the near future.

Question 3. According to yesterday's *Gas Daily*, the price for natural gas in the Rockies is $4.06. The price at the California border to Southern California Gas is $14.98 and to Kern River Station is $14.85. This is much higher than anywhere else in the country, including prices here in Washington ($5.08-$5.54), which is a long way from the producing region. What does it cost to transport gas from Wyoming to the California border? Is that transportation rate regulated by the Commission? Since high California natural gas prices are cited by generators in California as a reason for high electricity prices, what is the Commission doing to make sure that pipeline rates for transporting gas to California are just and reasonable?

Answer. All transportation of natural gas from Wyoming to California is subject to Commission regulation. Commission-approved maximum tariff rates along the several paths available for these movements range from about $0.60 to $0.70 per MMBtu, plus the cost of fuel retained by the pipeline for compression. As an alternative to purchasing natural gas transportation service from the pipeline, shippers may seek to acquire capacity released by existing firm transportation customers of the pipeline. The ceiling price for capacity release transactions was waived for a two-year period beginning in March 2000, allowing market-determined prices to be set for these transactions.

The Commission has taken a number of actions to ensure that there is sufficient transportation capacity to California at reasonable' rates. On May 18, 2001, the Commission, recognizing that prices remain higher in California than in any other market in the United States, proposed new reporting requirements to provide the Commission with the necessary information on the prices of natural gas delivered to California. On May 22, 2001, the Commission issued a notice seeking comment

on whether to re-impose ceiling prices for capacity release transactions on pipelines serving California.

To ensure that there is sufficient pipeline capacity available at reasonable rates, the Commission has expedited certification of new construction projects, held a technical conference to examine the ability of California intrastate pipelines to redeliver the interstate pipeline capacity delivered to the California border, and issued an order proposing enhanced reporting requirements on natural gas sales to California markets.

Since mid-December, 2000, natural gas prices delivered to California have fallen significantly from the levels seen over the past winter. Southern California gas prices have fallen from their mid-December 2000 peak of $59 per MMBtu to $3.54 (June 11, 2001). Northern California prices have fallen over the same span from $49 per MMBtu to $2.67.

Question 4. How does the Commission's market monitoring and mitigation order encourage investment in efficient generation and transmission? (Testimony at p. 3)

Answer. The Commission's April 26 Order seeks to replicate pricing in a competitive market. By doing so, the Order will provide price signals reflecting the current imbalance of supply and demand. These prices will encourage investors to provide capital for more construction of power plants. At times, prices in California also reflect the fact that power available in one part of the state is prevented by transmission limitations from being used where it is most needed. The Commission's price mitigation mechanism would reflect this fact (by setting a proxy price based on the least efficient supply needed to meet demand), and thus provide an incentive for market participants to expand transmission and eliminate the bottlenecks.

RESPONSES TO QUESTIONS FROM SENATOR DORGAN

Question 1. I am concerned about this most recent FERC Order for several reasons. I am concerned about making the mitigation plan contingent on the filing of an RTO, which I will elaborate upon shortly.

Answer. Order No. 2000 set forth the essential characteristics and functions required of regional transmission organizations (RTOs) but also left significant flexibility to adapt to regional needs. RTO filings were made by the California ISO and the three California investor-owned utilities on June 1, 2001. The Commission currently is reviewing the merits of the filings and I cannot prejudge the Commission's response to them.

Question 2. I also would like to know why the FERC's mitigation plan is being limited to the spot market and to times when reserves fall below 7 percent.

If the plan and investigation are being limited to those times, then how will the FERC know whether market power is being exercised during other times?

Answer. The April 26, 2001 order recognizes that FERC is limited in its ability to solve all of the problems facing California and the West. Under current conditions, the supply of electric energy available from existing generation capacity has not been able to meet peak demands in California. This supply-demand imbalance is the direct cause of both high prices and the blackouts experienced in California. However, the Commission's April 26, 2001 order, coupled with previous orders addressing California and the West, seeks to remove regulatory obstacles and provide incentives to increase investment in needed infrastructure, including ensuring that new generation is built, that the transmission system is upgraded, and that new gas pipelines are built. FERC has also sought to get California's market situation under control through, among other things, moving electricity purchases to serve load from the spot market to long-term contracts.

In addition, the April 26, 2001 order included a number of conditions which were designed to prevent anti-competitive behavior during all hours and not just during hours when emergencies are declared by the ISO. Among the measures is the conditioning of market-based, rate authority on not withholding available supply and not engaging in other anti-competitive behaviors; the coordination of planned outages by the California ISO; FERC's monitoring of unplanned outages; requiring all generators with Participating Generator Agreements (PGAs), as well as all non-public utility generators in California which sell through the ISO markets or currently use the ISO's interstate grid, to sell all available supply into the ISO's spot market; requiring ISO buyers to submit demand reduction bids by hour, amount, and customer; and the monitoring of all bids in all hours by the ISO and FERC through an ISO weekly report. Removing the volatility of prices in California through price mitigation should have a beneficial effect on prices in the West.

The Commission's price mitigation plan took effect only recently, on May 29. Most of its provisions apply during all hours—not simply during system emergencies. For example, the Commission will be receiving bid data for all hours and will monitor

that data to determine the effectiveness of its price mitigation approach. The Commission's price mitigation plan, which is in effect only during emergency hours, seeks to replicate the prices that would occur in a competitive market. By doing so, the plan will ensure that prices are just and reasonable.

Although the Commission's mitigation plan went into effect in California on Tuesday, May 29, 2001, there were no alerts, and hence no price mitigation occurring on that day. Price mitigation was triggered during portions of the day on Wednesday, May 30, 2001, and Thursday, May 31, 2001, when the California ISO called Stage I emergencies. As a result, prices for hourly imbalance energy, which had risen to around $299 per MWh before the emergency alert on Wednesday, fell to $120, and rose no higher than $135 per MWh during the rest of the day. On Thursday prices rose to $130 per MWh prior to the emergency, but fell to $108 per MWh when mitigation began, and fell further to $64 per MWh. Although no emergencies nor price mitigation occurred during the period from June 1 to June 4, 2001, prices remained relatively modest, not exceeding $150 per MWh, and generally trending below $100 per MWh for most hours.

The Commission's market monitoring and price mitigation plan took effect on May 29, 2001. Table 1, presented earlier within these responses, shows Western electricity spot prices before and after mitigation.

Question 3. Do the mitigation plan and structure that are being used in California and that are proposed for the rest of the West set a precedent for other parts of the country? In other words, in the future, will the FERC apply this same plan and these same guidelines to the rest of the country for investigating and mitigating high electricity prices? Does the proxy price system work in other parts of the country? Would a price cap work better elsewhere, or would the cap discourage new market entrants and new construction?

Answer. I do not believe price mitigation, when needed, must be approached identically across the country. Instead, any price mitigation should recognize, and be adapted to reflect, any relevant differences in market conditions. Having said that, however, I do not foresee circumstances in which a price cap would be preferable to a proxy price approach.

Question 4. In the past, the FERC has looked at the behavior of sellers to determine whether the seller, or utility, is doing something wrong or behaving as a "bad actor." (Market power: is the capacity to raise prices and sustain price increases over periods of time). It may well be that market power is not being exercised by individual utilities with mal (evil) intent, but that the market structure itself is flawed—as in California, where long-term contracts were not available for purchases. In cases where the market structure might be flawed, the FERC's traditional way of looking at the behavior of individual sellers does not appear to work any more. In California, the FERC can examine the ISO and the market structure, and can look at hourly prices.

What should FERC do in the rest of the country—where there isn't a clearly defined spot market, or market structure—to determine whether market power is being exercised, or whether instead market flaws are causing or encouraging prices to be unjust and unreasonable, but the price increases are based on the market structure, not necessarily on the malicious intent of individual companies? In other words, companies are in business to make a profit, so if the market is structured to make a maximum profit, why wouldn't companies naturally avail themselves of that opportunity?

How Should the FERC analyze the market itself to determine what needs to be done to cure the potential for market power to be exercised?

Answer. As you suggest, bulk power markets in different regions of the country are far from identical. The Commission cannot, and does not, assume that "cookie-cutter" approaches will work in ensuring just and reasonable rates. Moreover, the Commission must adapt its approach over time, as markets evolve.

In determining whether to grant an applicant's request for market-based rates, the Commission traditionally has focused on whether the applicant and its affiliates lack or have mitigated market power over generation and transmission. In recent years, the filing of open access transmission tariffs has reduced the ability of transmission-owning utilities to use their transmission facilities in ways that favor their own generation. The Commission examines the applicant's market share in the relevant generation market to assess generation market power. In addition, the Commission has looked to determine whether the applicant and its affiliates can erect other barriers to entry or engage in inappropriate reciprocal dealing. In most circumstances, this analysis has proven fully adequate to ensure that rates for wholesale power remain just and reasonable.

However, in recent proceedings, the Commission found that in California and the West, under current market rules and certain conditions, the rates for wholesale

power may not be just and reasonable, even though the jurisdictional sellers previously met the Commission's test for authorizing market-based rates. Accordingly, the Commission has imposed or proposed certain remedies to ensure just and reasonable rates.

The Commission regularly monitors prices for wholesale power in other parts of the country. Also, the Commission will investigate any complaints concerning wholesale prices in other parts of the country. If these efforts indicate that prices in a region are no longer just and reasonable, despite the Commission's prior determinations that sellers with market-based rates lacked market power, the Commission will take appropriate action, as it has in California and the West.

Question 5. Do you think that the increase in mergers, and the rapid consolidation of the electric utility market, is causing an increase in market power? Is FERC examining these changes sufficiently?

Answer. I do not think mergers and consolidation are causing an increase in market power. The Commission must authorize each merger involving a public utility, and a dominant issue in these cases is whether the merger will harm competition. The Commission examines carefully whether a merger will enhance the market power of the merging companies. In cases where relevant information indicates a possible concern about market power, the applicants usually propose mitigation alleviating the concern. If they do not, the Commission can impose (and has imposed) such mitigation as a condition of authorizing the merger.

Question 6. Related: Is the FERC gathering sufficient information, both in the West, and in other parts of the country, to know whether market power is being exercised? What other tools would help FERC determine whether market power is being exercised?

Answer. It is always difficult to know how much information is needed to say definitively that market power is or is not being exercised. However, the Commission's staff is gathering a significant amount of market information and developing more refined analytic tools. Staff has recently begun operations of a Market Observation room which gives our analysts access to some of the same on-line information and databases that are used by sophisticated gas and power marketers and traders. Moreover, the Commission has aggressively sought confidential market information from sellers and generators when we are concerned about how well markets are working.

OMB recently authorized the Commission to receive incident reports from generators within 24 hours of an outage. Commission staff have also assisted in resolving disputes between generators and the California ISO concerning the generating capacity (rating) of certain generation units, and are working with the California ISO to improve outage reporting accuracy.

Question 7. The new FERC Order requires California utilities and the ISO to file a Regional Transmission Organization (RTO) proposal by June 1 for the price cap to remain in effect. It seems fairly likely that California would file a one-state RTO. However, a one-state RTO does not seem consistent with FERC's Order 2000, nor would a one-State RTO seem to attempt to correct the problems that California has been experiencing with skyrocketing electricity prices.

If the FERC thinks California is likely to file a one-state RTO, but does not think a one-State RTO is a good idea, why did the FERC condition the price cap and mitigation plan on the RTO filing? And why would FERC withdraw, or threaten to withdraw, the mitigation plan if California does not meet FERC's RTO June 1 filing requirements?

Answer. On June 1, 2001, the California ISO and the California utilities filed a one-State RTO plan. However, the Commission's April 26, 2001 Order on RTO West made it clear that a West-wide RTO was a long-term goal—not a requirement for filing. I cannot prejudge the merits of the June 1, RTO filings.

However, it is important for California to work with other states within the Western region to stabilize the energy markets in the west. I expect RTO West, as well as participants in other RTO efforts under consideration in the West, to work cooperatively with the California ISO to develop comprehensive solutions to the problems confronting western markets. I view the filing of an RTO proposal by the California utilities and ISO as part of that collaborative process.

In addition, I would not describe the market monitoring and price mitigation plan outlined in FERC's April 26, 2001 Order as a price cap. Determining how to set a price cap would be difficult. On some days, the price cap could exceed the competitive marginal cost price that would be bid, while on other days, the price cap could be too low. In contrast, the Commission's mitigation plan is based on the prices generators would be expected to bid on a daily basis based on current costs (or "proxy price") of the highest-priced gas-fired generator dispatched.

Question 8. Can marketers and out-of-state sellers dodge the proxy price (i.e., conduct "Megawatt laundering")? Could marketers sell electricity to one another to raise the price, and in this way be able to demonstrate and justify a higher price, then sell the power back into the market at that higher price?

Answer. The April 26, 2001 order, at p. 12, acknowledged concerns regarding "megawatt laundering." In response, the order recognized that the California market is integrated with those of other states and, for that reason, FERC is instituting a West-wide, Federal Power Act Section 206 investigation into public utility sales for resale. The order solicited public comment on the proposed West-wide investigation. This issue is pending before the Commission on rehearing of its April 26 Order. Thus, I cannot comment on the merits of this issue. However, I recognize that the issue is an important one and warrants careful consideration by the Commission on rehearing. The Commission's price mitigation plan just became effective on May 29, 2001, and experience to date has been very good. But, if this concern about "laundering" is realized, I would consider modifying the Commission's approach to ensure the effectiveness of its price mitigation mechanism.

Question 9. You could also ask about the West-"wide" clearinghouse set up to let customers decide whether to curtail power use and bid their unused power back into the spot market. Who owns the power? Does this type of arrangement preempt state programs and/or infringe on states' rights? Would such an arrangement interfere with WAPA's, or BPA's, power obligations? Does FERC have sufficient authority to make such determinations with respect to retail management (decisions)?

Answer. The Commission did not impose a "one-size-fits-all" approach on how utilities should implement demand-side bidding. Thus, each utility, including WAPA and BPA, may implement an approach that fits its circumstances, including any contracts it may have with retail customers and any programs it may have for implementing retail load reduction. Generally, I would expect the utility's demand-side bids to reflect the expressed willingness of its customers to reduce load at certain prices. Thus, if 20 percent of a utility's customers indicate their desire to curtail usage when prices reach a specific level, and its other customers indicate a desire to continue consuming power, the utility could submit a demand-side bid corresponding with this consumption pattern.

The Commission wants to do what it can to promote demand reductions as a means of alleviating the supply/demand imbalances in Western markets, and does not want to interfere with existing state programs aimed at achieving demand reductions. To the extent a wholesale purchaser voluntarily reduces an entitlement under a contract and seeks to resell the reduction, this involves only Commission, not state, jurisdictional matters. To the extent a retail purchaser reduces an entitlement and seeks to sell the reduction for resale in interstate wholesale markets, this also invokes Commission jurisdiction. As the Commission recently stated in its Order Removing Obstacles in Docket No. EL01-47-000, the Commission is promoting wholesale programs that complement existing state demand-side management programs, and our goal is not to supersede state authority over retail customers, but to work cooperatively with the states to achieve a common good. Finally, I believe that the combination of existing state and Federal authority is currently sufficient to address demand response.

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