

Inside California's power crisis

The consequences of structural problems within the California electricity market were highlighted more than six months ago. So are the present attempts to alleviate the crisis too little, too late? **BY JEREMY WEINSTEIN**

In 1996, California split its regulated utility system into three parts: generation, transmission and delivery. As a result, utilities that had performed all three functions now performed just one – the delivery of power to consumers. The State took over transmission, and the utilities were required to sell off much of their generation.

The system's designers, saying their goal was to reduce the market power of the major utilities, installed a double-layered, centralised system. The California Independent System Operator (Cal ISO) controls most of the state's power grid, and the California Power Exchange (CalPX) is the state's main centralised power market, although the latter is due to close in April.

In order to ensure that the state's centralised system rather than the utilities had the market power, the utilities were generally prohibited from entering into forward contracts to hedge their forward exposure. The three investor-owned utilities in California were required to purchase their electricity through the CalPX, with little or no ability to buy through forward contracts. This exposed them to the volatility of the spot market without the ability to mitigate it.

A generator with electricity to sell, who previously knew his customer, now sells to every buyer through the centralised system. Even though payment to the sellers is nominally due from the Cal ISO, the ISO is not liable if the buyers do not pay it or the CalPX.

Small buyers put up collateral, but if one of the three big utilities – Pacific Gas & Electric (PG&E), San Diego Gas & Electric or Southern California Edison – defaults, the loss is spread among all the sellers. Although the pooling effect may dampen the risk of catastrophic losses between single buyers and sellers, the dissipated risk is now shifted to all sellers, especially since, if the utilities default, there's no meaningful enforcement mechanism for repayment.

Sellers cannot collect by suing the Cal ISO, but are permitted to independently

sue the defaulting utility. Sellers can pay the Cal ISO to sue the defaulting utility, as long as they also agree to indemnify the Cal ISO for bringing the action on their behalf. But if the Cal ISO lawsuit fails, the sellers will have their loss and will also owe money to the Cal ISO for its legal fees in failing. In addition, "free-riding" sellers who don't provide the indemnity would make the enforcement effort even less palatable to those sellers who might otherwise be inclined to provide it.

Even if a seller were to take independent legal action against a defaulting buyer, once a potential plaintiff has made out its legal theory tracing from the Cal ISO through the CalPX to the defaulting utility, involuntary co-ordination of that action with other disparate suits could quickly create a monster lawsuit. And the tracing itself should not be taken for granted, as the loss from the defaulting buyer has been spread to all the sellers.

GRINDING HALT

One could imagine a defaulting utility getting a friendly seller to sue immediately in Nevada City, for example, and all the sellers' actions being consolidated there. The paperwork burden on a small court in co-ordinating a burgeoning multi-party action would quickly grind the court – and that lawsuit – to a halt.

If the utility can work out another way to get electricity, at worst, this translates into for that utility a free standstill of enforcement. This effectively means an involuntary multi-billion-dollar loan is made by the sellers of the purchase price for the power – well worth the effort.

As a result of all this, the entire state effectively got the credit rating of its riskiest major utility early on. This increased the risk premium – that is to say, price – of all electricity sold into California. The increased profit potential attracted sellers, but only up to a point.

Since rate caps prevented the utilities from passing their wholesale electricity purchase costs on to their customers, sellers were worried about whether the utilities would have the ready cash to pay for their



Jeremy Weinstein: The California power market system started a domino effect

power. On top of that, most electricity markets require payment to be made in 20 days, but the Cal ISO pays at 60 days.

Even with the higher prices to which this credit risk premium drove California wholesale electricity markets, many potential sellers considered the risk of loss to be so high that they simply chose not to participate. The system set in motion a domino effect that worsened as the damage it caused deepened (see pages 14–15).

These structural problems and their consequences were brought to the attention of the Cal ISO by market participants during August and September of 2000, after the utilities lost their first few billion dollars. But no remedial action was taken before matters reached the current crisis.

Were it not for this credit risk issue, the utilities may have been able to absorb the wholesale prices, which would have been much lower, and pass them on to ratepayers over a period of years with incrementally higher rates as more generation was built. But the flawed credit design led to much higher wholesale electricity prices that the utilities could not bear, rendering insolvent utilities with innocent, conservative shareholders, and which will eventually cost taxpayers billions of dollars. ■

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