

Will the FERC See the Light on the Law? (Los Angeles Times, April 30, 2001)

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Out-of-state firms selling into the California wholesale electricity market at exorbitant prices have been blamed for the current electricity crisis. They are, claim many observers, exercising their market power to raise wholesale electricity prices.

Although it is not illegal under California or U.S. antitrust law for a firm to exercise its market power, it is illegal to do so under the Federal Power Act. The Federal Energy Regulatory Commission, or FERC, which regulates the California wholesale electricity market, is the entity charged with enforcing this law. Its refusal to take sufficient actions that would result in "just and reasonable" wholesale electricity rates is the fundamental cause of California's current energy crisis. It is highly unlikely that anything it has done in the last week has changed things at all.

In 1935, Congress passed the Federal Power Act and required the Federal Power Commission (the predecessor to FERC) to set "just and reasonable" wholesale electricity prices. Just and reasonable prices are those that recover production costs, including a "fair" rate of return on the capital invested by the firm. Moreover, if the FERC finds that wholesale electricity prices are unjust and unreasonable, the Federal Power Act gives it wide-ranging discretion to take actions that result in just and reasonable prices. The FERC can also order refunds for any payments by consumers in excess of just and reasonable prices.

Almost 10 years ago, the FERC began to allow generators to receive market prices instead of prices set through a cost-of-service regulatory process. However, there is no guarantee that market prices meet the just and reasonable standard required by the Federal Power Act. Markets often set prices substantially in excess of the production costs for significant periods of time. This occurs because one or more firms operating in the market have what economists call market power--the ability of a firm to raise market prices and profit from it.

However, if no firm possesses market power, the market price should be very close to a price that only recovers production costs. In such a circumstance, the price set by the market satisfies the just and reasonable standard of the Federal Power Act.

Before it allows any market participant to receive a market price rather than a cost-based price set through a regulatory process, the FERC requires each participant to demonstrate that it does not have market power. In other words, each market participant must submit sworn testimony to the FERC demonstrating it does not have the ability to raise market prices and profit from this behavior.

Each of the out-of-state generators made these filings before they began selling into the California market, which started in April 1998. Each firm had its authority to receive market prices approved by the FERC for a three-year period that ends before this summer for several of the firms. It is virtually impossible to determine on a prospective basis whether a firm possesses market power. Moreover, the methodology used by the FERC to make this determination uses analytical techniques that have long been acknowledged by the economics profession as grossly inadequate. The events of the past 10 months have demonstrated that contrary to their filings stating otherwise, all of the out-of-state generators possess significant market power.

A number of independent studies have shown that the market power exercised by these firms has resulted in unjust and unreasonable rates from May 2000, until now. Moreover, in its Dec. 15, 2000 report on the California electricity market, the FERC concluded that wholesale electricity prices during the summer and autumn of 2000 were unjust and unreasonable and reflected the exercise of significant market power.

Despite its own conclusion, the FERC thus far has refused to set just and reasonable prices for wholesale electricity in California. Instead, the FERC implemented market rule changes that have enhanced the ability of these firms to set excessive wholesale electricity prices. In addition, it has refused to order refunds for any overpayment during the summer and autumn of 2000 for the prices that it deemed unjust and unreasonable.

Fortunately for California consumers, the California Public Utilities Commission and Gov. Gray Davis refused to be accomplices in the FERC's decision not to enforce the Federal Power Act. They refused to pass on to California consumers prices that the FERC itself had determined were unjust and unreasonable.

Because these out-of-state firms must apply for renewal of their market-based pricing authority before this summer, the FERC has one more opportunity to set just and reasonable prices for wholesale electricity in California. It has before it several proposals that would enforce all provisions of the Federal Power Act. The health of the California and national economies would be severely undermined if the FERC continues to ignore its legal obligations.