

Testimony



**TESTIMONY OF
THE HONORABLE GRAY DAVIS
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BEFORE THE
SENATE COMMITTEE ON GOVERNMENTAL
AFFAIRS**

JUNE 20, 2001

Mr. Chairman, Ranking Member Thompson and Members of the Committee, thank you for inviting me here today.

I am truly honored to come before the Governmental Affairs Committee – a panel with a long and distinguished history of protecting the interests of the public. It is quite fitting that you are holding this very timely hearing on the role of the Federal Energy Regulatory Commission (FERC) in responding to the energy crisis in California and the West.

This morning, I want to provide a comprehensive overview of what the State of California is doing to take control of our energy future. In doing so, I hope to impress upon the Committee why I have been so adamant about the need for the federal government to play its appropriate role with respect to our energy crisis.

But before I proceed, I would like to make two brief points regarding the events of the past 48 hours.

First, the decision by FERC on Monday evening to expand its original price mitigation plan has altered the landscape. After having spent the better part of

the past 12 months urging and pleading FERC to grant meaningful price relief from out of control wholesale energy rates, I am grateful that FERC is moving in the right direction. I will reserve more detailed comments on this subject and share some of my concerns over various aspects of the order later.

Second, in light of Monday's action, the real test centers on FERC's willingness to carry out and enforce the order in a vigilant manner. That is where your Committee comes into the picture. It is my strong hope that the Committee will continue to carefully watch the actions of FERC in the days and weeks ahead and take any necessary steps to ensure that FERC is properly enforcing the terms of its order.

Mr. Chairman, as I have emphasized repeatedly over the past several months, we are meeting the energy challenge head-on by embarking on an aggressive, all-out strategy. The State of California is fighting the energy crisis on several simultaneous fronts: generation, conservation, and stabilization. I'd like to briefly elaborate on each of these areas.

GENERATION

We are determined to move toward greater energy independence. The best long-term solution to California's energy mess can be summed up in two words: more power. To get it, we have to build it.

During the 12 years before I took office – from 1986 to 1998 – not a single major power plant was built in our state. Not one. During this period of time, California's economy grew by 93 percent. Our population increased by six million.

But beginning in April 1999, my Administration took steps to reverse this trend by moving plants online at a rapid pace.

We cut approval times in half and licensed 16 major power plants. Ten are under construction as we speak. Four will be online this summer. The first will be open a week from today, two more by July 7th, totaling more than 1,200 megawatts of power. We've also approved 10 new "peaker" plants, for another 876 megawatts.

The combination of these new power plants, with additional renewables, distributed generation, and re-rates of existing power plants, will bring us closer to 4,000 new megawatts online by the end of September.

At no other time in the history of California have so many new power plants been under construction and in the pipeline.

I have also signed legislation establishing the California Public Power Authority to build, own and operate new power plants on behalf of consumers.

The Authority will supplement – not supplant – our existing network of privately owned plants. If the private sector won't build all the power we need to stabilize the energy market, then we will build it ourselves.

I am proud to say that we're accomplishing these goals without weakening our historic commitment to clean air and water. The bottom line is that we are working tirelessly and moving with a real sense of urgency to build new generation facilities in California. And we are clearly seeing the results.

CONSERVATION

Mr. Chairman, we have a great story to tell on conservation. California is now the most energy efficient state in the nation. We use less electricity per capita than any other state – in fact, 42% less than the national average.

But we are not about to rest on our laurels. Several months ago, I signed an \$850 million conservation program into law. It's the most sweeping conservation effort ever undertaken by a single state. It includes:

Rebates for energy-efficient appliances and air conditioners;

State-of-the-art, high-efficiency lighting;

Home weatherization assistance;

Real-time or time-of-use meters; and

Peak load reduction incentives for agriculture and industry.

We've also launched a \$35 million media campaign called "Flex Your Power", which is already demonstrating positive results.

I've signed an Executive Order, offering a 20 percent rebate to consumers and businesses that conserve 20 percent during this year's summer months.

All across our state, consumers and businesses are answering the call of conservation, reducing their electricity use and, thus, our dependence on out-of-state power.

Earlier this year, I asked all Californians to reduce their energy usage by 10%. And to their credit, Californians have responded in a big way. In February, California businesses and consumers

reduced energy consumption by 8%. In March, the reduction was 9.2%. For the month of April, we saved 9%. And in May, we made it all the way to 11%. The 11% savings would provide enough electricity to power the entire service area of San Diego Gas and Electric at peak demand times. These figures show that Californians fully understand what is at stake. They are making heroic efforts to cut back.

I am proud to say that California's business community has stepped forward and joined us in an exciting new conservation partnership. Nearly 140 businesses and organizations -- ranging from Bank of America to Pacific Bell to Hilton Hotels -- have committed to reduce their energy use by 20 percent. This is the biggest conservation commitment ever made by the California business community.

State government is leading by example. Energy use in state office buildings has dropped by as much as 25%.

Local governments are also getting into the act. 225 cities, counties and special districts throughout the state signed energy conservation agreements with us.

A partnership between the State, Commercial Building Owners, and the Service Employees International Union has produced a plan to reduce energy use by 10 percent in some 300 million square feet of office space.

It goes without saying that conservation goes hand in hand with energy efficiency. In this regard, California is a world leader.

For example, we are pioneering the use of light-emitting diodes (LED) in traffic signals. These use

75 percent less power than conventional traffic lights.

Through our "Powerwalk" Program, members of the California Conservation Corps are distributing 1.5 million compact fluorescent light bulbs door-to-door. These bulbs will save enough electricity to power 100,000 homes.

In short, California's aggressive conservation efforts are paying off. Businesses, homeowners, consumers, and state and local governments are heavily engaged in this massive effort. We expect to see even more positive results in the months ahead.

STABILIZATION

In addition to meeting the challenge of supply and demand, we

are also doing everything we can to bring stability to the situation.

On January 17, the State of California stepped in to purchase the power the utilities could no longer afford to purchase. By doing so, we were able to keep the power on and the economy growing.

Since then, we have moved aggressively to lock up a portfolio of long-term power, which in turn has significantly reduced our reliance on the volatile spot market.

Our emphasis on long-term contracts has played a major role in pushing prices downward, especially in the last few weeks. But I would argue that these prices are still far from reasonable.

In addition to long-term contracts, stabilizing the energy market also requires that our utilities remain viable. Towards that end, we have worked hard to restore the utilities to financial stability, provided they agree to meet three conditions:

They must provide low-cost regulated power to the state for 10 years;

They must sell their transmission lines to the state;

They must dismiss their lawsuits seeking to drive up rates.

On April 9, I announced a Memorandum of Understanding with Southern California Edison on the key principles of a balanced recovery agreement.

Just last week, an agreement between Edison and the state's "Qualifying Facilities" was reached that will increase supply and bring online those plants that were off line for economic reasons. It is estimated that this agreement will save the state \$100 million by the end of this year.

Two days ago, we announced an agreement with San Diego Gas & Electric. In this case, the state was able to negotiate a \$747 million balloon payment owed by San Diego ratepayers down to zero, with no increase in rates.

CALIFORNIA'S ELECTRICITY MARKET

In the summer of 2000, California's experiment with electricity deregulation began to unravel in a dramatic way. Unprecedented wholesale electricity

prices became the norm in the "market", and these exorbitant prices have continued to this day.

In 1999, total energy costs in California were \$7 billion. In 2000, we paid \$27.1 billion. In 2001, total spending is projected to be anywhere from \$35 to \$60 billion, despite the fact we are using less electricity. In the first quarter of this year, we spent a total of \$10.6 billion, compared to \$1.7 billion during the first quarter of 2000.

By any measure, we have a wholesale energy market that is not working. The California market is not competitive, it is not reasonable, and certainly not just.

Mr. Chairman, no one is more pleased than I am to see the drop in these outrageous prices over the past few weeks. This positive trend is the result of various factors : cooler weather; less reliance on the volatile spot market thanks to long-term contracts; a downward spike in natural gas prices; more generation coming back on line from maintenance; decreased demand due to conservation; and increased scrutiny of the generators' pricing practices by lawmakers and the media.

At the same time, however, I would strongly urge everyone not to be lulled into complacency over recent price decreases. Make no mistake, prices will rise again – when the weather heats up or when the power companies figure out another way to game the system. The fact remains that even with recent moderation, electricity prices remain subject to a number of variables at play in a dysfunctional wholesale market.

These wholesale prices have produced enormous profits for mostly out-of-state generators.

Economists and our own ISO have found that these generators are exercising significant market power, raising prices to well above where they reasonably should be in a functioning competitive market.

As the Committee heard last week, several independent economists have documented that out-of-state generators like Williams, Duke, Dynegy, Reliant and Mirant are exercising market power in California to raise electricity prices well in excess of typical levels in a fully competitive market.

FERC ROLE AND OBLIGATION

Mr. Chairman, we have clearly demonstrated that we can build supply and conserve unprecedented numbers of megawatts – but only the federal government has the power to ensure a just and reasonable wholesale electricity market in California.

This is not a matter of discretion for federal regulators. It is an obligation under law. Under the Federal Power Act passed by Congress in 1935, FERC is required to ensure that wholesale electricity prices are "just and reasonable". If prices are not "just and reasonable", they are unlawful and the Commission must act to control prices. They must then order refunds for prices in excess of just and reasonable levels.

URGING FERC TO ACT

From July 2000 to today, I have pressed federal regulators in every way possible to take immediate

steps to control runaway wholesale prices. I called on then-President Clinton to urge his FERC to take desperately needed action, just as I have called on President Bush to do the same. I have submitted statements to FERC. I have testified before FERC. In addition, through the Electricity Oversight Board, the Public Utilities Commission and ISO, the state has formally filed with FERC for relief from these unlawful prices beginning in August 2000. Collectively, we have submitted over 100 filings to FERC seeking relief.

We sought hard price caps. When that failed, Governor Locke, Governor Kitzhaber and I proposed temporary cost-based pricing. We have requested refunds when warranted. And we have asked FERC to deny AES, Williams, Duke, Dynegy, Mirant and Reliant the ability to charge market rates in our market which FERC itself has found to be dysfunctional.

Unfortunately, despite these pleas, at almost every point where FERC could have acted to control wholesale prices, it failed to do so.

FERC RECOGNIZES UNJUST AND UNREASONABLE PRICES

On November 1, 2000, FERC concluded that wholesale electricity prices in California were unjust and unreasonable. The Commission reaffirmed this finding on December 15, 2000. In March of this year, FERC again determined that wholesale prices for some power purchased in California were not just and reasonable and ordered very limited potential refunds as a result. And in April, the Commission found once again that California had a "dysfunctional market". As

Commissioner Massey wrote in his April 26 dissent, "Prices are not just and reasonable now and will not be this summer and the economic carnage is spreading throughout the western interconnection."

ATTEMPTS AT IMPOSING PRICE RELIEF

FERC's first attempt to address the collapse of our electricity market came on December 15, 2000. Ignoring warnings that their plan would actually lead to higher wholesale prices, FERC implemented a "soft price cap" proposal that permitted generators to be paid as bid above a soft cap price set at \$150. After the fact, FERC could review and adjust the price downward.

California opposed this mechanism on grounds that it would not restore reasonable prices. Instead, we believed it would lead to higher energy costs and exacerbate supply problems. Not surprisingly, sellers generally chose to demand very high prices and report them to FERC in the hope that FERC would not act.

This is precisely what happened; costs continued to escalate out of control. The average price in January 2001 was \$317 per megawatt hour – well above the \$150 so-called cap. Moreover, during January when demand for electricity is typically low, we experienced almost daily Stage 3 emergencies and two days of rolling blackouts.

Recognizing that its December order was ineffective, FERC adopted yet another inadequate scheme on April 26, 2001. This plan applied only during limited emergency conditions despite clear evidence that high prices prevail during non-emergency conditions – 24 hours a day, seven

days a week. FERC ordered the plan in place for too short a duration – only until May 29, 2002 – thereby leaving the state without protection next summer during peak energy usage.

The April mitigation order did not apply across all markets. It applied only to the ISO's real time markets, which constitute only about 3.5 percent of the short-term energy purchases in California. Once again, under the April plan, sellers were not held to a proxy price. Generators were free to charge in excess of the mitigated price and then submit a justification later. We pay the higher price and affirmative steps must be taken to ensure that any unwarranted excess is refunded.

FERC's April order allowed the least efficient, most costly plants to set the price for all sellers. It established a market clearing proxy price based on the highest cost plants in the state. All sellers are paid this price despite their lower costs and lower bids.

In perhaps the biggest loophole, the Commission failed to remedy against megawatt laundering. Under the April order, in-state generators were free to export electricity and then out-of-state companies could have resold that same electricity to California at much higher prices. This is because imports were not subject to price mitigation.

As FERC proposed a series of patchwork remedies, we have consistently called for a temporary, reasonable and results-oriented solution. Governor Locke, Governor Kitzhaber and I have advocated price relief in the form of cost-plus pricing. We have urged FERC to adopt price relief that (1) would be temporary in nature, (2) would allow generators to recover their costs

plus a reasonable profit and (3) would not apply to new power plants.

This approach has garnered the support of prominent economists from around the country, including those who have argued against price caps in the past.

This proposal is also similar to the legislation put forward by Senator Feinstein and Senator Smith, which, Mr. Chairman, you are co-sponsoring. The people of California and I are very grateful to both Senator Feinstein and Senator Boxer for their strong efforts to achieve real price relief.

My fellow Californians in the House of Representatives have been just as forceful in their efforts. A majority of our delegation has rallied around legislation introduced by Representative Jay Inslee to ensure cost-of-service-based rates in the West. This legislation is now the subject of a discharge petition in the House. Through the introduction of legislation and hearings such as this one, the Congress is shining a light on FERC that it clearly has not ignored.

FERC'S ACTIONS FALL SHORT

Even with its own admission that California's electricity market is dysfunctional, FERC consistently refused to set just and reasonable prices. It chose instead to impose two different ill-considered mitigation schemes.

Monday's action by the Commission confirms what I have been emphasizing – namely, that FERC had not fulfilled its legal obligation to ensure just and reasonable prices. While I believe that FERC took an important step forward on Monday, the FERC's

ineffectual actions at price mitigation up to this time have resulted in massive overcharges to the people of California.

THE CASE FOR REFUNDS

In March, ISO's Department of Market Analysis estimated that from May 2000 to February 2001, total costs in California's wholesale market exceeded reasonable competitive market levels by as much as \$6.7 billion. Extending the analysis through May 2001, we now have a potential overcharge of approximately \$8.9 billion.

To date, FERC has identified potential refunds of only \$125 million, 1.4% of the total potential overcharge identified by our ISO.

FERC has not ordered any refunds to be paid.

FERC will not even consider refunds prior to October 2000; it has refused to order refunds for the period between October and December 2000; and it has limited refunds to gains made only during Stage 3 emergencies.

Excessive profits above just and reasonable levels were allowed during all other hours.

The effect of this arbitrary limitation can be seen most vividly in FERC's conclusion that no potential refunds were due during the month of April. This determination was made not because charges were reasonable, but simply because there were no Stage 3 emergencies.

We have put before FERC compelling evidence of overcharges by generators selling electricity to our state over the last year. FERC must move quickly

to enforce the law and order the energy companies to give back the money.

THE NEED FOR RELIEF FROM NATURAL GAS PRICES

FERC must also give careful scrutiny to the problem of natural gas prices. High natural gas prices – which have been disproportionately higher in California than other states -- are linked inextricably to our high cost of electricity.

As recently as three weeks ago, California natural gas prices were two to three times higher than the national average. And at times this year, the price in California has exceeded eight times the national average.

As with electricity, FERC has the responsibility to control the exercise of market power and excessive pricing in natural gas markets. FERC has yet to take definitive action.

As I mentioned, California's energy woes have been compounded by the unacceptable disparity between our rates for natural gas and that of the rest of the nation.

This huge discrepancy is a result of the high cost and insufficient availability of pipeline capacity to and within California. As we now know, one company, El Paso Corporation, along with its affiliate, was able to control a significant portion of one pipeline into Southern California.

The California PUC filed a complaint against El Paso in April 2000. FERC was slow to act on these allegations of anti-competitive behavior. I credit Commissioner Wood for recognizing this delay,

which occurred before he joined the Commission.

In the El Paso case, FERC can demonstrate that it stands on the side of consumers against energy extortionists. I remain cautiously optimistic that they will take advantage of this opportunity.

FERC's obligations regarding natural gas extend even further.

After failing to respond for over five months to a complaint regarding high natural gas prices in California, FERC has finally asked for comment on whether it should re-impose the maximum rate ceiling on short-term capacity release transactions into California.

The answer is a resounding "yes."

Lifting the price cap for short-term releases of capacity was a failed experiment. The time has come to reverse that mistake and move on.

However, re-imposition of this price cap will not completely solve the problem of California's dramatically higher natural gas prices compared to the rest of the country. I continue to urge FERC to investigate and act to bring California's gas prices in line with national prices.

JUNE 18, 2001 FERC ORDER

I am gratified that after a year of pounding at FERC's door, the Commission has opened up and issued an order that is a positive step forward by providing some price relief. The FERC did correct the most obvious flaws in its April order, providing mitigation that covers all hours and the entire Western interconnect. While I am cautiously optimistic that the latest order will help to keep prices down in the spot market, there a number of

things FERC could have done better.

FERC insists on tying its price formula for wholesale electricity to the costs of the least efficient and most expensive generator. Using a cost-of-service-based rate, as championed by Commissioner Massey, would have been far preferable, and far more equitable than what FERC has settled on. The use of the least efficient generator may well result in the greater use of inefficient generation to encourage higher prices. In addition, while the Commission has altered the formula to provide a better gage of costs of generation, they undo that by slapping on a ten percent credit-worthiness surcharge.

The FERC order does not address the wildly fluctuating natural gas market, which has created the severe disparities in the price of natural gas bought at California's borders. Because of the close relationship between the price of gas and the costs of generation, the success of the June 18 order is tied to the continued moderation of prices in the natural gas market. The Commission needs to be vigilant about ensuring that we in California are not subject to continued exorbitant transportation costs for our gas supplies.

Finally, FERC continues to leave the question of refunds wide open, with little or no guidance on the process by which we in California can be made whole after months of paying unjust and unreasonable prices. FERC should exert its authority and order these refunds. We have been waiting for months for the Commission to exercise its responsibility to refund California ratepayers for the wholesale costs of electricity that the Commission itself has failed to control. In this respect, the Commission has a long way to go to finish its job.

CONCLUSION

Mr. Chairman, this Committee can play an essential role in ensuring that FERC's June 18 order is implemented in a manner that ensures true price mitigation of electricity costs in the West. I am hopeful that FERC will be vigilant in implementing its new order. As we cautiously and optimistically wait to see the impacts in the market, Californians will continue to demand that FERC exert its role to refund the unjust and unreasonable costs of electricity that the state so clearly is owed.

We have made some progress on prospective price relief. Now it's time to move forward on refunds.

Thank you for the opportunity to come before you today. I look forward to answering any questions you may have.

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