Testimony

TESTIMONY OF
THE HONORABLE JUDY MARTZ
GOVERNOR OF MONTANA
BEFORE THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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Mr. Chairman and members of the Committee, my name is Judy Martz and I am Governor of the Big Sky State of Montana. I appreciate the interest this Committee has shown in the struggles of Western states to deal with an electricity crisis.

We are here to discuss "The Role of the Federal Energy Regulatory Commission Associated with the Restructuring of Energy Industries." However, the real issue seems to be: "What went wrong in California and could it happen anywhere else?"

Let me try to answer this question. The facts show that the primary responsibility for the electricity crisis in the West lies with the State of California. A series of mistakes made by the State, and a failure by the State to take corrective action once problems first arose more than a year ago, led directly to this crisis.

This crisis could have been avoided if California had taken timely action. Instead of acting, the State has unfortunately engaged in a prolonged exercise of blame shifting.

I don’t say this to be disagreeable. I say this from the perspective of a State that has been hurt by the California electricity crisis. I also say this to make sure that other States do not make the same series of mistakes California made in recent years.

Montana has been hit hard as a result of the California electricity crisis. Montana industrials that gambled on declining future power prices have been hit hard hurt by with the resulting power prices.

We have seen several closures in Montana, a state whose economic base cannot afford to lose a single job. But, bWhile ecause since we are tied into the western grid, any excess energy is pulled to other states and we face higher rates ourselves.

Industries that choose to shop for energy found their traditionally low rates of about $30 per megawatt rise to as high as $300. Much of the pain that my State and others have felt could have been avoided if California had not shied away from taking tough decisions when they were called for last year.

Let’s review how we got where we are today. California was the first State to open its retail electricity markets to competition in 1996, with Pennsylvania following quickly on its heels. The California electricity law is often described as "deregulation" but it was nothing of the kind. California did not deregulate electricity markets, but merely exchanged one set of State regulatory rules for another – which led to disaster. We did better in Montana.

The 1996 law had a number of unusual elements. It forced California utilities to divest much of their electricity generation. It required utilities to rely completely on volatile spot markets to buy all their power, something no other State did. It also imposed regulatory rules governing spot market sales that increased wholesale market prices. It froze retail rates.

One provision missing from the 1996 law was reform of the State siting law. California’s siting law is the most burdensome in the world. It can take up to seven years to build a power plant in California, and the average period is 4.5 years – nearly twice the average in Texas.

This was a crucial mistake, since California retained a siting process suitable for long-term planning by regulated utilities with 10 or 20 year planning horizons, but completely unsuitable for a competitive market where independent power producers build virtually all power plants using much shorter planning horizons.

The failure to address siting reform was a major mistake. Independent power producers moved quickly to meeting California's growing electricity demand, filing applications to build 14,000 megawatts of new generation beginning in 1997. Because of the failed State siting process, none of these power plants are operating yet. Montana did not make the same mistake. We revised our siting laws to exempt generation facilities.

It is important to note that the supply shortage in California did not occur overnight. It developed over a five-year period when electricity demand rose by 6,300 megawatts. Incredibly, over this same period, electric generating capacity in California actually declined.

As I indicated earlier, California took a big gamble by forcing its utilities to buy all their power through volatile spot markets. It took an even bigger gamble not ensuring that electricity supplies were adequate to meet the needs of consumers and businesses. It does not take a panel of economists to know that supply shortages and spot markets are not a good combination. They produce the sky-high prices that California and the West have been paying for the past year.

California has had price caps for wholesale power sales since 1998. Last year, California experimented with four different price caps: a hard cap of $750 per megawatt-hour (under a hard cap no sale may take place above the capped price), a hard cap of $500, a hard cap of $250, and a soft cap of $150.

This year, FERC changed tacks, approving price mitigation that reflects gas costs and other costs. That approach seems to be working, and FERC earlier this week expanded the scope of its price mitigation plan.

Price caps exacerbated California's supply problems last year. Since the caps did not apply to Western markets in-State power producers often chose to sell electricity outside California at price higher than the hard cap. As a result, power exports from California rose 85 percent and California's electricity supply fell by 3,000 megawatts.

By the end of the year, when the hard cap had been lowered to $250, the price cap was seriously exacerbating California's electricity supply problem, since prices in uncapped markets had risen to more than $400.

Ultimately, California asked to lift the price cap on the grounds that it was causing serious supply problems. On December 8, 2000, the California ISO filed an emergency petition to waive the $250 hard cap, which FERC approved. At their request, FERC set a soft cap.

Price caps last year also did not control high prices. Each time price caps were lowered, average monthly prices rose. The experience last year showed that price caps failed to control high prices, and exacerbated supply problems.

The lesson California apparently drew from the failure of price caps last year was to expand the scope of price caps to encompass the entire West, notwithstanding the opposition expressed by 8 of the 11 governors in the region.

The main cause of the California electricity crisis is a supply shortage. It is the State's responsibility, not the Federal government's, to license power plants. It has been clear for a long time the State siting process is broken. Although it has made cosmetic changes, the State has shied away from making meaningful reforms to the siting process.

The secondary cause of high prices is the disastrous regulatory rules imposed on the electricity market by the State. Unfortunately, the State has simply refused to act in a timely and effective manner. The California electricity crisis in large part is the result of inaction over a crucial nine-month period after the price spikes and supply shortages began in May 2000. This inaction forfeited the last chance to prevent a crisis.

State rules barred California utilities from recovering wholesale power costs from retail rates, forcing utilities to buy power at 30 cents per kilowatt-hour and resell it for 3 cents. It was those rules – imposed by the State of California – that destroyed the financial health of the utilities and drove Pacific Gas & Electric (PG&E) into bankruptcy.

If the State had allowed cost recovery, the utilities' credit would not have been destroyed, PG&E would not have gone bankrupt, and the State would not be spending its surplus buying electricity and bailing out the very utilities' whose credit it destroyed. The bankruptcy of PG&E could have been avoided if the State had allowed cost recovery.

Perhaps the most serious mistake made by the State was forcing the California utilities to rely entirely on the volatile spot market for all their power, even after wholesale prices had risen ten-fold. If the Governor had allowed the utilities to enter into bilateral contracts last year, electricity prices would be a fraction of what they are now.

Last summer, Duke Energy offered to sell San Diego Gas & Electric power for $55 per megawatt-hour, a fraction of today's cost. However, the California Public Utilities Commission forced the utilities to continue relying on the spot market. The end result: instead of paying $55, utilities paid average monthly prices exceeding $300.

The State only recognized the need for bilateral contracts after the financial health of the utilities was destroyed, and the State assumed the burden of buying power for Californians. Once the State was paying the bills it realized reliance on volatile spot markets was foolish, and began to enter into bilateral contracts.

Ironically, the contract prices California has announced – and much of this remains secret – indicate they agreed to pay up to three times higher than what Duke Energy offered last year.

The State's indecision on raising retail rates was another major mistake -- one that led to higher rate increases than were necessary. Last fall, the utilities requested a modest rate increase. The State refused to consider this proposal, which directly led to the PG&E bankruptcy. In the end, the State ended up approving a much larger rate increase than was necessary if it had acted in a timely and effective manner.

Nine months after the beginning of this crisis, Governor Davis began to take action. In February, he announced an emergency plan to build 5,000 megawatts of new generation by July 1. According to recent reports, only 1,300 megawatts of plants that were under construction before his announcement will be available on that date.

Governor Davis announced a conservation plan to lower demand by 3,000 megawatts. I understand that plan also is falling short, and may produce less than 1,000 megawatts in demand savings. The Governor's plan to restore the financial health of Southern California Edison appears to be languishing in the State legislature. I am glad the State is taking this action, but regret they only acted in response to a crisis, instead of trying to prevent one.

Threats by the Governor and others to seize power plants and impose punitive taxes, which we did not ultimately do in Montana, will discourage what is needed most: investment in new generation. California has seen at least two power plants put on hold because of uncertainty about regulatory stability in California. As one power company put it: "I have more confidence in regulatory stability in Brazil than I do in California."

If the Governor takes such a rash step, investment in new generation in California will come to a complete halt. The State will find itself in the business of generating and transmitting electricity on a permanent basis. The State will continue to spend billions of dollars on electricity instead of on schools. The power plants and transmission infrastructure will slowly degrade.

And California's neighbors – Montana included – will find that they must continue to supply the power that California needs, since California refuses to provide for itself.

The time for blame shifting is over. FERC has taken strong action to mitigate high prices in California. The time has come for the State to buckle down and do its job: ensure adequate electricity supplies for California consumers and businesses.

Thank you.