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THE EAGLES OF DEREGULATION: THE ROLE OF THE COURTS IN A RESTRUCTURED ENVIRONMENT

BY
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In 1998, California became the third state in the nation to restructure its electric sector, but in 2000, this restructured electric power market imploded. In this Article, Professor Ferrey discusses what he determines are three important facets of electric deregulation that were exposed by California's energy debacle: 1) the fundamental unresolved legal conflict between state and federal authority to address electricity issues; 2) the growing importance of common law court adjudication; and 3) the judicial conflict resulting from re-regulation, in the form of reactive legislative responses. Ultimately, the Article concludes that the most profound legacy of the California experience may be the effect it has had on other states, many of which are now forestalling deregulation based upon California's mishandling of events.

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I. INTRODUCTION

Welcome to the Hotel California . . .
You can check out any time you like
But you can never leave[1]

The consumer in the Sunshine State has checked into the electric future suite at the Hotel California; it will be an extended stay, and the tab is running. The most capital intensive industry in the United States, in the largest state in the Union, which itself is the fifth largest economy in the world, came completely unhinged. From 1999 to 2000, California's expenditures on electricity quadrupled from approximately $7 billion in 1999 to approximately $28 billion in 2000.[2] For 2001, it is expected to be even greater.[3]

Three salient facets of the environment of electric deregulation are exposed by California's problems:

• A fundamental unresolved legal conflict between state and federal authority to address electricity issues.

• Common law court adjudication will replace the traditional role of regulation.

• Re-regulation, in the form of reactive legislative responses, will spawn yet more judicial conflict.

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1 THE EAGLES, *Hotel California, on* HOTEL CALIFORNIA (Elektra Records 1976).

2 Ahmad Faruqui et al., *Analyzing California's Power Crisis*, ENERGY J., Oct. 21, 2001, at 29, 2001 WL 14086918.

3 It is estimated that electric power plants are responsible for
·66% of SO_2 emissions
·9% of NO_x emissions
·35% of CO_2 emissions
·21% of mercury emissions
CLEAN AIR NETWORK, POISON POWER: HOW AMERICA'S OUTDATED ELECTRIC PLANTS HARM OUR HEALTH AND ENVIRONMENT (Sept. 1997). Statistics from the U.S. Department of Energy, Energy Information Administration, have these values for SO_2 and NO_x even higher on a percentage basis. *See* Energy Info. Admin., *Annual Energy Review: Environmental Indicators*, *at* http://www.eia.doe.gov/emeu/aer/envir.html (last modified Mar. 2002) (tables of estimated emissions measured by million metric tons of gas).

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II. WHAT REALLY HAPPENED AT THE HOTEL CALIFORNIA?

Welcome to the Hotel California
Such a lovely place, such a lovely face
They're livin' it up at the Hotel California
What a nice surprise. Bring your alibis.[4]

In late calendar year 2000, California's restructured electric power market imploded.[5] What really happened? The facile answer is that demand exceeded supply. But there is more.

A. The Restructuring

In 1998, California became the third state in the nation, after Massachusetts and Rhode Island, to restructure its electric sector, allow retail competition, and "incentivize" or force its investor-owned utilities to sell their generating assets. Because California's concept of deregulation contained a ten percent price cut to pacify consumers, this discouraged consumers from shifting to alternative retail suppliers.[6] Therefore, a vibrant retail market and significant customer choice did not become a reality. Only about two percent of customers—typically large customers—switched to other suppliers. The conventional utilities continued to supply more than ninety percent of the power being sold in the state.[7] They had to do this after selling their generating assets and by not hedging forward the electricity supply.

After deregulation, the California Energy Commission no longer assessed the state's need for power. Market participants, subject to regulatory siting approval, were responsible for supply. By law, deregulated power supply was bid to the California Independent System Operator (ISO) daily, with the last/highest price accepted setting the price for all sales of power during that period.[8] The utilities were required by regulatory authorities to buy a substantial amount of their power requirements on the "spot" market—day-to-day—rather than through hedged forward contracts.

Rather than rely on hedged forward contracts to mitigate price swings, California sought the imposition of spot electric price caps as a means to

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[4] THE EAGLES, *supra* note 1.

[5] For a pseudonymous article arguing against electric deregulation, see Price C. Watts, *Heresy? The Case Against Deregulation of Electricity Generation*, ELEC. J., May 2000, at 19.

[6] *See* Faruqui et al., *supra* note 2.

[7] *Id.*

[8] For a discussion of the experience and efficacy of this so-called "second-price" auction, see 1 STEVEN FERREY, THE LAW OF INDEPENDENT POWER ch. 9 (18th ed. 2001). For an analysis of how bidding markets are working with deregulation in California, see C. Vazquez et al., *If Pay-As-Bid Auctions Are Not a Solution for California, Then Why Not a Reliability Market?*, ELEC. J., May 2001, at 41. The authors argue that, since the auction mechanism in wholesale markets is not working satisfactorily in California and other constrained areas, a financial call option is a reasonable substitute for these market deficiencies, allowing the trade in electricity futures and hedged financial instruments, rather than in the electricity commodity itself. *Id.* at 48.

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control losses.[9] This may work as a political solution, but it destroys the price signals that the market would otherwise send, as well as dampens conservation incentives. California was unique among the states in not allowing hedged forward power contracts for wholesale supply. This prohibited the regulated California utilities, which still supplied by default most of the retail customers in California, from managing the risk of their electric commodity acquisition.

Approximately one-quarter of California's generating capacity is hydroelectric, which was susceptible to annual water flows that decreased.[10] California's reservoirs were down to minimal levels, leaving little energy capacity from these hydroelectric resources in the system.[11]

Some of the problem in California was made more complex by unregulated companies and their affiliates controlling both some of the natural gas supply and a significant share of deregulated wholesale electric power producers. About half of California generation relies on natural gas, a great majority of which is not extracted in-state.[12]

In California, the largest market participant has a share of only thirteen percent of the market.[13] However, for purposes of exercising market power during certain hours in certain sub-markets, at times when demand is very inelastic, there could still be horizontal market power for a generator with less than a twenty percent share. While the Federal Energy Regulatory Commission (FERC) originally concluded that market power would be fully mitigated by FERC Order No. 888,[14] which established open access transmission tariffs,[15] this conclusion is somewhat contradicted by FERC Order No. 2000,[16] which finds that undue market discrimination still continues in the industry.[17]

Some of the gas supply companies declined to sell natural gas to the cash-short integrated electric and gas utility companies in California that were required by law to serve residential and other natural gas customers.

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9 For an analysis of why there is so little price-response in electricity demand in response to capped wholesale electricity prices, and why price caps may defeat necessary consumer incentives for demand response, see Eric Hirst, *Price-Responsive Demand in Wholesale Markets: Why Is So Little Happening?*, ELEC. J., May 2001, at 25. Hirst argues that capped prices in California of $150 per megawatt-hour (MWh) are not sending proper price signals to consumers who otherwise might undertake demand-side management or conservation behavior. *Id.* at 31, 34. Therefore, efforts to restrain the price impacts of deregulated markets narrow the normally expected market responses. *Id.* at 36–37.

10 Cal. Energy Comm'n, *California's Electricity Market*, at http://www.energy.ca.gov/maps/electricity_market.html (last visited Mar. 10, 2002).

11 *In re* PG&E, Case No. 01-30923DM (N.D. Cal. filed Apr. 6, 2001).

12 Cal. Energy Comm'n, *Energy Facts*, at http://www.energy.ca.gov/html/calif_energy_facts.html (last visited Mar. 10, 2002).

13 Faruqui et al., *supra* note 2.

14 Promoting Wholesale Competition Through Open-Access Non-Discrimination Transmission Services by Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, FERC Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996).

15 *Id.* at 21,555.

16 Regional Transmission Organization, FERC Order No. 2000, 65 Fed. Reg. 810 (Jan. 6, 2000).

17 *Id.* at 811–12.

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This drove the price of natural gas higher and, therefore, the cost of power produced at wholesale by natural gas-fired power generation technologies. The utilities were unable to store sufficient amounts of natural gas; the state regulatory commission had discouraged investment in pipeline and in-state storage assets that were owned by the gas distribution companies.

California's spot market began March 31, 1998.[18] During summer 2000, spot market prices for electricity in California increased by 500%, and then doubled from that new plateau at the end of calendar year 2000.[19] When spot market prices of wholesale power increased dramatically due to shortfall, this caused the ultimate cost of power needing to be passed on in retail rates or otherwise recouped to increase correspondingly. In response to ratepayer protest, the state ordered retail rates frozen at 6.5¢/kilowatt-hour (kWh).[20] Many of the investor-owned retail utilities were purchasing power at substantially higher wholesale spot market prices, but not allowed to pass on the higher acquisition cost in retail rates under this retail rate cap.[21]

Thereafter, the revenue-strapped regulated California distribution utilities were unable to pay on time for their wholesale power acquisitions because of dwindling cash resources. The utilities teetered on the verge of bankruptcy. Over time, an increasing amount of total load was served through real-time spot market purchases, which reflected near-panic situations. The California ISO was allowed to purchase power from out-of-state suppliers at any price.[22] A phenomenon known as "megawatt laundering" then ensued, where out-of-state suppliers could sell power to neighboring states, which could then be resold to the California ISO at inflated prices.

B. The Descent

There she stood in the doorway
I heard the mission bell
And I was thinking to myself

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[18] Faruqui et al., *supra* note 2.

[19] Lyn Lorum, *As California PUC Probes Market, SDG&E Claim it Was Denied Hedging Authority*, POWER MARKETS WK., Aug. 28, 2000, at 1, 2000 WL 25140536.

[20] A.B. 265, 1999–2000 session (introduced Cal. 2000) (chaptered at CAL. PUB. UTIL. CODE § 332.1 (West 2000)).

[21] *See* Faruqui et al., *supra* note 2 (describing PG&E and Southern California Edison debt accumulation which could not be passed on to consumers who still billed at frozen retail rates). Price spikes experienced in deregulated wholesale markets included a price spike in the Midwest during the week of June 22, 1998, with prices rising up to $7500/MWh; a price of $10,000/MWh on February 14 to 15, 1999 in the New York ancillary services market, which was repeated in December 1998; prices in the New England ISO rose to $6000/MWh on May 8, 2000; and Pacific Northwest prices spiked at $1000/MWh in 2000 and 2001.

[22] S.A. Van Vactor & F.H. Pickel, *Money, Power and Trade: What You Never Knew About the Western Energy Crisis*, PUB. UTIL. FORT., May 1, 2001, at 32, 41, *available at* 2001 WL 10544674. As power sellers in Oregon and Washington became nervous about selling through multiple jurisdictions into Southern California, the financial risk began to decrease the trade from north-to-south on the West Coast. The deregulation legislation required all of the utilities to purchase their loads over a four-year transition period from the California Power Exchange, which was prone to purchasing power at spiked prices.

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This could be Heaven or this could be Hell.[23]

Rolling blackouts were visited on consumers during the off-peak winter and spring months of 2001. It is estimated that outages of electric supply, before adding the California experience, already cost the United States economy approximately $50 billion and could increase significantly in the future.[24] A shortage of electricity has dire social and political consequences; a blackout has been equated to a natural disaster.[25]

Moreover, allowing rolling blackouts is a very inefficient way to balance electricity supply and demand differences. Not every consumer attaches the same value to electricity at a given hour. For some industries, even a short blackout can ruin millions of dollars of production; for others, it is a minor inconvenience. However, because of simple meters, no residential consumers see price signals that reflect the actual time-sensitive costs their consumption imposes on the system at any given time of day. This fixed retail rate, with no metering feedback system to retail consumers, excludes substantial amounts of retail electric consumption from any meaningful price response role in the deregulated market.

The situation in California became so extreme that President Clinton used a statute reserved for national emergencies, or when the national defense is threatened by foreign powers, to try to keep the lights on in California. Declaring a "natural gas supply emergency"[26] under the Defense Production Act of 1950,[27] which was enacted at the commencement of the Korean War to keep supplies flowing to the government, the President compelled unregulated out-of-state natural gas companies to keep selling gas to California utilities who were unable to pay for it and were on the verge of bankruptcy.[28] The Clinton administration justified this action by claiming that, had the gas not been ordered moved to California, the California investor-owned utilities (IOUs) could have seized other gas in the pipelines to serve residential customers, cutting off federal military and NASA facilities.[29]

This was an extraordinary exercise of national defense powers in peace time to cause private companies to act contrary to their market interests. President Bush allowed this order to expire after extending it once.[30] California's Governor Gray Davis (D) urged President Bush

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23 THE EAGLES, *supra* note 1.

24 David Stipp, *The Real Threat to America's Power*, FORTUNE, Mar. 5, 2001, at 140.

25 Allen Williams, Jr., *The U.S. Electricity Sector: What After California?*, ELEC. J., June 2001, at 51, 52.

26 *See* Defense Production Act of 1950, 50 U.S.C. § 2062(a)(7) (2000) ("in order to ensure national defense preparedness, which is essential to national security, it is necessary and appropriate to assure the availability of domestic energy supplies for national defense needs.").

27 50 U.S.C. §§ 2061–2171 (2000).

28 *Wartime Gas Law Under Fire; Gramm Seeks to 'Curtail' Dangerous Federal Power to Force Fuel Sales*, S.F. CHRON., Feb. 10, 2001, at A13.

29 *Id.*

30 *Id.*

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> to stand up to your friends in the energy business and exercise the federal government's responsibility to ensure energy prices are just and reasonable.... What's going on here, pure and simple, is unconscionable price-gouging and market manipulation by the big energy producers and marketers—most of them, incidentally, located in Texas.[31]

During the first five months of 2001, only about ten percent of power sales to the state, in fact, were from Texas-based companies.[32] Former Republican Governor Pete Wilson countered that then-Lieutenant Governor Davis did not offer "a peep" during the original California deregulation debate.[33]

No state, particularly California, which imports power from eleven other states and Canada,[34] is an island. This is especially true regarding electricity moving almost at the speed of light. As a practical matter, California energy requirements are such as to utilize all of the electric power exported by Arizona, Oregon, Montana, New Mexico, Utah, Washington, and Wyoming, as well as from Canada and Mexico.

The Clinton administration required neighboring western states to export power to California to limit California blackouts.[35] This action spread concern regarding the operation of California's deregulated magnet market to several of the eleven states that export power to California.

As low-cost federal hydropower was exported to California, wholesale power costs for residual power in the Northwest rose. In the Pacific Northwest, the Bonneville Power Administration raised rates by seventy-five percent.[36] Retail electricity prices in the state of Washington increased as much as fifty percent due to the ripple effects of scarce Northwest hydroelectric power being diverted to California under federal order.[37] Louisiana-Pacific Co. had to close Northwest facilities; Boeing and Microsoft voiced corporate energy concerns.[38] Other states in the West threatened lawsuits for monitoring damages for injuries to their states resulting from the California restructuring debacle.

Ten aluminum smelters in the Pacific Northwest took advantage of increasing electricity prices by shutting down facilities and reselling their allotments of low-cost federal hydropower on the wholesale market.[39] At a

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[31] Remarks by Governor Gray Davis, Response to President Bush's Radio Address (May 19, 2001), *available at* http://www.gray-davis.com/Speeches/.

[32] *DWR Report Says In-State Suppliers Were Among Leaders in Power Sales Since Jan.*, ELEC. UTIL. WK., July 16, 2001, at 3.

[33] Robert Salladay, *Energy Crunch*, S.F. CHRON., June 24, 2001, at A1.

[34] Cal. Energy Comm'n, *supra* note 12.

[35] Mark Gladstone & John Woolfolk, *U.S. Keeps California's Lights On*, SAN JOSE MERCURY NEWS, Dec. 14, 2000, at 1A.

[36] Lynda V. Mapes, *Possible Rebates, Upcoming Rate Increase Leaves Northwest Power Picture Unclear*, SEATTLE TIMES, June 27, 2001, at B1; *Wash. GOP Solons Furious at California*, ELEC. DAILY, Feb. 7, 2001, at 1.

[37] Mapes, *supra* note 36, at B1.

[38] Allan Brettmann, *West Fails to Grasp Energy Situation*, OREGONIAN, Jan. 18, 2001, at D1.

[39] Sam Howe Verhovek, *Lack of Power in the West Proves a Boon for Some*, N.Y. TIMES, Dec. 29, 2000, at A15. Electric customers that have elastic or discretionary demand can forego consumption at times of maximum consumption. Low value-added customers can be induced to

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time of depressed aluminum prices and elevated electricity prices, this made eminent good sense and was economically rational. As prices receded in the latter half of 2001, these closures appeared less prudent.

California Governor Gray Davis sought additional federal intervention. FERC refused to restrain the operation of the market that California had created, other than to initially continue wholesale power sale "soft" price caps, and eventually refused to approve in June 2001 a cap on spot market prices for all western power transactions occurring when reserve margins fell below seven percent.[40] Nonetheless, power was "laundered," by being first sold out-of-state to marketers at prices above the soft cap, and then resold at market prices to or in the state.

The California ISO has had price caps that have descended over time from $750 per megawatt-hour (MWh) in June 2000 to $500/MWh in July 2000, to $250/MWh in August 2000.[41] However, the price caps that apply during certain periods of supply inadequacy do nothing to prohibit the recovery of otherwise excessive prices in other periods. This measure can occur in off-peak periods if the particular sub-market is dysfunctional. The New York ISO, ISO-New England, and the Pennsylvania-New Jersey-Maryland Interconnection (PJM) ISO have each approved price caps of approximately $1000/MWh, applicable during certain temporary conditions to protect consumers.[42] Trades do continue, but the price is capped in lieu of halting trades.

FERC ordered public power systems in the West to be subject to the same transmission constraints as regulated public systems, even though FERC does not have jurisdiction over them and they were not necessarily part of the problem.[43] This was imposed as a condition of using the transmission system. Gary Ackerman of the Western Power Trading Forum reacted that this was self-defeating regarding additional supply: "Any plant developer will have serious second thoughts about building a power plant in the West."[44]

County and municipal budgets were devastated by higher than expected electricity rates. Republican lawmakers sued Governor Davis to get access to secret State Department of Water & Power contract files with wholesale power generators.[45] The California State Senate found Enron and Mirant in

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not consume electricity at key times. This tactic is similar to the way that airlines typically overbook flights, and then coax the low value-added customers to exit the airplane in return for various incentives. However, with typical residential rates and metering, no such price signals or benefits are visited on consumers.

40 San Diego Gas & Elec. Co. v. Cal. Power Exch., FERC ¶ 61,418, 62,546 (June 19, 2001) [Apr.–June 2001 Transfer Binder].

41 Van Vactor & Pickel, *supra* note 22, at 40.

42 *See New England Wants Price Cap Extended,* ENERGY REP., Oct. 1, 2001, 2001 WL 8475454; *FERC Cites Tight Supplies in Extending $1,000 NYISO Price Cap Through October,* PLATTS NE POWER REP., May 21, 2001, at 1.

43 *FERC's West-Wide Plan Controls Market More than Expected,* POWER MARKETS WK., June 25, 2001, at 1, 2001 WL 10442423.

44 *Id.*

45 Lynda Gledhill, *Governor Set to Reveal Terms of Power Deals,* S.F. CHRON., June 13, 2001, at A15, 2001 WL 3406240.

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contempt for refusal to provide subpoenaed internal documents.[46] The California Senate issued subpoenas to major power generators and marketers for allegedly confidential business data, which several of the parties resisted.[47] A Sacramento Superior Court judge ruled on September 6, 2001 that Enron must provide state legislative panels with financial documents.[48] The court also granted a protective order.[49] The California State Senate report suggested that Enron be fined $1000, with the fine doubling every day that the company did not comply with subpoena requests for documents.[50] The requested documents included bidding data and strategies, energy capacity availability, information access and exchange, evidence of coordination, evidence of collusive conduct or market power, among others.[51] Enron argued that, as a wholesale market participant, it was exclusively regulated by FERC; therefore, California could not compel it to do anything, including provide documents that were kept outside of California. A deal was later worked out.[52]

Mayor Brown in San Francisco initiated an action asserting that utilities had been negligent or had not honored their franchises by providing reliable service.[53] These claims could allege inadequate system design, inadequate maintenance, or failure to prepare for weather-related events.

One geopolitical and environmental residue of the California crisis is that independent power companies are scrambling to establish power generation facilities just south of California along the Mexican border. Power can be exported to California pursuant to the North American Free Trade Agreement[54] and FERC permission.[55] Projects just across the U.S.-Mexican border include a 600 megawatt (MW) natural gas plant owned by Sempra, a 1000 MW natural gas plant owned by Intergen, and a 260 MW plant owned by American Electric Power (AEP).[56] Mexican power generation

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[46] *Court Tells Enron to Give Calif. Panel Documents, Grants Protective Order*, POWER MARKETS WK., Sept. 10, 2001, at 5, 2001 WL 27246875; *see also Calif. Drops Enron Contempt Charges*, ENERGY REP., Sept. 24, 2001, 2001 WL 8475425. Although the California Senate dropped contempt charges against Enron after it agreed to deliver documents to the Senate, the Senate has recently re-initiated contempt proceedings because Enron has failed to comply with this agreement. John Howard & Hanh Kim Quach, *Energy Probe Has Turned Up Little So Far*, ORANGE COUNTY REG., Feb. 13, 2002, 2002 WL 5440066.

[47] *Calif. Drops Enron Contempt Charges*, *supra* note 46.

[48] *Court Tells Enron to Give Calif. Panel Documents, Grants Protective Order*, *supra* note 46, at 5.

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *Id.*; *DWR Report Says In-State Suppliers Were Among Leaders in Power Sales Since Jan.*, *supra* note 31, at 4.

[53] *San Francisco City Attorney Sues PG&E Corp.*, DOW JONES ENERGY SERV., Feb. 11, 2002, Westlaw, 2/11/02 DJES 20:36:00.

[54] Dec. 8, 1992, Can.-Mex.-U.S., art 104, 32 I.L.M. 289.

[55] Diane Lindquist, *Mexicali Plant Permits Protested; Critics in S.D. and Imperial Counties Fear More Pollution*, SAN DIEGO UNION TRIB., Oct. 2, 2001, at B1, 2001 WL 27292296.

[56] Diane Lindquist, *Imperial County Reject's Power Plant's Proposal*, SAN DIEGO UNION TRIB., Sept. 21, 2001, at A13, 2001 WL 27290201; Diane Lindquist, *Wattage from Baja Is About to Flow; Mexican Official Tells of Growing Supply*, SAN DIEGO UNION TRIB., May 5, 2001, at A1,

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facilities are not exposed to the same stringent environmental regulations as California facilities, and the resulting air-borne pollutants may also drift into southern California. Environmental groups in San Diego are pressing for controls on Mexican power plants that would limit air pollution and conserve water resources. Representative Bob Filner (D-CA) stated, "[T]he Border Patrol has not found a way to keep out our pollution."[57] The construction of such plants in Mexico and their sale of power to California will raise new choice of law issues.

In March 2002, Earthjustice (the former Sierra Club Legal Defense Fund) filed suit in federal court in San Diego claiming that a federal permit for electric power lines to bring electricity from the Intergen and Sempra plants in Mexico into the U.S. could not be granted without the preparation of a full environmental impact statement (EIS) pursuant to the National Environmental Policy Act of 1969 (NEPA).[58] The claimed environmental impacts were to air emissions and water depletion in the U.S., resulting from cooling water use across the border. The U.S. Department of Energy had concluded that no EIS was required because there was no significant environmental impact.[59]

III. STATE-FEDERAL CONFLICT

Mirrors on the ceiling
Depict champagne on ice And she said
We are all just prisoners here
Of our own device.[60]

What has resulted from California's energy crisis? The first major implication for California is that the debacle highlights the growing fundamental conflict between state and federal jurisdiction. It is unresolved whether federal regulators, pursuant to the Federal Power Act,[61] or California, subject to its reserved retail regulatory power, have the legal authority to resolve issues.

A. Power Environment

One conflict was between state and federal environmental laws. Maximizing supply was essential. In the California market where there was a shortage of power, the effort of various installed generating units to be available caused them to exceed their permitted federal air emission limitations. Certain generators were constrained because of annual federal emission limits or local limitations on combustion turbines within city

2001 WL 6458348.

57 Lindquist, *supra* note 55, at B1.

58 42 U.S.C. §§ 4331-4370e (2000).

59 Tina Davis, *Enviros Sue DOE Over Transmission Links with Mexico*, ENERGY DAILY, Mar. 21, 2002.

60 THE EAGLES, *supra* note 1.

61 16 U.S.C. §§ 791a–828c (2000).

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limits.[62] Some of the plants had to shut down late in calendar year 2000 or late in a particular quarter during 2001, so as not to exceed their thresholds.

The California ISO rejected efforts by some of those plants to shut down, directing them to purchase additional emissions allowances from other generators, if necessary, even though they had no such permission to operate under provisions of federal air regulation.[63] In some instances, air emission credits, if available, can be purchased to allow additional generation—exceedances result in fines from the environmental authorities. In California, such allowances often are in very short supply. The resulting shortage in California power led to dramatic increases in deregulated wholesale power prices at the margin, where the last wholesale bid price accepted by the ISO hour-by-hour set the price for all power sales throughout the ISO.[64]

To overcome these hurdles, California air regulators subsequently permitted those plants to come back on-line, in return for paying daily fines for exceeding their allowances.[65] Only about half of the affected capacity responded to this permission. Governor Davis subsequently signed an executive order temporarily allowing some of the most polluting California power plants to operate as long as they wish during times of power scarcity, without violating air rules, in return for paying a fee, and without counting against their emission limits in the future.[66] This permission to operate was challenged by the City of San Francisco and environmental groups.[67]

Another step was necessary. In June 2001, Governor Davis issued an emergency order allowing all natural gas-fired units to operate, irrespective of emission limits in their permits, and without imposition of fines or penalties through summer 2001, without counting such excesses against permit limits (as could occur under the previous order), as long as mitigation fees were paid to the state.[68] The justification for this order was that extra generation from cleaner gas-fired units eliminated the need to startup dirtier oil-fired units. In so doing, California was interpreting, *inter alia*, its delegated federal Clean Air Act[69] authority, possibly in an inconsistent manner. Such units were required by the order to sell all power to the state, which could violate the exclusive federal control over wholesale power

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[62] Pasadena limited certain combustion turbine operation to 300 hours per year on 226 MW of oil- and gas-fired capacity. Even if units were allowed to run, the cost of obtaining additional emission credits in the heavily regulated California area substantially increased the cost of peak generation. Van Vactor & Pickel, *supra* note 32, at 40.

[63] *Davis Says FERC Action Loosening Reins on QFs Damages State Efforts*, ELEC. UTIL. WK., May 12, 2001, at 7.

[64] Van Vactor & Pickel, *surpa* note 22, at 40.

[65] *See California AG to Convene Grand Jury on Allegations of Price Manipulation*, ELEC. UTIL. WK., June 18, 2001, at 3, 4.

[66] State of California, Exec. Order No. D-40-01 (June 11, 2001). The mitigation fee is $7.50/lb. for NO_x and $1.10/lb. for CO. The federal EPA concurred on this waiver.

[67] San Francisco v. Mirant Potrero LLC, Case No. C012356 (N.D. Cal. June 19, 2001); Cmtys. for a Better Env't & Bayview Hunters Point Cmty. Advocates v. Mirant Potrero LLC, Case No. C012348 (N.D. Cal. June 19, 2001).

[68] State of California, Exec. Order No. D-40-01 (June 11, 2001).

[69] 42 U.S.C. §§ 7401–7671q (2000).

sales. This state action, even if legal, preempts regional air quality regulators, and may violate the federally approved State Implementation Plan for air quality maintenance, while filling state coffers with payments from the affected generators.

By an emergency order in December 2000, FERC authorized California Qualifying Facilities (QFs) to generate at full capacity, exceeding the federal small power producer fuel-use requirements,[70] without losing their QF status. Therefore, it appears that the political concern of maintaining adequate supplies of energy took precedence over federal environmental and QF regulatory concerns in that market.

B. Public Power Exemption

State-federal conflict is also evident in attempts to regulate amid the debacle. For example, FERC is being sued by California for its decision to limit potential refunds from wholesale power sales in California to only the period between October 2, 2000 and June 20, 2001.[71] FERC is also being sued over the same decision by public power groups that object to FERC's attempt to extend jurisdiction for refunds over non-jurisdictional public power systems.[72] The FERC order excluded power bought by the California Department of Water Resources from any potential refund order.[73] Nonetheless, FERC would require other non-jurisdictional entities, such as the Bonneville Power Administration, to make refunds.[74] Public power authorities allege that this violates the Federal Power Act as well as the authorization for the Bonneville Power Administration and other federal power marketing authorities.[75] Notwithstanding these facts, it is a legal question as to whether FERC refund authority extends to public power agencies.

The California Independent Energy Producers Association released a study in August 2001, purporting to demonstrate that the Los Angeles Department of Water and Power (LADWP) charged California a higher average price for power than charged by private generators that came under unnecessary attack by the governor.[76] An audit of LADWP by Pricewaterhouse Coopers found that there was a fifty-six percent profit on power sold to the California Power Exchange in the thirteen months that ended May 31, compared with a twenty-one percent profit on sales through

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[70] Federal Power Act, 16 U.S.C. § 824a-3 (2000); 18 C.F.R. § 292.300 (2000).

[71] San Diego Gas & Elec. Co. v. Cal. ISO, 96 FERC ¶ 61,120 (July 25, 2001).

[72] Suit was brought in September 2001 in the D.C. Circuit. The suit is being initiated by the California ISO. Cal. ISO v. FERC, No. 01-1396 (D.C. Cir. Sept. 10, 2001).

[73] San Diego Gas & Electric Co. v. Sellers of Energy & Ancillary Serv. Into Markets Operated by Cal. & Cal. Power Exch., 97 FERC ¶ 61,275 (2001).

[74] *Id.*, slip op. at 22–41.

[75] Public power advocates argue that sections 206(a) and 201(f) of the Federal Power Act do not extend jurisdiction of FERC over public power agencies.

[76] *Munis Selling to Calif. DWR at Higher Prices than Generators, IEP Claims*, POWER MARKETS WK., Aug. 13, 2001, at 7, 2001 WL 10442650.

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the California Department of Water Resources.[77] LADWP responded that it believed it had made only a fifteen percent return on power sold into the state's wholesale markets during that period.[78]

Republicans subsequently called for the resignation of S. David Freeman, who ran LADWP during this period, and who was subsequently elevated to the position of Chief Energy Advisor to Governor Davis to attempt to extricate the state from its high-cost electric scenario. Freeman responded that when at LADWP he was under instructions from the Mayor of Los Angeles to maximize profits.[79] Critics called this "gouging" other state consumers.

More issues of state-federal conflict have emerged. The Northern California Power Agency (Power Agency), representing municipal and public systems, complained formally to FERC that the California ISO was discriminating against its member customers in two regards. First, the California ISO allowed the investor-owned utilities more lax credit standards than the Power Agency, forcing the Power Agency to shoulder some of the credit support for the investor-owned utilities.[80] Second, the California ISO imposed rolling blackouts on Power Agency member customers to make up for deficient generating assets among the investor-owned utilities.[81] Reliant Energy asked FERC to order the California ISO not to attempt to dictate when Reliant's independent generators would perform maintenance or operate, since they are an exempt wholesale generator.[82]

Bankruptcy of a retail utility raises fundamental issues of state-federal conflict. Pacific Gas & Electric (PG&E), the nation's largest utility, filed for Chapter 11 bankruptcy protection in April 2001, voicing a lack of faith in California's legislative and executive response. The utility had incurred approximately $9 billion in purchased-power costs since June 2000, with no prospect of recovering these past costs in real time. Governor Davis had refused to deal with the utilities unless they dropped lawsuits filed against the California Public Utility Commission (PUC) for refusing to let them pass through high wholesale purchase costs in retail rates. The PG&E bankruptcy under Chapter 11 was meant to stem ongoing losses exceeding $300 million a month. Said PG&E Chairman, Robert Glynn, "We've heard a lot of the words [spoken by Governor Davis] but we have not seen action."[83]

The federal bankruptcy court could override California PUC jurisdiction and could abrogate existing contracts, including QF power

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[77] Doug Smith et al., *DWP Far Exceeded the Profit It Reported*, L.A. TIMES, Sept. 10, 2001, at A1.

[78] *Id.*

[79] Nancy Vogel, *Assembly's GOP Urges Resignation of Power Chief*, L.A. TIMES, Sept. 14, 2001, at B5.

[80] *Suppliers Claim CAL-ISO Is Violating FERC Creditworthiness Requirements*, POWER MARKETS WK., Nov. 5, 2001, 2001 WL 27247134.

[81] *Rift Opens Between CAL-ISO, IOUs, and Cities Over Rolling Blackouts*, INSIDE FERC, May 28, 2001, at 9, 2001 WL 11502076.

[82] Nancy Vogel, *Providers Accuse State of Unfair Practices*, L.A. TIMES, Oct. 19, 2001, at B9.

[83] Peter Behr, *California Utilities Took Different Lines; PG&E Unit Picked Bankruptcy Filing So Cal Made Deal*, WASH. POST, Apr. 17, 2001, at E1.

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purchase contracts. The PUC argued it is sovereign and immune from bankruptcy court orders.[84] This conflict is not fully resolved. In the last twenty years, this was only the fourth utility to have filed for bankruptcy protection (along with Public Service of New Hampshire, Tucson Power, and El Paso Electric).[85]

This bankruptcy filing raised issues of a federal strategy to trump state regulation. PG&E sought to move as much of the company's hard assets as possible away from state jurisdiction to federal jurisdiction, which it could do with the exception of its distribution company. However, the contracts that serve the distribution company can be moved to federal jurisdiction.[86] The bulk of generating assets held by PG&E are either hydroelectric generating assets subject to federal licensing authority, or independent power producers competing in the wholesale market, also exclusively subject to FERC regulation.[87] Gas pipeline assets owned by PG&E, traditionally not subject to federal jurisdiction, would become an interstate pipeline system subject to FERC rather than state jurisdiction. The Filed Rate Doctrine requires such federally approved contract costs to be passed through in retail rates by the distribution company, without state approval.[88] This bypasses state jurisdiction by restructuring assets.

The PG&E plan, while legally complex, is strategically very simple—avoid state regulation by restructuring assets to be federally (and preemptively) regulated. Since the switch in jurisdiction does not raise retail rates, it requires no PUC approval. Creditors of PG&E would support this restructuring because it increases the prospects that they will get repaid in full. Few with legal standing to object to the switch would oppose it. The state could lose. Here again, the tension between state and federal authority is palpable, and outcome-determinative.

Governor Davis criticized the PG&E bankruptcy plan: "I'm very wary of PG&E's proposal to transfer all of its generating capacity from a regulated environment to a non-regulated environment, which shifts oversight from the PUC to [FERC]."[89] Governor Davis criticized FERC for not handing him his demand for $6.9 billion in refunds from wholesale power supply sales in California. Added State Attorney General, Bill Lockyer's, "We also are looking closely at the PG&E reorganization plan because of serious concerns that the utility is seeking to evade further scrutiny by the [PUC] and is seeking to avoid state laws that apply to their transfer of assets."[90]

As the difficulties were evident, FERC approved PG&E's petition on an emergency basis to transfer stock, thus changing its corporate structure to

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[84] Maura Dolan, *PUC Not Ready to Concede Its Ratemaking Authority to Judge*, L.A. TIMES, Apr. 27, 2001, at A3.

[85] *Commentary: Bankruptcy California's Only Answer*, ELEC. DAILY, Feb. 26, 2001, at 2.

[86] Christian Schmollinger, *California Officials Sue PG&E*, NAT. GAS WK., Jan 14, 2002, at 5.

[87] *Id.*

[88] AT&T, Co. v. Cent. Office Tel. Co., 524 U.S. 214, 215 (1998); *see also* Kleine & Co. v. MCI Comm. Corp, 98 F. Supp. 2d 69, 71 (D. Mass. 2000).

[89] *Davis, Consumer Groups Worry that PG&E Reorganization Evades State Regulation*, PLATTS ELEC. UTIL. WK., Oct. 1, 2001, at 12, 13 [hereinafter *Davis, Consumer Groups Worry*].

[90] *Id.*

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protect most of its unregulated assets from the credit problems affecting their regulated electric distribution utility. This immunized certain assets of the company from any possible bankruptcy of the subsidiary retail electric utility company. The Northern California Power Agency called the reorganization of PG&E "unconscionable" and accused FERC of assenting to this "stealth filing" that "also smells of an insider preference, a solution barred by the bankruptcy laws," and the creation of a "ring fence."[91]

Stockholder and owner-derivative suits could be part of anticipated litigation. California Attorney General Lockyer asked the federal Securities and Exchange Commission (SEC) to probe the transfer of assets to PG&E's parent company prior to the PG&E bankruptcy filing.[92] The Attorney General also asked SEC to open an insider-trading investigation into the activities of energy consultants hired by Governor Davis.

Bankruptcy Court Judge Dennis Montali originally approved a $17.5 million bonus pay-out to senior managers, then subsequently asked for a more complete explanation. He received it on July 13 and again approved the pay-out so as to retain key employees.[93] The pay-out was opposed by the United States Trustee and retired former PG&E executives.[94]

There also is threatened administrative regulatory action, and possible lawsuits, over prior decisions of the California PUC to allow the three major California electric utilities to diversify into unregulated businesses and to restructure their assets.[95] The California PUC is determining whether California's large investor-owned utilities violated rules allowing them to diversify into unregulated businesses.

The bankruptcies were broader. The California Power Exchange filed for Chapter 11 bankruptcy protection in March 2001.[96] It blamed a slew of lawsuits by power generators for the necessity of seeking bankruptcy protection. Mindful of the failure of the purchasing utilities to pay, LADWP threatened to halt sales of surplus electricity to California's ISO unless payment was made in cash, or a letter of credit was tendered in advance of the transaction. The ISO subsequently filed for bankruptcy protection.

Southern California Edison Co. initially filed a suit asserting federal jurisdiction over its wholesale rate matters.[97] It later used this suit, which had lain dormant, to have U.S. District Judge Ronald Lew ratify a settlement in which Southern California Edison settled the suit in exchange for being allowed by the PUC to use a combination of existing cash and future

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[91] *Calif. Munis Slam PG&E Ring Fence Around Assets*, ELEC. DAILY, Feb. 13, 2001.

[92] Nancy Rivera Brooks, *California; State Seeks SEC Probe of PG&E Transfers*, L.A. TIMES, July 6, 2001, at C2.

[93] David Lazarus, *Big Bonuses Ok'd for PG&E Bosses/Bankruptcy Judge Agrees to $17.5 Million Payout to Retain Executives*, S.F. CHRON., July 17, 2001, at A5.

[94] *Id.*

[95] Michael A. Hiltzik, *PUC May Probe Utilities' Rule Compliance*, L.A. TIMES, Feb. 6, 2001, at A1.

[96] Rebecca Smith, *FERC Orders Power Suppliers to Pay Refunds*, WALL ST. J., Mar. 12, 2001, at A4.

[97] *Social Ed's PUC Deal Faces Consumer Challenges, Worry from QF Suppliers*, ELEC. UTIL. WK., Oct. 15, 2001, at 5.

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ratcheted retail rate revenues to retire amounts owed for past power purchases.[98]

C. Qualifying Facilities

Qualifying Facilities (QFs) are created exclusively pursuant to federal law.[99] There are more than 600 QFs in California, which provide about fifteen percent of total state power.[100] Renewable energy producers and cogeneration facilities were particularly hard-hit during the California crisis. It was estimated that California QFs were owed approximately $1.5 billion in back payments by utilities as of March 2001, rising to $1.8 billion by mid-2001.[101] Because the fossil fuel-fired cogenerating QFs had not received payment for the power output, they were unable to purchase additional fuels to keep operating their facilities. Consequently, about 110 QF energy producers, representing 3000 MW, shut down their facilities because of non-payment.[102] Many of these QF units were threatened with bankruptcy as a consequence of cessation of power production and power sale activities. Some simultaneously ceased paying property taxes to their local communities, causing a ripple effect on municipal coffers.

Heads of California's utilities responded that this non-payment was not a choice, but was a function of economic necessity and insolvency. Governor Davis accused the utilities of "irresponsible" and "immoral" conduct for not paying QF power producers.[103] And litigation raising issues of state-federal conflict resulted.

Southern California Edison Co. had not paid approximately $140 million for power purchased from QFs between November 2000 and February 2001. A California court freed hundreds of QFs from requirements that they supply wholesale power to major California retail electric utilities if they were not being paid for that power as required by contract. A requested lien against utility assets filed by an unpaid QF was denied. A QF owned by CalEnergy Corporation was granted permission by a California Superior Court to temporarily suspend performance under its Public Utility Regulatory Policies Act of 1978 (PURPA)[104] supply contract with its utility, and sell power (at higher prices) to more solvent third parties. After this ruling, Southern California Edison agreed to resume payments for past purchases to the QFs and to make advance payments before future power is delivered.

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98 This order was entered on October 5, 2001, in the federal district court located in Los Angeles. The settlement allowed the company to freeze retail rates in an era when costs were falling, thus keeping the surplus to pay past debts. *Id.*

99 For a discussion of QF requirements and case law, see 1 FERREY, *supra* note 8, ch. 4.

100 Bernadette Tansey, *Nuclear Power's California Comeback; Small Generators: State's Long-Term Pact at Risk*, S.F. CHRON., May 23, 2001, at A1.

101 Mike Taugher & Andrew LaMar, *No Cash, No Power Flowing*, CONTRA COSTA TIMES, Apr. 4, 2001.

102 Amy Strahan Butler, *FERC Holds Off on Letting California Generators Break Contract*, BLOOMBERG NEWS, May 16, 2001.

103 Harrison Sheppard, *Utilities Not Paying Up; Blackouts Continue*, DAILY NEWS OF L.A., Mar. 21, 2001, at N1.

104 Pub. L. No. 95-617, 92 Stat. 3117 (codified as amended in scattered sections of 16 U.S.C.).

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In June 2001, the PUC authorized Southern California Edison to pay fifteen cents on the dollar for past QF power purchases, assuming the QF demonstrated need for the funds, with the balance paid later, as well as incentive payments if the QF were to generate surplus power in the future.[105] Past amounts due would be paid at a ten percent rate, although this could be challenged as preferential.

An opposite approach was taken by PG&E, which threatened suit if it was forced to pay for QF power pursuant to federal law prior to a guarantee that it would recover such wholesale power acquisition costs in its retail rates governed by state law. Simultaneously, state legislators sought to reduce the price that QFs were allowed to receive pursuant to federal law[106] for their power by changing the gas fuel index used for setting avoided cost, even though the QFs could not procure gas at the place or price of this Northern California index.[107]

PG&E then filed for bankruptcy court protection. The bankruptcy judge in the PG&E matter refused to allow QFs to abrogate their supply contracts to PG&E even though they were not being paid for power sales to utilities, and refused to interfere with the new lower avoided-cost prices imposed by the PUC.[108] In July 2001, PG&E signed five-year agreements with 131 QFs with existing contracts, agreeing to pay back amounts owed plus an average energy price of 5.37¢/kWh going forward.[109]

As a means to create more power resources, the California legislature passed an emergency bill to create a $25 million loan guarantee program to fund new renewable energy projects.[110]

California made $40 million of awards to promote green power to nine renewable energy projects with a combined production capacity of 300 MW. These projects will receive power payments of 6.5¢ to 7.5¢/kWh during the first five years of operation.[111] Eligible projects would have to be 1 MW or greater, and the loans would primarily benefit solar photovoltaic and wind

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[105] *In re* S. Cal. Edison Co., Cal. P.U.C. A00-11-038 (June 13, 2001). In March 2001, the PUC ordered the utilities to pay all QFs for power purchases within 15 days of power sale, even though this could be a preferential transfer. Cal. P.U.C. Letter No. 3508. In April, it began investigating whether QFs violated their contractual obligations to supply power to the retail utilities. Cal. P.U.C. Docket No. 10104 (Apr. 19, 2001); *QFs Will Get Paid, But Methodology for Setting Rates Remains in Dispute*, PLATTS ELEC. UTIL. WK., Apr. 2, 2001, at 10, 13 [hereinafter *QFs Will Get Paid*].

[106] Federal Power Act, 16 U.S.C. § 824a (2001).

[107] The former index was Topock at the Southern California-Arizona border. This was changed to the Oregon-California border gas index. Cal. P.U.C. Docket No. 01-03-067, R.99-11-022 (Mar. 27, 2001). New five-year contracts were offered at 5.37¢/kWh. Additional payments could be authorized if the QF demonstrated that this price did not cover fuel costs. Such a change raises legal issues of FERC precedent, the Filed Rate Doctrine, and the Supremacy Clause, as well as charges of PURPA violations. *See* 1 FERREY, *supra* note 8, ch. 7.

[108] *PG&E Files for Bankruptcy: "Regulatory and Political Process Have Failed Us"*, PLATTS ELEC. UTIL. WK., Apr. 9, 2001, at 1.

[109] *PG&E Signs Contract with 131 Generators*, CONTRA COSTA TIMES, July 20, 2001.

[110] *Disclosures on FERC Review Could Help Calif. Effort to Rein in Market*, ELEC. UTIL. WK., Mar. 26, 2001, at 1.

[111] *P.U.C. Rejection of DWR Rate Agreement Continues Uncertainty on Bond Issue*, PLATTS ELEC. UTIL. WK., Oct. 8, 2001, at 5.

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turbines as the preferred technologies.[112] But even with the recent success of wind technology, it represents only an incremental contribution because it takes a large number of wind machines to make a substantial contribution to a centralized grid. California, the state with the most wind turbines, has more than 13,000 wind machines, which in 1999 produced 3.4 billion kWh. However, this is only slightly more than one percent of California's total electric generation from within the state and is less production than a typical single base-loaded 500 MW combined cycle generating facility.

For QFs, bankruptcies, and issues of environmental regulation, there are palpable state-federal conflicts. These will eventually be litigated. But in the interim, there is already ample litigation.

IV. THE PREEMINENCE OF LITIGATION AS THE DISPUTE RESOLUTION DANCE

How they dance in the courtyard
Sweet summer sweat
Some dance to remember
Some dance to forget.[113]

In a deregulated environment, common law adjudication, in an assortment of forums and venues, is supplanting the consolidated regulatory control of the conventional utility regulatory scheme. This change will shift power to the judiciary and make outcomes slower to realize and less predictable. Amidst the energy implosion, litigation arose instantly from the ashes.[114]

California utilities fell hundreds of millions of dollars in arrears in paying for purchased wholesale power.[115] The parties most owed were those who had purchased formerly regulated utility generating plants and had continued to sell power on the wholesale market. There followed numerous claims and suits involving the supply, failure of supply, pricing, and reliability of wholesale power supply and fuel supply in California.

Some litigation involved private parties. Wholesale power suppliers litigated the slow payment or non-payment of power previously purchased by utilities. A court rejected a motion by FPL Group, a wholesale supplier, to place a lien on utility company assets to secure amounts owed.[116] There will be contract claims that a supplier did not provide "firm" capacity and energy for sale during the California energy crisis, as opposed to supplying just non-firm energy. The University of California and California State University initiated, but subsequently withdrew, suits involving contract claims against Enron, a private wholesale energy supplier that withdrew from supplying

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112 *Id.* at 8.

113 THE EAGLES, *supra* note 1.

114 The following sections are meant to illustrate the possibilities of litigation when a complex deregulated energy system implodes, including pending, as well as possible, claims and litigation.

115 *Davis, Consumer Groups Worry, supra* note 89, at 13.

116 *QFs Will Get Paid, supra* note 105, at 10.

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retail power in California.[117]

Other litigation involved quasi-public defendants. Suits were pending against the California Power Exchange regarding its calculations of exchange transactions of wholesale power. In addition, the Imperial Irrigation District asked the D.C. Circuit to review whether it could be forced to sell its power through the state ISO, or could remain independent.[118]

Reliant Energy Inc. (Reliant), an independent power generator, sued to enjoin a California ISO order mandating suppliers to continue to sell power to the state even if payments for the power were not forthcoming.[119] Power was purchased by the state from Reliant when cheaper alternatives appeared to be available. In turning down Reliant's preliminary injunction request, the judge found that unregulated power supplies must continue to supply power that they did not otherwise choose to supply because the state's energy crisis, "of catastrophic proportions," had created a public health and safety emergency.[120] Separately, a state court ordered Reliant to sell emergency power to California, notwithstanding that such wholesale power sales are wholly jurisdictional to FERC, a federal agency.[121] Reliant argued that this would shift California's problems to other western states, characterizing it as "economic protectionism."[122] Appeal was taken to a federal forum.

Based on confidential data, the California ISO filed a report with FERC in March 2001 accusing power suppliers of overcharging the state by nearly $6.2 billion, representing thirty percent of wholesale power costs (the California ISO claimed that power suppliers overcharged by $500 million during December 2000 and January 2001 alone). These power prices were accepted at arm's length by the California ISO. In return for dropping the charges against it, Williams Energy Services Corp. (Williams) agreed to refund $8 million to the ISO, corresponding with a shut-down of two Williams plants in 2000, causing the company to sell power from more expensive units.[123] The matter at FERC was not successfully mediated, and it proceeds. An appeal of initial FERC decisions was launched in the Ninth Circuit by the California PUC.

Government agencies also pursued civil actions against market participants in the deregulated environment. Courts became the surrogate "regulators," also spawning private actions. For example, the City Attorney

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117 *California Universities Sue Enron*, ENERGY REP., Apr. 2, 2001, 2001 WL 8474716.

118 *As Pressure Mounts for California Refund Deal, Crisis Saps Investor Confidence*, ELEC. UTIL. WK., July 9, 2001, 2001 WL 10440404.

119 *High Level Talks, Legislative Action, Court Battles Continue in California*, ELEC. UTIL. WK., Feb. 12, 2001, 2001 WL 10439732.

120 *Id.*

121 *Court Orders Reliant to Sell to ISOs; Generator Challenges ISO at FERC*, ELEC. UTIL. WK., Mar. 26, 2001, at 9.

122 Cal. Indep. Sys. Operator Corp. v. Reliant Energy Inc., No. CIV S-01-238 FCD/JFM, 2001 U.S. Dist. LEXIS 1593 (Feb. 8, 2001).

123 San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Serv. into Mkts. Operated by the Cal. Indep. Sys. Operator & the Cal. Power Exch., FERC Docket No. EL 00-95-012 (Mar. 9, 2001); *FERC Settles Calif. Market Abuse Case*, ELEC. DAILY, May 2, 2001, at 1.

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of San Francisco sued Dynegy Power Marketing, Inc. (Dynegy) as did Ruth Hendricks on behalf of herself and other similarly situated people in a class action suit.[124] The Sweetwater Municipal Water District and the Padre Dam Municipal Water District also sued Dynegy (however, this was not a class action).[125] Pier 23 Restaurant in California, on behalf of itself and others similarly situated, sued PG&E Energy Trading.[126] Pamela Gordon brought a class action and a private attorney general action against Reliant.[127] These suits contain basic allegations of conspiracy to fix prices and of "gaming" the auction process in California.[128] San Francisco filed suit to enjoin three Mirant peaking plants of 156 MW from exceeding their emission allowances, which they had already done.[129]

Market participants responded by initiating litigation to restrain or compel government agencies to act. PG&E, the nation's biggest utility, initiated a federal lawsuit seeking an order directing the California PUC to allow the recovery of all wholesale power costs in retail rates.[130] SCE Corp., the parent company of Southern California Edison, sought and obtained in federal district court a declaratory order that it is entitled under law to recover all of the wholesale power costs from its retail ratepayers. The judge qualified his ruling by requiring a subsequent trial for SCE Corp. to demonstrate as an issue of fact that all of its power purchases from the California Power Exchange and California ISO were prudent pursuant to

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[124] Hendricks v. Dynergy Power Mktg., Inc., 160 F. Supp. 2d 1155 (S.D. Cal. 2001). Plaintiffs had originally filed cases in California state court, alleging that defendants violated California state law. Defendants had the cases removed to federal court, arguing that the artful pleading doctrine required that the plaintiffs' actions must be cast in federal terms under the Federal Power Act. The federal court held that it lacked jurisdiction, stating that "the court need not recast plaintiffs' state law claims in federal terms, a plaintiff is the master of his or her own claims." *Id.* at 1156–57. The court remanded the cases back to the state courts from which they originated.

[125] *Calif. Energy Crisis Lawsuits Continue As More Creditor Sue*, BLOOMBERG NEWS, Mar. 23, 2001.

[126] *Id.*

[127] *Hendricks*, 160 F. Supp. 2d at 1155.

[128] The legal authority for plaintiffs' claims is California's Cartwright Act, CAL. BUS. & PROF. CODE §§ 16,720–16,728 (West 1997), and California's Unfair Business Practices Act, CAL. BUS. & PROF. CODE §§ 17,200–17,209 (West 1997). The former provides treble damages relief similar to the federal Sherman Act, 15 U.S.C. §§ 1–37a (2000). Single damages are measured by what the prices would have been without a conspiracy. Joint and several liability is provided for all damages. Indirect purchasers, *i.e.*, consumers of power, are granted standing to sue. The latter statute outlaws "unlawful" business conduct, which is defined as conduct that violates some statute other than the Unfair Business Practices Act. Misleading conduct, which is not fraudulent, might be sufficient without regard to whether a consumer actually detrimentally relied. "Unfair" business conduct has been described as anything constituting "immoral, unethical, oppressive or unscrupulous" conduct. Cmty. Assisting Recovery, Inc. v. Aegis Sec. Ins. Co., 112 Cal. Rptr. 2d 304, 310 (Cal. Ct. App. 2001), *review denied* 2002 Cal. LEXIS 49 (Jan. 3, 2002). These lawsuits allege anti-competitive bidding techniques. Claims for relief are equitable in nature, seeking the disgorgement of profit, restitution, and civil penalty.

[129] Rachel Gordon, *Portrero Hill Power Plant Hit by 2 Lawsuits! Neighbors, City Ask Court to Cut Back Hours of Operation*, S.F. CHRON., June 20, 2001, 2001 WL 3406823.

[130] *PG&E Sues to Reduce the Portion of Its Rates Allocated to the DWR*, ELEC. UTIL. WK., June 11, 2001, 2001 WL 10440277.

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state law.[131] A similar rash of litigation has ensued and will ensue regarding the retail provision of power to end-use customers.

Threats of criminal action also followed. California Attorney General Bill Lockyer offered tens of millions of dollars (as a percentage of any recovery that is made in actions against wholesale suppliers) to anyone who "provides information lead[ing] to the successful prosecution of a false claim."[132] The statute in California would allow an informant, perhaps from inside one of the wholesale suppliers, to collect, in Lockyer's estimation, into the "hundreds of millions of dollars" if that information led to a successful recovery of monies from a supplier.[133] However, the Attorney General's investigation had concluded by mid-2001 that no criminal activity had occurred. No prosecutions followed, but the Attorney General, did convene a grand jury investigation.[134]

FERC next became involved as the adjudicator of claims in the California imbroglio. FERC entertained numerous petitions for investigations, complaints, and applications. California's Lieutenant Governor, Cruz Bustamante, said that unregulated companies that were successful in selling wholesale power to California utilities at higher than anticipated prices should pay restitution and fines, and their top officers should be thrown in jail.[135] Representative Filner, in April 2001, urged FERC to revoke the market-based rate authority of eighteen companies selling power in California, alleging that Williams, Reliant, Dynegy, Duke Energy Trading and Marketing, LLC (Duke), and Southern Company effectively control the California wholesale market.[136] However, these five provide only about twenty-five percent of California wholesale power.

California contested wholesale pricing and price cap issues at FERC, involving all of the competitive wholesale suppliers as respondents. Governor Davis stated, "We are going to Washington with one goal, and that is to bring back $9 billion. . . . The fact is that people have taken advantage of the market, gained the system, and ripped people off."[137] FERC first imposed a so-called "soft cap" on wholesale prices, and then extended it to the western system in June 2001.[138] No final determination on overcharges has yet been reached.

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[131] The California PUC had repeatedly held in the past that purchases made through the California Power Exchange and ISO were, by definition, prudent and reasonable.

[132] Julie Tamaki, *The California Energy Crisis; Punishing the Producers Could Add to Problem Shortage: Some Officials Want "Pirates" to Pay for State Crisis. But that Could Dissuade Them from Creating Needed Supply, Others Warn*, L.A. TIMES, Apr. 17, 2001, at A17.

[133] *Id.*

[134] *California Sets Criminal Probe of Power Prices*, FACTIVA ENERGY DIG., June 14, 2001, 2001 WL 4219920.

[135] *Governor's Bold Plan of Rescue Made Moot by PG&E's Bankruptcy*, ELEC. UTIL. WK., Apr. 9, 2001, 2001 WL 10439963.

[136] *The California Crisis: California Lawmakers Pass Bill to Form Power and Conservation Authority*, ELEC. UTIL. WK., Apr. 9, 2001, 2001 WL 10440071.

[137] Lynda Gledhill & Christian Berthelson, *The Energy Crunch*, S.F. CHRON., June 25, 2001, at A1.

[138] *The California Crisis: Western Regulators Gripe that FERC's Price Cap Is Biased Toward California*, ELEC. UTIL. WK., Aug. 27, 2001, 2001 WL 10440679.

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In March 2001, FERC ordered thirteen of these wholesale electric suppliers to justify that the rates they charged in the unregulated California market were "just and reasonable."[139] FERC focused on January price sales by Dynegy, Duke, Reliant, Williams, and Enron's Portland General Electric Company.[140] FERC in March 2001 also ordered refunds of wholesale prices charged by wholesalers during California Stage Three Power Emergencies, amounting to one to two percent of wholesale power costs.[141]

Both sides were indignant. The utilities countered that FERC was engaged in secret ratemaking, as they were expressly allowed to receive market-based rates. Dissatisfied with FERC's progress, Governor Davis charged that FERC had shown "little, if any, interest in consumers" and vowed to appeal.[142] Two California lawmakers, state Senate Speaker John Burton and Assembly Speaker Robert Hertzberg, responded immediately and sued FERC in federal court, alleging that FERC neglected its duty to cap wholesale power costs during the power crunch.[143] The Ninth Circuit Court of Appeals dismissed this mandamus action in May 2001.[144] Senators Joseph Lieberman (D-CT) and Jean Carnahan (D-MO) petitioned the U.S. General Accounting Office in April 2001 to investigate whether FERC had been derelict of its regulatory duties regarding California's wholesale market.[145] Congressmen challenged the use of the federal Defense Production Act to force natural gas sales on unregulated suppliers.

This litigation is not confined to the borders of California or its courts. The Washington State Attorney General alleged the negligence of California in setting in motion a situation that required the federal government to order the diversion of power from other regions to California. Instead of initiating suit immediately, attorneys general in Oregon and Washington conducted an investigation prior to a decision to litigate.[146] In April 2001, FERC launched an investigation of potential overcharging for wholesale power in the West. Northwest utilities sought $462 million in refunds to Seattle City Light, Tacoma Power, and others.[147] A FERC administrative law judge in

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139 *PG&E and Social Edison Ask FERC to Suspend Williams Energy Marketing's Market Based Rate Authority; California ISO Says Williams Obtained Excess Profits of $114 Million in Past Four Months*, FOSTER ELEC. REP., Apr. 18, 2001, *at* 2001 WL 10251617.

140 San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Serv. into Mkts. Operated by the Cal. Indep. Sys. Operator & the Cal. Power Exch., FERC Docket No. EL 00-95-012 (Mar. 9, 2001).

141 Nancy Vogel & Nancy River Brooks, *U.S. Power Order Won't Help State Prices Critics Say*, L.A. TIMES, Apr. 27, 2001, at A1.

142 *California Deserves Only $1 Billion Says Judge*, BUS. J., July 9, 2001, *at* http://sanjose.bizjournals.com/sanjose/stories/2001/07/09/daily15.html.

143 *California Lawmakers Take FERC to Court*, UTIL. BUS., June 1, 2001, at 12, *available at* 2001 WL 11848822.

144 David Kravets, *Appeals Court Declines to Order Energy Price Caps*, INLAND VALLEY DAILY BULL., May 29, 2001, http://www.dailybulletin.com/ social/power/articles/0501/29/caps.asp.

145 Letter from Jean Carnahan & Joseph Lieberman to General Accounting Office (Apr. 12, 2001), *available at* http://carnahan.senate.gov/press/gaoletter.html.

146 *California Can Share Energy Documents with States' Prosecutors*, BLOOMBERG NEWS, July 9, 2001.

147 Puget Sound Energy, Inc. v. All Juris. Sellers of Energy and/or Capacity Mkts. in the Pac. Northwest, 96 FERC ¶ 63,044 (2001) (opinion of ALJ Carmen A. Cintron).

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September 2001 concluded that "prices were not unreasonable or unjust" in the Northwest, and no refunds would occur in those states.[148]

This occurred despite Northwest prices being as high or higher than those in California. While retail electricity prices in Washington state increased by as much as fifty percent, California initially held California ratepayer increases to ten percent, before being forced higher. Prices were up to twenty times normal levels at Northwest trading points. FERC separately found refunds justified in California in amounts yet undetermined.[149]

In March 2001, the cities of Los Angeles and Long Beach filed lawsuits accusing several gas companies of conspiring in a Phoenix hotel room in 1996 to block construction of gas pipelines so as to limit supplies and drive up prices of natural gas.[150] Executives of Southern California Gas Co. admitted to the meeting, but denied its purpose.[151] Sierra Pacific Resources backed out of a planned sale of $1.7 billion of power generating assets in Nevada to NRG Energy and Dynegy because of the crisis in California.[152] This could spur litigation.

This patchwork of litigation occurs in a variety of federal and state forums and venues, which will collectively, and perhaps inconsistently, forge the new rules of the deregulated marketplace. It will supplant the conventional role of regulation in the monopoly market. It will result in inconsistent signals, delay, lack of finality, and confusion about applicability. There is a reactive legislative response.

V. THE LEGISLATIVE RESPONSE

Up ahead in the distance
I saw a shimmering light
My head grew heavy, and my sight grew dim
I had to stop for the night.[153]

In a matter of a few months, the restructured California electric system created a $14 billion loss for the state by purchasing power on an emergency

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[148] *Id.*

[149] *No Northwest Refunds, Says FERC ALJ*, ELEC. DAILY, Sept. 28, 2001, at 1.

[150] Leon Drovin Deith, *L.A., Long Beach Lawsuits Allege Natural Gas Conspiracy*, N. COUNTY TIMES, Mar. 21, 2001, http://www.nctimes.com/ news/2001/2001/200210321.html.

[151] *See In re* Cal. Retail Natural Gas & Elec. Antitrust Litigation, 170 F. Supp. 2d 1052 (D. Nev. 2001). Defendants in this case argued that the plaintiffs' claims were preempted by federal law concerning federal regulatory and statutory schemes, specifically: 1) the Federal Power Act, 16 U.S.C. §§ 791–828c (2000), 2) the Natural Gas Act, 15 U.S.C. §§ 717–717z (2000), and 3) the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301–3432 (2000). *Id.* at 1057. However, the court found no preemption language in any of the three above-mentioned statutes and therefore remanded the plaintiffs' case to the California state court. *Id.* at 1058–60; *see also* Jennifer Coleman, *California Lawmakers Probe High Natural Gas Prices*, N. COUNTY TIMES, Mar. 24, 2001, http://www.nctimes.com/news/2001/20010324/aaa.html.

[152] *Nevada Plant on Skids Because of Calif.*, ELEC. DAILY, Mar. 12, 2001, at 2.

[153] THE EAGLES, *supra* note 1.

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basis on behalf of its essentially insolvent investor-owned utilities.[154] This deficit will have to be subsidized and recouped over a decade by California taxpayers and ratepayers.

A. State as Utility

California instituted a complex legislative solution in 2001. At its core, the California legislation empowers the California Department of Water Resources to pay for the difference between acquisition of electricity by that agency and the retail price for which it is eventually resold. The cost of the California bailout, while publicly projected by Governor Davis to cost only $10 billion, was admitted by several of his cabinet members to be expected to cost up to $23 billion in the next two years alone. This would leave customers paying an approximately fifty percent increase for electricity, in addition to the ten to fifteen percent increase in the year 2000 and another ten percent increase scheduled for 2002, thereby wiping out the state tax surplus. An approximately $12 billion bond issue would allow the state to purchase long-term wholesale power, which could be sold to utilities for their retail resale. The bonds are to be retired from tax revenues over ten years.[155] State energy costs are paid before any surplus is repaid to the state general fund.

There are also provisions in the legislation, since it is reinforced by a PUC order, that will prevent commercial and industrial energy users from walking away from long-term contract deals with the California Department of Water Resources when lower rates are available elsewhere in the market.[156]

A group of power retailers threatened to sue the California PUC after it suspended retail choice for electricity in California.[157] Suspending retail choice forces most large consumers to participate in the existing centralized supply system. This system of maintaining a customer base enables retailers to collect revenue to repay California bonds. If these entities were allowed to shop for power, it would undercut the credit support for billions of dollars in proposed state bond sales. The approximately 180,000 largest customers are indentured to pay back through electricity rates the principal and interest on the bonds. Moreover, this law locks all current utility customers into place with their current utility.

This stops all the retail power shopping that the restructuring law allowed. In September 2001, the California PUC voted to suspend retail electric competition in the state so as to prevent customers from leaving

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[154] *See, e.g.*, Virginia Ellis, *8 State Power Contracts Seen As Bad Deals*, L.A. TIMES, Sept. 30, 2001, at B1.

[155] *See PUC Redesigns Proposal for Utilities to Pay DWR Expenses; Asks Less of PG&E*, PLATT'S ELEC. UTIL. WK., Jan. 14, 2002, at 5.

[156] *Calif. Agencies Spat Over Power Costs*, ELEC. DAILY, Oct. 26, 2001, at 1; *CPUC Ends Direct Retail Access, Effective Sept. 20*, ELEC. DAILY, Sept. 25, 2001, at 1.

[157] *Calif. Agencies Spat Over Power Costs*, *supra* note 156, at 1; *CPUC Ends Direct Retail Access, Effective Sept. 20*, *supra* note 156, at 1.

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state-purchased power for competitive suppliers.[158] The Commission split along party lines, with Democratic members supporting the ban on competition while Republican members voted against. This decision effectively terminated direct retail access in California, which was at the core of California's deregulation. Mack Seetin of the New York Mercantile Exchange alleged that consumers were first forced to "pay the ransom of the stranded costs" and then "pay off the bonds" prior to direct access.[159]

B. Rate Increases

To pay for power, in March 2001, the California PUC increased rates by an additional forty to fifty percent (3¢/kWh), the largest rate hike in state history.[160] California Controller, Kathleen Connell, stated that even this was not enough to prevent a state deficit.[161] Moreover, with residential rates effectively capped by legislation in California during the transition period, indications are that the PUC will pass larger rate increases disproportionately onto larger volume customers, including larger volume residential customers. This would create a conservation incentive, but may not be justified in terms of cost of service.[162] There are likely to be legal challenges regarding noncost-based allocation of rates to larger-volume customers.

Blackouts ensued nonetheless across California in the first half of 2001. The PUC agreed to exempt all hospitals, though initially it had tentatively decided to exempt only large hospitals. Ten thousand customers pled for exemption from rolling blackouts, including oil refineries, sports venues, and municipal entities not served by the power-short private utilities.[163] The California PUC decided that any circuit that can reduce consumption by fifteen percent will be exempt from future rolling blackouts imposed in the state.[164] This provided perverse incentives for keeping power consumption high, so they could subsequently show a fifteen percent reduction. Mass transit systems and oil refineries were eventually exempt.[165]

The legislation provides new authority to increase the rates for electric power paid by residential customers whose power use exceeds 130% of an administratively-set "baseline" consumption.[166] The formula for calculating that base line usage will vary in different locations throughout the state and will be sensitive to weather conditions, usage patterns, and other variables.

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[158] *Utilities, California PUC Does Away with Open Market*, GREENWIRE, Sept. 21, 2001.

[159] Maele Seetin, *Death of California Direct Access Delayed*, ELEC. DAILY, June 29, 2001.

[160] *Rate Hikes Ignite Widespread Protests, Yet Are Unlikely to Resolve Calif. Crisis*, PLATTS ELEC. UTIL. WK., Apr. 2, 2001, at 1.

[161] Nancy Vogel, *California and the West: California Energy Crisis: Group Says San Diego Power Users Overcharged*, L.A. TIMES, Mar. 29, 2001, at A3.

[162] For a discussion of cost-of-service retail ratemaking principles, see 1 FERREY, *supra* note 8.

[163] *The Political Way Out of Calif. Blackouts*, ELEC. DAILY, Apr. 6, 2001, at 1.

[164] *Id.*

[165] *Id.*

[166] *Calif. PUC Shifts Rate Hike Design to Lighten Impact on Big Customers*, ELEC. UTIL. WK., May 21, 2001, at 6.

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Residential customers using 130% of baseline amounts would see an average 13% increase, while the increase in rates for commercial customers would be 18%, and industrial customers 19% for exceeding 130% of the baseline consumption levels.[167]

In response to these incentives, in August 2001, California ratepayers used nine percent less electricity during peak periods than during August of the prior year.[168] 4.3 million ratepayers qualified for the rebate program where they received a rebate of twenty percent on their bills by using twenty percent less than they consumed one year before.[169]

By a gubernatorial order, the newly authorized so-called "Power Police" in large cities were authorized to prosecute businesses that use outdoor lighting when they are not open. The violations for outdoor lighting during non-business hours can be fines of as much as $1000 per day.[170] This enforcement could spawn a host of lawsuits over the interpretation of this differential pricing scheme for the same electric energy commodity to different consumers. California's past experience with water rationing does not bode well for a smooth implementation of this system.

There are calls for a political consumer revolt in California to overthrow state decision makers in 2002 and return the state power sector to regulation. A ratepayer revolt by initiative on the 2002 California ballot is threatened by Southern California Electric and San Diego Gas and Electric ratepayers, as well as other efforts to overthrow the legislation. In the intermediate term, the following litigation will likely be spawned in response to the legislative action:

- Fines assessed against high consumption ratepayers by the "Power Police" under the governor's order will be contested.
- Claims will ensue over differential pricing of power to certain users. A coalition of large commercial and agricultural users, including Silicon Valley manufacturers, formed to oppose the new rates.
- State Senator Don Perata asked Governor Gray Davis to check into so-called "price gouging" by LADWP in selling power to the investor-owned utilities. States Perata, "It's one thing to have some Texas guy ripping you off but it's another thing to have a public agency in your own state . . . . I think they ought to give the money back."[171]
- The California Chamber of Commerce, the California Manufacturers & Technology Association, California State University, and the University of California are crying foul regarding the emergency legislation which locks them into remaining with their current utility supplier through the crisis, regardless of the supposed ability to shop for other retail suppliers under the

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167 *Id.*

168 Press Release, Office of the Governor, State of California, *Governor Praises California for Continued Energy Conservation* (Sept. 2, 2001), *available at* http://www.energy.ca.gov/releases/2001-09-02_governor.html.

169 *Id.*

170 State of California, Exec. Order No. D-19-01 (Feb. 1, 2001), *available at* http://www.ca.gov/state/portal/myca_homepage.jsp.

171 Mike Taugher, *State Senator Wants Davis to Probe 'Price-Gouging' by LA Public Works Department*, CONTRA COSTA TIMES, Mar. 8, 2001, at 1.

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restructuring legislation.[172]

C. Confiscating Revenues

Legislative initiatives were aimed at deregulated market assets. Lawmakers proposed windfall profits taxes to attempt to confiscate super-normal earnings of wholesale generators (designated at rates greater than $80/MWh and $60/MWh, respectively by the legislation).[173] Senate Bill 1 of the 2001–2002 first extraordinary session, would impose a 100% tax retroactive to the beginning of 2001 on any power sales by generators or marketers that exceed a base price to be set by the regulatory agency.[174] The proceeds of the tax would be distributed to California consumers through a refund. The bill exempted the California Department of Water Resources, which purchases power on behalf of the state under the legislation. Such taxes could discourage the construction of new generation essential to adequate supply in the California market.

Legislative proposals go beyond taking away financial gains. Legislators in California considered seizing the California utilities' hydroelectric assets and transmission grid assets to backstop the bailout obligations incurred by taxpayers. Other legislators looked at taking a forced equity ownership in the utilities. State Senate President Pro Tem John Burton introduced legislation to force the legislature to back the Governor if he sought to seize power plants or contracts,[175] and to prevent the PUC from automatically increasing retail rates.[176] These various measures, if implemented, will spawn litigation.

In February 2001, Governor Gray Davis used his emergency power to seize two of the large utilities (PG&E and SCE) forward-power contracts held by the California Power Exchange minutes before the Power Exchange was due to liquidate them in order to repay power generators after PG&E and SCE defaulted.[177] This prevented the Power Exchange from liquidating the contracts to pay the utilities' outstanding bills. The value of these contracts was worth $150 million.[178] Having seized these, Governor Davis then disputed the invoice price under the forward contracts.

A hailstorm of legal action has encircled the basic exercise of governmental intervention and response. Both this seizure and the dispute

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[172] *California Business Group Mourns for Retail Choice*, ELEC. DAILY, Mar. 8, 2001, at 2.

[173] S.B. 1, 2001–2002 Leg., 1st Ex. Sess., pt. 14.5 (Cal. 2001); A.B. 2, 2001–2001 Leg., 2d Ex. Sess., Pt. 12 (Cal. 2001). This base price would be based on the cost of producing power after providing "a reasonable allowance" for profit margins and maintenance and operating expenses. That reasonable allowance is defined as an amount up to a 20% return on invested capital. Cogeneration and renewable energy facilities would be exempt from the imposition of this tax.

[174] S.B. 1, 2001–2002 Leg., 1st Ex. Sess. § 33001 (Cal. 2001).

[175] S. Res. 1, 2001-2002 Leg., 2nd Ex. Sess. (Cal. 2001) (introduced).

[176] S.B. 85, 2001-2002 Leg., 2nd Ex. Sess. (Cal. 2001) (introduced).

[177] *California Governor Seizes Long-Term Power Contracts Held by PG&E Unit*, DOW JONES BUS. NEWS, Feb. 5, 2001, Westlaw, 2/05/01 DJBN 23:28:00; Jennifer Coleman, *The Energy Crunch: Power Contracts Seized to Keep Credito at Bay*, COLUMBIAN, Feb. 6, 2001, at C2.

[178] *California Governor Seizes Long-Term Power Contracts Held by PG&E Unit*, *supra* note 177.

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over pricing mechanisms in these contracts resulted in litigation. In July 2001, Duke and Reliant sued California to recover $337 million owed under these long-term contracts.[179] On September 20, 2001, the United States Court of Appeals for the Ninth Circuit, by a two-to-one decision, overturned this action by the state as intruding on federal (FERC) powers under the Federal Power Act, taking away collateral, and thus violating the Supremacy Clause.[180] In his dissent, Judge Kozinski argued that a clear emergency affecting the health, safety, and comfort of the people justified the Governor's action, which the court should not second-guess.[181] This again illustrates the state-federal conflict discussed above.

Legislation was proposed in California to promote municipalization of investor-owned utility systems.[182] The bill would have reduced the ability of private utilities to challenge municipal condemnation and prohibit local land use planning agencies from vetoing formation of local utility districts.[183] Governor Davis vetoed a bill to allow San Diego County to have the right to set up its own publicly owned power system.[184] Because this would allow San Diego ratepayers to choose alternative suppliers, as normally would be their right under federal and state law, without contributing to paying the above-market costs incurred by California to purchase future power on behalf of utilities, Governor Davis refused to allow this exodus.

Another bill would foster municipal aggregation.[185] The California legislature created a state public power authority to finance construction of power plants and transmission facilities.[186] The authority would issue bonds, take property by eminent domain, and finance new projects. Any seizing or other acquisition of assets by the state will be litigated, notwithstanding that the Governor has implied that the state could operate the transmission assets more efficiently than the utilities.

Legislation advanced to move the twenty-two previously utility-owned, but now privately held, unregulated generating plants from their traditional place on municipal assessment rolls to the state's tax assessment rolls. Beginning in 2003, the California Board of Equalization will move property tax assessment of existing independent power plants to state tax rolls, assessing them at full value, unfettered by the previous restrictions imposed by state ballot initiative on local property taxes.[187] This would allow dramatic increases in the tax assessment of these plants, avoiding the state's

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179 *Calif. Senate to Act on Enron Contempt Finding In Ongoing Market Abuse Probe*, ELEC. UTIL. WK., July 30, 2001, 2001 WL 10440532.

180 Duke Energy Trading & Mktg., LLC v. Davis, 267 F.3d 1042, 1058–59 (9th Cir. 2001).

181 *Id.* at 1059.

182 S.B. 23, 2001-2002 Leg., 1st Ex. Sess. (Cal. 2001) (died on desk); S.B. 23, 2001-2002 Leg., 2nd Ex. Sess. (Cal 2001) (failed).

183 For a discussion of these topics, see 1 FERREY, *supra* note 8, ch. 6. This latter event had occurred in 2000 when the city of Davis attempted to municipalize its utility system.

184 Ed Mendel, *California Power Crisis: Davis Vetoes Supervisors' Power Bill*, SAN DIEGO UNION TRIB., Oct. 16, 2001, at B3.

185 A.B. 48, 2001-2002 Leg., 1st Ex. Sess. (Cal. 2001) (failed).

186 S.B. 6., 2001-2002 Leg., 1st Ex. Sess. (Cal. 2001) (amending Cal. Pub. Util. Code).

187 Lynda Gledhill, *Power Plant Assessment To Be Taken Over by the State*, S.F. CHRON., Oct. 25, 2001, at A19; *State to Gain Authority to Tax Power Plants*, L.A. TIMES, Oct. 25, 2001, at B8.

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Proposition 13's two percent annual increase limitation on municipal tax rate increases.[188] Such a move would also discourage new plant construction. Municipalities also sought preferential payment of their normal franchise fees from the PG&E bankruptcy court proceeding.[189]

VI. CONCLUSION

A. The Cost

The cornerstone of the California response on behalf of its insolvent utilities has been to execute $43 billion in long-term power contracts with eighteen wholesale suppliers to secure an emergency long-term power supply for a significant share of its future requirements.[190] This, in the long run, could prove inopportune. Timing is everything in power markets.

When both natural gas and local wholesale electric prices were at historic highs, it may not have been the time to lock in long-term deals in the market. California appeared to buy either too much or too little power during different months. California lost at least $25 million selling excess power that it had purchased during 2001.[191] It sold power to LADWP for 0.5¢/kWh and then essentially gave it away to Canada on another occasion in late May.[192] The long-term (ten-year) average price for future power paid by California under these contracts averages about 7¢/kWh,[193] which may prove to be above-market price.

Prices of natural gas, and by consequence the marginal cost of wholesale power, subsequently declined to eighteen-month lows by Labor Day of 2001. In June 2001, Governor Davis conceded that the state had locked in long-term power sale contracts at a higher price than available shortly thereafter on the spot market. State Legislator Tony Strickland reacted, "It seems like people are going to get ripped off for the next 10, 15, 20 years."[194] Governor Davis responded, "We've basically won the war[,] . . . [the state] is on the verge of breaking the back of the spot market."[195]

Over time, both long-term natural gas and wholesale electric prices are expected to decline from their early 2001 values in the California market. Even if time demonstrates that California got extremely favorable wholesale electric price contracts, those contracts could eventually cause the wholesale suppliers to go bankrupt over time, in which case the contracts

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188 Gledhill, *supra* note 187, at A19.

189 Rick Jurgens, *PG&E Files Bankruptcy Game Plan*, KNIGHT-RIDDER TRIB. BUS. NEWS, Dec. 20, 2001, 2001 WL 32033718.

190 Laura M. Holson & Richard A. Oppel, Jr., *Long Term Power Deals Scrutinized in California*, N.Y. TIMES, June 16, 2001, at A10.

191 Paul Feist, *State Loses $25 Million in Power Plays, Ploys*, S.F. CHRON., Oct. 25, 2001, at A19.

192 *Id.*

193 Nancy Vogel, *The State Audit Finds Power Pacts Ill-Concieved*, L.A. TIMES, Dec. 21, 2001, at B8.

194 Holson & Oppel, *supra* note 190, at A10.

195 David Lazamas, *State 'Turning Corner'*, S.F. CHRON., June 8, 2001, at A1.

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would not be enforceable. In some ways, this could serve to shift the bankruptcy risk from the existing utilities in California to wholesale suppliers who execute contracts that prove not viable for them in the long term. Although currently, California appears to have bought high.

California consumers saw an average nine percent electric rate increase in January 2001, and a thirty-seven percent boost in March 2001.[196] The Federal Reserve Bank of San Francisco calculated that the power costs for the typical California household would increase by $750 annually, plus an additional $200 per year for natural gas, for a total thirty-eight percent increase in total energy costs.[197] The average California bill increased by thirty-six percent according to J.D. Power and Associates.[198] The extra cost of extricating California from its power debacle was estimated by the Federal Reserve Bank of San Francisco, in direct cost for electricity and gas, as well as higher ultimate costs of goods and services produced using higher cost of electricity and gas, to have reduced California household income by an average of 1.5% for the typical family.[199]

This implosion upset the business community, which had been the major beneficiary of restructured retail competition in California. A poll by the National Federation of Independent Business found that the energy crisis could force small businesses from the state.[200] Intel Corp., because of uncertainties of power reliability, announced that it would curtail future chip and semiconductor manufacturing expansion plans in California.[201] California officials sought to expedite review of proposed new power plants and appointed a task force to expedite plant construction.[202]

More generation alone, however, will not solve the constriction along the eighty-four mile San Joaquin Valley Path 15, the congested transmission corridor limiting the flow of power from the southern to the northern parts of the state. The federal government proposed expanding this transmission capacity as part of President Bush's national energy strategy. This $300 million, 500 kilovolt (kV) expansion could take up to four years to complete.[203]

There is a certain irony to the fact that when all of the former regulated utility generating plants were sold for approximately $3 billion in capital

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196 *Calif. Lawmakers Struggle to Keep Social Ed. Out of Bankruptcy Court*, ELEC. UTIL. WK., July 23, 2001, at 3, 4.

197 Jenifer Warren, *Utility Bills Are Just One Way People Pay for Energy Crisis Consumers*, L.A. TIMES, May 7, 2001, at A1.

198 *Study: Most Californians Conserve Power*, ENERGY REP., July 23, 2001, 2001 Wl 8475156.

199 Warren, *supra* note 197, at A1.

200 *NFIB Poll Reveals Initial Effects of Deregulation on California Small Businesses* (Feb. 26, 2001), *at* http://www.nfib.com.

201 *See* Annette Cardwell, *Move East, Young Company*, SMART BUS. FROM 2D WIRE, July 16, 2001, 2001 WL 7488242.

202 *Hope for Timely Conservation, Generation Fades As Calif. Finger-Pointing Intensifies*, ELEC. UTIL. WK., Apr. 23, 2001, at 1, 13–14; *Calif. Lawmakers Struggle to Keep Social Ed. Out of Bankruptcy Court*, *supra*, note 196, at 5–6.

203 Rick Jurgens, *Energy Secretary Pledges to Upgrade California Electricity Link*, KNIGHT-RIDDER TRIB. BUS. NEWS, July 24, 2001, 2001 WL 25350651; *DOE Partnership to Spend $300 Million Adding 1,500 MW of Capacity to Path 15*, ELEC. UTIL. WK., Oct. 22, 2001, at 5, 5–6.

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costs, that in a few months the state was forced to pump an additional $14 billion into power purchases from these and other facilities.[204] It seems that these facilities returned profitably to their new unregulated owners.

B. Alternative Visions

California might solve its energy shortfall by deploying some of the estimated thirty gigawatts (GW) of privately-owned back-up and emergency generators already installed in California.[205] This is almost equal to California's total peak demand. However, this action would require examining environmental restrictions placed on these units,[206] in some cases improving or deploying interconnections, and most importantly, revising regulatory systems and incentives to make it worthwhile for the owners of decentralized generation to sell power to the grid. There are potential solutions in our midst, but they are inaccessible or impeded by regulation and inattention. In the near term, these solutions will not happen.

Unlike some commodities, electricity requires that infrastructure be created and moved to market. In a regulated model, utilities are required to build vertically integrated infrastructure necessary to accomplish adequate service, with a reasonable reserve margin. The costs of this reserve are rolled into basic service rates. The reserve is akin to an insurance policy against electric shortage. Utilities also have eminent domain powers to complete this job, even against resistance from communities or individuals.

In a deregulated model, no individual supplier has a particular incentive to create and maintain a reserve margin. When power is moved freely across state lines, even a reserve margin established in states surrounding California can collapse if that reserve is consumed across state lines elsewhere. The system as a whole must maintain a reserve margin so that one state's reserve margin is not cannibalized by a neighboring state. This issue has not been addressed.

It has been argued that the security of supply of electricity—having an adequate reserve margin to meet contingencies and keep prices down competitively in a deregulated market—is a public good.[207] If a secure and adequate supply is a public good, it will be undersupplied by private owners of electric generation. No single owner will want to incur the costs to provide the surplus for which it is not adequately paid, but is necessary to keep the entire system robust. Reserve margins will be slimmer than society may choose. Either regulation or subsidy of additional supply will be required to remedy such a shortfall. In deregulating electric markets, no states have analyzed the inadequacy of supply in a deregulated market as a public good.

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[204] Nicholas Riccardi & Julie Tamaki, *California and the West: California Energy Crisis; Rate Hikes Revive Calls for Seizure of Power Plants*, L.A. TIMES, Apr. 3, 2001, at A3.

[205] Mark Lively, *Saving California*, PUB. UTIL. FORT., June 15, 2001, at 14, 14.

[206] Many of these units utilize oil as their fuel and face operating restrictions.

[207] Malcolm Abbott, *Is the Security of Electricity Supply a Public Good?*, ELEC. J., Aug.–Sept. 2001, at 31, 33.

A number of factors would have ameliorated or eliminated the California crisis. First, California could have encouraged construction of additional power capacity prior to, or contemporaneous with, its deregulation to palliate the crisis. Second, California could have provided an equilibrating mechanism between wholesale power acquisition costs from unregulated suppliers and retail rates charged for consumption of that power, which would have dampened any financial crisis. In fact, when prices were finally increased people began conserving, reducing peak demand by ten percent. These conservation efforts alone made a substantial difference in getting California through summer 2001 with adequate supplies.[208] Finally, allowing the retail utilities to hedge some substantial part of their future demand with forward contracts also would have dampened exposure to spot market fluctuations.

Having taken none of these steps, California simultaneously set in motion several factors that led to high prices and spikes. There was no basis for California officials to assume that spot market electricity prices would stay low, absent hedging forward contracts, in the environment that they created. This resulted in the state having to step in to purchase future long-term energy supplies, at what may prove over time to be relatively high prices, on behalf of its bankrupt utilities. As electric prices declined dramatically in mid-2001, the state had already locked in to higher long-term prices and was not able to take advantage of declining prices or the competition that would be spawned.

One of the flaws in the California restructuring was that with set and inflexible retail rates, only the supply side of market activities established the market-clearing price. There was no demand-side component, no demand response to the higher prices, and ultimately no recovery of expenses through the demand portion of rates. This disconnect makes demand for power essentially inelastic even though prices are increasing. Consumers did not adjust their consumption as wholesale prices rose because they did not experience any realistic price signals.

Therefore, even a small demand imbalance results in a disproportionately high increase in prices. Correspondingly, there is no increase in supply to achieve equilibrium because supply is constrained by existing generating capacity, availability, and existing transmission capabilities. When a market operates on only one side (supply or demand) of the equation, significant imbalances can result. No demand response by consumers follows in such a dysfunctional market.

The ultimate *modus operandi* is evident: California's energy crisis and legislative response have and will breed a plethora of contests and litigation of every conceivable type in every possible forum. Even with legislation, court decision rules interpreting that legislation become as important now, or more so, as regulatory commission rules did during former periods of traditional regulation, and state-federal conflict regarding jurisdiction

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[208] Jason Leopold, *Calif. Can Drop Emergency Power-Supply Measures*, DOW JONES ENERGY SERV., Dec. 28, 2001, Westlaw, 12/28/01 DJES 13:04:00; *Hope for Timely Conservation*, *supra* note 202, at 13–14.

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remains.

In the end, California's cure has driven a stake through the heart of retail competition. California took the unprecedented step, after having deregulated its retail market, to make it illegal for additional consumers to take advantage of retail competition. This is extraordinary, as well as a testament to the bizarre repercussions of the California bailout.

For other states on the verge of deregulating power markets, the California experience has robbed them of their nerve to deregulate. A handful of states have backed away or delayed deregulation plans, based solely on the California experience.[209] California's disastrous experience cast a large shadow on other states that are not in a position to suffer what occurred in California. Rather than learn the lessons demonstrated by the California experience, politicians in other states wanted to avoid the political risk of deregulation. This falling out may be the most profound legacy of the California experience. In an environment that requires innovation and nerve, California's mishandling of events has killed or forestalled in other states the innovation that California embarked upon in the mid-1990s. Some states on the verge of deregulation and restructuring have retrenched and are trying to find their passage back to the place they were before. And California can never leave.

Last thing to remember
I was running for the door
I had to find the passage back
to the place I was before.
Relax said the nightman, we are
programmed to receive
You can check out any time you like
But you can never leave.[210]

[209] Andrew Caffrey, *Nevermind: Once Deregulation Starts, Undoing It Is a Monumental Task*, WALL ST. J., Sept. 17, 2001, at R14; Kristen McNamara, *Texas Lets Consumers Pick Power Source As Other States Are Watching Experiment*, WALL ST. J., Jan. 17, 2002, at A19.

[210] THE EAGLES, *supra* note 1.

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