



1-1-2001

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## Recommended Citation

Maximilian Barteau, *Power and Public Utilities / Horses Have Bolted, But Close the Barn Doors Anyway: Utilities Told Not to Sell Their Generation Assets after All, The*, 33 MCGEORGE L. REV. 355 (2002).

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## **The Horses Have Bolted, But Close the Barn Doors Anyway: Utilities Told Not to Sell Their Generation Assets After All**

*Maximilian Barteau*

### *Code Sections Affected*

Public Utilities Code §§ 216, 330, 377 (amended).  
ABx1 6 (Dutra); 2001 STAT. Ch. 2.

*"I take credit, frankly, for having launched deregulation, for being the first in the nation. I was aware at the time I signed the bill that some of the compromises made it a less than perfect piece of free-market legislation . . . I counted on the Legislature and the Public Utilities Commission to remedy whatever flaws they found."*<sup>1</sup>

### I. INTRODUCTION

True to Governor Wilson's admonition, AB 1890, enacted in 1996, and the deregulation it brought about were indeed "less than perfect."<sup>2</sup> Moreover, his faith in the Legislature and the Public Utilities Commission was misplaced.<sup>3</sup> The restructuring of California's electrical utility markets, in effect since 1998, has had disastrous consequences.<sup>4</sup> On June 14, 2000, Pacific Gas and Electric Company (PG&E) interrupted service to almost 100,000 of its customers in the San Francisco Bay Area for the first time in its history.<sup>5</sup> This was just the beginning of California's electricity problems.<sup>6</sup> In the summer of 2000, wholesale

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1. Mark Katches, *Ex-Governor Won't Take Blame for Energy Crisis*, ORANGE COUNTY REG., Feb. 8, 2001, at A1 (quoting Governor Pete Wilson).

2. *Id.*

3. See *infra* note 13 and accompanying text (noting that the regulatory agencies failed to make appropriate corrections in the market structure).

4. See generally Adam Bryant, *California Powers Down: Thanks to New Plants, Things Will Go Better in Texas*, NEWSWEEK, Jan. 22, 2001, at 48 (describing some of the consequences of the power crisis to small business consumers).

5. CALIFORNIA BUREAU OF STATE AUDITS, ENERGY DEREGULATION: THE BENEFITS OF COMPETITION WERE UNDERMINED BY STRUCTURAL FLAWS IN THE MARKET, UNSUCCESSFUL OVERSIGHT, AND UNCONTROLLABLE COMPETITIVE FORCES, at 5 (2001) [hereinafter AUDIT].

6. *Id.*

prices for electrical power in California increased an average of 270 percent over the prices in place for the same period in 1999.<sup>7</sup> As a result of deregulation, PG&E and Southern California Edison (SCE) were unable to pass on these wholesale cost increases to their customers,<sup>8</sup> bringing both companies to the brink of bankruptcy by December of 2000.<sup>9</sup> As Governor Gray Davis put it, deregulation has been a “colossal and dangerous failure.”<sup>10</sup>

When he signed legislation restructuring the electrical industry, Governor Wilson knew the plan was flawed.<sup>11</sup> However, he relied on the various regulatory agencies and the Legislature to fine-tune the bill.<sup>12</sup> Collectively, these agencies were unsuccessful in making needed changes.<sup>13</sup> Chapter 2 is one of many—if belated—attempts made by the Legislature to correct some of the known flaws of deregulation.<sup>14</sup>

## II. LEGAL BACKGROUND

While many Californians decry the effects of deregulation now,<sup>15</sup> there was little but unbridled optimism when deregulation was first implemented.<sup>16</sup> In fact, the concept has been successfully applied to the communications, transportation, and financial industries over the past two decades.<sup>17</sup> Even deregulation of power has been accomplished successfully in England<sup>18</sup> and, more recently, in other

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7. CALIFORNIA PUBLIC UTILITIES COMMISSION, CALIFORNIA'S ELECTRICITY OPTIONS AND CHALLENGES: REPORT TO GOVERNOR GRAY DAVIS, EXECUTIVE SUMMARY at 1, <http://www.cpuc.ca.gov/published/report/Executive-Summary.htm> (last visited July 9, 2002) [hereinafter EXECUTIVE SUMMARY] (copy on file with the *McGeorge Law Review*).

8. AUDIT, *supra* note 5, at 5.

9. *Id.* at 6.

10. Bryant, *supra* note 4, at 48.

11. Katches, *supra* note 1, at A1.

12. *Id.*

13. See AUDIT, *supra* note 5, at 39-42 (noting that the Independent System Operator (ISO) and the Power Exchange both noticed potential problems with the marketplace but that the California Public Utilities Commission (CPUC) and FERC were slow to respond, and, when they did respond, they did so only incrementally).

14. See *id.* at 69-82 (detailing the various executive orders and bills regarding deregulation that have been passed or were considered by the California Legislature).

15. See *A Shocking Backlash: Power Deregulation Under Attack: Inspired by Britain's Success, California Led the United States into the Brave New World of Liberalised Electricity Markets. What Went Wrong?*, THE ECONOMIST, Aug. 26, 2000 [hereinafter *Backlash*] (describing the reaction of some consumers affected by the electricity crisis).

16. See GOVERNOR'S OFFICE OF COMMUNICATION, CALIFORNIA'S ENERGY STORY A CHRONOLOGY 1976-2001, May 4, 2001 at 41 [hereinafter GOVERNOR'S REPORT] (quoting an article in *Electricity Utility Week* from September 30, 1996). AB 1890, the bill that deregulated California's utility market, passed unanimously in both houses of the California Legislature. *California: Legislature Approves Bill to Deregulate Electricity Market*, WEST LEGAL NEWS, Sept. 4, 1996, available at 1996 WL 496502 (copy on file with the *McGeorge Law Review*).

17. Richard A. Posner, *The Effects of Deregulation on Competition: The Experience of the United States*, 23 FORDHAM INT'L L.J. 7, S8 (2000).

18. See *Backlash*, *supra* note 15 (noting that the deregulation of electricity in Great Britain has been

states, even though they were wary of following California's example.<sup>19</sup> In its simplest form, deregulation is designed to open up to the free market what previously had been controlled by the government.<sup>20</sup> This should—and usually does—lead to more competition.<sup>21</sup> Typically, greater competition is a boon to consumers because it leads to better service and lower prices.<sup>22</sup>

What went wrong? It is a simple question with as many answers as there are experts.<sup>23</sup> Largely, the current situation is a combination of man-made error and bad luck.<sup>24</sup> Under the generally accepted starting point, the price increases were caused by a dramatic increase in demand coupled with a negligible or non-existent increase in supply.<sup>25</sup> Beyond these basic assumptions, however, there is wide disagreement about the causes of the failure of deregulation in California.<sup>26</sup>

The history of regulation in the utility industry can be broken down into three distinct stages.<sup>27</sup> First, there was the traditional "command and control" model, where the investor-owned utilities<sup>28</sup> provided power and charged rates governed by the California Public Utilities Commission (CPUC).<sup>29</sup> Chapter 854, enacted by Assembly Bill 1890 (commonly known as AB 1890), restructured the electric industry, and a transitional period, due to end by December of 2001, followed.<sup>30</sup> The electric industry never emerged from the transitional period, and the future—

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relatively smooth).

19. See Bryant, *supra* note 4, at 48 (noting that many states measure their deregulation by the differences between their plan and that followed by California).

20. See CALIFORNIA PUBLIC UTILITIES COMMISSION, CHAPTER 2 CALIFORNIA'S ELECTRIC SYSTEM, at <http://www.cpuc.ca.gov/static/industry/environment/historical+information/ceqa+electric+restructuring/chapter2.htm> (last visited on July 9, 2002) [hereinafter CPUC CHAPTER 2 REPORT] (copy on file with the *McGeorge Law Review*) (describing the structure of the new market mechanism and its goals).

21. See, e.g., *The Electric Acid Test*, THE ECONOMIST, Sept. 25, 1999, at 29 [hereinafter *Acid Test*] (noting the successful deregulation of the telecommunications industry).

22. *Id.*

23. See AUDIT, *supra* note 5, at 88 (listing some of the agencies who have identified or tried to identify the cause of the crisis, the solution, or both and describing how these regulatory agencies differed in their analysis of the energy crisis).

24. Bryant, *supra* note 4, at 48.

25. See AUDIT, *supra* note 5, at 88 (showing that all of the major regulatory agencies agreed that at least these two factors were major contributors to the current crisis).

26. See *supra* note 23 and accompanying text (noting that there is vast disagreement about the causes of the crisis).

27. See generally GOVERNOR'S REPORT, *supra* note 16 (describing, in detail, the chronology of power management in California).

28. CALIFORNIA ENERGY COMMISSION, 1996 ELECTRICITY REPORT, at 5 (1996) [hereinafter 1996 ELECTRICITY REPORT] (noting that there are seven investor-owned utilities in California). This article focuses on the largest investor-owned utilities: Pacific Gas & Electric Company (PG&E), Southern California Edison (SCE), and San Diego Gas & Electric (SDG&E).

29. See CALIFORNIA PUBLIC UTILITIES COMMISSION, CHAPTER 1 CALIFORNIA'S ELECTRIC SYSTEM, at <http://www.cpuc.ca.gov/static/industry/environment/historical+information/ceqa+electric+restructuring/chapter1.htm> (last visited on July 9, 2002) [hereinafter CPUC CHAPTER 1 REPORT] (copy on file with the *McGeorge Law Review*) (describing the structure of regulation prior to the enactment of AB 1890).

30. 1996 ELECTRICITY REPORT, *supra* note 28, at 6.

the third stage—of the deregulated industry is still in flux.<sup>31</sup>

A. *Existing Law—AB 1890 Generally*

When deregulation first took effect in 1998, AB 1890 ended the investor-owned utilities' status as closely regulated monopolies, and a competitive market mechanism was supposed to control the generation of electricity.<sup>32</sup> This system worked much as anticipated from its implementation in March of 1998 until the summer of 2000.<sup>33</sup> In May of 2000, however, the markets began behaving in an unpredicted way.<sup>34</sup> The transitional period—as it was expected to work—then ended, and a new, though not entirely unforeseen, reality emerged.<sup>35</sup>

The man-made errors began with the deregulation bill, AB 1890, itself.<sup>36</sup> The key provisions of restructuring as enacted by AB 1890 were (1) the creation of the Independent System Operator to administer California's transmission system (hereinafter "the grid"); (2) the creation of a Power Exchange as a one-stop wholesale market for power sold within California; (3) the requirement that the investor-owned utilities buy their power in the day-ahead market of the Power Exchange; and (4) a mandatory, bond-financed ten-percent rate reduction for all customers while freezing retail rates.<sup>37</sup>

AB 1890 was a bipartisan measure.<sup>38</sup> In fact, the utilities were heavily involved in the process leading to deregulation, gaining key concessions in the legislation.<sup>39</sup> By its own terms, AB 1890 prohibited utilities from signing long-term power contracts, but it did not require that they sell their generation assets.<sup>40</sup>

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31. See generally GOVERNOR'S REPORT, *supra* note 16, at 27 (describing the extraordinary measures being taken to solve the energy crisis and mentioning the bankruptcy of the Power Exchange, the entity created to serve as the wholesale energy market in the new deregulated marketplace). See also *infra* notes 132-34 and accompanying text (noting that ongoing issues in federal bankruptcy court could change the impact of this bill and affect the CPUC's ability to regulate the investor-owned utilities).

32. See CPUC CHAPTER 2 REPORT, *supra* note 20 (describing the new market structure and its objectives in great detail).

33. See GOVERNOR'S REPORT, *supra* note 16, at 203 (describing the dramatic price increases seen in the summer of 2000).

34. See *id.* at 204 (describing cost increases between 1999 and 2000).

35. See generally AUDIT, *supra* note 5, at 41 (explaining that both the ISO and the Power Exchange monitoring groups reported errors to the CPUC). For compelling evidence that several regulatory authorities knew not only that the market was flawed but the exact ways in which it was flawed, see *id.* at 43.

36. See *When the Lights Go Out: Don't Blame Deregulation for the Chaos in California's Electricity-Supply Industry. Blame "Deregulation,"* THE ECONOMIST, Jan. 20, 2001 [hereinafter *Lights Go Out*] (describing the regulatory structure that was put on top of the existing regulatory structure and the problems this layered regulatory environment caused).

37. See CPUC CHAPTER 2 REPORT, *supra* note 20, at 5 (describing the CPUC's decision to freeze retail rates, one of the cornerstones deregulation).

38. GOVERNOR'S REPORT, *supra* note 16, at 41-42.

39. See *Lights Go Out*, *supra* note 36 (noting that the investor-owned utilities successfully pushed for a way to recoup so-called "stranded costs" of inefficient generation assets).

40. See generally CAL. PUB. UTIL. CODE § 330 (West Supp. 2002) (dictating the terms of electrical restructuring under AB 1890).

Although restructuring policies did not require divestiture, the CPUC's "preferred policy"<sup>41</sup> called for voluntary divestiture of the investor-owned utilities' generation assets in order to mitigate the exercise of market power.<sup>42</sup>

*B. The Effect of the Sale of Generation Assets on the CPUC's Jurisdiction*

The key aspect of deregulation addressed by Chapter 2 is the CPUC's recommendation that the investor-owned utilities sell their generation assets.<sup>43</sup> The disposition of generation assets owned by the investor-owned utilities is governed by section 851 of the Public Utilities Code.<sup>44</sup> Section 851 provides, in pertinent part, that: "[n]o public utility . . . shall sell . . . or otherwise dispose of . . . its . . . property necessary or useful in the performance of its duties to the public. . . ."<sup>45</sup> While section 851 itself was unaffected by restructuring under AB 1890, the effect of that section on the standard by which the valuation and disposition of utility-owned generation assets occurred was markedly different.<sup>46</sup> The investor-owned utilities sold a number of facilities according to the CPUC's market valuation approach and currently own less than fifty percent of their original generation assets.<sup>47</sup>

Prior to AB 1890, there was little in the way of a wholesale market in California because over ninety percent of the State's power was generated within the State and regulated by the CPUC.<sup>48</sup> While retail rates are the purview of the individual states, the regulation of wholesale power falls under the jurisdiction of the Federal Energy Regulatory Commission (FERC).<sup>49</sup> The Power Exchange was, by definition, a wholesale electricity market.<sup>50</sup> Thus, after the implementation of AB 1890 in 1998, all of the power sold into the Power Exchange was considered wholesale, whether or not it came from the investor-owned utilities' in-state

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41. See CPUC CHAPTER 2 REPORT, *supra* note 20 (describing the preferred policy as presented to the Legislature).

42. *Id.*

43. See CAL. PUB. UTIL. CODE § 330(1)(2) (West Supp. 2002) (describing the transition to a competitive marketplace by way of commission-approved "market valuation mechanisms").

44. *Id.* § 851 (West 1975 & Supp. 2002).

45. *Id.*

46. See ASSEMBLY COMMITTEE ON ENERGY COSTS AND AVAILABILITY, COMMITTEE ANALYSIS OF AB1X 6, at 2 (Jan. 11, 2001) (explaining that under deregulation, the generation assets were subject to disposal through the market valuation method, but that, under Chapter 2, they will again be subject to the strictures of section 851 of the Public Utilities Code).

47. *Id.*

48. See CPUC CHAPTER 1 REPORT, *supra* note 29 (describing the sources of California's electricity generation supply).

49. *Id.* The FERC is an independent regulatory agency within the Department of Energy that regulates energy transactions relating to interstate commerce. *Id.*

50. See CPUC CHAPTER 2 REPORT, *supra* note 20 (describing the transition from the command-and-control market in existence prior to AB 1890 to the competitive wholesale market that would exist in the newly-created Power Exchange).

generation or from other sources.<sup>51</sup> Though the CPUC remained responsible for the regulation of retail rates,<sup>52</sup> the direct consequence of the creation of the wholesale power market in the Power Exchange, coupled with the divestiture of the investor-owned utilities' generation assets, was a significant transfer of jurisdiction from the CPUC to the FERC.<sup>53</sup>

### C. Supply and Demand

For years prior to deregulation, the western United States had a surplus of generation capacity.<sup>54</sup> During times of heavy demand—the summer months generally—California has traditionally imported hydroelectric power from the northwest.<sup>55</sup> Additionally, states in the southwest, notably Arizona, overbuilt supply,<sup>56</sup> leading to rates as low as one cent per kilowatt hour.<sup>57</sup> This, coupled with conservation measures reduced per capita consumption, and there was no urgent need for new power plants.<sup>58</sup> As a result, no major power plants were built in California in the past decade and little new generation capacity was built at all.<sup>59</sup>

The roaring economy of the middle to late 1990s was completely unforeseen when deregulation was first designed during the recession years of the early 90s.<sup>60</sup> During the boom years of the late 90s, however, demand in both regions—especially in the northwest—increased dramatically, thereby diminishing the supply of surplus power available for sale to California.<sup>61</sup>

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51. *Id.*

52. AUDIT, *supra* note 5, at 12. As discussed herein, inelastic response to prices, caused primarily by the CPUC-imposed retail rate freeze, is considered one of the contributing factors to the crisis. *Id.* at 35-36.

53. CALIFORNIA PUBLIC UTILITIES COMMISSION, CALIFORNIA'S ELECTRICITY OPTIONS AND CHALLENGES: REPORT TO GRAY DAVIS, at [http://www.cpuc.ca.gov/published/report/Gov\\_Report.htm](http://www.cpuc.ca.gov/published/report/Gov_Report.htm) (last visited July 9, 2001) [hereinafter OPTIONS AND CHALLENGES] (copy on file with the *McGeorge Law Review*) (noting that the creation of a wholesale market for California's power needs involved FERC a great deal more than before restructuring).

54. See GOVERNOR'S REPORT, *supra* note 16, at 22 (describing some of the reasons that there was little or no need to construct additional generation facilities).

55. See CPUC CHAPTER 1 REPORT, *supra* note 29 (describing the give-and-take of power supplies in the western region and how the system remained balanced for many years with little or no requirement to increase generation capacity).

56. See GOVERNOR'S REPORT, *supra* note 16, at 22 (noting that the Southwest overbuilt coal-fired plants to meet demand that did not materialize).

57. *Id.* at 23.

58. *Id.* at 22.

59. See *id.* at 23 (noting that only twelve small plants were licensed, three of which were never built).

60. See Bryant, *supra* note 4, at 48 (describing the economic conditions surrounding the decision to deregulate California's electricity market). For an analysis of the foreseeability of the demand increase and the inadequacy of California's economic models, see P. Joskow & E. Kahn, *A Quantitative Analysis of Pricing Behavior in California's Wholesale Market During Summer 2000* (Jan. 15, 2001) [hereinafter Joskow & Kahn].

61. CALIFORNIA ENERGY COMMISSION, POPULATION INCREASES & ELECTRICITY GROWTH IN WESTERN STATES, at [http://www.energy.ca.gov/electricity/population\\_electricity.html](http://www.energy.ca.gov/electricity/population_electricity.html) (last visited on July 9, 2002) (copy on file with the *McGeorge Law Review*).

Excessive supply regionally, however, does not adequately explain the total failure by anyone in California to build a major new power plant.<sup>62</sup> The investor-owned utilities, for their part, were instructed by the CPUC to divest their generation assets and were not given any incentives to build more plants to replace aging and inefficient ones.<sup>63</sup> Out-of-state generators, on the other hand, had different concerns.<sup>64</sup> Given the fact that any new plants they built would compete with the generation they had just purchased, these new companies were actually given a disincentive to build new power plants.<sup>65</sup> Additionally, California has long had the toughest environmental laws in the United States<sup>66</sup>—so stringent in fact, that planning and building a power plant in the state can take up to seven years.<sup>67</sup> Because of the lack of incentive to build new plants coupled with the uncertainty surrounding deregulation, regulators should not have been surprised that generators were reluctant to build new plants.<sup>68</sup>

The reduced out-of-state supplies and higher-than-average demand during a period of unseasonable heat and lower-than-average rainfall created a situation in which power supplies were dangerously low.<sup>69</sup> A basic supply and demand curve shows that as supplies tighten—assuming demand remains constant—prices rise.<sup>70</sup> If, as was the case, demand rises and supplies tighten or remain constant, prices also rise.<sup>71</sup> Therefore, whoever controls the supply also has some control of the price.<sup>72</sup> After the investor-owned utilities sold their generation assets, independent companies, with very different business models than the investor-owned utilities, controlled nearly thirty percent of the State's electricity demand requirements.<sup>73</sup>

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62. See AUDIT, *supra* note 5, at 55 (describing the various market forces that existed and noting that these alone do not explain the entire price increase seen in the summer of 2000).

63. See Sacramento Municipal Utility District, *Power Struggles*, at [http://www.smud.com/info/dereg/part\\_1/d\\_shortage.html](http://www.smud.com/info/dereg/part_1/d_shortage.html) (last visited Nov. 9, 2001) [hereinafter *Power Struggles*] (copy on file with the *McGeorge Law Review*) (explaining the lack of motivation for suppliers to build new power plants).

64. *Id.*

65. *Id.*

66. *Backlash*, *supra* note 15.

67. Bryant, *supra* note 4, at 48.

68. See *Power Struggles*, *supra* note 63 (explaining possible reasons that supplies became scarce).

69. See AUDIT, *supra* note 5, at 55 (describing the climatic conditions responsible for the combined increase in demand and reduction in available supply).

70. *Id.* at 19.

71. *Id.* at 18.

72. See *generally id.* (describing the econometrics of supply and demand and how it relates to price, and thus, to market power—the ability to control price).

73. Interview with Tom Greene, State of California Energy Task Force, in Sacramento, Cal. (July 18, 2001) [hereinafter *Greene Interview*] (notes on file with the *McGeorge Law Review*).



#### D. Market Power

Prior to restructuring, the investor-owned utilities were considered a legal monopoly because they controlled the generation, transmission, and distribution of power for a particular service area.<sup>74</sup> This top-to-bottom type of control is known as vertical market power.<sup>75</sup> If left unchecked, vertical market power can be used to block competitors' access; in the case of electricity, this entails blocking access to the transmission system.<sup>76</sup> Prior to deregulation in California, the investor-owned utilities controlled the vast majority of in-state generation.<sup>77</sup> As a result, they also possessed horizontal market power.<sup>78</sup> Horizontal market power results when a single utility controls enough assets to alter the supply-demand equilibrium and is thus able to increase prices by withholding generation.<sup>79</sup> AB 1890 was designed to prevent the exercise of both types of market power.<sup>80</sup>

Two provisions of AB 1890 were designed to curb the potential exercise of vertical market power by the investor-owned utilities.<sup>81</sup> First, AB 1890 required that all power be bid into the Power Exchange during the transitional period.<sup>82</sup> By doing so, the CPUC hoped to give the Power Exchange enough depth to make it truly a competitive marketplace.<sup>83</sup> Second, the utilities were required to turn over control—though not ownership—of the grid to the Independent System Operator.<sup>84</sup> The Legislature designed this transfer of control to the Independent System Operator in order to prevent the owners of the transmission system (the investor-owned utilities) from favoring their own generation facilities over non-utility facilities.<sup>85</sup>

During the process leading to deregulation, regulators and legislators generally accepted the notion that direct access to competing generators in the

74. 1996 ELECTRICITY REPORT, *supra* note 28, at 5.

75. *Id.* at 24.

76. See CPUC CHAPTER 1 REPORT, *supra* note 29 (describing the potential control that could be exerted by the investor-owned utilities to favor certain generation facilities in the use of the transmission lines).

77. See *id.* (noting that the in-state utilities provided more than eighty percent of the State's total electricity supply).

78. See *id.* (describing the effect of a concentrated holding of generation assets by a single owner).

79. *Id.*

80. See generally *id.* (explaining the steps taken to prevent the exercise of market power by the investor-owned utilities).

81. 1996 ELECTRICITY REPORT, *supra* note 28, at 24. It must be remembered that the decision to recommend that the investor-owned utilities sell their generation assets, while a key element of restructuring, was not included within the provisions of AB 1890. See *supra* note 39 and accompanying text (noting that AB 1890 did not require the sale of the investor-owned utilities' generation assets).

82. See CPUC CHAPTER 2 REPORT, *supra* note 20 (describing the role of the Power Exchange in the new marketplace and the requirement that investor-owned utilities sell all of their power into the Power Exchange during the transition period).

83. *Id.*

84. See *id.* (explaining that the ISO's function is to ensure that all generators are treated equally with regards to accessing "the grid").

85. *Id.*

Power Exchange and measures to prevent misuse of the grid would mean little if any one generator could exercise sufficient horizontal market power to manipulate the wholesale price of power or to block other users.<sup>86</sup> Thus, the Legislature established the requirement that investor-owned utilities sell their generation assets in order to prevent the exercise of horizontal market power.<sup>87</sup>

Despite these precautions, market power was exercised anyway.<sup>88</sup> Moreover, this exercise of market power was the direct result of a flaw in the design of the new marketplace.<sup>89</sup> Rather than creating one market through which the purchasing and selling of wholesale electricity took place, the Power Exchange and the Independent System Operator operated several markets in sequence.<sup>90</sup> The Power Exchange operated the "day ahead" market, designed by deregulation to be the primary market for wholesale electricity.<sup>91</sup> The Independent System Operator's markets, however, were designed solely for reliability purposes and were expected to accommodate no more than five percent of the State's wholesale electricity needs.<sup>92</sup> The resultant sequential market encouraged buyers to reduce demand in the "day ahead" market and encouraged sellers to reduce the supply bid into the Power Exchange's "day ahead" market.<sup>93</sup> As a result, much of the energy bought and sold in California shifted to the Independent System Operator's real-time market, where sellers had a considerable advantage.<sup>94</sup>

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86. *Id.* In fact, one of the provisions of AB 1890 allowed the investor-owned utilities to recover so-called "stranded costs" during the transition period. *Id.* However, in order to do so, the Legislature required the investor-owned utilities to turn over control, but not ownership, of their transmission lines to the ISO. *Id.* In this way, regulators offered the investor-owned utilities an incentive—one the utilities were required to take—to transfer control of the grid to the ISO, which regulators hoped would prevent the investor-owned utilities from exercising market power by blocking access to the transmission facilities. *Id.*

87. CPUC CHAPTER 2 REPORT, *supra* note 20; see generally 1996 ELECTRICITY REPORT, *supra* note 28, at 24 (noting that horizontal market power results from a "concentration or control of any single aspect, such as generation . . .").

88. See generally AUDIT, *supra* note 5, at 15-38 (describing in detail the actual functioning of the market and the ways in which the structure of the market allowed participants to use market power to influence the market clearing price in the Power Exchange).

89. *Id.*

90. *Id.*

91. See *id.* at 16-17 (noting that deregulation required the investor-owned utilities to bid all their power into the "day ahead" market).

92. See *id.* (explaining that the ISO's energy imbalance market was created for the procurement of energy necessary to provide real-time reliability). If the actual demand exceeds the actual supply, the ISO is required to purchase electricity to balance the system. *Id.*

93. See *id.* at 16 (explaining how the relationship between the Power Exchange and the ISO's markets encouraged under-scheduling).

94. See *id.* at 22 (noting that by the time demand was bid into the Independent System Operator's real-time market, the investor-owned utilities were forced to buy enough electricity to meet demand, regardless of price).

### III. CHAPTER 2

There is little the Legislature can do now to regain the jurisdictional control given away by deregulation since the generation assets have already been sold and the creation of a wholesale market is complete.<sup>95</sup> Nevertheless, Chapter 2 seeks to prevent any further divestitures of investor-owned utilities' generation assets without CPUC review.<sup>96</sup> Chapter 2 clearly accomplishes three things. First, it cleans up loose language from AB 1890 that created confusion about the CPUC's ability to regulate nuclear facilities.<sup>97</sup> Second, Chapter 2 prevents the investor-owned utilities from selling any more of their generation assets under the pure market valuation scheme of AB 1890.<sup>98</sup> Third, the bill prohibits the sale of any generation asset owned by any of the public utilities until March 2006.<sup>99</sup>

There is a fourth possible effect of Chapter 2 regarding a jurisdictional issue.<sup>100</sup> Prior to deregulation, utilities were not free to dispose of any asset "necessary or useful in the performance of its duties to the public."<sup>101</sup> Even under the terms of AB 1890, the investor-owned utilities had to obtain CPUC approval of their plans for divestiture.<sup>102</sup> When it became clear in December of 2000 that the investor-owned utilities were facing bankruptcy, legislators became concerned that a federal bankruptcy trustee—and not the CPUC—would control the disposition of the investor-owned utilities' remaining generation assets.<sup>103</sup> Seeking to avoid this result, Chapter 2 returns to the strict statutory standard for divestiture utilized before deregulation.<sup>104</sup> Additionally, Chapter 2 goes one step further, prohibiting the utilities from selling their generation assets until 2006.<sup>105</sup>

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95. See EXECUTIVE SUMMARY, *supra* note 7, at 3-5 (explaining that turning back the clock on deregulation is not possible); see also *supra* notes 52-53 and accompanying text (describing the jurisdictional shift caused by deregulation).

96. ASSEMBLY COMMITTEE ON ENERGY COSTS AND AVAILABILITY, COMMITTEE ANALYSIS OF AB1x6, at 1 (Jan. 11, 2001).

97. CAL. PUB. UTIL. CODE § 377 (amended by Chapter 2).

98. *Id.* §§ 216 & 330(l)(2) (amended by Chapter 2).

99. *Id.* § 377 (amended by Chapter 2).

100. Interview with John Dutra, Assemblymember, in Sacramento, Cal. (June 7, 2001) [hereinafter Dutra Interview] (notes on file with the *McGeorge Law Review*).

101. CAL. PUB. UTIL. CODE § 851 (West 1975 & Supp. 2002).

102. See Greene Interview, *supra* note 73 (stating that "Chapter 2 reaffirms the process for divestiture under section 851 of the Public Utilities Code.").

103. *Id.*

104. See ASSEMBLY COMMITTEE ON ENERGY COSTS AND AVAILABILITY, COMMITTEE ANALYSIS OF ABx1 6, at 2 (describing the change from a market valuation system of divestiture to the strict terms of PUC section 851).

105. CAL. PUB. UTIL. CODE § 377 (amended by Chapter 2).

#### IV. ANALYSIS OF CHAPTER 2

Chapter 2 seeks not so much to put the genie back in the bottle but, rather, to plug the hole until a more permanent solution can be found.<sup>106</sup> Not one agency writing on this crisis identified the sale of the utilities' generation assets as even a minor cause of the current crisis.<sup>107</sup> There is strong evidence to suggest, however, that the exercise of market power and the failure of regulators were major reasons for the dramatic increase in retail power rates in 2000 and 2001.<sup>108</sup> Chapter 2 clearly addresses the first issue and tangentially addresses the second.<sup>109</sup>

While most of the focus of deregulation was to prevent the investor-owned utilities from exercising market power, an ironic thing happened: other generators used the draconian limitations on the investor-owned utilities to their advantage and they exercised market power instead.<sup>110</sup> Chapter 2, by prohibiting further sales of generation assets owned by the investor-owned utilities, prevents out-of-state suppliers, many of whom are suspected of exercising market power, from obtaining a greater slice of the supply pie.<sup>111</sup> Because the ability of out-of-state generators to influence the price of electricity depends greatly on the amount of supply they control, Chapter 2 should prevent the problem from getting worse until other long-term measures take effect.<sup>112</sup>

The FERC, under the Federal Power Act, is responsible for ensuring that wholesale power rates are fair and reasonable.<sup>113</sup> After the creation of the wholesale power market in the Power Exchange, the FERC gained much greater influence over the ultimate price of electricity in California's electrical market.<sup>114</sup>

106. See generally GOVERNOR'S REPORT, *supra* note 16, at 39-42 (describing both the short-term measures taken as well as the long-term measures currently in progress).

107. See AUDIT, *supra* note 5, at 88 (detailing the key agencies' public ideas regarding the causes of the electricity crisis).

108. See generally *id.* (noting that climactic and market changes were insufficient to fully explain the price increases during the summer of 2000).

109. See *supra* notes 97-99 and accompanying text (referring to the specific provisions of Chapter 2).

110. See generally Joskow & Kahn, *supra* note 60 (describing the economics of market power and how it was probable that generators, without the limitations imposed on them by the CPUC, could manipulate the market to drive up the price).

111. See *supra* note 46 and accompanying text (noting that, prior to restructuring, ninety percent of California's generation supply was provided by the investor-owned utilities). Since the only change in ownership occurred from the sale of generation assets to out-of-state generators via the market valuation mechanism, it stands to reason that the only way for those generators to obtain greater market share would be through further divestiture of generation assets owned by the investor-owned utilities. Chapter 2, by preventing further divestiture, eliminates this possibility.

112. See GOVERNOR'S REPORT, *supra* note 16, at 28-29 (describing Chapter 2 as one of the measures designed to stabilize the current crisis).

113. Federal Power Act § 205(a), 16 U.S.C.A. § 791 (stating that "[a]ll rates and charges made, demanded, or received by any public utility . . . shall be just and reasonable . . .").

114. See *supra* notes 48-51 and accompanying text (explaining how the creation of the Power Exchange's wholesale marketplace resulted in a shift in jurisdiction from the CPUC to the FERC).

The CPUC, however, retained control of retail rates the investor-owned utilities were permitted to charge their customers.<sup>115</sup> Throughout the crisis, the FERC allowed wholesale prices to be determined by the market,<sup>116</sup> while the CPUC maintained a retail price freeze.<sup>117</sup> The utilities were forced to buy energy at the high wholesale price and sell their electricity at the low retail price, causing them to lose massive amounts of money and forcing both PG&E and Southern California Edison to the brink of bankruptcy by December of 2000.<sup>118</sup>

This tag-team approach to power sales is the hallmark of federalism and worked well until the formula changed when deregulation was introduced.<sup>119</sup> Whether it was for lack of preparation or lack of political will, the failure of the CPUC and the FERC, to properly regulate the markets during the transitional period is perhaps the most glaring—and ultimately most difficult to accept—reason for the energy crisis.<sup>120</sup> In and of itself, Chapter 2 does not address the failure of the various regulatory agencies to mitigate this crisis. However, Chapter 2 is part of a larger effort, insofar as it prevents any further jurisdictional erosion, by weaning California's electricity markets from the control of the two groups blamed by California legislators for the severity of the crisis: out-of-state investors and the FERC.<sup>121</sup>

Finally, according to Assemblymember John Dutra, the author of Chapter 2, one of the key concerns the Bill was designed to address is the control of the investor-owned utilities' generation assets should the utilities file for bankruptcy.<sup>122</sup> Legislators feared that generation assets critical to California's energy supply could be handed over to a federal bankruptcy trustee.<sup>123</sup> Judge Robert Montali, the federal judge conducting the bankruptcy proceedings, initially noted that "[t]he public interest is better served by deference to the regulatory scheme and leaving the entire regulatory function to the regulator,"<sup>124</sup> indicating to some that, while the issue was still open, the legislators' fears may have been unfounded.<sup>125</sup>

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115. See *AUDIT*, *supra* note 5, at 9-10 (describing the two-tiered regulatory scheme in California).

116. See *id.* at 35 (describing the FERC's "soft" price caps).

117. *Id.*

118. See *Unplugged*, *THE ECONOMIST*, Dec. 23, 2000 (describing the utilities' financial difficulties at the end of 2000).

119. *Backlash*, *supra* note 15.

120. See *id.* (noting that regulators pulled out before the new institutions matured, creating a vacuum).

121. See *supra* notes 49-52 and accompanying text (explaining how the creation of the Power Exchange's wholesale marketplace resulted in a shift in jurisdiction from the CPUC to the FERC).

122. Dutra Interview, *supra* note 100. PG&E, the largest of the investor-owned utilities, did file for bankruptcy on April 6, 2001; David Lazarus, *PG&E in Bankruptcy*, *S.F. CHRON.*, Apr. 6, 2001, at A1. On April 7, 2001, SCE and Governor Davis filed a Memorandum of Understanding (MOU), one component of which was assistance from the State to prevent SCE from following PG&E into bankruptcy. David Lazarus, *Davis Seals Power Deal With Edison to Buy Lines*, *S.F. CHRON.*, Apr. 10, 2001, at A1.

123. Dutra Interview, *supra* note 100.

124. *In re Pac. Gas & Elec. Co.*, 263 B.R. 306, 323 (Bankr. N.D. Cal. 2001).

125. See E-mail from Alan W. Kornberg, Attorney-at-Law, to Maximilian Barteau, McGeorge School of

## V. CONCLUSION

The energy crisis is a complicated subject, made no easier by the number of agencies involved in the decision-making process.<sup>126</sup> In order for the State to end this crisis, it must first increase supply to match the increase in demand over the past ten years.<sup>127</sup> Moreover, the marketplace must be redesigned to prevent the exercise of market power in the future.<sup>128</sup> In the interim, Chapter 2 will prevent further sale of the investor-owned utilities' generation assets,<sup>129</sup> precluding out-of-state generators from controlling any more of the state's power supply.<sup>130</sup> If out-of-state generators are precluded from obtaining a greater slice of the energy pie and supply is increased, it may be possible to prevent the exercise of market power, and the competitive market as originally envisaged may yet emerge.<sup>131</sup>

In addition to these modifications, the jurisdictional structure must be remedied.<sup>132</sup> As noted above, had the problems that were reported to regulators been fully addressed when they were initially identified, the power crisis might have been lessened or avoided.<sup>133</sup> Regardless, against a background of dramatically increased prices and either the unwillingness or inability of FERC to intervene,<sup>134</sup> Governor Gray Davis and the California Legislature took a number of steps on their own, one of which is Chapter 2.<sup>135</sup>

The primary unanswered question, with regard to Chapter 2, is its effect on PG&E's bankruptcy proceedings.<sup>136</sup> Throughout the proceedings in bankruptcy court, PG&E has challenged the CPUC's authority to regulate its retail rates.<sup>137</sup> At the heart of the utility's argument is that federal bankruptcy law automatically

Law (July 2, 2001) [hereinafter Kornberg E-mail] (on file with the *McGeorge Law Review*) (explaining the CPUC's position and that the matter is on-going).

126. See *supra* note 23 and accompanying text (noting the number of state agencies involved with electricity regulation).

127. See GOVERNOR'S REPORT, *supra* note 16, at 8-9 (describing the efforts to rapidly create more generation supply in California).

128. See AUDIT, *supra* note 5, at 37-38 (recommending various market remedies).

129. See *supra* note 99 and accompanying text (noting the provision of Chapter 2 that prevents the investor-owned utilities from selling their generation assets until 2006).

130. See *supra* note 110 and accompanying text (concluding that this provision will prevent out-of-state generators from obtaining greater market share).

131. See generally AUDIT, *supra* note 5, at 37-38 (describing the many flaws in the actual operation of the market and ways in which it might be remedied to attain the desired competitive market).

132. See *id.* at 39 (explaining the interplay between the FERC, the CPUC, the ISO, and the Power Exchange and how the division of responsibilities left clear, solvable problems unaddressed).

133. See *id.* at 40 (explaining the findings and the possible steps that could have been taken in response to those findings to mitigate the crisis).

134. See generally GOVERNOR'S REPORT, *supra* note 16, at 173-78 (claiming throughout that FERC failed to follow its legal mandate to ensure that wholesale prices were "fair and reasonable").

135. AUDIT, *supra* note 5.

136. Kornberg e-mail, *supra* note 125 (noting that the bankruptcy proceedings are on-going).

137. See Carrie Peyton, *Judge Rejects PG&E Tactic*, SACRAMENTO BEE, Feb. 9, 2002, at A12 (describing PG&E's stance as "all or nothing" and outlining the federal pre-emption issue argued by PG&E).

pre-empts a wide variety of state laws and regulations.<sup>138</sup> Thus far, the federal bankruptcy judge has been willing to defer to California's regulatory structure.<sup>139</sup> In fact, in the latest ruling before publication of this article, Judge Montali strongly criticized the "all or nothing" approach taken by PG&E.<sup>140</sup> Despite the strong language and unwavering position Montali has consistently taken, as of this writing, PG&E continues to maintain that it will meet the standards outlined by the bankruptcy judge to establish its federal pre-emption claim.<sup>141</sup> Although many commentators think the issue has been resolved against PG&E,<sup>142</sup> the utility's willingness to fight the ruling has left the future of Chapter 2 in the hands of the courts.<sup>143</sup>

To the extent that it returns the utility industry to its pre-deregulated state, Chapter 2 is a shift toward another stage, possibly a hybrid of two dichotomous systems.<sup>144</sup> The future of deregulation is unknown.<sup>145</sup> It is unlikely that we will return to a command-and-control system, but the market has proven an imperfect means of increasing competition, promoting efficiency, and controlling costs.<sup>146</sup> California's experience suggests, however, that markets may also have their limits.<sup>147</sup>

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138. *Id.*

139. Bob Egelko, *Judge Denies PG&E Bid to End Rate Freeze*, S.F. CHRON., June 2, 2001, at A11.

140. Peyton, *supra* note 137.

141. *Id.*

142. *See id.* (describing the reactions of CPUC's attorney, Gary Cohen, and State Attorney General, Bill Lockyer).

143. *Id.*

144. *See Acid Test*, *supra* note 21 (noting that "[d]eregulation will simply not work of its own accord."). Thus, some regulation may be necessary, even in a competitive market. *Id.*

145. *See Backlash*, *supra* note 15 (remarking that "[w]e have one foot in the old regulated world, one foot in the market, and a Legislature that keeps changing its mind.").

146. *Lights Go Out*, *supra* note 36.

147. *Id.*