ELECTRICITY MARKETS: CALIFORNIA

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ENERGY AND AIR QUALITY

OF THE

COMMITTEE ON ENERGY AND COMMERCE

HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

MARCH 20 and MARCH 22, 2001

Serial No. 107–6

Printed for the use of the Committee on Energy and Commerce

Available via the World Wide Web: http://www.access.gpo.gov/congress/house

U.S. GOVERNMENT PRINTING OFFICE

71–504DTP WASHINGTON : 2001

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ELECTRICITY MARKETS: CALIFORNIA

TUESDAY, MARCH 20, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON ENERGY AND AIR QUALITY,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2123, Rayburn House Office Building, Hon. Joe Barton (chairman) presiding.

Members present: Representatives Barton, Cox, Largent, Burr, Whitfield, Ganske, Norwood, Shimkus, Shadegg, Bono, Walden, Boucher, Wynn, Waxman, Markey, McCarthy, Barrett, and Dingell (ex officio).

Also present: Representative Harman.

Staff present: Jason Bentley, majority counsel; Andy Black, policy coordinator, Sue Sheridan, minority counsel; and Hollyn Kidd, clerk.

Mr. BARTON. The Subcommittee on Energy and Air Quality hearing on the electricity markets in California with testimony from the three commissioners in the Federal Energy Regulatory Commission will come to order.

Today we are going to turn our attention to the electricity problem in California and the West generally. We are going to explore what has brought us to this stage, what is being done to address it, what steps remain to be taken. This is not an academic exercise or an inside-the-beltway game. The issue is real.

Yesterday California was subject again to rolling blackouts. The State was short of power. The California independent system operator, or ISO, ordered utilities to drop 500 megawatts. That is enough electricity to power roughly 500,000 homes.

This lasted approximately an hour. For an hour, people sat in the dark with computers shut down and manufacturing plants idle. Today will bring even more blackouts. The question is why and what can be done about it.

The answer is simple, yet it is not simple to do. There is not enough supply to supply demand in the State of California. California's peak demand exceeds its ability to supply electricity.

The electricity deficit in California will continue through this summer, into September, and quite probably into next year, as well. The problem has spilled over to States outside of California, to clients in the Pacific Northwest and leaving some without even the promise of payment, while customer costs have risen and all-important water reservoirs in the West are draining lower and lower.

This summer they tell us is going to again be a deficit in terms of rain in the West, and additional generation is not available by other means.

There have been market structure problems in California. We are all familiar with the California law that was passed in 1996 that helped to cause the problem. There have been acts of God bringing high temperatures in the summer and cold temperatures in the winter. There have been low rainfalls, which you have already spoken of, and snowpacks, making hydroelectric generation not as available as it would be normally.

But there has also been a fundamental failure to understand that power plants and transmission expansion lines have to be constructed and they need to be built. The Federal Government does not site power plants or transmission lines, States do.

Our ability at the Federal level to help in this regard is limited. The Federal Power Act gives the Federal Energy Regulatory Commission, or FERC—three Commissioners are here today—jurisdiction over only about half of the wholesale sales being conducted in the West today.

As it should, the Federal Energy Regulatory Commission is taking a hard look at the recent history of some of these wholesale sales. But again, the FERC only regulates approximately half of these sales. If the rates they do regulate do not appear to be just and reasonable, it is the FERC's job to understand why and to do something about it.

FERC has requested more information on certain sales, and has suggested that refunds are in order if they cannot be properly justified. The FERC has taken other actions to streamline processes and direct the State of California to reform programs that have gone awry.

The Bush administration, in its 2 months in office has been active, as well. One of President Bush's first acts was to extend the emergency electricity sales for 2 weeks, giving California time to enact reform legislation to help maintain its existing electricity supply.

At the request of the Governor of the State, Governor Gray Davis, President Bush issued an executive order directing Federal agencies to expedite permits relating to construction of new plants in California. In response to that executive order, the Environmental Protection Agency has issued permits for three new power plants in the past month. In response to a request by the State of California, EPA has provided other assistance, clarifying rules relating to operation of backup generators.

President Bush and Secretary Abraham of the Energy Department have engaged in discussions with the government of Mexico about increasing electricity imports from Mexico. Again, at the behest of Governor Davis, Secretary Abraham has sent a letter to the FERC asking that the agency act on his request for an extension of the waiver for qualifying facilities from certain fuel requirements. FERC approved the qualifying facilities waiver last Wednesday, I am told.

After hearing the testimony of this panel and the second panel on Thursday, it is my intention to poll the subcommittee members

to see whether we should work on an electricity emergency piece of legislation in the next several weeks.

I want to be clear on this point: If there are some things that can help California and the West by taking legislative action, I am more than prepared to do that. In fact, I have had discussions with the White House on that point within the last week.

But we need to be cognizant that what we do legislatively should actually have the ability to help the problem, both in the short term and in the long term. To pass a bill out of this subcommittee simply to say that we have done something, if it does nothing in reality, is worse than not doing anything at all.

So the hearing today with the chairman and our two commissioners and our hearing on Thursday could quite possibly result in a legislative action item coming up in the next 2 weeks. It could also result in us making a determination, again, on a bipartisan basis and in conjunction with DOE and the White House, that legislatively there is not a need to do anything because it will not alleviate the problem.

But if we come away as a result of the hearing record and make a determination that something could be done to help, it will be done.

I want to thank the members of the FERC for coming today. They are still shorthanded. We have two empty chairs, one on the right and one on the left. I don't know if that is by design or not. But the three that are here, as we would say in Texas in high school football, are keepers. They are good folks, and I expect a good, fact-based hearing today.

With that, I yield to my ranking member, the gentleman from Virginia, Mr. Boucher, for an opening statement.

Mr. BOUCHER. Thank you very much, Mr. Chairman. I appreciate your scheduling this hearing today and the one that we will hold on Thursday of this week in our continuing examination of the problems affecting the western electricity markets, and for inviting today each of the three commissioners of the Federal Energy Regulatory Commission to offer their testimony. I want to join with you in extending a welcome to each of them.

I particularly appreciate Chairman Barton's willingness to work with interested members on our side to ensure that we hear from the full range of parties who have expertise bearing on the serious problems that affect the electricity markets in the western region.

I do not envy the FERC the role that it has in having to make these decisions. The Commission is obligated by law to review the wholesale aspects of California's electricity restructuring arrangements, and yet, it really has only very limited ability to affect the fundamentals of that State's competition plan.

Almost any action that the Commission takes or declines to take is going to be opposed by someone, and the stakes, in fact, are very high for consumers and for investor-owned utilities in the States on the West coast.

Last November, the Commission determined that it must modify its prior orders approving the wholesale aspects of California's restructuring plan. That decision was based on the Commission's finding that wholesale prices in the State in many instances were

no longer just and reasonable, a point on which the commissioners apparently were in agreement.

There was less accord, however, with respect to the proper remedy for that problem. That is one of the matters that I think it will be useful for our subcommittee to examine with the commissioners this afternoon.

Of particular interest to the subcommittee is the question of whether the FERC has sufficient authority under the Federal Power Act to address the present and anticipated future problems in the wholesale power markets in the western region.

I am also interested in whether the Commission's authority to address regional transmission matters is adequate. Of specific concern are the possible ramifications of California's current efforts to acquire the transmission assets of the investor-owned utilities, an event that some suggest might place thousands of miles of transmission lines beyond the jurisdiction of FERC, and the opinion of the commissioners on whether that would be the result of California's acquisition of these assets would be welcome.

I would respectfully suggest to my colleagues on the subcommittee that in considering whether Congress should attempt to legislate a solution to California's problems, we must take a careful and deliberate approach. Congress must provide the FERC with adequate statutory authority to address the problems that arise in wholesale markets, including charges by generators that are beyond the just and the reasonable, other inappropriate abuses of market power by electricity generators, and the management of transmission lines in a manner which impedes the effective functioning of wholesale markets.

It is appropriate as well for this subcommittee to conduct oversight to ensure that the Commission does its job. It is quite another matter, however, for Congress to attempt to devise specific remedies to a complex situation that is characterized by constant change. Since that undertaking would prove difficult, and since Congress has, at best, a mixed record in fashioning legislative responses in previous energy crises, I think we must proceed with caution.

Above all, we must avoid taking any action that would exacerbate the current circumstance or undermine the efforts of the State of California to remedy a problem which was, in significant part, its own creation.

That said, we will welcome suggestions from the Commissioners and from our witnesses at the hearing on Thursday of statutory changes which may be needed to empower the FERC to take such steps as it may deem necessary to ensure the effective functioning of wholesale markets, both markets specifically on the West coast, and wholesale markets generally around the Nation.

We will also carefully examine the actions taken by the FERC to this point with reference to the California market to determine whether its orders target the complete range of transactions that may involve an abuse of market power.

I have some particular concerns in this regard which I think we will address, Mr. Chairman, at a later point during this hearing.

I want to join with you in welcoming these witnesses, and thank them for taking the time to share their opinions, advice, and expla-

nations of the actions they have taken with us this morning, and along with you, I look forward to their testimony.

Mr. BARTON. I thank the gentleman.

The gentleman from Illinois, Mr. Shimkus, is recognized for an opening statement.

Mr. SHIMKUS. Thank you, Mr. Chairman. A lot of this has been covered, so I would like to submit my opening statement for the record and just follow up on the issue that I know we will get to in the hearing, which is on the debate on price caps, which I am avidly opposed to, because I feel that price caps do not work. They neither spur new generation nor do they lessen demand.

Price caps do not allow the market forces to work. If we cap wholesale rates, like how California capped the retail rates for individual consumers, how do you encourage conservation? How do you affect the other side of the equation, not just the supply, but the demand?

Governor Davis has said there is a solution to the crisis, and that is raising the retail rates. Unfortunately, that is not politically popular, and that is something we need to be careful of, especially in California, a government getting too involved in the market and then making decisions based upon politics. It distorts the market, and while the decision may appear good in the short run, it could have devastating effects in the long run.

With that, Mr. Chairman, for the sake of time, I will yield back and wait for the responses.

Mr. BARTON. I thank the gentleman from Illinois.

The distinguished ranking member of the full committee, the gentleman from Michigan, Mr. Dingell, for an opening statement.

Mr. DINGELL. Mr. Chairman, thank you for your courtesy. I commend you for holding these hearings.

In recent months, extensive attention has been paid to the flaws in California's electric restructuring plan and the efforts undertaken by the Governors, the State legislature, and the Federal Energy Regulatory Commission, FERC, to address the resulting problems.

With the passage of time, it has become clear that California's difficulties are having a profound effect on other western States who have become involuntary participants in this experience with retail competition.

Today's hearing is particularly significant for the subcommittee because we will be hearing from the three commissioners of the Federal energy agency to whom Congress has given primary responsibility for maintaining viable wholesale electricity markets. Since 1935, the Federal Energy Regulatory Commission and its predecessor, the Federal Power Commission, have been charged with ensuring that power rates are just and reasonable and that the grid is operated in a nondiscriminatory fashion. This has not always been easy, and it is especially difficult now, as the electrical industry undergoes a period of replaced change.

Today, however, we focus on more narrow issues: The Commission's role in approving California retail competition plans, its decision late last year that the State's plan was not operating in conformity with the Federal Power Act, and its recent efforts to decide

what the Act requires FERC to do to restore order to western electricity markets, and thereby protect consumers.

It is widely accepted now that the California problem is again in its own legislature, and that the problems in the electricity supply for California were created in California by Californians. The effort to remedy the resulting fiasco must begin in that State.

There are probably things that must be done at the Federal level. However, the role FERC has played in this matter is also worth reviewing. In 1996, FERC approved the California utilities' requests to participate in the system established by the State's new restructuring law. The Commission clearly understood that at the time, that in issuing an approval, it was making something of a calculated risk.

FERC characterized the proposal before itself at that time as a work in progress, which provided only, and I quote, an acceptable basis for going forward.

Two, last summer, as prices in California began to spike and the reliability of service degenerated, FERC was drawn into the maelstrom of California's troubles. On December 15, 2000, FERC amended its earlier order. It stated that "Flaws in the State's plans, coupled with an imbalance between supply and demand, have caused and continue to have the potential to cause unjust and unreasonable rates," in direct violation of the Commission's mandate under the Federal Power Act.

That mandate, contained in section 206 A says, "Whenever the Commission shall find any rate charges or classification demanded, observed, charged, or corrected by any public utility subject to the jurisdiction of the Commission is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rate, regulation, rule, practice, or contract to be thereafter observed and in force and shall fix the same by order."

The discussion of issues in the December order is particularly instructive for all, especially the subcommittee, because it goes to the heart of the Commission's authority and to its responsibility under the Act to ensure wholesale markets function in a fair and reasonable manner.

In separate occurrences, and concurrences, Chairman Hébert and Commissioner Massey took reasoned but altogether opposing views on the price caps, about which I am sure we will hear more today.

I would note, however, that the law is not a matter of opinion for the Commissioners. The law requires certain actions, which we expect will be taken in a suitable and proper fashion in conformity with law. I do not envy the work of the Commission since any action FERC undertakes is going to be criticized by somebody, somewhere. The situation presents a constantly moving target, complicated by litigation pending in Federal court and by California's attempts to acquire its private utility transmission lines, and other things.

In closing, I would like to offer the Commissioners a modest suggestion. Retail State plans to embrace retail competition have thrust themselves upon FERC, and this leaves FERC with difficult questions involving State-initiated hybrids that are neither traditional nor fully competitive regimes. The Power Act is not a static

document, and it falls to FERC to decide how to apply the law to a changing landscape, but to apply the law nonetheless, which is its function.

It is also important to FERC to recognize that to date, the Congress has not authorized the Commission to promote retail competition. The Commission has certain specifically enumerated enunciations by the Congress which are set forth here in the law.

It is not FERC's job to encourage or to save retail competition experience or experiments. Instead, Congress has vested the Commission with the unique responsibility for ensuring the soundness of wholesale power markets, and until that changes, this should and must remain the primary focus of the Commission's efforts until the Congress has afforded them different authorities, different duties, and different powers.

Mr. Chairman, thank you.

[The prepared statement of Hon. John D. Dingell follows:]

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

In recent months, extensive attention has been paid to the flaws in California's electric restructuring plan and the efforts undertaken by the Governor, the State Legislature, and the Federal Energy Regulatory Commission (FERC) to address the resulting problems. With the passage of time, it has become clear that California's difficulties are also having a profound impact on other western states who have become involuntary participants in this experiment with retail competition.

Today's hearing is particularly significant for the Subcommittee because we will be hearing from all three Commissioners of the Federal agency to whom the Congress has given primary responsibility for maintaining viable wholesale electricity markets. Since 1935, the Federal Energy Regulatory Commission and its predecessor, the Federal Power Commission, have been charged with ensuring that power rates are just and reasonable and that the grid is operated in a nondiscriminatory fashion. This has not always been easy, and it is especially difficult now as the electric industry undergoes a period of rapid change.

Today, however, we focus on more narrow issues—the Commission's role in approving the California retail competition plan, its decision late last year that the State's plan was not operating in conformance with the Federal Power Act, and its recent efforts to decide what the Act requires FERC to do to restore order to western electricity markets and thereby protect the consumer.

It is widely accepted now that California's problems began in its own legislature, and that the effort to remedy the resulting fiasco must begin in the State. However, the role FERC played is also worth reviewing:

(1) In 1996, FERC approved the California utilities' request to participate in the system established by the State's new restructuring law. The Commission clearly understood at the time that in issuing an approval, it was taking something of a calculated risk. FERC characterized the proposal before it as "a work in progress" which provided only an "*acceptable* basis for going forward."

(2) Last summer, as prices in California began to spike and the reliability of service degenerated, FERC was drawn into the maelstrom of California's troubles. On December 15, 2000, FERC amended its earlier order. It stated that flaws in the State's plan, coupled with an imbalance between supply and demand, "have caused, and continue to have the potential to cause, *unjust and unreasonable rates*"—in direct violation of the Commission's mandate under the Federal Power Act. That mandate, contained in Section 206(a) says:

> "Whenever the Commission . . . shall find that any rate, charges, or classification demanded, observed, charged or collected by any public utility . . . subject to the jurisdiction of the Commission . . . is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order."

The discussion of issues in the December order is particularly instructive for the Subcommittee, because it goes to the heart of the Commission's *authority—and responsibility*—under the Act to ensure wholesale markets function in a fair and reliable manner. In separate concurrences, Chairman Hebert and Commissioner

Massey took reasoned, but altogether opposing, views on the wisdom of price caps, about which I am sure we will hear more today.

I do not envy the Commissioners' task, since any action FERC undertakes will be criticized in some quarter. The situation presents a constantly moving target, complicated by litigation pending in Federal court and California's attempt to acquire its private utilities' transmission lines.

In closing, I would like to offer the Commissioners a modest suggestion. Recent state plans to embrace retail competition have thrust upon FERC difficult questions, involving state initiated hybrids that are neither traditional nor fully competitive regimes. The Power Act is not a static document, and it falls to FERC to decide how to apply the law to a changing landscape.

But it is important for FERC to recognize that *to date the Congress has not authorized the Commission to promote retail competition.* It is not FERC's job to encourage or to save state retail competition experiments. Instead, Congress has vested the Commission with unique responsibility for ensuring the soundness of *wholesale* power markets, and until that changes, this should remain the primary focus of the Commission's efforts.

I thank the Chairman.

Mr. BARTON. I thank the gentleman for his opening statement.

In order of appearance, the next statement would be from Mr. Whitfield of Kentucky, but Mr. Cox of California has a leadership meeting and has asked if he could go out of order, so we will recognize Mr. Cox and then resume regular order.

Mr. Cox.

Mr. COX. I appreciate your courtesy, Mr. Chairman. Out of courtesy to the other members, I will make my statement very brief, but I did not want to fail to extend my gratitude to the panelists who are testifying today. They have a responsibility for a great deal of what affects us in California and affects, in consequence of that responsibility alone, the entire Nation.

Yesterday afternoon I was in Southern California when rolling blackouts occurred. I was at the moment scheduled to take a facility tower tour of Broadcom, one of our Nation's and the world's most significant players in the new economy.

It struck me as particularly ironic that the chairman and CEO of this company spent the hour before our meeting using a letter-opener to open paper mail, sitting by a window so he could get some sunlight to read. The entire company, of course, could not function during this period of time, and the same was true for nearly a million people throughout the State for that hour.

It is a Third-World experience in California to have this going on, and it is entirely unnecessary. This is a man-made catastrophe. It is not happening in other places that did not have California's legislative restrictions.

So I urge you, as you take a look, for example, at California's application for your approval, which they must receive if they are going to go forward with their plan, to permit them to acquire the transmission system in California, that you consider just how wrong-headed the States' response has been so far.

What California is doing is not limited to California alone. It will affect the rest of this country. It is a significant share of our Nation's economy already, but as we speak, that share is slipping somewhat.

From my experience, taking these facility tours, which I have been doing a fair amount of of late, it has never failed that the executives point out that their incremental decisions about where to locate their new facilities, where to locate their new responsibil-

ities, and so on, are all taking place outside of California because of the uncertainty. Sometimes the decisions they make, once they decide not to stay where they are, are not always limited to the United States.

So this is hurting our country in that respect, as well. Neighboring States have sent their legislators to my office to complain about the dislocating impacts California's mess is having on the rest of the region.

So we have to ask ourselves why it is the Federal Government should, in any way, try and encourage this wrong-headed response by the State of California.

In particular, it concerns me that we have this blunt instrument of rolling blackouts, which treats all possible uses of electricity as if they are exactly the same, because the State cannot pick; it does not know when we could use price signals to force conservation.

Not all uses of electricity are equally important, but in a big, variegated economy such as California, it is the only way those choices can be made rationally is through a market distribution system. That is the one thing that California refuses to permit. It is the one thing the Governor refuses to permit.

The acquisition at a cost of billions of dollars of the State's power grid is not going to produce a single drop more of energy or a single bit more of electricity. It is all an elaborate Rube Goldberg mechanism to shift the costs from ratepayers to taxpayers, as if they are different people. It is an enormous amount of waste when there is much work that needs to be done.

I very much appreciate your being here at this hearing to help us work through the problem. The problems in California could not be more real. They are going to be equally real, but just bigger and more sustained this summer when, as the Department of Energy tells us, summer energy demand is going to outstrip California's supply by as much as 5,000 megawatts. That is about one-twelfth of our total demand.

So this is a serious, serious issue that deserves all the attention, Mr. Chairman, that this committee is giving it.

Mr. BARTON. I thank the gentleman from California.

We are going to go now to another gentleman from California who represents part of Los Angeles, the Honorable Henry Waxman, for an opening statement.

Mr. WAXMAN. Thank you very much, Mr. Chairman.

Mr. Chairman, we are now only 3 months into the Bush administration. Already a clear question is facing our country: Will President Bush look out for consumers and our national interest, or will he simply do what oil, gas, mining, and electric utility companies tell him to do?

There are, of course, times when one policy can serve both industry and the public, but sometimes choices have to be made and only one interest can be served. So far in the early days of this administration, the oil, gas, and mining industries are routing the American people and getting every penny's worth of the millions they donated to Republican campaign committees last year.

Last week, oil and coal lobbyists broke out the champagne to celebrate an early and major victory. They convinced the President to

break his campaign promise to support legislation to comprehensively clean up dirty, polluting power plants.

This was no easy feat. The President had made the promise clearly and publicly. His hand-picked administrator at the Environmental Protection Agency reaffirmed the promise as early as last month, and it appears he came remarkably close to talking about his promise in his first address to the Congress.

Then, with an impressive swiftness and effectiveness, the oil and coal companies demanded the President back down, which he promptly did. Just today EPA administrator Whitman has announced she is pulling back long overdue standards to protect the public from arsenic in drinking water.

Now we are on round two. As everyone knows, California has had a disastrous experiment with a State-wide electricity deregulation law. The result of that law has been skyrocketing energy bills and rolling blackouts across the State. Other western States, including Oregon and Washington, are beginning to feel the effects, also.

Clear and seemingly easy choices have to be made. Electricity generators should be prohibited from gouging consumers. Supplies should not be arbitrarily held back from utilities. Measures that spur immediate conservation should be implemented, and the Federal Government, through the Federal Energy Regulatory Commission, should be ensuring that reasonably priced supplies are available to western families.

But the oil and gas companies and electric utilities do not see it this way. They do not want gouging to be investigated or limited, and they do not want the Federal Government to interfere in what is becoming a very lucrative business opportunity.

On top of that, the oil and gas interests want California's failed attempt at deregulation to provide a new excuse for drilling for oil in the Arctic National Wildlife Refuge.

In October 2000, candidate Bush campaigned in Southern California and promised that if elected President, he would help California's energy crisis. At the time, FERC was resisting the idea of regional wholesale price caps, and candidate Bush reassured California voters by saying, "I believe so strongly that part of this region is going to suffer unless you have a President who is willing to tell the FERC to do what is right for the consumer."

Well, California is suffering. A year ago, wholesale prices for electricity ranged from $12 per megawatt hour to $29 per megawatt hour. Now, thanks to a completely dysfunctional deregulatory scheme, recent wholesale prices ranged from $429 per megawatt hour to $565 per megawatt hour.

Think about that. In less than a year, we have gone from $29 to $565 for the same amount of electricity.

Last week, the Governors of Oregon, California, and Washington joined together and asked that a cost-based price cap be imposed for power purchased in the smog market for 1 year. This is what most people believe is needed to protect western families.

It is not a radical or unprecedented idea. In fact, there are wholesale price caps in effect today in three ISOs in the East. Candidate Bush would no doubt have agreed, but now we are dealing with

President Bush and an administration that I fear looks to utility lobbyists to decide policy.

The industry lobbyists do not want anything to do with cost-based price caps. This is one of those situations where if you are not with us, you are against us. That is how it is for western families. If nothing is done, power that cost $7 billion in 1999 will cost consumers $70 billion this year.

I look forward to listening to today's witnesses. I hope to work with them and my colleagues to lend a helping land hand to western families. Thank you very much, Mr. Chairman.

Mr. BARTON. We thank the gentleman from California.

We go to the gentleman from Kentucky, Mr. Whitfield, for an opening statement.

Let me make an announcement. We are not timing opening statements today. We are not going to have opening statements on Thursday; it is a continuation. So the Chair is being very lenient with the 3-minute rule today on opening statements.

Mr. Whitfield.

Mr. WHITFIELD. Thank you, Mr. Chairman. I want to welcome members of FERC here, and particularly I want to welcome Linda Breathitt, former Chairman of the Public Service Commission in Kentucky, and also from my hometown. So I am sure that she will solve this problem in short order, Mr. Chairman.

I was going to say that I am glad that at this point we have not tried to politicize this issue, and it looks like we are keeping in that same spirit.

But I think all of us recognize that FERC alone cannot solve the energy crisis facing California. I do not think there is anyone who thinks there is a simple answer to the problem.

Our friend, the gentleman from California, Mr. Waxman, tried to place a lot of blame on the Bush administration. Maybe they deserve some of the blame. But I think if you are going to do that, you also have to look at the Clinton Administration and what they did on encouraging the use of natural gas. California has one of the most complex, difficult permit siting procedures of any State in the country, so we have not had a lot of generation plants built in California.

Then they adopted a law that you cannot enter into long-term contracts, but you have to go to the spot market.

So if we are going to try to place some blame around here, I think there is plenty of blame to go around. But I think the real purpose of these hearings is to try to come up with a comprehensive solution, not a short-term fix.

We have talked about people, some Governors who wanted price caps. I know in February of this year, eight western Governors wrote a letter to the FERC asking that there not be price caps. So price caps might be a short-term answer, but they are not a long-term solution.

I think that is why we are, or I certainly am. I am excited about listening to the testimony today from these three Commissioners who have legal responsibility in this area, who have studied the problem and maybe can come up with some recommendations that will help us put together a long-range solution to the problem.

Mr. BARTON. We now turn to the gentleman from Massachusetts, Mr. Markey, for an opening statement.

Mr. MARKEY. Thank you, Mr. Chairman.

Yesterday Energy Secretary Abraham delivered an address in which he warned that we were in a national energy crisis, and that we could have blackouts and brownouts in California and elsewhere around the country.

The Secretary warned that over the next 20 years, energy demands could increase by 62 percent for natural gas, 32 percent for oil, 45 percent for electricity.

The administration's solution to the situation is focused so far almost entirely on increasing production: Drill the Arctic National Wildlife Refuge, build more refineries, build more oil and gas pipelines, build more power plants. Indeed, Secretary Abraham is calling for 1,300 new electric power plants to be built over the next 20 years.

We have yet to hear the Secretary mention the word "automobile, SUV, light truck." We wait with bated breath his mention of where we put all the oil that we consume in the United States. Two-thirds of it goes into gasoline tanks. Perhaps at some point in the next year or so, the Secretary of Energy will mention that, and some recommendation as to what we can do to make our society more efficient.

While President Bush said yesterday that our current energy problems are caused by supply and demand, I have yet to see any evidence that this administration is focused on the demand side of the equation at all, for our Nation's demand in electricity, the subject of today's hearing, is nothing more than the sum total of all the refrigerators, air conditioners, space heaters, water heaters, and other appliances that consume electricity.

In 1997, 11.8 percent of all the electricity used in residences was used for air conditioning, and 12.9 percent was used for refrigerators; 11.4 percent was used for space heating, 9.2 percent was used for lighting, and 43 percent was used for other appliances, clothes dryers, TVs, dishwashers, et cetera, et cetera. That is all electrical generating plants are, just all of these appliances plugged in consuming the electricity.

Now, if we decide to make all these appliances more efficient, double their efficiency, then we do not need to build new power plants. So do we look first to automobiles, SUVs, and air conditioners and other appliances, or do we look first to the Arctic pristine wildlife refuge? Is it the God-made preserve that should be looked at first, or the man-made set of appliances?

Are we a technology society? Do we pride ourselves as being the technology committee, and do we look at those technologies in terms of what we can do to improve their efficiency? Or do we look at what God made and say, let us destroy that further, before we ask any questions about that which pushes the demand up there?

Now, the Bush administration right now is reviewing an appliance efficiency rule adopted by the outgoing Clinton Administration. If the Bush administration decides to weaken or repeal that rule, they will take our electrical generating problems and make them much worse.

Over the next 30 years, the new efficiency standards are estimated to eliminate the need to build 91 new 400-megawatt power plants, with air conditioning standards alone eliminating the need for 53 new power plants. By the way, in California in the summer, one-third of all electricity is just to keep the air conditioning going. What if we just doubled the efficiency of air conditioners? What a revolution that would be.

By the way, all the other efficiencies combined would be 240 power plants that would not have to be built.

But, what is the response from the administration? Well, here is their plan. They plan to cut the Department of Energy's budget by 6.8 percent, and they are going to cut the budget for energy efficiency funding by more than 30 percent, so energy efficiency is going to be cut in the Bush budget. That is exactly the wrong way of dealing with the underlying supply and demand problem.

In addition to reassuring that we become more energy-efficient, we also need to assure that we have fair and orderly wholesale and retail markets. Last year when the committee was considering the Federal electricity restructuring legislation, I tried to offer an amendment that would have helped to reinvent the Federal Energy Regulatory Commission, transforming it from a rate regulator to a market regulator that would be able to more effectively police the evolving competitive markets in California and around the country.

My amendment would have given Federal regulators the tools that they are going to need to address market power abuses in the emerging competitive markets. As the markets become national and not just individual States, which is what they were for the first 100 years—we have moved now to a national market. We need national market regulation.

But there was widespread opposition to my amendment from the electric utility industry and from members on the other side of the aisle. There is no market power problem, I was told. We should not be giving FERC any more authority in this area. We should leave it to the States.

Well, we ended up doing nothing. What happened? Last fall, an investigation by the FERC staff revealed that the California market was seriously flawed and caused unjust and unreasonable rates for short-term energy to be charged. The FERC also observed that the California energy regime provided an opportunity for sellers to exercise market power when supply is tight.

Unfortunately, it was not until last week that FERC finally took action against two companies for alleged withholding of generation to drive up prices. Is this type of activity limited to these two companies or, as Commissioner Massey suggested, might it be more widespread and pervasive, which is deeply troubling?

I know there are many factors that combined to produce California's perfect storm. Some, like the amount of rainfall in the West coast, are beyond our control. But when we see evidence of market power abuses that result in excessive and artificial levels of market volatility, it seems to me we should act quickly and decisively.

Markets are built on public confidence, and right now the public has little reason to have confidence in the dysfunctional market that has been permitted to develop in California. Hopefully, this

hearing will help bring us a step closer to solving that problem and hopefully our Nation's problems.

Mr. BARTON. We will hear next from the gentleman from North Carolina, Mr. Burr, for his statement.

Mr. BURR. I always cherish the fictional readings of Mr. Markey and the opportunity to hear what could be, what will be, and what has been, though it is not in a world that I necessarily see.

Mr. Chairman, I want to thank you, and I want to thank our witnesses for their willingness to come in. We deal with a very, very tough issue. I am pleased that our current slate of FERC commissioners is able to join us today to discuss the Commission's beliefs as to how this crisis came about, what remedies they have prescribed, and those they might see fit to add to them which might cure this situation.

While it may be difficult to remedy a short-term fix for the coming summer months, I am open to any and all considerations laid upon the table. However, it will take a good deal of convincing to make me believe that temporary wholesale price caps, absent retail rate increases by the State and other potential State-mandated requirements, will help correct the current imbalance between supply and demand.

Yes, it is real. We are all aware of the reasons for the generation scarcity: unseasonable cold temperatures in the West and northwest this winter; less-than-expected amounts of rainfall and snow amounts; lack of additional generation in the northwest States; mandatory divestiture of generation owned by California utilities; restrictions on hedging their price risk. The list goes on.

What is at the heart of this problem is the fact that California never fully deregulated its industry, which sends mixed signals to investors, regulators, and to customers. The former Chairman of FERC said this before he left: "California's market is clearly flawed by design. It will be very difficult to reform, but reform it must, and reform it can."

That is a very telling statement from somebody who was supportive of the direction for so long that it was headed in, but who faced the reality that it was flawed. It cannot work. That is what "flawed" means.

I will be interested to hear from our Commissioners what signals the wholesale price cap, with a continued retail rate freeze, might continue to send, whether intended or unintended, to end use customers; what conflict of interest might arise from State ownership of transmission assets as it relates to its participation in an RTO; and how has FERC handled this wholesale price episode differently than the midwest price spikes in the late 1990's.

Finally, Mr. Chairman, let it be known that we can debate all we want to about the States' role or the Fed's role in resolving this dilemma. The fact of the matter is that it will require tough decisions at both levels that might not be as politically saleable as some would prefer.

Quality leadership, though, requires us—in the final analysis, short-term political gains do not outweigh the long-term interests and needs of constituents and of the residents of California.

Mr. Chairman, again, thank you. I yield back the balance of my time.

Mr. BARTON. I thank the gentleman from North Carolina.

We would now like to hear from the gentlewoman from Missouri, Congresswoman McCarthy, for an opening statement.

Ms. MCCARTHY. Mr. Chairman, thank you for continuing this series of hearings and allowing this subcommittee to hear firsthand from the important decisionmakers in the energy industry such as those we have before us today, and those we will hear from on Thursday.

The continued blackouts are a reminder of why this committee needs to remain vigilant in its oversight of the problems in California so that we can do our best to avoid repeating them in other parts of this country.

We have heard significant debate in this subcommittee over the past 2 years on abuses of market power, as well as what is just and reasonable.

I am very interested in learning more about the recent decisions for which it was determined that prices nearly ten times what they were a year ago are deemed just and reasonable as a gauge for determining if market power abuses have occurred.

Prices like these raise basic affordability issues. People just are not going to be able to pay these bills, even if the State is protecting some small consumers. Because there are many stakeholders who have called for a regional price cap, and nearly as many who feel that there should not be one, I am interested in what Commissioners feel about another alternative being discussed, such as a cost-based or cost-plus pricing mechanism, at least for a short time, to return some stability to the market.

Thank you again, Mr. Chairman. I return the balance of my time in order to get to their important testimony.

Mr. BARTON. I thank the gentlewoman.

The gentleman from Georgia, Mr. Norwood, is recognized for an opening statement.

Mr. NORWOOD. Thank you very much, Mr. Chairman. As you are well aware, much of our country's focus recently has been on California, and very deservedly so.

However, the current crisis within the energy industry in the Golden State is not merely a California problem. I believe it is pretty critical for us to impress this fact upon the American people. California's energy crisis has had direct and far-reaching effects on the entire region and consumers in Oregon and Washington, Arizona, Utah, Idaho.

There has been much speculation and discussion as to the principal causes that have contributed to the energy problems California faces today. Although rising costs of natural gas and exceeding electricity demand over supply, lack of rainfall, and unforeseen weather conditions have exacerbated this situation, Californians' electricity market structure, capping of rates in the retail market while allowing the wholesale market rates to fluctuate, all of this has proved unworkable.

Electricity is the lifeline of our economy. It is far too important to the entire public interest to move with hasty, unproven plans for restructuring that industry. An electricity problem such as the one in California on a national scale could potentially unnerve the entire country economically, proving catastrophic.

I believe the failure of restructuring efforts in California should serve as a yellow light to this Congress as we examine proposals to restructure the industry at the Federal level.

Mr. Chairman, I do appreciate your leadership of this committee. Thank you for making members aware of the critical importance of examining the problems in California as part of enacting an effective national energy policy.

I do hope before we finish meeting, someone can explain to me why those mean old manufacturers of air conditioners and refrigerators do not make them more energy-efficient. I just cannot imagine that they would not do anything but sell more. So maybe we can get somebody to explain to me why we produce air conditioners and refrigerators that use so much electricity, because Mr. Markey thinks that solves the entire problem.

I look forward, Mr. Chairman, to hearing the testimony today from our FERC Commissioners on these issues, and hope we can work together to determine whether lessons can be learned from the current situation in California so that we may avert similar crises in the future.

Thank you, Mr. Chairman.

Mr. BARTON. I thank the gentleman from Georgia. Mr. Markey is not here. I'm sure he will return for the questions.

It might just be those mean old manufacturers, they realize if they made them more efficient, some people could not afford to buy them, and they might just have to sweat. There is a reason the market works.

Mr. NORWOOD. Nobody has thought of that. That is amazing.

Mr. WAXMAN. It could be, Mr. Chairman, that unless the government sets a standard, that one manufacturer does not want to be at a competitive disadvantage by having to pay to make sure their product is more efficient. That is why government needs to come in there and set a level playing field in order to protect the public interest.

Mr. BARTON. I am sure in air conditioning that the standard that would be accessible for the mansions in Beverly Hills, where people make $5 million a year, would be the same standard that is made in Waco, Texas, where my mother lives and exists on an income of perhaps $15,000.

Mr. WAXMAN. I think air conditioners ought to be made more efficient, no matter where they may be.

Mr. BARTON. You have to have air conditioning that people can afford.

The gentlewoman from California.

Mrs. BONO. Mr. Chairman, thank you for your ongoing interest in helping address California's energy crisis. Your concern is deeply appreciated by those of us most affected by the struggle.

I would like to welcome the Commissioners from FERC, and I look forward to their testimony today. Unfortunately, Congress, FERC, and the administration are faced with a challenging task of addressing a problem that is mostly in the hands of State officials. However, the Federal Government cannot and must not shirk its responsibilities.

FERC's December 15 order provided the State with a framework by which it could begin to rebuild its foundation. It was these Com-

missioners before us who urged the State to enter into long-term contracts, eliminate its single-market clearing price system, and expedite the siting of additional power plants.

While certain aspects of its order were not immediately addressed, the State did recognize the value of these pronouncements and has undertaken efforts to employ them. In addition, I was pleased to see the Commission commit itself to discharging its authority to order refunds for unjust and unreasonable rates charged by generators.

While I believe that wholesale price caps are not beneficial for our long-term needs, I do believe and further encourage FERC to exercise its authorities to call into question the wholesale rates.

I understand that FERC has jurisdiction over only 40 percent, or over 47 percent of California's generating facilities. Therefore, we must be mindful that any actions taken by FERC will factor in the 53 percent it has no jurisdiction over.

In addition, generators must be able to earn a rate of return which allows them to recover their operating expenses, make reasonable profits, and have the financial capability to invest in capital expenditures, which will bring on a much needed increase in our supply.

I believe we can both encourage an increase in supply and ensure just and reasonable rates, but we will never achieve stability without encouraging investments in both supply and transmission. Transmission of natural gas and electricity has been the unheralded and least-talked about issue during this crisis.

Without an adequate system by which to transport this electricity, new facilities are for naught. If we don't have reliable and plentiful sources of natural gas for all these new gas-fired generators coming online, we will never see the benefits of these plants because we will not be able to turn them on.

Therefore, I strongly urge California to expeditiously integrate itself into a West-wide RTO. I have stated before, and I do so again, that this is not a matter of quality of life, but of life itself.

Thank you. I look forward to hearing the testimony. I yield back, Mr. Chairman.

Mr. BARTON. Thank you.

The gentleman from Iowa, Mr. Ganske, is recognized for an opening statement.

Mr. GANSKE. Mr. Chairman, I am interested in moving on to the testimony, so I yield back.

Mr. BARTON. We have the presence of Congresswoman Harman, who is not a member of the subcommittee. She will be allowed to give an opening statement after all the subcommittee has been allowed to.

Mr. Largent, the vice-chairman, is recognized for an opening statement.

Mr. LARGENT. Thank you, Mr. Chairman. Every hearing this subcommittee has had or will have is crucial to developing a comprehensive energy policy, but I believe that today's and Thursday's hearings will prove to be an essential element in creating that blueprint.

We are fortunate to have with us this afternoon the chairman of FERC, Curt Hébert, and two FERC Commissioners, Commissioners

William Massey and Commissioner Linda Breathitt. Welcome to the subcommittee.

Mr. Chairman, the lead headline in today's Los Angeles Times is "Rolling Blackouts Hit California as State Gets Hint of Summer Heat."

For those who did not read the article, I will read a few excerpts: "Southern California was plunged into daytime darkness Monday as summer-like weather and a drastic drop in supplies forced the first deliberate State-wide blackouts since World War II.

"A series of rolling outages which could resume today began about noon, extending from San Francisco to San Diego and continuing into early evening. In all, power was cut to more than 1.3 million customers."

There was also an enlightening quote in the article from one of our witnesses for Thursdays hearing, Mr. David Freeman, general manager of the L.A. Department of Water and Power.

Mr. Freeman states, "Despite months of dire electricity problems and screaming headlines, Californians still do not seem to grasp the underlying problem: There is a shortage of electricity in this State. That is a fact. The general public does not seem to believe it, but it is true."

Mr. Chairman, there are a number of proposals floating out there calling for some type of Federal intervention to alleviate California's current crisis, some with merit, some without. But ultimately, Californians are going to have to heed Mr. Freeman's admonition that there is a shortage of electricity in the State, and act accordingly.

Mr. Chairman, I yield back.

Mr. BARTON. We thank the gentleman.

The gentleman from Oregon, Mr. Walden, is recognized for an opening statement.

Mr. WALDEN. Thank you very much, Mr. Chairman.

I found the comments of my colleague, the gentleman from Massachusetts, intriguing, of course as we all do every hearing. But I also find it interesting this administration has been on the job for 2 months, about 2 hours and 55 minutes, and it was the last administration's Department of Energy which could not safeguard our nuclear secrets, and admitted that it was asleep at the wheel when it came to the energy problem facing the United States.

There is plenty of blame to point around here. What we need to do is focus on what are the real issues at the heart of California's debacle, what impact is that having throughout the region, what can FERC do to make sure that consumers are not getting ripped off, and to fully use Federal law to make sure that the rates being charged are reasonable and prudent.

We also have to look long-range, something that I think has not been done. We cannot have the kind of growth in California's economy at 29 percent, and then have a subsequent reduction in actual power supply, and not expect we are going to reach out to the other regions to consume power that becomes a diminishing resource.

We have a heck of a mess on our hands. In the Northwest we are now facing what will most likely be the worst water year since they began keeping records in 1929. This summer, when we would normally ship surplus power to California to meet their energy-

starved needs, we may indeed be in a deficit situation ourselves. We may overrun the biological opinion on saving salmon in the Columbia River so as to keep the BPA from going bankrupt, and so as to keep the lights on to the extent that we can.

What we have to do is to look at how to streamline relicensing rules as they affect hydro facilities. Some 45 percent of the hydro capacity in California, 73 percent in the Northwest, has to be relicensed in the next 15 years. I am going to continue to press FERC on how there are ways to streamline that and what can be done.

We need to encourage conservation. We need to encourage California to do what the Bonneville Power Administration has done, which is buy down demand. We are doing that in the Northwest. We are shutting down industries.

I do not like it. In my hometown there are 1,285 people out of work at the aluminum plant that will probably never come back because we are buying down demand so power can go elsewhere. That is a head-in-the-sand mentality we have to use right now, but it does not make any sense in the long term.

The Vice President, with whom I met with the Northwest delegation earlier today, said we need between 1,300 and 1,900 new power plants over the next 20 years. That takes into account conservation measures in terms of demand.

Surely we can do more. I would join my colleague from Massachusetts in trying to do more on conservation. I believe in it strongly. That still means we need 65 plants a year online.

In California, according to the study, Mr. Chairman, that is going to be presented later to our committee, California probably has one of the most difficult, time-consuming, and costly power plant approval processes in the Nation. We ought to address this. California has to address its problem, because it is killing our economy. Thank you, Mr. Chairman.

Mr. BARTON. The gentleman from Arizona, Mr. Shadegg, is recognized for an opening statement.

Mr. SHADEGG. Thank you, Mr. Chairman.

I ask unanimous consent to insert my full opening statement in the record.

Mr. BARTON. Without objection, it will be included.

Mr. SHADEGG. Mr. Chairman, I will be brief. I would like to associate myself with the comments of my colleague, the gentleman from Oklahoma, Mr. Largent, and my colleague from Oregon. It is clear that we have an energy crisis in this country.

Flying out here on the plane today, I noticed there is a lot of coverage of this issue and of the President's emphasis on it, and a lot of skeptics saying no, we really do not have an energy crisis. Experts are saying the President is placing the wrong emphasis on this problem.

I want to make a few points clear. And I want to be brief and look forward to the testimony of the witnesses here today.

First of all, I think Americans do need to understand we clearly have no comprehensive energy policy in this country. When we do not have one, we will find ourselves in the kind of situation we are in.

No. 2, the allegation that the problem that is occurring in California is the result of deregulation is itself absurd. Any time that

we cap retail rates but leave wholesale rates uncapped, that is not, in fact, deregulation, and we will not produce the kind of proper market forces.

Many of the solutions that are proposed here today call for us to adopt some form of either cost-based price caps or some other type of price caps. Two of the Commissioners that appear before us make strong arguments on both sides of that issue.

I would urge our committee that this is the key issue. If we make the wrong decision on this issue—and I lean against any kind of cap, because I don't believe it will produce the right result—but if we make the wrong decision here, the consequences will be very, very significant.

In Arizona, we do not have increasing energy prices. In Arizona, we do not have a shortage of power plants under construction. Indeed, we have a number of plants under construction and even more plants on the drawing board. I believe that imposing so-called temporary price caps will send exactly the wrong signal.

It is interesting that in the testimony of both Commissioners, who argue each side of the price cap issue, they both point out that the real cause of the problem is a lack of the construction of new generating capacity and a lack of the construction of new transmission capacity, and yet reach absolutely opposite results.

I believe price caps will lead not to the construction of additional generating capacity and not to the construction of new transmission capacity, but will lead to the opposite result, even if they are imposed only on existing facilities, because the message will be sent clearly, just like the message of California's deregulation, that we are not truly deregulating and we are not going to allow market forces to apply.

I welcome the testimony of our witnesses, and I appreciate your calling this hearing, Mr. Chairman.

Mr. BARTON. I thank the gentleman.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON ENERGY AND COMMERCE

Mr. Chairman: I'd like to commend you for holding this hearing on the California energy situation. I think our previous two hearings have shed a lot of light on this complex and troubling issue. I am confident that the more we learn from California's mistakes, the more likely it becomes that we will reach a common conclusion on the best remedies for the West's energy problems.

California's problem is primarily one of supply and demand. Last summer's peak load in the Cal ISO was around 45,000 megawatts. This summer it's predicted to be another 2,000 plus megawatts higher. Last summer's available imports during that peak were around 4,500 megawatts, about half what they were the year before, and they're expected to be even lower this summer. Just yesterday, and again today, Californians went without power because temperatures were too high. What's going to happen this summer?

California, alone, needs about 5,000 megawatts of new generation to bring their grid back into balance. This summer, the entire West is only expected to get about half of that. Where do Californians think that power is going to come from?

I applaud California's recent efforts to conserve electricity. In addressing an energy supply problem, it is important to look at forces affecting demand and find innovative ways to improve efficiency. The fact that California has resorted to mandatory conservation orders, however, should convince consumers of two things: (1) that California does not have a functioning electricity market, and (2) that the State has an electricity supply problem.

In the long run, this Committee can help increase the supply of electricity. We will do that first by passing a national energy policy, which will promote the avail-

ability of all fuels. Second, we will pass electricity restructuring legislation that facilitates better wholesale competition.

This Committee cares deeply about what is happening out West. I hope these two days of hearings will explore what can and should be done to get California's electricity supply back on track. I am concerned about the prospect of State ownership of anything. I hope that California, and the West generally, can create a regional marketplace that will attract much needed capital investment in infrastructure. You do that by allowing market forces to function and by giving investors regulatory certainty.

I look forward to hearing what our FERC Commissioners and other witnesses have to say.

PREPARED STATEMENT OF HON. BILL LUTHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. Chairman, thank you for holding this important and timely hearing today. Rotating blackouts are again occurring throughout California and this situation may have the potential to spread to other parts of the country as the summer approaches.

What troubles me about the current debate is that some Administration officials and industry representatives seem to be using this crisis to simply advocate more drilling and exploration in pristine wilderness areas. It is clear that we cannot simply drill our way out of dependence of foreign oil. It is also clear that simply advocating for increasing domestic drilling will do nothing to alleviate the near term problems in Western energy markets.

I am pleased that we will be able to hear testimony today from the Chairman and two Commissioner's of the Federal Regulatory Energy Commission. The FERC has issued a number of recent orders attempting to address the volatility in Western markets and they may have further plans to devise remedies. I look forward to their assessment of the situation and testimony at today's hearing.

Thank you and I yield back the balance of my time.

Mr. BARTON. All members of the subcommittee that are present have been given an opportunity for an opening statement, so the chairman would welcome the distinguished member from California from the full committee, Congresswoman Harman, for an opening statement.

Ms. HARMAN. Thank you, Mr. Chairman. I appreciate the opportunity to come and learn more about a subject that affects my district and every district in California, and I think increasingly, every district in the United States.

I just wanted to make a few comments based on knowledge that I do have, and then I look forward to the testimony.

First of all, this issue is not partisan. I think today's comments make that clear. The rolling blackouts that California is experiencing do not just occur in Democratic or Republican households, or do not avoid even green households, they are happening to everybody.

Second of all, although this problem is centered in California for the moment, it is beginning to affect the whole western region, and a problem like this or this identical problem could be felt all over the United States.

Third of all, I feel that part of the answer is better technology and better efficiency. I agree with Mr. Markey. But I also agree with some comments that you made that we have to be sure that new standards are fair to everyone, not just certain folks with more assets. I think we can design standards that could be fair to everyone.

But most important, and the point I wanted to make as an observer to these witnesses, is that I have in front of me 42 U.S. Code

section 7172. This concerns the jurisdiction of FERC, the Federal Energy Regulatory Commission. In subsection B, it makes clear that FERC has jurisdiction over the establishment, review, and enforcement of rates and charges for the transmission or sale of electric energy.

In subsection (c) it makes clear that FERC has jurisdiction over the establishment, review and enforcement of rates and charges for the transportation and sale of natural gas by a producer or gatherer, or by a natural gas pipeline or natural gas company, and so we have before us an agency which can help solve this problem, and I hope that we all focus as much as possible on solving this problem. That is what our constituents want, and I believe that is what your excellent subcommittee is capable of doing. Thank you for letting me sit in.

Mr. BARTON. We thank the gentlewoman from California.

All members not present will have the requisite number of days to put their opening statements in the record, and as announced earlier Thursday, which is a continuation of today's hearing, Mr. Boucher and myself will give a brief opening statement, and Mr. Dingell and Mr. Tauzin. The others will put their statements in the record today.

We want to welcome the Federal Energy Regulatory Commission to the subcommittee. We are not going to time you. This is an important issue, and we want to give you an opportunity to elaborate, each of you.

We are going to recognize the Chairman first, the Honorable Curt Hébert, and we will go to the gentlelady from Kentucky Commissioner Breathitt, and then Commissioner Massey will be the cleanup hitter. We are going to set the clock at 10 minutes simply to kind of give you an idea of how long you have been testifying, but we want to give you a chance to elaborate.

So, Chairman Hébert, welcome to the subcommittee. Your statement is in the record in its entirety, and we recognize you to elaborate on it.

STATEMENT OF HON. CURT L. HÉBERT, JR., CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

Mr. HÉBERT. Thank you, Chairman Barton, and thank you to the 5members that are here. I appreciate you giving us this opportunity to appear to discuss a topic of electricity markets in California.

Wholesale and retail electricity markets in California are currently in a state of stress. Wholesale prices have increased substantially for a variety of reasons. Consumers are implored to conserve as much as possible, and utilities are facing growing financial problems. As a result many now argue that we need to turn to cost-based regulation instead of relying on market-driven principles and solutions.

First, in my view, price caps are not a long-term solution. We need to promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers, at least those not subject to a rate freeze. Market prices will increase supply and reduce demand, thus correcting the current imbalance in the mar-

ketplace. A price cap imposed through regulation or legislation will have exactly the opposite effect.

Second, infrastructure improvements are greatly needed in California and throughout the rest of the West. We need to create the appropriate financial incentives to ensure that new generation is built, the transmission system is upgraded, and that new gas pipelines are built.

Finally, we need a regional transmission organization, or RTO, for the West. California is not an island. It depends on generation from outside of the State. The shortage in and prices in California have affected the supply and prices in the rest of the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Consistent with these three points, the Federal Energy Regulatory Commission has been aggressively identifying and implementing market-driven solutions to these problems by stabilizing wholesale energy markets, by identifying additional short-term and long-term measures that will increase supply and delivery infrastructure as well as decrease demand, by promoting the development of a West-wide regional transmission organization, and by monitoring market prices and market conditions.

Let me highlight some of the Commission's recent actions. In January the Commission issued an order finding the PX in violation of a Commission order issued earlier in the month. The prior order required the PX to change its rules on payment to generators when their prices exceeded $150 per megawatt hour. The January order found that the PX's failure to comply with this change was imposing excessive charges on California consumers. In the past 2 weeks, the Commission has taken additional steps to mitigate prices in California, specifically the prices charged in California's spot markets during Stage 3 emergencies and in January and February of this year.

After examining prices charged in these periods, the Commission identified many transactions that warranted further investigation. The Commission required these sellers to either refund certain amounts, or offset these amounts against amounts owed to them, or provide additional justification for their prices. Specifically, the Commission required potential refunds or offsets of approximately $69 million for January and $55 million for February, based on the market clearing price that would have occurred if the sellers had bid their variable costs into a competitive single price auction.

Also this month the Commission staff issued a proposal on how the Commission should monitor and mitigate prices in California's wholesale spot power markets. This proposal is based on monitoring and mitigating prices on a before-the-fact basis instead of through after-the-fact refunds. After receiving and considering public comment, the Commission intends to implement appropriate changes to its current market monitoring and mitigation requirements by May 1, 2001.

Last Wednesday the Commission issued an order seeking to increase energy supplies in California and the West. The Commission implemented certain measures immediately. For example, the Commission streamlined regulatory procedures for wholesale electric power sales; extended and broadened regulatory waivers for

qualifying facilities under PURPA; authorized market-based rates for sales, onsite generation and sales of demand reductions; expedited the certification of natural gas pipeline projects into California and the West; and urged all licensees to review their FERC-licensed hydroelectric projects in order to assess the potential for increased generating capacity.

The Commission also proposed and sought comment on other measures, such as incentive rates for new transmission facilities and natural gas pipeline facilities completed by certain dates this year or next.

Also last week the Commission ordered two California power sellers to make refunds of over $10 million unless they can justify their actions. Specifically the Commission said the utilities needed to demonstrate that power outages at part of their facilities in April and May of 2000 were not extended for the improper purpose of raising prices for power from their own facilities.

Mr. Chairman and members of this committee, I have been Chairman for only about 2 months. These and other recent actions demonstrate my commitment to ensuring that energy markets in California and the West bring consumers the energy they need at reasonable prices. During this same time I have also emphasized the need for the Commission to act on pending applications filed by RTOs across the country enabling the Commission to issue two important RTO orders last week and others very soon. RTOs are a critical element in increasing the efficiency and competitiveness of power markets nationwide.

My fellow Commissioners and I have our differences on policies, but our actions these past 2 months demonstrate our shared commitment to the priorities of improving western markets and facilitating formation of RTOs. As long as we keep moving toward competitive and regional markets, I am confident that the present energy problems, while serious, can be and will be solved. I am also confident that market-based solutions offer the most efficient way to move beyond the problems confronting California and the West.

Mr. Chairman, I would ask you and the members of the committee to allow me to present my testimony in full into the record. I also have an attachment A, which would demonstrate to you, that I would like to attach as part of my testimony and have in the record, what this Commission has been doing.

Mr. BARTON. Without objection, so ordered.

Does that conclude your oral statement?

[The prepared statement of Hon. Curt L. Hébert, Jr. follows:]

PREPARED STATEMENT OF HON. CURT L. HÉBERT, JR., CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

I. OVERVIEW

Mr. Chairman and Members of the Subcommittee: Thank you for the opportunity to appear here today to discuss the topic of electricity markets in California. Wholesale and retail electricity markets in California, and throughout much of the West, are in a state of stress. Wholesale prices for electricity have increased substantially for a variety of reasons in the last year. California power consumers face near-daily pleas to conserve. California load-serving utilities are under severe financial stress. Companies supplying wholesale power into California are unsure how much, or even whether, they will be paid for their supplies.

While the situation in California is not representative of other parts of the country that are successfully developing competitive markets, it nevertheless under-

scores the fundamental infrastructure problems facing the country. The demand for electricity continues to expand while supply fails to keep pace. The development and licensing of new hydroelectric capacity—which provides much of the existing power supply in the West—is nearly exhausted. Very little fossil-fired generation has been added in many regions of the country over the last few years, and in California no major plants have been added in the last decade. And the existing electric transmission grid is often fully loaded and, absent necessary expansion, is often incapable of delivering power to those regions where it is valued the most.

I would like to make three main points with respect to these problems and to identify the steps the Commission is taking to address these problems.

First, price caps are not a long-term solution. We need to promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply and reduce demand, thus correcting the current imbalance. Capping prices artificially will have exactly the opposite effect.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that new generation is built, that the transmission system is upgraded and that new gas pipelines are built.

Finally, we need a regional transmission organization (RTO) for the West. California is not an island. It depends on generation from outside the State. The shortages and the prices in California have affected the supply and prices in the rest of the West. The Western transmission system is an integrated grid, and buyers and sellers need non-discriminatory access to all transmission facilities in the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Consistent with these three points, the Commission continues aggressively to identify and implement solutions to the problems:

- **First,** in recent months, the Commission has issued a number of orders intended to restore market stability. The Commission has acted to move utilities out of volatile spot markets to enable them to develop a portfolio of risk reducing and creditworthy contracts.
- **Second,** the Commission has recently adopted or proposed a range of additional measures that will increase supply and delivery infrastructure, as well as reduce demand for electricity in the Western Interconnection.
- **Third,** the Commission is continuing to work with market participants on developing, as quickly as possible, a West-wide regional transmission organization. Such an organization will bring a regional perspective and offer regional solutions to regional problems.
- **Fourth,** the Commission is monitoring market prices and market conditions with the goal of ensuring long-term confidence in Western markets. Moreover, the Commission's staff has proposed a new plan to monitor and, when appropriate, mitigate the price of electric energy sold in California's spot markets on a before-the-fact basis, instead of addressing prices through after-the-fact refunds. The Commission intends to act on this proposal by May 1, 2001.

By itself, however, the Commission can contribute only a small part of the solution to today's energy problems. A more comprehensive and permanent solution requires the involvement of the states and other federal agencies and departments. I am encouraged by all of the hard work and effort undertaken in recent months by the State of California and other Western states. The issues are difficult and the stakes are high. While reasonable minds can differ over the appropriate solutions to these problems, the Commission is committed to resolving these problems deliberatively.

An attachment to my testimony provides details on the Commission's major actions concerning California's electricity markets, particularly the Commission's original orders approving California's restructuring plan and recent Commission orders or decisions relating to California's markets, including enforcement actions.

II. HOW DID WE GET INTO THIS SITUATION?

A. Legislative Design

The State of California has been widely questioned for its restructuring legislation (A.B. 1890), enacted in 1996. While mistakes were made, California is to be commended for realizing that consumers are better off if supply and pricing decisions are based on market mechanisms, not bureaucratic fiat. The premise of this legislation is that consumers will enjoy lower rates and increased service options, without compromising reliability of service, if electricity providers are motivated to serve by market forces and competitive opportunities.

There were two major flaws in California's market design. First, the three utilities were forced to divest almost half of their own generation, and buy and sell power exclusively through the spot markets of the California Power Exchange (PX). This prevented the utilities from hedging their risks by developing a portfolio of short-term and long-term energy products. Second, the State mandated a retail rate reduction and freeze, eliminating any incentives for demand reduction, discouraging entry by competitors for retail sales and, more recently, threatening the financial health of the three utilities by delaying or denying their recovery of billions of dollars in costs incurred to provide service to retail customers.

However, California's situation does not demonstrate the failure of electricity competition. To the contrary, it demonstrates the need to embrace competition fully, instead of tentatively. Other states, such as Pennsylvania, have been successful in implementing electricity competition. California needs to move forward on the competitive path it has chosen, allow new generation and transmission to be sited and built, and allow its citizens to benefit from the lower rates, higher reliability, and wider variety of service options that a truly competitive marketplace can provide.

B. Other Factors

Until last year, California's spot market prices were substantially lower than even California's mandated rate freeze level. This allowed the California utilities to pay down billions of dollars of costs incurred during cost-of-service regulation. However, several events resulted in higher spot electricity prices beginning last summer. Those events included one of the hottest summers and driest years in history, as well as several years of unexpectedly strong load growth. Other factors influencing prices recently include:

- Unusually cold temperatures earlier this winter in the West and Northwest;
- California generation was unavailable to supply normal winter exports to the Northwest;
- very little generation was added in the West, particularly in California, Washington and Oregon, during the last decade;
- environmental restrictions limited the full use of power resources in the region;
- scheduled and unscheduled outages, particularly at old and inefficient generating units, removed large amounts of capacity from service; and
- natural gas prices increased significantly, due to higher commodity prices, increased gas demand, low storage, and constraints on the delivery system.

Taken together, these factors demonstrate that the present problems in electricity markets are not just "California" problems. Normal export and import patterns throughout the West have been disrupted. Reserve margins throughout the West are shrinking. Already this winter, when the demand for electricity is relatively low, Stage Three emergencies in California have become commonplace.

III. THE COMMISSION HAS TAKEN IMPORTANT STEPS TO HELP

These problems require bold and decisive action. Both the federal government and state governments have critical roles to play in promoting additional energy supply and deliverability and decreasing demand. Through its authority to set rates for transmission and wholesale power and to regulate interstate natural gas pipelines and non-federal hydroelectric facilities in interstate commerce, the Commission can take a range of measures to promote a better balance of supply and demand, but its jurisdiction is limited. The Commission can set pricing policies which encourage entry, but it is state regulators that have siting authority for electric generation and transmission facilities, as well as authority over local distribution facilities (both for electricity and natural gas). These authorities can go a long way in improving the grid for both electricity and natural gas. More importantly, state regulators have the most significant authorities to encourage demand reduction measures, which can greatly mitigate the energy problems in California and the West.

A. Promoting Market Stability

In an order issued on December 15, 2000, the Commission adopted a series of remedial measures designed to stabilize wholesale electricity markets in California and to correct wholesale market dysfunctions. The Commission recognized that the primary flaw in the California market design was the requirement for the three California utilities to buy and sell solely in spot markets. The Commission concluded that the foremost remedy was to end this requirement and allow the utilities, first, to use their own remaining generation resources to meet demands and, second, to meet much of their remaining needs for power through forward contract purchases. This measure freed up 25,000 MW of generation that the utilities owned or controlled, which could be used directly to serve their load without having to sell

it into the PX and buy it back at a much higher spot price. Our action returned to California the ability to regulate over one-half of its peak load requirements.

B. The Commission's Latest Efforts

Earlier this month, the Commission took further steps to mitigate prices in California, specifically the prices charged in California's spot markets during Stage Three emergencies in January of this year. After examining prices charged in these periods, the Commission identified many transactions that warranted further investigation. The Commission required these sellers to either refund certain amounts (or offset these amounts against amounts owed to them) or provide additional information justifying their prices. Specifically, the Commission required refunds or offsets of approximately $69 million dollars, or all prices charged during Stage Three Emergency hours in excess of $273 per megawatthour. This analysis seeks to use a proxy price based on the market clearing price that would have occurred had the sellers bid their variable costs into a competitive single price auction.

The California Independent System Operator (ISO) and the California Electricity Oversight Board ("California parties") had asked the Commission to require larger refunds. However, the Commission explained the difference between their approach and the Commission's. First, they included over $170 million for refunds from non-public utility sellers, such as the Los Angeles Department of Water and Power. The Commission has no authority to order refunds from these sellers. Second, they included refunds for sales during all hours of January; the Commission limited its approach to Stage Three Emergency hours, when the supply-demand imbalance is most severe and sellers know their power is most needed. Third, they used a pay-as-bid approach instead of the Commission's proxy market clearing price approach and they used prices only ten percent above variable costs. Finally, they included refunds for December 2000; the Commission will address the December transactions in a separate order. In sum, the Commission's approach fully protects consumers from possible exercises of market power during emergency conditions while still providing clear price signals encouraging sorely needed new generation and load reductions.

Also this month, the Commission's staff issued a proposal on how the Commission should monitor and mitigate prices in California's wholesale spot power markets in the future. This proposal is based on monitoring and mitigating prices on a before-the-fact basis, instead of through after-the-fact refunds. Comments on the staff's proposal are due on March 22nd. After receiving and considering public comment, the Commission intends to implement appropriate changes to its current market monitoring and mitigation requirements by May 1st.

Just last week, the Commission issued an order seeking to increase energy supplies and reduce energy demand in California and the West, to the extent of its jurisdictional authority. The Commission implemented several measures immediately, including:

- streamlining filing and notice requirements for various types of wholesale electric sales, including sales of on-site or backup generation and sales of demand reduction;
- extending (through December 31, 2001) and broadening regulatory waivers for Qualifying Facilities under the Public Utility Regulatory Policies Act of 1978, enabling those facilities to generate more electricity;
- expediting the certification of natural gas pipeline projects into California and the West; and,
- urging all licensees to review their FERC-licensed hydroelectric projects in order to assess the potential for increased generating capacity.

The Commission also proposed, and sought comment on, other measures such as incentive rates and accelerated depreciation for new transmission facilities and natural gas pipeline facilities completed by specified dates, blanket certificates authorizing construction of certain types of natural gas facilities, and greater operating flexibility at hydroelectric projects to increase generation while protecting environmental resources.

Finally, the Commission stated its intent to hold a one-day conference with state commissioners and other state representatives from Western states to discuss price volatility in the West, as well other FERC-related issues recently identified by the Governors of Western States. The conference will be held in Boise, Idaho, on April 6th.

Also last week, the Commission ordered two utilities (AES Southland, Inc., and Williams Energy Marketing & Trading Company) to show why they should not be found to have increased power prices in the California market and potentially compromised the reliability of the transmission network in violation of tariffs on file under the Federal Power Act. The Commission stated that the two utilities extended

outages at certain generating facilities from April 25 through May 11, 2000. These facilities are owned by AES, which sells the power to Williams for resale. The shut down forced the ISO to purchase power from other generation units also owned by AES, and whose power is also resold by Williams, at prices greatly in excess of the market price or the variable costs of operating the units. Williams and AES must explain why either or both should not make refunds totaling $10.84 million. Williams also must explain why it should not be precluded from receiving a market-based rate for AES' Southern California facilities for one year.

IV. PRICE CAPS WOULD MAKE THINGS WORSE

Some advocate price caps or cost-based limitations as a temporary way to protect consumers until longer-term remedies alleviate the supply/demand imbalance. The issue of price caps in the West has been raised on rehearing of the Commission's order of December 15, 2000, and, accordingly, is pending before the Commission. For this reason, I cannot debate the specific merits of price caps for California or the West. However, I will reiterate briefly the views I have stated publicly on this issue.

As a general matter, price caps do not promote long-term consumer welfare. Price caps will not increase energy supply and deliverability or decrease demand. Instead, price caps will deter supply and discourage conservation. At this critical time, legislators and regulators need to do everything they can to promote supply and conservation, not discourage them.

This viewpoint is based on experience, not just economic theory. The summer of 1998 illustrates the point. Then, wholesale electricity prices in the Midwest spiked up significantly. The Commission resisted pleas for immediate constraining action, such as price caps. Subsequently, suppliers responded to the market-driven price signals, and today the Midwest is not experiencing supply deficiencies.

In short, price caps can have long-term harmful effects because they do not provide appropriate price signals and may exacerbate supply deficiencies. Supply and demand cannot balance in the long-term if prices are capped.

In the context of California, today we have market prices and barely adequate supplies. If we reduce prices below market levels, supplies will go elsewhere, risking greater reliability problems. Price caps will only aggravate the supply-demand imbalance.

In addition, capping prices based on individual seller costs likely would require lengthy, costly and contentious evidentiary hearings. Litigating such a rate case for one seller requires a significant commitment of resources. Concurrently litigating such cases for scores of sellers in the West would be overwhelming both for the Commission and the industry. Moreover, neither buyers nor sellers would be sure of the prices until the conclusion of this litigation. This delay in price certainty would be unfair to customers and discourage new investments by suppliers.

Many leaders share these views. In a letter to the Secretary of Energy, dated February 6, 2001, eight Western governors expressed their opposition to regional price caps. They explained that "[t]hese caps will serve as a severe disincentive to those entities considering the construction of new electric generation, at precisely the time all of us—and particularly California—are in need of added plant construction."

In the face of the current challenges, we all must have an open mind to any proposals that may mitigate the energy problems in the West. I remain unconvinced that price caps will help solve the problems and I do not believe they are in the long-term interest of consumers. Price caps will only serve to drive investment and supplies to those markets without caps, harming consumers in the long-term.

V. CONCLUSION

The Commission remains willing to work in a cooperative and constructive manner with other federal and state agencies. The Commission will continue to take steps that, consistent with its authority, can help to ease the present energy situation without jeopardizing longer-term supply solutions. As long as we keep moving toward competitive and regional markets, I am confident that the present energy problems, while serious, can be solved. I am also confident that market-based solutions offer the most efficient way to move beyond the problems confronting California and the West.

Thank you.

COMMISSION STAFF SUMMARY OF MAJOR ORDERS ON CALIFORNIA RESTRUCTURING

I. OVERVIEW

The Commission began addressing the California restructuring in 1996. Initially, the Commission's approach was largely deferential to State decisions affecting

wholesale power market matters within FERC's jurisdiction. However, as problems started surfacing and then heightened significantly in the Summer of 2000, the Commission no longer deferred to State decisions affecting matters within the Commission's jurisdiction. The resources devoted by the Commission to California's restructuring were significant from the beginning and, in recent months, have increased steadily. In all, the Commission has issued over 80 orders involving California's restructuring, including over 30 amendments to the ISO tariff and 25 amendments to the PX tariff. This year alone, the Commission has issued over 20 orders involving California's wholesale power markets.

The following sections address the most significant of the Commission's California initiatives, without citations to concurring or dissenting statements of individual Commissioners.

II. INITIAL AUTHORIZATION OF CALIFORNIA RESTRUCTURING

California's efforts to restructure its electric industry began in 1994. Extensive hearings and negotiations in proceedings before the California Public Utilities Commission (CPUC) resulted in a final CPUC restructuring order issued in December 1995. The California legislature took up the subject next and this led to the unanimous enactment of Assembly Bill 1890 (AB 1890) in September 1996. FERC noted in its subsequent orders that California was the first state to enact a comprehensive restructuring plan and made it clear that FERC would give great weight to the decisions made in the state legislation.

The major features of AB 1890 included: (1) creation of an ISO and PX by January 1998 and simultaneous authorization of retail competition; (2) creation of the California Electricity Oversight Board with members appointed by the Governor and legislature; (3) a competitive transition charge for the recovery of the traditional utilities' stranded costs; and (4) a ten percent rate reduction for residential and small customers, and a rate freeze for all retail customers.

At California's request, the Commission considered the various aspects of California's restructuring in stages, resulting in a series of FERC orders as details were added to the restructuring plans.

On November 26, 1996, the Commission accepted the filings of Pacific Gas and Electric Company (PG&E), Southern California Edison Company (SoCal Ed), and San Diego Gas and Electric Company (SDG&E) (collectively, Companies) seeking approval for those aspects of the restructuring subject to FERC's jurisdiction. 77 FERC ¶61,204 (1996). The Companies' proposals reflected the CPUC's orders and AB 1890. The Commission's order approved the transfer of operational control of transmission facilities to the ISO, the overall framework for establishment of the ISO and PX, and the jurisdictional split between the transmission and local distribution facilities of the utilities. The Commission largely approved the California market design as filed and provided guidance on matters that needed further support by the companies in order to gain final approval under the Federal Power Act (FPA).

However, the Commission determined that it could not accept the proposed role of the Oversight Board in the governance or operations of the ISO and PX, or appellate review of ISO board decisions, because the Oversight Board's role was not limited to matters subject to State jurisdiction and concerned matters within the Commission's exclusive jurisdiction. Thus, the Commission did not approve a permanent role for the Oversight Board. Instead, the Commission approved only an initial start-up function for the Oversight Board, to expedite the establishment of the ISO and PX initial governing boards.

In March 1997, as supplemented in August 1997, the ISO and PX submitted Phase II of the restructuring proposal, including organizational and governance documents, an Operating Agreement and Tariff for each, a Transmission Control Agreement, and other materials and explanations previously required by the Commission. The Commission addressed these filings in an order dated October 30, 1997, conditionally authorizing limited operation of the ISO and PX. 81 FERC ¶61,122 (1997). The Commission reiterated, and provided additional guidance on, its findings on the Oversight Board.

In that order, the Commission also addressed the Companies' requests for market-based rates, which they filed at the direction of the CPUC. The Commission accepted the Companies' market-based rates, in part, due to the plans of PG&E and SoCal Ed to divest significant amounts of their generation. 81 FERC at 61,546-47.

III. EARLY ACTIONS ON PRICE CAPS

Shortly after the ISO and PX commenced operations on March 31,1998, prices for ancillary services in the ISO's markets increased significantly. See AES Redondo

Beach, L.L.C., *et al*., 84 FERC ¶61,046 (1998), *order on reh'g,* 85 FERC ¶61,123 (1998) (October 28, 1998 Order), *order on further reh'g,* 87 FERC ¶61,208 (1999) (May 26, 1999 Order), *order on further reh'g,* 88 FERC ¶61,096 (1999), *order on further reh'g,* 90 FERC ¶61,148 (2000). The ISO proposed price caps as a solution. In an order issued July 17, 1998, the Commission authorized the ISO for an interim period to reject bids in excess of whatever price levels it believed were appropriate for the ancillary services it procures. On rehearing, the Commission explained that, as the procurer of ancillary services, the ISO had the discretion to reject excessive bids. The Commission also stated that a purchase price cap is not an ideal approach to operating a market and that it did not expect the cap to remain in place on a long-term basis. October 28, 1998 Order, 85 FERC at 61,463. The Commission also directed the ISO to file a comprehensive proposal to redesign its ancillary services markets. AES Redondo Beach, L.L.C., *et al.,* 85 FERC ¶61,123 at 61,462 (1998).

The Commission later approved a filing by the ISO authorizing the ISO to adopt a purchase price cap for its imbalance energy market at whatever level it deemed necessary and appropriate. California Independent System Operator Corporation, 86 FERC ¶61,059 (1999).

In an order approving the ISO's ancillary services market redesign, the Commission allowed the ISO to retain the authority to specify purchase price caps for ancillary services and imbalance energy until November 15, 1999. May 26, 1999 Order, 87 FERC at 61,817-19. The ISO had proposed to raise and eventually eliminate existing price caps on ancillary services and imbalance energy upon the implementation of several redesign elements, but in the interim, it planned to maintain the then current $250/MWh purchase price caps. The Commission directed the ISO to eliminate the price caps by November 15, 1999, with the caveat that the ISO could file for an extension of its price cap authority if its experience with the market reforms over the summer indicated serious market design flaws still existed.

In September 1999, by direction of the ISO's Governing Board, the price caps were raised from $250 to $750. On September 17, 1999, the ISO filed proposed tariff revisions to extend for one year, until November 15, 2000, its authority to cap ancillary services and imbalance energy prices. The proposal gave the ISO the discretion to lower the price caps to $500 effective June 1, 2000, if the ISO Governing Board determined that any of three specific conditions were met. The proposal also gave the ISO discretion to lower the price caps by an unspecified amount in the event that it determined that the markets were not workably competitive. The Commission accepted the proposed tariff provisions in November 1999, giving the ISO the opportunity to complete its market redesign and to test its reforms under summer peak conditions. *See* California Independent System Operator Corporation, 89 FERC ¶61,169 (1999), *reh'g pending.*

IV. DEVELOPMENTS ON GOVERNANCE

On November 24, 1998, the Commission found the ISO and PX not to be in compliance with its prior orders on the role of the Oversight Board. 85 FERC ¶61,263 (1998). The Commission denied the ISO's request to defer enforcement of its prior orders, and directed the ISO and PX to revise their bylaws to be consistent with the Commission's determinations. The Commission again provided guidance on the proper sphere of action by the Oversight Board.

On August 5, 1999, the Commission granted a petition for declaratory order by the Oversight Board. The Commission said that the modified governance structures contained in proposed state legislation would comply with federal law. Under this proposed legislation, the Oversight Board's activities were narrowed to include, *e.g.,* an appellate function on matters affecting the general welfare of the State's electric consumers and the right to confirm only those ISO and PX board members representing end-users. This proposed legislation was subsequently enacted.

V. LAST YEAR'S ACTIONS

On July 26, 2000, the Commission ordered a fact-finding staff investigation on technical or operational factors, regulatory prohibitions or rules (Federal or State), market or behavioral rules, or other factors affecting the competitive pricing of electric energy or the reliability of service in electric bulk power markets. The Commission directed its staff to report its findings to the Commission by November 1, 2000.

On August 23, 2000, the Commission issued an order initiating a formal hearing on the justness and reasonableness of the rates in California's spot markets. 92 FERC ¶61,172. This action meant that refunds could be ordered as of the refund effective date of October 2, 2000, if rates were found to be unjust and unreasonable. The investigation was initiated partly in response to a complaint by SDG&E asking for the emergency imposition of a price cap to protect consumers from extreme price

increases. The Commission simultaneously instituted an investigation into whether the tariffs and institutional structures and bylaws of the ISO and PX were adversely affecting the efficient operation of competitive wholesale electric power markets in California.

On November 1, 2000, the Commission issued an order proposing measures to remedy the problems identified in a Commission Staff Report on Western Markets and the Causes of the Summer 2000 Price Abnormalities. 93 FERC ¶61,121. The Commission sought comment on its proposed remedies.

Beginning in mid-November, the ISO began experiencing repeated emergency conditions forcing it to serve increasingly large portions of its load through its imbalance energy market. On December 8, 2000, the ISO filed a tariff amendment seeking expedited consideration of tariff revisions to address these conditions. Most significantly, the ISO sought immediate implementation of an interim price mitigation proposal based on a concept that was proposed in the November 1 Order, rather than continuing its $250/MWh price cap, to encourage greater participation of generators in its markets. The mechanism would pay sellers their bids even if their prices exceeded that level but their bids would not set a market clearing price to be paid to all sellers in the market. The Commission approved the tariff revisions in an order issued December 8, 2000. 93 FERC ¶61,239.

Also on December 8, 2000, the Commission issued an order waiving certain regulations pertaining to QFs, effective for the period December 8 through December 31, 2000, to allow certain QFs to sell additional power to load located in California to help alleviate the supply-demand imbalance in California. 93 FERC ¶61,238.

On December 15, 2000, the Commission issued an order adopting many of the remedies proposed in its November 1, 2000 order. 93 FERC ¶61,294. It ordered specific short- and long-term measures to remedy the dysfunctional California bulk power markets.

First, the December 15 order eliminated the requirement for California's investor-owned utilities to sell all of their generation into and buy all of their energy needs from the PX. The buy/sell requirement resulted in an over-reliance on spot market purchases and created an excessive exposure to short-term price fluctuations. The Commission also ordered the termination of the PX's wholesale rate schedules effective as of the close of the April 30, 2001 trading day. This resulted in 25,000 megawatts of generation, either owned by or under contract to the three California utilities, being returned to the utilities for direct sales to retail customers subject to State regulation, instead of being sold to, and repurchased from, the PX.

In addition, the order addressed the problem of underscheduling, directing utilities to schedule 95 percent of their transactions in advance of real time, to reduce the reliance on the ISO's real-time market. A penalty was imposed for loads that exceed the prescheduled amount by more than five percent.

The order also established a $150 per MWh breakpoint mechanism intended to help ensure just and reasonable rates from January 1, 2001 until May 1, 2001, until long-term measures could be put in place. The single price auction was modified so that bids above $150 per MWh would not set the market clearing prices paid to all bidders. Public utility sellers (primarily the investor-owned utilities) that bid above this breakpoint were required to file weekly transaction reports with the Commission. Sellers were made subject to potential refund liability if the Commission finds they sold power at prices that were not just and reasonable.

The order directed Commission staff to develop a comprehensive market monitoring and mitigation program to replace the $150/MWh breakpoint mechanism and to be in place by May 1, 2001. The order also rejected calls for price caps or cost-based rates, stating that the remedies adopted by the Commission were "designed to help alleviate the extreme high prices being borne by Californians, but also to ensure that sellers continue to have incentives to sell into California and sufficient incentives to build sorely needed new generation and transmission necessary to provide reliable service in the future."

VI. THIS YEAR'S ACTIONS

On January 8, 2001, the Commission issued an order clarifying the December 15 order. 94 FERC ¶61,005. The Commission reiterated a directive for the PX to terminate its wholesale rate schedules effective April 30, 2001, but clarified that the order was not intended to preclude the PX from continuing its market for bilateral forward contracting.

On January 29, 2001, the Commission issued an order finding the PX in violation of its December 15 order by not implementing the $150 per MWh breakpoint, and it required immediate recalculation of wholesale rates by the PX. 94 FERC ¶61,085.

On February 1, 2001, the Commission staff issued a report on generating plant outages in California, focusing on whether unplanned maintenance or outages occurred to raise prices. Staff did not find evidence suggesting that the companies audited were scheduling maintenance or incurring outages in an effort to influence prices. Rather, the report concluded that the types of problems encountered (*i.e.,* turbine seal leaks) are common considering that these facilities had been operating above normal levels and were 30 to 40 years old.

Also on February 1, 2001, the Commission Staff released a study looking at power markets in the Northwest during November and December 2000. The report found, in sum, that the Northwest power markets saw increased demand through the 1990s, without increased generation capacity. In November and December of 2000, the market was driven by extreme cold, high natural gas prices and low storage levels, and by low water, precipitation and stream flow levels. These conditions were made worse by a large number of plant outages and environmental constraints, and a general atmosphere of market uncertainty.

On February 14, 2001, the Commission issued an order addressing the creditworthiness tariff provisions proposed by the ISO. 94 FERC ¶61,132. The credit ratings of PG&E and SoCal Ed had deteriorated significantly, resulting in the inability of the utilities to meet the existing creditworthiness standards. The ISO proposed to amend its tariff to lower the creditworthiness standards. The order accepted the ISO's amendment for purposes of allowing PG&E and SoCal Edison to continue to schedule their own generating resources to serve their load. The order held, however, that the utilities could continue purchasing through the ISO from third-party suppliers only if they obtained financial backing from creditworthy counterparties.

On March 9, 2001, the Commission directed 13 jurisdictional sellers of power into the ISO and PX short-term markets in January to either make refunds for certain power sales (or offsets against accounts receivables) or provide further justification of their prices. 94 FERC ¶61,245. The Commission reached this decision after reviewing generators' transaction reports and reports by the ISO and PX, and finding that certain transactions exceeded a Commission-determined market-clearing proxy price for Stage 3 emergency hours in January. The proxy price was based on data including average natural gas prices, average NO_X allowance costs, and variable operation and maintenance costs.

Public utility sellers with transactions above the January proxy price of $273/MWh must notify the Commission on or before March 23, 2001 that they will either: (1) refund the excessive amounts or offset such amounts against any amounts due or owed to them; or, (2) supply further data to justify transactions above this level. The Commission will determine a proxy clearing price for each month through April 2001. Commission staff will issue notice of the proxy price within 15 days of the end of each month.

Also on March 9, 2001, the Commission's staff issued a proposal on how the Commission should monitor and mitigate prices in California's wholesale spot power markets in the future. This proposal is based on monitoring and mitigating prices on a before-the-fact basis, instead of through after-the-fact refunds. Comments on the staff's proposal are due on March 22nd. After receiving and considering public comment, the Commission intends to implement appropriate changes to its current market monitoring and mitigation requirements by May 1st. These changes will supersede the $150 breakpoint mechanism currently in effect.

On March 14, 2001, the Commission issued an order seeking to increase energy supplies and reduce energy demand in California and the West. The Commission implemented certain measures immediately. For example, the Commission streamlined regulatory procedures for wholesale electric power sales, extended (through December 31, 2001) and broadened regulatory waivers for Qualifying Facilities under the Public Utility Regulatory Policies Act of 1978, authorized market-based rates for sales of on-site and back-up generation and sales of demand reductions, expedited the certification of natural gas pipeline projects into California and the West, and urged all licensees to review their FERC-licensed hydroelectric projects in order to assess the potential for increased generating capacity. The Commission also proposed, and sought comment on, other measures such as incentive rates for new transmission facilities and natural gas pipeline facilities completed by certain dates this year or next. The Commission also announced that it intends to meet with state regulators this Spring.

Also on March 14, 2001, the Commission ordered two utilities (AES Southland, Inc., and Williams Energy Marketing & Trading Company) to show why they should not be found to have inflated power prices in the California market and potentially compromised the reliability of the transmission network in violation of tariffs on file under the Federal Power Act. 94 FERC ¶61,248. The Commission stated that the two utilities extended outages at certain generating facilities from April 25 through

May 11, 2000. These facilities are owned by AES, which sells the power to Williams for resale. The shut down forced the ISO to purchase power from other generation units also owned by AES, and whose power is also resold by Williams, at prices greatly in excess of the market price or the variable costs of operating the units. Williams and AES must explain why either or both should not make refunds totaling $10.84 million. Williams also must explain why it should not be precluded from profiting from outages of AES' Southern California facilities for one year.

Mr. HÉBERT. It does, Mr. Chairman.

Mr. BARTON. We would like to hear next from Commissioner Breathitt. Your statement is in the record, and, again, we are going to set the clock at 10 minutes. We will at least let you know that, but we do want you to have the full ability to elaborate on your written statement.

STATEMENT OF HON. LINDA K. BREATHITT, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Ms. BREATHITT. Thank you, Mr. Chairman.

Good afternoon, Mr. Chairman and members of the subcommittee, and Mr. Whitfield, whose State and hometown we both share. I appreciate this opportunity to appear before you today to discuss the energy crisis in California and the worsening conditions of electricity markets throughout the West. This crisis is affecting the lives and well-being of millions of citizens and threatening the existence of thousands of businesses. In addition, the extraordinarily high prices for electricity and the extreme shortages of supply are creating a consumer backlash against newly restructured electricity markets. I fear the move toward a competitive electricity marketplace will be severely affect ed by this crisis and could even be suspended by States that fear what is happening in the West.

For months the Commission has been grappling with and attempting to resolve the market disruptions in California and elsewhere in the West. I believe our actions to date have been significant and appropriate and will ultimately improve the long-term situation in the western electricity markets. However, I am becoming increasingly concerned about the near-term problem, particularly about what will happen this summer in California.

I believe yesterday's blackouts and today's are a harbinger of what is to come. The predictions I am hearing for this summer, including prolonged blackouts, supply shortages and even higher prices, are very alarming. In fact, a spokesman for the California ISO said that yesterday was, "clearly the worst day we have ever had in California."

I am concerned that our actions to date, and those of California officials, will not improve the immediate situation in California. All of us together, FERC, State officials, Members of Congress and the administration, may have to begin exploring other shorter-term remedies to address the disruptions and volatility in these markets. It is imperative that the Commission place all available options on the table for consideration and prepare itself to make even tougher decisions necessary to resolve these problems.

My written testimony discusses some of the causes of the energy crisis, including high production costs, increased demand and scarcity of generation. It is becoming increasingly apparent that the causes of the California energy crisis are not only State-specific,

but regional in nature. We can no longer just look at California. It is now necessary to consider and understand the conditions throughout the entire Western Interconnection. Electricity markets in the West are interrelated, and the solution to these problems will likely be regional in scope.

My written testimony also discusses several decisive actions taken by the Commission over the past several months to address these market distortions and instances of potential market power abuses. These include establishing specific remedies for the California market, launching an investigation of California marketers whose sanctions appear to have inflated electric prices in California, and requiring certain sellers in the California market either to refund potential overcharges totaling $124 million or to provide additional cost justification.

In addition, we have scheduled a conference on April 6 in Boise, Idaho, with Western State Commissioners to discuss price volatility in these markets and to identify additional regulatory remedies that may be necessary.

Mr. Chairman, I would like to ask that a copy of the notice for the meeting we are having in Boise on April 6 be entered into the record.

Mr. BARTON. Without objection, so ordered.

Ms. BREATHITT. Going forward, I believe the Commission may need to have a greater role in the siting of new infrastructure, because shortages of generation and transmission will no longer be single-State issues, and this would likely require an amendment to the Federal Power Act. Furthermore, I believe the formation of regional transmission organizations in the West is vital to the ultimate resolution of market disruptions and for expansion and enhancement of the transmission grid.

With respect to the possible State purchase of the investor-owned utilities transmission system, I believe the issue is not so much who owns the transmission system in California. The issue is that the transmission system needs to be operated on an open, nondiscriminatory basis with full access, and it needs to be part of a regional grid.

To address volatile natural gas prices, I would urge California regulators to limit the incentive for natural gas purchasers to gravitate to the spot market. The Commission will continue to do its part to get adequate pipeline infrastructure to California, but California needs to also assess whether there is sufficient intrastate capacity to take gas from the border to the market.

And finally, I support the Commission's initiative to explore the feasibility of easing certain operating constraints for jurisdictional hydroelectric projects, but only if we can do so without compromising important environmental resources.

In conclusion, I believe that competitive and open wholesale bulk power markets are still attainable and should remain the objective of Congress, energy regulators and State legislators throughout the country, and I look forward to working with this subcommittee and others to address these significant issues.

[The prepared statement of Hon. Linda K. Breathitt follows:]

PREPARED STATEMENT OF HON. LINDA BREATHITT, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. Chairman and Members of the Subcommittee: I appreciate this opportunity to appear before you today to discuss the energy crisis in California and the worsening conditions of electric systems and markets elsewhere in the Western United States. I believe it is not only appropriate, but necessary, that we meet at this time to examine a crisis that is affecting the lives and well-being of millions of citizens and threatening the very existence of thousands of commercial enterprises throughout the West.

The magnitude of this growing crisis, and its potential disruptive capability, cannot be overestimated. The extraordinarily high prices for electricity and the extreme shortages of supply are creating a consumer backlash against newly restructured electricity markets. Unfortunately, the move toward a competitive electricity marketplace will undoubtedly be affected by this crisis and could even be suspended if other states, fearful of what they are seeing in the West, terminate their restructuring efforts. For these reasons, I welcome the interest and involvement of Congress in this matter and I look forward to working with you to address these problems.

For many months, the Federal Energy Regulatory Commission has been grappling with and attempting to resolve the California energy crisis. We are now taking specific action, as well, to address problems in other parts of the West. I believe our actions to date have been significant and appropriate and will improve the long-term situation in the Western electricity markets. I am becoming increasingly concerned, however, about the near-term problem, particularly what will happen this summer in California. The predictions I am hearing for prolonged blackouts, supply shortages and even higher prices are alarming, to say the least.

I am very concerned that, even as important as they are, our actions to date, and those of California officials, will not improve the immediate and near-term situation in California. We may have to explore other short-term remedies to stem the damaging disruptions in these markets. Indeed, over the past several weeks we have received letters from members of the California Congressional Delegation, governors of some Western states, and others urging immediate, short-term action by the Commission, including the imposition of regional price caps, to restrain the high wholesale costs of electricity in the region. I believe it is imperative that the Commission place all available options on the table for consideration. The solutions to these problems will be as multi-faceted and complex as the causes. We must recognize that fact and prepare ourselves to make the tough decisions necessary to resolve the problems.

My testimony today will build on that theme by discussing some of the apparent causes of the disruptions in Western electricity markets, some of our important actions intended to relieve these disruptions, and, what I believe to be, the appropriate role of the Commission in addressing the volatilities and uncertainties that exist in these markets. I will also briefly discuss recent actions taken by California officials. In addition, I adopt the attachment to Chairman Hébert's testimony which provides a description and summary of several important orders issued by the Commission over the past five years regarding California's restructuring plan and electricity markets. This summary was prepared by Commission Staff and I believe it will provide you with a sufficient framework for understanding the chronology and details of FERC's key decisions and actions addressing California's restructuring efforts, some of which were issued before I began my tenure on the Commission.

The Commission has focused much of its attention over the past several months in defining and understanding the causes of the market disruptions and high electricity prices in California and throughout the West. As expected, we found that multiple factors contributed to the situation. A Commission Staff report completed in November 2000 found, among other things that: (1) market forces in the form of significantly increased power production costs combined with increased demand due to unusually high temperatures to create unstable conditions in the West; (2) scarcity of available generation resources throughout the Western region played a significant role; (3) existing market rules worsened the tight supply-demand conditions by exposing the three investor-owned utilities in California to the volatility of the spot energy market without affording them the opportunity to mitigate price volatility by hedging their positions in forward electricity markets; (4) an underscheduling of demand and supply in the California Power Exchange's day-ahead and hour-ahead markets increased the activity in the more volatile real-time spot market operated by the California Independent System Operator (ISO); and (5) unplanned outages of power plants increased significantly during the summer of 2000.

It is becoming increasingly apparent that the causes of the California energy crisis are not only state-specific, but are also regional in nature. In other words, to fully understand the problems in California, it is necessary to look at conditions in the entire Western Interconnection. California has historically relied on imports to supply 15 to 20 percent of its capacity needs during summer peak periods, primarily from hydroelectric plants in the Northwest. Due to increased demand elsewhere in the West and low water levels in hydroelectric reservoirs in the Northwest, available imports into California in 2000 were less than half what they were in 1999. As a result, the California ISO had approximately 3,000 MW less generating capacity available from outside the state in 2000 than in 1999. This is but one example of the regional nature of the problem in the West.

I believe the Commission has taken bold and decisive actions, within its jurisdiction, to remedy the extreme distortions in the California markets and to address instances of potential market power abuses. First, on December 15, 2000, we issued a major order establishing a set of remedies for the California market. In an effort to significantly reduce California's exposure to the volatile spot market, we eliminated the requirement set by the California legislation that the investor-owned utilities sell all of their generation into, and buy all of their power needs from the California Power Exchange. In effect, this action immediately returned 25,000 MWs to State regulation. This should allow the IOUs to move their purchase power needs to long-term bilateral contracts and to adopt a balanced portfolio of contracts to mitigate cost exposure. We also adopted a benchmark price of $74 per megawatt-hour for assessing prices of long-term electric supply contracts. In an effort to reduce the real-time spot market to only about 5 percent of peak load, we initiated a penalty charge that would be imposed on any market participants that under schedules load in day-ahead and other forward markets.

To ensure that prices in the ISO and PX spot markets are just and reasonable, the Commission established an interim breakpoint mechanism for sellers bidding into the spot market. Sellers bidding at or below $150 per megawatt will receive the market clearing price. Sellers bidding above that level will receive their actual bids, but the bid will not set the market clearing price. In addition, these bidders will be subject to certain reporting requirements and monitoring. Bids above $150 are subject to refund pursuant to Section 206 of the Federal Power Act. This breakpoint mechanism will be replaced on May 1 by a permanent and comprehensive market monitoring and mitigation program which will screen for market abuses.

On March 9, 2001, we issued an Order directing certain sellers into the California market to either provide refunds totaling $69 million dollars in excessive charges for electricity during January 2001 or supply further cost or other justification for prices charges above a proxy market clearing price established in the order. Similarly, on March 16, 2001, we ordered potential refunds totaling $55 million dollars in excessive charges for electricity during February 2001. These Orders directing potential refunds are pursuant to our December 15, 2000 order establishing remedies for the California's wholesale electric markets.

Last Wednesday, March 14, 2001, the Commission launched an investigation of two California power marketers, Williams Energy Market & Trading Company and AES Southland, Inc., and issued a Show Cause Order directing the companies to explain why they should not be found to have violated the Federal Power Act by engaging in actions that inflated electric prices in the California market and potentially compromising the reliability of the transmission network. If these companies are found to have violated the terms and conditions of filed tariffs, the Commission could direct the companies to return profits, in excess of $10.8 million, and condition the companies' future market-based rate authority.

Also on March 14, 2001, the Commission issued an order announcing certain actions that we will take or propose to take to increase the supply of electricity in the West. Our order examined both electric supply-side and demand-side actions that could be taken, and how best to assure the input of natural gas needed for electric power production. We acknowledge that our authority is somewhat limited, but the steps we plan or propose to take should help increase supply from existing power sources and could provide regulatory incentives to build new electric and natural gas infrastructure.

From my perspective, two aspects of the order are especially worth noting. First, the order establishes a conference in which FERC Commissioners will meet with Western state commissioners to hear their views on how FERC can assist them in addressing the market disruptions in the West. This type of interaction and coordination is important since state regulators, not the FERC, presently have siting authority for electric generation and transmission facilities. Moreover, state regulators have the most significant authorities to encourage demand reduction measures. I look forward especially to seek state commissioners' advice on what the Commission

can do with respect to price volatility in the region. Although our March 14 order does not focus specifically on the volatile wholesale prices in the West, I believe that FERC has to examine all its options in that aspect of the electricity markets as well. I will urge my state colleagues to be forthcoming and candid with us as we examine together the extreme price volatility in these markets and implementation issues associated with any additional actions.

Second, our March 14 order supports and addresses the requests made by California Governor Gray Davis and Secretary of Energy Spencer Abraham for the Commission to extend our waivers of certain regulations for Qualifying Facilities. In our order, we extended through December 31, 2001, our temporary waiver of operating and efficiency standards and fuel use requirements for QFs, in order to allow them to increase their generation. In addition, we found good cause to apply those waivers to the entire Western System Coordinating Council (WSCC). In so doing, we require that all additional output from those QFs be sold exclusively through negotiated bilateral contracts at market-based rates. This should benefit all parties and help serve load in the WSCC at a time when generation resources are inadequate.

As I have stated, the Commission has taken important steps in these orders to address the market disruptions in California and the West. If these steps prove to be unsuccessful, the Commission must act quickly to establish alternative remedies. As I have stated publicly on recent occasions, I am maintaining an open mind and a willingness to implement the structural or regulatory remedies that are required. We must strive to stabilize the markets in the West before the summer peak period begins and before the California market imperfections further worsen the market problems that are already developing in the Northwest and elsewhere in the Western Interconnection.

As we continue to monitor the situation in the West, the Commission will continue to examine its role in these matters and to take appropriate action when necessary. One important aspect of the electricity system in the West and elsewhere in the country in which the Commission's jurisdictional role is restricted as it pertains to the siting of new transmission and generation facilities. Currently, under the Federal Power Act, the Commission has no role in the permitting and siting of these new facilities. I am beginning to believe this may need to be changed. FERC may need to have a greater role in the siting of new infrastructure, because shortages of generation and transmission likely will no longer be just single state issues. I believe these shortages could become interstate commerce issues that must be addressed by the Federal government.

Already we are seeing how a shortage of electric infrastructure in California can affect prices and the efficient operation of the interstate transmission grid. We've recognized that California is experiencing a shortage of generation capacity. But the state's need for new transmission infrastructure is also becoming an important factor affecting the electricity markets. The last major transmission line that was built in California was the California-Oregon Transmission Project in 1993. The California ISO has identified a number of transmission projects that will both increase import capability and improve the reliability of the grid in various parts of the state. In addition, the ISO has identified projects in the San Francisco area that should be constructed in the next 2-3 years. These projects, evidently, would relieve congestion along the major north-south transmission path and improve the overall reliability of the ISO grid. I am concerned that some of these needed projects may not be built. My concern is heightened by delays such as are being experienced by San Diego Gas & Electric's proposed Valley-Rainbow 500 kV Project. Although this project was approved by the California ISO in May 2000, it is being delayed because of local opposition. The ISO has determined that this project or a comparable alternative is needed to reliably serve load growth in San Diego beyond 2003. This is just one example, but I believe that a federal role in transmission siting throughout the country could be helpful in instances such as this, and could, in fact, become necessary in the future.

With regard to transmission upgrade and expansion, I believe the Commission's Order No. 2000, issued in December 1999, will create an important regulatory framework. Order No. 2000 is intended to encourage the formation of Regional Transmission Organizations throughout the United States. The Order includes a specific functional requirement for RTOs to develop a strategy for transmission planning and expansion. The order also describes innovative pricing options that the Commission would consider for RTOs. Such ratemaking mechanisms could provide necessary incentives for the construction of new or enhanced transmission facilities. I believe the formation of RTOs in the West will be a significant benefit for many aspects of the electric markets in that region, including the expansion and enhancement of the transmission grid.

Due to the continuing convergence of the electric and natural gas industries, problems that have affected the electric utilities in California and the West also have been felt in the natural gas industry. Furthermore, there is a clear nexus between the pressure to capture all megawatts available and the increased use of hydroelectric facilities in the West. I will first address natural gas issues.

I believe that there are both short-term and longer-term actions that need to be taken on the natural gas front. In the short-term, there appears to be an over-reliance on spot-market purchases of natural gas. Our December 15th order found that a major cause of the high electric prices in California was the over-reliance on the spot market for electricity. In that order, the Commission recommended that the IOU's put 95 percent of their load in forward markets to minimize exposure to the price volatility of the spot market. I believe that the same logic holds for the natural gas market.

It is my understanding that the California Public Utilities Commission allows for recovery of gas costs that meet a benchmark determined by the use of monthly spot market purchases. It is my opinion that this policy creates an incentive to rely on spot market purchases of natural gas. Accordingly, I would suggest that policies should be in place that provide an incentive for natural gas buyers to use risk management tools, such as price hedging, to decrease commodity pricing uncertainties.

I strongly believe that regulators need to be careful to discern the difference between hedging to reduce exposure to price volatility, and mere speculating. It may be a fine distinction, but it is one that is critical. Hedging can be a useful tool to decrease uncertainty, while speculating to beat the market can increase the possibility of risk. It could even be said that failing to hedge and, therefore, limit the exposure to the vagaries of the spot market, is actually speculating. Consequently, I would urge regulators in California to look at the benefits that may accrue by limiting the incentive for natural gas purchasers to gravitate toward the spot market.

The Commission's March 14th order on supply and demand issues presented a number of longer term measures that the Commission is taking or may take to increase the amount of interstate natural gas capacity into California and the West. Specifically, the Commission has realigned its staff to be able to respond as quickly as possible to applications for new gas pipeline capacity for the West. Through this order, FERC also is seeking comments on the need to provide rate incentives to expedite construction of projects that will make additional capacity available this summer on constrained pipeline systems.

However, there is another California infrastructure concern that should be resolved at the state level. While FERC has jurisdiction over the siting of interstate natural gas pipelines, the states have siting authority for intrastate facilities. Consequently, FERC can do its part to get adequate pipeline infrastructure to California, the state needs to assess whether there is sufficient intrastate capacity available to take natural gas from the border to market.

The Commission is addressing the need for increased supplies through the administration of its hydro licensing program, as well. With hydropower comprising approximately 40 percent of the total WSCC generation capacity, the Commission has launched an initiative to explore the feasibility of easing certain operating constraints, such as minimum flow and reservoir level requirements, that act to reduce the energy production, peaking capacity, and other power benefits of hydropower projects. These operating constraints serve to protect many resources—such as resident and anadromous fish, water quality, recreation, municipal and industrial water supplies, and agricultural resources. The tension will be in finding a balance between greater operational flexibility and the protection of environmental resources. In addition, a more efficient use of available water resources at licensed projects could contribute to meet the electric capacity and energy needs of the Northwest.

The Commission's goal is to establish a methodology by which the Commission can quickly identify projects where there is a potential for more electricity to be generated with the least effect on resources, and then to create a process by which we can quickly review requests for modifications. The Commission's experience with emergency drought conditions in California in the 1980s provides a general framework for this exercise. The tension in will be in finding a balance between greater operational flexibility and the protection of resources. In order to achieve this objective, it will be necessary to seek the cooperation not only of FERC licensees, but also federal, state, and local resource agencies and other interested parties. In our March 14th Order addressing supply and demand issues, we announced a staff conference, to be held as soon as possible this spring. I will be willing to support greater flexibility in cases where the reliability of the system can be enhanced during this critical time, without compromising important environmental resources.

As I have stated throughout my testimony today, I believe the Commission is taking appropriate and important steps to address the market disruptions in the West.

I want to point to some actions that are also being taken by California officials in their efforts to address some of the problems in their state. For instance, Governor Davis has: (1) implemented a limited-term rate reward program for conservation efforts by residential, commercial and industrial customers; (2) expedited the processing of applications for certification for peaking and renewable power plants; (3) provided for performance awards relating to the construction of power plants brought on line prior to July1, 2001; and (4) modified emissions limits that restrict the hours in which certain plants can operate.

In addition, as noted in Chairman Barton's March 12, 2001, letter inviting me to testify before you today, the state has enacted legislation and regulations facilitating state contracting for power. The state is also considering other options, such as purchasing utility transmission lines. Most of these actions, I believe, will have beneficial long-term effects on California's electricity market. I would like to comment briefly, however, on one of these measures. The possible state purchase of the investor-owned utilities' transmission systems has received a great deal of press coverage and discussion. In my opinion, the issue is not so much who owns the transmission system in California, or elsewhere for that matter. The real issue is that the transmission system, whether public or private, needs to be part of a regional grid. Only independent, regionally operated grids will ensure competitive electricity markets that are open, efficient, reliable, and free from discrimination. As we continue discussing this matter, what's truly important is that California's transmission system remain as much a part of the Western regional grid in the future as it is today.

In conclusion, I believe that competitive and open wholesale bulk power markets are still attainable and should remain the objective of regulators and legislators throughout the country. I remain confident that we can implement appropriate short-term and long-term solutions to current problems so that we can stay the course toward open and competitive markets. Let me again say that I look forward to working with this Subcommittee and others to address these significant issues.

Mr. BARTON. We thank you.

We would now like to welcome Commissioner Massey, comes from the great State of Arkansas.

Your statement is in the record in its entirety, and we recognize you to elaborate on it.

STATEMENT OF HON. WILLIAM L. MASSEY, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. MASSEY. Thank you, Mr. Chairman and members of the subcommittee. As we approach the second summer of a wildly dysfunctional wholesale market in California and the West, we stand at the edge of an abyss. We know the market will be several thousand megawatts short of generation this summer. We know that there is very little demand response that will dampen high prices in this market. We have reason to believe that market power is present in the market. The market monitors in California have told us this time and time again, and withholding of generation can be a highly profitable strategy, as we know from the recent order that we issued involving two sellers into California. We have already declared that the California market is severely dysfunctional and is not producing just and reasonable prices.

The dysfunctional nature of the market will not be remedied by this summer and prices will soar even higher. Soaring prices will not get even one more megawatt of generation built by this summer. The price signal has been sent. Elementary school children in Bethesda, Maryland, know that the West is capacity-short now because of all the news programs on it.

A recent Wall Street Journal article detailed the concern in Washington State about the loss of jobs caused by high electricity prices. It is important to understand that while prices had climbed to $400 or even $500 or higher in California, they have recently

been in the $50 range in the PJM market. Many new generators want to enter the PJM market. They are clamoring to do so because they are receiving the price signal of a well-functioning market. Without effective price mitigation out West, I fear a disaster in the making for the summer.

I can see no constraint on prices for the summer under current policy. I have no idea whether Professor Wallach, the California market monitor, is accurate in his projection of a $70 billion market in California for this year. It was $7 billion in 1999. If he is anywhere close to correct, it will be a catastrophe.

We need a temporary time-out in wholesale markets out West. FERC should consider capping prices in short-term markets in the western interconnection at each generator's marginal production cost plus a reasonable capacity payment in the range of, say, $25. I would exempt new generation and impose a sunset date perhaps tied to achieving a certain reserve margin in the West.

Without some effective price control this summer, I fear for the worst. What is more, the prices that arise in a dysfunctional wholesale market, and that is what we have declared it to be, are, according to the courts, unjust, unreasonable and flatly unlawful. We have the statutory obligation to ensure just and reasonable prices. There is no exception for poorly functioning markets, in Federal law. There is no exception for bad State law. There is no exception, period.

FERC must take more forceful action to fulfill our statutory obligation. We cannot risk the health of the western economy for the philosophical purity of an unfettered price signal. Our policy favoring markets must surely be tempered with compassion and common sense at this critical time. Yes, there is a supply shortage out West, a critical one, and there is a critical price problem as well that appears to be getting worse, not better.

That is the short term. Regarding long-term fixes, I agree with my colleagues, we need a large western interconnection, regional transmission organization, because California is not an island. I am indifferent about who owns the California transmission grid as long as they make a firm and lasting commitment to participate in a regional transmission organization. We must end overreliance on the spot markets. We must work with the State to elicit a demand response when prices get too high. We probably need to take the rules of our best market, which is the PJM market that we function in right here in this region, and we need to replicate that in California. Among the rules are efficient congestion management and a standing generation reserve requirement.

Mr. Chairman and members of the subcommittee, I also appreciate Commissioner Breathitt's comments about the gas market. The transportation differential for natural gas into California has been at times exorbitant. That exorbitant transportation differential, sometimes in the range of $20- to $30 for delivering natural gas into California, then is leveraged into the wholesale price of electricity because the units that are on the margin are gas-fired units, and two-thirds to three-fourths or even higher of their marginal production cost is natural gas. We have got to get a handle on that problem as well, and I appreciate Commissioner Breathitt's remarks in that regard.

I look forward to your questions.
[The prepared statement of Hon. William L. Massey follows:]

PREPARED STATEMENT OF HON. WILLIAM L. MASSEY, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. Chairman and Members of the Subcommittee on Energy and Air Quality: Thank you for the opportunity to testify on the subject of the problems facing the California electricity market. The Federal Energy Regulatory Commission has been moving the electricity industry to a structure that relies on well-functioning wholesale markets to produce an economic and reliable supply of electricity for the nation. In supporting that policy, my expectation continues to be that markets will produce consumer benefits and lower prices over the long term compared to cost of service regulation. The recent events in California and the West present a significant challenge to that expectation.

I am very concerned about the recent behavior of California's electricity market and its effects on consumers there and throughout the West. I cannot overstate the enormity of this market catastrophe. Power that cost California $7 billion in 1999 increased to over $27 billion last year. Costs for 2001 may exceed $70 billion. This severely threatens the political consensus necessary to sustain a market-based approach to regulation, not just in California but across the country. The Commission must act forcefully and decisively to reassure market participants, policymakers and consumers that jurisdictional wholesale markets will produce consumer benefits and just and reasonable rates. Among other things, FERC must immediately declare a time out.

I. THE CAUSES OF MARKET DISRUPTIONS

A. Infrastructure

The western electricity markets are in the midst of a serious market disruption. California has experienced extraordinarily high and volatile electricity prices in the last ten months and has skated on the edges of power outages for most of the winter. Other areas of the West have also seen very high wholesale prices, in part due to the problems in California. These are the symptoms of the problems. What are the problems?

I think most observers agree on a number of factors that have affected the electricity market in California and the West. First and foremost among the causes is inadequate infrastructure. Whether it be due to regulatory uncertainty, siting restrictions, process inertia, or simply poor judgment, not enough generation has been built over the last few years to keep pace with demand. There has also been a significant lack of rainfall in the West such that normal hydroelectric generation levels are unavailable. Transmission constraints, especially along the notorious Path 15 in California, have played a role in local supply shortages and high prices. The critical transmission infrastructure has not kept pace with the needs of the electricity market.

B. Market Design

California also suffered from a number of defects in market design. For example, a combination of rules resulted in creating an incentive for under scheduling in day ahead markets. Scheduling imprecision is to be expected to some degree, but my understanding is that deliberate under scheduling was done in the California PX day ahead markets by both load serving entities and generators in order to affect market prices. This forced the ISO to go into the real time markets to make up the difference between what was scheduled and what was needed to keep the system in balance. Under such conditions, the ISO paid very high prices. Perhaps even more important, last minute resource imbalances pose reliability concerns.

Another market design defect was placing entirely too much reliance on the spot market. Spot markets and real time markets are almost by nature volatile. By way of analogy, a traveler purchasing his ticket while passengers are boarding the plane would expect to pay the highest price. While the spot market is the appropriate venue to secure limited portions of needed supply, it should not be relied upon for most or all of the supply portfolio. Unfortunately, there were rather severe state regulatory restrictions on the degree to which load serving utilities in California could forward contract. Surely purchasers having access to a balanced portfolio of long-term and short-term supply must be an ingredient of well-functioning markets.

There has also been a lack of demand responsiveness to price. This is a standard means of moderating prices in well-functioning markets, but it is generally absent from electricity markets. When prices for other commodities get high, consumers can

usually respond by buying less, thereby acting as a brake on price run-ups. If the price, say, for a head of cabbage spikes to $50, I simply don't purchase it. Without the ability of end use electricity consumers to respond to prices, there is virtually no limit on the price that suppliers can fetch in shortage conditions. This is a defect in virtually all U.S. electricity markets.

Finally, there was a spike in natural gas prices in the winter that drove up electric generation prices, because some of the least efficient gas-fired generators were the marginal facilities to be dispatched.

C. Withholding of Generation

I have been discussing what most observers generally agree have been contributing factors to the market problems. Market manipulation by some generators is also believed to have been present. On March 14, 2001, after a non-public investigation, the Commission issued an order to show cause against Williams Energy and AES alleging the withholding of RMR generation during April and May of 2000. The order seeks the refund of over $10 million. While there is not universal agreement whether widespread withholding has occurred, I believe there is enough evidence to render this a reasonable suspicion. The Chairman of the California ISO's Market Surveillance Committee, Professor Frank Wolak, has repeatedly charged that the rapid escalation in price last summer was caused by market power and withholding of generation. A recent San Francisco Chronicle article, using data from the California ISO, challenges the notion that supply was short during much of the price run up. For example, California consumption grew only 4.75 percent in 2000 from 1999, and average peak demand was only 4.79 percent higher. Demand growth was only 8.3 percent higher from May to August. I know that some also allege that market power can only be exercised during severe shortage conditions, but the ISO called only one Stage 3 alert (reserves of only 1.5%) during all of the year 2000, and that was in December. Yet prices soared beginning in June. The Commission has also received studies, most notably from Professors Paul Joskow and Edward Kahn, that indicated the market was manipulated by generators to drive up prices. While there are surely some legitimate supply inadequacies, I cannot help but suspect that some supply was withheld from the market by sellers.

II. STATE GOVERNMENT ACTIONS

California is taking both short and long term measures intended to resolve the current market crisis. What's needed foremost is to close any gap between supply and demand. The state's program, as I understand it, is taking some steps to address this objective. One of California's major initiatives is entering long term contracts with generators to assure a reasonably priced and reliable supply of electricity. FERC has encouraged long term contracting. The state placed itself in the position of power purchaser because of the credit problems of the state's major utilities.

Unfortunately, the state is signing long term contracts at a time when the spot market prices are very high and volatile and the market has been dysfunctional. Long term contract prices are based on the expectations of future spot market prices. California may be creating a new stranded cost problem by signing contracts that are too long and at too high a price. Long term contracts protect against volatility, but they do not protect against high prices.

I am also aware that California is acting to speed up new supplies of electricity capacity. The state has identified 32 potential sites suitable for peaking plants that could be sited under the state's emergency siting process, streamlined somewhat its review of new plants, proposes to provide bonuses to plant developers to accelerate plant construction, and is providing incentives for distributed and renewable generation. These measures seem to be on target, although I have no way of predicting whether they will be sufficient.

The state has also announced an energy conservation program that it hopes will reduce peak load by 3,200 MWs this summer. This also is on target. For the longer term, however, I would strongly recommend that California, and indeed all states, explore ways of increasing the responsiveness of demand to price signals. Without the ability of end use consumers to respond to price, there is virtually no limit on the price suppliers can fetch in shortage conditions. This does not make for a well functioning market.

Instilling demand responsiveness into electricity markets requires two conditions: customers must be able to see prices before they consume, and they must have reasonable means to adjust consumption in response to those prices. Accomplishing both of these on a widespread scale will require technical innovation. A modest demand response, however, can make a significant difference. A recent study by the Electric Power Research Institute (EPRI) indicates that during this past summer,

a 2.5% demand reduction at peak times could have reduced energy costs in California by $700 million. Other studies show that price spikes can be reduced by 73% if just 10% of demand is on real time pricing.

And once there is a significant degree of demand responsiveness in a market, demand should be allowed to bid so called "negawatts" into organized markets along with the megawatts of the traditional suppliers. This direct bidding would be the most efficient way to include the demand side in the market. But however it is accomplished, the important point here is that market design simply cannot ignore the demand half of the market without suffering the consequences, especially during shortage periods.

The state of California is also actively exploring a purchase of the transmission assets of the three major investor owned utilities. Such an action, if it comes to pass, raises a number of issues. First, will it help stabilize the electricity markets in California? The answer to this is uncertain. Over time, I believe that state ownership might help bring better coordination with public power transmission owners, thereby improving grid operation. A state owned grid may provide a better chance of making needed transmission improvements at constraint points, such as the infamous Path 15 that is responsible for substantial congestion in California.

The other major issue raised by a state purchase of the transmission facilities is how will the Commission view the transfer? The Commission has jurisdiction of such a transfer under section 203 of the Federal Power Act. One of our major review criteria is the effect of the transfer on competition. We would not view favorably any asset transfer that is inconsistent with the requirements of regional competitive wholesale markets. I am personally indifferent whether the state or private interests own the transmission assets. I have strong views, however, on how those assets are operated. The Commission should consider conditioning the asset transfer on participation in a Regional Transmission Organization with a more expanded scope than California. This would ensure open access and efficient and non-discriminatory operation of these critical strategic assets.

III. THE FEDERAL ROLE

The fundamental problems in the California market must be addressed by short and long terms actions. Siting authority for bringing on new generation and transmission facilities currently rests with state and local authorities, as does the authority to improve the retail price signals so that customers can respond better to market conditions. There are, however, a number of actions that the can taken at the federal level to fix the broken market in California and ensure well functioning electricity markets throughout the nation. Some can be achieved by the Commission under present authority, and some will require legislation.

A. Commission Action Under Current Authority

The Commission should do all it can to narrow the gap between supply and demand in the short term and bring immediate price relief to consumers and businesses. Last week, the Commission issued an order that is aimed at removing obstacles to increased supply in the western United States. This order addresses modest short term actions. Among them are: temporary waivers of operating and efficiency standards for QFs, market based rate authority for sales from generation at business locations, and authorizing customers to "sell" load reduction at market based wholesale rates.

These quick fix measures, though well motivated, will not close the gap between supply and demand substantially in the short term. Current estimates are that California will be at least several thousand megawatts short this summer. Moreover, it is generally agreed that demand in California and elsewhere in the West is not responsive enough to prices. So we will have a severe shortage of supply, and demand that is not responsive to price signals. In these circumstances, what will restrain prices? Absolutely nothing. California ISO market monitors reported that in such circumstances last summer, there was no constraint whatsoever on the prices generators could bid and still get dispatched. The situation this coming summer may be worse by orders of magnitude. The Commission has already found that the dysfunctional market in California is not producing just and reasonable prices. Addressing these problems is a long term endeavor. Unfortunately, market participants are forced to purchase in today's markets, and at prices that are arguably unlawful under the Federal Power Act.

1. Immediate Price Mitigation

I am very concerned with the economic effects of the current market meltdown. The price shocks of short supply threaten serious economic dislocation and harm in the region. Already, factories are closing and utilities throughout the West are ask-

ing for exceptional rate increases. Bonneville is doubling its rates to cover wholesale purchased power costs: the City of Tacoma, Washington, has voted a 50-70 % increase. State regulators are put in a tough spot. Refusing the price increases could threaten their utilities with bankruptcy. But allowing the rate increases could unleash a political backlash from consumers who think the prices in the wholesale markets are a blatant rip-off. An article in the March 13, 2001 *Wall Street Journal* reported that the current western energy crisis could cut disposable household income by $1.7 billion and cost 43,000 jobs over the next three years in Washington state alone. Some fear that it could tip the whole region into a recession. Moreover, the current volatile and high prices, which may be worse by magnitudes this coming summer, are devastating consumer and investor confidence in a market based approach to electricity regulation.

Over the past three months, I have attended and spoken at two separate conferences sponsored by the Western Governors Association dealing with these issues. Scores of market participants and western public officials spoke passionately and eloquently about the nature of the problems they face. Certainly the issue of supply is a big problem that must be addressed, but so is the issue of price. Without price protection, there is huge concern out West about what the summer will bring in terms of high wholesale prices and volatility. If the West experiences another summer like the last, I fear for the future viability of our policy favoring wholesale competition. It may suffer irreparably.

The Commission must initiate a formal section 206 investigation into the appropriateness of effective price mitigation in the Western interconnection until the longer term solutions are in place and the markets operate normally. This investigation would assess whether conditions in the Western interconnection are preventing competitive market operation, how long those conditions are expected to last, and possible wholesale price mitigation. We would also inquire about how any mitigation measures should be applied and how long they should last. A specific sunset provision is important to maintain investor confidence that price mitigation is temporary and imposed only to deal with a poorly functioning market and to provide an incentive to ensure that the market problems are addressed expeditiously. Most importantly, a section 206 investigation would set a refund effective date 60 days hence so that the Commission can protect consumers if our investigation finds that prices are not just and reasonable.

It is time for FERC to call a time out from this broken western electricity market. At this point, high prices that exceed production and operating costs serve no useful purpose. Is it worth dragging down an entire regional economy, or perhaps even the national economy, for the theoretical purity of an unfettered price signal? I say no. FERC should consider a temporary cost-based price cap on sales in the Western interconnection. Such a price cap could be calculated on a generator-by-generator basis at each generator's variable operating costs plus a reasonable capacity adder perhaps in the range of $25/MWH. New generation sources should be exempt. In addition, such a cap should have a well specified sunset provision, tied either to a date certain or the attainment of certain specific conditions, such as some measure of adequate reserves.

Such a wholesale price cap would allow generators to recover all their operating costs plus a return, so generators should have every incentive to provide power to the grid. In addition, such a cap would restore credibility to wholesale market prices, and thereby make any retail rate increases politically saleable. Surely suppliers have gotten the message by now that more supply is needed. They no longer need such extreme signals.

2. Good Market Structure

Over the longer term, the Commission must insist on a good market structure that will produce just and reasonable prices. The difficulty is that good structure cannot be easily parsed between wholesale and retail jurisdictions. A well functioning wholesale market is needed for a well functioning retail market. For example, retail prices will suffer if the wholesale market is not characterized by competition and rational grid operation. Wholesale prices cannot be disciplined without adequate generation and transmission facilities sited by state and local officials, and without substantial numbers of retail customers seeing accurate market price signals and having the ability to react to them. This relationship means the Commission and the states must work together. But the bottom line is that the Commission must insist on a good wholesale market structure.

One key element of good structure in California and the West is a single Regional Transmission Organization for the entire Western interconnection. I firmly believe that RTOs consistent with FERC's vision in Order No. 2000 are absolutely essential for the smooth functioning of electricity markets. RTOs will eliminate the conflicting

incentives vertically integrated firms still have in providing access. RTOs will streamline interconnection standards and help get new generation into the market. A West-wide RTO will help ensure access to the western power market, improve transmission pricing, regional planning, congestion management, and produce consistent market rules across the West. We know for a fact that resources will trade into the market that is most favorable to them. Trade should be based on true economics, not the idiosyncracies of differing market rules across the region.

To realize these many potential benefits, RTOs must be truly regional in scope—large and well shaped. Markets are regional in scope—this has been well demonstrated recently as prices over the entire West rose and fell with events in California. Thus, we need an RTO that covers the entire West. At last Wednesday's Commission meeting. Chairman Hebert indicated that he shares this objective, and I welcome his commitment.

As mentioned earlier, the California market is defined by an over reliance on the volatile spot market. The Commission has recently encouraged substantial forward contracting by wholesale purchasers. Although some progress has been made in this area, it does not appear that significant forward hedging contracts will be in place for the summer. Substantial reliance on forward contracts is a key element of good market structure. The Commission must insist that this element is in place.

Another element of good market structure is an *ex ante* assurance of adequate generating capacity, including a reserve margin requirement. The California market design called for no capacity obligations and very little forward contracting. Presumably, it was expected that the invisible hand of the market would ensure that capacity would show up when needed. Yet, given that electricity cannot be stored, relying solely on market signals for capacity could mean significant fluctuations of price and capacity availability as supply and demand adjust. The fundamental role that electricity plays in the social, economic, health and public safety fabric of our society, however, argues that substantial fluctuations in availability and price should be minimized. One way of guarding against these fluctuations would be to place an *ex ante* reserve requirement on the load serving entities that they could meet however they see fit. This is the current practice in PJM, and, given the level of capacity additions planned there, suppliers seem to have confidence in that market design.

Markets also need demand responsiveness to price. Without the ability of end use consumers to respond to price, there is virtually no limit on the price suppliers can fetch in shortage conditions. Consumers see the exorbitant bill only after the fact. This does not make for a well functioning market. I addressed demand responsiveness earlier in this testimony.

Good market structure also requires attention to efficient congestion management, the sequence of bidding, reasonable market rules and other details. It is generally recognized that the best functioning wholesale electricity market in the United States is the Pennsylvania, New Jersey, Maryland Interconnection, known as PJM. PJM has an excellent market structure that incorporates virtually all of the elements that I have mentioned. Market participants tell me that they have great confidence in the PJM market design. PJM works. The Commission should replicate the PJM structure in all U.S. wholesale electricity markets, including California and the West.

Even with our best efforts to put in place well structured electricity markets, however, there may be times when those markets fail to do their job. When markets fail, the Commission must be aggressive in ensuring just and reasonable prices. If the states cannot depend on the wholesale market regulator to ensure reasonable prices for consumers, then states will surely think twice before heading down the restructuring path. Moreover, ensuring just and reasonable prices is our statutory mandate, and there is no exception for dysfunctional markets.

3. Mitigating Market Power

The task of ensuring reasonable prices in wholesale markets must be addressed by FERC far differently now than under the old regime. It's much harder now. Our focus is no longer on the costs of individual companies. Instead, our focus is on markets and ensuring that they are free of market power and have the needed components to function well. This means that we must have the data, the analytic capability and the manpower to do the job well. FERC has yet to instill confidence in this policy area.

In order to protect against market power, the Commission must identify and clearly define what constitutes an exercise of market power. We must update our market power standards. Is it market power when a generator regularly bids above its variable operating costs? I say yes, but the record in our California proceeding indicates there is no consensus on this issue. We need to develop clear standards for what is not acceptable market behavior. We cannot expect players to follow the

rules when the rules haven't even been posted. We must ensure that markets are adequately monitored, and that the monitoring and policing task is equipped with the right data, and with sufficient manpower, to do the job. And when market monitors in California and elsewhere tell us that market power is being exercised, we must not ignore there pleas. We must forcefully respond.

And finally, the Commission must aggressively intervene when the markets are not producing reasonable prices. New electricity markets need a lot of attention. They are just emerging from almost a century of monopoly regulation. Moreover, the unique characteristics of electricity make the markets exceptionally vulnerable to market power and to the potential for breathtaking price run-ups when supply is short. Billions of consumer dollars are at stake, so we must conduct tough-minded investigations. We have to be willing to impose a time out on markets that are not functioning. Even the venerable New York Stock Exchange uses circuit breakers to mitigate exceptional price fluctuations. When the stock market drops by a set percentage, the NYSE halts trading. In fact, all of the world's most sophisticated commodity markets have time outs.

The Commission must demonstrate through decisive action a more forceful commitment to these tasks. This market crisis began last June with California's clearly dysfunctional market. On December 15, we found that the California market rules in combination with the imbalance of supply and demand have caused, and will continue to cause, unjust and unreasonable prices. High prices are rippling throughout the West causing great alarm and economic pain for citizens. Yet, the Commission has failed to provide any effective price relief. Our statutory mandate requires more forceful action by the Commission to resolve this crisis.

B. Federal Legislation

There also is a need for federal legislation to ensure that the nation reaps the benefits of well-functioning electricity markets in California and beyond. I would not advocate a legislative solution for all of the causes of the recent problems in the California market. Many market design flaws, the lack of hedging, and the lack of demand side responsiveness can be addressed under existing authorities. But I do believe that this experience has demonstrated that electricity markets are inherently interstate in nature. Prices throughout the western United States rose and fell with events in California. In order to thrive, such markets must have an open, nondiscriminatory, well managed, and efficiently priced interstate transmission network that links buyers and sellers of power. The existing patchwork of inconsistent and outdated jurisdictional rules for this essential interstate delivery system, coupled with splintered network management, create obstacles and uncertainties that undercut the market. If buyers and sellers lack confidence that electric power will be delivered reliably and on reasonable terms and conditions, they will not commit resources to those markets.

Legislation should facilitate the development of a reliable and efficiently organized grid platform upon which vibrant wholesale markets can be built. Jurisdictional uncertainties or anomalies should be eliminated, the development of Regional Transmission Organizations should be ensured, and the authority to site interstate transmission facilities should reside with an interstate authority.

My recommendations for federal legislation fall into five broad areas.

First, Congress should place all interstate transmission under one set of open access rules. That means subjecting the transmission facilities of municipal electric agencies, rural cooperatives, the Tennessee Valley Authority, and the Power Marketing Administrations to the Commission's open access rules.

In addition, all transmission, whether it underlies an unbundled wholesale, unbundled retail, or bundled retail transaction, should be subject to one set of fair and non-discriminatory interstate rules administered by the Commission. This will give market participants confidence in the integrity and fairness of the interstate delivery system, and will facilitate robust trade by eliminating the current balkanized state by state rules on what is essentially an interstate delivery system.

Second, I continue to strongly believe that the development of well structured Regional Transmission Organizations is a necessary platform on which to build efficient electricity markets. The full benefits of RTOs to the marketplace will not be realized, however, if they do not form in a timely manner, if they are not truly independent of merchant interests, or if they are not shaped to capture market efficiencies and reliability benefits. While the Commission may have more authority regarding RTOs than it has exercised thus far, I nevertheless recommend that the Congress clarify existing law to authorize the Commission to require the formation of RTOs and to shape their configuration.

Third, we need mandatory reliability standards. Vibrant markets must be based upon a reliable trading platform. Yet, under existing law there are no legally en-

forceable reliability standards. The North American Electric Reliability Council (NERC) does an excellent job preserving reliability, but compliance with its rules is voluntary. A voluntary system is likely to break down in a competitive electricity industry.

I strongly recommend federal legislation that would lead to the promulgation of mandatory reliability standards. A private standards organization (perhaps a restructured NERC) with an independent board of directors would promulgate mandatory reliability standards applicable to all market participants. These rules would be reviewed by the Commission to ensure that they are not unduly discriminatory. The mandatory rules would then be applied by RTOs, the entities that will be responsible for maintaining short-term reliability in the marketplace. Mandatory reliability rules are critical to evolving competitive markets, and I urge Congress to enact legislation to accomplish this objective.

Fourth, the FERC needs the authority to site new transmission facilities. The transmission grid is the critical superhighway for electricity commerce, but it is becoming congested due to the increased demands of a strong economy and to new uses for which it was not designed. Transmission expansion has not kept pace with these changes in the interstate electricity marketplace. The Commission has no authority to site electric transmission facilities that are necessary for interstate commerce. Existing law leaves siting to state authorities. This contrasts sharply with section 7 of the Natural Gas Act, which authorizes the Commission to site and grant eminent domain for the construction of interstate gas pipeline facilities. Exercising that authority, the Commission balances local concerns with the need for new pipeline capacity to support evolving markets. We have certificated 10,000 miles of new pipeline capacity over the last six years. No comparable expansion of the electric grid has occurred.

I recommend legislation that would transfer siting authority to the Commission. Such authority would make it more likely that transmission facilities necessary to reliably support emerging regional interstate markets would be sited and constructed. A strong argument can be made that the certification of facilities necessary for interstate commerce to thrive should be carried out by a federal agency.

Finally, I recommend legislation that would give the Commission the direct authority to mitigate market power in electricity markets. It should be clear by now that, despite our efforts, market power still exists in the electricity industry. The FERC, with its broad interstate view, must have adequate authority to ensure that market power does not squelch the very competition we are attempting to facilitate. However, the Commission now has only indirect conditioning authority to remedy market power. This is clearly inadequate. Therefore, I recommend legislation that would give the Commission the direct authority to remedy market power in wholesale markets, and also to do so in retail markets if asked by a state commission that lacks adequate authority.

CONCLUSION

I stand ready to assist the Subcommittee in any way, and I thank the you for this opportunity to testify.

Mr. BARTON. Thank you, Commissioner.

We are going to have at least two rounds of questions and perhaps more, depending on how many members stay. So we are going to start the clock at 5 minutes for the first round. Chair recognizes himself.

Each of you in your testimony in one way or the other elaborated on the price caps, and some of you indicated why you thought they might be necessary, and others explained why they may not work. I would like the Chairman, and then if either of the other two Commissioners want to comment, explain the California price cap that the State put in last year and why it did not work, and what would be different about a Federal price cap if we were to put it in this year.

So we will start with you, Mr. Hébert.

Mr. HÉBERT. I am assuming, Mr. Chairman, I am assuming when you are talking about the price cap, you are talking about on retail level the prices that were placed into effect with it.

Mr. BARTON. There was an ISO cap put in place by the State last year, I am told, on wholesale. Now, I may be misinformed.

Mr. HÉBERT. The purchase price cap or the bid cap—I am sorry. Well, as you know, I have been on record suggesting and, in fact, time and time again saying that price caps put us in exactly the wrong direction. I think they continue to do that. It doesn't matter if we are talking about a State bid cap or if we are talking about a price cap not only in California, but in the Northwest. The real question that comes to mind is what are we doing, if anything, to do one of two things that has to happen? What are we doing to increase supply, and, in fact, does that price cap accomplish that? Or what are we doing to decrease demand, and, in fact, does that price cap accomplish that?

Well, we know the answer to both of those questions is no, the price cap is not going to do either of those things. As a matter of fact, even more so than what they have seen on the State side, what we saw with the FERC is as we move forward with price caps, moving them down from 1,000, 750, 500, and even 250, and then down to 150, we saw the average prices go up. We saw supply never build itself up, never provide more opportunity, never provide investment opportunity for infrastructure.

It is funny because every time we talk about price caps, Mr. Chairman, everyone—when you read it in the media, what they would like you to do is make you think it is a simple solution, but, quite frankly, it is not simple, and it is not a solution. As you know, when we start capping the marketplace, we start doing two things generally. One is sending the wrong price signals, and two is—the second thing that we are doing through that is not giving the proper demand signals. The proper prices do not come to the marketplace.

Mr. BARTON. But it is safe to say that what California tried did not balance supply/demand, isn't that—for very long, so——

Mr. HÉBERT. We currently have an imbalance in supply and demand. The real question is how do we accomplish getting beyond that. Congresswoman McCarthy was talking about her home State of Missouri, great example of where FERC actually had a shining moment, and actually where we did it right. And actually my colleague here and I were on somewhat different sides then on where we thought we needed to go. We had an imbalance in the marketplace.

There was some suggestion to withdrawing market-based authority. There was some suggestion to price caps, at that point, certainly price mitigation. I had asked the Chairman at that time, Chairman Dennis Eckhart, please let's not do that; let's stay the course, let's send the price signals to Missouri. Well, that was in 1999 Mr. Chairman. We have not heard anything since then. You know why? Because they have got the adequate supply.

Mr. BARTON. Let me give Commissioner Massey and Commissioner Breathitt a question. My 5 minutes is down to 51 seconds. First Commissioner Massey and then Commissioner Breathitt.

Mr. MASSEY. Congressman, California capped retail rates so low that alternative retail suppliers decided not to enter the market, and I think that has been a problem. On the other hand, I don't think it necessarily follows that an unfettered price that results

from a badly functioning market is the answer. First of all, it is unlawful. Second, it is bad policy. I don't support a long-term low price cap. I support a well-functioning market, but I really worry about the summer.

I would also argue with respect to the demand side that Congress has said wholesale prices must be just and reasonable. So the price signal to the demand side of the market has to operate within that just and reasonable range.

Mr. BARTON. I am going to give Commissioner Breathitt a chance here, but isn't it true that if you regulate the price at the retail level so that there is an unlimited demand, ultimately you cannot manage the wholesale level?

Mr. MASSEY. I agree, Mr. Chairman.

Mr. BARTON. And Federal Government, it is my understanding you don't—the Federal Energy Regulatory Commission, you have no authority over retail prices.

Mr. MASSEY. No, sir, we don't.

Mr. BARTON. That is the State or local issue.

Mr. MASSEY. That is right.

Mr. BARTON. Commissioner Breathitt.

Ms. BREATHITT. You were not misinformed. California ISO does in their tariff have the prerogative to set a price at which they will purchase energy for their imbalance and their spot market needs, and so that started out at $750, went down to $500, went down to $250, and then ended up at $150 soft cap price. At the same time retail rates were not reflective of the cost of energy. So when you cap the retail market, and you don't have the same cost restraints on the wholesale market, you end up with this distortion that has occurred and is occurring now.

I hope that answers.

Mr. BARTON. And again, at the Federal level your authority, the Commission authority, is restricted to the wholesale.

Ms. BREATHITT. Yes.

Mr. BARTON. So if there is a solution at the retail, that is not within the jurisdiction of the Federal Government.

Ms. BREATHITT. Correct.

Mr. MASSEY. May I make a comment, Mr. Chairman?

Mr. BARTON. And then Commissioner Hébert, and we will go to Mr. Boucher.

Mr. MASSEY. I think part of the problem at the State level, part of the unwillingness to flow through wholesale prices is they believe the wholesale price is a rip-off. They don't want to flow it through to retail customers. I think if we can restore some credibility in wholesale prices, local policymakers also will be willing to flow them through. They should flow them through as long as they are just and reasonable, but it really poses a dilemma for them because my Commission has said prices throughout the summer and the fall were at many times unjust and unreasonable.

It is very difficult to argue to State commissioners that they ought to flow those through, although they may be required to as a matter of Federal preemption.

Mr. HÉBERT. Mr. Chairman, I would like to point out two things, and I think it is important for the committee to understand. One is that when you move toward these price caps in the spot market,

you have got to understand indirectly what you have done is you have penalized everyone who has made a good decision and gotten it to the forward markets and properly hedged and therefore may be reliable. So while we are trying to move everyone into the forward market, what you do by capping that price is quite the opposite, because you are saying move to the forward market, but what you are doing is you are giving spot market purchasers a forward market price so they have no incentive to move to forward market.

Another thing that is very important, if you look at California and what California did, when at a question of reliability when times got tough, and when you add the lack of an intersection, if you will, between the supply and the demand curve, when they started to do this and they didn't cross, what did California do? They didn't impose a cap. They went above the cap. They went above the cap to get power, keep the lights on. A cap is unworkable, it is impractical, it is not a solution.

Mr. BARTON. Gentleman from Virginia for 5 minutes.

Mr. BOUCHER. Thank you very much, Mr. Chairman.

I, again, want to thank each of our three witnesses for your testimony and your attendance here this afternoon.

Mr. Hébert, I would like to spend a few minutes discussing with you some of the provisions that are contained in your March 9 order that suggest that certain transactions involve prices that are not just and reasonable, and frankly, I have some concerns that your order may not be directed toward the full range of transactions that involve overcharges by the generators during the month of January, which is the month that your order was directed to. And in posing this question, let me just review several facts with you.

In your order of December 15, you set a soft cap of $150 per megawatt hour, and sales above that cap then would have to be justified under the terms of your December 15 order, and presumably you believe that prices in excess of $150 per megawatt hour were suspect and were potentially both unjust and unreasonable.

Then in your order of March 9, you set a rate screen at the level of $273 per megawatt hour, and you limited your order only to the charges that were above that number that occurred during the times of Stage 3 alerts. And so even charges that were above that number that occurred at some time other than during the Stage 3 alerts were not included in your March 9 order.

In the month of January there were 70,300 transactions that were above the soft cap of $150 per megawatt hour. Only 13,000, approximately, or 19 percent of that number, occurred during the Stage 3 alerts.

And so with reference to your soft cap of $150, some 57,000 transactions were above the break point; that is, fully 81 percent of the transactions of those escaped any review in your order. And then even applying your proxy number of $273 per megawatt hour, fully 7,793 transactions in January escaped your order and were exempted from your order by virtue of the fact that they did not occur during the hours of Stage 3 alerts.

Now, it would seem to me that a price that is unjust and unreasonable is unjust and unreasonable. It shouldn't matter whether it happens during a time of Stage 3 alerts or at some other time

when that very high price is charged. And so my first question to you today is why did you exempt these 7,793 transactions, the price of which was above your $273 rate screen, simply because they did not occur within that very narrow window when the Stage 3 alerts were in effect?

Mr. HÉBERT. It is a lengthy answer.

Mr. BOUCHER. That is okay. We have got some time.

Mr. HÉBERT. No, I will attempt to shorten it, but I appreciate you asking the question because I will tell you, Congressman, there has been a lot written on this issue lately that, quite frankly, I wish people would read the orders specifically and spend time with them. They would understand how some of these things do work. I understand how tough that is to do, but I will explain to you the best I can.

The $150 as we set up in the December 15 order was set up to be a break point, and at the break point above the $150 you would get an "as bid" pricing. Below it you would get the market clearing price.

The reason the Commission did that at that time was twofold. One, the Commission did not want to allow prices bid above 150 to set the market clearing price. It would come back down, so it got the average back down, if you will.

The other reason is the Commission wanted to make certain that anything that came in over $150 was going to be subject to a reporting requirement on a weekly basis to give us information that might be necessary on a going-forward basis to look and see whether or not they were just and reasonable. Now, that is not to say that there was a suggestion that anything above the $150, in fact, was per se unjust and unreasonable, but that we would want to take perhaps a second look at it, and we didn't want the clearing price to be set.

Well, as we move forward and you talk about the $273 proxy price, that is a price that the Commission came up with to try to mimic a market that would be working given working conditions, working considerations. Now, obviously we know we did not have a working market at that time.

There has also been some things mentioned and written that perhaps there are some 70,000 transactions that were exempt and we didn't look at. Nothing could be farther from the truth. We looked at all those transactions, and, in fact, when we came up with the proxy price that mimicked the market, what we said is we aren't going to demand more of anyone over $273, in fact.

Mr. BOUCHER. Mr. Hébert, let me direct you precisely to the question, if I may, because my time has expired, but we do need an answer to this.

Mr. HÉBERT. I am trying.

Mr. BOUCHER. For purposes of this question, I am respecting your proxy price of $273. I do have some questions about the methodology for arriving at that, and if time permits in a subsequent round, I will ask you about, it but for purposes of this question, I will accept that. My question to you is applying that price of $273 per megawatthour, why did you not apply it to some 7,793 transactions that took place during the month of January where the price charged by the generator was above that number, but the

transaction itself simply did not fall within the time when the Stage 3 alerts were in effect? Why did you not respect this screen number of $273 and apply that to these some 7,793 transactions?

Mr. HÉBERT. As you know, there are several groups that, one, we cannot apply our price to, public power, the power marketing agencies, co-ops, munies. We have no jurisdiction over those whatsoever.

Mr. BOUCHER. Did all of these fall within that category?

Mr. HÉBERT. I am not certain which numbers you are talking about.

Mr. BOUCHER. Let me ask Mr. Massey if he would care to comment on this matter. He perhaps has some knowledge about it.

Mr. MASSEY. Congressman, I dissented on that order not because I disagree with providing refunds, but I thought the order, by drawing the line that it drew, was arbitrary and an abuse of discretion by the agency. If we are concerned about a $273 bid in Stage 3 conditions, you would think we would be even more concerned about a $273 bid that occurred when the shortage situation was not nearly so great. To me, the line that was drawn serves only one purpose, and that is to limit the scope of refunds, and I objected to it on that basis.

For the refund order that was issued for the month of February, this is a another order that just came out last Friday, the new proxy price is $430. We are not concerned about a bid of less than $430 whenever it occurs, and we are only concerned about $430 bids that occur in Stage 3. We are not concerned about the 14,168 transactions that occurred outside of Stage 3, which is 56 percent of the transactions above $430. It makes absolutely no sense, and it will not withstand scrutiny on court review.

Mr. BARTON. Mr. Hébert, and then we are going to have to go to Shimkus.

Mr. HÉBERT. Thank you, Mr. Chairman.

I just need to correct a couple of things. One, I want to make it very clear to Congressman Boucher that all transactions, all 70,000, were subjected to the methodology replicating competitive conditions, all 70,000. Now, you need to make certain and understand that the Commission felt like we should be clear and recognize that we should not depress prices and eliminate scarcity price signals. It was very important that we sent price signals to get the adequate supply there. What we were worried about is a Stage 3 when reserves are at 1.5 percent, and the lights were about to go out, and that is where we injected ourselves.

Mr. MASSEY. Can I just make one other comment?

Mr. BOUCHER. Mr. Massey.

Mr. MASSEY. There were only 2 hours of Stage 3 transactions during the year 2000, 2 hours the whole year, but we declared the market to be wildly dysfunctional for most of that period of time.

Mr. BOUCHER. Well, let me say, Mr. Chairman, my time has long since expired, and I am just going to conclude this with a comment.

Mr. BARTON. It was your first question.

Mr. BOUCHER. It was only my first question. I am going to conclude this with a comment. I think we do deserve a more complete answer about why the Commission decided not to find that the transactions that were priced above this $273 figure in January were unjust and unreasonable, when they were finding that prices

at that level were unjust and unreasonable during the Stage 3 alerts? Why not do it during the entire month? I think we deserve a more complete explanation of why the 7,773 transactions that were outside the Stage 3 alert hours that were over that price were not also unjust and unreasonable, and I am sure we will pursue that at greater length. Thank you.

Mr. BARTON. Before we go to Mr. Shimkus, I just want to elaborate on what Commissioner Massey said, I am told, in 2000, because they basically let the—they let a clearing price set the market, they never got—they didn't get to the Stage 3 shortage very often because at some price—they took whatever was needed at some price, which should have been substantially above 273. I mean, this is where we hear the horror stories of 1,500 and $2,000. So it is not a good answer, but that would explain why they only had 2 hours of Stage 3 alerts.

Mr. MASSEY. Yes. Mr. Chairman, my concern is that if this is our new standard, Stage 3 alerts above a certain price, there were only 2 hours of those all of last year when prices fluctuated wildly.

Mr. BARTON. The gentleman from Illinois Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. I am going to try to get a couple of questions in. This is highly technical, and so the answers get pretty long, and I don't ask technical questions. But, Chairman Hébert, briefly, how would an RTO help the situation in California? I think most of you had agreed it would have, but if you could just tell me shortly how an RTO would have helped.

Mr. HÉBERT. What the Commission recognized through Order 2000 is that, in fact, there were certain natural markets, certain patterns of trading, certain flow paths that would develop a North American grid. The question in the end is how many regional transmission organizations do we end up with? We would like to get as few as possible.

What we have found in the West, certainly found it through reports that the staff has done, that you do have a natural market there, and California is not an island in and of itself. As a matter of fact, what California has found is that, quite frankly, they are very dependent on friendly strangers. They have to have help from the other jurisdictions. We even saw during some off-peak periods and even some peak periods where prices were up in neighboring communities such as Arizona, and those prices and power would be needed, so the power wouldn't get shifted back down to California.

The RTO has a natural opportunity to correct the problems of the past means that California and the rest of the West is going to have to work together, but I do want to make it clear that it is not that we think California is really any different than anyone else. The Commission has held and, quite frankly, is moving forward with RTOs. We are making it clear. We think it is important to have a southeastern RTO, to have a northeastern RTO, but the same is true in the West, and we have got to make certain as they plan transmission, electric transmission, that they understand a good and bad decision in Washington and in Arizona and in California probably has ramifications to each other; and the same on natural gas pipelines, and the same on siting generation, that we are all in this together.

Mr. SHIMKUS. Thank you.

I bring this up because, as you know, I am from Illinois, and in the Midwest we have four—three or four of our utilities, and they are in different ISOs, and I know you are reviewing that. And I think if you are—I think we are receiving a message from the country in different parts that we are going to need, you know, one honest broker partner in regions, and I just say that as a concern how lessons can be translated throughout the country and as kind of lobbying on my behalf that if we could get down to some manageable number.

The L.A. Times article today, and I am going to go to Mr. Massey, states the ISO had hoped—this is today's—the ISO had hoped demand would start to subside and conservation would kick in, but that did not happen, officials said. "We have been giving the conservation message since last May, and I am at a loss about why it is not working as well anymore, spokesman Pat Dorenson said."

Do you know why the conservation is not working, the conservation message is not working in the California market?

Mr. MASSEY. Most of the consumers have a flat rate and have no opportunity to respond to any sort of price signal, even a price signal that was within a reasonable—just and reasonable range. That is problem No. 1.

Problem No. 2, I think that we need to work harder so that the demand side of the market can bid in along with the supply side of the market in real-time, so that a "negawatt"—a consumer willing to cut back—is paid a market clearing price, the same as a megawatt. But thus far I think it is because they simply do not see any sort of price signal at the retail level.

Mr. SHIMKUS. So good intentions do not translate into quality decisions on demand without a price signal.

Mr. MASSEY. I think that there is the necessity for at least some portion of the consumers to see a price signal that arises from a reasonable—just and reasonable wholesale price, and to have an opportunity to respond to that signal, and to have the tools, the various new computer technologies, chip technology that allow them to manage their load.

Mr. SHIMKUS. I am going to cut you off so I can get my last question. It also deals with price signals. You have indicated that new generation of sources should be exempt from price caps, and you said that in your opening statement. Since new and existing generation are often owned by the same entities, won't this invite gaming or selling of uncapped capacity and withholding cap capacity?

Mr. MASSEY. It could. We would have to watch that very carefully, but I would exempt new generation because I want to send a signal to the marketplace to encourage entry; and No. 2, I would make this price cap temporary, tied to a reserve margin in the West.

Mr. SHIMKUS. Thank you, Mr. Chairman. I yield back my time.

Mr. BARTON. Gentleman from California Mr. Waxman.

Mr. WAXMAN. Thank you, Mr. Chairman.

Mr. Massey, the Governors of California, Oregon and Washington requested that FERC establish a cost-based price cap to purchase power in the spot market for 1 year. This is an approach similar to what you have suggested in the past; isn't that right?

Mr. MASSEY. It is, Congressman.

Mr. WAXMAN. Now, Secretary Abraham has criticized any kind of restraint on wholesale prices because he claims it would deter investment in new generation. I would like to know if you think he is right, and is there a smarter way to do this that can protect consumers while preserving incentive for investment?

Mr. MASSEY. We must recognize that we face a debacle this summer without some sort of price relief out West. We must impose a temporary mitigation measure that is effective, that carries out our statutory responsibility, and that exempts new entry from the price cap. A badly dysfunctional market is not an investor's friend either, and if there is a political revolt out West because the prices are just too high, and consumers rise up through initiated act or whatever and make bad decisions, that won't help investors either.

Mr. WAXMAN. Well, I think that is a good point, and I think if you look at it from that perspective, it is hard for me to understand statements like that of Secretary Abraham when he said price controls on electricity will lead to more blackouts. Well, short-term price controls are not going to lead to more blackouts. It looks like there is going to be more blackouts because of the dysfunctional market; is that correct?

Mr. MASSEY. Well, stated the other way, an unfettered and very high, exorbitant price between now and the summer will not add one new megawatt of generation to the market for this summer, not one.

Mr. WAXMAN. Well, how about this statement that it is a myth that energy companies are withholding energy? Do you believe that it is a myth that they are withholding energy?

Mr. MASSEY. We just found—the Commission just charged that two companies were withholding last year. No. 2, the market monitors out West, both inside and outside the ISO, have told us time and time again that they believe there is withholding. Professor Joskow from MIT, a very respected economist, has told us that he believes that there was significant market power to the tune of more than a billion dollars exercised in the California markets that was exercised through withholding and other means.

I think that we need to wake up and realize that this is a dysfunctional market that is subject to being gamed and manipulated by those who participate in it.

Mr. WAXMAN. Well, I have to say that I am concerned when I see that your testimony, you say the current western energy crisis could cut disposable household income by $1.7 billion, cost 43,000 jobs over the next 3 years in Washington State alone. Some fear it could tip the whole region into a recession, and the current volatile and high prices may be worse by magnitudes this coming summer. They are devastating to consumers' and investors' confidence in the market-based approach to electricity deregulation.

So when I see those kinds of statements, I just can't understand how we get the views that are being expressed that we want a deregulated market, and all we should do is just remove the cap on the consumers and let them pay more. If we remove the cap on what is charged the ultimate consumers, would that lead to anything like conservation or lower prices, or are they just going to pass on the charges?

Mr. MASSEY. Well, if the cost of power in California this year is as high as it is projected to be, I don't know how you flow that through quickly to consumers. You can't increase their prices 4- or 5- or 6-fold. Ultimately, just and reasonable prices ought to be flowed through to consumers, but unless the wholesale price has credibility, unless it is a just and reasonable, lawful price, State policymakers aren't going to want to make retail customers pay it.

Mr. WAXMAN. On March 9, 2001, FERC issued an order to some generators to either pay refunds or provide further justification for their prices, and to many of us in the West, this order was too little too late. The order eliminates consideration for refund any sale below $273 a megawatt and any sale that did not occur during a Stage 3 emergency. I know you disagreed with this order. Would you explain why you disagreed with it?

Mr. MASSEY. I disagreed because I felt like the order artificially limited the scope of our review of just and reasonable prices. The order only—it limits our review to Stage 3 transactions, which are our severest conditions, and only to prices above $273. For the month of February, we just issued another order limiting our review to bids above $430 during Stage 3.

There were 14,168 transactions in which the bid was above $430 that did not occur in Stage 3, and they get a free and clear. This makes no sense.

Mr. WAXMAN. Do you think the FERC decision gives a formula for generators to have a road map as to how they can charge without FERC asking any questions whatsoever?

Mr. MASSEY. I think it makes clear that FERC is going to be looking for the wallet under the lamp post with the light shining, and nowhere else. And that concerns me.

Mr. BARTON. The gentleman from Georgia, Mr. Norwood, is recognized for 5 minutes.

Mr. NORWOOD. Thank you, Mr. Chairman.

Mr. Massey, let us see if we cannot say this so people can understand it.

California does not have enough electricity. If they had a lot more electricity, we simply would have perhaps lower rates, and we would then not have the rolling blackouts. Correct?

Mr. MASSEY. Correct.

Mr. NORWOOD. Why don't they have enough electricity?

Mr. MASSEY. They have not built enough generation over the past 10 years.

Mr. NORWOOD. Is that a legislative decision from the State of California?

Mr. MASSEY. I don't think it is a legislative decision. There was a lot of uncertainty in California about whether there would be a market-based approach or not throughout the nineties. I think new generation just did not enter.

Mr. NORWOOD. These folks who build transmission and generating facilities do so for a reason, obviously. Why wouldn't they want to go into such a large, wonderful market like California?

Mr. MASSEY. It was not clear that there would be shortages. But here we have a low hydro year in which California cannot count on sufficient power from the Northwest, and it is shining a spotlight on the need for new generation in the State.

Mr. NORWOOD. You are telling me that the people in this industry were not aware that they potentially could run out of power in California under certain circumstances, and therefore the California legislature or the public service commission, working with them, were not concerned about this over the last 10 years? Just all of a sudden this is a big surprise?

Mr. MASSEY. It is rather shocking that it is a big surprise.

Mr. NORWOOD. Is California a State that lends itself to making people want to come running in to build generation facilities and transmission facilities, or is it a State that makes it very difficult?

Mr. MASSEY. I think the generators would argue it is a State that makes it very difficult. But that does not get me off the hook in terms of just and reasonable prices. I still have to ensure just and reasonable prices.

Mr. NORWOOD. Tell me what "consumers have a flat rate" means in California.

Mr. MASSEY. The consumers have their retail rates capped at a certain rate. That means that very high wholesale prices that have been paid in California, they are not getting flowed through to most of the retail consumers, they are just building up.

Mr. NORWOOD. Somebody thinks this is a good way to get the consumer to conserve?

Mr. MASSEY. I don't think it is a good way.

Mr. NORWOOD. Obviously it does not work. I don't believe it is working, is it?

Mr. MASSEY. It is not working very well.

Mr. NORWOOD. That is the kind of thing I am trying to get at. California has been very helpful in bringing part of this on themselves.

Mr. MASSEY. There is no question about that.

Mr. NORWOOD. That has nothing to do with the fact that we all need to worry about this summer. But at this point, you have to say for sure they brought a lot of this on themselves.

Part of the solution, and help me if I am wrong, would be to build more transmission and build more generation?

Mr. MASSEY. Exactly. I agree with those comments.

Mr. NORWOOD. Now, explain to me, if I were an investor and was going to spend billions of dollars to build more generation and build more transmission, why I would do that if you were going to put caps in place?

Mr. MASSEY. Transmission rates are generally capped most everywhere. I think investors understand that. They sometimes complain about the rates of return that they get.

Mr. NORWOOD. I think the chairman has pointed out, we have a pretty serious problem of transmission in America.

Mr. MASSEY. Precisely.

Mr. NORWOOD. Is that connected to the caps they are complaining about?

Mr. MASSEY. The transmission owners argue their rates of return are not high enough, but I think for the most part transmission will continue to be a regulated business that is subject to price controls.

Mr. NORWOOD. Go to the generation end of it. California could certainly use—and forgive me, Mr. Markey—two or three nuclear plants right now in a bad way.

Mr. MASSEY. They could certainly use some new generation in a bad way.

Mr. NORWOOD. I will bet you those folks who had their business shut down at Mr. Cox's aluminum plant, I will bet they would be happy to have that electricity right now, perhaps wherever it came from.

Mr. MASSEY. That is correct.

Mr. NORWOOD. How are you going to get anybody to take seriously an idea to go in there and spend billions to get the generation capacity when we say to them, no matter what you do or what it cost, baby, we know best what you can collect for revenue?

Mr. MASSEY. But, Congressman, that is the Federal law, to ensure just and reasonable prices. There is an oversight respnsibility.

Mr. NORWOOD. That is not the same thing as caps, is it?

Mr. MASSEY. It was the same thing as caps for years and years and years. Now we have moved to a market-based approach. If the market is dysfunctional, the courts have told us time and time again that the prices are unjust and unreasonable. We have the obligation to ensure a well-functioning market. We cannot get that in place by this summer. It is impossible.

Mr. NORWOOD. The last comment. One of the things that is possible here, if it is a long, hot summer in California, there could very well be some interesting results at the polls for the State legislature. Sometimes that is not all a bad idea. Thank you, Mr. Chairman.

Mr. BARTON. All right. The gentleman from Massachusetts, Mr. Markey, is recognized for 5 minutes.

Mr. MARKEY. It is a good idea, and I appreciate that accent.

So we have had the worst drought in 100 years, the worst drought in 100 years in the Northwest, but we are sending very strong price signals to the clouds that we expect them to rain a lot more. And the higher the price goes, the more we are going to punish the electrical consuming public for the drought.

Usually what we do out in the Midwest is we take care of the farmers whenever there is a drought. Here, though, we send strong price signals to the marketplace, notwithstanding the fact that the consumers do not have any relief that they can get.

Now, Chairman Hébert, at the subcommittee's September 11 hearing on the California energy situation, when he was asked whether or not we should impose price caps to protect people from the fact that it did not rain, he said, "I have always felt and always thought that if the truth kills Granny, then let her die, but the truth has to be told here. Price controls didn't work in the Nixon era, they didn't work in the Carter era."

Now, that doesn't sound exactly like compassionate conservatism, because we know that Granny did not design this system. We know Granny did not have anything to do with the fact that it did not rain for a year in the Northwest, notwithstanding the fact that I am sure she wishes that it did. But she is going to get killed by the blackouts, by the brownouts, by the rate increases.

Mr. BARTON. Will the gentleman yield?

Mr. MARKEY. Yes.

Mr. BARTON. The record will also show that the chairman who held that hearing said he wanted to save Granny. I hope you would put that in the record also.

Mr. MARKEY. Yes, the chairman from Texas stood solidly with Granny on this issue. We have a bipartisan agreement that Granny——

Mr. BARTON. That is compassionate conservatism.

Mr. MARKEY. Granny should not have anything to do with this. Also, I am sure it was a metaphor.

Mr. BARTON. And Massachusetts is for Granny, we will stipulate that Massachusetts is.

Mr. MARKEY. Granny is the key person in all of this, no question about it.

So we also would like to state for the record that there may not have been a lot of utility construction in California in the last 5 years, but we also have to remember that it was the utilities who were seeking stranded cost recovery which said that they were expecting a surplus of electricity through the year 2005. So that was their representation to the PUC in California as the guise for their recovery of stranded cost investment.

Now, Mr. DeLay and I have always cast a little bit of an arched eyebrow toward that stranded cost argument in legislation which we have introduced. But that notwithstanding, I think there is a queen of spades here, and we should put it right in front of the utilities which were trying to gain that kind of a benefit.

You mentioned several long-term measures, Mr. Chairman, such as RTOs, new electricity transmission improvements, but these will take time. Commissioner Massey notes that the power that cost $7 billion in 1999 increased to $27 billion last year and is projected to cost $70 billion this year; from $7 billion to $70 billion for the same power over a year's period.

Now, the demand, however, only increased 4.75 percent from 1999 to 2000. Now, if demand for Wonder Bread, for a $1.39 loaf of Wonder Bread, went up 4.79 percent and the price increased from $1.39 to $13.90 for a loaf of Wonder Bread, we would be very concerned about that in our country, because that is what is happening to electricity in California.

Now, under the Federal Power Act, are we not supposed to disapprove prices that are unjust and unreasonable? It seems to me that, by any definition, this is unjust and unreasonable that a 4.7 percent increase in demand results in that kind of a price spike.

Mr. Chairman, what are you going to do about it? Are you just absolutely, unconditionally opposed to any kind of price relief for consumers?

Mr. HÉBERT. How did I know you were coming to me?

First of all——

Mr. MARKEY. Because I don't want it to come to Massachusetts. I don't want it to come to New York. I don't want it to come east of the Mississippi. I don't want it to come east of the Rockies.

Mr. HÉBERT. Part of the problem—and Chairman Barton, these questions are not 5-second sound bites to answer. I want to answer your question fully. So if you will give me just a couple of minutes,

I will address quite frankly some of the things that you raised that I think are very important in your opening statement.

But before I do that, let me defend my grandmother, both my grandmothers, who I am fortunate to have. The exchange was between the chairman and I, and I was trying to make a point not about, if I remember correctly, price caps, but in fact about market mitigation.

In fact, they did have a dysfunctional market. They needed to do some positive things in California. In fact, they were not. I was trying to make the truth very clear.

But let me answer your question. And it goes back to the proxy price of $2.73, because I truly believe if it would have been legal for me to sit down with you, Congressman Markey, and say how can we frame this methodology, and I could have sat down with you, I think you and I would have agreed what we came up with is workable.

Let me tell you why. It is workable because what we did is we looked at exactly what you pointed out that we need to be looking at: inefficiencies, and how do we promote efficiency.

When we are looking at setting parameters on cost, parameters on screening, a proxy price, if you will, should we not probably look at inefficiencies and what the inefficient unit is going to be at the margin, and if so, we should use that?

In fact, that is what we did with our methodology, to give some incentive back to say we need adequate supply, but quite frankly, we need some new supply, which is also consistent with your argument on refrigerators, air conditioners.

The reason it is important to understand this is that if we can set this price at such a point that we say that we are concerned whether or not they are going to intersect, whether the lights are going to go out—because what we do know is in fact that price caps are not working. I don't know how you argue they do not work on the retail side and do not send proper signals, but, by the way, let us set up an artificial market on the wholesale side. That is a totally inconsistent economics argument. We know this.

Why did you have the same demand, yet you had a problem with outages? Well, you were exporting all types of energy to Arizona. You were exporting energy, quite frankly, to BPA, because you were doing a two-for-one trade in California on-peak/off-peak. You were trying to refill some hydro facilities, pump storage. So you had a lot of factors going into this why you did not have the supply that you should have had.

But at the very end of this argument, when it comes to some of the things that I think we all agree upon, bringing new supply into the system while at the same time concentrating on efficiencies, it proves that the methodology is correct. It proves that we are going to give signals with scarcity. But we are going to try to make certain that those lines are not going to cross, that we are going to intervene; because what FERC must do, while ensuring just and reasonable rates, is give markets certainty. We cannot intervene all the time, we have to give markets certainty.

Let me close by saying this. If we are concerned with efficiencies and we know we need new supply, why would we not send the proper signals to suggest that, look, we know there are some

30,000 heat rate systems, some real dogs in California. We know every time we replace one of those generators, we replace them probably with a 7500 heat rate, much more efficient system, and we would all be winners in the end: California gets more supply; Californians and the rest of America get cleaner air.

I think we are on the right track. It means we have to make tough decisions and it means I will have to defend those, but I think we are doing that.

Mr. MARKEY. I will just finish up, if I could, Mr. Chairman.

It seems to me what the FERC is saying is that it is not okay for the cornerstone to raise the price of bread to $13 apiece a loaf right before a snowstorm, when everyone descends upon the corner store, but it is okay to charge $13 for a loaf of bread at all other times. That is what you are saying about this electricity crisis; that you are going to investigate the blackouts and the brownouts and see if there is an exploitation; but if the very same price is being charged every other day of the week and month, that you are not going to investigate, even though it is ten times higher than what common sense and experience tells us it should be.

There is just something fundamentally wrong with that. I just think if we do not do something, then we are going to see the California economy and much of the West in very dire conditions by the end of this fall with, unfortunately, a ripple effect.

I will tell you when I know I have a problem, when Craig Barrett, the chairman of Intel, says that he is not going to expand in California, but he is going to look to Massachusetts to expand Intel. Then we know that something is wrong, okay? All I can tell you is that his comment is going to be replicated by hundreds of other executives in California and other States out West in the very near future if something is not done.

Mr. HÉBERT. Congressman, I think that has everything to do with that Sable Island project that we got done for you.

Mr. MARKEY. I appreciate that. Thank you.

Mr. BARTON. Before I yield to the gentleman from Oklahoma, we have been talking about markets. Let us just set the record straight: In a classic supply demand market, as the cost of the product goes up, the demand of it goes down. That is economics 101.

Mr. HÉBERT. Agreed.

Mr. BARTON. We don't have that in California. We have a retail market that is capped below the price of the wholesale market. The wholesale market is infinity. It is infinity. It does not matter what the wholesale market pays, they do not pass it through to the retail, or at least most of the retail.

To draw the demand-supply curve for California is crazy. You have demand below the cost of supply. It is just irrational, except in the real world of what is going on in California.

Mr. Largent for 5 minutes.

Mr. LARGENT. Thank you, Mr. Chairman.

I was listening to my friend, Mr. Markey, when he asked you, Mr. Chairman, about are you going to offer any sort of price relief. It turned my attention to Granny that we talked about in his hypothetical question.

It made me think, I wonder how this debate would fall out if the discussion was on a just and reasonable Federal tax cap; in other words, the Federal Government would have to cap the amount of taxes that we actually received every year. We could not take any more than that.

I wonder how the debate would fall out on either side of the aisle if we had a Federal tax cap and we said that the Federal tax had to be just and it had to be reasonable.

Mr. HÉBERT. I like the idea.

Mr. LARGENT. I do, too.

I started thinking, if we really wanted to offer relief to Granny, then we would be voting for things like the death tax repeal and we would be voting for marriage penalty relief, and perhaps even Mr. Markey's Granny would be in the 39.5 percent marginal rate and would think that that would not be fair, and we could offer her some relief in that respect, too.

My question is to you, Mr. Chairman; does the FERC have some pretty objective measure in determining what is a just and reasonable price?

Mr. HÉBERT. Congressman Largent, we do. That is what we are trying to do by somewhat mimicking a market, quite frankly, during a dysfunctional period of a market.

When we set up this proxy clearing price—and I know there has been some suggestion that you had the 273 and then you have the 430, and there may have in fact been some different standard.

The standard is the same. You are going to look at a weighted average on what the fuel costs were, you are going to look at what the NOx costs were, which, as you would know going into the $430 period, they were higher. Thus, the proxy price is higher.

You also have the fixed cost of the system itself. Now, if you look at that and try to say, well, but there is this conversation out there about this $25 fixed cost rate with this adder, why is that not a good idea? Well, it goes back to your question? Have we got a methodology, will it work?

I think it will work. We do have a methodology. The reason the $25 plus the adder does not work is, one, you have some systems, hydrosystems, quite frankly, their fixed costs may in fact be above $25.

If we look at the adder and look at it on a separate transaction basis, we could manipulate that market by changing the transactions, so it will not work. Not to mention if we are going to go back to some type of cost-basing area, what you and I understand is that we cannot do that on a daily, a monthly, or even a yearly basis, because when we look at those systems, we look at them generally on 20- and 30-year terms. You cannot have a cost-based or cost-plus system and then come back in and do what we call market mitigation, which is what we are attempting to do, and what we are seeking comments on right now. We cannot do both. It just will not work.

Mr. LARGENT. Mr. Massey?

Mr. MASSEY. Congressman, you asked a very good question. It is one that I have struggled with, because the standard is a vague standard, "FERC shall ensure just and reasonable wholesale prices." That is essentially all the law says.

The courts have said, and we must pay attention to what they tell us or they reverse us, that if FERC is to move away from a cost-based system, it must do so carefully, with attention to the market design. In other words, FERC must ensure a well-functioning market, and only if there is a well-functioning market does FERC have the legal authority to assume that prices are just and reasonable.

No. 2, the courts have also said that in a well-functioning market, it is likely that producers over time will bid close to their marginal costs.

Mr. LARGENT. Okay. That goes to the point of my question. That is, you all have filed suit against two companies on this very issue of just and reasonable prices. How can you hold anybody liable for a standard you don't know?

Mr. MASSEY. It is an excellent question. We need to define what market power is, what acceptable conduct in the market is—we have not done a good job of that.

Surely they cannot have reason to believe that any price, even the price of a dysfunctional market, is just and reasonable. But I agree with you, we have not done a good job of defining what just and reasonable means, what market power is, what is the definition of it, and so forth.

Mr. LARGENT. I guess my point is that it seems unconstitutional, frankly, that you hold somebody responsible for a standard that you cannot define and has not been defined yet, and yet you are going to take them to court and incur a lot of legal costs in doing that, besides whatever other penalties are going to be handed out, when there is no standard defined in the first place.

I yield back, Mr. Chairman.

Mr. BARTON. Before I yield to Mr. Wynn, I think in classic economics, if you cannot meet the demand at any price, the supply is infinity. You cannot get a just and reasonable price if there is not some way to clear the market. I may be wrong on that, but I think that is right.

Mr. Wynn is recognized for 5 minutes.

Mr. WYNN. Thank you, Mr. Chairman.

Let me ask first a quick question, a follow-up.

A lot of people are citing the November 1, 2000 investigation by FERC to suggest that there are no abuses in the system. In light of your orders of March 9 and March 14, would you say that that statement still holds true, or would you back away from that statement?

Ms. BREATHITT. Congressman Wynn, I would not agree with your earlier statement that the November 1 order found that there were no abuses in the system.

On December 15, we found that there were, and we set our remedies in place to correct some of those abuses, particularly with respect to the market design.

Mr. WYNN. So anyone running around saying now FERC has found that there are no abuses would be really in error; is that fair to say?

Ms. BREATHITT. I would say so.

Mr. WYNN. Okay. Thank you. That really kind of clears it up. People have said no, you are completely off base with that. But it seems to me clearly, based on what you said, that it is not the case.

This discussion has seemed to come down in my mind to a statement of either caps or true price signals to encourage conservation and stimulate generation. I recognize off the top that generation is the key issue.

But I think that setting it up that way is really not necessarily the most helpful way. It seems to me the issue is caps versus gouging.

I want to go back to something that Mr. Massey said, that elected officials would not flow through these price increases because they thought they were a rip-off.

Do you stand by that statement, Mr. Massey? If so, why do you believe that that is true—or why do you believe that perception exists? Let me rephrase that.

Mr. MASSEY. I believe that perception because State officials have told us that in hearings before us. I believe that perception because I think the prices have been way too high myself. I believe it because the Commission has declared the market to be dysfunctional and declared prices to be unjust and unreasonable.

I know that it is very difficult for local officials to say to their retail consumers, we want you to pay a price that Federal regulators have determined to be unjust and unreasonable. That is very difficult for them to do.

Mr. WYNN. Thank you.

Now, Mr. Hébert, in light of that comment and in light of your colleague's comments that there is evidence of abuses, Mr. Massey then says that, well, these prices are way too high and it is hard to pass through unjust prices. I guess I would pose to you, if not caps, what? What is the mechanism that we use to protect the consumer, not from the true cost, because I think people will concede that consumers ought to pay the true cost—and if that stimulates conservation for generation that would be great—but how do we protect them from this unjust and unreasonable cost that seems to exist in some abundance based on the recent orders that you have issued?

Mr. HÉBERT. An excellent question. Let me try to clear it up.

Before I speak directly to that, let me clear up one conversation that took place a moment ago when Commissioner Massey was talking to Congressman Largent. He was talking about an abuse and some rates that were unjust and unreasonable.

When it comes to the Williams AES case, which is what was being discussed, that was a tariff violation. It is a little different. We can get into that more. But actually, that was a little different than just rates being unjust and unreasonable.

We have got out for comment right now something that goes to the heart of your question. That is, what direction will FERC take to ensure just and reasonable rates during this dysfunctional period? We are going to look at what anti- market mitigation, immediate market mitigation, should take place; how do we resolve that on a going-forward basis from May 1 forward? That is out for comment right now. We are going to hear back from parties soon, and we will be moving forward with something on or before May 1.

But the reason it is important to at least make certain there are price signals during scarce periods is because we do know, and everyone in this room knows, I believe, there is an imbalance of supply and demand. I don't know how long this committee has been talking about this problem, but quite frankly, we three have been talking about it for a very long time and I think you have been engaged that entire time.

You have to ask yourself, if the price signals are clear because they are so high, why in fact have they have not turned a shovel on the first substantial generation unit in the State of California?

Mr. WYNN. That is certainly a legitimate question. But to go back to the flow-through question, to the extent that the prices are not just and reasonable, why should the elected officials pass through those costs, those inflated, perhaps abusive, manipulative costs, on to the consumers in order to suggest that this is a true price signal?

I wouldn't object to the true price signal being sent to the consumer. The objection is to the inflated price signal that a substantial body of evidence that you have presented seems to suggests exists.

Mr. HÉBERT. Let me just tell you, I can't say why anyone in any other appropriate jurisdiction may or may not be doing something. I mean, I am within the realm of speculation there. But I was a retail regulator for almost 6 years, and as much as it disheartened me and as painful as it was, when costs were prudently incurred, they were therefore passed on to the consumer.

Mr. WYNN. We are beating the same horse. No one is objecting to true costs being passed on to the consumer. What we are objecting to is—you have disclosed evidence to suggest that there were abuses, specific cases of tariff violations, cases that merited a refund, 80 percent of which were excluded from your order.

That suggests that there is a lot of gouging going on. If that is true, what are you going to do about the gouging; not the true price, not the legitimate price signal, but the gouging that seems to exist?

Mr. HÉBERT. One, let me clear up the misinformation that you were given. Of those transactions, as we have already said, 53 percent of the marketplace we do not regulate, so we could not look at those transactions if we wanted to.

We certainly have not been able to look at transactions that took place from October through the end of December, because quite frankly, one, we have not set up a methodology, and two, we have not gotten the adequate information. That was the beauty of the $150 breakpoint where we would get the weekly information, and we are going to do that.

Let me clear this up, as well. No matter what we are talking about here, no matter how many times we want to talk about price caps or market mitigation or anything else, there is one way to solve the market power problem. When you have more supply, you have less market power.

Mr. WYNN. But we still have to come back to what we are dealing with.

I know my time is about up. If the chairman would indulge me, I would like to ask Mr. Massey to respond on the question of the

80 percent of the transactions that were excluded which Mr. Hébert has suggested were justifiably excluded. That may or may not be the case, but since I believe it was cited in your dissent, I would like you to respond.

Mr. MASSEY. I don't think they were justifiably excluded. I think the standard that the Commission chose limits the availability of refunds, and it is illogical, as far as I am concerned.

No. 2, I may be wrong about this, but I think the only transactions that were reported to us were jurisdictional transactions.

Mr. WYNN. Within your jurisdictions.

Mr. MASSEY. Yes. So I don't think it is true that 53 percent of those were nonjurisdictional transactions.

Mr. HÉBERT. I was actually speaking to the ISO's numbers in that. Those numbers did include that.

Mr. WYNN. I would like to ask the other Commissioner.

Ms. BREATHITT. Mr. Wynn, I voted for that order setting up the refund methodology. From my understanding, from a tough day to get an order out, in my conversations and briefings with senior staff, the figure and transactions that the ISO asked us to refund, once we took out the nonjurisdictional entities that we do not regulate and we looked at the month of January only—because their filing captured more transactions over several months—it is my understanding that we captured 70 percent of the transactions that the ISO filing would have captured if you compare what we did in January to what they requested for the month of January alone, backing out the nonjurisdictional entities.

So we captured 70 percent of their figure. And I think it is a point that I have been wanting to make this afternoon, because if we look at just the numbers of transactions, we are not comparing the same thing.

Mr. WYNN. Thank you, Mr. Chairman.

Ms. BREATHITT. One more point. Starting in May, we will be going to a more permanent market monitoring plan. And if I find between now and May 1, when we go to that permanent one, that the methodology that we are using now needs to be adjusted or tweaked, I will be willing to do that.

Mr. BARTON. The gentleman from Oregon is recognized for 5 minutes.

Mr. WALDEN. What percent of California's energy does FERC regulate, Mr. Chairman?

Mr. HÉBERT. About 47 percent.

Mr. WALDEN. Forty-seven percent of that consumed by California is under your regulation? California, then, has the ability to regulate the other 53 percent under some sort of wholesale price cap. Is that correct or not?

Mr. HÉBERT. Actually, so many of their transactions with co-ops, communities, public power administrations, do not go through our jurisdiction. They certainly have the ability through the ISO to treat transactions accordingly, and that would be within their realm, and certainly not ours.

Mr. WALDEN. Can you tell me, what is California doing in terms of the wholesale controlled price on the power they do have jurisdiction over? What have they chosen to do?

Mr. HÉBERT. At this point? I don't know what they are doing at this point. We have somewhat changed the scheme of things. They are moving around the PX now and not through the PX. We have returned 25,000 megawatts back into the system. So I will have to say they are making some very important strides in California.

The one thing that they are not doing, where they are not stepping up to the plate, is trying to get some new supply online.

Mr. BARTON. Will the gentleman yield?

Mr. WALDEN. Yes.

Mr. BARTON. I am told that the State of California does not have jurisdiction over municipal rates or co-op rates. Is that true or not true?

Mr. HÉBERT. That is correct.

Mr. BARTON. So at the wholesale level, if it is not FERC jurisdictional, then it is not jurisdictional?

Mr. HÉBERT. That is correct.

Mr. BARTON. Okay.

Mr. WALDEN. So, Mr. Chairman, are you saying that no one has control over that that is not controlled by FERC?

Mr. BARTON. They are subject to the——

Mr. HÉBERT. The point is if you are going to subject them to a price cap, if we are, they will be free and clear of that price cap.

Mr. WALDEN. The 53 percent.

Mr. BARTON. They are subject to the market negotiations between the supplier of the power, i.e., the municipal, and the consumer, whether it be retail, the city council, or wholesale, a commercial user, but they are not subject to FERC jurisdiction and not subject to the PUC State of California jurisdiction is my understanding.

Mr. WALDEN. So less than half of the power consumed in California could be affected by rate caps?

Mr. HÉBERT. Correct. Which is one of the main reasons why it is totally unworkable.

Mr. WALDEN. What could happen, then, to that being produced in California? Is there anything that stops that rate from spiking if you cap the wholesale market that you do have jurisdiction over?

Mr. HÉBERT. You are saying, would there be anything that would stop the 53 percent from spiking?

Mr. WALDEN. Correct.

Mr. HÉBERT. Not that I am aware of. And probably what it would do is it might spike, but it will most assuredly be exported somewhere other than California.

Mr. WALDEN. Can you elaborate on that? Why would it be exported?

Mr. HÉBERT. If they are going to be subjected to perhaps a 25 percent adder, cost-plus cap, you can bet they are going to maximize their opportunity cost somewhere else, which is one of the reasons that you saw that while the demand curve was somewhat constant between 1999 and 2000, they were not getting enough supply in, partially because of caps in place and partially because of weather.

Mr. WALDEN. Help me out here, because what I hear from some is a price cap at the wholesale level that you have jurisdiction over,

the 47 percent or whatever it is, would have a short-term positive impact.

What I hear you saying, though, is it could actually have a short-term negative impact because the 53 percent that you do not regulate could go elsewhere?

Mr. HÉBERT. In fact, that is absolutely true. The studies that have been done by the staff also show that as the price went down, the average price went up, which proves your point out.

Mr. WALDEN. Say that again. What do you mean?

Mr. HÉBERT. As the average price from $750 went down to $250, the average price per megawatt hour in the State of California went up.

Mr. WALDEN. Price caps could actually drive up the cost of power?

Mr. HÉBERT. They did in that case.

Mr. WALDEN. How broad a sample is that case? Is it a one-time issue?

Mr. HÉBERT. I don't know the exact sampling. I can get that for you. I will be glad to provide that for you.

Mr. WALDEN. Are you aware of any energy companies that had proposed to add to the supply in the West or in California that, since this talk of price caps, have decided to take their money elsewhere?

Mr. HÉBERT. They seem to have some trouble entering into long-term contracts at this point, although I have seen and heard today—not seen, but heard—that they signed a contract for, I think, 1,500 megawatts for this summer with Dynergy.

The important thing is what megawatts are going to be brought on for the summer. But then again to get back to a comment, actually, that was brought forth through some comments that Secretary Abraham had made, if you look at the opportunities that have been passed on, in other words, there was a conversation and some testimony given by the Secretary that was right on point, suggesting that in fact they could have signed up for $55 a megawatt back in November.

If you look at that on an annual basis, that itself, had they done it, would have saved $5 billion in California.

Mr. WALDEN. Who disallowed them from doing that long-term contract?

Mr. HÉBERT. There are two sides to that story. One is that in fact the State CPUC was not allowing them to move into the forward markets and was pushing them into the spot market, which quite frankly was very volatile, a very wrong move.

The other side of that is that they did not maximize their opportunity within the forward markets as well.

Mr. BARTON. The gentleman from Arizona, Mr. Shadegg, for 5 minutes.

Mr. SHADEGG. Thank you, Mr. Chairman.

I was intrigued by my friend, Mr. Markey, when he talked about trying to send price incentives to the clouds to induce raining, and making fun of that whole series of thoughts, and indeed making fun of the idea of sending price incentives at all.

That line of questioning or commentary might be apropos if the only problem here were lack of rain; but, of course, the only prob-

lem is not a lack of rain, it is a whole series of problems that have converged together at the same time.

He said he is worried about protecting Granny and thought we needed to insulate Granny from the consequences of her conduct, and that she did not create the system so she should not be punished for it.

My concern here is that if we look at what happened in California, I think we will see a series of bad decisions by governmental bodies. And if we are to protect Granny, I believe at the risk of making another bad decision by a governmental body, that worries me.

Mr. Massey, I am fascinated by your testimony. I think, quite frankly, at the end of the day I understand you basically to say that you agree that the long-run price caps send the wrong signal. You certainly have agreed here today that we have artificially low retail prices in California, and indeed, I think you called them ridiculous or absurd. You have used the word "dysfunctional" a number of times to describe the market in California.

You would agree with me in part that it is dysfunctional because retail rates are capped and wholesale rates are not capped. You would say that causes the market not to function, would you not?

Mr. MASSEY. I think that is part of the problem.

Mr. SHADEGG. You would also agree it is dysfunctional because we have a lack of supply compared with demand; is that right?

Mr. MASSEY. Yes.

Mr. SHADEGG. You would agree that lack of supply is driven by the reluctance of the people in California, and indeed the governmental bodies in California, to site and allow the construction of new power plants?

Mr. MASSEY. That has been true in the past. I don't think it is true now.

Mr. SHADEGG. I hope you are right. I would only note in a poll taken in February, 57 percent of the people in California say there is no energy shortage, even now. This is an article from the March 10 newspaper discussing a proposed 550 megawatt power project in Southgate, apparently located near Downey, California, in the L.A. Basin, where they have dropped the plan to build a plant.

It seems to me one of the things we have done is we have a dysfunctional market in that the people of California, because they have capped retail rates, capped at a ridiculously low rate that they do not even realize there is a crisis. They are turning down plants and they are saying—almost two-thirds of them are saying there is no crisis.

So we have a dysfunctional market because there is a lack of supply. We also have a dysfunctional market because we have a lack of transmission. You would agree with that?

Mr. MASSEY. I think I would. I think Congress should transfer that siting decision to FERC.

Mr. SHADEGG. When I was traveling with the Chairman, we were told the cost of building and siting a plant is anywhere between 2 and 3 times as much as anywhere in the country, and the time it takes is somewhere in the neighborhood of 10 times as long as it takes elsewhere in the country.

Let me ask you, each of those problems involve government kind of, I think, messing with the marketplace and distorting the reality: retail caps, by their so-called deregulation; failure to site plants; failure to site and construct transmission.

As I understand the California law, it also caused one of the problems we are here discussing today, which is the overcharging, because the California law mandated, correct me if I am wrong here, that the price be driven not by a mix of long-term and short-term contracts, but, rather, be mandated by the short-term spot market.

Is that not correct?

Mr. MASSEY. That is exactly right.

Mr. SHADEGG. So all four of those are government-created problems that create this dysfunctional market. You would agree with that?

Mr. MASSEY. I do agree.

Mr. SHADEGG. Okay. I am not sure that the right answer, then, is to set other caps.

You said just a moment ago, in response to a question by one of my colleagues, that one of the reasons why there was inadequate construction of new generation was because there was uncertainty through the nineties on whether California was going to deregulate or not.

Mr. MASSEY. Yes.

Mr. SHADEGG. Would you not agree that if you impose wholesale price caps now, will there not be uncertainty in the future as to whether or not those price caps, which you say are going to be temporary, will not in fact become permanent or long-term and therefore discourage future construction?

Mr. MASSEY. That argument is always raised. I think it depends on how we do it and whether the marketplace senses that we are in fact committed to long-term, market-based solutions. I am myself, but I think it depends on how we do it.

If we exempt new generation, if we get——

Mr. SHADEGG. That is the point. I have the idea of exempting new generation, so I am encouraged to come in and say I will go ahead and build new generation because they are exempting me now. But how will they know 12 months from today that this same Commission and Congress may say, no, prices are still high; we are going to cap rates, but we won't price it if you build it after next June rather than this June.

Mr. MASSEY. They all operate in a marketplace in which they are very much aware that my Agency has the statutory obligation to ensure just and reasonable prices.

Mr. SHADEGG. That is a difficult point.

Mr. MASSEY. Yes.

Mr. SHADEGG. That creates a problem.

Mr. MASSEY. They all know that.

Mr. SHADEGG. They all know that government can make bad decisions, and we have just cited four of them. I agree that there is a problem with gouging or bad market incentives in the past, but I am worried about repeating those in the future.

You said in your oral testimony, point blank, that price signals have been sent. I think you said that in the context of signals to

outside producers to come in and build because the prices are high. But you would agree with me that price signals have not been sent to the people of California, when 57 percent of them agree or believe that there is no shortage and when they are turning down future power plants? You see both sides of the price signal issue?

Mr. MASSEY. Of course. Of course. But I say again, my agency has declared the market to be dysfunctional. We have declared prices to be unjust and unreasonable.

It is extraordinarily difficult politically for State policymakers to flow those through, although I think retail prices are going to have to increase, and retail customers are going to have to see a price signal.

Having said that, State policymaker decisions do not relieve me of the obligation to ensure just and reasonable wholesale prices. There is no exception in the law.

Mr. SHADEGG. I understand that. You keep using the word "dysfunctional market." I think we have all agreed that four of the major factors that have caused this to be dysfunctional are not greed on the part of the utilities, though that may be there, but very bad government policies.

Mr. MASSEY. Yes.

Mr. BARTON. Let the record show we gave you double time. We reset the clock.

Mr. SHADEGG. Let the record show I was not the only one who got double time.

Mr. BARTON. But you were one of the ones that got double time.

The gentleman from North Carolina is recognized for 5 minutes.

Mr. BURR. Clearly, there was one hell of a precedent set while I was gone. I will take advantage of it.

Let me read a statement that is attributed to the Governor and just ask for your comment. The Governor said in his State of the State speech on January 8, "Never again can we allow out-of-State profiteers to hold Californians hostage."

Could I ask each one of you to comment as to whether you believe that the Governor's statement is accurate as it relates to the suppliers that have supplied that State?

Mr. Massey?

Mr. MASSEY. I will say that for a politician at the State level that is trying to get a handle on the situation——

Mr. BURR. I am asking you to address whether the companies who supply on a wholesale level fit the description that the Governor of California referred to as them holding Californians hostage.

Mr. MASSEY. No, I don't agree with that. I think there has been some profiteering. I think there has been withholding. I think there have been abuses that we have not ferreted out.

But to take that kind of swipe at an entire industry, I don't agree with that.

Mr. BURR. We will get to some of the reasons that possibly the price went up.

Commissioner Hébert?

Mr. HÉBERT. Again, I would rather not get into speculation as to what he intended. But as to whether or not I agree with that, I guess it depends on how we define profiteers.

Mr. BURR. He said profiteers—"to hold Californians hostage."

Mr. HÉBERT. I think it is inaccurate; inaccurate in that it does not complete the subject class. If the subject class is profiteers, then you have to include the in-state profiteers, the munis, the co-ops; other people who were involved in this, as well. So I think it is very unfair to segregate the subject class.

But let me speak to something quickly in regard to that.

A moment ago my colleague, Commissioner Massey, was talking about the rates and how we found many to be unjust and unreasonable. Actually—and I don't have the language in front of me—but I am pretty sure that the language was, we found rates to be unjust and unreasonable at certain times during certain conditions. It is a little different language there. I know we are talking about semantics, but I think it is important that you understand that.

Since we are talking about the profiteers, we have already concluded that for half the marketplace, FERC cannot do anything about it. As you know, through the December 15 order, we put pressure, downward pressure if you will, to have less of a spot market. A year ago, the spot market was nearly 100 percent in California. Now we are hoping it is somewhere near 5 percent.

So if you get the bilaterals out of the way, which is where we are trying to press them toward—now we are talking about capping prices, but we are talking about capping 5 percent of the marketplace.

Mr. BURR. I can assure you, anyone who was in this institution in the last Congress was very attuned to making sure that we understand the definition of words. So I appreciate your clarifying that.

Mr. HÉBERT. Thank you.

Ms. BREATHITT. I believe the Governor may have felt that way, but I think it was a generalization that I don't agree with, although I concur with Commissioner Massey's comment that while it was a generalization that I do not agree with, I do think that there have been instances of market power abuse and withholding.

Mr. BURR. I will go back over something my colleague, Mr. Walden, commented on.

Last summer the volatility of the spot market reinforced the need for utilities to be able to enter into bilateral long-term contracts. Duke Power is my power supplier in North Carolina. Duke offered to supply the needs to San Diego Gas and Electric on a long-term basis at a price of $55 per megawatt hour for 5 years.

In your opinion, tell me how an offer like that is profiteering and holding Californians hostage. Now, that is not ultimately what California paid for their power, because they would not allow that contract to be entered into, but Duke Energy was willing to sell for 5 years at $55 a megawatt, to sign a contract with San Diego Electric.

Tell me how that is profiteering and holding Californians hostage.

Mr. MASSEY. That sounds like a good deal to me. I am sure that many of—that the utilities in California wish they had those kinds of bargains available to them now. But of course they don't, because the spot market is so high-priced it affects the long-term price in forward contracts.

I think in retrospect, that looks like a pretty good deal.

Mr. BURR. Isn't it true that over the last decade consumption has grown 25 percent and generation capacity has gone down? Is that not a reality, or 29 percent?

Ms. BREATHITT. Congressman, that is 5.5 cents a kilowatt hour. Hindsight being 20/20, I am sure they would have loved to grab that deal now.

I have been somewhat disappointed in my reading in the trade press of the pace at which bilateral contracts are being negotiated, and we had begun that process before a FERC ALJ, and then it moved to the Treasury Department in the last days of the Clinton Administration. Now those negotiations are occurring at the State level, and we do not have a lot of information on the success of moving the spot market into the bilateral market for this summer.

Everything that I have read is that the contracts are beginning in the fall, or even later than that. So I do not know how successful that is.

Mr. BURR. Commissioner Massey said that hindsight is a wonderful thing. I would tell you when you have a 25 percent increase in consumption and you have a reduction in your generating capacity, it does not take hindsight to realize that potentially you are headed off of a cliff that actually we saw this year.

Let me ask one last question, and then I know Commissioner Hébert has something to add.

Mr. BARTON. This round will be your last question.

Mr. BURR. We are several months into this crisis. Tell me what California has done to increase the generating capacity within their State; not relying on the outside, on the profiteers and individuals who are holding California hostage, but what specifically has California done to increase the generation, the generation capacity within their State?

Ms. BREATHITT. I have been told by FERC senior staff that the California electricity siting authority has sped up their review to 21 days, but that is just one level of the siting. Then it has to go through all this local siting, and it gets bogged down there.

So I have been told that they have sped up their siting timeframes significantly at the State level.

Mr. BURR. What was their siting timeframe before, do you know?

Ms. BREATHITT. A year or 2. I don't know. It was a long time.

Mr. BURR. It is amazing how efficient you can get when you have a problem.

Commissioner Hébert, was there something you wanted to add?

Mr. HÉBERT. Let me add to this one thing that I think you will find important.

One of the questions is what is California doing, but also what have they not done? The things that FERC has asked them to do to help us help them, if you will, that they have not done is a congestion management plan has not been filed. They are the only State yet not to file an RTO. There was a deadline October 15; one, January 15. They have yet to file anything on a regional transmission organization plan.

A governing board, that is inconsistent with the 12/15 order; the PX failure to implement on as-bid pricing. SoCal for weeks failed to stop selling its own generation through the PX; creditworthiness;

a tariff provision the ISO failed to implement properly; slow to move toward a more balanced protocol, but they are moving there.

This announcement today with Dynergy is important. I am not convinced California is doing everything it can to expedite construction. It goes back to my point. They have not turned the first shovel on anything meaningful.

But we got a letter today, actually, that I shared with my colleagues, after we issued an order last week looking for short-term and some long-term remedies for removing obstacles, if you will; something that the FERC could do to aid and assist California.

I received that today from Governor Gray Davis. I will be glad to give you a copy.

And it says I understand if the FERC is willing to do everything within its power to encourage the construction of additional natural gas supply transmission lines to bring needed natural gas and energy supplies to the State of California for its possible usage, and plants and hope to bring on line not later than July 1, 2001, including all activities that will help expedite licensing and approval of such as a resolution of environmental and other regulatory concerns will help meet critical construction deadlines and will help relieve the energy challenges we are facing.

The Federal Energy Regulatory Commission's assistance in this regard will serve the public interest and help greatly to meet the challenges that exist in the State of California. So there is good news. We have got a good news letter here that basically says that the Governor is thankful for action we have taken to help them.

The other thing I would like to quote is the question you asked about Duke and the $55 per megawatt hour, which is the one that I quoted earlier, that actually Secretary Abraham had brought out in his discussion, that would have saved $5 billion over a 1-year period, but here is the opposite of that, too, and this is the type thing that we don't think about, but I must think about as the Chairman of the FERC.

At $55 a megawatt hour, chances are, December, January, February, March, because of——

Mr. BARTON. But they would have entered it willingly. They would have just—their stockholders would have got on them at the next meeting.

Mr. HÉBERT. The secret is a balanced portfolio.

Mr. BARTON. They are probably happy that California didn't take them up on it.

Mr. HÉBERT. Oh, they're probably ecstatic.

Mr. BARTON. That is what they are celebrating in North Carolina.

Mr. BURR. We celebrate every day in North Carolina.

Mr. BARTON. Not celebrating the NCAA basketball tournament from North Carolina's perspective.

Mr. BURR. We still have one small entry, Duke.

Mr. BARTON. And Texas has none. I don't think we got even past the first round.

Is LSU still in?

Ms. BREATHITT. No, but Kentucky does play Duke Saturday night.

Mr. BARTON. Oh.

The gentleman from Virginia. We are going to do a second round. I would ask if you let Mr. Boucher do his questions, and if you all want to take a quick personal convenience break, then I have got questions, Mr. Shadegg has got questions, Mr. Markey has got questions. So we are going to do at least three more questions. Mr. Boucher has got a pending engagement. I am not going to let him go now, and if you want to take a quick break, then we will come back.

Mr. HÉBERT. Mr. Chairman, we could take turns if that would be convenient. I may stay gone longer than the rest.

Mr. BARTON. We may want to ask all three of you the same question.

Mr. Boucher.

Mr. BOUCHER. Thank you, Mr. Chairman. I just want to spend a moment now talking about the methodology that the Commission has employed in setting the rate screen, in the case of January, $273 per megawatt hour; in the case of February, a much higher number, $430 per megawatt hour; and this is the number above which you then determine that the rates that are charged for the transactions are unjust and unreasonable.

Now, I am told that there was a time in the not-too-distant past when electricity at the wholesale level was being priced at something on the order of $30 per megawatt hour. Now, maybe that is low, but I am told that that, way back in the dark ages of 1998-1999, was the price; and in view of that historical record, one has to wonder if your methodology in arriving at these numbers of $273 for January and $430 for February is really based on an average of all of the costs of the utilities in California, or whether you are only looking at the cost of the most inefficient of the generators selling power into the State.

Which is it? Is it the broader measure of all of the utilities in California, or is it the more narrow measure of only the most inefficient of those generators, and then if it is the latter, how can you justify that? If—in fact, if it is the latter, I would strongly encourage you—Ms. Breathitt, taking you up on your suggestion that you would be willing to look at this methodology and alter it if some alteration appeared to be necessary as you begin to look at the months that are subsequent to January.

So let me ask you the basis on which you have arrived at this number. Is it an average of all utilities' costs, or is it just the most inefficient ones?

Ms. BREATHITT. We used three of—we used the top three most inefficient power plants that were previously owned by the three investor-owned utilities. For example, with PG&E, it was their top three least efficient power plants, with SoCal Edison and with San Diego.

Mr. BOUCHER. Why did you choose the least efficient plants? Why did you not take an average of all of the utilities in the State?

Ms. BREATHITT. We then averaged those and came up with a price for a combustion turbine, using those. But we used those because in the tightest supply shortage, those units would be called on to operate, and those units—because California is under a market structure now, those units would have set what we call the

"market clearing price," and that is how the market is designed in California.

So we used those because those units would be called into service, and the cost recovery would be based on the most inefficient plants put into service.

Mr. BOUCHER. It would seem to me that at that time there would be a lot of generators selling power into the State who would have operating costs far below those most inefficient generators. And would it not be unjust and unreasonable for them to be selling power at a rate that is essentially the same as the least efficient of these generators—at a rate that is far below the rate that you were pegging for the least efficient of these generators?

Why would it not be unreasonable for them to be selling power at a lesser number than that? Why are you holding them to the same standard?

Ms. BREATHITT. They would have been selling power at a lesser number than that, but we found that market power would most be abused during that—the tightest supply demand conditions, and one of our goals in setting up a market mitigation plan was to capture transactions that would have been—transactions that would most likely have involved the abuse of market power.

Mr. BOUCHER. Mr. Massey, let me ask you for your comment on this methodology. Do you have any problem with the way that that proxy number is established?

Mr. MASSEY. Well, I do. I don't think we did what we said we would do. We said in our December 15 order that when we get the transaction information, the Commission will look at the transaction information that is submitted and we will look for market power, we will look for evidence of strategic bidding, we will look for evidence of withholding and so forth. We didn't do any of that. We simply set a threshold below which the bidders get at free and clear, and it has the impact of excluding most of the transactions that occurred during that month over $150.

And the point I have made before—I know I sound like a broken record, but if you are concerned about a $273 bid in stage three, you would be even more concerned about a $273 bid in stage two or stage one or where there weren't shortages at all. So it is, I think, illogical; and it gets worse for February where the price is $430, and the stage three limitation has the impact of giving 14,168 transactions above $430 a free and clear because they did not occur in stage three.

Mr. BOUCHER. Well, I understand the concern you have, and it is one that I share about limiting the orders just to the transactions that occur in stage three. My question was really directed more toward the formulation of the screen itself.

Mr. MASSEY. Oh, I think the formula was fairly generous as well, looking at only the inefficient 18,000 BTU units.

Mr. BOUCHER. Would you agree that it would be sensible to look at average operating costs of all of the utilities of the State, not just the least efficient ones?

Mr. MASSEY. That is another way you could do it.

Mr. BOUCHER. Is it a better way to do it?

Mr. MASSEY. It perhaps is. You could look at all the transactions. We have the actual data now, I think, before us. We don't actually have to use a screen.

Mr. BOUCHER. So you could look at the actual operating costs of each generator; is what you are saying?

Mr. MASSEY. Yes. The reason the Commission chose a screen is because it is easy to administer but it is not necessarily the most just way to go about it.

Mr. BOUCHER. Are you going to advocate some change in this methodology as the determinations are made with regard to, let's say, February and subsequent months, or maybe March and subsequent months?

Mr. MASSEY. I am, and I am concerned if this methodology is used for the period of time last year in which there is a refund effective date, almost no transactions will qualify for refunds because there were only 2 hours of stage three during all of the year 2000, and I think, going forward, we have to broaden our mitigation plan to hours other than stage three alerts.

Mr. BOUCHER. Okay.

Thank you very much, Mr. Chairman.

Mr. BARTON. We are going to take a quick—and I mean quick—personal convenience break, and I want the audience to let the testifiers have precedence on the facilities.

I am going to be back here by 5:15, so maybe 5:16. So if you all will take a quick run for whatever you need to run for, and then we will be back here in about 4 or 5 minutes.

We are in recess.

[Brief recess.]

Mr. BARTON. I see two of the Commissioners—there is the third. So if we could get our stars back and continue.

Okay, I want to apologize for keeping you past 5 o'clock, but at the Republican leadership meeting with the Speaker this afternoon, one of the items on the agenda anyway was what to do in California; and I have been asked to make a presentation to Chairman Tauzin later this week.

So we really—we have got to focus. So I—normally we wouldn't keep you here this late, but these are not normal times.

I want to put into the record a chart that was prepared by EIA about retail electricity charges around the country, and it shows that in Washington State from 1998 through the end of calendar year 2000 the retail rate charged to consumers was right at 5 cents a kilowatt hour. In Oregon it is fluctuating around 6 cents a kilowatt hour; in Texas, between 7 and 8 cents a kilowatt hour; in Michigan between 8 and 9 cents a kilowatt hour.

Here in the PJM market, in the Atlantic, mid-Atlantic Coast region it has been between 8 and 9 cents a kilowatt hour, and in California it has been between 10 and 11 cents a kilowatt hour. So we are talking a lot about a retail price signal.

I think the record—it is only fair to show that California is paying some of the highest retail rates in the country. Having said that, it is obvious that the market is still not working, because the wholesale rates coming into that market show the retail rate should be considerably higher than it is. But we will put this chart into the record at the appropriate point .

We have focused most of our attention so far today on a debate about price caps, wholesale price caps, and who is for it and who is against it, and whether they work or not; but it has been pointed out by the Chairman, the FERC only has wholesale jurisdiction over approximately 50 percent of the market in California. The State of California, on the other hand, has total jurisdiction on the demand side.

Now I would like to hear, first of all, is it your opinion as commissioners at FERC—if the State of California wished to put in a mandatory demand management program, does it have the authority to do that?

Mr. Massey says yes.

Chairman Hébert says yes.

Ms. BREATHITT. You are asking if the State has the authority?

Mr. BARTON. Does the State——

Ms. BREATHITT. More so than we do, in my opinion.

Mr. BARTON. Does the State of California have the authority to put in a mandatory demand management program? Because, let's be serious, you know, every one of you has testified—if not today, at some point in the last month between some committee of the House or the Senate—that you are not going to solve the supply problem this summer. There is anywhere from a 5,000 megawatt peak load demand shortage—I hear as low as 2000; I have heard as high 8,000. The average is around 4- to 5,000 that just ain't going to be there. So we need to look at the demand side.

Now, Mr. Markey has got and Mr. Waxman has got some ideas about efficiency standards for appliances—perhaps not a bad idea, very tough to implement this summer. So my first question for this round is, if the State wanted to, could the State put in a mandatory demand management program that would cause certain factories to shut down at certain times of the day, protect that certain users, such as hospitals and schools and low income—so that they took this demand supply shortage situation and actually proactively tried to manage it?

Could the State of California do that if they wished to?

Ms. BREATHITT. Yes, and it is my understanding from having regulated at the retail level that there are protocols for periods of outages, like the most critical—hospitals, nursing homes, et cetera—would stay—would have access to power.

Mr. BARTON. We will ask the State on Thursday. They have several officials. We will ask them what they are doing on the demand side, but I just want to get it on the record.

From a Federal perspective, every commissioner—Republican and Democrat, there is unanimous agreement that the State could manage its demand this summer if it wanted to, all right?

Mr. HÉBERT. Absolutely, and there are lots of different ways to do it.

Mr. BARTON. All right, second question.

On the supply side there are a number of small energy suppliers, electricity suppliers, in California that are called QFs, qualified facilities, under PURPA, I believe. Many of them are shutting down not because their equipment is worn out, not because of air quality constraints, but simply because they have not been paid; and if they are a natural gas qualifying facility, they don't have the

money to keep supplying power into the market if they don't get the money to pay for the power they have already supplied.

What, if anything, could the FERC do to require the qualifying facilities that have shown good faith, have put power into the market in California which is on the order of 1,500 megawatts, to make sure that they are paid? Could you tell the State of California to pay those bills, or is that again a State decision whether to pay for those bills?

Mr. MASSEY. There is an argument that we could tell them to pay those bills because of the special provisions of PURPA, that those bills ought to actually have a priority in payment because of PURPA.

I don't know whether that is the right answer, but I know that there are strong arguments that my agency could direct a payment.

Mr. BARTON. So, Commissioner Massey, you say that the FERC could say that those bills had to be paid?

Mr. MASSEY. I think there are good arguments that we could say that.

Mr. BARTON. You are not saying you would say it.

Mr. MASSEY. No.

Mr. BARTON. Chairman, would you say that you could? Do you agree there are good arguments where you could dictate the State to pay those bills or the utility to pay those bills?

Mr. HÉBERT. Not directly, and let me tell you why.

The one thing we have done is, like the refunds we spoke about, the refunds that came through January and February; we said they could either refund or be held against accounts receivable. Implicitly that is one way we can do something.

Now, obviously we can't reach out and touch those QFs, but through the file rate doctrine, it is generally accepted and legally accepted that wholesale charges prudently incurred, or wholesale costs prudently incurred, shall be passed to the ratepayers absent some preconditioned agreement between, perhaps, the State of California and the utilities.

Mr. BARTON. Okay.

Commissioner Breathitt.

Ms. BREATHITT. Mr. Barton, I do not know the answer to your question. If you would like me to, I will confer with some of the attorneys back at the agency.

Mr. BARTON. That is fine with me. Just get me the answer by close of business Friday.

Ms. BREATHITT. Okay.

Mr. BARTON. We are going to make some decisions this weekend.

Yes, sir.

Mr. HÉBERT. My guess is, Mr. Chairman, at some point, due to the file rate doctrine, some judge somewhere, somehow, will force those costs through.

Mr. BARTON. Well, any part of a comprehensive plan to minimize the shortage has got to put into play the existing facilities that could provide power, if they could be paid for the power they have already supplied and paid enough money to operate this summer.

It is crazy to take 1,500 megawatts off the table. Most of it is clean power, most of it is relatively new power. So that is just—it is going away if we don't do something.

Mr. Massey.

Mr. MASSEY. I agree with you, Mr. Chairman. This is a problem that has to be solved before the summer.

Mr. BARTON. Last question, and then I will go to Mr. Markey.

The fly in the ointment that nobody is talking about today so far is the permitting process for new power plants in California. Commissioner Breathitt said she talked about it, so we will give her a halo for that.

What role, if any, does the Federal Government and the FERC have in expediting or reviewing applications for new power plants in any State—not just California, but specifically California, but generally, any State? Is there a FERC role in new plant certification permitting?

Ms. BREATHITT. There is no role, Chairman Barton. We attempted to carve out a role through the RTO process, to consult with the RTO and its members and State——

Mr. BARTON. But under current law, the FERC can't dictate a permit application?

Ms. BREATHITT. No. And in my opening statement, I advocated a change in the Power Act.

Mr. BARTON. Okay.

Mr. HÉBERT. Only one exception to that as to generation, and that would be the licensing of a hydro facility.

Mr. BARTON. On Federal lands perhaps that would be an exception, too, would it not? If you wanted to build a new power plant on Federal property in California, is that an exception, or would that have to get a State permit?

Mr. HÉBERT. It is going to be a State permit and they are probably going to have, quite frankly, substantial dealings with the Department of Interior.

Mr. BARTON. Okay.

Mr. Massey, Commissioner Massey.

Mr. MASSEY. I agree with those answers. Generally speaking, we have no role with respect to certification of plants.

Mr. BARTON. Okay.

Now, current law, there may be an exception, but generally there is no Federal role. If you all were us—we can write law; that is what this subcommittee does.

Would you want us, in an Emergency Electricity Act of 2001 to give the FERC the right to override all State permitting requirements and set a time certain—not yes or no whether the plant should be built, but set a time certain that the State has to make a decision? Instead of its taking 3 years, 7 years, whatever, we said the State of California and every other State that is above the national average has to meet the national average within 6 months so that all decisions are made within 6 months effective May 1 or June 1, 2001.

In other words, would you want us to change the law, if you were us, on permitting? I want you to answer the question.

Mr. HÉBERT. I will be glad to start.

Mr. BARTON. You can say yes or no. It is a real question.

Mr. HÉBERT. The real answer is, I don't know; and let me tell you why.

Mr. BARTON. Okay.

Mr. HÉBERT. And I will tell you the answer as I see it.

Siting of generation has been decided by States. There is a long history there, and there is a reason. I have handled the retail side of it, and here is the perplexing situation you get yourself into. Who is to decide if California wants to say, we don't want——

Mr. BARTON. We will still let California say yes or no. We are just going to say, they have got to say it sooner.

Mr. HÉBERT. No, but I am just saying, who is to say if they decide they don't want new generation and, quite frankly, they are going to embrace blackouts and brownouts; and they are going to embrace two and three times their current retail rates, as compared to someone perhaps maybe like a Texas, maybe like a Mississippi.

Mr. BARTON. Again, we are not dictating they have to say yes; we are just saying in a time certain—Mississippi can make a decision in 3 months, Ohio can make a decision in 6 months, Texas can make a decision in 9 months; the great State of California apparently can't make a decision in 3 years most of the time.

Mr. HÉBERT. I guess the answer then changes to, if you are going to cross the bridge and say we are going to make this energy decision and make it a national and Federal decision, then the answer would be yes. But——

Mr. BARTON. We can make it temporary. We don't have to make it permanent.

Mr. HÉBERT. I understand. But at the same time I do think that is a part of the beauty of Order 2000 and the RTOs, because understanding that the markets are national and regional, we are going to try to promote some of that.

Mr. BARTON. My time is way over.

Commissioner Breathitt, would you want an emergency electricity act to require that the States make permitting decisions in a time certain?

Ms. BREATHITT. I think it would be cleaner to amend the Federal Power Act, at least temporarily, giving siting authority to FERC——

Mr. BARTON. So you want the authority. You don't want to just tell them they have got to do it; you want to do it?

Ms. BREATHITT. I am——

Mr. BARTON. You want to be the Power Queen of the West for the next year. That's okay.

Ms. BREATHITT. I wouldn't go that far.

Mr. BARTON. All right. So you say, temporarily give the authority to the FERC.

What about you, Commissioner Massey?

Mr. MASSEY. I think her comment was on transmission.

Mr. BARTON. I am talking power siting.

Mr. MASSEY. On generation, you raise an interesting point because FERC does not have the tools to ensure a just and reasonable wholesale market, because so much authority is with the States.

So, on an emergency basis, I think it is an intriguing idea. However, if you set a time limit, you might just get "no" answers from the States.

Mr. BARTON. I don't feel—I very strongly—I can't stand here or sit here and say I want the Federal Government to make all these decisions because California can't do it, you know. I think States have the right to make bad decisions, and have made good decisions; but when that—when a particular State's particularly bad decisions over time impact the rest of the region and to some extent the country, I think it is in the Federal role to come in on a temporary basis perhaps and say, you are going to have to expedite making those decisions, and if we force you to in a constrained period, you might say, yes, more than you have in the past.

Mr. HÉBERT. If I might just add two things——

Mr. BARTON. My time is way over, so Mr. Chairman and then Mr. Markey.

Mr. HÉBERT. Quickly, one is, don't hard-wire it, don't be prescriptive if you are going to do it; and the second is—and I have testified to the effect that some type of one-stop shopping is a good idea.

Mr. BARTON. So you are kind of leaning toward Commissioner Breathitt's, let you folks do it for a while.

Mr. HÉBERT. No, I didn't say let us do it.

Mr. BARTON. You said one-stop shopping.

Mr. HÉBERT. I am not suggesting that. I will do either, but——

Mr. BARTON. Set up a regional commission, let them do it?

Mr. HÉBERT. I do think the RTOs move in that direction.

Mr. BARTON. Okay, my time has expired.

Mr. Markey for 5 minutes.

Mr. MARKEY. Thank you, Mr. Chairman.

Mr. Chairman, would you support immediate initiation of a formal 206 investigation?

Mr. HÉBERT. Beyond what is going on now?

Mr. MARKEY. Yes, so that consumers could get a refund if FERC found that prices aren't just and reasonable.

Mr. HÉBERT. I have been open to any and all considerations. I have not seen the need at this point to initiate further 206 proceedings.

Mr. MARKEY. Commissioner Massey makes the case that we have reached that point, that the conditions are there.

Where do you disagree with Commissioner Massey? What is wrong in his analysis?

Mr. HÉBERT. Well, obviously we disagree on price caps. I don't think there is any way to price-cap 5 percent of the market and have any effect in a positive manner. If you are going to have price caps, it is certainly evident that you are going to have to have some type of 206.

Mr. MARKEY. So do you agree with Commissioner Massey that widespread withholding may have occurred?

Mr. HÉBERT. I would rather speak to our December 15 order and say that we found that market power may have existed during certain conditions and certain periods.

Mr. MARKEY. Is it possible—if in your mind that widespread withholding did occur, is that something that you think you should look at?

Mr. HÉBERT. I think we continue to look at that. I think that is our role.

Mr. MARKEY. Why not initiate a formal proceeding in order to formally look at the question of whether or not energy companies were deliberately withholding energy? Why doesn't that make sense?

Mr. HÉBERT. Well, obviously I think the Commission is moving in the right direction. I think we are moving in the right direction as to market mitigation, sending the right signals while making certain that a portion, that 5 percent of the spot market, does not create a further problem.

Now, if I didn't believe that, then it may lend itself to some type of further 206 investigation, but the fact I do believe it moves me away from it.

Mr. MARKEY. I appreciate that, but Commissioner Massey is saying that we are heading toward an abyss in the West this summer, an electricity abyss. Don't you think it makes sense for us to start now with a formal inquiry to make sure that there is not systematic gaming going on by these companies, because the profits are just so great that many companies might just find them irresistible, because ultimately the penalty that they might have to pay after the fact is small compared to the profits which they are able to reap and tipping Western consumers upside down.

Mr. HÉBERT. I understand your concern, and I am certainly sympathetic to it, as well as to the people of California. That is why this Commission has acted, we have acted in setting up a proxy price. We are looking for comments to come in on what we are going to do with market mitigation, and quite frankly—let me make it clear one more time because I really need this to sink in.

When you talk about me stepping in, the Commission stepping in, we three, you are talking about half of the marketplace; and now that we have pushed that 5 percent, we are not talking about the bilaterals. So we are talking about 5 percent of the spot market that perhaps we are going to intervene, and our direction is that we are going to give the profit-price signal while insulating against excessively and unjust and unreasonable prices, and I think that is what we are doing.

Mr. MARKEY. Well, what is the test that you are using in your mind as to how much worse it has to get before you will commence a 206 proceeding? What additional evidence do you need in order to convince you that Mr. Massey is correct in terms of his analysis of this inexorable path toward the abyss which the West is taking in this electricity marketplace?

Mr. HÉBERT. Let me be very careful in my comment because it is subject to rehearing. So my mind is open and I am considering.

But you are very good at trying to get me to say something, quite frankly, that I am not going to be comfortable saying; and I will just stand by the record and tell you that I think the order speaks for itself, it is on rehearing, and we are doing something.

Mr. MARKEY. Commissioner Massey, what is the nub of the disagreement that you have with Mr. Hébert? What is it that you disagree with him on in terms of your analysis of the crisis?

Mr. MASSEY. I think what it boils down to is a philosophical disagreement about the role of my agency in ensuring just and reasonable prices. I think that we have no choice legally but to do so. In addition, it is the right thing to do, and we can't rely on a dysfunc-

tional market that will not be fixed by this summer—and I think the law is clear on that—and that, frankly, we are not fulfilling our legal obligation.

Mr. MARKEY. Commissioner Breathitt, whom do you agree with in this fight?

Ms. BREATHITT. I have recently signaled my willingness to look at the whole notion of price mitigation or capping the market. What I would prefer to do, which didn't go as far as my colleague, Commissioner Massey, in calling for a 206 investigation, is—and we are going to do this—is to have an honest dialog with my State colleagues on April 6 in Boise. And they have—the State commissioners want to talk to us about price volatility in the West and what implementation issues there are.

So I first wanted to talk to my State colleagues to see——

Mr. MARKEY. But what would you want to hear from them? What is it that you could hear from them that would have you agreeing with Mr. Massey, that would then trigger a 206?

Ms. BREATHITT. What I would like to hear from them is that there is broad enough support to move forward. In other words, it would be very difficult to cap the market in three States only; it would need to be West-wide. I would need to be assured that there would be some participation of public power, because there is a lot in the West that is public power, and they would not be subject to that.

And I would also like to be assured that there was a way to provide price mitigation to what is technically a bilateral spot market. There is no mechanism in the West outside of California.

Mr. MARKEY. Does the Federal Energy Regulatory Commission usually wait for concurrence by the States before it initiates a 206 inquiry into fair and reasonable prices?

Ms. BREATHITT. It doesn't have to, but when you have got a disagreement among Governors whose States this would occur in and have something to say, quite frankly, about the matter, I think it makes sense to confer with my State colleagues.

Mr. MARKEY. If I could ask one final question, do you agree with Mr. Massey that we could be heading toward an electricity abyss in the West this summer?

Ms. BREATHITT. I don't know if I would use the word "abyss." I agree with Commissioner Massey that we are potentially headed for greater problems than we have thus far seen.

Mr. MARKEY. Greater than today by a significant magnitude, do you believe, in the middle of the summer?

Ms. BREATHITT. Yes, yes. I think that we could have more blackouts, that they won't just be rolling blackouts. And I said in my opening statement, I think prices could go even higher.

Mr. MARKEY. And when do you think we are going to reach the last clear chance in terms of time before we will lose our ability to deal with this summer issue? Do you think time is of the essence? Do you think we are reaching that point?

Ms. BREATHITT. I think time is of the essence.

Mr. MARKEY. Do you have a deadline in your mind—if I could ask each of you, when do each of you think you have to make a decision to avoid a real crisis in the West this summer? Do you have a deadline in your own mind?

Ms. BREATHITT. Whenever the heating season begins in the West, and I am told it is late June, early June. It is different from the East.

Mr. MARKEY. You think you have until then to decide?

Ms. BREATHITT. At the farthest edge of it.

Mr. MARKEY. So you don't think you have to initiate——

Mr. BARTON. The gentleman's time has expired.

Mr. MARKEY. Thank you, Mr. Chairman. Thank you for indulging me.

Mr. BARTON. It is a serious question, and it is what we are wrestling with, how much time do we have to do anything if we think there is something we can do.

Mr. MARKEY. Mr. Chairman, I am very concerned by the answers that I am receiving from the Commission in terms of the deadlines that I think are arriving.

Ms. BREATHITT. Mr. Markey, I also don't know, if Bill and I agree that this is the right thing to do, I have no idea what the practicality of our wanting to go down that path would be at the FERC.

Mr. BARTON. Chairman Hébert, and then we go to Congressman Shadegg.

Mr. HÉBERT. Real quick, Congressman Markey, a couple of things.

I think the Commission has reflected on what our last clear chance is, and I think that is what the market mitigation filing is about, and we are looking for those comments where we are going to hopefully have some plan that will mitigate any concerns through an ex-anti—through an immediate market mitigation plan on May 1 going forward. I think actually it came in from the staff for 1 year.

Now, when you are asking me for a last clear chance, the reason I can't accurately answer that for you is, I can market-mitigate 5 percent of the spot market now, which is what we are going to end up talking about.

But let me tell you what I cannot do and what this Commission cannot do; and you know this. We cannot build interstate pipeline. We can remove barriers, and we can make it easier to do it, which is what we are doing and which is what the letter is about. But then if I get them six pipelines, and they don't have enough takeaway capacity to deliver it once it gets there, I can't do anything about that. I can't site generation. This Commission cannot site transmission, can't build it.

So we can mitigate. There are things we can do. I think we are exercising our discretion, but so much of this, an unbelievable amount of this, is outside of the control of this agency.

Mr. MASSEY. May I have a 30-second comment.

The market mitigation plan only applies to the California spot markets. If we are to deal with price volatility elsewhere in the Western interconnection, we have to open a formal 206 investigation and set a refund effective date; otherwise, we have no authority to take any action whatsoever to mitigate price.

And we need to be doing that right now, because under the statute that Congress passed, the earliest date is 60 days hence from the time we open the investigation. So if we opened it today, it

would already be the middle of May before price relief could be effective.

Mr. MARKEY. I think that you should initiate the proceeding now, gather the evidence, proceed, and then if you decide, then you already have fulfilled your legal requirements. If you decide not to, nothing's been lost, but if you decide you have to, then at least you are in a period of time where you might be able to do some good.

Mr. BARTON. The gentleman's time has expired.

The gentleman from Arizona for the last question.

Mr. SHADEGG. I thank the chairman and I appreciate his indulgence of my colleague, because I have a fair amount of ground to cover myself.

Let me first say, my compliments to all three of you. Your testimony here today and your written statements are some of the most thoughtful I have seen while serving in Congress, and I appreciate that. These are difficult problems that we are dealing with.

I have a series of questions. The first one I want to direct to you, Commissioner Massey.

You said in your testimony, and you repeated it in answers today—maybe you said it just in answers today—that uncapped high wholesale prices this summer will not create one additional megawatt this summer. As I have read your testimony and your comments here today, I don't know if there was price gouging in the past. I think you are concerned about price gouging in the future, and I am too, but I want to look at that statement very carefully, "uncapped high wholesale prices this summer will not create one additional megawatt this summer."

You would agree with me that a higher price, a higher wholesale price, would incent the creation of additional megawatts, at least at some point in the future when they can be built; an assurance that you could recover the cost of what you put into a plant will encourage people to come in and build plants, right?

Mr. MASSEY. It will, but the constraint in Federal law is "a just and reasonable wholesale price."

Mr. SHADEGG. I am glad you raised that, because one of the comments I wanted to make during this series of questioning is, I think we have given you a near-impossible task. How you ascertain what a just and reasonable price is in the transition between a regulated market and unregulated market is extremely difficult. Indeed, I think the Congress may have given you an impossible task.

When we had a regulated market, we knew how to figure out what a just and reasonable price is. How we figure that out in this circumstance, I don't know.

I want to go to a second argument I would have with your assertion. You believe, for example, that one way to deal with the immediate problem in California is the concept of megawatts, that is, a large consumer of electricity coming back and saying, we will agree not to use electricity or we will agree to reduce our load or perhaps to reduce our load at certain times of the day. That is the concept of the megawatt. You would agree with me that in terms of producing an additional megawatt of electricity to be used this summer, a higher price for the wholesale cost of electricity would, in fact, encourage the exchange of megawatts by consumers back for others to use than a low price, would you not?

Mr. MASSEY. I would agree with that.

Mr. SHADEGG. So, in point of fact, a high price, if it is an uncapped high wholesale price, could in fact create additional megawatts of electricity, even this summer?

Mr. MASSEY. I don't know whether it could this summer or not. I think it depends on whether my agency and State agencies can work together to try to create a more robust demand side response between now and this summer.

The State of California has said that it hopes to come up with a 3,200-megawatt demand reduction for the summer. Now, I don't know how they are going to do that, but I commend them for trying.

Mr. SHADEGG. It takes me exactly to the next question I want to ask Commissioner Breathitt. You really asked the question, which we haven't discussed very much today, and that is what I care the most about, solutions for this summer. For example, you would agree with me, would you not, that creating some kind of a link between retail prices and wholesale prices—that is, getting rid of the unrealistic disconnection or disconnect between retail prices and wholesale prices—would be one thing we could do for the summer, wouldn't it?

Ms. BREATHITT. Yes. I talked about earlier that retail rates in California—and this is not in other parts of the West—are not reflective of the cost of energy, and that retail caps impede that; and in order for there to be a true picture of the whole value stream from the wholesale cost to the retail rate, if FERC gets involved in price mitigation at the wholesale side, then the State of California needs to do their part on the retail side.

Mr. SHADEGG. Well, certainly then one thing this Congress could do would be to do what it can to get rid of those unrealistic retail price caps or encourage the State of the California to begin to move those up to where they more appropriately reflect the market.

You would also agree that another thing we could do for this summer would be to encourage the megawatt concept that Commissioner Massey has talked about?

Ms. BREATHITT. Correct.

Mr. SHADEGG. And that also would be encouraged by a higher retail price and a higher wholesale price?

Ms. BREATHITT. I don't know how that would encourage a higher retail price. I think it just makes more megawatts available to the marketplace, but I think it also has some implications in terms of the work force.

Mr. SHADEGG. Can you provide—and I don't have time here today—but can you provide the committee with a list of other solutions for this summer that we might be looking at, because I am intensely interested in that and I don't think we have focused that much on it in your testimony. I would ask that of all three commissioners.

Commissioner Hébert, I want to make sure——

Mr. BARTON. Would the gentleman yield on that? We need that list sooner rather than later, like the end of this week, sometime Friday.

Mr. SHADEGG. I want to make sure I understood one of the points you made about wholesale price caps. As I understood it, you said

one negative context or consequence of a wholesale price cap, even a temporary one, this summer would be to discourage the purchasers of electricity in California, the wholesale purchasers, from looking at long-term contracts; is that not correct?

Mr. HÉBERT. That is correct.

Mr. SHADEGG. It will encourage them to look at short-term contracts because they don't have to worry about managing out into the future?

Mr. HÉBERT. Well, that is correct. In our December 15 order we put pressure on them to try to move away from the spot market toward the forward market. Now, if these entities are going to have the ability to buy a spot market product at a forward market price, why do they ever go to the forward market?

Mr. SHADEGG. I think it is a very good point.

I want to talk about another concept that we haven't discussed here today of price caps. If we cap the prices—and you are saying in the Western area; I will tell you in Arizona if you cap just the prices in California, I am deeply worried. If you cap them in the other—in a region, don't we still have a problem of an unfairness to other areas where that electricity might have been sold?

Mr. HÉBERT. Well, absolutely. What you are going to do is, you are going to cut yourself off in the West from Canada and Mexico.

Mr. SHADEGG. Is there any reason to believe, or do you have any authority—if you cap prices in the Western United States, do you have authority to force people to sell in the Western United States; or could they take the power they have and simply say, well, I am not going to sell into California, I am going to sell it somewhere else?

Mr. HÉBERT. That power is not vested in this agency. It is vested in the Department of Energy.

Ms. BREATHITT. But because of the Western interconnection, the power can only move around in the West because it can't cross into the eastern interconnection or to ERCOT. So when people who propose price mitigation believe that, the only way that it could be done fairly is if it were entirely in the West so you don't have electrons unfairly flowing out of one State into another one that isn't capped.

Mr. SHADEGG. But you would agree with Commissioner Hébert that that would cause a problem with regard to both Canada and Mexico?

Ms. BREATHITT. Only because power flowing into the United States from Canada and from Mexico would not be subject to that price mitigation.

Mr. SHADEGG. Would not be subject to that price mitigation.

Wouldn't that encourage capital formation, that is, the construction of plants outside the United States, encourage someone to build a new plant just across the border in Mexico or just across the border in Canada?

Ms. BREATHITT. I don't know the answer to that.

Mr. SHADEGG. I would suggest that it would have that effect.

I thank you very much. I appreciate your testimony.

Mr. BARTON. That concludes our questions. We are going to have the second part of this hearing on Thursday where we have officials from California and the private sector. At the close of that

hearing, I will sit down with Congressman Boucher and interested members of the subcommittee and decide what, if anything, we are going to do.

Mr. HÉBERT. Mr. Chairman, if I could have one point of personal privilege——

Mr. BARTON. You may.

Mr. HÉBERT. If you are looking at passing legislation, could I get you to put together a piece for me to expunge from all records any mention I have ever had of killing Granny.

Mr. BARTON. Well, we certainly will allow you to put a statement in the record that you love granting.

Mr. MARKEY. Can I say, once again, I know it is a metaphor; I know it is not literal here. I want to make that clear, that I understand.

Ms. BREATHITT. Mr. Barton, when I was having a conversation with Mr. Wynn and I was talking about the refund order, what I meant to say was that I believe that we captured 70 percent of the dollars, in comparing that to the California filing, not the transactions.

Mr. BARTON. Correct. Thank you.

We do want your thoughts on solutions, short-term and long-term. We understand the reason we have more than one commissioner is because honorable people can disagree honorably on solutions and that is a good thing, not a bad thing. If we all agreed up here, we wouldn't need 435 members of the House. So it is a sign of vigor that there is a vigorous debate within the FERC on these issues, and I want the record to show it is not definitive that we are going to do something legislatively.

But it is definitive, if this subcommittee is going to act to help the West on an emergency basis, it has got to do it within the next month. We can't be debating this in June and July. If we are going to do something, we have got to do it starting next week, at least attempt to put the package together.

So we will recess this hearing. It is going to reconvene Thursday at 10 a.m.

[Whereupon, at 5:55 p.m., the subcommittee was adjourned, to reconvene at 10 a.m., Thursday, March 22, 2001.]

ELECTRICITY MARKETS: CALIFORNIA

THURSDAY, MARCH 22, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON ENERGY AND AIR QUALITY,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2322, Rayburn House Office Building, Hon. Joe Barton (chairman) presiding.

Members present: Representatives Barton, Cox, Largent, Burr, Whitfield, Shimkus, Wilson, Shadegg, Pickering, Fossella, Blunt, Bryant, Radanovich, Bono, Walden, Boucher, Sawyer, Waxman, Markey, and McCarthy.

Also present: Representative Harman.

Staff present: Jason Bentley, majority counsel; Hollyn Kidd, legislattive clerk; and Sue Sheridan, minority counsel

Mr. BARTON. The Subcommittee on Energy and Air Quality second day continuing series of hearings on the electrify market in California will come to order. We are waiting on the ranking minority member to do the opening statements. By prior agreement, myself and Mr. Boucher will give an opening statement. I am going to go ahead and give mine and hopefully, by the time I finish, Mr. Boucher will have arrived and we can begin. I assume that all of our witnesses are here. I see the Honorable Mr. Freeman making his way, with his cowboy hat. Is Mr. Keese here? Hopefully he will arrive.

The lights went out again on Tuesday for half a million homes and businesses in the golden State of California. Newspapers are full of predictions that supply will not equal demand for much of this summer.

Today, the subcommittee will continue its focus on the electricity crisis in California specifically, in the West generally. Tuesday, we heard from the three Commissioners of the Federal Energy Regulatory Commission which oversees wholesale markets in the country. Today, we will hear from California State agencies, market participants, and market observers, people on the ground in California who are trying, to the best of their ability, to keep the lights on.

I want to welcome all of our witnesses today, and I look forward to your testimony.

One witness before us today is the Chairman of the California Energy Commission, Mr. Bill Keese, although he is actually not here yet. He has been helpful to this subcommittee before, and I will thank him personally when he arrives, for being here.

His job is an important one, to use the current law and State authorities to get new generation built. Hopefully he is very involved in trying to further change the law and regulations to streamline the California permitting process. Time and again I am told that California is the toughest State in the Union to site a new power plant. If that is still the case in this time of crisis, the supply and-demand problem will not go away very quickly.

In Chairman Keese's testimony, he anticipates 5,000 megawatts of potential new generation to be built and operational this summer. Mr. Keese, to me, seems like a good man, and I have heard from many people that he is doing all that he personally can. However, I understand that these are times when one is told by higher authority to give us a big number.

According to his testimony, 25 percent of that 5,000 megawatts is to come from plants that are already approved; the other 75 percent worries me. Even the staff of the California ISO warns that peaking plants take longer to construct than the State is suggesting, and some of these may never be ready at all. One observer has said that the State's objections of new generation for this summer are so rosy and hopeful that this amounts to the most important faith-based initiative we have ever heard. I hope this is not the case.

Dr. Lloyd, of the California Air Resources Board, makes his first appearance before the subcommittee today. We welcome you, sir. His job is also important, to do what the State can do to keep plants that are already built operating in this vital time, while protecting the environment. I am going to ask him to give us a clear picture of what is happening today in terms of the environmental regulations in California, why we have gotten to where we have gotten, where there is such a problem trying to comply with those regulations. I am going to also ask if he believes that the State of California would need to have any additional new authority in this area.

If some of the witnesses' speed in submitting testimony is in any way an indicator of the State's speed at addressing problems, I think I am beginning to understand why California is what it is today. It is not just the State officials that we have had problems with, even our friends in the private sector, such as Mr. Kline of PG&E, was late getting his testimony. We can't study the testimony and give it to our staffs and to our members if it comes in after six o'clock the night before the hearing. That is not a good way to do business.

We also have Mr. David Freeman here today, from the Los Angeles Department of Water and Power. We welcome you, sir. You are truly, in my mind, one of the heroes in the municipal power agencies of your generation, so it is truly an honor to have you here.

Mr. Freeman is on leave from the city of Los Angeles to help Governor Davis establish a new system in which the State is going to buy power on behalf of the incumbent investor-owned distribution utilities. If that is not a real job, I don't know what is.

Mr. FREEMAN. It doesn't pay too much, though.

Mr. BARTON. I don't envy you in that effort, but I know that you are trying the very best that you can to do it. Mr. Freeman has a

lot of experience in these issues, and I again want to thank him for making the trip.

I welcome all of our witnesses here. I especially want to call to the subcommittee's attention Mr. Larry Makovich. His group, the Cambridge Energy Research Associates, continues to offer some of the best analysis of the situation in California to this day. His work, the work of his company, has been very useful to me and other subcommittee members in giving us a broad overview.

As we said on Tuesday, the Federal Government does not site power plants or transmission lines, States do. The ability of the Federal Government to help is limited, however, we do care about what is happening in California and the West, and we do want to do what can be done if what we do is a positive step in the right direction. We certainly want to help California avoid blackouts and deal with any blackouts that must occur.

If there are new supply related Federal authorities that Congress should consider extending to the States in this electricity crisis, the subcommittee wants to hear them today. The time for addressing the expected summer supply problems is upon us. If we are going to act legislatively, we need to begin that process next week.

I am sending to the White House a list of ideas at the end of this week, hopefully to consider on how to address the problem. Perhaps we can work with the State authorities in Sacramento on a bipartisan basis to do this.

I welcome you gentlemen here today. We are going to have a good hearing. I would now like to turn to my ranking member, Mr. Boucher, for an opening statement.

Mr. BOUCHER. Thank you very much, Mr. Chairman. I will be brief in my comments this morning so that we can turn rapidly to the testimony of our witnesses.

The testimony to be presented this morning involves that of a wide range of parties with an interest in the western regional electricity market. This subcommittee's deliberations will be assisted substantially by the views of this morning's witnesses concerning several key questions. First, has the Federal Energy Regulatory Commission done enough to ensure that the prices for wholesale power transactions are just and reasonable, and what additional actions, if any, should be taken by the FERC to address the problems that affect the western regional electricity market?

Second, what measure of confidence should this Committee take in the actions by the State of California, either actions taken to-date or those that can be reasonably anticipated, to address these concerns?

And, finally, what recommendations, if any, do our witnesses have for Federal legislative approaches that now may be necessary either to address the problems of California and the Western States, or to prevent similar problems from arising elsewhere?

I want to commend Chairman Barton for the careful and thorough examination which this subcommittee has undertaken of the western regional electricity problem. Through four hearings, we have been given the opportunity to review the malfunctioning of the market in detail, and a sound record has been established upon which to decide what actions, if any, this subcommittee should now take.

I thank the chairman for his cooperative approach, for this careful review and, along with him, I look forward to the witnesses' testimony.

Mr. BARTON. Thank the gentleman for his statement. By prior agreement with the minority, those are the only opening statements that we are going to have today. All other members that wish to put an opening statement in the record, if you will submit it to us in writing, we will make it a part of the permanent record of the hearing.

We are going to start with you, Mr. Keese, and we are going to go right down the line, ending with Mr. Cooper. We will give you 6 minutes. If it takes longer than 6 minutes, we will give you a little bit longer than that. We have got seven other witnesses, so we can't give you unlimited time, but we do want to hear from you.

I said, as you were coming in, we do appreciate you coming. You have got a very difficult job. I have heard nothing but positive things about your attempts to keep the plants operating and to get new plants sited, so we are very interested especially in any ideas that you might have on how we can help expedite the siting process.

Welcome to the subcommittee.

STATEMENTS OF HON. WILLIAM J. KEESE, CHAIRMAN, CALIFORNIA ENERGY COMMISSION; ALAN C. LLOYD, CHAIRMAN, CALIFORNIA AIR RESOURCES BOARD; S. DAVID FREEMAN, GENERAL MANAGER, LOS ANGELES DEPARTMENT OF WATER & POWER; STEVEN L. KLINE, VICE PRESIDENT FEDERAL, GOVERNMENTAL AND REGULATORY RELATIONS, PACIFIC GAS AND ELECTRIC COMPANY; JIM POPE, ELECTRIC UTILITY DIRECTOR, SILICON VALLEY POWER; WILLIAM F. HALL, VICE PRESIDENT WESTERN REGION, DUKE ENERGY NORTH AMERICA; LAWRENCE MAKOVICH, SENIOR DIRECTOR, CAMBRIDGE ENERGY RESEARCH ASSOCIATES; AND MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

Mr. KEESE. Thank you, Mr. Barton. You have my written statement, so if you will also enter that into the record, I will be brief.

Mr. BARTON. Without objection.

Mr. KEESE. It is my pleasure to be here. And I would like to focus my testimony this morning, California's efforts to respond to the situation at hand—namely, a dysfunctional electricity market brought on by a flawed deregulation plan in 1996.

Through the Governor's leadership, we have an aggressive plan of attack. We are working nonstop, day and night, to restore stability to the marketplace, bring down the prices, and ensure that adequate electricity supplies are available now and in the summer.

I am going to deal with the set of actions we are taking: 1) to increase energy supplies through expedited power plant construction and other sources; 2) decrease energy demand and increase energy efficiency; 3) expand the use of long-term energy contracts; and 4) maintain the financial viability of California's utilities. I will briefly hit each of these, particularly focusing on generation.

I would like to say, as I start, that we hear a lot of cliches about why California got in trouble last year—it was inordinately hot, it

was a low hydro year, we had unexpected growth. Wrong, wrong, wrong.

Let me start with a myth. There are no generating facilities under construction in California. We have six under construction. We have three that will be completed by July 1.

Myth #2: With our high tech industry, we are an energy hog. We have the lowest energy intensity in the West. Only Rhode Island is lower in energy intensity than California.

Myth #3: Our environmental regulations and our reluctance to approve power plant applications have created our current shortage. We had no large major power plant submitted to the Energy Commission during the 1990's. None. The two largest that we licensed were not built because of economic reasons. Prices were low in California. Had you built a plant in 1997, you would have lost money in 1998, you would have lost money in 1999. However, with the certainty that has been assured in the last few years, we now have 60 projects in front of us.

Let me, Mr. Chairman, make it clear, Governor Davis is not interested in casting blame on anyone for the situation we have inherited. Californians do not care who started the problem or how it got started. They expect us to solve it and get the State back on course. We fully intend to do that.

Let me talk about generation for a moment. In the past 2 years, the Energy Commission has approved 13 power plants, with generating capacity of 8,400 megawatts. We currently have 15 more major power plants under review, for an additional 6,700 megawatts.

Roughly 15,000 megawatts in the process. A majority of those that are in the process will be finalized by the end of May of this year. We have a 1-year process at the Energy Commission. Through an Executive Order issued by Governor Davis last month, we now have an expedited siting process of 21 days. Let me explain personally what that means.

The Palm Springs peaking plant as filed on March 16. I will be holding a hearing on Tuesday. We will take it to the Commission on April 4. It will be, if appropriate, approved.

Mr. BARTON. If appropriate.

Mr. KEESE. Governor Davis asked President Bush to direct Federal agencies to expedite Federal permit reviews to go along with us, and the President has issued a memorandum calling on agencies to comply with our timetable, and we are very appreciative of that effort.

Through all of these efforts, we anticipate bringing 5,000 megawatts online this summer. That is an aggressive goal. We have not given up on it. We will work at it.

Let me deal with conservation initiatives. Governor Davis initially called on Californians to reduce their energy consumption by 7 percent. Last month, consumption was down by 8 percent, in our opinion. The State has vowed that when we are in Stage II, we will reduce State usage of power by 20 percent. We are on our way toward meeting that goal.

Specific measures of the conservation plan include an $800 million package for energy efficiency and renewable energy, and aggressive conservation measures in State buildings. Let me mention,

the Governor announced his "20/20" program last week, in which consumers who reduce their energy use by 20 percent will get a 20 percent rebate. That is his promise.

Earlier this week, we signed, at the Energy Commission, 12 grants and contracts for $9 million to install "energy smart" technology in commercial and industrial buildings. This itself should save 93 megawatts.

On stabilization issues, getting our market back to where it should be, we have made significant progress in the last few weeks, particularly by reducing our reliance on the spot market. On Tuesday night, Governor Davis announced that the State, through the Public Utilities Commission, will take immediate steps to restructure the contracts between our QFs and the utilities. QFs will have the option of 5- or 10-year contracts.

I am going to leave the details of the stabilization plan to someone on my left who knows much more, Mr. David Freeman.

As you know, in the transmission area, we continue negotiations with the utilities. We believe that acquiring the transmission lines would enable the State to gain a valuable asset, at the same time allowing utilities to regain their financial solvency. The State's ownership would also ensure that critical and necessary infrastructure improvement in projects can be undertaken.

Where are we going from here? Mr. Chairman, I believe you will see that we are aggressively pursuing every remedy available to us in an effort to increase generation, reduce demand and lower prices, but the Federal Government must intervene to help us fix a dysfunctional electricity market by reining in unacceptably high wholesale energy prices.

Earlier this month, the Governors of California, Oregon and Washington called on the FERC to adopt a temporary cost-based regional price cap that would allow generators to recover all of their costs plus a reasonable rate of return.

While I understand this is a controversial proposal, there are several points worth noting. First, the regional price cap would be temporary in nature. Second, generators would have the ability to recover all of their operating costs and receive a return. This proposal embodies the kind of bold, decisive action we are seeking from FERC. If FERC refuses to exercise its full authority under the law to restore price stability, we believe it is only appropriate for the Congress to do it for them.

Mr. Chairman, California is determined to tackle the problem at hand. We are working feverishly to reverse course. At the same time, we need your assistance in partnering with us to encourage a responsible plan of action on the part of FERC.

Thank you for being here. Thank you for allowing me to be here, I would be pleased to answer any questions.

[The prepared statement of Hon. William J. Keese follows:]

PREPARED STATEMENT OF WILLIAM J. KEESE, CHAIRMAN, CALIFORNIA ENERGY COMMISSION

Thank you, Mr. Chairman, for inviting me here this morning. I appreciate the opportunity to testify before the Subcommittee in my role as Chairman of the California Energy Commission (CEC).

I would like to focus my testimony this morning on California's efforts to respond to the situation at hand—namely, a dysfunctional electricity market brought on in large part by a flawed deregulation plan in 1996.

The State of California, through the leadership of Governor Davis, has developed an aggressive plan of attack. We are working nonstop to restore stability to the marketplace, bring down prices and ensure that adequate electricity supplies are available now and in the summer.

Towards this end, California has launched a comprehensive set of initiatives in four fundamental areas: 1) increasing energy supplies through expedited power plant construction and other sources of power generation, 2) decreasing energy demand and increasing efficiency, 3) expanding the use of long-term energy contracts rather than relying on the volatile and expensive spot market, and 4) maintaining the financial viability of California's utilities.

I will elaborate briefly on each of these issues, with a particular focus on our generation development initiatives. But before proceeding further, I would like to dispel a few myths surrounding California's electricity situation.

MYTHS AND MISCONCEPTIONS

Myth #1: There are currently no new generating facilities under construction in California. To the contrary, four months into the Davis Administration, new power plants began to be approved. Thirteen have been approved and *six are under construction.*

Myth #2: California, with its high tech industry, is an energy hog. The reality is that California's per capita electricity usage ranks the lowest in the Western region. Nationally, only Rhode Island uses electricity at a lower rate per capita than California. Our state's energy demand has grown at a rate of only 1.2% per year, which is considerably lower than other Western states such as Oregon, Nevada, Idaho, Utah, Arizona, Colorado and New Mexico.

Myth #3: California's environmental regulations and a reluctance to approve power plant applications have created our current shortage. While it is true that no major power plants were built in California from 1986 to 1998, the reasons had nothing to do with environmental regulations. The reality is that generation failed to keep pace with supply because of over-reliance on the market to determine additional need, as well as regulatory uncertainty associated with restructuring and deregulation.

The enactment of the Energy Policy Act of 1992 spearheaded a movement away from planning and toward a reliance on the market to decide when additional power plants would be built. The 1992 law, and resulting discussions on deregulation, introduced great uncertainty into the generation development market and discouraged developers. This factor, along with low energy prices during the mid-1990s, resulted in no major power plants built in California.

CALIFORNIA'S CURRENT EFFORTS

Mr. Chairman, Governor Davis has made it clear that he is not interested in casting blame on anyone for the situation we have inherited. Californians do not care who started the problem and how it got started. They expect us to solve it and get the state back on course. We fully intend to accomplish this mission.

As I stated earlier, California has embarked on an aggressive course of action in the areas of generation, conservation, and stabilization. Let me touch upon each of these areas.

GENERATION DEVELOPMENT INITIATIVES

We are determined to develop additional energy supplies in an expedited manner to meet this summer's anticipated demand. Towards this end, an all-out effort is underway in California to bring new plants on line and fully operational.

In the past two years, the Energy Commission has approved 13 power plants with generating capacity in excess of 8400 megawatts. There are currently 15 more projects under review with an additional 6700 megawatts of capacity.

Through an Executive Order issued by Governor Davis last month, the Energy Commission has instituted a new streamlined review and licensing process. Natural gas fired or renewable "peaking" power plants that can be in full operation by the 2001 peak demand period and provide power to California residents are eligible for an expedited permit process. The Energy Commission will complete the permit process for these emergency peaking facilities within 21 days. CEC staff is currently utilizing this expedited process for several proposed peaker power plants, including one in Palm Springs.

Another component of California's generation program centers around financial incentives to plant owners and local governments. Developers who can complete construction and bring plants on line before August 1, 2001, will receive an acceleration bonus of $1,000,000 for a 50-megawatt facility. This applies to distributed-generator, co-generator, or peaker power plants. In addition, local government agencies that expedite the permitting process for the siting of new plants will receive $10,000 per locally approved megawatt.

Additionally, Governor Davis asked President Bush to direct federal agencies to expedite federal permit reviews for power projects. He has granted this request and issued a memorandum calling on agencies to comply with our timetable. The Davis Administration greatly appreciates the President's cooperation with this effort.

Through all of these initiatives, we anticipate bringing 5,000 megawatts on line this summer. 1,640 megawatts will come from three plants we have already approved, plus one plant that was licensed in December 2000 under a previous expedited permitting procedure. We expect to pick up approximately 3,800 megawatts through distributed generation, cogeneration, peaker and renewable energy facilities. Looking ahead to summer 2002 and beyond, we anticipate an additional 5,000 megawatts next summer and 10,000 megawatts by 2004.

The bottom line is that we are moving at warp speed to put new generation on line by accelerating the permit process, providing financial incentives and taking other measures under the Governor's emergency authority. We fully expect to meet our goal of securing 5,000 additional megawatts this summer to meet the peak demand period.

CONSERVATION INITIATIVES

Last month, the State unveiled a conservation strategy that includes, among other programs, appliance rebates, incentives to reduce commercial lighting, and a public media campaign. Governor Davis initially called on Californians to reduce their energy consumption by at least 7% and pledged that the State would cut consumption by 20% during Stage II alerts.

Mr. Chairman, California has answered the call. Our businesses and consumers reduced energy consumption last month by 8%. Our data shows that electricity demand went down by 2,578 megawatts in February. As a result, the Governor is now asking Californians to conserve at least 10%.

Specific features of our conservation plan include the following items:

- $800 million package of incentives and rebates for conservation and efficiency efforts.
- Aggressive conservation measures in state buildings, resulting in 200 megawatts of savings during energy emergencies.
- Comprehensive outreach and education campaign to reach businesses, organizations, and millions of California consumers.
- Partnerships with private sector businesses and organizations to reduce energy use.
- Retrofitting government buildings for energy efficiency.
- Adoption of the strongest energy efficiency standards in the world for residential and non-residential buildings and appliances.
- Incorporation of energy efficiency, sustainable building designs in new state building projects.

Additionally, just last week, California created an innovative energy rebate program. The "20/20" program will provide a 20% rebate to customers who reduce their electricity consumption this summer by 20% over last summer's levels. It is a voluntary program that will cover both households and businesses in California. If only 10% of our residents and businesses achieve the 20% reduction, it will reduce our state's overall peak consumption this summer by as much as 2,200 megawatts, thereby eliminating the need to purchase as much as $1.3 billion in additional energy.

Finally, the Energy Commission earlier this week signed 12 grants and contracts totaling over $9 million to install "energy smart" technology in commercial and industrial buildings throughout California. These agreements will account for about 93 megawatts of projected savings from buildings outfitted with demand responsive building systems technology. With these grants in place, our state will continue to be the national leader in energy efficiency.

STABILIZATION INITIATIVES

Over the last month, we have made significant progress in stabilizing the market by reducing our reliance on the spot market. The state's flawed deregulation scheme led to 30% of all electricity purchases to be made on the spot market. The spot mar-

ket represented an inexpensive source of power during the first two years of "deregulation". However, we are currently paying between 500 to 900 times what we paid for electricity last year on the spot market. This is in spite of the fact that the single greatest hour of electricity usage in 2000 was actually lower than any peak demand period in 1999 or 1998.

Before I continue with the issue of spot markets, I would like to call your attention to a recent development on an important matter related to this week's blackouts in California. It has to do with our efforts to keep "qualifying facilities," or QF"s, up and running.

As you know, QF"s produce alternative forms of energy, such as wind, solar, geothermal, biomass and cogeneration. QF"s account for roughly 25% of California's electricity.

Why did California experience blackouts earlier this week? The primary reason centers around the fact that many of these QF"s have not been paid by utilities. As a result, they ran out of money and shut down. California lost several thousand megawatts due to this action.

On Tuesday night, Governor Davis announced that the state, through the California Public Utilities Commission (PUC), will take immediate steps to restructure the contracts between QF"s and utilities. QF"s will have the option of choosing 5- or 10-year contracts, and the contracts will indicate that payment will be forthcoming starting April 1, 2001.

This effort, which is based on earlier negotiations led by State Senators Jim Battin and Debra Bowen and Assemblyman Fred Keeley, will ensure that QF"s remain in operation and be made financially whole.

QF"s are the only generators in California that are not being paid for the power they have produced. Governor Davis strongly believes that QF"s have been good corporate citizens and that we have a moral obligation to move quickly to fully compensate alternative energy producers in California.

The PUC will take action on this proposal next Tuesday. We anticipate a final resolution to this matter in the very near future.

Returning to the issue of spot markets, the Subcommittee should be aware that California is mounting a major effort to greatly reduce California's reliance on the spot market. Governor Davis earlier this month announced the signing of 40 long-term contracts and agreements between the State of California and companies such as Calpine, Duke, Dynegy, Enron, Reliant, Williams, Sempra, Merrill Lynch, Morgan Stanley, El Paso, Constellation, Panda, Cal Peak, Avista, PX BFM, PacifiCorp, and Primary Power. The long-term contracts and agreements are fairly evenly divided between three-year, five-year, and ten-year lengths, with one contract for 20 years. Together they provide:

- A total of 629,000,000 megawatts in a diversified long-term portfolio over the next ten years, with 5,000 megawatts scheduled to come on line within 24 months and some as early as this summer.
- An average of 8,886 megawatts per year over the next ten years.
- 6,000 megawatts for this year, increasing to 10,000 megawatts by 2004, and declining to 9,000 megawatts by 2010.
- An average price of $79 per megawatt for the first five years, including "superpeak" periods. This is a 75% savings from recent spot market prices.
- An average price of $61 per megawatt for the second five years, including "superpeak" periods. This is an 80% savings from recent spot market prices.

In addition, we continue to negotiate a plan to revitalize the financial viability of the investor-owned utilities, which have been virtually bankrupt by the unjust and unreasonable wholesale rates being charged by generators and power marketers. The plan involves all three utilities: Southern California Edison, Pacific Gas and Electric, and San Diego Gas and Electric.

On February 23, 2001, Governor Davis announced an agreement in principle with Southern California Edison. The State has agreed to purchase the utility's transmission lines for an estimated $2.76 billion, which is 2.3 times the estimated book value, and to allow the utility to issue bonds for a substantial amount of its debt. Southern California Edison has agreed to do the following:

- Make payments of approximately $420 million from its parent company, Edison International, to the utility.
- Commit the entire output of the parent company's Sunrise Mission power project at low cost-based rates for ten years, which has a value to ratepayers of $500 million over the next two years.
- Provide cost-based rates from the generating facilities the utility owns for another ten years.

- Grant to the State 99-year conservation easements over 20,000 acres of watershed lands the utility owns.
- Drop the utility's pending litigation against the California Public Utilities Commission that could have resulted in immediate higher electric rates for consumers if the utility prevailed.

Negotiations continue with Southern California Edison, as well as with the other two utilities, Pacific Gas and Electric, and San Diego Gas and Electric.

We believe that acquiring transmission lines would enable the State to gain a valuable asset while at the same time allowing utilities to regain their financial footing. Under the plan, the State intends to lease the transmission lines back to the utilities, which in turn would assume day-to-day management of the transmission system. The State's ownership of the transmission lines will also ensure that critical and necessary infrastructure improvement projects are undertaken.

WHERE DO WE GO FROM HERE?

Mr. Chairman, California is aggressively pursuing every remedy available to us in an effort to increase generation, reduce demand and lower prices. We are fully prepared to meet the challenge head on. But the federal government must intervene to fix a dysfunctional electricity market by reining in unacceptably high wholesale energy prices.

In addition to the serious economic harm to California and other western states that will likely continue if stronger mitigation efforts are not adopted by the Federal Energy Regulatory Commission (FERC), I want to emphasize that the "unjust and unreasonable" prices being charged by generators serve absolutely no useful end. They do nothing to accelerate power plant construction in the short or long term.

Earlier this month, the Governors of California, Oregon and Washington called on the FERC to adopt a temporary cost-based regional price cap that would allow generators to recover all of their costs plus a reasonable rate of return. Their request is based on a plan by Commissioner Massey, who appeared before you earlier this week and provided an overview of the proposal. If adopted by the FERC, this plan would go a long way in protecting consumers and businesses from the unpredictable nature of the current and add a much-needed dose of stability.

While I understand the controversy surrounding this proposal, there are several points worth noting. First, the regional price cap is completely temporary in nature. Second, generators would have the ability to recover all of their operating costs and receive a return. For these reasons, I must take strong exception to the view that this plan would discourage the development of new generation facilities. We believe otherwise.

This proposal embodies the kind of bold, decisive action we are seeking from the FERC. As Governor Davis has stated, high wholesale electricity prices is an issue that falls squarely on the shoulders of Washington. If the FERC refuses to exercise its full authority under the law to restore price stability, we believe it is only appropriate for the Congress to do it for them.

Mr. Chairman, California is determined to tackle the problem at hand. We are working feverishly to reverse course. At the same time, we need your assistance in partnering with us to encourage a responsible plan of action on the part of the FERC.

Thank you for the opportunity to appear before you today. I look forward to answering your questions.

Mr. BARTON. It is my job to be here. You are here voluntarily, and we appreciate that. I failed to mention that Mr. Keese is the Chairman of the California Energy Commission, so I want to give you the title. It took him about 8 minutes, so we are going to set the clock for everybody else at 8 minutes. Feel free to give us back some time, but we want to give you all the same opportunity.

We now want to hear from Dr. Alan Lloyd, who is the Chairman of the California Air Resources Board. This is your first appearance before the subcommittee. Again, we thank you for voluntarily appearing. Your statement is in the record in its entirety, and we recognize you for 8 minutes to elaborate on it.

STATEMENT OF ALAN C. LLOYD

Mr. LLOYD. Hopefully I can save you 3 minutes. Thank you, Mr. Chairman and members of the subcommittee. My name is Alan Lloyd, and I serve as Chairman of the California Air Resources Board. I am pleased to be here to provide an overview of California's electricity challenge with respect to air quality issues.

Governor Davis has embarked on a comprehensive strategy to address the electricity situation. A major component of this effort is to increase energy supplies by expediting the construction of power plants and other sources of generation. As of today, as Mr. Keese mentioned, 13 plants have been approved, six are under construction, and three will be online by this summer. Our goal is to bring 5,000 megawatts online this year and 20,000 megawatts by 2004, to meet energy demands this summer and beyond. A second component of our effort is to maintain our existing generating capacity and allow it to operate when needed.

Mr. Chairman, my main message is this: We can accomplish these goals within the existing framework of California's air quality regulations. Furthermore, environmental laws do not pose a barrier in terms of our ability to bring new generation online and ensure that existing power plants can operate at maximum capacity. In short, we can increase energy supply in an expedited manner while at the same time maintaining our commitment to the environment.

Air pollution controls have been identified as a major contributor to California's current energy challenge. That perception is not accurate. Where air quality rules might have affected or might have potentially affected the ability to create power, we have moved swiftly to keep needed plants online. Simply put, no essential electricity generation has been curtailed due to air emission limitations. California programs to protect public health are not a major factor in electricity shortages experienced to-date.

Similarly, the allegation that environmental laws have prevented bringing new electrical generation facilities online is also erroneous. In the last 2 years, 13 major power projects totally over 8,400 megawatts of additional capacity have been fully permitted. Four of these units will be online this year. Another 15 projects that comply with air quality requirements are currently under review and can provide an additional 6,700 megawatts of capacity. All of these projects include the necessary environmental offsets and utilize all required emission controls. Compliance with air quality requirements have proven to be both technically and economically feasible.

Finally, although existing air pollution laws and regulations provide mechanisms for addressing our power needs. Our processes can be streamlined. Governor Davis has used his emergency powers to enable State and local agencies the ability to apply flexibility and common sense to act quickly to ensure that power generation will continue.

By issuing Executive Orders, Governor Davis has added substantially to the State's ability to deal with our current energy situation. These orders ensure that where statutory and regulatory impediments exist, they will be swiftly addressed and resolved. For example, for the Governor's action will allow the operation of facilities that might otherwise face limits on hours of operation. The ex-

pedited approval for new peaking facilities and baseload units will provide emission credits to new peaking plants.

The Governor's Executive Orders maintain all substantive environmental protections. For example, new units must utilize the best available control equipment, and must continue to provide emission reduction credits to mitigate their emission increases.

Permitting will take less time, but will not be less protective. No single factor can explain the current energy crisis, the matter obviously is far too complex. However, it can be said with certainty that environmental laws are not to blame. Under existing environmental programs and the policy direction of Governor Davis, State and local regulators have had, have used, and will continue to use flexibility to ensure that power is supplied when needed and under environmentally sound conditions.

While the review processes and decisionmaking timelines are being streamlined, substantive environmental standards and mitigation requirements have not been compromised.

In sum, the air quality regulatory system works. The Governor's utilization of his emergency powers to expedite the process of power plant siting while maintaining environmental standards confirms that California can maintain its environmental and economic objectives.

Thank you, Mr. Chairman, for the opportunity to testify this morning.

[The prepared statement of Alan C. Lloyd follows:]

PREPARED STATEMENT OF ALAN C. LLOYD, CHAIRMAN, CALIFORNIA AIR RESOURCES BOARD

INTRODUCTION

Thank you, Mr. Chairman and Members of the Subcommittee. My name is Alan Lloyd, and I serve as Chairman of the California Air Resources Board (ARB). I welcome the opportunity to provide an overview of California's electricity challenge with respect to air quality issues.

SUMMARY

Over the past several months, Governor Davis has embarked on a comprehensive strategy to address the electricity situation in California. One of the major components of the State's plan centers around increasing energy supplies by expediting the construction of power plants and other sources of generation. Specifically, we are in the midst of an aggressive effort to bring 5,000 megawatts on line by this summer and 20,000 megawatts by 2004 in order to meet anticipated energy demand this summer and beyond.

Mr. Chairman, my main message is this: We can accomplish this goal within the existing framework of California's air quality regulations. Furthermore, environmental laws do not pose a barrier in terms of our ability to bring new generation on line and ensure that existing power plants can operate at maximum capacity. In short, we can increase energy supply in an expedited manner while at the same time maintaining our commitment to the environment.

BACKGROUND

Air pollution controls have been identified as a major contributor to California's current energy challenge. That perception is not accurate. Air quality issues are a very small part of the State's overall power production problem. Where air quality rules *have* affected or *might have* potentially affected the ability to create essential power, state and local regulators have moved swiftly and successfully to keep needed plants on line. Simply put, no essential electricity generation has been curtailed due to air emission limitations. California's programs to protect public health are not a major factor in the electricity shortages experienced to date.

No single factor can explain the current energy crisis. The matter is far too complex. However, it can be said with certainty that environmental laws are not to blame. Under existing environmental programs and the policy direction of Governor Davis, state and local air regulators have had, have used, and will continue to use, the considerable flexibility included in California's regulatory programs to ensure that power generating sources remain in operation under environmentally sound conditions. While the review process and decision making timelines have been streamlined, substantive environmental standards and mitigation requirements have not been compromised.

HISTORY

Over the last several months, there has been an increasing focus on environmental laws as contributors to the energy crisis. This concern has taken two distinct forms:

1. The charge that environmental laws have prevented maximum utilization of existing electrical generation facilities; and
2. The allegation that environmental laws have prevented bringing new electrical generation facilities online.

There have also been charges that the State of California has not been responsive enough in addressing the power issues, and has not been willing to take the extraordinary actions needed to deal with how environmental requirements have affected electricity production.

Mr. Chairman, I submit to you that these statements have diverted attention from the true and complex causes of the current energy situation. As a result, they have not contributed to productive efforts to resolve it. I would like to briefly address each of these issues.

ACTIONS TO EXPEDITE REVIEWS AND PERMITS

Although existing laws and regulations provide mechanisms for addressing our power needs, they can also require substantial time and process. Governor Davis, through the exercise of his emergency powers under state law, has significantly expanded state and local agencies' ability to apply flexibility and common sense to act quickly to ensure that power generation will continue.

By using his emergency powers and issuing Executive Orders, Governor Davis has added substantially to the state's ability to deal with our current energy situation. Executive Orders D-24-01, D-26-01, and D-28-01 ensure that where statutory and regulatory impediments exist—related to either the continued operation of an existing plant or the construction of a new clean facility—they will be swiftly addressed and resolved. The Executive Orders also provide that these actions will be accomplished without sacrificing needed air quality protections.

State and local agencies now have both the direction and the authority they need to expeditiously review and approve permits. Under the Governor's Executive Orders, they are:

- Allowing the continued operation of existing facilities that might otherwise face limits on hours of operation.
- Expediting the review and permit approval for new peaking facilities that have acquired the needed control technology and mitigation, but need rapid processing to come on line quickly.
- Enabling new peaking plants to obtain emission credits needed for permitting through the state, rather than arranging for them through private transactions.
- Completing permit reviews and approvals for new large facilities in as little as four months to enable new capacity to begin construction expeditiously.

The Governor's Executive Orders maintain all substantive environmental protections. For example, existing units must continue to utilize all of the required emission control equipment, and must provide funds to mitigate the impact of their increased hours of operation. Similarly, new units must utilize the best available control equipment and must continue to provide emission reduction credits to mitigate their emission increases. Permitting will take less time, but will not be less protective.

IMPACTS OF ENVIRONMENTAL LAWS ON EXISTING ELECTRICAL GENERATION

All central station electrical generating facilities are permitted by local air pollution control districts under rules incorporated in the State Implementation Plan (SIP). These permits reflect operator-provided information, including factors such as intended hours of operation and fuel type. This information has a direct bearing on the facility's anticipated emissions. Based on operator-provided data, emission limits

are established through the air permits. It is these operator-defined limits that have been at issue. In many cases, these facilities are now in a position of having, or wanting to generate additional electrical power in excess of the time periods assumed in the original permitting process.

Despite this unanticipated high level of operation, through the joint efforts of local air districts, the Air Resources Board (ARB), and the California Energy Conservation and Development Commission (CEC), as well as the assistance of the U.S. Environmental Protection Agency (U.S. EPA), needed electrical generation has not been interrupted. State law and local regulations provide several means to address permit limitations without disruption of electrical generation or unmitigated damage to air quality.

The ARB has assisted local air districts in addressing any potential issues arising out of their efforts to maintain power generation. ARB has maintained close coordination with the U.S. EPA to ensure that state and local response to the energy situation does not raise concerns at the federal level. We have approached the electricity shortage with an environmentally sound balance of need awareness and impact concern. U. S. EPA has indicated its understanding of the complexities California is facing and has indicated a continued willingness to assist.

At the Governor's direction, the ARB and air districts have been able to balance the State's energy needs with the public's right to clean air. *Existing air quality regulations have provided the flexibility to address expeditiously the unexpected power demands of the State without material harm to air quality.* These accommodations have been completed in very short time frames and have ensured continued power generation. This flexibility has been used numerous times over the last six months to enable continued power production. These have affected both large and small plants and are summarized in Attachment 1.

The additional grants of authority to the Governor under the Emergency Services Act augments existing statutes and increases the ability of state and local agencies to work together in significantly reduced time frames. Whether it is providing for an existing source to operate beyond its permitted hours of operation or streamlining certification of new peaking sources, the Governor's emergency Executive Orders provide even greater flexibility in responding to source specific generation issues than previously existed.

IMPACTS OF ENVIRONMENTAL LAWS ON BRINGING NEW ELECTRICAL GENERATION ONLINE

All new proposed power plants must be constructed and operated in compliance with applicable federal, state, and local air pollution requirements. Within California, the 35 local air districts are responsible for regulating emissions from stationary sources, including power plants. At the state level, ARB is the agency charged with coordinating efforts to attain and maintain federal and state ambient air quality standards and comply with the requirements of the federal Clean Air Act. To this end, ARB coordinates the activities of all the districts in order to comply with the Clean Air Act.

Some have cited California's environmental laws as the reason new power generation has not been built in recent years. However, a review of CEC data demonstrates otherwise. Since April 1999, CEC has approved 13 major power projects (including one expansion) totaling over 8,400 MW of additional capacity. Six of these plants are under construction and four of those six are expected to be on line this year, with start dates spanning from July through November. Another 15 projects (new sitings and expansions) are currently under review for an additional 6,700 MW of capacity. Lastly, there is still an additional 7,960 MW of capacity that has been publicly announced and for which the CEC anticipates receiving applications this year.

Some have also argued that costs of compliance with air quality regulations are too substantial and must be relaxed to achieve needed power generation. This argument is also flawed. Today, approximately 15,000 MW of new electrical generation has either been approved or is in the licensing process. All of these projects have included the necessary environmental offset packages and have incorporated all required emission controls. Compliance with these requirements has proven to be both technically and economically feasible.

To bring new, additional peaking facilities on line, Governor Davis has created both a streamlined review process and an ARB-operated emission offset bank. These actions will ensure that all necessary peaking facilities can also be sited.

The CEC's siting process is designed to take 12 months. However, a number of factors, other than environmental regulations, have recently influenced individual project timelines. Over the last two to three years, the actions of local activists,

businesses, and others have slowed the pace of some projects. *In fact, power generators themselves have utilized the siting process to hold up the licensing of a competitor.* Since 1997, competing companies have intervened in 12 of the 21 projects proposed for licensing. Their participation has slowed the process in at least four cases.

OPPORTUNITY FOR DISTRIBUTED GENERATION

Constraints on electrical generation capacity from central station powerplants have caused increased interest in the use of distributed generation (DG). DG is electrical generation at or near the place of use. Governor Davis supports legislative action that will provide incentives for distributed generation. Last September, the Governor signed Senate Bill 1298, which directs ARB to establish a certification program and adopt uniform emissions standards and general air quality guidelines for DG technologies. By law, this program must be in effect by January 1, 2003. ARB is on a fast track and expects to complete this December—over a year ahead of schedule.

As the foregoing demonstrates, it is not environmental regulation that has prevented the creation of additional power generation. Rather, many factors have contributed to the current crisis. Among those is also the fact that market participants can and do manipulate the electrical power market by withholding capacity in order to maximize their price of electricity.

Even the Federal Energy Regulatory Commission (FERC) agrees. Although it found insufficient evidence of market manipulation by any individual market participant:

> "... there was clear evidence that the California market structure and rules provide the opportunity for sellers to exercise market power when supply is tight and can result in unjust and unreasonable rates under the FPA—we reaffirm our findings that unjust and unreasonable rates were charged and could continue to be charged unless remedies are implemented."[1]

CONCLUSION

The Air Resources Board is continuing its efforts to ensure that California has the maximum electrical power output possible, while still protecting public health and mitigating any adverse effects of increased electrical output. This is being done within the confines of existing law as recently expanded through the Governor's Executive Orders. To quote Governor Davis, California is demonstrating that we can cut red tape, build more power plants *and* continue to protect the environment.

Our State's history reflects a pattern of success even in the face of unparalleled challenges. California, the most populous state in the nation, has made incredible strides in improving air quality and protecting public health. At the same time, the State has enjoyed immense population and business growth. During this current energy situation, California will maintain its record of achieving a balance among all the issues to ensure that a reasonable and successful solution is achieved.

In sum, the air quality regulatory system works. The Governor's utilization of his emergency powers to expedite the process of power plant siting while maintaining environmental standards confirms that California can maintain its environmental and economic objectives.

Thank you, Mr. Chairman, for the opportunity to testify this morning.

ATTACHMENT 1

BACKGROUND PAPER ON FLEXIBILITY PROVIDED TO ENABLE EXPANDED OPERATION OF EXISTING POWER PLANTS

March 16, 2001

SUMMARY: The Air Resources Board and local air districts have been proactive and effective in working with power plant owners/operators and the California Independent System Operator (ISO) to address potential operating limitations resulting from existing air quality permit restrictions.

BACKGROUND

—There are 35 local air districts in California responsible for regulating emissions from stationary sources within their jurisdictions, including power plants.

[1] Order Directing Remedies for California Wholesale Market 91 FERC 61,294 December 15, 2000 (California Order 215 at pp. 33, 34).

—District new source review (NSR) rules require major new or modified sources of air pollution to install best available control technology (BACT) and to mitigate any remaining emissions with "offsets."
—When originally constructed, many facilities voluntarily limited their operating hours or fuel usage to keep emissions below levels that would have triggered BACT and/or offset requirements.
—Those choices reflected the original owner/operator's balancing of forecasted electricity demand (i.e., potential profit), versus the cost of controls at higher production levels. These decisions also reflected the anticipated retirement of older, less efficient and higher emitting units.
—Where chosen, operating restrictions were incorporated into each facility's air permit and are subject to compliance action if violated.
—Today, California power plants both need and want to operate longer hours to meet the State's energy needs.

RECENT FACILITY OPERATIONS

—Due to the State's power shortage, the California Independent System Operator (ISO) has requested that facilities operate more frequently than they originally anticipated.
—As such, some facilities are exceeding, or expected to exceed, the operating limits specified in their air quality permit.
—When it is determined that a facility may exceed its allowable operating limit, the ISO, ARB, local air districts, and power plant operators have negotiated operating agreements which allow the facility's to help "keep the lights on" while minimizing air pollution.
—Typically, the negotiated agreements provide for increased fuel use or additional operating hours.

EXAMPLES OF SUCCESSFUL POWERPLANT NEGOTIATIONS

—AES Alamitos
—AES Huntington Beach
—AES Redondo Beach
—Duke Energy—Morro Bay
—Duke Energy—Oakland
—Los Angeles Department of Water and PowerReliant Energy—Mandalay Unit 3
—Southern Energy Company—Potrero Peaking Turbines
See Attachment 2 for more detail.

ATTACHMENT 2

DETAIL ON SUCCESSFUL POWERPLANT NEGOTIATIONS

March 16, 2001

AES Alamitos

—AES operates the following facilities within the South Coast Air Quality Management District: Huntington Beach, Alamitos, and Redondo Beach.
—These facilities are subject to the District's RECLAIM NOx trading program.
—The Alamitos facility exceeded its Year 2000 RECLAIM trading credits (RTC) allocation and was issued a Notice of Violation by the District.
—Based on available information, the Districts projected that the Huntington Beach and Redondo Beach facilities would also exceed their Year 2000 RTC allocations.
—The District and AES negotiated a settlement agreement based on the principle of "environmental dispatch" (i.e., bringing cleaner units on-line first).
—The settlement agreement also requires AES to: 1) install selective catalytic reduction (SCR) or the equivalent on Alamitos units 1 thru 4, Huntington Beach units 1 thru 2, and Redondo Beach units 5 and 6; 2) purchase sufficient RTCs to comply with District rules; 3) deduct this year's excess emissions from future year RTC allocations; and 4) provide $17M to mitigate the impact of higher emissions.

Duke Energy—Morro Bay

—Duke Energy operates four utility boilers at its Morro Bay power plant (two boilers rated at 345 MW and two rated at 170 MW).
—The permit to operate issued by the San Luis Obispo County Air Pollution Control District limits the plant's NOx emission to a cumulative of 3.5 tons per day.

—As a result of California's power shortage, the California ISO requested that Duke Energy operate its Morro Bay facility more frequently than allowed by the daily permit limit.
—On January 11, 2001, the District Hearing Board granted Duke Energy an 30-day emergency variance that allows the facility to exceed the daily emission cap during a Stage 1, Stage 2 or Stage 3 electrical emergency.
—The emergency variance also requires Duke Energy to pay a mitigation fee of $7,800 per ton of excess NOx emissions.
—The District and Duke Energy are currently investigating the feasibility of longer-term options to allow for extended facility operation.

Duke Energy—Oakland

—Duke Energy operates six peaking combustion turbines at its Oakland Power Plant.
—The operating permit issued by the Bay Area Air Quality Management District limits the facility's annual hours of operation.
—As a result of the mid-January power shortage and need for additional power, the operating restriction would not allow the facility to operate to the extent it was needed.
—On January 18, 2001, Duke Energy submitted an application to the District for a minor permit revision (increase limit to 877 hours per year), which would allow the facility to continue operations.
—The District promptly reviewed the application and deemed it complete on January 19, 2001. This action will allow the facility to continue operating until a longer-term solution can be identified.
—The District is in contact with Duke Energy to discuss the terms of a possible agreement to allow operation in excess of the 877-hour limit, as the turbines are expected to reach the limit in the near future.

Los Angeles Department of Water and Power

—LADWP operates several power generation facilities within the South Coast Air Quality Management District.
—LADWP is subject to the District's RECLAIM NOx trading program which limits the facility's allowable operations.
—At the request of the ISO, LADWP operated their power generation more than originally expected during the summer of 2000 to help address California's power shortage.
—LADWP anticipated that it would deplete its RTC allotment before the end of year 2000.
—The District and LADWP negotiated a settlement agreement which would allow LADWP facilities to operate beyond the levels allowed by their year 2000 RTC allocation.
—The settlement agreement includes the following mitigation measures:
  —LADWP will install SCR emission control equipment on Haynes Unit 6 which meet a NO_X emission limit of 7 ppm.
  —LADWP will also install SCR on Valley units 1-3, Haynes units 3 and 4, Scattergood units 1-3, and Harbor units 6 and 7 if deemed cost effective.
  —LADWP will be liable to the District for the revenue resulting from emission in excess of its RTC allotment. LADWP agreed to provide a minimum of $14,000,000 to be used for supplemental environmental projects which benefit the residents of the South Coast Air Basin.

Reliant Energy—Mandalay Unit 3

—Reliant Energy operates a 120 MW natural gas-fired turbine peaking power plant in Oxnard, CA.
—The permit to operate issued by the Ventura County APCD establishes a limit on the facility's annual fuel consumption.
—Due to California's power shortage, the facility anticipated a need to exceed its annual operating limit.
—On July 31, 2000, the facility entered into a compliance agreement with the District which would authorize additional facility operations (942 MMscf per year, equivalent to about 394 hours), provided that: 1) Reliant would apply best available control technology within one year; and 2) Reliant would pay an emission mitigation fee of $4,000 for each hour of operation above the permitted limit. The compliance agreement was subsequently approved by the Ventura County Hearing Board on October 5, 2000.
—On February 14, 2001, the District sent a letter to Reliant Energy stating the enforcement requirements under which the District would take no further action against Reliant Energy if the fuel use limit were exceeded. The letter required

Reliant Energy to sell electricity generated using fuel in excess of the limit to the California Department of Water Resources.
—On February 15, 2001, the District issued a letter broadening the scope of the February 14, 2001 letter to allow electricity generated using fuel in excess of the compliance agreement to be sold to the ISO.

Southern Energy Company—Potrero Units 4, 5, and 6

—Southern Energy operates three oil-fired peaking turbines in the San Francisco Bay Area.
—Permits to operate issued by the Bay Area AQMD limit operation of each turbine to 877 hours per year. The limit was requested by the prior owner to avoid costs associated with installation of additional pollution control equipment and emission offsets.
—Southern Energy and the ISO informed the District that the facility might need to exceed its annual operating limit to avert/reduce the magnitude of firm-load shedding in California.
—The District exercised its enforcement discretion to allow Southern Energy to operate its turbines for the remainder of calendar year 2000 (December 15-31, 2000), subject to the following criteria:
  —The turbines may operate at the request of the ISO only under specific circumstances:
    —Potrero turbines are used as a last resort under emergency transmission system conditions and to avert firm-load shedding in the Greater San Francisco Bay Area.
    Potrero turbines will operate up to 4 hours per day per engine, only after declaration of a Stage 3 emergency.
  —Southern must provide mitigation funds for excess emissions.
  —Southern Energy shall pay civil penalties of $5,000 per turbine per day for operation beyond permit limits.
  —By June 1, 2001, Southern Energy shall provide the District with an analysis of the feasibility of applying NOx controls on the Potrero peaking units.
—As of January 1, 2001, the clock for the 877 hours per year permit limit restarted. However, the turbines are expected to reach the limits shortly. The District is in discussion with Southern Energy regarding the possible terms of an agreement to extend operating hours.

Mr. BARTON. Thank you. I think that was exactly 5 minutes, which is amazing.

We now want to hear from Mr. David Freeman, who is the General Manager of the Los Angeles Department of Water and Power, but he also has an additional duty, to coordinate the contract negotiations for the State of California in purchasing power on the open market for the incumbent utilities that are on the verge of declaring bankruptcy.

Your statement is in the record in its entirety, Mr. Freeman. We welcome you to the subcommittee.

STATEMENT OF S. DAVID FREEMAN

Mr. FREEMAN. Thank you. It is a privilege to appear before you. In view of my multiplicity of duties, perhaps I should simply say that I am a free man and I am testifying on my own behalf this morning, so I won't get anyone in trouble, but I do think I reflect the views of most Californians.

Let me first acknowledge, Mr. Chairman, our appreciation for your coming to our State, putting in long hours of hearings, and then having the miserable prospect of listening to me late into the evening. I think that is above and beyond your job and it is much appreciated.

Mr. BARTON. It is actually a pleasure, and you always learn by listening. I have enjoyed our conversations.

Mr. FREEMAN. That is correct, so I will try to be brief so I can spend most of my time listening.

I also want to acknowledge the presence of two Members of Congress who represent our area, Henry Waxman. It is a pleasure to be before you. And as far as Congresswoman Jane Harman is concerned, I think the record should show that she and I once worked for the other side of the aisle. I don't know whether everyone knows that or not.

Mr. BARTON. Those are the good, old days, and you are welcome to come back anytime you want.

Mr. FREEMAN. Well, what happened is that we passed and then Mr. Dingell and company would straighten them out, and we would spend long hours at the tune-in trying to get the legislation straight. So, this is nostalgia for me.

Ms. HARMAN. Mr. Chairman, may I just make a comment, which is we worked for the other body, not the other side of the aisle.

Mr. BARTON. I like the other side of the aisle better, myself.

Mr. FREEMAN. I sit corrected. Let me first say that when we talk about California, there ought to be a paragraph in each of these stories saying, "But not in Los Angeles." We are just an old-fashioned utility, owned by the people of Los Angeles. We kept our power plants. We added capacity while everybody else was going to seminars on deregulation. We have 15 percent reserves and then a little surplus. Our rates are stable. The lights don't flicker. And we have a modest surplus that we supply to the rest of the State from time to time.

Mr. BARTON. At a modest profit, I am told.

Mr. FREEMAN. We learn from the Texans.

Mr. BARTON. That is a good group to learn from.

Mr. FREEMAN. Amidst all the rabbit trails we chase, I think there is a jugular issue here that needs to be stated, at least my opinion of it, and that is that deregulation is a disaster when there is a shortage. There is just no getting around it. It is not that California did it wrong, it is just that this is the oxygen of life, and when there is a shortage, the prices go through the ceiling, especially when the Federal Energy Regulatory Commission—which I had the privilege of serving as Executive Aide to the Chairman in the early 1960's—does not do its job.

The statute has not been changed, Mr. Chairman. Sam Rayburn is turning over in his grave at what is happening now. That law is on the books, and it is not being enforced. And it seems to me that this Congress ought to either repeal the law or see that it is enforced. It is not a discretionary thing.

Now, let me say to all these conspiracy-theory-types, they are wrong. There is a real shortage. But the reason, as has been explained here, is not environmental laws. Power plants were not built in Utah or Montana or any of the other Western States. It is what was explained about Chairman Keese, the price was a dog-eat-dog competition price of 2.5 cents a kilowatt hour in 1997, and the same capitalists would not invest their money in a new power plant when they weren't going to get a return at those prices. And so the power plants weren't built in Utah and they weren't built in California.

And the new President is entirely correct, we have a national energy problem, not a California problem. And I think that one has to look at this and recognize that this is the oxygen of life, natural

gas and electricity, and the marketplace just does not really do the perfect job, or an even adequate job, for the producer or the consumer.

I don't know whether any other witness will say this to you, but the reason we have a natural gas shortage is that the market price got too low. Producers have said the same thing. The market price was too low for electricity, so that we have to have a hybrid system, in my opinion, where we let the market fluctuate over a wide band, but have floors and ceilings, because the volatility is what kills us. And it is a serious lesson that I think needs—we need to put our ideology aside, all of us. This is not an ideological issue, we are dealing with the lifeblood of this civilization. And we do not have a national energy policy, but the policy has to recognize that just as in housing we supplement the market with some housing, otherwise there wouldn't be any housing for poor people. We supplement the market—the Federal Reserve supplements the market with money. We have to have some presence to assure that businesses can know what their price is going to be in the future, and that drillers will know what they will get in the future, or else they won't drill.

That is the burden of my testimony. Also, I want to say, don't feel sorry for California. We are going to come through this and be stronger than ever. I think that—I pray to you, sir, I know you are sincere. You believe in State's rights. You defended that issue a year ago, I recall, when people were trying to rush through a bill. And I know this Committee is a committee made up of people that are looking out for the public interest.

We have underway in California a really large-scale effort to move through this crisis and come out of it with a stronger grid system, with stronger policies and, frankly, you will see us ushering in the age of the fuel cell and the micro-turbine and a whole set of new technologies. California will continue to lead this Nation as it has in the past, in the field of new technology and innovation.

And let us just do our thing and leave us alone, with Federal legislation. If you can, help us; if you can't, make the FERC do its job—and I understand how stubborn regulatory agencies can be—but if you can't do that, at least my prayer is, you let the Governor of the State go ahead with the various programs that he has underway, a tremendous array of efforts that will, I believe, contain this problem, and California will emerge stronger than ever.

And my last plea, don't try to use California as an excuse for messing up the Arctic Wildlife Refuge—please don't. The people of California don't want that, and I don't think the people of America want it.

Oil production has gone down steadily since 1970. The supply side will not get us off all these imports. We have got to get back to the statute that this Congress passed under the leadership of Mr. Dingell and others in the 1970's, namely, improving the mileage of cars and working on the demand side. We are an old oil patch. We burned up the Prudhoe Bay oil between the last crisis and this one, and we have to preserve what is left of America the Beautiful. Thank you, sir.

[The prepared statement of S. David Freeman follows:]

PREPARED STATEMENT OF S. DAVID FREEMAN, LOS ANGELES DEPARTMENT OF WATER AND POWER

The City of Los Angeles has an adequate supply of electricity at stable prices. The reason is that we did not "go down deregulation road." We are still an "old-fashioned" utility owning our generation, transmission and distribution, and maintaining 15 percent reserves with a modest surplus from time to time.

Basic lesson of California's deregulation experiment is that it is a disaster when there is a shortage of electricity especially when the FERC fails to carry out its statutory duty to set "just and reasonable" rates for electricity and natural gas transportation.

There is a real shortage, but the reason is not the environmental laws in California. It is a fact that there was a surplus in California before 1998. The wholesale price (about 2.5 cents per kWh) was too low to encourage the construction of new power plants. No new power plants were built in California, but they are not built in Utah either.

The surplus and the low prices discouraged new plants, while loads grew. We ended up with the shortage and the high prices.The same is true with natural gas where market prices at the wellhead fell to about $2.50 per mmcf. Drilling slowed and now we have wellhead prices at triple that amount.

There is a serious lesson to be learned from all this. A completely free market for electricity and natural gas is too volatile for either the producer or the consumer.

Deregulation can work over time only if the price is not allowed to go so low that it does not reward new capital, and where the price is not so high that it punishes the consumer and businesses alike.

Let us put all of our ideology aside and accept the fact that we are dealing with the oxygen of life in a high-energy civilization. We need a hybrid policy of "floors and ceilings" with a market price fluctuating in between.

California has underway a program of massive conservation, acceleration of power production, power purchases by the State, buy-out of transmission lines and other facilities of the investor-owned utilities to restore their financial health, and any rate adjustment that may be necessary to assure that the State and the utilities can pay their electric bills in the future. In addition, thelegislature is in the process of enacting a California Power Authority that would be the builder and conserver of last resort to assure that we move to a surplus situation and maintain a surplus indefinitely.

We recognize that the current administration and various legislators have their own opinion as to the California situation. My personal plea is that you respect the principle of State's rights which the new President has proclaimed.

Opinions and suggestions are certainly welcome and everyone can profit from listening to the other person's point of view. But my personal plea is that if the Federal Government is not going to help us, the least it should do is to refrain from legislation that attempts to tell us what to do.

We regret that FERC, under the previous administration, as well as this one, doggedly fails to do its job. And we would appreciate the Congress reviewing the Federal policy on wholesale prices and impose controls on a cost of service basis during the period when the market is clearly dysfunctional. We also appreciate any funds that would help support our own very strong conservation efforts, but please don't use the California energy crisis as an excuse to destroy the Arctic Wildlife Refuge with drilling or any other sacrifice of this Nation's natural beauty for any short-term inadequate production scheme.

The United States production of petroleum has gone steadily down since 1970 despite periods of increased price and major subsidy. We cannot produce our way out of energy shortages. It could come only through a combination of major conservation and the development of cleaner alternative sources, such as wind, solar, biomass, geothermal, as well as natural gas and petroleum in areas where drilling is not the enemy of America the beautiful.

Mr. BARTON. Thank you, Mr. Freeman. Leave California alone, huh? That might be a good motto.

We are going to hear now from Mr. Steven Kline, who is the Vice President of Federal, Government and Regulatory Relations for Pacific Gas and Electric Company. Your statement is in the record in its entirety. We recognize you for 8 minutes, Mr. Kline.

STATEMENT OF STEVEN L. KLINE

Mr. KLINE. Thank you. Good morning, Mr. Chairman and members of the subcommittee. This hearing comes at an especially opportune time, with California experiencing rolling blackouts in recent events. I would like to briefly share with you our view of what the current situation is, how we got here, and what, in our view, needs to be done both in the short- and longer-term to resolve this crisis.

In terms of how we got here, or rather, where we are, prices remain at very high levels as you have heard. February's estimate average wholesale price in the wholesale market was over $225 per megawatt hour. Supplies, you have heard, remain extremely tight. Northwest hydro is at record lows, California hydro is, at best, at 70 percent of normal levels.

On Monday and Tuesday, the California ISO ordered statewide rolling blackouts, which is an extraordinary development under any circumstance, but especially given that this is the low-usage springtime period.

The outlook for peak usage summer period is especially dire both in terms of price and supply, and the State's investor-owned distribution companies and a number of small power producers all teeter ever closer to bankruptcy.

How did we get here? I know you have heard a lot about this, I am not going to belabor it, but clearly the problem is fundamentally one of supply and demand. In addition, higher natural gas prices across the country have led to higher electricity prices.

I do want to stress that the problems in California are not the result of the concept of opening markets. I don't believe they are the result of the concept of deregulation. Basic economics tells us that under any regulatory system, higher demand, higher gas prices, shorter supply, will produce higher prices—not necessarily the higher prices we are seeing in the market today, but they would have produced higher prices, in any event.

That said, California's approach to electric restructuring—in essence, partial deregulation—made the problem worse, and certainly contributed to the 500 to 1,000 percent wholesale price increases we have seen over the last 8 months.

The reasons, in more detail, are described in my written testimony, require divestiture without contracts, total reliance on spot market, inability to use bilateral contracts or financial hedges, are designed to work in a system of abundant supplies. As Mr. Freeman pointed out, California's market structure clearly has not served customers well in a period of short supplies.

And, finally, frozen retail prices have shielded consumers from the real cost of electricity, including higher gas prices, and they have nearly eliminated the signals in prices to make energy efficiency investments and conservation, hence, demand reductions real.

So, where do we go from here? California's energy crisis cannot be resolved until supply and demand are back in balance. In order to do that, we need to increase supply. We need additional energy infrastructure, new clean and efficient power plants, natural gas transmission and distribution, and high voltage power transmission lines. In order to reduce demand, we need energy efficiency invest-

ments and consumers ultimately need to see accurate price signals. Over time, with infrastructure investments and wise public policy, supply and demand can be brought into balance, and the market will be workably competitive again, as we believe wholesale prices should then return to appropriate levels.

Having addressed that longer-term, let us talk about the very short-term in the form of this summer. The challenge, in our view, there is to moderate or limit electricity price increases, while still sending the longer-term market signals we all recognize we need.

In short, we need market-oriented solutions that attack the supply problem first and encourage fast-track projects, as Chairman Keese described, as well as demand-reduction incentives which build on those that were initiated last summer.

Even then, given the supply and demand imbalance we see, it is not clear that these tools will fully mitigate the potential economic impact, which leads us to the notion of temporary price caps.

Historically, we have not supported price caps. In the long-term, we believe they create market distortions and have unanticipated and unintended consequences.

That said, based on our experience, we have come to recognize that in cases where the power markets are clearly broken—for example, where FERC has determined that prices are not just and reasonable—short-term price caps may be warranted and necessary.

We are very concerned that there is a good chance that California and possibly other Western States are heading for a meltdown this summer where, due to short supplies, the price of power could increase from today's already high levels to stratospheric levels this summer. That would inflict severe hardship on households and economies of the Western States to no good end; prices are already high enough to encourage new generation and, as you have heard, that new generation is being built as fast as it can be permitted and constructed not just in California, but across the West.

In order to avoid such a meltdown, we think policymakers should create a mechanism, which would allow either the Secretary of Energy or the FERC to implement temporary price caps, should these worst fears be realized. It seems only prudent to start now to create such a policy tool and carefully define how and when that tool can be used, including the duration of use.

My prepared testimony sets out some thoughts on the circumstances and limitations may be appropriate under those circumstances.

What can be done now? State officials and stakeholders are still working to craft a comprehensive solution. These efforts are of paramount importance and are proceeding on an urgent basis.

Beyond the necessary State actions, there is much the Federal Government can do. Specifically, I believe, be prepared to moderate prices this summer; encourage Regional Transmission Organizations that are truly open and push open access transmission systems across the country; accelerate permitting of natural gas pipelines; streamline Federal agency review and approval of energy infrastructure projects; encourage efficient use of electricity through research and efficiency standards; encourage continued development of renewable energy resources by maintaining the existing re-

newables production tax credit; and, finally, increase funding for low-income energy assistance to help assure that those least able to pay continue to have access to reliable energy.

Thank you for the opportunity to appear before you today. I would be happy to answer any questions.

[The prepared statement of Steven L. Kline follows:]

PREPARED STATEMENT OF STEVEN L. KLINE, VICE PRESIDENT, FEDERAL GOVERNMENTAL & REGULATORY RELATIONS, PG&E CORPORATION

INTRODUCTION.

Good morning Mr. Chairman, and members of the subcommittee. I am Steven Kline, Vice President for Federal Governmental and Regulatory Relations of PG&E Corporation. Thank you for the opportunity to testify before you today, as you continue your examination of California's electricity shortages and related price impacts across the West.

This hearing comes at an opportune time, with California experiencing rolling blackouts in recent days. Let me share with you what our current situation is; how we got here; and what in our view needs to be done, both in the short and longer-term, to resolve this crisis.

WHERE ARE WE?

As you know, wholesale electricity prices in California and the West remain at unprecedented levels—the estimated average wholesale price for February in California was $228 per megawatt hour, with no relief in sight. Supply, both in terms of available megawatts and the natural gas used to produce electricity, is extraordinarily tight. Hydropower, in particular, continues to be short. At this point, it appears certain that the availability of hydropower across California and the Pacific Northwest will be substantially below normal. Our utility currently forecasts hydro availability of about 70 percent of normal and BPA continues to forecast hydro at around 60 percent of normal.

As I mentioned, the California ISO ordered statewide rolling blackouts because available supplies were inadequate to meet demand, an extraordinary development to occur in the normally low usage springtime. As we look to the peak usage summer season, the predictions are dire. At best, according to the California ISO, the state will be short 2 to 3 thousand megawatts for the summer, and that forecast may not fully reflect current hydro conditions in the Northwest.

HOW DID WE GET HERE?

California's problem is fundamentally one of *supply and demand:* statewide, between 1996 and 1999 electricity demand grew by 5,500 MW, while supply grew by only 672 MW. The effects of this extreme imbalance between supply and demand have been exacerbated by reduced hydropower supplies and rapid economic and population growth across the West.

In addition, higher natural gas prices across the nation are contributing to higher electricity prices.

The problems in California are not the result of the overall concept of opening electricity markets to competition. Basic economics tells us that under any regulatory system, wholesale power costs would be substantially higher under the conditions I have just described. That said, it is true that California's approach to electricity restructuring, combined with short power supplies, have undoubtedly led to the unexpected 500 to 1,000 percent wholesale power cost increases experienced over the last eight months and to the resulting financial crisis for the utilities.

California's restructuring approach required utilities to divest their power plants and to purchase all of the power needed to serve their customers on the volatile spot market. Further, until recently, the use of long-term bilateral contracts or other price hedges were also precluded. Designed to work in an environment of abundant power supplies, California's market structure has not served customers well under short supply conditions.

In addition, frozen retail customer prices have shielded consumers from the real costs of electricity, nearly eliminating price signals to make energy efficiency investments or to conserve, and thus reduce demand.

WHERE DO WE GO FROM HERE?

California's energy crisis cannot be resolved until supply and demand are back in balance. In order to increase supply, new clean and efficient power plants must be sited and built, together with natural gas transmission and distribution pipelines and high voltage power transmission lines. In order to reduce demand, energy efficiency investments need to be made [1] and customers need to see accurate price signals. Over time, with infrastructure investments and wise public policy, supply and demand can be brought into balance, market forces will prevail, and wholesale prices should return to appropriate levels.

In the very short-term, however, we anticipate major problems this summer. The summer challenge is to somehow moderate or limit electricity price impacts—while simultaneously sending the correct market signals to promote supply-demand equilibrium. California and the West will be scrambling to use all tools currently available to address the problem. In California, that means 1) bringing power plants not currently operating back on line; 2) siting and building additional "peaking" power plants in an expeditious manner; and 3) implementing emergency demand reduction efforts. All three of these measures are the best mechanisms available to address the very top of the demand peaks that will occur—and to help mitigate prices without exacerbating the supply problem.

In short, we must act immediately to provide market-oriented solutions that attack the supply problem first and encourage fast-track projects, such as is being done now with peaking units. In the interim, a combination of supply and demand initiatives is imperative—everything from the longer-term bilateral contracts being implemented now between the state of California and suppliers, as well as demand-reduction incentives which build on those that were initiated last summer.

Even then, given the extent of the expected supply-demand imbalance for this summer, it is not clear that these tools will fully mitigate the potential economic impact. This leads us to consider legislation that addresses temporary price caps in one way or another.

Historically, PG&E Corporation has not supported price caps; over the long term, they create market distortions and have unanticipated and unintended consequences. In a functioning market, they mask the peak price signals that spur conservation, changes in usage patterns, and investment in energy efficiency and new supply. Thus, price caps often make matters worse.

That said, almost a year ago we recognized that in circumstances where power markets are not fully competitive, short-term implementation of price caps might be necessary. Therefore, we adopted a corporate policy statement (attached) that addressed those circumstances, which can be summarized as follows: where markets are clearly broken—for example, where FERC has determined that prices are not "just and reasonable"—short-term price caps may be warranted.

With that context, I would like to address temporary price caps for the Western energy market, for the summer of 2001. Based on what we know today, there is a very good chance that California and possibly other Western states are heading for a meltdown where—due to short supplies—the price of power could increase from today's already historically-high levels to sustained stratospheric levels for the summer. That would inflict severe hardship on households and the economies of the Western states to no good end; prices are already high enough to encourage new generation, which is being built as fast as it can be permitted and constructed.

In order to avoid that meltdown, policy makers should create a mechanism, which would allow either the Secretary of Energy or the FERC to implement temporary price caps, should worst fears be realized. It seems only prudent to create the policy tool and carefully define the circumstances under which that tool can be used, including the duration of use. For example, any price cap should have an explicit start and sunset date, for instance, May 1st and September 30th of this year. And in order not to inadvertently discourage new, badly needed power plants, the price cap should apply only to existing generation.

With respect to setting a price cap, it must be simple enough to be easily administered, and it should allow suppliers to make a reasonable profit. Most options being given serious consideration involve benchmark rates that build up from a cost basis. Frequently discussed are technology-specific caps that would cover suppliers' costs plus a stipulated profit margin. Under this approach, caps would be set at different levels based on the type of generating resource—natural gas, coal, hydro, etc. Other options include fixed price caps at levels high enough to accommodate input price

[1] Pacific Gas and Electric Company has long been a leader in energy efficiency. The Company was honored to receive from the Department of Energy and Environmental Protection Agency the Energy Star award for "Excellence in Consumer Education" earlier this week.

fluctuations, such as variations in the price of natural gas, or indexed caps equal to some multiple of current input prices.

WHAT CAN BE DONE NOW?

State officials and stakeholders are still working to craft a satisfactory resolution that assures reliability and public safety, stabilizes retail rates to customers, addresses the longer-term infrastructure needs while protecting California's environment, and returns the State's utilities to financial health. These efforts are of paramount importance and are proceeding on an urgent basis.

Beyond the necessary state actions, the federal government should also do everything it can. Specifically, we believe the federal government should:

- moderate prices for the summer;
- encourage Regional Transmission Organizations and truly open access transmission systems;
- accelerate permitting of natural gas pipelines;
- streamline federal agency review and approval of energy infrastructure projects;
- encourage efficient use of electricity through research and efficiency standards;
- encourage continued development of renewable energy resources by maintaining the existing renewables production tax credit; and
- increase funding for low-income energy assistance to help assure that those least able to pay are not left without access to reliable energy.

Thank you for the opportunity to appear before you. I would be happy to answer any questions you might have.

Mr. BARTON. Thank you, Mr. Kline. We now want to hear from Mr. Jim Pope, who is Electric Utility Director of the Silicon Valley Power Authority in Santa Clara, California. Welcome to the subcommittee for the first time. Your statement is in the record. We will recognize you for 8 minutes to elaborate on it.

We apparently have a pending vote on the floor. We are going to try to continue the hearing, so go ahead, Mr. Pope.

STATEMENT OF JIM POPE

Mr. POPE. Good morning. It is a privilege to be here. This is my first opportunity to enjoy this exercise.

As you have heard, California is struggling, and struggling makes you better, makes you tougher. Fixes are going to take time, as you have heard. The Northern California Power Agency is a strong proponent of a competitive wholesale power market, as is Silicon Valley Power.

The Western power markets are dysfunctional and they lack the conditions for a competitive market, and you have heard a lot of examples of that.

While California's municipal utilities have fared well during the crisis, we have not been insulated from this dysfunctional market. Our utilities and our consumers have suffered through blackouts and rate increases. NCPA and its members have suffered economic hardships.

I have a customer that I recently shut two of the three of their facilities because the recent blackouts caused their furnaces to damage their product and they lost $2.7 million in the January rotating blackouts. And they now are possibly going to file bankruptcy.

According to the Los Angeles Economic Development Group, $1.7 billion worth of economic loss was suffered by the State in the rolling blackouts, two blackouts in January, and I believe the blackouts we had last week probably doubled that because we had the entire State rather than just Northern California blacked out.

The municipals in the North have lost their summer reserves. We have used hydro to keep the lights on in December and January. We have operated our gas-fired power plants and used up 20 percent of our energy credit or energy hours by the Environmental Air Credit Rules in the month of January. We have purchased power at the high market prices, and we have faced rate increases. Some of our utilities, one like the Lassen Municipal Utility District, may face 160 percent rate increase.

We have sold to the California ISO and we have not been paid yet. But, as Mr. Keese pointed out, the State is taking steps and we support the State streamlining of power plant siting. We support the public ownership of transmission. We support the supply side improvements of more generation.

NCPA members of Silicon Valley Power, Lompoc and Reading, have power plants planned. I have got an RFP on the street for four facilities in the city of Santa Clara to meet our growing load. We believe that the air emission efforts can go further.

We support the energy conservation efforts. My customers have curtailed over 30 megawatts of peak load last summer, and are curtailing to the tune of 7 to 8 percent within the city of Santa Clara, as is the city of Santa Clara.

State transmission acquisition: We support a transmission Publico, and we support some improvement or replacement of the California ISO, but we do have a couple concerns about the State transmission acquisition.

It appears that the purchase price will be at a premium and it will impact future transmission rates. Second, the municipal utilities in Northern California and some in Southern California have interconnection agreements with the investor-owned utilities, and those must be respected in the acquisition.

We must get the system upgrades and repairs done. I am the Chairman of the Transmission Agency of Northern California, and we are stepping forward with the Western Area Power Administration to help offer assistance in those upgrades and repairs.

The California ISO reform is critical. Transmission additions on a statewide basis, our most critical congested path is Path 15, which is the area in the center of the State from essentially Modesto down to Fresno.

The Western Area Power Administration TANC in the State is the fastest fix and, most recently, the ISO supported our particular proposal at the California Public Utilities Commission.

We need some appropriate Federal action. We need price stabilizing rates in the West. You have heard a couple of proposals. I don't really care what you call it, but we do need something in the West to help us manage through this crisis for an interim basis.

Non-jurisdictional utilities are part of the solution. The municipal utilities make up a small share of the wholesale markets. NCPA members in Santa Clara are net purchasers in the wholesale market. Many of our sales have been at the request of the ISO or the PX, and we were early and consistent supporters of interim price protections. But there are no "band-aid," "silver bullet" solutions. The recent California experience has taught us a number of critical lessons.

We believe FERC needs clear authority and direction on Regional Transmission Organizations to promote truly effective, regional and independent transmission management. Markets are regional, and the transmission system must be run in a manner that supports interstate commerce.

Current transmission constraints, like Path 15, must be eliminated. Ultimately, RTOs should have clear authority and responsibility to plan and expand the transmission grid. Federal transmission siting authority is also needed.

While there is a need for institutions to ensure independent grid management, these institutions should have minimal market involvement.

FERC must establish clear and effective rules to promote sustainable competitive markets prior to granting authority for market-based rates. Reformatting FERC's role so that it is an effective market monitor, with clear authority and direction to detect and correct market manipulation or abuse is critical and needed.

In conclusion, the municipal utilities have only one master. We live the obligation to serve. We buy resources, deliver resources for our citizen owners. NCPA, Public Power, Silicon Valley Power, continue to be part of the solution in the State of California and the West, and not part of the problem.

We look forward to working with the subcommittee in promoting these objectives. Thank you.

[The prepared statement of Jim Pope follows:]

PREPARED STATEMENT OF JIM POPE, GENERAL MANAGER, SILICON VALLEY POWER ON BEHALF OF THE NORTHERN CALIFORNIA POWER AGENCY

Mr. Chairman, members of the subcommittee, thank you for this opportunity to testify on the current electricity crisis and the corrective steps that can be taken. I am Jim Pope, general manager of Silicon Valley Power—the municipal utility serving the city of Santa Clara, California. I am testifying today on behalf of the Northern California Power Agency (NCPA).[1] I also serve as Chairman of the Transmission Agency of Northern California (TANC),[2] another municipal joint action agency that is the principal owner of the California-Oregon Transmission Project, the publicly owned high voltage transmission link between California and the Pacific Northwest.

Today, in California, we are struggling to develop solutions that will get us beyond the mistakes that have been made in restructuring the electricity market. NCPA has long supported steps to foster and promote sustainable and effective competition in the wholesale electricity market. Regrettably, the market conditions needed to sustain effective wholesale market competition are not present in California. It will take time, courage and coordinated state and federal efforts to develop and implement both the near-term stopgap protections and the long-term solutions. NCPA looks forward to working with our colleagues in the industry, the State, Congress and FERC to advance the necessary measures to ensure a reliable and affordable power system.

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[1] NCPA is a nonprofit California join powers agency established in 1968 to generate, transmit, and distribute electric power to and on behalf of its fourteen members: cities of Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alton, Redding, Roseville, Santa Clara, Ukiah, the Port of Oakland, the Truckee Donner Public Utility District, and the Turlock Irrigation District; and seven associate members: cites of Davis, Santa Barbara, ABAG Power, Bay Area Rapid Transit District, Lassen Municipal Utility District, Placer County Water Agency, and the Plumas-Sierra Rural Electric Cooperative serving nearly 700,000 consumers in central and northern California.

[2] TANC is a joint exercise of powers agency organized and existing under the laws of the State of California. Among TANC's purposes is the provision of electric transmission facilities and services for the use of its Members. TANC's Members are the California Cities of Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alto, Redding, Roseville, Santa Clara, and Ukiah; the Sacramento Municipal Utility District; the Modesto Irrigation District; and the Turlock Irrigation District.

CAUSES OF THE CURRENT CRISIS

While there is no value in finger pointing, it is clear that many factors contributed to the current crisis—a crisis that spills beyond California's borders and infects the regional power market. At its core, the California and associated Western power markets lack the conditions necessary for a competitive market: multiple sellers, ease of entry, free flow of commerce and price transparency. In California:

- There is a **shortage of installed and operable generation** in California. This shortage has allowed market participants to withhold generation, strategically bid and game the system to maximize profits.
- There is a **shortage of transmission capacity within the State.** Alleviating current transmission constraints between northern and southern California would have prevented the recent rolling blackouts. However, no party has both the responsibility and authority to relieve such constraints.
- There is a **shortage of transmission capacity to import electricity** products from outside California.
- The **absence of a seamless, independent regional transmission system** impedes commerce and narrows the relevant market.
- From its inception, **the Cal ISO and PX lacked the proper rules, procedures and mechanisms to promote competition,** monitor market conditions and take corrective action.

Market forces can only serve to check prices when competitive market conditions exist. In the absence of such conditions, sellers are able to dictate prices without suffering competitive responses that reduce sales and revenue. Whether generators in the state collected scarcity rents or excess profits, the result is the same: power prices that can devastate the economy. As recent experience in California demonstrates, market based rates only work when competitive market conditions exist.

CALIFORNIA MUNICIPAL UTILITIES HARMED BY DYSFUNCTIONAL MARKET

The general perception is that California's municipal utilities have been insulated from the volatile market. While it is true that California's municipal utilities retained the generation assets needed to serve load, our consumers have been far from insulated from the dysfunctional market. NCPA and its members:

- Voluntarily participated in the Cal-ISO load curtailment programs and have been subject to rolling blackouts—even though we had sufficient resources to meet our native load. The cost to high-tech industries of variations in power quality or unanticipated supply disruptions is severe. For example, a silicon chip manufacturer in the area may be pursuing bankruptcy due to the recent January rolling blackouts. These blackouts caused their furnaces to shutdown and stopped development of the silicon chips that caused them to lose $2.7 million of product.
- Have drawn down the reservoirs at our hydro projects to help meet the electricity demands of the state, putting at risk our ability to generate power at these projects during the critical peak Summer months.
- Operated gas-fired combustion turbines at the sole direction of the Cal-ISO, using 20 percent of available air emissions in the first 20 days of January (at a time when the plants would usually not operate)—again reducing our ability to operate the plants during the Summer.
- Purchased power from the market at rates above what would exist in a truly competitive market. Another NCPA member, the Lassen Municipal Utility District, faces a 160% retail rate increase as a result of the high price of its market purchases. While Silicon Valley Power has sold surplus energy in the market, we are net purchasers and should not be punished for what benefit we may receive when we sell surplus energy. To do anything else is fiscally irresponsible for our citizen-owners.
- Sold power to the Cal-ISO, for service to the state's investor-owned utilities, for which we have since been told we will not be paid.

As consumer-owned utilities, the effects of these developments will be felt directly and exclusively by our consumers. We have no stockholders to "share" in the pain.

CALIFORNIA'S EFFORTS TO RIGHT THE SHIP

As outlined above, there are many factors contributing to the current crisis. The State has taken, or is considering, a number of short and long-term actions to address the current crisis. I would like to share with you my views on those proposals.

1. Supply Side Improvements

All parties agree that California desperately needs generation additions. State siting laws, emissions limitations, investor uncertainty, and public opposition have all contributed to the inadequacy of current generation resources.

However, my utility and the other utilities within NCPA have built, and will continue to build, desperately needed generation resources. The Lompoc municipal utility, located in Santa Barbara County, is looking at building a plant in cooperation with NCPA. In the Bay Area, my utility (Silicon Valley Power) and others are looking at new resources. We have been in discussions with merchant plant developers for over a year and now have a Request for Proposal (RFP) on the street for four sites within the City each ranging from 50 to 150 Megawatts. It is not impossible to build new resources. In order to succeed, project developers must exhibit both environmental and community sensitivity, and advance smart, cost-effective technology choices.

The Governor's Executive Orders streamlining the siting process and providing greater flexibility in air emissions are important first steps—to maximize use of existing resources, jump-start generation additions, and show that the State is committed to adding generation. California municipal utilities believe these efforts can go farther. For instance, the short-term waivers of hourly emissions limits apply only to those plants under contract with the State Department of Water Resources. We believe the waiver should be expanded to include generation units owned by municipal utilities that are not under contract with the Department.

2. Energy Conservation Efforts

The Governor and the State Legislature are pursuing important energy conservation efforts. Demand reductions are the quickest way to meet our energy needs for this summer, and it is incumbent on all parties to take part in this effort. For example, Silicon Valley Power was able to reduce our peak demand in summer 2000 by 30 Megawatts through our customers' energy conservation efforts. Additionally, during the rotating blackouts in January 2001, we were able to reduce our load by 20 Megawatts as requested by the PG&E and CA-ISO.

With service to more than a quarter of the State's consumers, municipal utilities are pushing for a proportionate share of state conservation funds to allow us to assist our consumers in reducing energy demand even further.

3. State Transmission Acquisition

NCPA supports the formation of a non-profit, public transmission entity—or Publico—to replace the California ISO and own and operate the transmission facilities within the state. The State is pursuing purchase of the private utilities' transmission facilities as a means of restoring the financial health of the companies and providing collateral to the state.

While a state purchase of the transmission assets of the IOUs can work, we have serious concerns with the framework of the proposed acquisition. We are working with the Governor and others to address the following issues:

- **Purchase Premium—**NCPA and its members depend on the transmission facilities of Pacific Gas and Electric, one of the State's three investor-owned utilities, to move power from our generation resources to our member communities. Paying 2.3 times the book value to acquire PG&E's transmission assets could raise our transmission rates significantly and make our consumers pay disproportionately for the financial rescue of PG&E. It is possible for the state to both purchase these assets at a premium, and avoid increasing costs associated with transmission, either through targeting the acquisition premium to IOU consumers or through other savings. There is a point, however, when the purchase price will outstrip the anticipated value. We hope that the purchase price stays within the range that does not require transmission price, or tax, increases to our consumers.
- **Interconnection Agreements—**NCPA and its members have interconnection agreements with PG&E that outline the terms and conditions of our transmission service. It is our expectation that any final agreement to purchase the IOU transmission system should respect and extend existing interconnection agreements.
- **System Upgrades/Repairs—**We believe the state should give full consideration to the upgrades and repairs necessary in the existing transmission systems of the IOUs. Any final negotiations over price should reflect those anticipated projects and costs. The publicly owned electric systems of California, through TANC and SPPCA, have offered to assist in this endeavor.
- **ISO Reform—**We continue to work on reaching an agreement to participate in the Cal-ISO or some future, similar organization. To date, the complexity and

costs associated with Cal-ISO membership prevent municipal utilities from joining. Reform of the Cal-ISO should be tied to a state purchase of the IOU transmission system.

We believe these issues can be adequately and fairly addressed, either through the purchase terms or through Federal Energy Regulatory Commission review of the asset disposition under Section 203 of the Federal Power Act.

Fair, open access to the transmission system is critical to our industry and consumers as a whole. NCPA believes that it is possible to use the IOU's financial situation to accomplish this public good. We agree that this opportunity should not be missed and that a reasonable framework can be designed to accomplish both goals.

4. Transmission Additions

The transmission system within the State is woefully inadequate. We believe that the current system must be both upgraded and expanded. One critical component of this effort is Path 15—the major link between northern and southern California.

Had the current Path 15 transmission constraint been eliminated, we could have avoided the rolling blackouts that Northern California experienced last June and this January. Relieving this constraint—building a third, 95-mile line between Los Banos and Gates—has been identified by the Cal ISO as the top transmission priority in the state.

Given the financial position of PG&E and the uncertainty about transmission ownership, alternative approaches are needed to fast-track this project.

It is NCPA's belief that, given the current situation, the best and fastest way to move this project is to support the federal Western Area Power Administration (WAPA) as it exercises its role as the lead agency for the environmental assessment for the project. WAPA performed initial environmental and engineering work on the project. That experience and familiarity with Path 15 will expedite the process. Additionally, WAPA should be authorized to work on the design, engineering and land acquisition activities for this project. In addition, WAPA's ability to acquire rights-of-way could help to expedite the construction process.

It is not necessary for WAPA to either construct or own the line. A myriad of options are available. However, the line needs to be built, and WAPA is in a position to help start the process more quickly than any other entity.

At this time, we, cooperatively though TANC, are working with the State to secure support and financial assistance. However, we believe that federal support is also warranted and appropriate. The arrangements with TANC and WAPA, which were the last successful constructors of high-voltage transmission in the State, give the highest probability of success for this project.

APPROPRIATE FEDERAL ACTIONS

I understand that the response of this Administration and many in Congress has been for California to get its house in order before looking for federal assistance. I believe the State is taking positive steps, however, I believe federal action is also needed.

In the short-term, NCPA supports the need for price stabilizing rates for the entire western wholesale power market. Consumers and the economy are bleeding, and we must apply a tourniquet. Imposing price stabilizing rates is neither a cure, nor a long-term solution. However, it is an appropriate step to provide interim relief until the long-term steps can be taken to support a competitive wholesale market. We are willing to work with all parties to design this interim measure in a manner that will maintain incentives for building new generation. I understand some have raised concerns about the treatment of non-jurisdictional utilities in any FERC-applied interim rate. I would urge you to consider the facts and not be distracted by any jurisdictional red herrings:

- Municipal utilities make a small share of total wholesale market sales in California—with the majority of our generation dedicated to serving native load;
- NCPA members are net purchasers on the wholesale market. We must attempt to recover our variable, fixed and opportunity costs when we make sales to offset the high prices we pay when we are purchasing. To do otherwise would be fiscally irresponsible.
- Many of our sales have been at the request of the Cal-ISO or PX to provide needed power—and these sales have reduced our ability to operate our plants to serve native load consumers this Summer;
- We were early and consistent supporters of interim price protections—and have pledged to voluntarily abide by any interim pricing structure.

Another near-term step that the federal government can take is to support the upgrades to Path 15 through clear authorization for WAPA to participate in this

project as a partner, and by providing the initial funding that would be fully repaid by either the state, or the ultimate owner of the line.

I hope, however, that we look beyond short-term "band-aids" and take actions that address the underlying problems that plague the Western market.

The recent California experience has taught us a number of critical lessons:

- Without clear authority on RTOs, FERC accepted inadequate, inferior and flawed filings from the Cal-ISO. *FERC needs clear authority and direction on RTOs to promote truly effective, regional and independent transmission management.*
- While California would be the 6th largest country in the world based on GDP, it is not big enough to serve as a stand-alone energy market. *Markets are regional, and the transmission system must be run in a manner that supports interstate commerce.*
- There are numerous transmission constraints in California that have contributed to the rolling blackouts and locational market power. While the Cal-ISO identifies these constraints, it has no authority to take corrective action. *Current transmission constraints—like Path 15—must be eliminated. Ultimately, RTOs should have clear authority and responsibility to plan and expand the transmission grid. Federal transmission siting authority is also needed.*
- Creation of contrived markets—within the PX and ISO—don't work and exacerbate market problems. *While there is a need for institutions to ensure independent grid management, these institutions should have minimal market involvement.*
- Markets do not work well when there are too few market participants and scarcity of supply. *FERC must establish clear and effective rules to promote sustainable competitive markets prior to granting authority for market-based rates.*
- While there are conflicting accounts on whether generators have exercised market power, manipulated supply and bids, taken advantage of poorly designed market rules or simply profited from scarcity, it is clear that there is little public confidence in the current system. *Reformatting FERC's role so that it is an effective market monitor, with clear authority and direction to detect and correct market manipulation or abuse, is needed.*

Congress and FERC have exclusive authority over interstate commerce in the sale of electricity. The interstate market is not currently working and will not sustain effective competition. It is critical that the structure and mechanisms necessary for a competitive market be established.

NCPA is a participant in the Electricity Stakeholders—a diverse coalition supporting wholesale market reforms—and urges the Committee to adopt legislation consistent with the Stakeholder principles.

CONCLUSION

NCPA remains committed in its belief that a competitive market is beneficial to all consumers. However, such a market will not miraculously appear simply by declaring markets deregulated. As the California experience has demonstrated, deregulated markets that lack the structure to support effective competition will simply cause consumer and economic hardship.

California has begun to take steps that, if properly executed, can help resolve the current crisis. But Congress cannot simply pass the buck and watch the fall-out. Federal action must also occur. As a first-step, FERC must re-impose regulatory discipline in the uncompetitive western power markets. But we cannot stop there. Congress must also provide FERC with necessary guidance and authority to promote and monitor effective competition in the wholesale market.

NCPA looks forward to working with the Subcommittee in promoting both of these objectives.

Mr. BARTON. Thank you, Mr. Pope. We now want to hear from Mr. William Hall, who is the Vice President for the Western Region for Duke Energy North America, and he is headquartered in Morro Bay, California. Your statement is in the record in its entirety, and we recognize you for 8 minutes to elaborate on it.

STATEMENT OF WILLIAM F. HALL

Mr. HALL. Thank you, Mr. Chair and members of the subcommittee. My name is Bill Hall, and I represent the California assets. I am based in California, and I have lived there for 3 years. I represent a company who purchased those facilities that is based

in North Carolina, and I have a North Carolinian accent. I have had the chance in the last few years to travel up and down the State from San Diego to Sacramento, participating in numerous public forums and hearings, and have felt first-hand the frustrations, the anxiety and, at times, the anger of Californians over the situation they are in. Duke has continued to offer solutions and supply and risk-management tools to the utilities and to the State to help mitigate this issue as soon as possible. We have a long-term commitment to the State.

I want to talk about some short-term actions we think need to take place, as well as long-term, a few comments about who we are in California, very quickly. We own four fossil generating plants in the State, with a combined capacity of about 3,300 megawatts, about 4 percent of the total capacity available in the State. Those plants range in age from about 30 to 50 years.

Our plants produced in the year 2000 50 percent more generation than they did in 1999, and we have in plants—and we have actually permitted through Mr. Keese's agency, a project at our Moss Landing Facility where by the Summer of 2002 we will have 1,060 megawatt combined-cycle facility in service. So we are investing in excess of $1.5 billion to bring new supply on-line over the next few years to help the situation in California. We also have plans to add within the West 6-7,000 megawatts of generation over the next three to 4 years.

Now, let me talk a minute about short-term actions. As you have heard from the other panel members, we certainly have a significant situation that we have already experienced blackouts and we think certainly the Summer of 2001 and potentially 1902 could be significant in terms of additional blackouts, and we have some thoughts around what needs to be done there.

First of all, Duke recommends a key Federal and State agency should immediately form a Crisis Team made up of key stakeholders capable of monitoring energy needs in the West, and with the right people who can bring to bear the needed actions to resolve problems as they arise this summer. We think it is critical that Federal and State organizations work together on this matter.

Next, we do have some units, some plants, that are constrained due to emission limits. And we do applaud the Governor and his Executive Orders to require the air and water districts to work with us to see how those constraints could be lifted. Mr. Lloyd and his organization have been very cooperative, and we are making substantial progress. But at times, we do have situations where Federal and State agencies collide. U.S. EPA, for example, at one of our plants, they have the overriding constraint on that plant, and we are going to need the support of Region IX in that effort, and we ask the subcommittee to help with Region IX in terms of the sensitivity and need to rush forward with providing relief. And we are only asking for relief in stage emergency events to help produce more megawatt hours into the system.

We think it is going to be a real challenge to bring new significant generation on-line this year. We appreciate Mr. Keese's comments, but we also urgently ask that, again, Federal and State agencies, in advance, identify where there are conflicting issues, resolve those so once projects get into the permitting process they

don't buck up against those obstacles in the process, they are resolved up-front and we can quickly move through.

And, finally, the only real chance in California to minimize blackouts this summer is through demand-side management. The Governor has instituted many initiatives to help out both the State agencies and consumers in California. We ask the Federal Government, who has a significant presence in California, to help with conservation, as well. The Governor has a goal this summer of shaving 3,700 megawatts off the peak during the summer months, and that is going to require everybody's efforts.

Now let me talk about long-term actions—and long-term means over the next 3 years because we think, fundamentally, we have got to get between 15-20,000 megawatts of generation in service by 2004 in California, and obviously other generation in the West.

We think if a cohesive and successful program is to be undertaken, the following issues must be addressed. We must stabilize the existing business climate situation in California. We must deal with the deficiencies in gas and electrical transmission; deal with the robust wholesale markets and retail markets; continue efforts to streamline permitting, and look for a Regional Transmission Group which will help the West. And I will talk about a couple of those very quickly.

As you know, the Governor is contemplating the acquisition of the Utilities Transmission Grid as one means of helping them with their debt situation. Duke takes a neutral position on who owns the transmission grid, but we do ask FERC to work with California to ensure that any transfer of utility transmission assets will be conditioned to ensure open access, and that California will integrate itself into a larger regional transmission organization. You get consistent policy, you get consistent pricing, and you get consumers who have more options to go out and manage their portfolio of needs. So, we ask that the transfer be conditioned such that no one can interfere with interstate commerce or hamper the development of an effective regional market.

Energy infrastructure issues: We have talked already quite a bit about supply. Again, we encourage Federal and State agencies to work together to streamline the process. A good example is the Endangered Species Act, where the Federal Government has certain species on their list, the State doesn't, and we get caught in the middle trying to sometimes deal with that and determine which agency prevails and what sort of monitoring programs have to be put in place.

Also, the California ISO has identified most of the significant bottlenecks on the electric transmission grid in California, the most famous being the Path 15 constraint, and we ask again that FERC and the State agencies work collectively together to determine how we can make upgrades as quickly as possible.

Let me also be candid here that while supply is difficult to site anywhere in North America, certainly new transmission projects are even more difficult. Nobody wants wires in their backyard. So we also recommend that while we look at building new transmission infrastructure, we look for other creative ways as well, and that is to upgrade wires to strategically place power plants on the grid near load centers, to get the power into the needed areas of

the State because building new transmission projects will be difficult in California.

Intrastate gas transmission is of real concern. We have already had rotating curtailments at our plants in Southern California. There are simply not enough pipes and storage capacity to supply the increased electrical generation from our plants in Southern California, and the increasing core loads in Southern California as well. So we think it should be a top priority to build the infrastructure of gas system because, as we build new power plants in the State—and they are natural gas plants—we have got to be able to get the gas to the plants, and that is a real concern. Again, FERC and the State agencies, Public Utilities Commissions, it is important that they work together in that manner. The FERC Order of March 14 begins the initial steps to create incentives and to reduce obstacles to site both electric transmission and natural gas upgrades. So we applaud FERC for their efforts.

Certain, a Utility Stabilization Plan, which Mr. Kline talked about, is very critical. And the Governor and Sacramento are working on that effort. We think it is very important that we get loads—in this case, utilities—out of the spot markets and into forward markets to mitigate their risk to wholesale market volatility. In hindsight, certainly that was something that was lacking. The laws or the regulations were designed such that couldn't be done. And companies like Duke who do that on the output side of our facilities, we manage our risk by selling in the forward markets. Certainly, to protect consumers in competitive markets, forward contracting should be one of many products that they use to mitigate their risk to market volatility.

So those are thoughts that we have. That concludes my remarks. We look forward to working with both Federal and State agencies to help solve the problems in California and the West. We have a long-term commitment and we look forward to working with you. Thank you.

[The prepared statement of William F. Hall follows:]

PREPARED STATEMENT OF WILLIAM F. HALL, VICE PRESIDENT, WESTERN REGION, DUKE ENERGY NORTH AMERICA

Mr. Chairman and Members of the Subcommittee: Good morning. I am Bill Hall, Vice President of Duke Energy's California operations. I want to thank the members of this subcommittee for inviting Duke to your hearing. As we collectively explore needed solutions for California and the west, it is vitally important that all stakeholders be heard in this process. I am a career employee with Duke Energy, and am now based in California. So, I think I not only bring an industry perspective to these discussions but a perspective that feels firsthand the emotion and confusion over the events of the last 12 months. From its initial entry into the California market in early 1998, Duke has continued to offer solutions and ideas to the State's energy woes. Today, I would like to offer Duke's thoughts on both near and long term issues and our ideas for resolution.

Background on Duke's California Operations

Duke owns four fossil fired generating units in California, with a combined capacity of 3,300 megawatts ranging in age from 30 to 50 years. In December 1998, long before the hint of an energy crisis, Duke announced its intentions to develop an additional 1,500 megawatts of combined cycle generation at an investment in excess of $1.5 billion. In addition, Duke announced it would spend in excess of $100 million to retrofit its existing assets with environmental control equipment and perform upgrades to enhance reliability and flexibility. Our commitment to California and the west is long term, we have plans to add an additional 6,000 to 7,000 megawatts of generation in the west over the next 3-4 years.

What Happened in California

The events of the last twelve months are well documented but I think it's important to highlight a few key points. First, we should remember that during the first 2 years of market operations, power prices remained at or below initial expectations. In fact, on many occasions power was sold during off peak hours at $0 per megawatt hour, and during on peak at values typically in the $20-50 per megawatt hour range. Why did this occur? The answer lies in market fundamentals, there was an adequate balance between supply and demand. With adequate supply to meet demand market prices remained at very attractive levels. The state's utilities were able to pay down their stranded costs while under a state mandated retail rate freeze by procuring their power through the various available spot markets at prices well below the rate freeze. However, this strategy failed miserably in 2000 when wholesale prices exceeded the fixed retail tariff rates and utilities had no hedging tools available to mitigate their exposure.

Over the last ten years California has enjoyed significant growth in its economy. Since 1996 electricity demand in California has grown by 25% while supply has grown about 6%. Up until the summer of 2000 its economic growth and thirst for energy had been met through abundant electricity imports, and weather patterns that produced abundant winter rain and snowfalls and mild temperatures in the summer months. So California's decision to rely heavily on cheap available hydroelectric power from the northwest in the summer months and relatively cheap fossil generation available from the southwest during the winter months instead of building an adequate in state supply seemed prudent. This combination of favorable weather patterns and abundant cheap power lulled everyone in the west into a false sense of security.

Not only has California benefited from a robust economy, but in fact most western states have seen their economies grow at similar or even higher rates. Just last week census figures were released that showed Nevada's population has grown at a faster rate that any other state in the nation over the last ten years. In the summer of 2000, the tremendous economic growth enjoyed by many western states coupled with a very dry 1999/2000 winter and high seasonal temperatures produced scarcity of a very valuable commodity . . . electricity. I have not encountered anyone who has yet to profess his or her surprise at the magnitude of the imbalance between supply and demand. The market is reacting to the severe shortage of electricity supply and the resulting fierce competition for this scarce commodity.

In addition to the scarcity of electricity, California is now experiencing natural gas shortages due to the lack of available intrastate gas transmission infrastructure. With the passage of clean air laws in the early 1990's most California utilities switched to burning 100% natural gas to meet compliance, as burning fuel oil produced higher levels of emissions. With the increased demands on gas fired generation the past twelve months, Duke's California plants produced 50% more electricity in 2000 than in 1999, the gas transmission system has been severely strained causing curtailments to gas fired plants in southern California, and resulting price spikes of natural gas that translate into higher electrical production costs.

California's energy infrastructure is severely challenged and must be dealt with immediately and effectively. While efforts are being made at the state level to improve the process, permitting and building new power plants and gas transmission is a tedious and laborious effort and will not be done overnight. As an example, at one of Duke's existing sites where we are proposing to modernize the site with new gas fired combined cycle technology it is anticipated to take 5 years to permit and build the new plant due to NIMBY impacts. While there are numerous opportunities to repair market policies and rules, this effort will be to no avail if we collectively do not address the very basic of market fundamentals, inadequate energy infrastructure.

Needed Solutions

The very nature of problem solving in this business requires combinations of legislative, regulatory and investment schemes, all of which involves multiple players including federal and state governments, regulatory policy makers, suppliers and financial institutions. Already the California legislature has introduced in excess of 160 uncoordinated and conflicting bills, which send very mixed messages to existing and potential suppliers. In order to resolve these very complex issues California and the west, working cooperatively with federal and state agencies, must commit itself to a long term integrated energy policy that improves the investment climate to stimulate supply buildup, puts the necessary legislation and regulatory policy in place, and stabilizes energy prices for consumers. If we are unsuccessful in our efforts we will see an immediate retrench to a regulated environment. Even with the level of emotion and anger all of you have seen coming from California in the last

year, I must say that those who ultimately desire to see competitive, unencumbered markets in the west far outweigh those who seek a return to regulation. However, as a resident of California for the last 3 years let me say unequivocally that if we do not restore stability to the market in an expeditious manner consumers will demand a return to regulation. Remember, the events of last summer only exposed 10% of the state's population directly to the volatility of the wholesale market. Already we see a "slowdown de-regulation" ripple effect moving from the west to the east.

In Duke's opinion the elements of a comprehensive energy policy must include at least the following:

- Permit and build new supply quickly
- Institute appropriate retail tariff reforms that signal to consumers the need to alter their consumption, while providing them choices and tools
- Infrastructure improvements (electric and gas)
- Move towards a regional transmission framework with appropriate market reforms
- Achieve these objectives while balancing the needs of the environment

I will address Duke's thoughts on needed solutions in two categories; the first being the very immediate and impending crisis this summer, and second what needs to be done in the long term though long term should not be viewed in the traditional sense of elapsed time. Additionally, I will comment on those areas where the federal government can assist California and the west in resolving its energy problems in a timely manner.

Summer 2001 Outlook—Immediate Action

While there are varying opinions as to the potential severity of this summer's pending crisis we should not make the mistake of pinning our hopes on the cooperation of weather and new supply which has yet to manifest itself. The signs of impending supply shortages are evident, lack of rainfall and snow pack in the Pacific Northwest. The California ISO has projected this summer's peak capacity will be about 10% shy of peak demand. We must seek every way in which to responsibly free up constrained megawatts, put new generation on the ground, and institute aggressive conservation measures. Duke recommends the following actions be taken immediately:

- Key federal and state agencies should immediately form a crisis team capable of monitoring energy needs in the west and when required bring to bear needed actions and decisions to avert potential blackouts.
- In concert with the Governor of California's executive orders to make available potential constrained megawatts at existing facilities due to environmental regulations, the US EPA and state agencies should seek resolution on existing emission constraints that allow variances during periods of critical short supply. Many existing facilities are mandated by federal EPA Title V programs. Under normal hydro and weather years most plants can operate within these limits, but the projected increased demands on generating facilities in 2001 will result in premature curtailments of generation. Appropriate and sound methods should be developed that allow plants to operate in critical periods while ensuring appropriate and reasonable mitigation measures are employed to offset any increased emissions.
- It is highly unlikely that any new significant generation can be brought on line this year. While the Governor of California has approved new legislation and issued executive orders to streamline plant permitting the reality is there is little hardware to bring into the State and the current regulatory instability will deter suppliers from taking significant financial risk. However, where new generation permitting is feasible this year, then both federal and state agencies should ensure adequate resources are made available to expedite permit processing, both the federal and state government should make this the highest of priorities.
- The only real chance California has this summer to avert blackouts is through demand side management. Duke applauds the Governor's initiatives over the last several months to incent industry, small business and residential consumers to employ energy efficiency programs and curb consumption during peak demand periods. The Governor has a goal this summer of reducing on peak demand by 3,700 megawatts. However, as long as consumers are locked into fixed rates I'm afraid we will not see an appropriate level of response to curb consumption. Let me be clear that Duke is not advocating consumers be exposed to wholesale price volatility with no protection. In conjunction with the phase out of retail rate caps, utilities should be given the ability to mitigate their price

exposure and consumers should have available tools to monitor and make wise energy choices.

We should also be prepared to enact these same measures in 2002, as no significant new supply in the west will come on line until 2003.

Starting the Process to a Long Term Comprehensive Energy Policy—The Solution

There are many pieces to the energy puzzle, some must be identified but all must eventually fit together into an integrated policy for the west. California is not a market place unto its own. In fact, California through its own decision in the 1980's is heavily dependent on other west markets for its energy needs. While California should take immediate and decisive steps to reduce its dependence on imports, the very nature of energy supply in the west would not make it practical or cost effective for California to become wholly self sufficient. And as a practical matter it simply isn't technically or politically possible. So, a west region energy policy needs to take into account the overriding fundamental need for a region wide marketplace. Duke offers the following comments on the needed elements of a region wide energy policy:

- First and foremost California must restore stability to its market, principally by restoring the utilities to financial health as soon as possible. As you know California recently passed legislation (AB1X-1) which provides for the State Department of Water Resources to "step in" and cover the net short position (difference between projected load and their self provided generation) of the utilities, both for near term power and long term power contracts. While this is major first step, it is only a first step. The state is expending approximately $50-70 million per day on power from the spot markets, with no regulatory relief to collect these expenditures from ratepayers. The California Public Utilities Commission (CPUC) must act now to create sufficient revenues from retail rates to cover the state's expenditures. Just this past Friday the California State Senate Budget Committee informed the Governor's office that it would suspend appropriating additional funds from the state's budget until the CPUC dealt with the recovery matter.

  Next, the state must determine a method that will allow the utilities to pay off their past debts. As you maybe aware the State is contemplating the purchase of the utilities' transmission assets to at least retire a portion of the utilities' debt. Duke takes no position on the potential sale of the transmission grid to the State, however it does expect FERC approval of any transfer of this asset conditioned on commitments of fair and open access. The transfer of this asset cannot be permitted to become a means to interfere with interstate commerce or hamper the development of an effective regional market.
- Build more power plants as quickly as possible. Some new capacity will be online in neighboring states for the Summer 2001, but these supplies will probably be absorbed to meet local needs for 2001 and beyond. California's internal demand growth is growing at a rate of at least 1,000 megawatts per year. To provide for that growth and an adequate reserve margin, public and private generators must construct approximately 15,000 to 20,000 megawatts in California by 2004. In addition, the US Department of Energy should hold discussions with Canada and Mexico to determine if and how available native generation supplies can be sold into the west.

  The permitting process of new power generation projects needs to be streamlined. Duke applauds the Governor for his actions to provide legislation that expedites the process. However, there are cases where federal and state environmental requirements collide and slow down the process. One example is differences between the federal Endangered Species Act (ESA) and the state ESA. In the case of one species, it was given federal "endangered" status, the highest level under the federal ESA, but it has no state protection status. Even though it has been proposed for federal delisting, it remains on the list requiring and required Duke to spend months of additional time performing sampling studies. Federal and state agencies should meet and determine where differences exist that impede new plant permitting and then devise acceptable solutions.
- Eliminate energy infrastructure deficiencies. Building more power plants will not help if the electrons cannot get to loads. Transmission congestion has frequently occurred at the seams between California and other western states, and between each of the three utilities. The best example is the January 2001 rolling blackouts that occurred in northern California, due in part because of the well-known "Path 15" constraints which prevented generation in southern California and the southwest from flowing north. The California ISO has identified most of the bottlenecks. The challenge will be to address them quickly. It is imperative that FERC, other states and California work quickly to provide solutions

to upgrading an aging and weak grid. The US Department of Energy should direct the Bonneville Power Administration and the Western Area Power Administration to identify any action they could pursue to address transmission bottlenecks. A major impediment to new additions will be local community resistance, which is even more pronounced than resistance to power plants. In conjunction with new additions, the industry should look for other alternative more friendly measures such as wire upgrades, and effective placement of power plants on the grid.

Even more ominous for California are impending constraints on the intrastate natural gas system that could impede the delivery of fuel. In the winter of 2000/2001, the combination of high electrical generating loads and high core loads strained the gas infrastructure. San Diego Gas and Electric curtailed power plants in its service area on numerous occasions. It is expected that gas transmission infrastructure in San Diego this summer will be inadequate as additional load is added from Mexico generating plants. Adding new power plants to the existing gas system in California requires careful gas supply planning, including consideration of new gas pipeline capacity to California, the intrastate gas pipeline system, and probably significant expansion of gas storage capacity in Northern California and San Diego.

Duke applauds the actions taken by FERC in its Order of March 14, 2001, to remove obstacles to permitting and constructing new electric and gas transmission infrastructure.

- Need for regional price stability and transmission grid. California must work with the western states to develop and enhance a regional transmission grid that maximizes effective resource utilization and minimizes costs to consumers. California as a net importer of electricity stands to benefit from a regional market. To facilitate regional transmission planning that would insure power could reach its markets without undue congestion, California transmission owners (state agencies, utilities, municipalities) should be encouraged to form a Regional Transmission Organization that could include the Northwest, Intermountain, and Desert Southwest regions. Any transfer of transmission assets should require the integration of those assets into a larger transmission framework that complies with FERC 2000. Regional transmission systems would promote consistent and fair policy, tariffs, promotes open access, and would prevent power leaving one area for higher prices in another.
- Retail markets must be given the opportunity to respond to energy price signals. As long as retail price caps exist, there will be no demand response to elevated power prices. However, as retail markets are de-regulated, consumers must be given adequate assurances that their exposure to wholesale market volatility is mitigated. This can occur through the use of fixed term power supply contracts in conjunction with the utilities self provision of still a large portfolio of generation and an appropriate level of procurement from spot markets. This will create a balanced portfolio of energy products but at the same time allow electric service providers to reenter the marketplace and compete with the default service provider. In addition, with education and tools to make wise choices consumers can then begin to respond and dictate the terms under which they desire to procure electricity, this called the elasticity of demand.

Conclusion

As I stated throughout my testimony today, Duke has a long-term commitment to California and the west region. I can not emphasize enough how crucial it is for California to integrate itself into a larger electric wholesale market. Talk of commandeering instate supply assets sends a chilling signal to new investment and spurs retaliatory measures from other border states who have historically sold their native generation to California. Already we see Nevada and Arizona contemplating legislation to give their state's the right of first refusal as a condition for any merchant generator to build power plants in their states.

Finally let me say I'm pleased to see FERC's request for a convening of west region political and regulatory leaders on April 6, however this is much too late. If we are to solve these very complex energy issues in a timely manner, then all federal and state entities who can influence a successful outcome must make this the very top priority within their administrations.

Let us all work together to solve this crisis just as this great country has dealt so effectively with other challenges of the past.Thank you.

Mr. LARGENT [presiding]. Thank you, Mr. Hall. We are going to implement our own rolling blackout here in this subcommittee hearing. Due to the unpredictable nature of Congress, we have

three additional votes that are about to occur. And so we are going to issue our rolling blackout until 11:30, when we will reconvene and hear the final two witnesses, and proceed with the questions.

So, I apologize, but we will be back. Thank you.

[Brief recess.]

Mr. BARTON. The subcommittee will please come to order. We will now hear from our next witness, Dr. Larry Makovich, Senior Director for the Cambridge Energy Research Associates. Dr. Makovich, your written statement will be included in the record in its entirety, and we recognize you for 8 minutes to elaborate on it.

STATEMENT OF LAWRENCE J. MAKOVICH

Mr. MAKOVICH. Thank you, Mr. Chairman and members of the subcommittee.

The real lesson of the California power crisis is that there is a right way and a wrong way to set up a power market. California's power crisis is the result of poor market design, which included some serious structural flaws in these markets right from the start. And it is these flaws that created the 5,000 megawatt shortage in supply that exists in the State today. Unfortunately, actions taken so far do not address the underlying structural flaws of this market and, in some cases, these actions are likely to make matters worse.

California should fix its market flaws instead of further distorting the market by taking over the transmission sector and entering into long-term energy contracts that defer the cost of this crisis into the future.

The crisis in California arose because people believed that electric markets were just like other commodity markets—when demand and supply tightened up, prices would gradually rise, stimulate investment and keep supply and demand in balance. That notion was wrong. The power business is complex and has unique characteristics. There has been research done over many years that indicate if you are going to set a power market up, there are a minimum set of structural elements that need to be in place, and California simply didn't set its market up properly.

So, it is no surprise that 5 years ago, when this restructuring legislation was passed, when this flawed market structure was put in place, the California economy has grown over 32 percent, electricity consumption has gone up by 24 percent, generating capacity has actually declined.

Why wasn't generation added? When California set up its market, it did many things, but not everything, to set it up properly. Two major flaws prevented people from building power plants. One was something that people have talked a lot about here, which is the siting and permitting process was simply too burdensome, and it is not clear today that that problem has been solved. It looks like California, with all of its current focus on this, and effort, may actually complete by this summer versus last summer, enough capacity to just satisfy 1 year's growth in demand, let alone make any closure on this shortage.

Now, besides being difficult to build power plants, one of the key problems here was it was not profitable to build power plants. Both Mr. Keese and Mr. Freeman have noted that power prices were in

the past too low in California, and that is the result of one of the structural flaws in this market.

To set up a power market, you really need to set up markets for two commodities, energy—the megawatt hours, and capacity—the megawatts. California set up a market for energy, but it did not pay for the capacity. There was no market for megawatts.

The energy market they set up worked the way it ought to work. What it did was, it kept the market in balance in the short-run. Most of the time, electric demand is well above the amount of capacity you have, so the problem in any hour is to figure out which plants ought to be running to provide the most efficient electric supply. So, an energy market that is clearing on the basis of fuel and operating costs does the job of efficiently supplying power at any point in time, but because that market should and does clear on short-run cost, it doesn't provide a price signal that is high enough to support new plant development.

And so, as you look back through time over the 1995 to 1999 period, the price of power that cleared in this market was $14-31 a megawatt hour. That is less than half of what you would need to justify new power plant construction. I mean, the amazing complacency about California was no one complained the prices were too low when there was very clear evidence that this market was tightening, and nobody had the incentive to build power plants because it was neither profitable nor possible to do so.

Now, this energy market was very competitive over the past. It continued to clear at short-run cost when it was in surplus, when it came into balance in about 1998, and even when it moved into shortage in 1999, and it was only when in 2000, in the summer, we had a severe shortage that, of course, the prices exploded, and they went from being too low to being at multiples of what is necessary to justify power plant development.

Now, this has created a very acrimonious debate regarding price gouging, but it is very, very clear—prior to the shortage, the energy market was very competitive and produced prices based on variable cost.

Now, when you get into a shortage and you are talking about a commodity that customers regard as a necessity, if not a basic human right, and for which there are very few substitutes, you don't need market manipulation to have all of this demand chase far too limited supply and drive the price up.

So there are no features in the California market with regard to supplier concentration or production agreements that would lead us to believe that this was a problem of market structure and collusion that led to gaming and higher prices. This is simply a shortage, and that is the crux of the problem.

Now, what is just and reasonable? If a power market produced prices that did allow you to cover the cost of new supply, then it is very clear the prices we saw in 1995 through 1999 were unreasonably low. Now that we have created a shortage, the prices are unreasonably high.

It would be a mistake to argue that because prices were low in some periods and then too high in others that, on average over some period, we have got reasonable prices. The problem here is these wide swings in prices were both unreasonable, they create an

unfair cost recovery because customers and their consumption patterns change through time, so we have had subsidized consumption in the past and now we are burdening the customers of today with paying for the prices that were too low in the past.

A properly structured power market ought to pay for capacity, and that requires that if you are going to buy energy, you also have to buy capacity. That can be done through a number of mechanisms including the right type of long-term contract, but California has signed volume-based contracts which are likely to create enormous take-or-pay obligations in the future. If the State owns the transmission network, the vital linkage between buyers and sellers in this marketplace, it will further distort the market. Price caps are very difficult to employ. The current FERC price caps based on average incremental cost of the most expensive units are going to create market distortions. At best, those most expensive units are in different operation, most likely they are beginning a perverse incentive to shut down when they feel their prices are above monthly averages.

The recommendations here are clear. We need to set these markets up with independent, expert governance structures. We need to align wholesale and retail deregulation. You can't deregulate wholesale without retail. You need energy and capacity markets. You need to allow entry, set goals, and enforce siting and permitting targets, and you need to give people the right incentives, which means public ownership of transmission price caps are going to be a problem. Thank you.

[The prepared statement of Lawrence J. Makovich follows:]

PREPARED STATEMENT OF LAWRENCE J. MAKOVICH, SENIOR DIRECTOR FOR NORTH AMERICAN ELECTRIC POWER, CAMBRIDGE ENERGY RESEARCH ASSOCIATES

Lawrence J. Makovich is Senior Director for North American Electric Power at Cambridge Energy Research Associates (CERA) and heads CERA's Global Power Forum. His recent writings include: "Beyond California's Power Crisis: Impacts, Solutions, and Lessons," "A Crisis by Design: California's Electric Power Crunch" and "Regulation versus Market Competition: Is Electricity Restructuring Changing Course?" His recent studies include, *High Tension: The Future of Power Transmission in North America and Electric Power Trends 2001.*

When California passed its electric power restructuring law in 1996, it prided itself with being on the leading edge of deregulation in the United States. At that time, the state took on the daunting task of power deregulation for good reasons. The state's power prices were among the highest in the country, and the industry was mired in a complex regulatory system that promised to lead to still higher prices. The hopes were that deregulation would deliver lower prices and that California would be a model for other power markets to follow. That's not what happened. The results, instead, are today's power crisis: shortages, skyrocketing prices, rolling blackouts, financial distress and political turmoil.

Today, one of the biggest problems in California is that no one can agree on what went wrong. Customers, regulators, politicians and power producers are all pointing a finger at each other to assign blame. Although tempting, it would be incorrect to blame the problems in California on deregulation itself. Indeed, there is a grave danger of drawing the wrong lessons. If this crisis drives California back to the heavy-handed regulation that launched deregulation in the first place or to a expansive public power authority then the state is likely to find its electric sector becoming increasingly inefficient and expensive—and very much disadvantaged compared to regions with properly structured power markets. California is now at a critical juncture—the state can go backwards by reregulating—or even taking outright ownership—or the state can fix the flaws in its power market. The latter is the way to go.

Urgent action is needed not only to meet the current crisis but swift and dramatic steps are needed to avert an ever more severe shortage in the coming summer.

THE REAL LESSONS

The real lesson of the California power crisis is that there is a right way and a wrong way to set up and run a power market. California's electricity crisis is the result of three critical failures:

1. California set up its power market with serious structural flaws that made timely investment in new power supply neither unprofitable. These flaws were part of the California market design right from the start of deregulation. Consequently, the current power crisis was both inevitable and yet could have been prevented.
2. It has been enormously difficult to site and build new plants in the state. California has perhaps the most daunting power plant approval process in the nation. This process and the inability to site have thwarted efforts by companies to build the new power plant facilities that could have averted the supply shortfall.
3. Although described as "deregulation," the California system is only a partial deregulation. Customers remain under controlled prices (retail) that are well below the prices paid by utilities to generators (wholesale). This is a fundamental misalignment between the two parts of the market that creates a liquidity problem for utilities and disconnects the demand side from the market.

The crisis in California arose because people believed that electric energy markets were just like other commodity markets—when demand and supply tightened up then prices would gradually rise, stimulate investment and keep supply and demand in balance. That assumption, however, is wrong. Power markets are not like other commodity markets. The power business is complex and has unique characteristics. Research over several decades pointed out that power markets are far more challenging to set up properly than most other markets. The system that was set up in California *could* have taken these realities into account—and come out with a good result. The system that was set up did not take these realities into account—with the results that we now see.

WHAT TRIGGERED THE CRISIS

The flaws of the market design prevented supply from keeping up with demand. Five years ago, when California passed its power restructuring legislation, the state had a surplus of power generating capability. Since that time, the California economy grew a phenomenal 32 percent, fueled by a 24 percent increase in electricity consumption. The fact that electricity use increased less than overall economic growth meant that the state was becoming more efficient in its use of power. Yet conservation and greater efficiency could not stem the need for additional supply. By 1998, demand growth had ended California's power surplus. The record of the past five years is clear—California failed to approve the siting and permitting of anything near the 1,200 Mw needed each year to keep demand and supply in balance. As a result, far too few new power plants were added to California's power sector over the past five years. Moreover—and this point needs to be faced—not enough power plants are currently under construction to end this shortage in the near term.

Why was new generation not added? That is the heart of the matter. The California power market was simply not designed to add enough generating capacity at the right time.

THE MARKET DESIGN

California's restructuring law involved sweeping changes that did many—but not all—of the things necessary to make a power market work properly. The legislation unleashed competitive forces: customers could choose electric service providers (ESPs); utilities were required to divest at least 50 percent of their generating capacity to create a large number of independent rival generators. The legislation replaced the existing decentralized wholesale power market with a centralized energy market called the California Power Exchange (PX). Another institution called the Independent System Operator (ISO) became the traffic cop in the transmission grid that physically interconnected the electric consumers and producers. The ISO also ran a market for other services power plants provide (for example, voltage control) to manage power flows on the grid.

The California restructuring plan faced a particular complication—"stranded costs." The traditional utilities had billions of dollars of costs that could not be recovered at expected market prices. Thus, California included a transition plan to move to a market while recovering these above market costs. To do this, the state backed utility bonds to finance a rate reduction of 10 percent along with the establishment of a retail price cap with a competitive transition charge—otherwise known

as the "CTC." The CTC was the difference between the retail rate cap and sum of all power costs, including the wholesale power price. The retail price cap and its associated CTC expired once a utility recovered enough revenues to cover stranded costs. At this point, utilities remained obligated to serve customers by buying power from the power exchange and passing along this cost. The California crisis exploded when stranded cost recovery began to end and thousands of customers were released to the market just in time for the shortage to hit with far too little additional power supply in the works. As an emergency measure, the state returned to price caps to counter the shortage driven price shocks.

TOO FEW NEW PLANTS: OBSTACLES TO SITING

The state's approval process creates significant obstacles to building new plants. These include an open-ended environmental review process, tough siting and permitting procedures and well-organized community opposition. These hurdles make California one of the most difficult places on earth to build a power plant. As a result, year after year, the state failed to approve anything near its annual requirement for new supply to keep up with its growing demand.

TOO FEW POWER PLANTS: INSUFFICIENT INCENTIVE TO ADD "CAPACITY"

Even without these obstacles to siting and building, California set up a power market that guaranteed power prices that were too low to support enough timely investment in new supply. California set up an energy market that paid power generators to run their power plants but did not set up any market mechanism to pay generators for capacity—in other words, no capacity price signal to create an incentive to bring on new capacity. This meant that prices were lower in the short run, but it also meant that prices would eventually explode in a future shortage.

Setting up a power market with the right price signals requires payments for two electric commodities—energy and capacity. For example, when someone turns on a 100-watt light bulb, the power system needs to have a power plant with the capacity to produce an additional 100 watts of power. If capacity is available to meet this demand then utilization of the capacity through time can produce the watt-hours of energy. Unlike other commodities, electric energy is not stored in an inventory and thus requires capacity as well as utilization of that capacity to meet customer needs. Unlike other non-storable commodities like telecom, a busy signal is not an acceptable way to get around this capacity requirement "because, when you're talking about electric power, a "busy signal" takes the form of a blackout.

California needs enough capacity at any point in time to meet the sum of customer demands. During the summer time when air conditioners are humming, California reaches a peak demand of about 53,000 megawatts. Since generating capacity can break down or hydroelectric capacity can vary depending on how much snow there was the previous winter, California like any other power market needs a capacity reserve—an additional 15 to 20 percent of capacity to insure that supply meets demand at all times. This margin provides the cushion that can absorb shocks caused by shortfalls in supply or surges in demand. In California, that cushion was eliminated by the growth in demand, on the one side, and lack of new capacity on the other.

Although compelling evidence of a developing shortage was apparent, most industry observers were complacent due to the belief that when new supply was needed the energy price would rise and bring forth new power plant in time. This faith in the energy market was ill founded. The California energy market alone was incapable of providing a timely investment signal because it was successful in doing the job of providing a price signal to efficiently utilize existing power plants.

Most of the time the amount of generating capacity available to meet customer needs exceeds the sum of customer demands. Thus the typical problem for a power market is to figure out which plants ought to be running to minimize production costs at any hour. To do this, sunk costs are irrelevant and competition should drive energy prices to reflect the short run costs of rival producers—even at time of peak. The evidence in California is compelling—as long as a surplus existed, the wholesale energy market cleared on the basis of short run production costs with a level and volatility that was half of what was needed to support new investment. Similarly, when demand and supply were in balance, energy prices continued to reflect production costs. Even in a slight shortage during 1999, competitive forces were so strong that the energy market did not break significantly from production costs. Thus the problem in California began with prices that were too low. The average annual price of wholesale power in California from 1995 to 1999 ranged from 14 to 31 dollars per MWH, a level that is half of what is necessary to cover the full costs of new power plants. When the market tipped to a severe shortage in 2000, energy prices

soared and volatility exploded to levels that were multiples of what was needed to support new investment.

The shortage induced California wholesale price run-up created an acrimonious debate regarding price gouging. The evidence from California is clear—prior to the shortage, the energy market was competitive and produced prices based on variable costs. However, when a shortage developed for a commodity that customers regard as a necessity and for which they have few substitutes then substantial price increases were necessary even in the absence of any manipulation from suppliers. Thus, high prices alone are not proof of market manipulation. There are no features in the California market such as market concentration or production agreements that would lead to the expectation that the price run-ups would arise from anything other than too much demand chasing too little supply in a shortage.

Nevertheless, high wholesale prices trigger the question of what is the "just and reasonable" wholesale price level? When the market is in balance, the price should reflect the full costs—both fixed and variable—of new power supply. Prior to the shortage—when wholesale prices were too low—prices should have been recognized as unreasonable because they did not come close to covering both the fixed and variable costs of new power plants in a market that needed to stimulate investment. Conversely, during the shortage—when wholesale prices were too high—it was a mistake to judge the reasonableness of these prices without taking into consideration the foregone fixed cost recovery of previous years. Unfortunately, the California market guaranteed that just and reasonable prices would seldom prevail because the design required periodic shortages and reliability crises to provide fixed cost recovery for power investments.

Furthermore, it is a mistake to argue that prices that were too low in some periods and then too high in other periods but were on average, reasonable over some interval. A properly structured market should give customers a consistent price signal that reflects the true cost of electric supply. Wide price swings resulting from the flawed power market create a misalignment of power consumption and fair cost recovery. In such a flawed market, customers and their consumption patterns change through time while the price swings end up shifting cost recovery to some time periods and not others.

Clearly, a properly structured power market should not rely on periodic shortages and reliability crises to provide timely investment incentives. Such a flawed market design produces investment signals that are too sudden, too high and too late. The price signal for new investment needs to come several years before demand and supply reach balance to account for the lead-time needed to site, permit and construct new power plants. California provides a clear lesson—a properly structured power market should not rely on the energy market alone to keep electric supply and demand in balance.

A properly structured power market needs a capacity payment mechanism. This begins with the simple requirement that anyone selling electric energy to customers must also buy enough capacity to cover these customers capacity needs plus a reserve. A capacity requirement met by the right type of bilateral contract or through a formal capacity market can provide the timely price signal needed to avert shortages and keep power markets in balance in the long run.

HOW OTHER STATES HAVE SOLVED THE PROBLEM

California's lack of a capacity payment mechanism stands in stark contrast to other restructured power markets such as New England and the Middle Atlantic region. For example, New England had a market rule that required anyone supplying electric energy to customers to also have enough capacity (either owned or under contract) to meet demand plus a reserve. As a result, power developers in New England expected to sell both the capacity and energy from power plants. Besides looking more profitable due to two revenue streams instead of just one, building new electric supply in New England was also possible. New England states approved the siting and permitting of more than enough new supply to keep the market in balance.

SHORT TERM ACTION

California is currently about 5,000 Mw short of supply. Unfortunately, actions taken so far do not address the underlying shortage problem and in some cases are making matters worse.

The state is creating large problems for the future by financing current power purchases and pushing payments into the future. California has signed the wrong types of long-term power contracts by agreeing to pay for energy volumes at fixed prices in the future. Remember, just such contracts were mandated by the Public

Utilities Regulatory Policy Act and accounted for half of California's stranded costs. Having signed these contracts at the height of a shortage market, California is likely to have expensive take-or-pay obligations for decades.

Continuing the retail price-freeze at 1996 price levels is subsidizing current power consumption and contributing to demand growth. If California customers faced a twenty percent increase in retail electricity prices then within a few months, demand would decline by over 1000 MW and close a significant portion of the shortage gap. The retail price freeze also created a grave liquidity problem. The state's utilities are trapped in a sort of no-man's land, between high wholesale prices and regulated, frozen retail prices. Forcing California's utilities to buy power at levels many times greater than the level they can charge customers caused major utilities to accumulate over twelve billion dollars of uncollected power expenses in just the past six months. Besides bringing these utilities to the brink of bankruptcy, the liquidity problem makes power sellers very nervous about selling their power and never being paid. This summer is likely to generate billions of dollars of additional wholesale power charges that will appear on the states books and need to be paid off over an untold number of years.

The proposal for the State of California to acquire the transmission assets of the three major utilities to provide an infusion of cash to stave off bankruptcy will further distort the market. The state, through the Department of Water Resources, is now the largest buyer of power in the market. As the owner of the transmission assets, the state would also control the physical linkages of all suppliers to the market. Such a lack of independence would create incentives to distort the market. For example, the state has the incentive to include other costs in the transmission charge and increase this monopoly service price in order to squeeze profits from the many suppliers that agreed to long term fixed prices for their output. The prospect of the state controlling the physical infrastructure necessary for market transactions produces a chilling effect on power investment.

The prospect for price caps also contributes to a negative power investment climate. Without fundamental reforms, the California power market remains a market in which a supplier should expect energy prices to reflect variable costs in the absence of a shortage. As a result, price caps retain all market downside risk and remove all market upside potential in the flawed design.

Unfortunately, there is no quick fix to California's power problems. Nevertheless, there are many short run actions that can reduce demand and add supply. These measures include:

- Reconnect demand to the market. Necessary competitive forces arise when customers react to market prices.
- Find more conservation and interruptible load on the demand side.
- Add greater flexibility in legal and environmental limits on the power supply side. For example, the back-up and emergency generating systems at hospitals, hotels and office buildings in addition to barge mounted and mobile emergency power sources could provide a critical amount of additional supply in short order.
- Reactivate mothballed generating units.
- Expedite permitting and construction of power development already underway in California.

LONG-TERM ACTIONS

California needs an independent and expert governance structure for its power market. The flaws in California's power markets resulted from a flawed process of deregulation based on an idea riddled with uncertainties—market governance through a stakeholder democracy. Stakeholder democracy is the belief that if all of the stakeholders of a problem are brought together, the correct policy will emerge through negotiation and compromise. Instead of independent, expert oversight, California intentionally designed large committees of stakeholders for the governance boards of the California Power Exchange and the Independent System Operator. When California formulated its deregulation policy with plenty of power plants already in place, it was no surprise that the majority of stakeholders voted not to pay for capacity as long as the reliability was free. Citizens and businesses throughout the West, as well as the utilities, are now stuck with the bill for what has turned out to be a huge and costly failure in deregulation policy formulation. The Federal Energy Regulatory Commission should make independent and expert market governance a keystone of the long run solutions to the California power crisis.

Besides reforming the market governance structure, California needs a mechanism to pay for capacity and needs to set and enforce targets for approval of development plans each year for enough capacity to close the current gap and keep up

with demand. These reforms are not simple. California could mistake its current long-term energy volume contracts for the needed capacity payment mechanism. Consequently, instead of using the appropriate type of contract or making the proper rules for a capacity market, the market flaws will continue. In addition, the politics of "not in my backyard" may subvert real attempts to site and permit needed supply in order to meet development targets.

Mr. BARTON. Thank you, Mr. Makovich. We want to hear now from Mr. Mark Cooper, who is the Director of Research for the Consumer Federation of America, located in Silver Spring, Maryland. Your statement is in the record. We recognize you for 8 minutes. Welcome.

STATEMENT OF MARK COOPER

Mr. COOPER. Thank you, Mr. Barton. You have mentioned a number of times about the frequency with which others have appeared before Congress. Actually, I took a look. I have testified before every Congress that has looked at electricity, at least since 1986, and, frankly, we told you so. We warned policymakers that the fundamentals of electricity were such that it is extremely difficult to create retail markets in which residential consumers would benefit. The physics of electrons and the economics of electricity are just very, very difficult.

Now, we supported the 1992 Energy Policy Act. We believed that wholesale competition would work. But in the 10 years or so since that Act was passed, policymakers made two fundamental mistakes. State policymakers pushed deregulation into retail markets before there were workably competitive wholesale markets, and the Federal Energy Regulatory Commission failed utterly to create an interstate electricity market that would work.

Electricity is a vital commodity in a vulnerable market. It cannot be economically stored. It has no substitutes. It requires perfect instantaneous balance. The rigorous real-time physics of electricity make it susceptible to highly disruptive accidents. Surplus generation and transmission capacity have been lacking, and take a long lead-time to develop.

On the demand side, inelasticity of demand—its blood, its air, as you have heard—and weather-sensitivity make electricity prone to severe spikes and we lack the ability to shed load quickly in order to respond to those spikes.

Managing the complex set of physical and financial transactions necessary to clear this market has proven to be extremely difficult, and clearly open to gaming and manipulation.

Ignoring the warnings of Californians, the Federal Energy Regulatory Commission deregulated a market that was capacity-constrained. It used the wrong definitions of markets. It opened the wholesale market to abuse.

In California and elsewhere, the Federal Energy Regulatory Commission rubberstamped industry rules that were inadequate to discipline abusive behavior or produce open markets. FERC allowed a wave of mergers to concentrate the industry, rendering them more vulnerable to abuse. FERC made matters worse year after year by failing to discipline abusive practices, up to and including the most recent decisions on above-market prices.

Premature deregulation—that is, deregulation in a market that was not workably competitive—led to perverse incentives. We re-

duced supply in California. Utilities limited their reserves. We had no reserves in California. Utilities eliminated alternative fuel capacity. They undercut conservation programs. They went into court to say, "We don't want to buy conservation." They went into the PUC and said, "We don't want to buy distributed generation." They destroyed the reserve margin that we needed in order to make that market work much better. And, of course, in a tight market, the ability to extract windfalls, whether through collusion or conscious parallelism, is a major, major problem.

Price spikes for a commodity like this produce jumps that are nowhere else seen. This is not just a commodity. It is air. It is blood. You need it. You will pay whatever you can for it.

The inevitable result of the combination of irresponsible deregulation, mismanagement of a vital commodity, and greed—which is a constant and exploits advantages wherever it finds them—the result has been a massive and unjustified run-up in prices and an inefficient transfer of wealth from consumers to producers.

The electricity bill in California this year, at the January-February prices, will be something in the neighborhood of $70 billion, a $60 billion increase over 1998. If you look at our oil import bill between 2001—assuming OPEC successfully defends its $27 a barrel price—the total national import bill for oil will go only $50 billion. You cannot put that kind of burden on a State economy and expect it to survive or thrive.

Consumers now face the claim that the larger reserve margins, higher capital costs, faster depreciation, are necessary to make the market work. In addition, we have got all these new transaction costs from deregulation and the creation of new market institutions.

Consumers in California have rightly resisted the effort to put these price spikes into their bill because a large part of these price spikes are a result of artificial scarcity induced by market actors pursuing their profits, which is legal, but there are artificial scarcities, there is abuse of market power, and there is the pure stupidity of a poorly designed market.

Until the utility industry demonstrates that it can wring these rents out of the system, consumers don't want to pay the ransom, and that is a legitimate and reasonable action. They are willing to pay a fair price for electricity, but not to be held up by stupidity, artificial scarcity and the abuse of market power.

As I have suggested, Federal authorities bear a significant part of the blame for this problem because, if restructuring is going to work, it must be an interstate issue. Most States are too small to have a market, so we have to have an interstate generation market that is competitive and open, if any State is to succeed.

We have to have serious law enforcement. As long as the windfalls from withholding power are much larger than the incentives to produce, you are going to get a constantly tightening market. No one dreamed we would have the price spikes we have in California at 25,000 megawatts. We didn't have that problem in the past.

We believe that a cost-based price cap—cost-based—the soft cap we have today is not worth fighting for. We need a cost-based price cap for a number of years throughout the relevant market region. We need vigorous demand side management. We get lip service for

demand side and dollars thrown at the supply side. We need dollar-for-dollar match, supply and demand programs at the Federal level. We need the Federal level in the wholesale market to be willing to look at distributed generation—it is very difficult to get it approved—to be willing to look demand side reductions.

A megawatt in California, taking a megawatt of demand out of the market has a value that is at least 5 to 10 times the market clearing price. If you get a price at that. You need to get a price at that. But the value of the collective decision to reduce demand is infinitely higher in California today than the market clearing price.

There are a set of policies here at the Federal level that must be implemented if the States are to be able to at least have competition on the wholesale side. We still believe that could work, but if we don't have a functioning interstate market, no one can benefit from this process. Thank you.

[The prepared statement of Mark Cooper follows:]

PREPARED STATEMENT OF MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

Mr. Chairman and Members of the Committee, I am Dr. Mark N. Cooper, Director of Research for the Consumer Federation of America (CFA). CFA is the nation's largest consumer advocacy group, a non-profit association of some 260 pro-consumer groups, with a combined membership of 50 million, founded in 1968 to advance the consumer interest through advocacy and education. I greatly appreciate the opportunity to appear before you today to offer our view of deregulated electricity markets.

I have submitted for the record three CFA analyses of the real world performance of electricity markets since the beginning of restructuring. They do not present a pretty picture, but they come as no surprise to us. From the start of the electricity deregulation debate over 15 years ago we have warned policymakers that the fundamentals of electricity service—"the physics of electrons and the economics of electricity"—make it virtually impossible to create orderly retail markets that will benefit residential consumers.

We have an open mind about the wholesale generation market and aggressively supported the Energy Policy Act of 1992. Unfortunately, in years since that Act became law policymakers made two fundamental mistakes. State policymakers pushed deregulation from the wholesale market into the retail market and federal policymakers failed, totally, to create an open and vigorously competitive interstate market. These mistakes are the root cause of the chaos in electricity markets across the country today.

Electricity is a vital commodity in a vulnerable market. It cannot be economically stored, has no substitutes and requires perfect, instantaneous balance. The rigorous real-time physics of the electricity network make it susceptible to highly disruptive accidents. Surplus generation and transmission capacity are not generally available and take long lead times to build. Inelasticity and weather-sensitivity of demand make electricity prone to severe peaks and programs to rapidly shed load have not been developed.

Premature deregulation led to profit maximization that tightened electricity markets by reducing supplies, limiting reserves, eliminating back up requirements, undercutting conservation programs, and preventing facilities from being built. The small number of suppliers and the tendency for electricity product and geographic markets to be highly restricted in time and space make the exercise of market power and the implementation of gaming strategies that drive prices up easy to execute. Price spikes produce such huge windfalls that suppliers exhibit an OPEC-like (backward bending) supply curve, in which supplies are reduced, not increased, as prices rise.

Ignoring warnings about the existence of market power and capacity constraints, the Federal Energy Regulatory Commission (FERC) irresponsibly deregulated the wholesale market. Federal policymakers should never forget that FERC fought for control of California markets and deregulated them over the opposition of many in California. In California and elsewhere, FERC rubber stamped industry rules for operating the grid that are prone to manipulation and abuse. FERC's voluntary ap-

proach to forming regional transmission organizations has failed to produce nondiscriminatory access. FERC allowed a wave of mergers to concentrate generation markets, rendering them more vulnerable to the abuse of market power. FERC made matters much worse by refusing to exercise responsible oversight authority until very recently, when the abuse became just too blatant to ignore any longer.

Managing the complex set of real-time transactions necessary to physically and financially clear electricity markets raises transactions costs and has resulted in institutions that are plagued by manipulation and gaming. California's market institutions may appear to have been particularly flawed—including split markets for various types of energy and transmission, an auction that paid all producers the highest price allowed, a lack of reserve requirements, and a ban on long term contracts—but there is an ongoing debate about how important these factors were in comparison to the underlying problems of market power and the nature of the commodity. Markets with different institutions have suffered similar problems, albeit not as severe as California's.

The inevitable result of greed, irresponsibility and mismanagement of a vital commodity in a volatile market is a dramatic run up in price and a massive, unjustified and economically inefficient transfer of wealth from consumers to producers. In one week in 1998 in the Midwest, $500 million changed hands. Well over a billion dollars of rents was collected in California before the summer 2000 problem and billions more are being litigated for the summer's debacle. The California Independent System Operator has asked for over $500 million in refunds for last December/January. Over $70 million was collected in spike costs in New York City in one day. The New England power pool experienced price run-ups and PIM has been afflicted with dramatically rising capacity charges.

Competition has recently collapsed in the places like Pennsylvania and utilities there are seeking to bust their price caps, just as in California. This in spite of the fact that restructuring in Pennsylvania was supposed to be easy because of high prices at the outset, excess generation capacity, and location in the middle of a long standing power pool, well-endowed with transmission assets.

To the extent residential ratepayers have benefited from restructuring, it has been a result of rate reductions mandated by regulators not driven by market developments. In fact, a good case can be made that, given market conditions, consumers would have saved as much or more under effective regulation, without exposing them to price spike risk. Under the best of circumstances, for residential consumers, electricity restructuring was a solution to a high cost problem that has not worked very well, under the worst of circumstances it threatens to make them much worse off.

Consumers now face claims that larger reserve margins, higher capital costs, and faster depreciation are necessary to make the market work, in addition to new transaction costs resulting from the creation of new market institutions. Gone are the fanciful claims of 40 percent savings that were used to sell electricity restructuring to the public. Rather than bring dramatic new innovation and efficiency to the market, many of the entrants seem to have based their business models, and policymakers based their projections of consumer savings, on the ability to sell electricity powered by cheap natural gas. When cheap gas disappeared, so did the benefits of electricity restructuring.

Consumers resist effort to force price spikes into their bills, and rightly so, because a large part of the market price run up is caused by artificial scarcity, abuse of market power and the pure stupidity of poorly designed markets. Until utility industry institutions demonstrate that they have wrung the inefficient and unjustified rents out of the system, consumers are unwilling to bear the burden of dealing with legitimate scarcity problems. This resistance is reinforced when they discover that the solutions now proposed are to use mandatory economic dispatch in transmission, long term contracts in supply, and vigorous interruptible and conservation programs on the demand side. In other words, after wasting tens of billions of dollars, we find that the old system works better.

I have been all across the country educating state policymakers about what went wrong, and here in Washington I will focus on the large role that failed federal policy played in this tragedy.

The failure to recognize the important role of the continuing monopoly in transmission resulted in the under-regulation of the wires segments of the industry. The transmission wires are the highways of commerce over which electricity flows. This is a highway system, not a market, which constitutes an essential, bottleneck facility with virtually no redundancy and never likely to support head-to-head competition. One of its primary inputs is right-of-way, which relies on governmental power of condemnation. The biggest obstacle to the expansion of transmission capacity is a social externality—public concern about ugly wires and local health effects—not

inadequate economic incentives. Proposals to let the marketplace solve the wires problem are not likely to succeed, since given the market power that the wire "owner" would possess and the non-market barriers to expanding capacity, profit maximization would only result in the abuse of market power and the creation of artificial scarcity rents.

The right model for transmission is a public or private entity imbued with the public interest and dedicated to ensuring that this essential facility fulfills it public functions—ensuring reliability and supporting nondiscriminatory market transactions in the widest area possible to achieve economies of coordination and maximum competitive effect. It must be independent of market participants and directly accountable to public authorities for achieving those goals. Transactions must be standardizes and transparent, with the creation of an exchange in which all rates terms and conditions can be identified. Brokers must be subject to rules that are similar to those applied to financial transactions like stock sales.

The generation market must be demonopolized before it is deregulated. FERC should reconsider market-based pricing for markets that have not been found to be effectively competitive. Ownership limits should be established and additional mergers should be denied until effective market structures are defined.

Aggressive policies to discipline abuse of market power should be implemented. It is critical to monitor closely the supply, bidding and pricing behavior of generation entities even in markets where divestiture and/or open access have taken place. The basic supply and demand conditions in electricity markets may be so severe, that market structures that are traditionally defined as competitive will break down situationally.

Abusive conduct must be identified, investigated, eliminated and punished. Much closer market scrutiny than has occurred in the first few years is necessary. Law enforcement must be proactive, rather than reactive. It may be necessary to turn law enforcement over to agencies that have no stake in the day-to-day operation of the industry. It may also be necessary to identify a broader range of practices that are per se illegal, or at least trigger heightened scrutiny and to have a broader range of disciplinary measures to reflect the especially vulnerable and volatile nature of the commodity. Triggers for heightened scrutiny should be based on well-known structural conditions that are believed to increase the likelihood of the exercise of market power. Any entity that has engaged in market tightening behavior and later profited from actions that exploit the tightness should be subject to greater scrutiny.

Consumers express a strong commitment to reliability and an aversion to price shocks. This is the baseline against which "competition" will be judged. The most obvious means for preventing the overheating of markets is to have adequate reserve margins. However, in a competitive market, it is not clear that any supply-side entity has an interest in carrying excess capacity. For firm residential and small business customers, it may be more important to develop programs that let them enjoy stable prices without sending utilities plunging into markets to avoid blackouts. Proposals to build peaking reserves at stabilized prices become attractive if markets are going to be extremely volatile. Distributed generation and interruptible industrial load could provide a source of reserves on which utilities could rely to prevent price spikes. Aggregators could provide these functions.

Having experienced repeated spikes, policymakers should also implement a series of circuit breakers to prevent the sort of abuse that has occurred. The most obvious circuit breaker is a price ceiling or cap that simply does not allow trades to take place at prices above a certain level. Caps on wholesale prices that are uniform throughout the relevant interstate market—most likely intertie-wide—should be set to protect consumers from wild price swings and to prevent energy suppliers from forum shopping and pursuing beggar they neighbor behaviors.

My advice to state policymakers has been simple. Forty-seven of the lower forty-eight states are interconnected in the interstate grid and few have adequate generation resources to stand alone. They are dependent on a well-functioning interstate market and should not restructure retail markets until federal authorities demonstrate they can actually produce open, efficient, competitive interstate markets. Given the track record of the past decade and the current attitude of federal regulators, it is unlikely this will happen any time soon. Retail competition was always a dubious proposition for residential ratepayers. In the face of the failure of interstate markets, it is no longer just a disaster waiting to happen, it is a disaster that is actually happening in markets across the country.

Mr. BARTON. Thank you, Mr. Cooper. It is good to know that you have always known the answers. I would be happy to have them in writing to me by tomorrow afternoon at 5 o'clock so that I can

give them to the White House and they can rubberstamp them, and we will just make that the law next week.

Mr. COOPER. Well, I actually sat with you a couple of years ago about—face-to-face—and explained some of these problems.

Mr. BARTON. I remember that.

Mr. COOPER. And we never did get a bill that reformed the interstate market.

Mr. BARTON. We are working on it.

The Chair is going to recognize himself for 5 minutes for the first number of questions.

Mr. Keese, I would like for you to tell us, based on your best information, what the peak supply demand shortage for this summer is expected to be in California in terms of megawatts?

Mr. KEESE. Thank you, Mr. Chairman. I believe that the consensus that we are operating under is approximately a 5,000 megawatt shortage.

Mr. BARTON. On a peak demand?

Mr. KEESE. On a peak demand basis.

Mr. BARTON. Now, you indicated in your testimony you have six base-load power plants under construction, you have expected three of those will be in operation by July. What is the capacity of the three that you expect to be in operation by July?

Mr. KEESE. 1,300 megawatts.

Mr. BARTON. 1,300. So 5,000 minus 1,300 is still 3,700 that we are short.

Mr. KEESE. 3,700 to go.

Mr. BARTON. Okay. Now, there are a number of qualifying facilities that are currently shut down in California. If those facilities were to be paid the money that they are owed, how many megawatts could you get back on-line—not you personally, but the State of California—in terms of facilities that are available that are shut down because they haven't been paid and they have had to cease operations?

Mr. KEESE. Mr. Chairman, I have heard the number a high as 3,000 megawatts. However, that would not add to our supply. We are already counting on those.

Mr. BARTON. Oh, you are counting on those. You are an honest man to say you are already counting on those. I was going to give you some credit, but you have already—okay.

Mr. KEESE. We are hoping for enhancements, and both we and the Federal Government have issued rulings the QFs do not have to limit themselves to what they may have been permitted at. For instance, in our case, there are a number of facilities that are 49 megawatts because they would have been licensed at 50. We don't care if they operate at 65.

Mr. BARTON. Now, Mr. Freeman, you have been trying to negotiate contracts for power, I would assume, both within the State and out of the State. Do you have any definitive information on the availability of additional power that you think you will be able to contract for on behalf of the State of California for this summer, that we are not counting on right now?

Mr. FREEMAN. No, sir. Just to be frank, we acquired all the power that was still available from the marketplace this summer, that wasn't already sold to someone else, but I think to put the sit-

uation in perspective, the California power supply, 25 percent of it is for municipal utilities, and that is in good shape. The other 75 percent goes to the investor-owned utilities. That is divided into three parts. About a third of the power is still self-generated. They didn't sell all their plants. So, PG&E and the others still have——

Mr. BARTON. I can have an extended conversation with you off-camera and off the record. What I want to determine in my first 5 minutes is that we are actually going to have a real power shortage in California, and there is no disputing that, and it is apparently going to be in the 2-3,000 megawatt——

Mr. FREEMAN. No question about that, in the conservation program of a World War II size is what the Governor is proposing to balance the books.

Mr. BARTON. You are not promising that you have gone out and negotiated additional power supplies to come in and make it, and Mr. Keese can't promise that he is going to——

Mr. FREEMAN. No, sir, but I think the record should show that we negotiated about $42 billion worth of power with all the major companies, and we have an adequate power supply beginning about 2003 on, and this market is vigorous and there will be competition. There is a serious problem this summer and the conservation program is——

Mr. BARTON. I want to establish in this first round that you have got a major problem in California in terms of peak demand, and that if good-faith efforts aren't made on a demand management program that could reduce demand, that there are going to be significant blackouts. Does anybody dispute that? And they may not be confined to California. The record shows that everybody agrees that we are going to have a major problem.

Mr. KEESE. Mr. Chairman, I can augment the 1,300, if you would like. We also have in front of us at this time at the Commission, 362 megawatts of peaking projects which are slated to come on-line in July and August, and I have already indicated they are in the 21-day process.

We have been informed by developers of another 1,300 megawatts of peaking plants that will come on-line by September, approximately half of the in August and half in September. I can't guarantee that. I can tell you that five are in front of us. We are aware of another 13, for 1,326 megawatts.

We also are aware of another 1,500 for next year, but that should be off the table. So, the two numbers I would add would be 360 and 1,300.

I would then, in line with my question previously on the QFs, indicate that we are looking at current units which, with augmentations and waivers, can add another 1,200 megawatts to their current generating capacity.

Mr. BARTON. My last question—okay, I still have time.

Mr. SAWYER. You are the chairman.

Mr. BARTON. Well, I know that, but I am trying to be—I am a minute over, so I will ask my next question in the next go-around, and recognize Mr. Boucher.

Mr. BOUCHER. Thank you very much, Mr. Chairman. I want to commend these witnesses for the valuable information they have shared with us today.

Mr. Keese, I have several questions of you. During your testimony, you indicated your support for a regional price cap on the wholesale prices, perhaps along the lines suggested by Commissioner Massey in his testimony and in his recent dissenting opinion. And as I am sure you know, there is a split among the members of the Federal Energy Regulatory Commission about the wisdom of that approach.

I personally think that there are strong arguments that the Commission at least should undertake a Section 206 investigation in order to examine the merits of a proposal for wholesale price caps. And I would note that it could take just about any form.

The State of Texas recently imposed a wholesale price circuit breaker of, I think, $1,000 per megawatt hour, in case the prices in that State become truly extraordinary. So, a FERC could take any number of forms in terms of what kind of cap is imposed.

My question to you is this: A bill was recently put forward, at least in draft form, by Senators Feinstein from California and Smith of Oregon, on a bipartisan basis, that would provide a temporary cap on wholesale prices in the Western Region, conditioned upon the willingness of the State of California to lift its retail price cap. And I wonder what your view is of a proposal, an approach, that would follow those lines?

Mr. KEESE. I am aware that our Governor has been in contact with Senator Feinstein on a regular basis. She introduced that bill in collaboration with the other States of the West because we are all in this problem together and our prices are high.

I would certainly hope that the Senator and the Governor were communicating on that issue, but I do not know the answer.

Mr. BOUCHER. So you don't have a position, as the Chairman of the Energy Commission in California, on that question?

Mr. KEESE. I do not. I would cede that position to the Governor.

Mr. BOUCHER. The second question that I have of you relates to the proposal by the State of California to acquire the transmission lines that are currently owned by the investor-owned utilities in exchange for a purchase price. And I can acknowledge readily the value of that kind of approach, and I clearly understand the possible merits of it—it would provide a cash infusion for the electric utilities, and that would be of some substantial assistance in the effort to restore their financial health and, at the same time, the State of California would obtain an asset that is of considerable value.

Some people, however, have raised the concern that if the State of California obtains ownership of the transmission lines, that that act might remove the transmission lines from the jurisdiction of FERC, and that removal might have implications for the effective management of national wholesale transmission policies.

And so my question to you is, I wonder what your advice would be on the possibility of the Federal Energy Regulatory Commission conditioning the transfer of the transmission lines to the State of California on a willingness of the State of California, perhaps, to participate in a Regional Transmission Organization—a number of witnesses before this Committee have suggested the appropriateness of that occurring—or perhaps the FERC imposing conditions on the transfer of the lines to California in some other way that

would have the effect of a retention of FERC jurisdiction over those lines. So, your general advice, really, on two issues: First of all, the appropriateness of FERC retaining jurisdiction over the lines and, second, the appropriateness of California participating in a Regional Transmission Organization?

Mr. KEESE. I am aware that California is still open to discussions with the other Western States on how we handle the West as a unit, recognizing that from Mexico to Canada, we are one grid, and you can blow the grid with a toaster in Mexico, in any State in the West, or in Canada. Recognizing that, California is amenable to those discussions.

As you have also indicated through your question, there is a very strong likelihood—if not an absolute—that FERC must approve your relationship under which these lines are changed. I would imagine that FERC would assert whatever policies they continue to have, and their past policy has certainly been to answer that they would want to condition the transfer.

Mr. BOUCHER. You would not oppose FERC retaining jurisdiction over these lines, in the event that California obtains ownership?

Mr. KEESE. I would doubt that FERC is going to yield those lines to California, and abdicate control.

Mr. BOUCHER. Let me just ask one very brief question of you, Mr. Keese—with your indulgence, Mr. Chairman. You used a phrase that I have not heard before, in your testimony, and that was "energy intensity," and you were indicating that California has the second-lowest energy intensity of any State.

Is that a measure of energy consumed per capita? I am curious as to the standard.

Mr. KEESE. Yes.

Mr. BOUCHER. That is what that is.

Mr. KEESE. Energy per capita.

Mr. BOUCHER. If you have further information concerning that measure and how the various States rank, I would appreciate having that. You might submit it.

Mr. KEESE. Yes, I will. There is an EIA, Energy Information Agency, report. I will submit it to you.

Mr. BARTON. We are going to recognize Congresswoman Wilson for 5 minutes, then we are going to recess until 12:30—and it really will be 12:30 because we have three votes, and the votes won't be through 'til about 12:20. So we are going to recognize Congresswoman Wilson for the last 5-minute questions before we recess.

Mrs. WILSON. Thank you, Mr. Chairman.

Mr. Keese, you talked about a projected energy shortage of peak time between 2,000 and 3,000 megawatts this summer in California, depending on what comes on-line when. Is it your estimation that the rolling blackouts and the shortages will extend beyond the State of California?

Mr. KEESE. Mrs. Wilson, we are optimistic and are hopeful, and our plan is not to have rolling blackouts. We have an agenda that the Governor has put forward, to bring on 5,000 megawatts of generation by July 1. We have a balancing program to institute 5,000 megawatts of conservation by July 1. So, we remain optimistic that we can accomplish enough of that goal not to have blackouts.

Mrs. WILSON. Perhaps I should ask Mr. Pope and Mr. Kline and Mr. Hall, do you think that there will be rolling blackouts in California, and that they will extend beyond the State of California this summer?

Mr. POPE. I will start. We are clearly hoping that conservation and new generation——

Mrs. WILSON. I am not talking about hope. I have got constituents. We supply power to California and New Mexico is on the grid with the State of California. We have market power that we sell to you, although we have stopped selling it to you because you are not paying your bills.

I want to know if I can turn on the lights in New Mexico this summer, your best estimate.

Mr. POPE. My best estimate, New Mexico probably will be okay. You have got enough coal in that area that you probably are going to be okay. I think the problem areas are going to be California and the Northwest, given the shortage of supply, the shortage of transmission capacity, and possibly the shortage of natural gas and air credits to get the energy produced and delivered into the State.

I would like to point out, summer for California starts May 15 and goes until about October 1. So those are the critical windows, the normal critical windows, and where you have risk of rotating blackouts and shortages. We have seen them in December, January, February, March.

Mr. HALL. I agree with Mr. Pope. I think the key factor, particularly for California, is Mother Nature and what weather patterns look like this summer. If we have the kind of heat wave we did in June of last year, and spikes through the rest of the summer, I think it is going to be very precarious.

So, Mother Nature is the key in the West this summer. I believe that we are going to have some level of blackouts in California, the question is how severe, and then how that impacts the rest of the West, depending on weather.

Mr. KLINE. I agree.

Mrs. WILSON. Mr. Hall, I think this question is for you, but your colleagues may have something to add as well. This issue of NO_X and whether there will be power taken off-line because power plants use up all their NO_X chits. Can you talk about that a little bit and whether you anticipate power generation being taken off-line because of that?

Mr. HALL. Well, certainly there are within our permits and our facilities, there are NO_X caps in place, and typically those are based on the historical operation of the facilities and, when those permits were developed, how it was thought those plants understood they would operate in the future, but that has kind of all changed because now these plants are operating at a magnitude higher level than they were in the past.

So, we do know for a fact that some of our plants could be constrained but, again, I am confident that the Governor, the Air and Water Districts—and we need the support of the EPA—will work with us to allow those megawatts to be freed up during those critical periods this summer. And that is going to be a key to helping the supply demand imbalance this summer.

Mrs. WILSON. I do want to ask Mr. Freeman a question about fuel cells and microturbines, which you mentioned about using those in the California market. These distributed generation technologies, which ultimately is one of the ways to get competitive power. When do you expect these technologies to be installed? Is this a short-term or a long-term impact on the supply of power?

Mr. FREEMAN. The fuel cells will begin to be available in this calendar year, probably not this summer, though, in large numbers. There are plans for manufactures of hundreds of thousands of these machines next year and the year after. They are coming, and they will come decisively when they do, mainly, because the customers that have been interrupted are just sick of it, and they are just going to buy these things and they will start to happen in a big way. The marketplace, in its wisdom, does work. If the central station system won't work, these fuel cells and microturbines will come on like thunder.

Mrs. WILSON. Thank you, Mr. Chairman.

Mr. BARTON. We are going to recess until 12:30, and it really is going to be 12:30, so I would ask our witnesses to be back in their seats by 12:30.

[Brief recess.]

Mr. BARTON. The subcommittee will come to order. Let the record show that I am late, that somebody said, "You are late," and that is true. When we recessed, Congresswoman Wilson of New Mexico had asked questions. We now go to the Democratic side, to Mr. Sawyer, for 5 minutes for questions.

Mr. SAWYER. Thank you very much, Mr. Chairman. Let me just open with an observation, and that is that I think we all feel very much like trapeze artists who set out to get from one podium high above the crowd, and to travel his trapeze across to the other side and get safely on the other podium. Instead, he found himself not having jumped quite far enough, and is slowly dangling in the middle, unable to get back to the platform from which he came—a regulated environment in a fashion that we have been used to for most of the last century—nor can he get to the destination podium on the other side where he can safely stand in a—"safely" is a relative term—in a restructured environment.

We have not done a very good job of getting form one to the other, and my first question really goes to the comments that were made by both Chairman Keese and Mr. Freeman, where you suggested, each of you in different ways, that if we need to do something to break that sense of equilibrium where we are in between two—point of initiation to point of destination—and each of you suggested in different ways some of the same things.

Mr. Keese, you suggested that we call on Washington—that is to say, FERC—to adopt a temporary cost-based regional price cap that would allow generators to recover all of their cost plus a reasonable rate of return.

And, Mr. Freeman, you said, "My personal plea is that if the Federal Government is not going to help, it should at least refrain from legislation that attempts to tell us what to do, and we would appreciate the Congress reviewing Federal policy on wholesale prices and impose controls on a cost-of-service basis during the period when the market is clearly dysfunctioning."

Both of those sound like a plea for return to a rate of return on investment style of regulation at least in the interim, until we can recover some measure of stability and go on to a period of more thoughtfully restructuring.

Could you comment on that, either one of you—and if others would like to chime in, I would appreciate it. First of all, is my impression correct, No. 1, and, second, can you tell us how to get from where we are to where you suggest we be?

Mr. FREEMAN. Yes, sir. I think you succinctly summarize our testimony, and, for me, it is not hard. I used to work there. The Federal Power Act is fairly clear. All they have to do is what they were doing, at least to my knowledge, from the early 1960's until about 2 years ago, of just looking at the cost of generation and allowing people—I would even give them a generous rate of return on their cost-of-service and fixing the prices on that basis. And it is necessary because the statute requires that they fix rates that are just and reasonable, and no one can claim that the kind of prices in the wholesale market of recent vintage are either just or reasonable. To me, it is just that simple.

It is not a discretionary thing where the policy of the administration can be one way or the other, it is a statute that was enacted under the leadership of Sam Rayburn a long time ago, been on the books, enforced until a couple of years ago when they decided to experiment with market-oriented price, with the idea that the market was going to give us a similar result, but it hasn't, not on electricity and not on the transportation of natural gas, which is the most overlooked issue in Washington. It is a double-whammy on the consumer. That is my view.

Mr. SAWYER. Mr. Keese?

Mr. KEESE. I would suggest, Mr. Sawyer, that the letter from the Governors, I believe, had a figure of $25 over costs. Two years ago, the average price at this time of year was $25. So, in a way, that is not an unreasonable return, cost-plus, and that would take into consideration the increases in natural gas that have taken place. I concur with Mr. Freeman's comments that that is another concern that we should have.

Mr. SAWYER. Mr. Chairman, I would hope that we could just hear from others, but I would like to express a concern, and that is that I can appreciate the desire to press FERC to do those things which is within FERC's ability to do. I am deeply concerned about trying to do, by a show of hands here or on the floor, the kind of things that have been done by careful regulation for more than a century. Other end of the table?

Mr. BARTON. We need to expedite. Answer the question, but we need to go to the next questioner.

Mr. COOPER. There is a difference between what you have to do when you are trying to work out of a situation—a bankruptcy, a market failure, whatever—and the structure you want it to look like at the other end. I think it would be very helpful if policymakers in Washington and California would pick a time period and say, "Here is what we need to work out," and they give you your supply curve, or when we think we will have rebuilt the supply curve, and in the interim work out a series of steps we need, extraordinary measure—one might be a price cap, you have heard

someone suggest a NO_X moratorium—a variety of things during the workout period, which is a classic set of actions that you take during this emergency, rather than throw the corporation into bankruptcy and destroy all of its assets.

And, so, it would be very helpful for people to pick a time period—and we have heard the question of this-summer/next-summer—and say, "Here is what we are going to do extraordinary, this is what the market will look like when we are done."

Mr. MAKOVICH. It is important to realize that these solutions we are talking about are really two different sets—the short-run and the long-run. Price caps, cost-based price caps, are all short-run solutions. Most of the things people are talking about right now are things they want to get us through this summer and next summer.

The problem is, we are failing to address the long-run solutions here. You can set up these power markets to work properly, if you set them up with the right rules. The good example is New England. New England started deregulation with a far tighter supply and-demand balance than California, because they had nuclear outages, unexpected outages with Millstone, but they set up a market that made it both profitable and possible to build power plants. New England has had thousands of megawatts of power plants added. The market works to bring forth supply. And it is all a matter of getting the structure right, and California is yet to do that.

Mr. SAWYER. Thank you, Mr. Chairman.

Mr. BARTON. I think we need to put in the record—and Mr. Freeman knows this—the Federal Power Act was passed in the 1930's. There was no regional market or national market. There was a law passed in 1992, I think, called the Energy Policy Act, that created a wholesale market, a deregulated market. So the first mission is a little bit different post-Energy Policy Act than it was between 1934 and 1993.

Mr. Shimkus, for 5 minutes.

Mr. SHIMKUS. Thank you, Mr. Chairman. I am going to try to go quickly. I have a couple of questions. First, Mr. Lloyd—and many of you, although Mr. Cooper just talked about an aspect of NO_X capping—but most of you said our environmental regulations have not impacted this issue. But most of you have all continued to praise Governor Davis for his lifting of some of the environmental requirements.

So, my question is, if environmental rules aren't a problem, why would you praise Governor Davis for waiving some of the requirements?

Mr. LLOYD. I think that is an incorrect statement. Governor Davis has not waived the environmental requirements. What he has asked for is to speed up some of those issues that are on the books so, in fact, we can——

Mr. SHIMKUS. What does that mean, speed up?

Mr. LLOYD. Well, what it means is looking at some of the permits there from an air quality viewpoint. So, what we are saying is that, yes, we recognize there can be some speeding up in that process, but we are not talking about sacrificing the environment. We are not talking about sacrificing public health.

Mr. SHIMKUS. And I would disagree that you would be sacrificing public health on some of the more stringent environmental stand-

ards that you all may have imposed on your public, but that is a different debate.

Let me go to Mr. Pope. In your statement, you mention that in the first 20 days of January, you used 20 percent of your allotted air emissions in the first 20 days, is that correct?

Mr. POPE. That is correct.

Mr. SHIMKUS. What if the remaining 80 days were similar to the first 20 days and you used 100 percent of your allotted air emissions, what would have happened?

Mr. POPE. If we would have used all the air emissions for a combustion turbine, we would not be able to run that for the remainder of the year.

Mr. SHIMKUS. Mr. Lloyd, is that an impact?

Mr. LLOYD. There is a process whereby we work with the local districts and we work with EPA so that, in fact, that does not happen.

Mr. SHIMKUS. But it could happen.

Mr. LLOYD. The point is, in the past, we have seen this as a possibility, but what we recognize now, because of the additional need for energy, we have to look at this and then——

Mr. SHIMKUS. So you might waive some of the strict requirements.

Mr. LLOYD. We would not waive the strict requirements, but you have to make up for those emissions down the lines. You are going to have to put on some additional controls.

Mr. SHIMKUS. So you fudge on them a little bit.

Mr. LLOYD. No.

Mr. SHIMKUS. You stretch them a little bit.

Mr. LLOYD. No.

Mr. SHIMKUS. You are doing something.

Mr. LLOYD. Recognize that these plants were put on with certain limits because they are higher emissions than what we typically allow, and that is why you have a cap on that, and that is what is agreed to by all parties. If, in fact, that cap is exceeded, what the Governor's Executive Order allowed us to do is work with the districts to make sure we keep the power there, but not sacrifice——

Mr. SHIMKUS. Let me go to a little filibuster and I will follow up with a question. We know that the past 8 years of this administration, we have had a fuel of choice, which is natural gas. There was a comment here that natural gas is a part of this equation, and I will make my comment based upon my parochial interest in nuclear and in coal and in clean-burning alternatives, that if you continue to rely on natural gas as a solution to this problem, with the understanding that our baseload is met primarily by coal and nuclear, we continue to run on natural gas, not only are we going to have these continued power problems, but we are going to have continued high natural gas prices that we are experiencing all over the country.

Mr. Freeman, I am a big supporter of munis. I represent Springfield, Illinois. We have a tremendous muni-power generating facility, and they do a great job.

Is it not true that you are not regulated under FERC?

Mr. FREEMAN. That is true.

Mr. SHIMKUS. Is it also true that you were not impacted by the California Deregulation Bill?

Mr. FREEMAN. It is true that we had a choice under the State law, and we chose to remain a vertically integrated utility, and the lights are on and the rates are stable.

Mr. SHIMKUS. Very good, you are 2-for-2. Let me then go on and ask, you are a power exporter, correct?

Mr. FREEMAN. We have modest surpluses from time to time, but we basically build on for our native load. But we conserve and when we have a slight surplus, we sell it to the rest of the State, to the ISO.

Mr. SHIMKUS. And were you using the spot market to sell?

Mr. FREEMAN. We were in the past, but we now have a contract with the Department of Water Resources that I did not negotiate, someone else did.

Mr. SHIMKUS. Who negotiated it?

Mr. FREEMAN. I was on leave and I was negotiating with some of my friends at the table here and ended up buying $42 billion worth of electricity from the State over the next 10 years, under the authority of the Governor. I am simply pointing out that we moved from the spot market to a contract within the last 30 days, as has a lot of other people.

Mr. SHIMKUS. And I think we have identified, Chairman, one of the problems with the California deregulation bill was the spot market, the short, 1-day purchasing of power instead of long-term contracts.

Mr. FREEMAN. We have moved mightily away from that.

Mr. SHIMKUS. I appreciate your responses, I am sorry for the quickness of them. I got a lot in in 5 minutes. I yield back, Mr. Chairman.

Mr. BARTON. Before I recognize Mr. Markey, I just want to follow up on what Mr. Shimkus just said. I don't think this is the case, but it just tweaked my interest. There is not a chance that you were negotiating on behalf of the State of California with yourself on behalf of the city of Los Angeles——

Mr. FREEMAN. No, sir, I walked out of the room deliberately and had nothing to do with the negotiations with the city of Los Angeles. I have some pride, though, in the fact that I think I cut better deals on the deals that I negotiated than the ones that I didn't.

Mr. BARTON. It wouldn't be difficult to negotiate with oneself.

Mr. FREEMAN. It would be a conflict of interest back and forth, and it did not happen.

Mr. BARTON. I have driven a car that I owned into another car that I owned, and had to negotiate with myself on the insurance claim. That is not a fun experience.

Mr. FREEMAN. I suspect you did rather well.

Mr. BARTON. It depends on which one of myself I was negotiating with. Mr. Markey is recognized for 5 minutes.

Mr. MARKEY. Thank you, Mr. Chairman, very much. As the author of the wholesale bill in 1992, it was the Markey-Moorehead Bill, Carlos Moorehead. I went to him and I suggested this would be a good idea—worked out great for Massachusetts, by the way. Carlos was from California, although I think in L.A. County, so he is probably still at the time, but it was my bill back then. And I

did it with Bennett Johnson, actually, in the Senate, and included it into the 1992 Energy Act. And it was a little deal that I cut with Bennett, because Bennett was trying to remove the restriction which prohibited electric utility companies from generating electricity outside their own regions or outside the country. And so, in turn, I said why don't we open up this wholesale marketplace as well.

Now, obviously, New England, Pennsylvania and other places are examples of where it is working quite well. California is an example of where it is not working well. You also have these extraordinary external events, including the greatest drought in 100 years. You cannot, plan on losing 3,000 megawatts, reduce hydropower generation as you are moving into a year, but you are also not assuming that if there is an increase in demand by 5 percent, reduction by 5 percent, the prices go from $6 or $7 billion for a commodity to $70 billion for a commodity over a 2-year period of time. That is irrational.

That is why I believe that the FERC has to come in and order a time out. If the price of a loaf of bread went from $1.39 to $13.90, it would be impossible for us to envision any circumstances under which that would be acceptable, especial absent an ongoing 365-day-a-year snowstorm where there was a rush on bread. And that is what is happening here to electricity. It is now 365-days-a-year.

So it is obviously a dysfunctional marketplace, and it has tremendous adverse long-term consequences for the economy of California, perhaps the West, and we don't want it to spread any further than that.

Just to clarify, just so I can get back to my own Act so that it is not misunderstood, FERC's basic obligations and authorities to ensure just and reasonable wholesale rates, or required cost-of-service rates, were not altered by Markey-Moorehead in 1992, those authorities are in Section 205 and 206 of the Act, and were not erased by the new Section 211 that my amendment added to the Act. In fact, when FERC issued its Order 888, it relied 211 which limited them to issuing wholesale transmission access orders on a case-by-case basis, but on Sections 205 and 206 which, in light of the congressional guidance set forth in my amendments, FERC interpreted to give them the flexibility to go to market-based rates. FERC always retains the power to return to cost-based rates either temporarily or permanently, just so everyone understands, in fact, what happened back then, and what my intent was.

So, this power still sits there. The question is, does it make sense to go to a cost-based system for a period of time? Obviously, the regulatory system is quite familiar with that, especially when you are in a situation where such an incredible anomaly is occurring which has tremendous economic and societal consequences.

Mr. Keese, today's L.A. Times reports that California's Independent System Operator is filing a study with FERC today, alleging that wholesale electricity suppliers overcharge California by about $5.5 billion between May 2000 and February 2001. Specifically, the study found that the five largest in-State generators, 16 smaller suppliers withheld supplies and manipulated prices. They are calling on these companies to refund the money.

Does the California Energy Commission agree with these findings and recommendations?

Mr. KEESE. Mr. Markey, they have not been presented to me, and I am reading about them while you are reading about it. The ISO, Independent System Operator, is independent of State government.

I would point out your comment that—regarding our comment—that perhaps some form of temporary price controls might be appropriate. There are obviously many ways FERC can do this.

Mr. MARKEY. Mr. Hall, your company, Duke Energy, is one of the alleged manipulators. So, can you tell us, at anytime during the period covered by the California ISO study, did you effectively withhold supplies and bid at excessive prices? At anytime, did you have power generation available and did not bid at all?

Mr. HALL. I have been asked this question a thousand times in California and elsewhere, and again I will say this, and I have said it over and over again, we do not conduct ourselves in that manner. We do not conduct ourselves in an illegal manner. We don't withhold generation. And the facts and the output of our facilities demonstrate that. We don't manipulate markets.

Mr. MARKEY. Mr. Cooper and Mr. Freeman, your comments on price gouging.

Mr. BARTON. This will have to be the last comment on this round. We are going to have additional rounds.

Mr. MARKEY. Thank you, Mr. Chairman.

Mr. COOPER. The question of the cost-based rates is fairly straightforward. What the FERC has decided to do is find the least efficient generator and assume the highest price and assert that that is a just and reasonable price. That simply transfers all the economic rents to anyone who has actual cost below that level. That is not the point of a price cap. And so we have absolutely no interest in a soft price cap that is simply going to rubberstamp the windfall profits.

Now, if we can start to work toward a reasonable binding wholesale price cap that gets prices toward costs, then you will hear a lot less shouting about giving up a hard retail cap. So, the fundamental point is, the point of law enforcement, the point of regulation, is to control rents, not rubberstamp them.

Mr. FREEMAN. I haven't seen the study, but I think the study dramatically demonstrates the failure of FERC to do its job. This is the kind of report, the kind of analysis, that you would expect a regulatory agency with a statutory responsibility to conduct. And I think it should be an embarrassment to the FERC to have some agency in California suggesting that rates that they have sanctioned are not just and reasonable, and they don't have apparently a working knowledge from a regulatory point of view, to refute it. They need to be dealing with it, this is FERC's job, and they are not doing it. That is what that study demonstrates.

Mr. BARTON. The gentleman from Oklahoma, Mr. Largent.

Mr. LARGENT. Thank you, Mr. Chairman. Mr. Freeman, how many transactions did the Los Angeles Department of Water and Power conduct in selling electricity above the soft cap?

Mr. FREEMAN. We sell—our policy has been to sell on the basis of cost plus a reasonable rate of return of about 15 percent, and

we consistently sold on that basis other than in the years in the past——

Mr. LARGENT. Did those exceed the soft cap, any of those transactions exceed the soft cap?

Mr. FREEMAN. I don't have that knowledge in my head, but if I could finish——

Mr. LARGENT. How much money has L.A.——

Mr. FREEMAN. If I could complete my answer, sir. You asked me a question and I want to answer it.

Mr. LARGENT. I don't need to know the rest of that. What I——

Mr. BARTON. Let us have a little decorum. The gentleman from California has the time. Let him ask the question—I mean the gentleman from Oklahoma, and then the gentleman from California can answer.

Mr. LARGENT. I have seven questions. I have 5 minutes, and so I just need to ask you not to filibuster the question so I can get the answers so I can get through.

How much money did L.A. Department of Water and Power make during the last year and a half, say, on those transactions?

Mr. FREEMAN. Frankly, we are owed $200 million now, but we haven't been paid. So we haven't made a lot of money lately. In the years past, we have earned between about $150-200 million over a 3-year period, excepting the amount of money that the State decided was the price, and leading the fight, I might add, to lower those caps with the other municipalities during that period. Mr. Pope is my witness that we provided the votes to reduce the caps. We are in favor of low-priced electricity for everybody.

Mr. LARGENT. Thank you. Did the Los Angeles Department of Water and Power withhold power to increase prices?

Mr. FREEMAN. No, sir. We are the only outfit that added power during the last 3 years to the State of California. We added 1,000 megawatts, and our units are available whenever they are needed by the rest of the State.

Mr. LARGENT. Mr. Makovich, I have a question for you. How much demand would need to be suppressed in order to avoid blackouts? How much would we have to suppress current demand to avoid blackouts this summer?

Mr. MAKOVICH. The analysis that we provided in our report showed that under expected conditions—soft economy, 8 percent availability on thermal, 80 percent normal hydro—we are looking at about a 5,000 megawatt gap.

Demand can be reduced, in our estimate. If retail prices went up by 20 percent, like the way they have through the rest of the West, in California, you could probably get over 1,000 megawatts in response after a couple of months.

Mr. LARGENT. Would it be true to say that the rest of the West, minus California, is experiencing higher prices as a result of the retail caps imposed in California?

Mr. MAKOVICH. Yes, that is true.

Mr. LARGENT. So, basically, California is profiting as a result of——

Mr. MAKOVICH. In fact, the low prices in California have stimulated demand and made the market tighter that has created higher prices throughout the West, which has pushed some of the burden

of the 1996 frozen prices in California onto the rest of the retail customers in the West.

Mr. FREEMAN. But the record shows that the price of electricity in California is much higher than it is in most of the other Western States.

Mr. BARTON. We put into the record at the hearing on Tuesday the latest EIA actual numbers on retail prices for the region. The California average price was a little over 10 cents a kilowatt hour at retail. In Arizona, it was around 8 cents a kilowatt hour. In Washington State it was around 5 cents. I am quoting from memory, but California has the highest retail prices in the region. Having said that, retail prices in the other States are going up more rapidly than they are in California. That is in the record and we can make those tables available.

Mr. FREEMAN. Thank you, sir.

Mr. LARGENT. Mr. Makovich, I wanted to ask you again, we have kind of a long-term issue that has to be addressed as well as a short-term issue getting through this summer. Do you see any other way to reduce demand in the snort-term, other than doing something about the retail caps in California?

Mr. MAKOVICH. I think that is the most efficient way to get any kind of real meaningful demand response. I think many of the efforts now to search out a greater interruptible power and so forth are very expensive and are going to produce rather small decreases in demand, given this gap.

What seems to be lacking is a very focused and concerted effort to do everything you can to get additional supply on. That would be the more efficient way to close this gap in the short-run.

Mr. LARGENT. Dr. Lloyd, I had a question for you. You mentioned that you have got your folks basically running a little faster in terms of expediting the process, but what specific actions have the State and local Air Quality Management Districts taken with respect to air regulation, to keep the lights on?

Mr. LLOYD. I think what we have done, thanks to the Governor's Executive Order, worked with the local districts more closely so we have an oversight from the State. In those cases where we are needing to get the lights continuing to burn, if you like, we are working with the local districts and with EPA to, in fact, raise some of those caps so we can keep them running, the existing plants——

Mr. LARGENT. Raise the NO_X caps, you are talking about?

Mr. LLOYD. Yes, to keep those running over a period of time, and then we have the flexibility then during this time period we can keep them running as long as then we have to reduce the NO_X emissions down the line in a period where we are not expected to need such electrical demand.

Mr. LARGENT. So the NO_X caps are too low?

Mr. LLOYD. The NO_X caps are set because, as I said earlier, typically these plants are those which don't have state-of-the-art NO_X controls on there, and so they have these caps because, in fact, they run for a certain period of hours so, in fact, we are protective of public health.

Once they put those controls on, then they can run for much longer periods of time, and that, you see, is happening all over the State of California.

Mr. LARGENT. Mr. Chairman, I will yield back. I see my time is up. I just want to tell Mr. Freeman, I wasn't trying to be rude, I was trying to be fast. So, I apologize if it appeared otherwise.

Mr. BARTON. Well, the Chair will indicate that our 5-minute cap is a soft cap, not a hard cap. We are going to try to allow for good questioning and good answers. And we are all in this together, if we can find some solutions, this subcommittee, on a bipartisan basis, is very interested in working to help not only California, but the rest of the region and the country, for that matter, on some of these issues.

The gentleman from California, Mr. Waxman, is recognized for 5 minutes.

Mr. WAXMAN. Thank you, Mr. Chairman, for recognizing me, and for the statement you just made because we do very much look forward to working with you.

At Tuesday's hearing, there were a number of points of confusion, and I would like to clear up the record by introducing a letter from Governor Davis, which explains some of these misconceptions, and also make his letter available to the press. I think it is worth reading.

I would also like to introduce into the record a Letter to the Editor from former Senator Bennett Johnson, which explains the flaws with a recent editorial in the Washington Post which was co-authored by Mr. Makovich.

And, finally, I would like to introduce into the record an article from today's L.A. Times, which documents the allegations that consumers in California have been overcharged by $5.5 billion.

Mr. BARTON. We will show that to the staffs on both sides, but I am sure, without objection, we will put those documents into the record.

Mr. WAXMAN. Mr. Keese, as you know, we heard testimony from FERC on Tuesday, and I was astounded to hear FERC Chairman Hebert reply that there have been inadequate market signals in the West to spur the development of new power plants. In fact, Mr. Hebert stated that the shovel has not been turned on the first new power plant in California. This statement leads me to believe that either Mr. Hebert is not following the California situation very carefully, or he is not being straightforward with this Committee.

You mentioned in your testimony that six new power plants are currently under construction, and another seven have been approved. Would this be taking place if there were insufficient market signals in the West?

Mr. KEESE. No.

Mr. WAXMAN. So now there is an incentive for these power plants to get on-line, where there was not that incentive before?

Mr. KEESE. Mr. Waxman, briefly, the power plants were started to be filed with us in 1998. We continue to get power plant filings. As I mentioned, we didn't have any basically built in the 1990's. Now we have 50 in front of us. They are arriving still at two a month.

So, siting of major power plants was last year's problem. We are done with that. Siting peakers is today's problem, and seeing that those that we sited get built is today's problem.

Mr. WAXMAN. Dr. Lloyd, let me ask you, President Bush, some Members of Congress, and some generators have claimed that the Clean Air Act has restricted electricity generation in California. These statements, though, don't appear to stand up to scrutiny.

On February 26, 2001, EPA Administrator Christie Whitman appeared on the television show "Crossfire" and was asked if environmental regulations in California contributed to the energy crisis. And she responded, "That is not the case. What is happening in California is due in large part to decisions made in California over a period of 10 years. I asked our people to go back and give me the environmental clean air regulations that were hampering the ability of utilities in California to provide power, and we couldn't find any". That was a quote from Christie Whitman.

Mr. Lloyd, how many permit applications for new power plants were denied in the last decade, on the basis of Clean Air Act regulations?

Mr. LLOYD. Well, in fact, Congressman Waxman, we looked similarly back there, at the request of the Governor, and we could find no evidence of that at all. In fact, we see the flexibility provided under the Clean Air Act is, in fact—gives us that flexibility.

Mr. WAXMAN. Now, Mr. Pope and Mr. Hall have implied that electricity generation may be curtailed due to the NO_X trading program. Their comments don't seem to reflect the current changes in the program. Mr. Lloyd, do you expect any needed generation to be taken off-line due to the unavailability of NO_X emissions credits this summer?

Mr. LLOYD. We do not expect that. We are working under the Governor's Executive Order. We are working closely with the districts, with the EPA, to assure that. In addition, some of the issue of the reclaimed credits from the South Coast, their board is, in fact, looking at modification of that program in May of this year.

Mr. WAXMAN. I just have to say, I am quite stunned. Here is the L.A. Times for today, and the headline is "Energy Overcharge of $5.5 Billion Alleged." It just seems clear to anybody who looks at this situation in California objectively, is that this market is dysfunctional, and the producers, generators, of electricity have taken advantage of the situation and gouged the consumers, gouged at least the utilities, and made the system not work because they held back on supply, even though, as Mr. Freeman said, still not sufficient supply. They have taken advantage of an opportunity to make a lot of money.

And what do we see in another newspaper? In the Washington Post, it says, "Spencer Abraham, the Secretary of Energy, said 'We need policies that are more friendly to the generators, more friendly to the business interests'." It seems to me somebody has got to look out for the consumers and taxpayers in California and all around the country, when a so-called "de-regulation" ends up as an opportunity for an enormous amount of mischief and unfair trade practices.

Mr. Freeman, is that an accurate statement, from your point of view?

Mr. FREEMAN. I think is. The other point I want to make—I just got through negotiating for contracts for long-term power. We were flooded with offers for electricity beginning in 2004 and 195, and turned down a number of offers because the price was too high, and negotiated.

So, the myth that California is an unfriendly place for new power plants is a myth.

Mr. WAXMAN. Well, I don't think it is a myth to think that our policies ought to be changed to be friendlier to these utility wholesalers, be more friendly to them and ignore the fact that the California ratepayers are being overcharged for electricity.

Thank you, Mr. Chairman.

Mr. BARTON. Thank you. Before I recognize Congresswoman Bono, my staff indicates, Mr. Lloyd, on the question that Congressman Waxman just asked, that, in fact, there are several units that have been off-line within the last week because they have exceeded their Title 5 permit—specifically, Goleda FMC and Oakland No. 2. Do we just have wrong information?

Mr. LLOYD. I don't have that information ahead of me, but, in fact, this may be some of the units we are working on closely with those areas. I can't confirm or deny that.

Mr. BARTON. These are peaking units, they are not baseload units. They are peaking units.

Mr. LLOYD. Yes. I am not aware of the specific instances you talk about. Clearly, that is not what we desire. We are trying to work with those to make sure it doesn't happen, and I will certainly get staff to look into that issue and report back to you.

Mr. BARTON. The gentlelady from California, Congresswoman Bono, is recognized for 5 minutes.

Mrs. BONO. Thank you, Mr. Chairman. I want to thank you all for your patience today. This problem, to me, is interesting. I was gone for the first part of January and February, I was home sick, and I have been back basically 2 weeks, and I have been hearing the same thing for 2 weeks. It is like Ground Hog Day. Every time we wake up, we are hearing the same thing out of everybody, and there is really nothing new. You know, we have supply, we have demand, and in between we have, for lack of a better term, "voodoo economics," and we are sitting here going around and around, but if we are not addressing supply and demand, it seems we are addressing political problems more than anything else.

Right now, I am telling you Palm Springs and Cochella Valley, Thermo-Cochella, are already hot. It was 88 degrees Monday, and getting hotter.

What can we do now? I need to ask you all, why can't we at least warn our consumers that a blackout is coming their way? Why are we leaving people stranded in elevators? Why are people forced to shut down production lines when things are on the line? Why are people on life-saving devices suddenly being turned off and having to scramble for backup power? Why can't we at least—and, Chairman Keese, I guess this is directed to you—why can't you at least inform people, "This is coming your way, be prepared"?

Mr. KEESE. Well, if one looked at the Energy Commission Web site starting in late 1999, one would have seen this was coming.

Mrs. BONO. No, I am not talking about politicians and people here, I am talking about my constituents. I am talking about 90-year-old women who are on respirators. Do you want them to check a Website? I don't think that is fair.

Mr. KEESE. I am sorry, my answer was that we had indicated that 2001 was going to be a very year. We had not anticipated that as of earlier this week we would have 15,500 megawatts of production out, and that is what called this week's blackout. That is an economic. That is a market outage. That is not a supply outage.

I think people should be forewarned that there is the possibility of blackouts this summer. If it gets as hot as 1998, we probably can't take it.

Mrs. BONO. Well, I understand that they are predicting a worse summer, too. I don't know if you all——

Mr. KEESE. 1998 was the worst—was a 1-out-of-40-year-experience. If we would get something like that, we would clearly have problems.

Mrs. BONO. Well, 1998, I think it was a few years prior to that it was 127 in the city of Cochella, it wasn't 1998. I thought I heard you all saying earlier it might not happen, we might not have blackouts. Did I—nobody said that?

Mr. KEESE. I did say, and I will say again, we are optimistic that we can meet the needs of a normal year.

Mrs. BONO. You know, I think it is better for the California people that you say you are not optimistic, and you want them to be prepared. I don't think you should give them false hope.

Mr. KEESE. I will give both answers. We are optimistic, and they should be prepared.

Mrs. BONO. That is a great political answer. We call it "tap-dancing," but, you know, do you have another approach for people? Do we have something in mind that people can do to go hook up to power? There are generators coming on-line, portable generators, anything that people can do when there is nowhere to go, when it is 118? Do you have plans, contingency plans, anything that they can do? Are there red plugs somewhere that they can go find and hook up to?

Mr. KEESE. They can certainly check—we have two Websites in California, I can't tell you the other—I know you can get it through the Energy Commission Website, but the Governor's office has created a Website with——

Mrs. BONO. That is great. We have no power, but we will go ahead and fire up our Website.

Mr. BARTON. Would the gentlelady yield just briefly?

Mrs. BONO. Yes, Mr. Chairman.

Mr. BARTON. Is it possible, Mr. Keese, to have a directed blackout where certain facilities could be kept on-line—I mean, hospitals, senior citizen homes—or is it pretty much if you are in that area, you are going to get hit with it?

Mr. KEESE. We perhaps have somebody who can better answer that, however, we do not shut down fire stations, police stations, hospitals. They are immune.

Mr. BARTON. So, there are certain facilities that——

Mr. KEESE. If you want to buy a home next to—between a hospital and a police station, you will never have your power go out.

Mr. BARTON. I yield back.

Mrs. BONO. I understood that that wasn't the case. Just going off, again, everything I have heard for 2 weeks, wasn't there a hospital that was actually without power during one of the recent blackouts, does anybody know?

Mr. KEESE. That would be an error.

Mr. BARTON. It could have happened, but it was an error if it did happen?

Mr. KEESE. It should not have happened.

Mrs. BONO. Yesterday, I spoke with the folks from Loma Linda University, and we are not just talking about the lights, but we are talking about people who are going through radiation therapy. At least if we could figure out a way where they are not having to check the Website, that we could inform people to not schedule radiation treatment during a 2-hour blackout, it would be very helpful. And I would like to suggest that you look into that somehow because this, again, is a matter of life or death for some people.

Mr. KEESE. We are working on it, and I will carry that message back.

Mrs. BONO. And you have three new plants coming on-line. Can you tell me where they are—this summer?

Mr. KEESE. Yes. We have a plant coming on in Yolo County, about 40 miles north of Sacramento. We have a plant coming on in Pittsburgh, which services the Bay area, and we have one in the Corine County area.

Mrs. BONO. So, Northern California reigns supreme again? So Southern California won't see any of that benefit.

Mr. KEESE. Southern California would probably see the benefit because Northern California, which has the greater need, occasionally in summer will not draw down from——

Mrs. BONO. So Path 15 won't be an issue?

Mr. KEESE. This will assist some of the problems on Path 15.

Mrs. BONO. Thank you. I see my time is expired. Thank you very much.

Mr. BARTON. Thank the gentlelady. The gentleman from Arizona, Mr. Shadegg.

Mr. SHADEGG. Thank you, Mr. Chairman. I guess I am hearing very different information. I heard today that California is a very friendly place for the siting of a power plant, and there is no reason why anybody wouldn't go there, and yet I was in Pasadena, California a few weeks ago with the chairman of this committee, and we had in front of us a panel of all of the independent power producers, and they testified quite clearly and quite bluntly to us that it is indeed very difficult to site a power plant in California. They explained that it cost them on-average three times as much, and takes on-average three times as long to site a power plant in the State of California.

I just heard Dr. Lloyd, I think, say that no power plant ever gets turned down because of the Clean Air Act, and yet it appears that is not consistent with the information we have. I am holding here a whole series of articles about local opposition to power plants. Here is a story from the Press Enterprise in Riverside, California, "Local opposition to a power plant in LaCresta, California"; another story from the Press Enterprise, "Local opposition to the LaCresta

power plant." Here is another, a Reuters story about local opposition to a power plant in the Coyote Valley, south of San Jose, being led by Cisco Systems, and two stories here from the Associated Press and the Press Enterprise in Riverside, California, about local opposition to a power plant in Blythe, California. Another story here from the South Bend Tribune, this one March 13, "Local opposition to a power plant in the Newburg Township." Another story here about the Southgate power plant and local opposition to that power plant. Another story on that same opposition to the Southgate power plant. And then a story from the L.A. Times from March 10, about the opposition or additional requirements being posed for a power plant in Huntington Beach.

Mr. Makovich, in light of your testimony that the low retail prices in California are imposing upon the rest of us in the West—and I am from Arizona—higher energy costs, I am a little concerned that the West is being asked to bear an unfair burden for both regulatory policies in California that have caused there to be a lack of siting of power plants, and also transmission lines. I am also concerned that while we talk about a dysfunctional market in California which may have led to price gouging—and, indeed, maybe it did, I don't know—but I am worried that that dysfunctional market was really created by Government action. It seems to me that the California "de-regulation" bill—and I agree with my colleague, Mr. Waxman, he called it "so-called de-regulation"—it clearly was not deregulation.

When you de-regulate the wholesale price but don't de-regulate the retail price, no one can see that as de-regulation. When you artificially, through Government action, don't allow supply to meet demand and construction to meet the projected demand, you don't have de-regulation.

I guess I would like to start by asking you, first of all, we are under a lot of pressure to go along with, or to agree to, the creation of some kind of price caps—cost-based, temporary cost caps.

My own conclusion is that those will not incent the production or the construction of future power, and that indeed that will make the problem worse on into the future. How do you see that issue, and would you analyze it for us?

Mr. MAKOVICH. Okay. In my testimony, I said that one of the fundamental flaws of California was that it was not profitable nor possible to build power plants. I hear the same thing from our clients that are power developers. The reality in California is that it is still a very difficult place to site power plants.

The second thing is, my advice to our power development clients is, California is still not a place to recommend building power plants based on the market prices.

The evidence is very, very clear—Mr. Freeman and Mr. Keese both confirmed this—the record is, if there is not a shortage in California, the prices that prevail in the market as it is structured today will not provide a profitable return to power development.

So we have got a market here that the only way you can hope to get a return on your investment is to have a periodic shortage. And if the response to that periodic shortage is to cap the prices, we have taken all the up-side out of this dysfunctional market and left developers with only the down side.

So, yes, the investment environment in California is not conducive to power development. This market still suffers from the long-run problem of not being able to stimulate investment.

Mr. SHADEGG. Proponents of price caps say, "Well, we will solve that problem by not capping the price on new power plants." Doesn't that just send the opposite signal that you go in there, you build a new power plant, we say, "Well, we are not going to cap the price on the new power plant for now," but the long-term message is, "The minute you get your plant completed, we are going to decide, 'oh, well, on second thought' "——

Mr. MAKOVICH. It will create all sorts of crazy arguments about "is the incremental supply from the old power plant really new supply or old supply," and people will be fighting to get refurbished power plants considered new plants instead of old plants, and it is just another example of the distortions from a lot of these crisis remedies.

Mr. SHADEGG. Correct me if I am wrong, but there is no way that we can, in fact, at this level, in the U.S. Congress, cap the price of power sold from either Canada or Mexico into California, is that right?

Mr. MAKOVICH. I am not sure of the legal particulars there, I wouldn't think that is possible.

Mr. SHADEGG. It seems to me fairly difficult. I mean, they have the right to sell the power where they want. Wouldn't then price caps cause an incentive for a power producer to construct a plant somewhere outside the United States either in Mexico or in Canada, and not be under those caps, and wouldn't that discourage further production of power in California?

Mr. MAKOVICH. That is certainly possible, and it is probably more true of Canada than it would be of Mexico, but that is true, yes.

Mr. BARTON. This will be the last question.

Mr. SHADEGG. And this can be for any member of the panel. When we were in California, in Pasadena, a few weeks ago, looking at this issue, we were told by a number of people that on the short-term problem, the problem for this summer, the State of California could be aggressively pursuing the concept of megawatts and encouraging consumers, large consumers of power, to sell back essentially power that they wouldn't use—and I presume they could even have the concept of "megawatts during peak" power. But we were told by the people there that the Governor is not actively pursuing that, that that is not one of the things he is doing.

Mr. FREEMAN. That is just not true.

Mr. SHADEGG. Okay. Well, I am asking—I am asking you, can you give us evidence——

Mr. FREEMAN. For one thing, my utility yesterday just approved a tariff where my customers can bid in megawatts, and the Governor has proposed that he will pay people 20 percent of their power bill if they save 20 percent.

Mr. BARTON. That just came out this week, isn't that right?

Mr. FREEMAN. That is correct.

Mr. SHADEGG. So he was telling the truth several weeks ago and you are telling the truth today because time has changed the truth.

Mr. FREEMAN. And the process is working. We are influencing each other, and we are sending a market signal.

Mr. SHADEGG. Can you give us an idea of how much the megawatt process between now and the summer might reduce this 5,000 megawatt count?

Mr. FREEMAN. We think that it will reduce the total demand by 5,000 megawatts, that is 10 percent, and that is the whole idea. This is going to be the most advertised, the most vigorous conservation program this country has seen since World War II.

Let me say to you, sir, I just got through negotiating with all these companies, and there is a tremendous desire to sell electricity to California in 2003, 194, and 195. We got more offers than we can take. So, it is just not correct to leave the impression that California is a place where these generators don't want to sell electricity in the future. They have made the offers and we have accepted.

Mr. SHADEGG. I don't doubt that they want to sell you electricity, my question is, are they willing to allow it to be built, and it appears that the citizens of California aren't really anxious to have it built in some places.

Mr. FREEMAN. Democracy is alive and well in California, sir, it is a good thing.

Mr. BARTON. Well, it is alive and well in the United States.

Mr. SHADEGG. It is alive and well in Arizona.

Mr. BARTON. The gentleman referenced several news articles. Does he wish those put in the record?

Mr. SHADEGG. I would like them put in the record, Mr. Chairman.

Mr. BARTON. Then as Mr. Waxman did, Mr. Shadegg will have to make a unanimous consent request that they be put in the record. Will you do that?

Mr. SHADEGG. I so request.

Mr. BARTON. We will show those to the minority staff and majority staff, and we will affirmatively act on that, I am sure.

Mr. COOPER. This was an open question on megawatts, and there is an important point about megawatts that I wanted to make.

Mr. BARTON. You will get to make it because we are going to go to Mr. Walden for 5 minutes of questions.

Mr. WALDEN. Thank you, Mr. Chairman. I want to follow up on this power buy-back plan and ask the question, why did it take until this week for the State of California to enter into this because in my part of the world up in Oregon, the Bonneville Power Administration entered into these sorts of agreements months ago. We have shut down aluminum smelters. We have put people out of work for buying back power. And I, like my friend from Oklahoma, need quick answers, if we can. Can anybody tell me why it took this long?

Mr. FREEMAN. We just may not be as swift as the people in Oregon.

Mr. WALDEN. I will accept that. I have another question. I want to preface some of my questions, too, by saying I am the last one who wants to wreak any kind of economic havoc on California. Your economy is too important to this country. We need to find both short-term and long-term solutions to this problem.

Now, I am new to this Committee so I am learning as I go, so bear with me. The other day, the FERC folks told me that they only have jurisdiction over, I believe they said, 47 percent of the power that California consumes, which means some 53 percent, plus or minus, is actually not under their control.

What is happening to that power? Are there hard caps, soft caps, what price range is being dealt with there?

Mr. FREEMAN. Sir, this is municipal power that is self-sufficient. In other words, I have 7,000 megawatts in Los Angeles. It is to serve the people of Los Angeles.

Mr. WALDEN. What rate are you charging, megawatt hour rate?

Mr. FREEMAN. We are charging the people of Los Angeles a cost-based rate. We are a non-profit, publicly owned utility.

Mr. WALDEN. What is that rate?

Mr. FREEMAN. At retail, it is about 10 cents a kilowatt hour, three times what you pay in Oregon.

Mr. BARTON. Would the gentleman yield?

Mr. WALDEN. I will get back to that.

Mr. BARTON. Mr. Freeman, if the FERC put in a wholesale price cap, the city of Los Angeles, since it is a municipal utility, would not be subject to it, isn't that correct?

Mr. FREEMAN. Our rates would not be subject to it.

Mr. BARTON. Nor would any other municipal power authority in California, nor would any other co-op in California.

Mr. FREEMAN. But it would set the market price and we would abide by it.

Mr. BARTON. But you wouldn't be legally subject to it.

Mr. FREEMAN. That is correct.

Mr. WALDEN. Thank you, Mr. Chairman. I appreciate your comment about how your rates are double or triple, but I will tell you what, we don't have enough power to meet demand in our hydro system. And, Mr. Keese, when you say you are optimistic that we can meet the needs this summer in California, in the past you have been able to do that because we have had surplus power in the Northwest to sell to you, isn't that true?

Mr. KEESE. That is correct.

Mr. WALDEN. And I understand that California depends on importing power for 25 percent of its peak load, and it represents 42 percent of the summer peak in the West—numbers I have been given. Given that we may have a deficit in the West because we have the lowest precipitation levels probably in the history of recordkeeping of precipitation level, how are you going to make up for that because I don't think we are going to have a surplus. What is your plan?

Mr. KEESE. We have figured that into some of our calculations. Historically, you are correct, we get 14 percent from the Southwest, 11 percent from the Northwest. We do not expect to get it this year.

Mr. WALDEN. And so you have calculated that. You aren't going to need the surplus we normally would provide.

Mr. KEESE. Yes, we need it.

Mr. WALDEN. You have calculated that you aren't going to get it.

Mr. KEESE. We are prepared that we may not get it.

Mr. WALDEN. All right. So that is in your calculations.

Mr. FREEMAN. Well, Mr. Walden, we traditionally swap power with the Northwest.

Mr. WALDEN. I am aware of that.

Mr. FREEMAN. And we provide power to you in the wintertime when you need it, so it is not just a one-way street.

Mr. WALDEN. That is not my point. We appreciate that and it has been a good working relationship. Again, I am not here to throw stones at you or have you throw stones at Oregon, I don't think we are engaging in that, nor should we. The point is, what do we do in the short-term between now and next winter because we have been able to rely on this partnership. And, indeed, we have been getting a 2-to-1 return this winter which has helped us buildup some reservoirs that may help you down the road.

What I am looking at is to make sure when you say you are optimistic, I am struggling in my own mind, how do you get there when that——

Mr. FREEMAN. I just want you to know that we negotiated just within the last few weeks, additional exchange arrangements with both Bonneville and the British Columbia company, so we are working together.

Mr. WALDEN. I don't think I have alleged anything less than that. My question, though, is, how you meet—I want to make sure—well, forget it. I will just grant you that.

I know that Bonneville and the co-ops and the other power companies in my State and neighboring Washington State are in the process of shutting down any heavy manufacturing by buying the power out. We are in the process of shutting down irrigated agriculture right now, by buying power out, which is what you tell me you are engaging in as well. We are going in the dumpster up North in terms of our economy. What I am trying to do is make sure that Congresswoman Bono's constituents and others don't fry this summer.

I mean, I am in the broadcast business by trade. I have lived through power outages and helped with emergency communications, have backup generators at my own facility. What I want to make sure of is that we are accessing every asset possible, whether it is FEMA or National Guard or Army, to make sure that there is power to meet the emergency this summer that is coming. I see that as a critical short-term problem. I don't want you to fail, and I don't want my people to fail. I yield back, Mr. Chairman.

Mr. BARTON. Thank the gentleman from Oregon. The gentleman from California, Mr. Radanovich, is recognized for 5 minutes.

Mr. RADANOVICH. Thank you very much. Mr. Cooper, I understand that in your testimony, which I thought was very interesting, may I assume out of that that you do support some sort of temporary cost-plus caps, or however you want to say it, for wholesale markets to bring cost in line with supply?

Mr. COOPER. Yes. To put it simply, we don't think you should deregulate markets before they are effectively competitive, and when they are proven not to be workably and effectively competitive, you have to do some regulation to control the rents.

Mr. RADANOVICH. In the California situation, part of the problem with the de-reg plan—I probably shouldn't even call it that anymore—but the plan that was installed fixed the cost or the rates

that could be charged at the retail level as well. When you look at solving the California plan, I think you would agree that it is a problem of bringing supply in line with demand and pray for good weather.

Where is your position on the demand side of this thing with regard to the cap on retail rates, are you in favor of lifting that as well?

Mr. COOPER. No. We are vigorous supporters of administer demand side measures—that is, while there is no enthusiasm here for identifying specific types of interruptible load and interrupting it, we think that is a good approach. We think that when you take—if you take the average residential customer, who makes the fundamental choices about the energy consumption characteristics of their residence? Basically, the building and the landlord. They chose the shell, and they chose the appliances, and the consumer moves in, and if you increase his price by 330-fold or 1,000-fold, well, there is not a lot they can do except turn the lights off and turn the air conditioning off, and that is not what we are interested in.

Mr. RADANOVICH. Again, you know, this tight schedule routine, I am going to have to ask these questions quickly. How can you then expect FERC to raise or impose a cap on Californians when the rest of the West and Oregon, their retail rates are going up 20 percent when the Governor refused to increase rates retail in California?

Mr. COOPER. We support an areawide cap so that no one has to beggar-thy-neighbor, first of all. Second of all, it is the case that the rates in California are higher than anyplace else in the West.

Mr. RADANOVICH. So, to our knowledge, the retail rates in California have not gone up in 10 years and, in fact, have decreased 1 percent.

Mr. COOPER. In point of fact, if you go back to the bill that none of us liked, and we certainly didn't support, one of the ways you got to de-regulate was to tell consumers you were going to protect them from the dangers of this market, about which we have warned people from Day One. And that was part of the deal.

And so now when the market goes crazy and there are billions of dollars of abuse in the market, you come along and say to the ratepayer, "Well, we fooled you. We weren't going to protect you from this market," and that was part of the deal.

And so from our point of view, you go back and you do a cost-of-service price cap areawide, so no more beggar-thy-neighbor policies here. You establish a specific timeframe, whether it is a 2-year workout, or a 3-year workout—we do this all the time in the corporate world—we look at—as I have said, you have had a bunch of things put on the table. This question of NO_X, and make sure nobody is shut in. In the context of a defined time period and quid pro quos, we should be able to make these exchanges.

Mr. RADANOVICH. Thank you. Mr. Keese—and I want to thank you all for coming to this hearing. I do have a couple of questions. And, yes, in my district, we have been subject to rolling blackouts. Yesterday, there was a cataract surgeon who was in the middle of surgery and the lights went out, and the patient was going nuts

while they were trying to get their generator on. Had no foreknowledge of any blackout coming, and were not warned.

Given that, when we do get to a situation of blackouts this summer, what is the ability that you have, or is it possible to give a forewarning for areas in the country so that death and destruction don't occur—which they will, when we get to rolling blackouts this summer—some foreknowledge of that would help a lot not only in human health and lives, but also in cost of business. And I think it is good for you to accept the fact that they are with us and devise a means to prepare people for them, and your response is welcome.

Mr. KEESE. I believe that is certainly a reasonable suggestio. I believe our Governor may perhaps have already ordered that action, but since I am not responsible for emergencies, I cannot vouch for that.

Mr. FREEMAN. Can I just say, every utility has a detailed knowledge of the critical loads, and it was just a mistake that it wasn't done yesterday or the day before. But people on life-support, and things like that are not interrupted, and PG&E has that detailed——

Mr. RADANOVICH. But, sir, that was interrupted in my district, it is actually happening, so you can't say that.

Mr. FREEMAN. I say that it shouldn't have happened, it was wrong, but there are these plans—and I don't know what happened yesterday, we didn't have blackouts in L.A.—but I do know that we have knowledge of every load, and so does PG&E, and so does——

Mr. RADANOVICH. I don't see how you can. I mean, I can see where you can take hospitals and block that part of the grid out of hospitals, but where surgery like this is being conducted almost in residential areas, you have no knowledge of that kind of stuff going on.

Mr. FREEMAN. Every life-support customer is on a special rate in L.A., and we know who they are.

Mr. BARTON. This will have to be the last because I want Mr. Burr——

Mr. RADANOVICH. I do have one more short question. Did I run out of time already?

Mr. BARTON. Yes, sir, unfortunately. And I want to let Mr. Burr ask his questions. Then we are going to have to recess for three votes, then we will come back. If Mr. Blunt comes back, he will be the first questioner, any other subcommittee members, and then we will go to Ms. Harman of the full Committee, and then we will start the second round. If you have one quick last question, and then we are going to go to Mr. Burr. Did you have one last question?

Mr. RADANOVICH. I do. It is a quick question, I think. A lot of the reasons why the power went out yesterday was because COGEN facilities, which account for 30 percent of California's power, had not been paid. I think it makes sense to go—let those COGEN plants go direct to the consumer this summer. It may mean higher prices to the consumer, but they will not have blackouts as a result of that.

Mr. KEESE. I believe that situation will be rectified next Tuesday. The Governor did issue something Tuesday night. I believe there is a consensus agreement that will be handled by the Public Utili-

ties Commission next Tuesday. It will require a brief piece of legislation after that, but I believe that deal is done.

Mr. RADANOVICH. Thank you.

Mr. BARTON. The gentleman from North Carolina, Mr. Burr, is recognized for 5 minutes. This will be the last 5-minute question round before we go vote. There will be three votes. We will come back at approximately 2:20 and conclude the hearing.

Mr. BURR. I thank the Chair. I know that there is frustration on both sides, that table and this dias. I think everybody is after an answer and, unfortunately, spending time pointing fingers and blaming does not necessarily get us the answer, and I think it has been displayed at all levels in the State and the Federal Government.

Let me suggest that if I summarize what I have heard in the short time I have been here is, California did everything right except they bought power from the outside, and that was our big mistake because people profited from it. I don't think it is quite that simple, but I would challenge you that we need to constructively look for solutions, if you want the Federal Government to play a role, and that "if" is yet to be decided.

Mr. Keese, if I understood you correctly, you said California had no shortage of electricity generation. Is that accurate of what you said?

Mr. KEESE. Today?

Mr. BURR. Today.

Mr. KEESE. Correct. We have generating facilities that could easily produce in California, 45,000 megawatts. We are down in the 30,000 range, I believe, and we are short. But we have 15,500 megawatts out for repair.

Mr. BURR. Dr. Lloyd, you said that no generation application had been turned down for the purposes that Mr. Barton had asked about. Tell me, how many applications for generation placement have been turned down in total in the last decade.

Mr. LLOYD. I can get that to you. We will get it to you.

Mr. BURR. Any?

Mr. BURR. The reality is, from what I have been able to uncover is, you never turn them down, you just never accept them in California. And if you do, it is just drug out and out and out. So, your statement was fairly accurate to the chairman, but I think he maybe just misstated exactly how he should have asked it.

Let me ask you, Mr. Freeman, I know that L.A. Power sold some power to the system. You had some surplus, you said that. FERC kicked in during the Stage 3 cap, which they used to determine any over-payments that needed to be paid back.

When that threshold was hit in January, did L.A. Power sell anything above that $273 threshold per megawatt?

Mr. FREEMAN. I am sure that we did because the price of natural gas was higher than that.

Mr. BURR. And did you sell any——

Mr. FREEMAN. Let me just finish my answer. We sold only cost-plus-15-percent basis, which is what we are advocating for everybody.

Mr. BURR. So if you sold above that threshold of $273 and other people had to give back and you didn't give back, yours was based——

Mr. FREEMAN. No one has given back anything yet.

Mr. BURR. But did FERC require you to rebate——

Mr. FREEMAN. FERC has not required anyone to rebate. They are looking into the charges by some people——

Mr. BURR. Let me ask you, could FERC, since they have no control over you, force you to rebate?

Mr. FREEMAN. No.

Mr. BURR. Should FERC have control over public power?

Mr. FREEMAN. No, because we are locally owned, and this has been tradition for about 80 years in this country, of local public ownership.

Mr. BURR. Mr. Freeman, I have only got 5 minutes. In February when the threshold was $430 per megawatt, did you sell any power over that $430 threshold?

Mr. FREEMAN. I was working for the Governor in January, and I don't know the facts, but our policy, which we have scrupulously implemented, is to sell on a cost-plus-reasonable-return basis. The cost of natural gas has gone nuts in California, and the prices have gone nuts, and FERC is responsible for the lack of regulating the transportation of natural gas, so the prices are sky-high.

Mr. BURR. But L.A. Power did not profiteer at the price they sold electricity to the systems, am I correct?

Mr. FREEMAN. The word "profiteer" is a pejorative term. We earned a 15-percent return on our investment.

Mr. BURR. Let me ask you, Mr. Hall, could you explain to us the importance of a formation of a Western RTO?

Mr. HALL. Yes. There are a couple of fundamentals, and obviously we think California should integrate itself into a larger Regional Transmission Organization. It is a net importer of power, it has been for years, it only makes sense. And part of the problem is when you have different market——

Mr. BURR. California is a net importer of power?

Mr. HALL. Yes.

Mr. BURR. I thought Mr. Keese told me they had enough generation in California to take care of California's needs.

Mr. BARTON. If it was all up and operating, but there is a lot of it just not up and operating.

Mr. HALL. But historically it has been a net importer. The problem is when you have different markets within a region, you get different price signals and you get, obviously, generation chasing those different price signals. So what we advocate is a Regional Transmission Organization that has fair and consistent policy and fair and consistent tariffs, and in that way things are done on behalf of the region for California and elsewhere. So, when loads needs supply, there are consistent signals out there that don't necessarily skew the market and send power in another direction.

Mr. BURR. I personally have some questions that I will pursue later, and possibly written to some of you, as relates to if California State owns the transmission grid, how can they become part of the RTO based upon what FERC was trying to accomplish with the di-

vestiture of ownership by entities that might have a problem with Order 888.

So, my last question would be, how important is it that California, if the State owns the transmission grid, fulfilled the obligations for the free flow of power under Order 888?

Mr. HALL. It is extremely important. If that doesn't happen, it will send a chill into the marketplace, and you will see companies leave that particular region if there is a bias to California.

Mr. BURR. So that should be a firm condition of any FERC agreement.

Mr. HALL. Yes.

Mr. BURR. I thank the entire panel.

Mr. BARTON. We are going to recess until approximately 2:15 to 2:20. When we come back, Mr. Blunt is the first questioner, if he returns; if not, we will start the second round.

[Brief recess.]

Mr. BARTON. There are going to be other subcommittee members come back. To expedite the hearing, I am going to start asking my second round and as other members come, we will recognize them for their first round and then go into the second round.

I understand that Mr. Freeman has a flight at 5:30. Mr. Pope, are you on the same plane?

Mr. POPE. I don't know if it is the same plane.

Mr. BARTON. Well, we really should be able to get out of here by—we are through voting for the day, so I would hope that 3:30 to 4 we can adjourn the hearing.

The Chair will recognize himself for such time as he may consume until another member arrives, on the second round of questions.

Chairman Keese, I want to ask you a question about the permitting process in California—and, Dr. Lloyd, you will be involved in this also. I am very positively impressed with the latest bill that the California Legislature has put in place on expedited review for permits, but I am not a wordsmith and I am somewhat confused about when the clock starts ticking on something that has been submitted.

What is the protocol if Barton Energy, philanthropic Texas billionaire who doesn't want to make any money, just watches this hearing today and is moved to help build a power plant in California. I have not done anything until I see this hearing today, but I am so moved that we need to do something to help ease the plight in California that next week I send my agents. Do they come to the California Energy Commission first? Do they go to the California Air Quality Board first? Do they go to the California Public Utility Commission first? Do they go to one of the Regional Air Quality Boards first? What is the first thing that Barton Low-Cost Energy has to do to even let you know that I might want to build a power plant in your State?

Mr. KEESE. I would say that typically the process, it is almost a 5-year process. You spend a year making that decision, you spend a year finding your site, we license you in 1 year——

Mr. BARTON. I don't spend a year. I decided today that I want to do it.

Mr. KEESE. Right, I meant 2 years building. I would advise you to come to the Energy Commission. We are a one-stop shop, I override local laws.

Mr. BARTON. If I come to you first, you will help me with Dr. Lloyd's Air Quality Board.

Mr. KEESE. Correct.

Mr. BARTON. Dr. Lloyd, does that mean that the State California Air Quality Board also helps with the like 14 regional—some number of regional Air Quality Boards?

Mr. LLOYD. There are 35 Air Quality Districts in the State and, in fact, it is their responsibility on the siting. We will work with them as, obviously, part of the Governor's Executive Order, we will expedite the air side of that as well. Clearly, if you came for such an offer 1 day, I am sure we could get that turnaround.

Mr. BARTON. I just want to understand. I get such a totally different message when I talk to a Duke Energy, or Relion, or an Enron, or any of the operators that have come into the State, that I want to make sure we know the reality.

Now, the reality is, from the time a reputable provider makes it known that they really want to site and build a power plant, it is going to take 3 years? Five years? One year? If everything goes well and they actually show that the design works and they meet the air quality standards and they meet the local site standards, how long is that process?

Mr. KEESE. Our standard process for a major power plant would be 12 months. We are under these orders, and with the additional staff that the Governor has——

Mr. BARTON. When does that clock——

Mr. KEESE. Well, we call it "data adequacy," when they have submitted an application that shows what the project is and answers most of the key questions so the environmental work can start. Generally, that takes another 3 or 4 weeks after the first—they file it——

Mr. BARTON. Is it possible—we have heard the term "gaming" a lot in relationship to power providers gaming the system to get a higher market price. Is it possible that people that don't want power plants built can game the data adequacy of it so that that drags out?

Mr. KEESE. You know, I don't believe so because I believe that—I can't remember one in the last 2 years that has taken more than 2 months after filing.

Mr. BARTON. These are honest, reputable people over here. They are looking at me with a straight face and saying that it is just hunky-dory out there in California. What is your view, from the time—if your company wanted to build, site and build a new power plant within the State of California, and your CEO made that decision today, when do you think they would give you—the clock would start ticking on this 12-month process? How long would it take before they officially accepted your application and began to review it in this 12-month period?

Mr. HALL. I can give you two examples. One is our Moss Landing project which is under construction, and when we submitted the application which had to then be deemed data adequate, that did take longer than the initial 45 days, it took almost twice that. Then

we went into the process once it was deemed data adequate, and it took there slightly longer than 12 months. That project was virtually unopposed up in the Monterrey-Carmel area, and it went, you know, fairly quickly, even though, again, it is a long process compared to other projects we do elsewhere whereas at our Morro Bay facility, which is a 50-year-old plant where the town grew up around it, we have encountered significant local opposition and long story short, from the time we announced the project to when that new plant could conceivably go on-line in 2003, 2004, it will have taken 5 years to permit and build the plant.

Mr. BARTON. Five years in an existing site, admittedly within a built up community.

Mr. HALL. Correct.

Mr. BARTON. And in a new site in a rural area, from the time you decided you wanted to do it, it is going to take how long to get the permit to construct it?

Mr. HALL. Well, there are a lot of things that influence, and a lot of it again is just whether the local community supports or opposes it because, again, California is a State of—you know, where the stakeholder process is alive and well, and they get very involved in that process.

So assuming everything went reasonably well through the process, it usually takes us about 6 months to get our arms around the project, develop and application, and then put it into the process, and it would come out on the other end.

Mr. BARTON. To use your terminology, "to get your arms around the process," in California it takes you about 6 months. That is before you submit the formal application.

Mr. HALL. Yes, and that is the minimum. Again, depending on whether the community is receptive or not.

Mr. BARTON. In the rest of the country, does it take you 6 months to get your arms around the process, or does it take you 6 weeks, or 6 years?

Mr. HALL. It varies, but typically the entire process certainly doesn't take as long as it does in California. We have sited other projects in the Midwest, the Northeast, and the Southeast, and we can do it much quicker. In the time some of these projects have gone through the mill and we have gotten the permits to construct, we would have already gotten the permits and built the plants elsewhere.

Mr. BARTON. The reason I ask the question is because we are under active discussions about what package, if any, to put together for an emergency electricity bill for this summer. And we are trying to decide whether we want to put some incentives to State and local governments to expedite siting review. And we had the State of Ohio's Commissioner, and they have a system where from the time you bring a project forward—I mean, literally—they will give you a decision within 6 to 9 months, go-no go, period. And I don't get that impression in California.

Now, as Mr. Freeman has pointed out, democracy is alive and well in California, and I am all for democracy, but if California is so democratic that it takes years to get everybody talking on the same page, that doesn't help build many new power plants in the next 12 months to 24 months.

Mr. HALL. Well, there are extremes and there are some in the middle. Some we can do pretty much within the defined timeframes of the permitting process, others take much longer.

Mr. BARTON. We have other members back, so I am going to reserve the balance of my such-time-as-I-may-consume for later. I am going to recognize the gentlelady from California, who has waited patiently to ask questions, and then we will go to Mr. Largent, then to Mr. Shadegg, and then back to myself, if no other members show up, for 5 minutes.

Ms. HARMAN. Thank you, Mr. Chairman. I appreciate the opportunity to sit in on this subcommittee hearing, as a member of the full committee, and it was worth the wait. It has been a very interesting hearing.

I would just like to note a couple of things for the record. First of all, I knew David Freeman when we were Senate staffers together 30 years ago, and he was smart then, but he is much smarter now because he is a California resident now, and has been rendering good service to a great State. That is the first point.

The second point is that Mr. Boucher stated incorrectly earlier today that the Feinstein-Smith bill had been introduced. It has not been introduced, and I want to commend them for continuing to talk to people about whether that is the best approach or not. I gather they—I know they are in discussions with Members of the House, and I believe they are in discussions with Governor Davis, too, on this issue. It would be better to bring the right bill that has bipartisan and substantial support to the floor, rather than some other bill. And so I think that is a good idea.

Third observation, I just read Governor Davis' long letter to Henry Waxman that he asked to be put in the record. It lists lots of initiatives that the Governor and his team are taking—and, by the way, Mr. Chairman, there are lots of initiatives that I believe would provide what you were looking for, a prompt action on siting of new power plants. But, at any rate, I just want to observe, as one Member of the House, that the Governor should be doing more to talk to us back here. The State Legislature is talking to us, but the Governor could do more to work directly with the Members of the House and Senate who do want to solve this problem not just for California, but for the Western Region and for the country.

And I commend you, Mr. Chairman, particularly, because I know you are working on this hard, and I have worked closely with you in the past, and I am just hopeful we will come to some good options soon.

I don't have much time, so I would just like to ask a question to my good friend, Mr. Freeman. My impression is that information about the State taking over the power grid is not well understood. Mr. Boucher was talking about it. Could you enlighten us again about what the State is proposing to do, and whether or not that has—what the relationship is between that and Federal law?

Mr. FREEMAN. Yes, ma'am, but, first I want to complain—I don't understand why a Member of Congress is not growing old while I have grown old over the last 30 years.

Mr. BARTON. Who is that?

Mr. FREEMAN. Ms. Harman. I just don't understand why she looks the same and I have gotten to be an old man, but I guess that is life.

Mr. BARTON. It is her friends in Congress that keep her young.

Ms. HARMAN. It is the easy elections I have.

Mr. BARTON. I actually thought you were referring to Henry Waxman, who isn't here.

Mr. FREEMAN. I better stop there. The transmission system is the interstate highway, and I agree completely with my friend from the Duke Power Company. It has got to be open on equal terms to everyone, and that would be the whole idea. But we can build all the power plants in the world, Mr. Chairman, if we do not add lanes to that interstate transmission system. We won't get the power where it is needed, and we will not have just reasonable rates, by anyone's definition.

The investor-owned utilities in the State are broke, nearly broke. We try to keep them from going broke. They have not the resources to fund the expansion that is needed. So, one of the reasons the State is taking over the transmission system is to be able to finance the expansions on Path 15 that Congresswoman Bono is so familiar with, and I am impressed by that—she is not here—but there's a lot of knowledge of what the problems are on the transmission system. The State is determined to expand the transmission system so it will flow freely.

The other point is, with all due respect to FERC, with all of their orders, they have not created a Regional Transmission Organization in the West. Most of the transmission is owned by public entities, not private entities. Bonneville Power, one of the companies that is cleaning up on us, is owned by the Federal Government, but they own the transmission system out there. L.A. owns a big chunk of transmission. A lot of public agencies own the transmission.

I think under the leadership of Governor Davis, we will form a Regional Transmission Organization that we do not have now. So, I think that it should not be thought of as something that will detract from the national interest, but rather that it will add to the national interest and help us solve this problem.

Ms. HARMAN. Thank you. Second, time is short. Everyone has been holding up this article in today's Los Angeles Times about the energy overcharge—alleged energy overcharge—$5.5 billion. I wanted to afford others on this panel an opportunity to comment on this issue. I see my time is out, but has anyone not commented who would choose to comment?

Mr. COOPER. One of the important things to recognize with these overcharges, or alleged overcharges, is that part of it may be rent, and part of it may be gaming, and part of it may be some form of manipulation, and the bottom line for the residential ratepayer is that we don't care. The bill is too high. It is either stupid, or abusive, or just too smart, and other people were not smart enough, but the point is that to reform the system so that—there are two different steps here.

The $5.5 billion is a big number, but if we are looking at $20 billion or $30 billion electricity bill in California, that is a real bill, that is a big number, too, and we have got to worry about that also.

So, yes, the rents are important, and we shouldn't confuse cartel versus smart people versus stupid market structures. On the other hand, we ought to also think about how we are going to make the market work in the long-term.

Ms. HARMAN. I agree with that part. Thank you very much. Thank you, Mr. Chairman.

Mr. BARTON. The gentleman from Oklahoma, Mr. Largent.

Mr. LARGENT. Mr. Hall, would you like to respond to that last question?

Mr. HALL. Well, I was just going to say, any market reforms that need to take place need to be done in the context of all the participants who play into the California market, and it is more than the five out-of-state generators. And I have not seen the information yet released by the ISO, but hopefully that is recognized in their analysis.

Mr. LARGENT. Mr. Keese, I have a question for you. Does the CEC have some forecasting responsibilities for the State of California?

Mr. KEESE. Yes, we have had, historically. It has been diminished the last couple of years.

Mr. LARGENT. And how did your forecast for the year 2000 match actual usage in California?

Mr. KEESE. The maximum we anticipate for the year 2001, this year, is lower than what we have predicted since 1988.

Mr. LARGENT. So you are lowering the expectation.

Mr. KEESE. The expectation has been coming down, correct.

Mr. LARGENT. What has reality been? In other words, what did you predict for 2000?

Mr. KEESE. We basically predicted a 2-percent growth in demand year after year after year, and we have stayed right about that, but in the early to mid 1990's, we had a recessionary period where we got under the 2 percent. I will say that all indications are that in the year 2000, perhaps our overall demand grew about 4.5 percent, someplace in that range, but it is still within the range that had been predicted, that 2 percent going out.

Mr. LARGENT. So you predicted 2 percent, but actual growth was 4.5 percent, is that what you said?

Mr. KEESE. We had predicted that on a decade basis, 10-year basis, the growth will be 2 percent. Sometimes it is under, sometimes it is over. Last year it may have been as high as 4.5 percent.

Mr. LARGENT. Okay.

Mr. KEESE. But it is still under what——

Mr. LARGENT. When did the CEC first believe that there were any problems with the design of the restructured California markets, how long ago?

Mr. KEESE. We have not voiced an opinion on the restructuring of the California markets. We issued our heat storm report in the Fall of 1999, indicating that 2001 was going to be a critical year.

Mr. LARGENT. You did that when?

Mr. KEESE. The Fall of 1999.

Mr. LARGENT. And what actions did the State of California take immediately following the predictions that you gave them?

Mr. KEESE. I believe the State of California—all the parties concerned looked at the report. At first, it was not accepted, but after

a couple of months it was accepted, and I believe people have started putting it into their planning.

Mr. LARGENT. So, the report showed that the plane was in a nosedive.

Mr. KEESE. Right.

Mr. LARGENT. But nobody really responded to the report?

Mr. KEESE. There were no drastic actions taken in response to the report.

Mr. LARGENT. Mr. Makovich, I wanted to ask you about price caps because that has been suggested by a number of the people on the panel today, wholesale price caps. What do wholesale price caps do in terms of encouraging new supply in the State of California, which really is the long-term fix that you talked about throughout your testimony and in many of your responses. What do those price caps do in terms of encouraging new supply in the State of California?

Mr. MAKOVICH. I think, at best, they don't discourage it, but they very likely will discourage it because the price caps we are seeing now that the FERC has established for what is just and reasonable, this is exactly the problem that we anticipated. Price caps are very difficult to employ properly. They are a limited emergency procedure, and all too often they are done wrong and make things worse.

The caps that are in place right now are too low. The most expensive generating units have the incentive not to run, given these price caps. If they think that they are in the month and that their fuel or environmental costs are above what will turn out to be the average, they have been given the perverse incentive not to run. And that is exactly the kind of distortions that price caps produce. If they are indefinite, if they are something that is going to come and go in this marketplace, they increase the uncertainty on investment and, on whole, probably a negative influence on investment.

Mr. LARGENT. Do you think even having price caps on a temporary basis is a wise idea, like just to get through this summer?

Mr. MAKOVICH. Given how bad this summer is, based upon our computer simulations of supply and demand, we expect at least 200 hours under expected conditions—normal weather and so on—when there is no reserve left in California. And when you get through all your interruptions and emergency procedures, there are going to be 20 hours that we just see you have to have rolling blackouts. So, yes, over those very limited points in time, this market will not clear. These prices can go to astronomical levels. But a price cap of $1,000 or something would be far more appropriate than what we have seen.

Mr. LARGENT. But it wouldn't do anything to abate the blackout.

Mr. MAKOVICH. No.

Mr. LARGENT. At all.

Mr. MAKOVICH. No.

Mr. LARGENT. Mr. Chairman, I see my time has expired.

Mr. SHADEGG [presiding]. I don't think there is anyone on the minority side. Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. Let me ask a question about nuclear. Someone—and maybe it could go to Mr. Keese and

maybe Mr. Freeman, to begin with. Is there a prohibition of siting nuclear facilities in the State of California?

Mr. KEESE. There is, to the extent that California passed a law that indicates we cannot site a power plant until there is a Federal Repository in operation.

Mr. SHIMKUS. So what would help California if we move the Yucca Mountain Plan and Facility?

Mr. KEESE. If there was a Federal Repository in operation, a project that came to the Energy Commission would be reviewed by the Energy Commission.

Mr. SHIMKUS. We have had that bill on the floor a couple of times. It has been vetoed by the President. We look to move that bill again. I hope we have the Members of the California Delegation support.

Let me then also ask, I know that the chairman——

Mr. FREEMAN. Could I comment on that?

Mr. SHIMKUS. I would rather move on, sir, thank you.

Mr. FREEMAN. I can understand why.

Mr. SHIMKUS. I would like to move back on this issue that Chairman Barton mentioned, which I was informed no one gave an answer to, which deals with Title 5 permits under the Clean Air Act. And if we have an assumption that three power plants had to reduce their productivity because of bumping up to the Title 5—and I know you are going to get answers to that because no one had the answers to that—if we are projecting higher demand, how many other existing peaker units in California will face Title 5 operational constraints this summer?

Mr. LLOYD. I am not sure about the exact number there. We have a mechanism in place, however, to take care of those because we have some offsets available.

Mr. SHIMKUS. I don't understand this mechanism. From what I understand, I understand that the State of California can be gracious in its use of some of its regulations. The question is, if you bump up onto the Clean Air Act under Title 5, and if you surpass that, any individual—any individual—can sue. Is that correct?

Mr. LLOYD. In fact, that is where we are working with EPA and working with Region IX to, in fact, try to get an administrative order to make sure that we don't run into those issues.

Clearly, we would have to be concerned with that issue. That is one sensitive area.

Mr. SHIMKUS. So you are asking for an Administrative Order waiver?

Mr. LLOYD. We are asking for, in fact, that help from the EPA.

Mr. SHIMKUS. So then are you saying that there are some Clean Air requirement issues that are in place that are limiting the ability of California generators to create generating capacity?

Mr. LLOYD. We are saying that, in fact, the flexibility exists for us not to run into that issue.

Mr. SHIMKUS. Flexibility by the State of California, but not flexibility under the Federal Clean Air Act.

Mr. LLOYD. Flexibility under the Federal Clean Air Act, since the Administrator has that flexibility.

Mr. SHIMKUS. Only if the individual does not want to be—individual consumers can continue to sue under Title 5 of the Clean Air Act.

Mr. LLOYD. Oh, I see.

Mr. SHIMKUS. Mr. Hall, do you want to respond?

Mr. HALL. Yes. We have a peaking unit right now that is in this dilemma where we have got the State working with us to issue an enforcement agreement so that we can operate beyond our limits. But then we are bumping into the Title 5 restriction. And what we have got to have there is some assurances from the EPA, through some sort of an agreement, that they will not come back and litigate against us because we momentarily exceeded the limit in a crisis situation. But that still doesn't prevent any public citizen, person, or group from litigating us because we exceeded our permit. So we are always going to carry that exposure, and that has to go into our analysis of whether even with the assurances of EPA and the State that they are not going to litigate, we still have to weigh that risk of whether a public citizen's group will litigate against us.

Mr. SHIMKUS. Thank you. Mr. Pope?

Mr. POPE. As a municipal entity who serves load, I plan on 877 hours from my peaking power plant in Santa Clara. Those are hours behind the dam, water behind the dam, that I need for energy for this year. I planned it in my operating plan.

If I run out of those hours or that water behind the dam in July or August, I then have to go to the market to buy that energy. So there is a financial consequence if I don't manage that resource. So, if I am given the order to operate in an emergency and not forgiveness of that, I put myself at a financial risk and my citizen owners at a financial risk downstream for the second half of this year. We faced that situation in December, last year, with many of the power plants in the Northern California municipal community.

Mr. SHIMKUS. Mr. Chairman, if I could just finish up with Mr. Pope, based upon his response to the question. So if you have to go to the wholesale market because you are reaching the Title 5 limits, you are then competing with other entities that are trying to wield wholesale power, and if you understand the basic economic model of supply and demand, instead of being able to produce your own power, you are now competing with people who are trying to import power. Wouldn't that suggest that the price of power, wholesale power price, would be greater?

Mr. POPE. Experience in the last year and a half has been that, that the price has been higher. I am a net buyer, and if I need to buy, I have to buy on the market. I try not to do that. I want cost certainty for my citizens. So, if I am short, I have to buy. If I am long, I sell. But I sell a very small amount compared to the entire energy market, as do the rest of the municipal community.

We may have a third of the residents and the customers in California, but we are very small in comparison to the total energy market because the bulk of our energy is committed to load in our towns and cities.

Mr. SHIMKUS. Thank you. Again, I have been supportive on record with the co-ops and the munis and stuff, and I have a strong record. I appreciate what you do. Mr. Chairman, I yield back my time. Thank you.

Mr. SHADEGG. Dr. Lloyd, let me start with you. I was a little stunned to hear you say earlier that you thought that California would lose no capacity producing electricity this summer due to NO_X limitations. That is not what I have heard elsewhere.

And I just heard you say that, in point of fact, at least the Governor is trying to create flexibility at the State level, but you are not certain that there is flexibility at the Federal level with the EPA.

Mr. Waxman tried to make the point that there is no problem with the Clean Air Act or with the EPA.

This Committee is desperately trying to figure out what it can do to help in this problem, and I think we are being urged to impose rate caps. There is a concern that some of us have that they will not, in fact, help the problem. So we are searching for other things we might do to try to help.

We have talked a little bit about the concept of megawatts. I am trying to understand. Do you maintain that in point of fact, the lack of NO_X credits will not reduce the ability of California to produce as much power in-State as it can this year? And do others on the panel disagree with that statement, or agree with it?

Mr. LLOYD. Let me try to help you with some of the confusion. I understand where you may have that because I think as we discussed earlier, things are evolving. There may be things that happened 6 months ago, before the Governor's Executive Order, before we all realized that we need to act very expeditiously here.

Things are changing, and so we have been identifying these on basically and emergency basis, working with the local districts, working with EPA.

Mr. SHADEGG. Let me ask you again, because I am concerned about the time—do you need help from this Committee, with the EPA, for this summer, so that we don't have plants sitting idle because of NO_X credits?

Mr. LLOYD. To my knowledge, given the flexibility that we have, working the way we are with the EPA, we do not need that.

Mr. SHADEGG. I see Mr. Hall and Mr. Pope have a different opinion. Gentlemen?

Mr. HALL. You asked if the Committee could provide support, and the answer is, I think, yes, to help again be sure that the EPA is appropriately attuned and aligned to what is going on in California and sensitized to the situation.

Another comment real quick, because we share the same problem here with the peakers. When we do get relief to operate above, assuming that happens, there are certain expectations that we pay mitigation fees to offset those increased emissions. All we ask for there is that they be reasonable. And in some cases we have been told that we will allow you to do that, but you have to put like SCRs, low NO_X control equipment, on the back end. These are old peakers that typically operate 100 to 200 hours a year, that now are operating as baseload and, in a couple of years as new supply comes on, they are going to be back in the supply stack and start operating again as they were intended, not as baseload but as peakers. It doesn't make economic sense to put that kind of equipment on those units.

Mr. SHADEGG. So, that demand is not economic, is that what I hear you saying?

Mr. HALL. Right.

Mr. SHADEGG. It is an unreasonable demand. Mr. Pope?

Mr. POPE. Just to add to that, if we get forgiveness for hours we are operating in emergencies this summer, let us say, then we will be able to have that energy available and avoid the consequences of rotating blackouts which would be congested traffic, which would create an air quality problem, and emergency generation would go on that would be inefficient, and would create—so it is a tradeoff that we need to work on. And we need the support from the Federal EPA all the way down.

Mr. SHADEGG. Mr. Pope, would it help—or, Mr. Hall, would it help—if we, as a piece of emergency legislation, provided that citizen suits could not be brought under certain circumstances, so that you wouldn't face the uncertainty of that?

Mr. HALL. Yes, absolutely, it would.

Mr. POPE. Yes.

Mr. SHADEGG. Mr. Makovich, you, I think, wanted to comment on this issue.

Mr. MAKOVICH. The availability of power plants due to environmental regulations is certainly a key issue, but the other thing that needs to be understood, the price of NO_X allowances increased dramatically over the past year. They went from $6 to $50 a pound.

The generating units that are setting the wholesale prices are emitting 2-to-10 pounds of NO_X per megawatt hour. So, even if they are not restricting the capability of power plants, it is important to realize the environmental policy that made NO_X allowances scarce at the same time that the market got short, added hundreds of dollars per megawatt hour to the wholesale power price.

Mr. SHADEGG. Is there something we can do about that in the short-run?

Mr. MAKOVICH. Well, obviously, if the NO_X allowances were nowhere near as scarce, if they were $6 and not $50, you would get immediate relief on those wholesale power prices.

Mr. SHADEGG. And that $50 is a Government-set price, is that right?

Mr. MAKOVICH. That $50 is a market-set price given the State regulations set by the South Coast Air Quality District and the schedule of reductions they put in place in about 1995.

Mr. SHADEGG. So that is an issue the Governor would have to address.

Mr. MAKOVICH. Yes.

Mr. LLOYD. Can I just say, as I indicated earlier, the Board of the South Coast Air Quality Management District recognizes the problem, they are acting on that in May.

Mr. COOPER. Could I give you one little bit of help. If you are going to look at excuses here, or forgiveness, a critical point is a date-certain and a time-certain for how long they last, so that, you know, this is an emergency, we are not trying to undo your air quality, this is a crisis situation. So, let us have a date-certain and combine it with other things that are part of the workout, as I call it.

Mr. SHADEGG. It is a very valid point. Let me ask you, Glenn Canyon Dam, which happens to be located in my State, is under severe restrictions. It is not allowed to produce near the amount of power that it is capable of producing, as a result of various environmental restrictions. Some of those I believe are ongoing and necessary, but some, I believe, could be examined to determine if they are really needed this year. For example, they are talking about a low-flow evaluation.

Do you know, or does anybody on the panel have information, with regard to environmental restrictions, for example, at Glenn Canyon Dam, that could be modified for this emergency to allow peaking power, additional peaking power, to be generated, or other dams where we face that same kind of problem with regard to hydro power? Anybody have a comment on that?

[No response.]

Thank you very much. I see my time is up, and the chairman is back.

Mr. BARTON. I had to do a meeting on the world oil situation, a minor thing compared to what we are talking about today, but something that still has to be done. I will recognize myself for 5 minutes, and then we will go to Mr. Largent in the third round.

I tried in the first round of questions to find out what the shortage was this summer in California, and it was generally agreed that on peak demand days it is going to be in the neighborhood of 3,000 megawatts.

In my second round, I tried to get a handle on the permitting situation in California, and it appears to me that California is really trying to expedite its permitting process, at least on an emergency basis, and I think that is to be commended.

Third round I am going to ask something that hasn't been asked today, which is amazing that we are now 3 o'clock in the afternoon, and it is this concept of retail price increases.

Now, I notice that our officials, Mr. Keese and Mr. Lloyd and Mr. Freeman, were studiously absent in any discussion of any need for a retail price increase. I have had a little economics, not a lot—three or four college courses—and I know the basic supply and demand curve, and I know that if you maintain the demand curve in a flat line, that regardless of quantity consumed, you pay the same price, and if you are in a shortage situation, the supply is never going to catch up. The supply goes up in a vertical line and the demand just goes out in a flat line, and you create this huge delta and we saw that in practice. The two incumbent utilities in Southern California burned through about $12 billion in less than 6 months.

So, the Federal Government doesn't have—the FERC cannot institute a retail rate increase under current law. Now, we could preempt it. We could pass a bill next week, the President could sign it, and it could set the retail price for electricity in California at whatever we wanted to. All hell would break loose if we did that, but we could do it. But we are not going to do it.

Now, I want to ask Mr. Keese and Mr. Lloyd and Mr. Freeman, do you all see any scenario in which a retail rate increase might be in order as part of a comprehensive solution to the short-term problem in California?

Mr. KEESE. Mr. Chairman, the first crack in that, I believe, was when the Governor did announce his 20/20 program which, in effect, is that. This says that in the 4-month period of the summer, for any retail customer who reduces their demand by 20 percent, they will get a 20-percent rebate on what they paid. A market signal.

There have been suggestions in the Legislature to that effect, but at this point I am not aware of any other initiatives of the Governor in that area.

Mr. BARTON. Why would that be—I understand it is a demand management technique, and I commend the Governor for doing that, but unless you pay people more the less they use so that they get a higher price the more they save—which would be a rate increase to the State of California, I guess, paying more for them using less—if you pay them the same per kilowatt hour regardless of how much they use, they just get it back in rebate, that is not a price signal.

Mr. KEESE. Mr. Chairman, again, as the Energy Commission, we have suggested—my response to this is extremely critical, and that the failure of the California system was to deregulate the supply side and fix the demand side, so there was a disconnect here.

If you look at the rates that are being paid on the wholesale level today, it would be unconscionable for California to pass those on in the retail system. That would be politically unacceptable.

Mr. BARTON. I accept it is unconscionable, Mr. Freeman pointed it out and I backed him up. California is paying some of the highest retail rates in the country right now for electricity. So, it is not like you all are at 3 cents and the rest of the country is at 8, so you are paying high prices. But it is unconscionable, in my mind, to ask the ratepayers in Arizona and Oregon and the rest of the West to raise their retail rates when the California retail rate is frozen. I am not saying that is the answer, but it would appear to me, to anybody that is acting objectively in a prudent, comprehensive way, that a retail rate increase would be a part of the answer. Governor Davis himself is quoted as saying he could solve this problem in 20 minutes by raising retail rates, but yet not any one of the officials—and I understand you come with a certain amount of guidance from higher authority on what you can say—but it is just not credible to say that shouldn't be something—if you are pushing wholesale price caps, you ought to also acknowledge that, as a part of that, there should be some retail rate increase tied to it.

Dr. Lloyd or Mr. Freeman, either one.

Mr. FREEMAN. Mr. Chairman, there is a myth that has been repeated that the retail rates in California are frozen. They are not. First of all, there is a 10-percent rate increase that was enacted just sometime ago, that was at the time called temporary, but we all know it is permanent. There is another 10-percent increase that will be automatic next year as a result of the end of this 10-percent reduction that was part of the deregulation scheme.

The Legislature has deregulated one-third of the electricity. The fund that I was helping to administer where we bought all this power, the law of California says in plain English, and it has been confirmed by the PUC, that the rate for that power can be adjusted

upward, if necessary, to pay for the power that we bought. The power that is on a cost-of-service basis is below the existing rate.

Now, obviously, the rates will be further adjusted upward. There is a serious question at the moment as to whether the wholesale rates all need to be passed-through. I use plain English, there is talk of a haircut, of a deal being negotiated where everybody would settle for some percentage of that on the grounds that the rates included a credit risk margin. And if you paid the whole 100 percent, you would be over-compensating. That is the theory that is being discussed. But there is nobody in California, including the Governor, that doesn't realize that if it is necessary, the retail rates will be adjusted. But he is a consumer-oriented Governor that is trying his best to keep the rates as low as he can and still pay the bills, but we are not trying to repeal the laws of supply and demand, or forget the laws of economics.

Mr. BARTON. Dr. Lloyd, would you like to comment on that before I go to Mr. Largent?

Mr. LLOYD. No, I don't feel equipped to comment on that.

Mr. BARTON. Any of the other—Mr. Hall or Mr. Makovich or Mr. Cooper?

Mr. COOPER. Well, I will reiterate what Congresswoman Harman suggested. It is important—and, again, in working out the elements of a buyout, everybody takes a haircut. And one of the things we don't want to do is swap a hard retail cap for a very bad soft wholesale cap, which is what we are getting from the FERC.

When we begin to get a conversation about prices that reflect cost on this interim basis in a dysfunctional market, I suspect you may start to see less resistance to whose hair gets cut how short. And it is important to give and take here.

Mr. BARTON. Mr. Makovich—Dr. Makovich. I am told you are a Doctor. We have been calling you Mister. I should say Doctor.

Mr. MAKOVICH. It really is an attempt to repeal supply and demand. I mean, it is just common sense. If you are going to set up a market, the demand side ought to be connected to it. And this isn't a problem in just California. Go across the country, and time and again, when we have tried to deregulate our power markets, we have these well-intentioned price freezes, but they are multiple year. They are going to create big problems down the road, and California is just a specific example of if you are going to set up a market, have the demand side connected.

Mr. BARTON. Mr. Hall, your group that you represent—I mean, you are here for a specific company, but you represent generically the merchant power group. What is their general feeling on a wholesale price cap if tied to a retail price increase in some fashion that objective people found acceptable?

Mr. MAKOVICH. Well, again, of course you know fundamentally our position is we don't support price caps.

Mr. BARTON. I understand. That is my fundamental position, but I am trying to——

Mr. MAKOVICH. I think the way to sum that up is, you know, if you look at what has occurred in California in the last 2 years with price caps, Duke hasn't left the State, and others haven't. We have a long-term vision and, to some degree, a leap of faith that with these caps in place, things will begin to get fixed such that markets

can become unencumbered. So, again, we don't think that is necessarily the right solution, but I think the key is if those kinds of things are done, it has to be done on a fair and equitable basis.

Somebody mentioned earlier that FERC only has jurisdiction over 47 percent of the capacity. There is a lot of other capacity out there that is not going to be tied——

Mr. BARTON. You wouldn't want to accept price caps that are FERC jurisdictional, and have our good friends in the co-ops and municipals not have price caps and, although with the best of intentions, if there was a shortage situation and one price was capped, it is obvious that prices would go up in the area that wasn't capped. So, we would have to get the State or some entity to have a relationship so that if you are going to be capped, everybody is capped together.

Mr. MAKOVICH. Yes.

Mr. BARTON. Mr. Pope?

Mr. POPE. I think to add to that, we are not supporting the municipals to come under FERC jurisdiction, but——

Mr. BARTON. I would be stunned if you did.

Mr. POPE. We would support an interim relief and we would abide by them in the marketplace in the West, as I think all of——

Mr. BARTON. Well, I think the municipals—I mean, have made a good-faith effort to be team players. But it is obvious that if there is money to be made, it behooves the taxpayers of Los Angeles or Santa Clara to make some money, too, because that helps to pay up for infrastructure in the future, and there is nothing wrong with that. That is not illegal, and it is not unethical. So, we don't expect if the market is at $75 or $100 a megawatt hour for people who consistently sell into if they don't have to at $30 a megawatt hour. I mean, you just don't do that.

Mr. Largent.

Mr. LARGENT. Mr. Hall, how does Duke Power determine just and reasonable prices?

Mr. HALL. Of course, Duke Power is a regulated business in Carolina, so Duke Energy North America is the business unit I represent, that is the merchant generation business. And, again, we factor in the basic variable costs that it takes to operate our plant and to cover that, and that is the price of fuel, that is environmental emission credits, there are fixed-costs that are associated with that, and then obviously there is some built-in expectation of some rate of return that we would expect to gain in the market, and that is what we bid into the market. So, it is basic fundamental market bidding that we perform.

Mr. LARGENT. And those costs vary from $50 to $1,000?

Mr. HALL. Yes, depending on a number of factors—relative to variable costs, and the scarcity of power, and who is demanding it where, and what somebody is willing to pay for it.

Mr. LARGENT. Mr. Cooper, how do you determine just and reasonable costs?

Mr. COOPER. Well, we started out with the same definition, and then he ended up with what somebody is willing to pay for it. He started out from a cost description, of variable costs and fixed costs and a reasonable return, and that is a cost-based rate. And he said he bid that in, and he has got one plant that may be at $100 and

one plant that may be at $1,000. And the thing that we don't want is the plant that costs $100, including a reasonable rate of return, to be paid $1,000. That is what he ended up with because that is what the market is clearing at in California. So we have let the price be set for the $100 plant by the $1,000 plant. That is just rent. That is what we are fighting about.

And so the difference in a truly competitive market, people don't collect a lot of rents. There may be a little bit of rent because the supply curve is upwardly sloping, but by and large no markets look like this one where the supply curve is vertical.

And so as we described in the paper we released a couple days ago and submitted to the Committee, it is that problem—that he has got two plants, one costs $100, one costs $1,000, and he is getting paid $1,000 for both. And on the $100 plant there is $900 of rent, and that is a problem. We don't want to pay that rent in this market.

Mr. HALL. Well, again, the market is sending a signal. There is a scarcity of power, and this is the premium that is going to be required to purchase the power, but because of that signal, then new generation is being redeployed into the State, so eventually there is an equilibrium between supply and demand, the prices come back down to very reasonable levels. We have seen that in other areas of the country. And when we had an adequate balance of supply and demand in the first 2 years of the market operation, we saw very low prices. And that is where we have got to get back to, and that is the signal being sent, and that is why we are spending a lot of money to build new generation in the State.

Mr. BARTON. Would the gentleman yield? Are you a Doctor also?

Mr. COOPER. I am a Doctor.

Mr. BARTON. You sounded like a Doctor in that last answer, so I thought maybe you were. Dr. Cooper makes, I think, a reasonable persuasive argument that we should switch to what we would call a "bid auction" system as opposed to this market clearing system. Had the State done that in their Power Exchange, had a bid auction, so that if his plant that cost $100 a megawatt hour bid in its capacity at, say, $150, you took it. And then when you use up all that power, you bid the next increment that was less efficient, so that finally you are bid auction for the $1,000 was just a tiny bid at the top of the market, would that have worked as opposed to what they did before they disbanded the Power Exchange?

Mr. HALL. Again, you had a spot market in operation, and I am not necessarily that familiar with the bid-ask. I know it is used in other regions and seems to be fairly successful——

Mr. BARTON. Well, it works on the Yew York Stock Exchange, although the last week or so it has been working the wrong way.

Mr. HALL. We are not opposed to that. The key is to get load out of the spot market and get some percentage over into the forward market, so then you don't have that much exposure in the spot market. So whether you have got the single market clearing price or bid-ask to us, it doesn't really matter.

Mr. BARTON. Well, it would matter to the consumers because—you know, I have to admit, I have looked at this—and I am not a Ph.D. economist—but I can't understand why you couldn't use a bid-ask market clearing mechanism as opposed to what——

Mr. COOPER. And another point that I guess Mr. Makovich was going to point out, we also need a capacity market. The markets that have worked better have had separated out energy and capacity. Now, I will tell you that there is a debate between consumer advocates in California about how much this stuff matters, and I have given you my view, and that is shared by a significant number of consumer advocates—absolutely, capacity markets.

Mr. BARTON. Do you all have debates, too?

Mr. COOPER. Oh, yes, we have debates.

Mr. BARTON. Maybe I could be invited to one of those debates, it might be educational.

Mr. COOPER. So the point is that we think that is—we prefer a bid price. This was a lottery in California. I personally went to every RTO meeting that FERC had, and I have a sweatshirt to prove it, and I talked to these people. And what happened in California was essentially a lottery mentality. You bid in a certain number of capacity and you had a certain amount you could hold back, and you put an outrageous price on it. And, lo and behold, not only did they pay off on that, but they paid you the same price for everything else.

Mr. BARTON. I have taken up 5 minutes of Mr. Largent's time, we are going to restart his clock.

Mr. LARGENT. Well, I just have one other question. Mr. Freeman, I wanted to ask you, it is fairly apparent that you are not a big fan of the deregulation of electricity in California, but why is it that California and their deregulation effort looks so bad, and yet in a State like Pennsylvania they love what they have done in deregulation?

Mr. FREEMAN. I think one difference is that they have a surplus of power in Pennsylvania. Ours worked rather well the first year, too well. The price was real low and it discouraged power plants from being built. Then the curves crossed and we had a shortage, and with no caps. I think there are some caps in the Pennsylvania system.

A hybrid system will work. Just turning it loose in a shortage is a disaster.

Mr. COOPER. Mr. Largent, we took a hard look at Pennsylvania, and I actually testified in several of the cost cases in Pennsylvania for AARP. Pennsylvania is a rather different kettle of fish. And I said frequently that you really maybe can't export it to other places. You had surplus capacity and high prices. The constituents I represented in Philadelphia were paying 8 cents per kilowatt hour out of a nuclear power plant with excess capacity, and they were selling the excess capacity down the road in Baltimore for 2 cents. Now, I always thought we should have gotten the 2-cent power and let them sell the 8-cent power to the other guy. But we were the captives, and you couldn't sell 8-cent power back then.

So it was easy to lower people's rates because they were so high, so that a system with excess capacity starts selling into a tight market, and the utilities were better off.

But let us be careful about Pennsylvania. In the last 2 or 3 months, a couple hundred thousand of the people who switched have come back. And why have they come back? Because Pennsylvania was driven by cheap gas. Electricity restructuring was driven

by cheap gas, and the cheap gas is gone, and it remains to be seen whether or not anybody is going to save any money in Pennsylvania in the market. They have all saved money, but that was through regulation, through the write-off of stranded costs and very high prices, and that dynamic. Very few other States have that dynamic, and nobody has cheap gas except maybe Texas where you are on the right side of the——

Mr. BARTON. We have no cheap gas in Texas.

Mr. COOPER. But the point is—it is cheaper than California. But the point is that so that it remains to be seen. I am not saying Pennsylvania has failed, but I am not so sure it succeeded, not nearly to the level of promises that were made, for sure. And, of course, let us be clear. There is a rate cap in Pennsylvania, and we have a utility in Pennsylvania that is seeking to bust that rate cap exactly like in California. GPU has come in and asked for $300 million of rate increases above their cap, which they claim they can do under the statute. So, let us be clear. California is worse, and you have heard a number of reasons, but the underlying dynamics in other places—and we are hearing concerns about New York. The underlying dynamics in other places ought to give people some pause and concern.

Mr. LARGENT. Thank you, Mr. Chairman.

Mr. BARTON. The gentleman from Arizona for 5 minutes.

Mr. SHADEGG. Dr. Makovich, let me start with you. Correct me if I am wrong because I am trying to understand this, but as I understand it, the California deregulation structure essentially encouraged emphasis solely on short-term purchases—that is to say, it was created to say, we are going to create a system where people bid and they don't do long-term contracts. The analogy I heard was it is like somebody who shows up at the airport and buys an airplane ticket right there at the airport to go to the other side of the country. That person is going to expect to pay dramatically more than somebody that calls them up ahead and says, "When can I get the best rate to fly across the country." That is exactly what the California "deregulation plan" calls for, is it not?

Mr. MAKOVICH. Well, yes. The California plan did involve a rule that meant the incumbent utilities, once they have released customers to the market after their stranded costs were recovered, were then obligated to buy just from the spot market. They weren't supposed to go into long-term contracts and then pass that along, just be an intermediary as a default-provider. Of course, the irony there is we release customers just in time for a shortage where that would become a huge problem.

It is not true, though, that the spot market is the problem. The spot market worked very well once it was established, until the shortage occurred. The spot market is the basis for a futures market. A futures market has to be based on a spot market because ultimately it has to clear to the spot market. But a futures contract isn't the mechanism that is going to pay for the capacity to get you to build. Long-term contracts—the right type of long-term contract could work out there, where people are paid for capacity and then there is an option to buy energy at a particular price. But long-term energy volume contracts, as I understand that have been

signed in California right now, are a mistake, and it is going to be something that California regrets down the road.

Mr. SHADEGG. Let me just finish this point. They are forced to buy short-term at a certain point in time, now they are forced to buy long-term.

Mr. MAKOVICH. They are forced to buy long-term at the top of the market.

Mr. SHADEGG. We instead should have a blend all the time, ongoing, back then and now, of short- and long-term contracts.

Mr. MAKOVICH. Yes.

Mr. SHADEGG. And that is forced by the California law. That consequence that drove prices up then—part of the problem that Dr. Cooper just talked about and is going to talk about again in a moment—was driven by the California law, essentially commanded by the Legislature, and it created a problem then, and now it is creating another problem and they are buying in a long-term market and not necessarily getting any good deals in the long-term market, is that right?

Mr. MAKOVICH. Yes.

Mr. SHADEGG. Dr. Cooper?

Mr. COOPER. The airplane analogy is really useful in the following sense. You said you will pay a lot more if you turn up at the airport and say "I want it." Well, actually, you know what? If there was an auction there and that plane was about to leave and there were some empty seats, they would actually sell to you cheap. They would figure out what it cost to put your body on the plane, and you could get it pretty cheap.

The problem is, I don't want my lights to depend on that kind of stuff. I mean, if you get there and there is a seat there and it is cheap, I am great, and if there is no seat, my lights go out.

Mr. SHADEGG. So you would agree there ought to be a mix of long-term and short-term.

Mr. COOPER. Absolutely.

Mr. SHADEGG. And you would agree that it was a flaw in the law that commanded the spot market.

Mr. COOPER. The document we have submitted to you tells people to stay out of the spot market, avoid the spot market like the plague. But let me talk about these long-term contracts—because there is a debate—that are being signed. The question now is, essentially the State of California is the provider of last resort. They are behaving just like any utility behaves—that is, they are trying to keep the damn lights on at a reasonable price. Are those 7-cent contracts a good deal? Well, it depends if you think 3-cent power is coming back, or you think 40-cent power is the future. if Iou can legitimately tell people that "I avoided 40-cent power for 6 months," those contracts are cheap. If it turns out that 3-cent power or 5-cent power—actually, 5-cent power would not even be a problem. So, it is a question of, you are here today, how do you keep the lights on at a price people can afford? It is a workout.

Mr. SHADEGG. The point I am trying to figure out is, one of the questions that is kind of hanging over all this is the question of price gouging. Do we have a $5.6 billion price gouging that has already occurred, and if we don't impose price caps now, though many of us are opposed to that, will there be price gouging in the

future? And I just want to establish the fact that, as a part of this question of whether or not there was price gouging, the merchant plants were buying into a system that incentivized that very kind of structure where price would go to the highest point. Wouldn't you agree, Mr. Pope?

Mr. POPE. I believe that the market is dysfunctional, has been, and we have got a circumstance where having diversity in your resource mix as a utility to serve the load is the way it should be, but because of the circumstance that we have now where the State is playing catch-up and the merchant plant owners are trying to play in this market and figure it out on where to bid going forward, that is the dilemma that California is. And the obligation to serve is now resting with the State of California to be a default provider.

Mr. SHADEGG. Mr. Hall, you were accused by Mr. Cooper of essentially price gouging in this conversation just a moment ago, by the way you determined fair and reasonable price. Didn't the system created by the Legislature encourage the bidding of that price up by everybody in the business in California?

Mr. HALL. I don't know that it did. Again, if you look at the first 2 years of operation of the marketplace, prices were very low because, again, market fundamentals were in place. There was an adequate supply meeting the needs of the loads. Again, when things began to disconnect, it started sending signals to the market. It wasn't necessarily that there was—you know, we don't think there was market gouging going on, it was simply a signal to say there is a scarcity of power and there is a competition for that power, and it drives the price up, and that is what occurred.

Mr. SHADEGG. Dr. Makovich, do you want to comment on that, and then I am finished.

Mr. MAKOVICH. Yes. I think the point is, when there is a shortage—and this is a shortage problem, and I don't believe that there is strong evidence to support the allegation of price gouging. It is simply a fact that electricity doesn't have many substitutes. It is something that is considered a necessity. And when you create a shortage, although there is some price elasticity there, it is fairly inelastic, and you have got a lot of inelastic demand chasing a very limited supply, and price goes up. And that is not manipulation, it is not gouging, it is the way that the market works in a shortage.

Mr. SHADEGG. Thank you very much.

Mr. COOPER. One caveat. As long as you are not shutting in capacity. If you are withholding capacity, then it is not just a shortage, and I haven't seen his plant, I don't know, but that is a critical debate in California.

Mr. HALL. That doesn't happen.

Mr. SHADEGG. I would like to thank you all for your testimony, I appreciate it.

Mr. BARTON. I think it is down to the nitty-gritty now, just me and you guys. So, when I run out of questions, we are going to excuse the panel and you can go catch your airplanes.

I want to go back to you, Dr. Lloyd. It is my understanding that the State of California, as it is allowed to under the Clean Air Act, has got air quality standards that are, on average, about 25 percent higher than the national standards. Is that true or not true?

Mr. LLOYD. What do you mean by higher?

Mr. BARTON. Stricter. More restrictive, less emissions allowed.

Mr. LLOYD. And you are talking about air quality standards?

Mr. BARTON. Yes, sir.

Mr. LLOYD. I don't know the percentage, but typically they may be stricter, yes—understanding that we have typically more air pollution in California.

Mr. BARTON. Well, there is reason. Los Angeles Basin is more difficult, and you have got a lot more cars and a lot more people than any other State. There is nothing negative about that, at all. The Clean Air Act allows it, and you all have chosen to do it. But if Mr. Waxman were here—he is not here—he has made the point repeatedly that the standards have no impact on the price of electricity. I agree with him, they haven't caused a problem, but it would appear obvious that if you have got a stricter standard, it is going to cost more to meet that standard, and that is going to end up meaning it costs more to generate electricity. Would you agree or disagree with that, in general?

Mr. LLOYD. Well, recognize when you talk about the Air Quality Standard, there are many factors that play into what people breathe, and power plants are just one of those. So, in many cases, it is not going to be dominated by power plants, it is going to be dominated by mobile sources.

Mr. BARTON. In my region, is it dominated by mobile sources, so I agree with you on that.

Mr. LLOYD. And we do, in fact, have the strictest standards on mobile sourcing in California.

Mr. BARTON. But, in general, the stricter the standard, the more expensive it is going to be to me. If you have got the strictest standards in the country, it stands to reason that the cost to meet those standards is going to be a little bit high. I don't know what that delta is. I don't know if it is a half-a-cent a kilowatt hour, or maybe a tenth-of-a-cent a kilowatt hour, but it almost has to be some higher, and we had some testimony at a previous hearing about the reclaim program—which is not Statewide, it is just in a part of California—but it is a trading system for NO_X emissions, and the price of those emissions went through the roof. It went to like, I want to say, $200 a pound to try—as the generators were trying to generate to meet electricity demand, they were having to pay more and more to get these NO_X standards under the reclaim program. So there is at least one sample in California in the last year where there is a measurable data file on the cost of meeting clean air standards.

Mr. LLOYD. But I think in this case, that was clearly an aberration in terms of the way the market went up. If you go back historically——

Mr. BARTON. It is a lot lower, I understand that.

Mr. LLOYD. No, I was going to say, if you go back historically before reclaim was put into place, you had a system whereby people could either choose—before that, they could either choose to put controls on, or buy credits on the market. Many companies did not choose to put emission controls on, they bought credits in the market. That worked perfectly until it began to really hurt, and I think Mr. Freeman can also attest to some of those, if you like, tradeoffs.

Mr. BARTON. And I am told, just at the staff level, this reclaim drove the price of NO_X credits to $45,000 a ton, which would be phenomenal.

Mr. LLOYD. In fact, I think there were peaks when that was the case. The point I was trying to make, Mr. Chairman, was, in fact, if companies had put on controls, had put on SCR, in fact, they wouldn't have to buy such large numbers of NO_X credit, and so they would not have the problem.

Mr. BARTON. You didn't know you were doing that, but you led right into my next question. Because of the chance of blackouts this summer, I am told that the California ISO has proposed to your Board that you delay—they be allowed to delay installation of these SCR units, or selective catalytic reduction units, on certain plants. If you agree to that, your Board agrees to that, that is going to delay the anticipated reduction in certain NO_X emissions from those plants. Have you estimated the amount of those emissions, and have you also worked with the Regional EPA to see how that affects the SIP plan, the State Implementation Plan, and whether that, in fact, somebody could sue that an illegal had been created by delaying the SCR unit installation? It is a long question.

Mr. LLOYD. Yes, a many-part question. The first part of that, we have been aware of the ISO request. We have agreed that they could be delayed in about a third of those. Two-thirds we feel should go ahead, and they will go ahead this spring before the summer period so, in fact, these plants can operate longer hours, polluting less, which is exactly what we want.

We are working with the local districts on that part of it as well, and I assume, to my knowledge, we are working very closely and well with both the local districts and EPA Region IX.

The issue you talk about about the citizen suits, clearly, I am going to have to look more at our legal part of that.

Mr. BARTON. That goes to the next part of my question. If, in fact, it is the Governor's decision and the California Air Quality Board decision to delay installation of these SCR units——

Mr. LLOYD. A small portion of them.

Mr. BARTON. [continuing] then it is arguable that a citizen suit could be brought, that that is an illegal act under the Clean Air Act, because any citizen can bring a suit. So, one part of our Federal Remedy Bill could be an indemnification against such suits for a definite period of time. Would you support that, if we put that in an emergency relief package?

Mr. LLOYD. Well, I think this issue, as I say, I don't think because of their limited emissions amount, you would not create a SIP problem. The more significant issue you talk about is the Administrator does have administrative power to actually grant that discretion.

Mr. BARTON. The Administrator doesn't have the ability to prevent suits under the law. And as Mr. Freeman has pointed out, democracy is alive and well in the State of California.

Mr. LLOYD. That is an area where I would have to consult our lawyers.

Mr. BARTON. But my question is for everybody. We are looking at remedies. We are looking at solutions. We could put in the law for a specific period of time—to go to Dr. Cooper's concern earlier—

some relief from lawsuits, if the Governor of a State has declared an electricity emergency and, as a part of that, is asked for relief from certain of these air quality standards, again, for a specific period of time.

Mr. LLOYD. Mr. Chairman, what I would like to do is go back to our staff, our legal staff, to look at that issue and respond in writing to you to see whether that would be a helpful request and under what condition.

Mr. HALL. There is another dimension of that decisionmaking process because—in concept, it sounds good, but keep in mind that the outages that have to be taken to perform these retrofits, while in concept it sounds good, but let us delay it a couple of years if we can work out these other issues. These are typically time to do it in major outage intervals when other work has to be done on units. Every 5 years is typical standard, prudent utility practice that units have to be brought down and major maintenance performed. So, if we push all of that out, those SCR retrofits, we have still got these major outages coming up where, if we don't do that work, we are going to have reliability problems. So, it is not quite as easy as it sounds.

Mr. BARTON. But wouldn't your group have the ability to give that information to Dr. Lloyd's agents. It would not make sense to me to say we are going to delay this SCR implementation so that we can run the plants, without checking with the plant operators, and say, "Well, great, we are going to shut the plant down anyway because we have been running it full-bore for the last 18 months and it is going to wear out if we"——

Mr. HALL. The independent system operator asked us for our feedback on that and we gave it to them. Now, we haven't to Mr. Lloyd. Maybe we need to have a conversation directly with him, but we have fed that back to——

Mr. BARTON. Aren't these hearings a wonderful mechanism for communication?

Mr. HALL. We will do that.

Mr. BARTON. Well, let us get down to the heart of the matter here. I have to make some recommendations to the White House this weekend on what, if anything, to do at the Federal level in California. Mr. Boucher is working with his membership to see what solutions they think they would be willing to put on the table in an emergency bill that we will put together in the next several weeks.

So, I am going to ask a series of questions—these are all things that have come up in discussions that we might could do. Again, these are Federal things that could be done, Federal actions, not presumptive to what the State of California would do or anything like that.

One issue is the Path 15 transmission link between Northern and Southern California. It is an idea that has been bandied about, apparently hasn't been acted upon because of the cost of construction of the transmission facility. What would the State's view be if the Federal Government were willing to pay for that either directly or through some sort of a long-term loan that could be paid back with transmission fees generated by the transmission link? Mr.

Pope, what would you think the State of California's reaction to that would be?

Mr. POPE. I don't know. I think it is something that we certainly bring up. I think there is a unanimous opinion that Path 15 has to be fixed, and the faster we can fix it, the better.

Mr. BARTON. Mr. Freeman.

Mr. FREEMAN. Hooray.

Mr. BARTON. Hooray.

Mr. FREEMAN. Hooray.

Mr. BARTON. I understand that. That means yes, you would like it.

Mr. FREEMAN. A strong yes.

Mr. BARTON. Mr. Keese, Chairman Keese.

Mr. KEESE. I will go with a strong yes.

Mr. BARTON. Dr. Lloyd, I don't know that California Air Quality Board would have a view. Mr. Hall, what do you think the private——

Mr. HALL. Same position as Mr. Pope.

Mr. BARTON. I have been told that there are sites that are Federal lands that would be excellent sites for power plant siting, and that such sites are not subject to the entire range of siting requirements on privately owned land. Would there be any interest in the Federal Government making available sites to at least emplace peaking plants as quickly as possible—federally owned land that would be made available for some sort of a power plant generation facility. Chairman Keese?

Mr. KEESE. Mr. Chairman, I think we can probably give a very specific answer on that. We have met with all the military branches in California. We have brought up this issue. We have done some preliminary identification of sites. And I believe that the team that is working on this has identified problems with it. So, I think I can get you a very specific response to that question. I don't have the answer here.

Mr. BARTON. We would need it probably no later than next Wednesday.

Mr. KEESE. We will get it for you immediately.

Mr. BARTON. This would be for Dr. Lloyd. It goes kind of to the question I asked you earlier. We understand under the Clean Air Act certain standards are in place, and we also understand the State of California has exercised discretion and enforcement of those standards, but that discretion is technically not allowed under the Clean Air Act.

Would it be helpful to explicitly put into Federal law on an emergency basis, the authority or the permissiveness to allow the relaxation of certain standards for a definite period of time? Would that be helpful or hurtful?

Mr. LLOYD. Offhand, I would say it would be hurtful.

Mr. BARTON. Hurtful. So that would not be something you would think we should do.

Mr. LLOYD. Relaxation of standards, I think it would not be protective of public health, and I think it would not be necessary because we have the flexibility that we need.

Mr. BARTON. But my understanding is the flexibility that you are using, while commendable, is technically illegal.

Mr. LLOYD. Then, in fact, what I would get back—if we isolate that one element you were talking about, I promise that we will get back to you a letter addressing that issue.

Mr. BARTON. What I am trying to get at is, we want you to be flexible. We don't want you to commit an illegal act. We want your flexibility to be legal while also protecting the public health and safety. And this wink-and-a-nod situation is——

Mr. LLOYD. It is not a wink and a nod because what I promised you—your question was a very good one, but I am not going to be able to answer here.

Mr. BARTON. Well, thank you. A 6-hour hearing, I have had one good question.

Mr. LLOYD. I appreciate your sense of humor. But I did promise to get you back, when our legal staff has looked at that, whether or not we need additional help there and under what conditions. And we will get that back to you.

Mr. BARTON. This next ones seems somewhat farfetched, but it has been postulated, the Navy has large warships that are powered by nuclear reactors. Some of those warships dock at ports in California. Is there enough capacity in those warships that if they were to be docked and be tied into the grid, that would help alleviate the peak problem in California this summer?

Mr. FREEMAN. I have heard that idea discussed and, in concept, of course, it makes a lot of sense. I think there is a practical question of physically whether that power could be fed into the system. It should be looked at, but perhaps the Armed Forces have spare generators somewhere in the world that they could get one of their great, big transport planes and fly in before the summer.

Mr. BARTON. Well, Congressman Duncan Hunter has a bill on that issue, and the generator issue is being researched, too, and that will almost certainly be a part of any package that we put forth, but this is a little bit different because the ships are so much larger that they actually might have enough capacity, if they could be fed in the right way, that it could be somewhat significant. So, who would be the right person in the State of California to research that? Would that be Chairman Keese's Commission, or the PUC, or how would we do that?

Mr. KEESE. Well, it is actually multi-agency. It is the generation team. There is a team that is working on this, and I was approached by an ex-Navy man earlier this week at another presentation I was giving, and I referred him to the team. So, again, I——

Mr. BARTON. This ex-Navy man, was he acting in an official capacity, or was he just a good citizen?

Mr. KEESE. He was just a real good citizen, but he brought the pictures of the ships of the fleet that he thought were available.

Mr. BARTON. So, if we get an official of the United States Navy——

Mr. KEESE. That would probably carry a little more weight.

Mr. BARTON. And you would be receptive to the official at least making the contact?

Mr. KEESE. Absolutely. Absolutely. And I can give your counsel the name.

Mr. BARTON. We also have a pending bill before the subcommittee that would give the Governor of the State the authority

to declare double-Daylight Savings Time. There is the theory that if you start demand clocks earlier, that it requires less electricity at peak time. Now, I don't know that I subscribe to the theory but, again, with our State officials, do you think your Governor would be receptive to having the authority to declare double-Daylight Savings Time? Apparently, under Federal law, a State can only declare normal Daylight Savings Time.

Mr. KEESE. Mr. Chairman, I would say we have a report that does indicate that such would save, and I do not recall whether it is 1 or 2 percent—but it would impact a 1 or 2 percent reduction in peak demand. We have that report. I am not aware that it has been presented to the Governor for action, but we can do that also.

Mr. BARTON. I would ask each of the panelists, if you have an idea to help in the short-term, i.e., this summer, to put it in writing and get it to the Committee staff. We will get copies to the majority and the minority. It has not been decided if we are going to put together an emergency bill, but if we are going to, I have declared that we are going to put it together in the next 2 weeks so that we can pass it as soon as possible, so that it actually is available before this summer.

So there may be a decision made that there is not enough that can be done, and the existing statutes are satisfactory to an emergency situation. I am of the opinion we probably should put a bill together, but the final decision is yet to be made.

Does anybody have any last great ideas for action in terms of a legislative solution you want to put on the table before we adjourn the hearing?

Mr. FREEMAN. Mr. Chairman, being the person who said leave us alone, you are in the process of changing my mind. Money always talks.

Mr. BARTON. Well, it is easy for me to promise. It is the appropriators and the President that have to put the money on the table.

Mr. FREEMAN. But we have not talked about the demand side. There is a tax bill going through the Congress, perhaps this Committee, but tax credits for investments in new appliances that would be much more efficient could help this summer, in tax credits for the most efficient refrigerator, air conditioner, lighting. That could be a wonderful help. And all that would be pulled through the market by the 20/20 program of the Governor.

So, if the Committees talk to each other up here, perhaps that could be part of your package.

Mr. BARTON. We do. We are like the consumer activists, we do have debates from time to time, that are not seen on camera.

Mr. LLOYD. I would also just like to follow up on a comment that David Freeman made early on, and I think it can help—not right immediately, but certainly in the coming months, and certainly in the short- or longer-term—and that is to continue to look at renewables. Wind is very cost-effective in California. Solar, anything you can do there. Biomass, and obviously fuel cells. I know when I was at South Coast, we could site a power plant without actually getting air quality permits. So I think those are areas, all those areas—air quality regulation is not an issue, and we can move ahead. And we need to encourage that energy diversity.

Mr. COOPER. Similar vein as Mr. Freeman. The idea of having Federal tariffs look at demand side management and compete in a regionwide basis here, so that every time some load comes out of anyplace in the West, we now learn everybody in the West may benefit. To the extent that Federal funds can support that——

Mr. BARTON. Put that into regular language.

Mr. COOPER. The point is that we are basically bribing people to give back their megawatts with this 20/20 program. That is a State program. It is not clear to me that the cost of the share problem through the interstate problem in the West, the FERC should not look at similar programs that could be justified in the context of that broader wholesale market. So perhaps some Federal dollars could go into demand side management.

Mr. BARTON. It is always a mistake to put Federal dollars on the table with this many people at the table.

Mr. COOPER. It is exactly the same concept that people sort of were encouraging California to do insofar as it is an interstate problem and an interstate market, so maybe Federal dollars should go into it.

Mr. BARTON. You want a wholesale megawatt buy-back emergency provision——

Mr. COOPER. At the Federal level.

Mr. BARTON. [continuing] at the Federal level. I don't hold out a lot of hope for that.

Mr. COOPER. Well, it is the same principle, and people seem to like it when the State did it, insofar as it is a collective problem, and maybe the collective entity, the Federal Government, should think about it.

Mr. BARTON. Chairman Keese?

Mr. KEESE. I would be remiss if I left one factor out, but I don't think it was particularly appropriate to this hearing earlier. Approximately 30 percent of our power at peak goes to air conditioning in California. The Federal DOE did adopt a new air conditioner standard at the end of the last administration, that is being reviewed now.

California has adopted an even tighter air conditioning standard, and we are going to be asking the administration for a waiver so that we can impose that.

Mr. BARTON. Waiver so that you can delay——

Mr. KEESE. So that the State can have a stricter standard on air conditioners than the Federal standard. I am leaving in here, I am saying 30 percent of our electricity goes to air conditioning.

Mr. BARTON. But a stricter standard—it is going to cost more to buy that air conditioner.

Mr. KEESE. Correct, in the short-term.

Mr. BARTON. You are going to ask Californians this summer, that already have an air conditioner, to go out and buy a more expensive air conditioner.

Mr. KEESE. It is not appropriate to this hearing because it is not going to happen this summer, but we would like to, within the next year or so, have better standards——

Mr. BARTON. Permission to enact a tighter appliance standard, and specifically for air conditioners.

Mr. KEESE. Correct, for air conditioners, which in the long-term will be extremely beneficial to keeping our peaks down, shaving our peaks off.

Mr. BARTON. Okay. I understand.

Mr. POPE. And in California, we have a public benefits program that we can add incentives back to incent those to be—inefficient air conditioners to be replaced with these more efficient air conditioners. In Santa Clara, we are doubling that rebate, or quadrupling that rebate right now.

Mr. BARTON. My last question, Mr. Hall. I have been told that last summer your company offered the State of California Power Exchange, I think, a lot of power at $55 a megawatt for 5 years. Do you wish to put that offer back on the table today, effective immediately, or at least no later than June 1.

Mr. HALL. Mr. Freeman knows, we have made offers to the State. He has been the chief negotiator on that side of the fence, and we have a Memorandum of Understanding that provides a portfolio of products—baseload, peaking, and such—and we have an agreement in place.

Mr. FREEMAN. We think it is just and reasonable.

Mr. BARTON. Just and reasonable. Okay. Well, thank you, gentlemen. A lot of members are not here, they may have written questions for the record. If we get them to you quickly, we expect you to get them back quickly, and for any idea you want considered in terms of legislation, we really need it by the early part of next week.

This hearing is adjourned.

[Whereupon, at 3:50 p.m., the subcommittee was adjourned.]