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ONE HUNDRED SEVENTH CONGRESS

# Congress of the United States

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July 30, 2001

### MEMORANDUM FOR MEMBERS OF THE GOVERNMENT REFORM SUBCOMMITTEE ON ENERGY POLICY, NATURAL RESOURCES AND REGULATORY AFFAIRS

FROM:

Doug Ose 

SUBJECT: Briefing Memorandum for August 2, 2001 Hearing, "FERC: Regulators in Deregulated Electricity Markets"

On Thursday, August 2, 2001, at 2:00 p.m., in room 2154 Rayburn House Office Building, the Subcommittee on Energy Policy, Natural Resources, and Regulatory Affairs will hold a hearing to review the ability of the Federal Energy Regulatory Commission (FERC) to monitor deregulated electricity markets. The hearing is entitled, "FERC: Regulators in Deregulated Electricity Markets."

The root causes of the California energy crisis include: a flawed market design, lack of supply growth over the preceding decade, substantial demand growth in California and the entire West, high natural gas prices, and historic low hydro levels. These factors combined to create a serious deficiency in electric power supply and caused wholesale energy prices to skyrocket.

The 1935 Federal Power Act requires that FERC must ensure "just and reasonable" prices in the wholesale energy market. FERC has played a significant role in the events surrounding the California energy crisis. The agency issued licenses to generators, allowing them to sell power in California at market rates. FERC approved many aspects of California's deregulation plan, largely deferring to California State agencies on the design and structure of the market. Also, FERC issued several orders in response to the crisis, including various soft and hard price caps, conducting an investigation of outages, eliminating the California Power Exchange, disbanding the California Independent System Operator's stakeholder board, and setting in place a market mitigation plan for California on April 26, 2001 and the entire Western region on June 19, 2001.

The purpose of this hearing will be to review FERC's market monitoring capabilities and determine how FERC can improve to avoid a future crisis, like the one experienced in

California. Specifically, the Subcommittee will assess FERC's vision for market monitoring, as it outlined in Order 2000, agency staff levels and experience, and FERC's plan for addressing unplanned outages.

#### History of Electricity Market Structure

Traditionally electricity has been supplied through vertically integrated utility companies. These companies owned the generation, transmission and distribution facilities. States granted regional monopolies to the utilities in exchange for the requirement that they must serve all the customers (load) in a certain geographic region at regulated rates (cost plus a reasonable rate of return). States regulated the utilities through State public utility commissions.

#### PUHCA

In 1935, Congress passed the Public Utilities Act. This legislation contained both the Public Utility Holding Company Act (PUHCA) and the Federal Power Act, which is the basis for the electric power market law today. PUHCA was designed to curtail abuse by utility holding companies that operated in multiple States beyond the regulation of State utility commissions. If utility holding companies chose to operate in multiple States, PUHCA set up Federal regulation through the Securities and Exchange Commission (SEC). The Federal Power Act gave the Federal Power Commission (the predecessor to FERC) authority to regulate interstate electricity commerce, including the wholesale market. Thus, the 1935 Act represented a major shift in jurisdiction of energy markets to the Federal government.

The system worked very well for decades. Electric rates declined until the late 1960s. In the 1970s, several factors configured to disrupt the benefits of vertically integrated utilities. The energy crisis caused prices to rise and demand to fall. This situation left many utilities with excess capacity. Many public utility commissions forced the utilities to swallow these costs rather than pass them on to customers. New technologies, such as efficient natural gas fired combustion turbines, and improved transmission lines began to undermine the regional monopolistic structure of most utilities. In addition, the energy crisis created a public demand to reduce dependence on coal and oil, the predominant fuels for electric generation.

#### PURPA

In 1978, Congress passed the Public Utility Regulatory Policies Act (PURPA), which created the first non-utility generators. PURPA forced utilities to buy power at generous rates under long-term contracts from these independent energy producers. Qualifying facilities (QFs) -- small generators that produced power from renewable sources (biomass, wind, solar, geothermal) -- were essentially subsidized in the bill. PURPA had some far-reaching effects on the electric industry, including: changing the prevailing view of vertically integrated utilities; contributing to the growth of renewable power sources through subsidization; stimulating innovation, such as combined combustion gas turbines; and creating an interest group that wanted to reform the regulatory system to the benefit of independent producers.

### Energy Policy Act of 1992

In 1992, Congress passed the Energy Policy Act to further encourage the independent generation sector. This bill gave independent generators exemption from PUHCA if they sold exclusively in wholesale markets. It also gave FERC authority to force utilities to open access to their transmission lines.

### FERC Order 888

In 1996, FERC issued Order 888 requiring all transmission owners to publicly state their transmission rates and improve open access. These rates must be comparable to those that the utility gives to itself and its affiliates. As a result, today almost all wholesale electric rates are market-based, rather than cost-based. The 1992 Energy Policy Act and FERC Order 888 aided the development of independent power producers and stimulated the wholesale energy market.

### FERC Order 2000

Order 2000, proposed in December 1999, outlines FERC's vision for Regional Transmission Organizations (RTO). FERC issued a final order on January 6, 2000. Order 2000, among other things, directs RTOs to develop market-monitoring plans and be the primary monitors of electricity markets.

On July 11, 2001, FERC ordered the creation of a Northeast and Southeast RTO and indicated it intent to eventually create a total of four RTO nationwide (plus Texas). In the same order, FERC signaled its preferred market monitoring structure by approving the concept put forward by Pennsylvania-New Jersey-Maryland (PJM).

In this Order, FERC stated that a market-monitoring plan must ensure that a RTO provides reliable, efficient and not unduly discriminatory transmission service. The RTO must provide for objective monitoring of its market to identify market design flaws, market power abuses, and opportunities for efficiency improvements and propose appropriate actions. Market monitoring must also include monitoring the behavior of market participants in the region, including transmission owners other than the RTO to determine if their actions hinder the RTO in providing reliable, efficient and not unduly discriminatory transmission service. FERC envisions RTOs as the first line of defense in monitoring deregulated markets. FERC will continue to monitor markets on its own and maintains the ability to issue sanctions or penalties if markets fail.

FERC also provided the RTOs with the ability to issue minor sanctions and fines, on the contingency that such measures are clearly spelled out in the RTO's Market Monitoring Plan (MMP), which must be approved by FERC. FERC also provided the RTOs with the choice of creating a Market Monitoring Unit (MMU) within the RTO or independent of the RTO. FERC requires that the MMU send its reports to FERC concurrently with its reports to the RTO to ensure that FERC preserves its ability to monitor markets and issue sanctions independent of an RTO.

### GAO Report on California Outages

On February 1, 2001, FERC issued a report on plant outages in California. The General Accounting Office (GAO) reviewed this report and concluded that audited companies were not scheduling maintenance or incurring outages in an effort to influence prices. While many market participants hailed the report as conclusive evidence that market power was not being exercised, others pointed to the report as proof that FERC did not have the tools and expertise to properly monitor deregulated markets.

### Changes at FERC

As an agency, FERC is undergoing major changes. Deregulation of electricity and gas markets are the predominant cause of the change. Under the old system of vertically integrated utilities, FERC staff largely occupied themselves with computing cost-based tariffs. Lawyers and accountants dominated the agency. As deregulation took hold, FERC was not properly staffed. The agency has a serious lack of experience with deregulated markets.

Currently FERC has 103 staff members who are involved in market monitoring. Twenty-nine lawyers are in the General Counsel's office and 74 staff members are in the Office of Markets, Tariffs, and Rates. Of the 74 staff in the Markets division, most are accountants who previously calculated tariffs under the cost-based regime; only 11 are economists. FERC has only one staff member with private sector experience in the market. The market monitoring staff has grown by 30 since the beginning of 2001; however, most of these have been transferred from other offices at FERC.

One step FERC has taken to improve its market monitoring is to invest in state-of-the-art technology. After its February 2001 report on outages in California, FERC sought to improve its monitoring capabilities. The agency spent \$650,000 to create a Market Observation Resource Center. FERC consulted with the SEC, the Federal Trade Commission (FTC), and the Commodity Futures Trading Commission (CFTC) and visited energy companies, such as Enron, Dynergy, and El Paso, to determine how and with what technology these agencies and companies monitored markets.

The Center opened in July 2001. FERC can now track energy markets in real time. FERC can also listen in on trader conversations through a news service, allowing them to understand the world of energy trading. FERC staff noted that the Center will be an educational tool, helping the agency learn how deregulated markets work in detail.

The invited witnesses for the August 2, 2001 hearing are: Kevin Madden, FERC General Counsel; Shelton Cannon, FERC Deputy Director of the Office of Markets, Tariffs, and Rates; Jim Wells, Director of Natural Resources and Environment, GAO; Terry Winter, Chief Executive Officer, California Independent System Operator; Phillip Harris, President, PJM Interconnection, LLP; and William Hogan, Professor of Public Policy and Administration, John F. Kennedy School of Government, Harvard University.