

POWER RESTRUCTURING EXPERIENCE IN CALIFORNIA WILL NOT OCCUR IN TEXAS*

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The recent crisis in California's power markets has raised national concern among politicians and consumers alike regarding restructuring of electric utility markets in their home states. However, there are significant physical, political and contractual differences between the power market crisis facing Californians this summer and power markets in other states that are beginning or completing the restructuring process towards fully competitive markets.

Texas is scheduled to open for full market competition in January of 2002, and the question on the minds of Texans is whether the problems in California will come home to roost in their backyard. But the differences between the California and Texas markets are clear. Many of the issues and mistakes associated with the California market will not be repeated in Texas. In fact, many industry experts predict that the Texas market will be the most successful market to open to competition to date.

CALIFORNIA CRASH

In power markets, like many other markets, there are wholesale buyers and sellers and retail buyers and sellers. Regulated utilities, like Houston-based Reliant Energy, sell power to industrial, commercial, and residential consumers in the retail market. Some of that power is generated by the utility at its own plants and some is purchased in the wholesale market from other power generators.

Historically, when utilities purchased power, it was from other utilities, and generally on a smaller scale to meet immediate peak power needs. The advent of deregulation encourages utilities to purchase increased power supplies from independent power producers, thus creating a wholesale power market.

Each state has taken its own approach to opening up the wholesale and retail power markets to competition. California opened its wholesale and retail markets simultaneously in 1996, at a period of generation supply shortages. Under the California plan, utilities sold off their power plants to independents and began to purchase their power on a day to day – or hour to hour – basis from the California Power Exchange and the California Independent System Operator. Both were intended to ensure that adequate supplies of power were available and delivered to meet consumer demand.

Had the California market been opened with adequate supply and under modified market rules, deregulation there might have been successful. The California market, however, lacked rules which would encourage continued investment in supply, give market participants the ability to site plants easily and provide long-term risk management tools for market participants. For these reasons, the simultaneous opening up of both the wholesale and retail power markets in California was unsuccessful. California is faced with insufficient generating capacity, and the entire state is now scrambling to avert a power crisis this summer. What has Texas done differently?

TEXAS TWO-STEP

Instead of deregulating an industry that grew up under strict regulation all at once, Texas did it in two steps. First, Texas deregulated its wholesale market successfully with the passage of legislation in 1995, creating an economic environment in which power generating companies were encouraged to build new power plants in Texas. Over roughly the same period, Texas increased its generation capacity by more than 3,750 megawatts compared to only 672 megawatts of generation constructed in California.

**Summary of New Generation in Texas and
ERCOT as of February 28, 2001**

New Generation	Texas	ERCOT
Completed Projects by In-Service Date		
1996	341	341
1998	824	570
1999	1,403	1,023
2000	5,385	5,342
2001	1,390	1,390
Total	9,343	8,666
Projects Under Construction By Expected Completion Date		
2001	7,798	6,857
2002	4,993	4,993
2003	1,200	0
Total	13,991	11,850
Announced Projects By Projected Completion Date		
2001	746	665
2002	745	745
2003	7,588	6,388
2004	5,055	5,055
2005	500	500
2006	55	55
Indefinite	3,765	2,765
Total	18,454	16,173

Source: 2000 Annual Update on Activities in the ERCOT Wholesale Electricity Market, Texas Public Utility Commission Project No. 19616

Once the competitive wholesale market in Texas had developed to the point that construction of new generating capacity and continued investment was stimulated, the Texas Legislature turned its attention to examining the restructuring of the state's retail power market. One of the reasons that Texas is believed to be the most competitive market to open yet, is that Texas made sure that the wholesale market would function properly before exposing retail customers to an otherwise volatile market. A pilot program for retail power competition was slated to begin June 1 but was delayed until the end of July. Full scale competition is still set to begin in January 2002 in 80 percent of the state.

PHYSICAL AND POLITICAL DIFFERENCES

In addition to a phased-in deregulation, a number of physical characteristics distinguish the Texas market from that of California. California has not invested in its power infrastructure over the last decade, relying instead on its neighbors to provide the additional power supplies that it requires.

At the same time, overall demand for electricity in California increased 24% from 1995 to 2000, nearly twice the national average for electrical demand growth. Unfortunately for California and its neighbors, hydropower, a primary source of power generation in the northwest, has literally dried up due to two years of drought.

Even without the drought, California would still be in a precarious position relative to Texas. Given the increased demand for natural gas fuel to replace the decreases in imports of hydropower from the northwest, California's pipelines will have to operate at maximum capacity. The pipelines in California have a maximum capacity of 6.7 billion cubic feet a day, while pipelines carrying gas to California have a capacity of 7 billion cubic feet a day. The lack of capacity and bottlenecks means that an additional 300 million cubic feet of gas is stranded at the state's border each day.

Not only has California failed to invest in home-based power generating capacity, it lacks the infrastructure to access its natural resources that could fire more efficient generation at lower cost. Natural gas is the feedstock of choice for modern peaking power plants. Texas continues to enjoy ample supplies of natural gas and a well-maintained infrastructure of pipelines to carry the natural gas produced from Texas' gas fields to the power plants around the state.

Unlike Texas, Californians have been vociferous in their opposition to production of natural gas and oil in California and offshore in its waters. Large deposits of oil and gas discovered more than 40 years ago offshore Santa Barbara continue to lay untapped due to moratoriums and other environmental regulatory obstacles to new offshore drilling.

Much of Californians' opposition to the energy industry has translated into some of the most stringent environmental regulations and permitting processes in the United States. Whereas it takes two to three years to build a power plant in Texas, in California the time required is seven to eight years. Since the power crisis in California, the California Public Utility Commission has only approved construction of five new plants that will provide 3,600 megawatts of new power.

Texas currently has 26 power plants under construction that will provide over 14,200 megawatts of new power. In contrast to California, Texas' less cumbersome process for approving new plants has also resulted in an additional 31 new power projects on the drawing board or already permitted.

Because of the open regulatory environment, Texas currently has a surplus of power generation in excess of 15% projected for the foreseeable future, with additional capacity being added to the system on a monthly basis.

MARKET CERTAINTY

Another significant difference between the California market and the Texas market is that the California market was not designed to allow power companies to hedge their costs. Instead, the California structure mandated the use of a spot market for all sales of electricity. Market entrants could not engage in long-term contracts for the sale of electricity.

As such, no ability to fix long-term prices of the commodity exposed the utilities to high price spikes for power costs over the last year. Last winter, California power markets were roiled by an unseasonably early cold snap and a continued robust gas market. Without long-term contracting authority, utilities were forced to purchase their immediate power needs on the spot markets at high rates.

The Texas system permits long-term contracts that tend to stabilize the market by fixing the price for buyers. Additionally, long-term contracts also benefit buyers and ultimately consumers by allowing buyers to take advantage of fuel diversity. The Texas market does not prevent power companies from responding to the economic incentives to avoid the spot market, which is widely viewed to yield power at more expensive and volatile prices.

The Texas plan for opening power markets to full competition is not a free ride for power companies or consumers, however. Texas' open competition will not hold down costs to consumers below that which the power costs to produce, and certainly as the cost of running the power plants increases, so too will consumers' power bills. However, unlike California, the excess capacity should lead to decreased costs and any increased costs should also translate into increased reliability for electrical power suppliers.

INADEQUATE HEADROOM FOR COMPETITION

Given the nature of the California market – with spiraling wholesale power costs and inelastic tariffed retail rates – there has been no margin, commonly referred to as “headroom,” within which retail providers could enter the market and successfully compete.

As a result, many retail marketers did not engage in competition in California. Many that did compete withdrew shortly thereafter, leaving the existing utilities to offer retail service at rates that were lower than the rates they paid for wholesale power.

Over the past year, Southern California Edison and Pacific Gas & Electric lost over \$12 Billion selling power in the retail market at prices below cost. PG&E finally filed bankruptcy on April 6, 2001 and Southern California Edison continues to seek a political/business solution other than bankruptcy. Past experience has shown that a bankruptcy case of an investor-owned utility is inevitable lengthy, expensive, involves complex jurisdictional, standing and federal preemption issues. Most importantly, bankruptcy may not provide a comprehensive solution to a utility's problems – absent a political compromise – since any Chapter 11 plan of reorganization must be contingent upon appropriate regulatory agencies, such as the California Public Utility Commission, approving any rate changes proposed by the utility in a Chapter 11 plan. 11 U.S.C. Sec. 1129(a)(6).

In Texas, there should be adequate margin for retail market participants to enter and compete in the market. Already many new market participants have invested substantial sums in preparation for what is expected to be robust retail competition.