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ATTORNEY GENERAL'S ENERGY WHITE PAPER



A LAW ENFORCEMENT PERSPECTIVE
ON THE CALIFORNIA ENERGY CRISIS

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State of California
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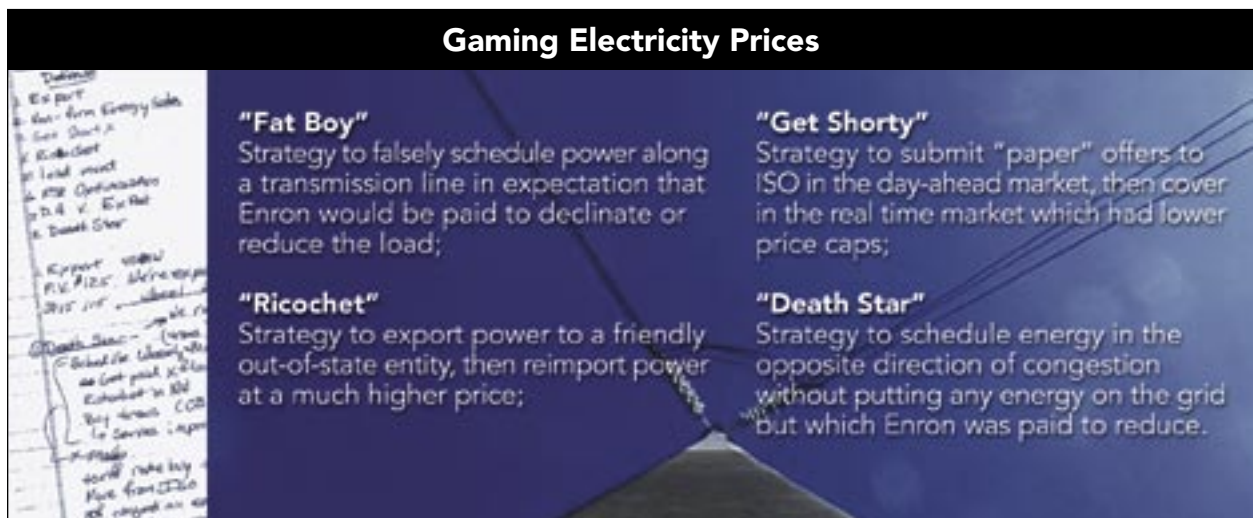


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exports from California between May and October 2000 were approximately 200 percent higher than in the same months in 1998 and 1999.²³

Although the withholding of power through reduced production and redirection of California production out of state explain a significant part of the crisis,²⁴ a series of so-called “games” were also run against California. These games came to light when Enron, responding to subpoenas issued by the California Attorney General, made available internal reports on its strategies for manipulating the California markets. The games had catchy monikers such as “Fat Boy” and “Get Shorty,” but a single purpose — to take money from California’s energy market and other western state energy purchasers.



Many of these trading strategies are highly complex, making detection, proof, and enforcement extremely difficult.

By the end of calendar year 2000, California consumers and industry had paid \$27 billion for energy, over three and one-half times the \$7.4 billion they paid in 1999.

4. Natural Gas Prices Explode

Starting in the late fall of 2000, natural gas prices began to increase dramatically on the major pipeline serving southern California. By winter 2000 – 2001, prices were *four times* what they were the year before.²⁵ These price hikes were immediately felt in increased prices for electricity generated by gas-fired boilers. However, as dramatic as these natural gas price increases were, they explain only part of the dramatic run-up in electricity prices.

²³ U.S. GENERAL ACCOUNTING OFFICE, PUB. NO. GAO-02-828, RESTRUCTURED ELECTRICITY MARKETS: CALIFORNIA MARKET DESIGN ENABLED EXERCISE OF MARKET POWER 32 (2002).

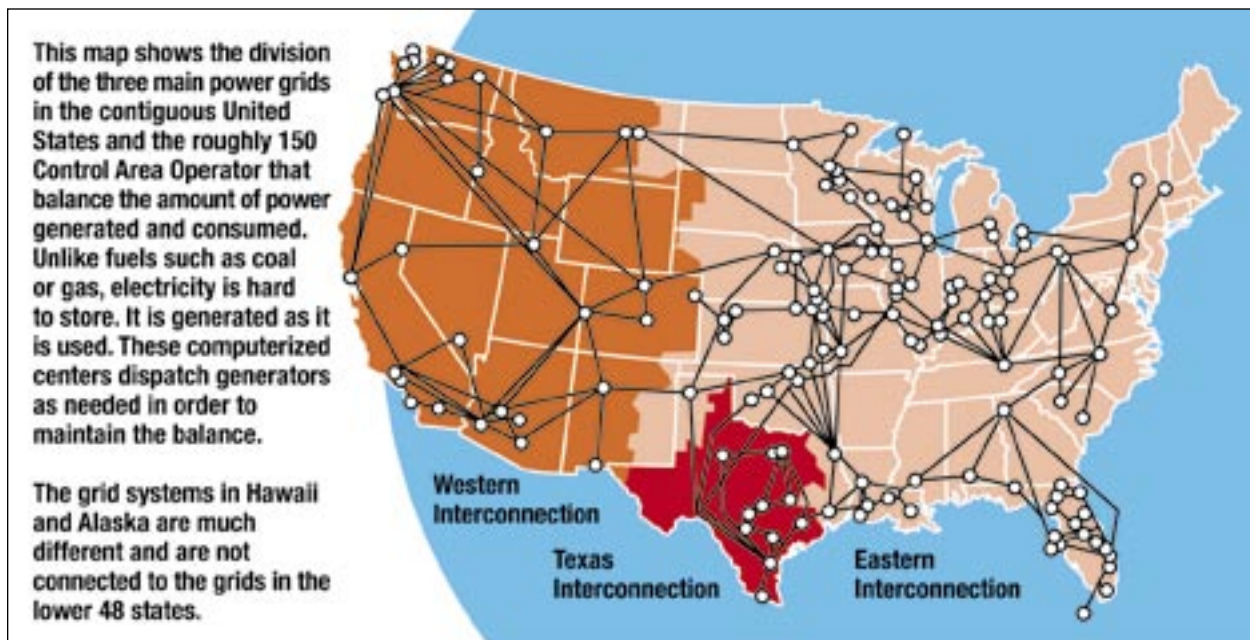
²⁴ James Bushnell, *Market Power and Market Manipulation: Definitions, Measurement and Mitigation*, University of California Energy Institute, 2002 CSEM Policy Conference, Slide 4.

²⁵ *Public Utilities Commission of California v. El Paso Natural Gas, et al.*, 100 FERC ¶ 63,041 (2002). See http://ferris.ferc.gov/idmws/File_list.asp?document_id=4033592.

failure to file actual rates, which effectively prevented FERC from exercising any real market oversight. Civil actions on behalf of large industrial users of energy, and class actions on behalf of consumers, have been filed against all of the major generators and traders involved in the crisis. These suits challenge sales of both natural gas and electricity. A key defense in these actions is the filed rate doctrine, which the generators invoke as a shield against any financial liability beyond that approved by FERC, even when the challenge is based on allegations of fraud or price-fixing. Federal criminal actions are also pending. Most notably, Timothy Belden, Enron's chief trader for the California market, has pled guilty to federal criminal charges. As part of his plea bargain, he is cooperating with prosecutors in their ongoing investigations. Administrative, civil and criminal litigation arising from the California energy crisis is expected to continue for years.



B. Overview of Government Entities with Responsibility for Market Oversight and Enforcement



Sources: Distributed Energy Resources, NERC, Energy Information Administration, Office of Coal, Nuclear, Electric and Alternative Fuels. Based on data contained in EIA-861, "Annual Electric Utility Report."

Oversight of electricity markets and enforcement of the tariffs, regulations, and laws that govern the markets and the marketers are surprisingly limited. This section of the report briefly describes the major regulatory entities responsible for oversight of the electricity markets. The following sections then detail deficiencies in the mechanisms for monitoring and enforcement, discuss the implications of those deficiencies, and make recommendations for improvement. Included after the section on FERC is an in-depth discussion of the filed rate doctrine, and the unjust results from its misapplication to market-based wholesale electricity markets. In each and every aspect of the current system, FERC occupies the central position for market structure, operation, governance, and enforcement, with significant authority delegated to the ISO for more immediate market control.



1. FERC

FERC has broad jurisdiction with respect to wholesale electricity and natural gas, including authority over transmission, price, and market regulation issues. It has statutory authority under the NGA and the FPA to promulgate regulations, and it can enforce both the regulations and the statutes to ensure compliance. FERC has an investigatory staff and an enforcement branch. Perhaps owing to philosophy, inadequate resources, lack of data or a combination of these factors, FERC insufficiently monitored California's energy markets. It has since limited its investigation of anomalies and market manipulation, failed to take meaningful and timely enforcement action, and failed to order full refunds even after determining that prices during the crisis were unjust and unreasonable. Congress should act to ensure, in a market-based rate system, that unjust and unreasonable rates are subject to refund, whenever they occur. FERC should define and implement an effective oversight approach, to ensure adequate monitoring and timely enforcement of the laws governing the wholesale electricity and natural gas markets.



2. ISO



The ISO is primarily responsible for running the electric grid that serves California, making sure power is available to keep the grid operating and prevent interruptions in service. To do this, the ISO runs numerous short-term wholesale electricity markets. The ISO has the authority, delegated from FERC and under California law, to ensure compliance with market rules and tariffs. Initially, the ISO was governed by a board made up of “stakeholder” interests, such as power generators and traders, as well as large and small energy users. That Board has been replaced with appointees of the Governor. The ISO has a small enforcement unit. Although the ISO's market monitoring unit provided key insights, still largely ignored by FERC, into the uses and abuses of market power

during this crisis, the agency needs significantly increased resources for monitoring and enforcement, and a clear mechanism for enforcement and compliance, as discussed below.

“ The consequences of FERC’s application of the filed rate doctrine to market-based rates are profound and disturbing. ”

As a result, sellers of wholesale electricity are no longer required to file their proposed prices or any cost support for their proposed prices. Instead, sellers are required to file a generic “market-based tariff,” which states only that rates will be determined “by agreement” between the parties to the transaction. In order to obtain tariff approval (known as “market-based rate authority”), sellers are required to demonstrate that they lack market power in the relevant market, or that they have taken steps to mitigate any market power they may have.

Sellers with market-based rate authority are also required to file quarterly, after-the-fact reports listing transaction-specific information (i.e., the actual prices they charged in the market) about all of their sales and purchases during the prior three-month period. These reports, however, are submitted for “informational purposes” only. FERC uses them, in theory, to monitor the seller’s ability to exercise market power and to determine whether the seller’s rates are just and reasonable. If FERC perceives a problem based on the information contained in quarterly reports (or for any other reason), the seller’s rates can be adjusted, but *prospectively only*. FERC takes the position that the market-based tariff, not the quarterly report, is the “filed rate” for purposes of determining whether the filed rate doctrine applies. FERC’s acceptance for filing of the market-based tariff amounts to blanket authorization of *any* price charged pursuant to the market-based tariff. The Attorney General believes that FERC’s formulation of the market-based tariff as a “filed rate” is fatally flawed, and is currently seeking judicial review.⁷⁶



3. FERC’s Misapplication of the Filed Rate Doctrine to Market-Based Rates

The consequences of FERC’s application of the filed rate doctrine to market-based rates are profound and disturbing. Under FERC’s construction, no specific market can be challenged because the seller’s “rate” has been filed, thereby immunizing all past sales.

FERC has used just this formulation to bar refunds, likely in the billions of dollars, for California consumers for much of the crisis period. FERC determined that California purchasers of wholesale electricity are entitled to refunds for unjust and unreasonable prices only for the time period after October 2, 2000, even though FERC determined that purchasers were charged unjust and unreasonable prices between May 1, 2000 and October 1, 2000. In FERC’s view, because San Diego Gas & Electric filed the first California rate challenge on August 3, 2000, no refunds can be granted until sixty days after the filing date.

⁷⁶ *State of California ex rel. Lockyer v. FERC*, Ninth Circuit Court of Appeals No. 02-73093.

Draining Assets from Public Utility



PG&E Company

- 1997** \$5 Billion
- 1998** \$3.8 Billion
- 1999** \$3.4 Billion
- 2000** \$1.8 Billion
- 2001** Files for Chapter 11 Bankruptcy Protection
- 2003** Asks ratepayer hikes totaling over \$6 Billion



1997
\$699 Million
 (Taxes: \$40 Million)



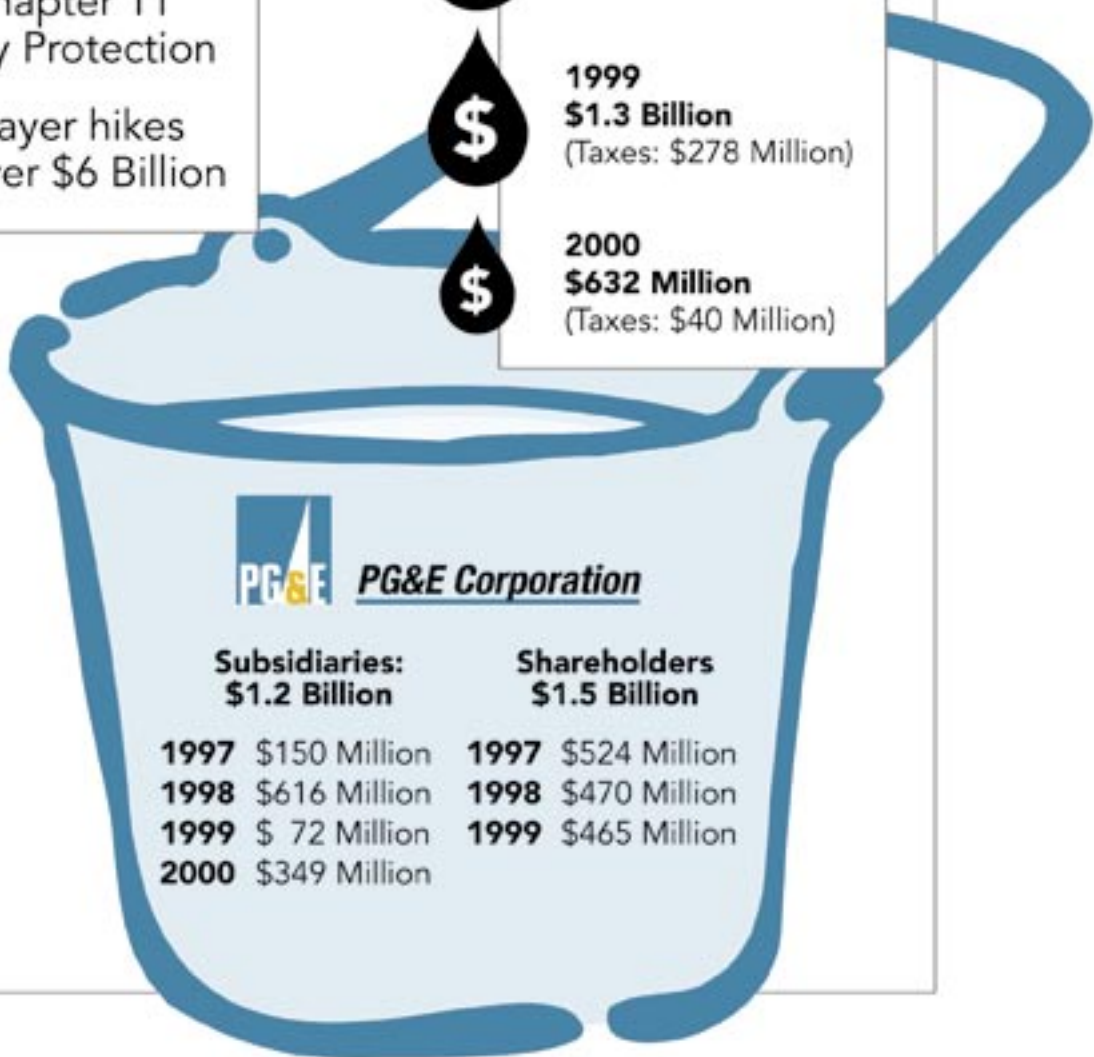
1998
\$2 Billion
 (Taxes: \$345 Million)



1999
\$1.3 Billion
 (Taxes: \$278 Million)



2000
\$632 Million
 (Taxes: \$40 Million)



PG&E Corporation

Subsidiaries:
\$1.2 Billion

Shareholders
\$1.5 Billion

1997 \$150 Million
1998 \$616 Million
1999 \$ 72 Million
2000 \$349 Million

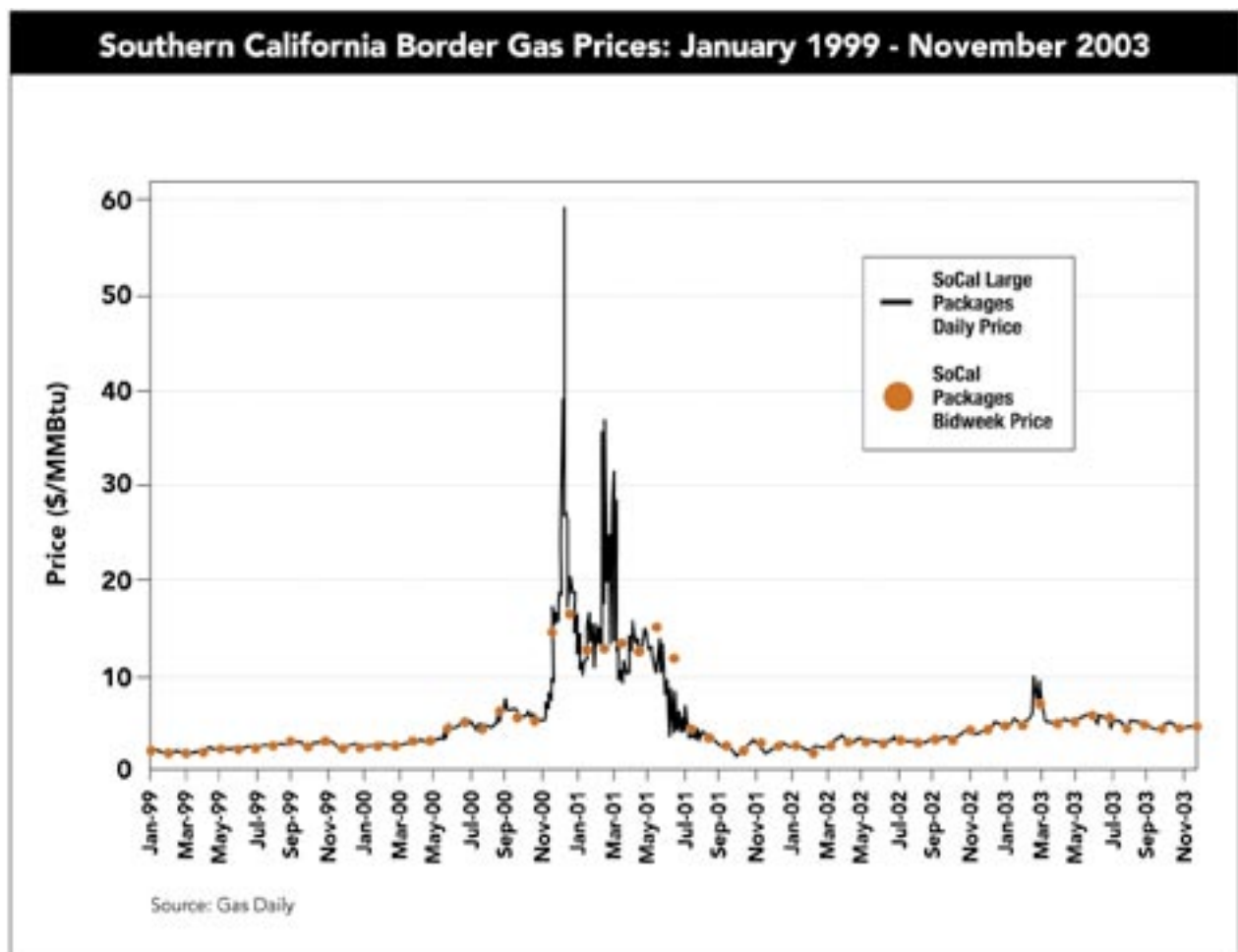
1997 \$524 Million
1998 \$470 Million
1999 \$465 Million



J. Forcing the State into Federal Court and the Issue of Sovereign Immunity

Under the Eleventh Amendment to the U.S. Constitution, states — and their taxpayers — enjoy sovereign immunity and typically cannot be sued in federal court. This immunity can be waived, however, if a state chooses to participate in federal court proceedings. If state agencies wish to make claims against a bankrupt debtor's estate, the agencies must file proof of claims with the federal bankruptcy court. The question faced by state agencies with claims against PG&E was whether filing a proof of claim would be deemed a waiver of the state's sovereign immunity, exposing the agencies to lawsuits in federal court.

States should not have to face this quandary. Bankruptcy law should be clarified or amended to ensure that a state or local government can file a proof of claim without waiving sovereign immunity or subjecting its taxpayers to liability in federal court.



Interstate Pipeline and Supply Basins Serving California



winters. Unable to get sufficient gas from storage, and with capacity along the pipeline constrained, generators paid premium prices for gas increasing the prices consumers paid for electricity.



1. A Brief Description of the Natural Gas Industry and Legal Actions Against El Paso

The regulatory framework for the natural gas market is best understood with reference to three separate functions: (1) The production and gathering of natural gas in the field — the step at which the “wellhead price” is generally set; (2) the transmission of the gas by pipeline from the wellhead to local distribution companies or large end users; and (3) local distribution of gas to consumers.

The first of these functions, establishment of the wellhead price, was completely deregulated by the federal Natural Gas Wellhead Decontrol Act of 1989. The second function, transportation, is regulated by FERC and the reasonableness of the rates for interstate transportation falls within FERC’s exclusive jurisdiction. The final function, local distribution, is not regulated by FERC, but by the PUC or public power agencies.

El Paso Settlement Consideration

I. Up-Front Consideration

A. Cash – upon execution of the Escrow Agreement	\$78,590,070
B. Cash – upon effective date of MSA	\$2,000,000
C. Cash – 180 days after execution of MSA	\$243,229,464

Total Up-Front Cash **\$323,819,534**

D. Stock – El Paso Corp.: 26,371,308 shares*	\$227,584,388
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Total Up-Front Consideration **\$551,403,922**

II. Deferred Consideration

40 semiannual payments of \$21,890,652 beginning July 1, 2004	\$875,626,072
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III. Contract Reduction

Reduction in price of CDWR electricity purchases from EPME	\$125,000,000
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TOTAL CONSIDERATION **\$1,552,029,994**

* Stock value based on June 13, 2003 closing price of \$8.63

During the energy crisis, the ISO initially, and later FERC, imposed limits on what electricity generators could charge for wholesale electricity. FERC's soft cap, however, allowed suppliers to charge higher prices if the costs they incurred to generate electricity exceeded the price cap. Where the costs of generating electricity included the price of natural gas, FERC used a market-based rate formula for determining the cost of that natural gas rather than actual costs. This rate formula relied on published natural gas spot prices in California or at the California border. Energy firms with gas-powered generating facilities in California or on the California border had an incentive to increase the published price of natural gas over the actual price they paid.¹¹⁹

¹¹⁹ This is not to suggest that all firms engaged in such manipulation. It is clear, however, that several firms did engage in manipulation and that all such firms had financial incentive to do so.

complaint and our request for rehearing of the order denying the complaint in part. We have appealed FERC's order to the Ninth Circuit (State ex rel. Lockyer v. FERC).



IV. ADMINISTRATIVE HEARINGS AND ARBITRATIONS

Allegheny Energy Supply Co. v. Department of Water Resources On 2-21-03, Allegheny Energy Supply Company filed a formal administrative claim against the State of CA, DWR, the CPUC and the EOB, alleging that DWR conspired with the CPUC and EOB in a “bad faith campaign” to force Allegheny to re-negotiate its \$4.4 billion long-term energy supply contract with DWR. The matters have settled.

