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California constrains competition again

By Steven F. Greenwald and Jeffrey P. Gray

Given a chance to make a positive change in California's wholesale generation market, the California Public Utilities Commission (CPUC) in December opted instead to maintain the state's existing "hybrid" market model. That decision will further restrict meaningful opportunities for independent power producers (IPPs) and increase the likelihood that future generation will consist of utility ratebase projects.

The CPUC presented its decision as an interim measure that supports development of a competitive market that will stimulate private investment in new generation without the need for long-term power-purchase agreements. However, promoting new utility ratebase generation is the antithesis of a "merchant model" and, notwithstanding the CPUC's reasoning, will likely inhibit the emergence of a competitive market.

Still ignoring the problems

As previously discussed in this column, institutional advantages favor utility generation over IPP resources and make the benefits that hybrid markets supposedly offer, at best, illusory (*POWER*, March 2006). An administrative law judge's proposed decision recognized this inherent flaw in the California hybrid model and, if adopted, would have prohibited utility-owned projects from participating in utility resource solicitations. But the CPUC commissioners dismissed this recommendation in favor of protective measures. In particular, a (currently undefined) "code of conduct" prevents the sharing of information between utility personnel responsible for developing utility bids and utility personnel responsible for selecting winning bids.

Restrictions on the sharing of information presuppose that utilities actually develop and construct "utility generation" and do not address fundamental problems of a hybrid market. Recent utility-owned generation projects in California have consisted of facilities added to the utility's ratebase that were developed and bid into resource solicitations by third parties—circumstances the "code of conduct" would not affect. However, the financial incentive for a utility to select a "turnkey" project over a competing IPP power-purchase agreement in a resource solicitation is the same as for projects developed by the utility: an incremental addition to the utility's ratebase and the attendant ability for shareholders to earn a cost-plus "return" for 30 years or more.

The absence of a rational and transparent methodology for comparing utility-owned generation and IPP power-purchase agreements on an apples-to-apples basis means that the hybrid model provides a utility with ample opportunity to favor projects promising ratebase recovery, irrespective of the cost consequences to customers.

If that weren't enough . . .

The CPUC identified five "unique circumstances" in which it will authorize development of utility-owned generation outside of any competitive process. Inviting utilities to acquire new ratebase generation assets that are not subject to competitive

scrutiny simply denies electric consumers the benefits of competition. The unique circumstances include mitigating "market power," developing preferred/renewable resources, expanding existing utility facilities, acquiring "unique" opportunities, and meeting reliability needs. The reasons for allowing utility generation under these circumstances, however, are unconvincing and seem aimed at solving problems that do not exist.

For instance, the CPUC suggests that markets may be inadequate to ensure that utilities procure sufficient preferred/renewable resources. Currently, the primary impediments to the successful development of preferred/renewable resources include such "nonmarket" factors as permitting challenges and the lack of adequate transmission—each of which affects utility and IPP projects equally. Given the utilities' near-monopsony power and their discretion to specify the resources they procure, the development of additional utility generation should be expected—without the opportunity for IPPs to compete in any meaningful manner.

A self-fulfilling prophecy

The perception of an unlevel playing field in the procurement process is sufficient, by itself, to dampen participation from IPPs and their investors. IPPs will become increasingly reluctant to invest in the development of new generation in California and will migrate to other markets, where the regulatory environment better ensures that projects can compete fairly and be judged on their merits.

To the extent that fewer IPPs participate in California's hybrid market, the state's ability to meet reliability requirements and environmental mandates through utility resource solicitations will suffer, creating (in the CPUC's view) "unique circumstances" that the utilities can use to justify bypassing any competitive process and increasing their own generation. Thus, California utilities will be perversely rewarded for failing to conduct successful resource solicitations, and competitive procurement will be further inhibited.

Two steps backward

A truly competitive wholesale market encourages private investment in new generation, promotes innovation, lowers prices, and best ensures the timely availability of resources needed to meet reliability requirements and achieve environmental goals. The CPUC has missed an opportunity to advance meaningful competition and instead chose to perpetuate an inherently flawed hybrid model. That model further erodes competition by, in effect, encouraging the acquisition of utility ratebase generation outside of even the minimally competitive process offered by the existing hybrid model.

The actions of the CPUC undermine effective competition in the near term and threaten to set back efforts to develop a competitive wholesale energy market over the long term. ■

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