

Regulation's Rationale: Learning from the California Energy Crisis

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Further deregulation of energy markets has been challenged by the California energy crisis of 2000-2001 and the collapse of Enron. Many observers have argued that these events are unrelated, and, therefore, deregulation itself should not be questioned. Each disaster is just a symptom, however, of something more fundamental and structural: the failure of modern American political discourse to appreciate regulation's rationale. In particular, both the California energy crisis and Enron's collapse were caused by legislative and administrative failures to design regulatory institutions that adequately constrained opportunistic behavior. This Article challenges the conventional wisdom about what happened in California and therefore challenges the conventional wisdom about what should be done to avoid similar problems. This inquiry has relevance both for other states considering deregulation (or its euphemistic cousin, "restructuring"), as well as how the federal government approaches its role in a partially-deregulated electricity market. The dominant story of what happened in California is riddled with both factual and conceptual errors, and those errors engendered a series of policy responses that exacerbated, rather than alleviated, the underlying causes of the crisis. Political discourse on the Bush Administration's National Energy Plan suffers from similar problems. Our nation, therefore, runs a serious risk of repeating the conditions that gave rise to the California energy crisis, rather than learning from them.

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Introduction

The collapse of Enron Corporation,¹ the criminal indictment of its auditor Arthur Andersen,² the bankruptcy of Pacific Gas and Electric

¹ Enron Corporation filed for Chapter 11 bankruptcy protection on December 2, 2001. The Justice Department formed a task force to investigate the company in early January 2002. Kurt Eichenwald & Jonathan D. Glater, *Justice Dept. to Form Task Force To Investigate Collapse of Enron*, N.Y. TIMES, Jan. 10, 2002, at A1. Washington was also abuzz with concern about the close ties between Chairman Ken Lay and President George W. Bush. See Robert Scheer, *Connect the Enron Dots to Bush*, L.A. TIMES, Dec. 11, 2001, at B13. For a detailed account of Enron's rise and fall, see Kurt Eichenwald, *Audacious Climb to Success Ended in a Dizzying Plunge*, N.Y. TIMES, Jan. 13, 2002, at A1; see also Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 24, 2001, at 58. Although I had no personal stake in Enron, the University of California lost \$144 million in Enron's collapse, California teachers lost another \$49 million, and the California public employees pension fund lost \$40 million. See Leslie Wayne, *Enron's Many Strands: Fallout*, N.Y. TIMES, Jan. 27, 2002, at A32.

² The Department of Justice issued a criminal indictment for obstruction of justice against Arthur Andersen of Chicago for destroying documents related to the Enron investigation on March 14, 2002. Kurt Eichenwald, *Andersen Charged with Obstruction in Enron Inquiry*, N.Y. TIMES, Mar. 15, 2002, at A1. Andersen previously settled shareholder lawsuits and/or regulatory actions against its auditing practices regarding the books of Sunbeam and Waste Management, both of which also went bankrupt. See Kurt Eichenwald & Floyd Norris, *Enron's Auditor Says It Destroyed Documents*, N.Y. TIMES, Jan. 11, 2002, at C1.

Company,³ and the rolling blackouts and price spikes of the California energy crisis of 2000-2001 all have one thing in common: They were caused by legislative and administrative failures to design regulatory institutions that adequately constrained opportunistic behavior. Each of these specific events has more proximate causes as well, of course, and many analyses will probably point to specific circumstances that suggest each is an aberration. There is great temptation to blame the Enron collapse on unethical, and perhaps illegal, behavior,⁴ for example, while the dominant narrative of the California crisis places blame on California legislators and regulators for poorly implementing electricity deregulation. For some, the collapse of Enron illustrates the power of market forces to make intelligent judgments swiftly and without political consideration,⁵ and the California crisis would have been averted if politicians had been willing to rely more on the market than politics. Such a perspective leaves the basic thrust of the deregulation project intact. Why throw the baby of deregulation out with the dirty bathwater of Enron's greed and California's incompetence? This view is quite dangerous, however, if we are going to learn useful lessons from these events. Each crisis is, in fact, a symptom of a more fundamental and structural problem: the failure of modern American political discourse to appreciate regulation's rationale.⁶

This Article will explore these issues more deeply with respect to the California energy crisis. In particular, I will correct several common misperceptions about what happened in California and, therefore, challenge the conventional wisdom about what should be done to avoid similar problems in the future. This inquiry has relevance both for other states considering deregulation (or its euphemistic cousin, "restructuring"), as well as for how the federal government approaches its role in a partially deregulated electricity market. Both Congress and the Federal Energy

3 Pacific Gas and Electric Company of San Francisco filed for Chapter 11 bankruptcy protection on April 6, 2002. The relationship between its bankruptcy filing and the California energy crisis is discussed in detail later in this Article. See *infra* Section III.C.

4 By August 2001, even some of Enron's senior managers were concerned about these practices. Sherron Watkins, a former Andersen auditor who served as Enron's vice president for corporate development, sent a detailed memo to Kenneth Lay in August 2001 raising serious questions about the accounting treatment of "off balance sheet" entities. Her frankness and integrity stand out as exemplary in the Enron debacle. Jim Yardley, *Author of Letter to Enron Chief is Called Tough*, N.Y. TIMES, Jan. 16, 2002, at A1 (the full text of her letter was reproduced at C6).

5 Following Enron's collapse, Treasury Secretary Paul O'Neill said, "Companies come and go. It's part of the genius of capitalism." White House economic advisor Lawrence B. Lindsey described the event as a "tribute to American capitalism." Paul Krugman, *A System Corrupted*, N.Y. TIMES, Jan. 18, 2002, at A25. Neoclassical economic theory is not based on cronyism and corruption, however, which both appear to have been features of Enron's culture.

6 For commentaries on the Enron crisis as just a symptom of our culture, see, for example, John Balzar, *Enron: A Scandal So Good That It Hurts*, L.A. TIMES, Jan. 18, 2002, at B17; and Marjorie Kelly, *Waving Goodbye to the Invisible Hand: How the Enron Mess Grew and Grew*, S.F. CHRON., Feb. 24, 2002, at D1, available at <http://sfgate.com/cgi-bin/article.cgi?file=/chronicle/archive/2002/02/24/IN83497.DTL> (last visited Apr. 22, 2002).

Regulatory Commission ("FERC") would do well to examine the California case more carefully.⁷ The dominant story of what happened in California is riddled with both factual and conceptual errors, and those errors propagated a series of policy responses that exacerbated, rather than alleviated, the underlying causes of the crisis.⁸ Many of the same errors appear to permeate the Bush Administration's recently developed National Energy Plan. Learning from the California experience, therefore, has national relevance.

What are the implications of the Enron scandal to this inquiry? Enron was both a leader and prime beneficiary of electricity market deregulation throughout the nation, and it played a central role in the California crisis.⁹ In particular, the pervasiveness of Enron's relationships with policymakers illustrates how corporate interests are interwoven with legislative and administrative decision-makers to the point that they are often unable to consider the broader public interest when formulating and implementing policy.¹⁰ Just as Enron's collapse has precipitated Congressional action on

7 The scope of FERC's authority to regulate electricity markets was recently addressed by the U.S. Supreme Court in *New York v. FERC*, 122 S.Ct. 1012 (2002).

8 The power of rhetoric or narrative to frame both the "problem" and policy responses cannot be overstated. For an illustrative example in the context of electricity planning and regulation, see JAMES A. THROGMORTON, *PLANNING AS PERSUASIVE STORYTELLING: THE RHETORICAL CONSTRUCTION OF CHICAGO'S ELECTRIC FUTURE* (1996). I recognize that I am engaged in a similar exercise by reframing the narrative through this Article. I also recognize that my interpretation will be contested. Arthur O'Donnell, *Bottom Lines: Revisionist History 101*, in *CAL. ENERGY MARKETS* No. 659 (Mar. 8, 2002), <http://www.newsdata.com/cem/blines.html> (last visited Apr. 22, 2002).

9 Richard A. Oppel, Jr. and Jeff Gerth, *Enron Forced Up California Prices, Documents Show*, *N.Y. TIMES*, May 7, 2002, at A1. Internal Enron memoranda describe a number of market manipulation strategies, but these documents were unavailable for any detailed analysis at this Article went to press. Enron has resisted subpoenas for such documents issued by California investigators. *Cf. supra* note 210.

10 Senator Ernest Hollings has said "[I]n my 35 years in the Senate, I have never witnessed a corporation so extraordinarily committed to buying government. In the last decade, Enron gave campaign contributions to 186 House members and 71 senators, including \$3,500 to me." Ernest F. Hollings, Editorial, *Time for a Special Counsel*, *N.Y. TIMES*, Feb. 9, 2002, at A27. Enron, its employees, and its political action committee made "soft money" donations equaling an astounding \$1.143 million to Republicans and \$532,065 to Democrats in 1999 and in 2000 alone. *Dollars and Cents: Enron's Political Giving*, *N.Y. TIMES*, Jan. 12, 2002, at B4 (table). Enron also gave generously to some key Democratic politicians, but the Bush Administration is filled with officials who have ties to Enron. Attorney General John Ashcroft and his key deputy had to recuse themselves from the Justice Department investigation, while the leading fundraiser for the Republican Party is a former Enron lobbyist. Richard L. Berke, *G.O.P. Weighs Chief's Stance on Enron Tie*, *N.Y. TIMES*, Jan. 18, 2002, at A16. Secretary of the Army Thomas E. White is a former senior Enron manager who sold his Enron shares for \$10 million. Alex Berenson, *Army Official Kept Options on Enron Stock Until January*, *N.Y. TIMES*, Mar. 7, 2002, at C1. Texas Senator Phil Gramm's wife, Wendy, joined the Enron board shortly after weakening regulatory oversight of the company while as a member of the Commodity Futures Exchange Commission. She subsequently served on the Enron board's audit committee and earned between \$915,000 and \$1.85 million from Enron from 1993 to 2001. Bob Herbert, *Enron and the Gramms*, *N.Y. TIMES*, Jan. 17, 2002, at A29; Alison Mitchell, *Enron's Ties to a Leader of House Republicans Went Beyond Contributions to His Campaign*, *N.Y. TIMES*, Jan. 16, 2002, at C1; Richard A. Oppel, Jr. & Don Van Natta, Jr., *Bush and Democrats Disputing Ties to Enron*, *N.Y. TIMES*, Jan. 12, 2002, at C1. Conservative political strategist Ralph Reed was also given

campaign finance reform, the relationship between Enron and policymakers should give pause to those considering a further extension of electricity deregulation consistent with Enron's vision. Instead, it is time to step back and re-think some fundamental assumptions. Why did we abandon the previous regulated, cost-of-service system for providing electricity services? What are the benefits and risks of going forward with further deregulation or restructuring of the electricity industry? Is further deregulation inexorably destined? Most importantly, what is the proper role for regulation in relation to whatever form of electricity market and industry that we now have?

The answers to these questions require an inquiry into both the historical rationale for electricity industry regulation and the specific history of how California altered that system. I will demonstrate in this Article that an understanding of both the specific regulatory history of the industry and technically complex economic and engineering analysis is necessary for the development of successful policy and the design of enduring institutions that meet the broad purposes of promoting the public interest. We would do well, therefore, to incorporate similar analyses into our consideration of what to do next in all regulatory arenas

The Article proceeds as follows. In Part I, I describe the original rationale for electricity regulation in the United States and how the "utility consensus" that dominated the industry from the 1920s began to erode in the 1970s. I then show how California responded to the challenges of the 1970s in an unusual way, charting a path that emphasized improved end-use efficiency, robust development of alternative generation sources, and adoption of an integrated resource planning approach by the late-1980s. Part II shows how this approach was challenged by national deregulation efforts and industry restructuring in the 1990s. In particular, I describe the specific market and regulatory structure adopted by California in response to those pressures and how that structure laid the foundation for the crisis of 2000-2001. Part III then examines the proximate causes of the crisis and the inadequacy of policy responses by both state and federal regulators. Part IV explores alternative policy options and discusses the ramifications of the adopted responses for the future of California. The Conclusion then presents specific lessons for regulating electricity markets from my analysis of the California crisis. It also suggests that there are more general

an Enron contract for \$10,000 to \$20,000 per month during the Bush campaign for President, apparently to ensure his support for Bush. Richard L. Berke, *Associates of Bush Aide Say He Helped Strategist Win an Enron Contract*, N.Y. TIMES, Jan. 25, 2002, at C1. Enron also paid a wide range of influential figures \$50,000 per year to serve on its advisory board—including President Bush's senior economic advisor, Lawrence B. Lindsey. David E. Sanger & Don Van Natta, Jr., *White House Says Economics Adviser Saw Little Risk on Enron*, N.Y. TIMES, Jan. 17, 2002, at C1. New York Times columnist Paul Krugman also served on the advisory group. Paul Krugman, *Enron Goes Overboard*, N.Y. TIMES, Aug. 17, 2001, at A19.

lessons regarding regulation's rationale in a wide variety of contexts. These lessons have potentially profound implications for our entire society.

I. Evolutionary Regulation: When the State Still Played a Central Role

A. *The "Utility Consensus": 1920s-1970s*

The history of modern electricity regulation begins a century ago with the development of what Richard F. Hirsh calls the "utility consensus" in the United States to regulate investor-owned electric utilities as "natural monopolies."¹¹ Michael D. Reagan describes the natural monopoly argument for regulation, which he himself challenges as the primary motivation for regulation, in this way:

The meaning is that the competitive running of wires and pipes above or below the ground in duplicate, triplicate, or more would be so obviously inefficient and costly a use of resources that we "naturally" permit monopolistic supply of such goods with decreasing average costs. However, price gouging of the consumer will not be prevented by the classic workings of the competitive elements, and too little electricity will be produced and consumed, so regulation substitutes for the missing competition.¹²

The theory of natural monopoly has been the subject of extensive study by economists,¹³ and it is a standard part of any college-level introductory economics course. Economic theory alone is insufficient to explain the development of the "utility consensus," however, and the institutional literature is dominated by two general explanations for regulation: (1) that "the rise of regulatory programs could be explained as a response to political demands from victimized groups for protection,"¹⁴ or (2) that "regulation is acquired by the industry and is designed and operated for its benefit."¹⁵ These two rationales converged in the case of electricity. The regulatory approach adopted in the U.S. granted individual companies

11 RICHARD F. HIRSH, *POWER LOSS: THE ORIGINS OF DEREGULATION AND RESTRUCTURING IN THE AMERICAN ELECTRIC UTILITY SYSTEM* 11 (1999).

12 MICHAEL D. REAGAN, *REGULATION: THE POLITICS OF POLICY* 36-37 (1987).

13 See, e.g., WILLIAM W. SHARKEY, *THE THEORY OF NATURAL MONOPOLY* (1982). Some empirical studies of this assumption, however, have found lower costs in some areas with direct competition. See WALTER J. PRIMEAUX, JR., *DIRECT ELECTRIC UTILITY COMPETITION: THE NATURAL MONOPOLY MYTH* (1986).

14 REAGAN, *supra* note 12, at 28.

15 George J. Stigler, *The Theory of Economic Regulation*, 2 *BELL J. ECON. & MGMT.* 3, 3 (1971).

