

# CAN A CALIFORNIA ENERGY DEBACLE OCCUR IN ILLINOIS?

AN OUTLINE OF SOME DIFFERENCES  
AND SIMILARITIES BETWEEN  
CALIFORNIA AND ILLINOIS

*Richard L. Mathias  
Chairman  
Illinois Commerce Commission*



statutory obligation to sell power to the Illinois utility. In fact, the owners of the generation facilities have an obligation to their shareholders to maximize the profit on the power they market. None of this is unlawful or necessarily faulty public policy. However, this winter Illinois consumers of natural gas have learned what can occur when they are subject to market prices.

***Length of Transition Period***

The Illinois transition period runs until at least 2005 and perhaps longer when transition charges are considered. This is a longer transition period than California. However, this longer time period will not of itself result in a smoother transition to competition.<sup>5</sup> Illinois can learn from its own and other's errors, undertake corrective action where necessary, and in so doing avoid the California debacle and problems of Illinois' own making.

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<sup>5</sup>In fact, as noted in the Report of Chairman's Fall 2000 Roundtable discussions, several Roundtable participants believe the longer transition period actually inhibits competition and may mask current problems.

### ***Conservation Measures***

While much has been accomplished, more conservation and voluntary, compensated load curtailment activities need to be undertaken in Illinois to reduce or slow the rate of growth of electric demand. The Clean Energy Trust, the Commerce Commission as well as other state agencies should be able to play pivotal roles here.

### ***Competition Among Electric Suppliers***

Although the terms “competition” and “competitive” appear more than 70 times in the Illinois Customer Choice law, most observers agree that outside of the ComEd service territory there is very little competition in Illinois. Some observers even are unwilling to conclude that competition exists in the ComEd service territory.<sup>4</sup> If significant competition among suppliers does not soon develop, Illinois consumers - and the electric utilities that have the obligation to serve - may have bleak supply alternatives available for they will be subject to the prices charged by the corporate owners of the generation facilities, and these corporations likely will have very substantial market power.

### ***Utilities/Customers at Price Risk***

Until December 2004, the risks of price fluctuations are born by the Illinois electric utilities. This risk is quite similar to the risk structure in California, although Illinois utilities do have the ability to enter into various risk management arrangements not available to California utilities. After 2004 Illinois electric customers are subject to the whim of the market and of the marketers. Although subsequent rate increases must be approved by the Commerce Commission, the Commission will have little direct authority over generating companies that are selling the electricity to the vestiges of electric utilities which in most instances will be merely distribution, i.e., wires companies. The affiliate or unrelated third party that owns the generating facility is under no

<sup>4</sup> Report of Chairman's Fall 2000 Roundtable Discussions: Richard Mathias, October, 2000 [www.icc.state.il.us/icc/inside/cc/ops/001031cmoetround.doc](http://www.icc.state.il.us/icc/inside/cc/ops/001031cmoetround.doc)

that peaker plants and intermediate and base load facilities provide power when Illinois citizens are most in need. These facilities also can significantly improve electric reliability and forestall the construction of additional transmission lines.

### ***Transmission Constraints***

As noted earlier, there are constraints on the transmission of electricity into, within and out of Illinois. Many argue adamantly that there are genuine wholesale power liquidity problems in Northern Illinois and other areas of the state. If there is to be effective wholesale and retail competition, these constraints must be corrected.

### ***Appropriate Regional Transportation Organization***

The structure, governance and ownership of the regional transmission organization which controls power imports and exports into, within and from Illinois must be resolved in the best interests of the public and not alone by considering only the economic self interests of the electric utilities and generation companies. Unfortunately, this issue is largely subject to the jurisdiction of the Federal Energy Regulatory Commission, which historically has been very timid in implementing corrective initiatives.

Generating supply and transmission constraints are somewhat analogous to the constraints of the airline industry. No one will order a new 747 airplane unless they are assured of good routes and landing slots located at desirable airports. Likewise, no company will commence the long process of acquiring the land and permits and designing and building a generating facility unless assured of being able to transmit electricity to specific, targeted locations. Whoever controls the desirable routes and landing slots - or the transmission lines - has a choke hold on competition. Regulators term this "market power".

### **Foreward**

This paper outlines some of the significant differences and similarities between the electric power environments which exist in California and Illinois. It closely parallels a memorandum I recently wrote to members of Governor Ryan's Illinois Energy Cabinet. This paper is one of several reports I have written during past months relating to the implementation of the Illinois Electric Service Customer Choice and Rate Relief Law of 1997. These reports are available on the Commerce Commission web site at [www.icc.state.il.us](http://www.icc.state.il.us).

This paper does not necessarily reflect the views of other Commissioners or of the staff of the Illinois Commerce Commission.

Richard L. Mathias  
Chairman  
Illinois Commerce Commission  
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requested. We reject the notion that companies must be paid to do the right thing - to reduce load on those days when electricity reserves become sparse.” (Emphasis added)

## **Part II. Electric Power Related Challenges Facing Illinois**

Many commentators appear to agree that the most significant flaws that led to the California debacle relate to the supply/demand imbalance, the limitations of the Power Exchange and inability of utilities to enter into various types of long term supply contracts and hedging agreements. These flaws currently do not exist in Illinois. Therefore, through vigilance and thoughtful initiatives, Illinois can avoid a California style electricity debacle. However, some fundamental issues still must be addressed.

### ***Supply/Demand Mismatch***

Supply and demand in Illinois must not become mismatched, but instead must remain roughly in balance. This applies to base supply as well as peak load. Adequate supply can be accomplished by having enough generating capacity available to Illinois consumers, by ensuring the ability to transmit electricity into, out of and within Illinois, and/or by energy conservation measures that reduce or slow the growth in demand.

### ***New Generation Facilities***

Adequate supply likely will require the construction of additional generating facilities. In order for this to occur there must be an accommodation of the very real fears of those who oppose the construction of peaker plants and other generation facilities as well as a recognition

There are constraints in some service territories in Illinois regarding the import and export of electricity as well as constraints on the import and export of power into Illinois. For instance, the Chicago metropolitan area appears to be a “load pocket” with limited import capability in summer months. In addition, the Midwest Independent System Operator (MISO), which was to determine how electricity is to be delivered in Illinois and surrounding states, is in disarray. Several Illinois electric utilities are attempting to withdraw from MISO and to join a different organization. This would bifurcate the governance of the transmission system in Illinois and likely lead to a dysfunctional system.

**Conservation Activities**

Reports indicate that California electric utilities have fewer megawatts of power than Illinois on interruptible power supply contracts in spite of the fact that California is a much larger state. Although the data available is incomplete, it appears that ComEd alone may have more interruptible and curtailable demand (roughly 1500 - 1900 megawatts) than utilities in the entire state of California.

A recent report<sup>3</sup> from the California Public Utilities Commission and Electricity Oversight Board to Governor Davis concluded that California electric utilities should not have to, in effect, pay customers not to take power in times of tight supply. It reflects a much different approach than that of Illinois. This California report states in part:

*“Many companies have volunteered to reduce their electric use when it is really necessary. We applaud their efforts and ask all Californians to join in conserving electricity usage for the next three months when*

**Table of Contents**

<b>Part I.</b>	Some Differences and Similarities:	
	California and Illinois	1
	Divestiture of Generating Facilities	1
	Power Exchange (PX), Long Term Contracts and Hedging Activities	2
	Capped Retail Rates/Uncapped Wholesale Electric Prices	3
	Supply Adequacy	4
	Fuel Mix	5
	Transmission Constraints	5
	Conservation Activities	6
<b>Part II.</b>	Electric Power Related Challenges Facing Illinois	7
	Supply/Demand Mismatch	7
	New Generation Facilities	7
	Transmission Constraints	8
	Appropriate Regional Transportation Organization	8
	Conservation Measures	9
	Competition Among Electric Suppliers	9
	Utilities/Customers at Price Risk	9
	Length of Transition Period	10

<sup>3</sup>California’s Electricity Options and Challenges: Report to Governor Gray Davis by Michael Kahn, Chairman, California Electricity Oversight Board and Loretta Lynch, President, California Public Utilities Commission, Summer 2000.

Most commentators agree that Illinois currently has adequate base load supply and peak load likely is adequate as well. However, there is concern for supply in future years. More on this Illinois situation below.

#### ***Fuel Mix***

California has been served by a mix of hydroelectric, nuclear, coal and gas fired generating facilities, some of which are located in neighboring states. It is more dependent on gas-fired facilities than is Illinois, has more limited gas storage capacity and has far fewer nuclear facilities. While hydroelectric facilities comprise a relatively small portion of the power supply, in times of short supply this hydropower is extremely important. In years past, low reservoir water levels have hampered California power production.

Illinois has virtually no hydro power, has many coal fired facilities, is well positioned with a supply of natural gas because several interstate gas pipelines traverse the state and, as of now, the eleven Illinois nuclear power plants appear to be operating efficiently. However, in years past Illinois nuclear facilities have performed poorly. Also, on occasion during extended summer hot spells warm water discharges into Illinois rivers from nuclear facility cooling lakes have been in excess of Illinois Environmental Protection Agency standards and have threatened the shut down of the related nuclear generating facilities.

#### ***Transmission Constraints***

States west of the Rocky Mountains are dependent upon each other for power supply because these states, in general, are not interconnected with states east of the mountains. There are transmission constraints among/within these western states and within California as well.

Customer Choice Law provides that approximately 80% - 85% of the residential customers of Illinois electric utilities receive roughly a 20% rate decrease. Residential customers of lower cost utilities receive lesser rate reductions. There is no cap on the price the Illinois electric utilities must pay to purchase the electricity that they supply to their customers.

In addition, the Illinois law provides some safety valves that the California restructuring law may not. For example, even while rates are capped, if an Illinois utility's return on equity falls below the benchmark levels in the Illinois Law, the utility may petition the Commerce Commission for rate relief.

### ***Supply Adequacy***

As has been well documented, California and the states which neighbor California experienced very significant economic growth during the past several years. As a result, base and peak electric load usage soared. Very few new generating facilities were built in California during past years and neighboring states no longer have excess supply which can be transmitted into California. As a result there now is a significant electric supply/demand imbalance in California both in base and peak load.

California must grapple with its upcoming summer supply problems, inasmuch as the summer, not winter, is the season of California's highest electric demand. Customarily the Pacific Northwest supplies California and the Southwest with power in summer months and the Southwest sells power into the Northwest in the winter months. This seasonal exchange system may well be collapsing due to several factors such as high natural gas prices, low water levels and a general shortage of capacity to meet demand. This winter the Northwest has been selling large amounts of power into California, as have the Southwestern states.

This memo first outlines several of the significant differences and as well as some of the similarities between the electric power environments which exist in California and Illinois. It concludes by noting that, with vigilance, a California style energy debacle need not occur in Illinois.

## **Part I. Some Differences and Similarities: California and Illinois**

### ***Divestiture of Generating Facilities***

The California electric restructuring law was enacted by the California legislature with no dissenting votes in 1996. It provided, among other matters, that any California electric public utility wanting to collect stranded costs was required to divest its non-nuclear and non-hydroelectric generating facilities to a non-affiliated entity. As a result, the three major investor owned electric utilities - Pacific Gas and Electric, Southern California Edison and San Diego Gas and Electric - now purchase most of the power they sell to their customers from unrelated third parties which own most of the generating facilities.

The Illinois Electric Service Customer Choice and Rate Relief Law of 1997 (Illinois Customer Choice Law) has no such divestiture requirement. The Illinois law allows the utilities to unlock the hidden value in their generating facilities by other means. Many Illinois electric utilities have simply transferred ownership of their generating facilities to affiliated companies. For example, Central Illinois Public Service transferred its generation facilities to an affiliate, Ameren Energy, and Illinois Power Company (I.P.) transferred its generation facilities to a generation subsidiary of I.P.'s Houston, Texas based parent, Dynegy Inc. These affiliates are free to sell electricity to their affiliated utilities and to unrelated

third parties at market rates. In addition, ComEd sold its coal and gas fired generating facilities to an unaffiliated entity, Mission Energy Mid West, which is an affiliate of Southern California Edison.<sup>1</sup> Also, Illinois Power Company “sold”<sup>2</sup> its Clinton nuclear generating facilities to Amergen, a joint venture of Exelon and British Energy unaffiliated with Illinois Power Company. Both ComEd and Illinois Power Company have power purchase agreements with their respective buyers, which gives each the right to purchase substantial portions of the power produced by their divested facilities for several years. In Illinois therefore, with the two exceptions noted above, in general, the same holding company owns the generating facilities, which were previously owned by the electric utility. The ownership may be through an unregulated affiliate or through the regulated utility. More on this Illinois situation below.

#### ***Power Exchange (PX), Long Term Contracts and Hedging activities***

The California restructuring legislation required all electric utilities to purchase the electricity they supply their customers through the California Power Exchange, a non-profit, state created agency, which is overseen by the Federal Energy Regulatory Commission (FERC). Though the PX is ostensibly a voluntary market, the majority of the transactions (approximately 80%) were conducted by or on behalf of the three major investor owned California electric utilities which were required by the California restructuring law to conduct all of their transactions through the PX until March 2002.

Not only must the utilities purchase electricity only through the PX, the electricity could only be purchased for the following day or for the day of use. Long term supply contacts and other hedging activities were prohibited. In addition, the rules governing how electricity was to be bought and sold on the Power Exchange created some financial incentives which, in hindsight, fre-

<sup>1</sup>According to various credit rating agencies, Edison International which indirectly owns Mission Mid-West has “ring fenced” Mission Mid West in order to protect it from any bankruptcy filings that might be made by any Mission Mid-West affiliate. The Illinois coal and gas fired facilities owned by Mission Mid-West provide 40% - 45% of ComEd’s current supply.

<sup>2</sup> It can be argued that Illinois Power paid Amergen to acquire the Clinton facility.

quently resulted in highly dysfunctional market clearing prices being charged by the PX.

Another factor that may have exacerbated daily price swings has been the role of the California Independent System Operator (Cal ISO) in buying daily and hourly power in order to fulfill its responsibility to assure the integrity of the California electric transmission system. Also, several commentators have been critical of the separation of the market making and transmission operating functions in two separate entities, i.e., the California Power Exchange and Cal ISO. According to published reports the California Power Exchange is being disbanded, and Cal ISO’s operations are under intense scrutiny.

Illinois has nothing similar to the Power Exchange. Illinois electric utilities and Alternative Retail Electric Suppliers of power in Illinois can and do enter into long term supply contracts and are allowed to engage in various hedging activities. It is widely believed that these contracts and hedging strategies can result in lower, less volatile electric supply prices. Currently in Illinois there is no operational independent system operator comparable to Cal ISO. More on this below.

#### ***Capped Retail Rates/Uncapped Wholesale Electric Prices***

The California restructuring legislation capped residential and small business retail electric rates until the earlier of the date the utility recovered its stranded costs or until December 31, 2001. In addition, residential and small business rates are to be reduced by 10% to 20%. The California law provides no cap on the price the utility must pay to purchase the electricity (i.e., wholesale electric price) that it supplies to its customers.

The Illinois Customer Choice Law caps all customer rates until at least January 1, 2005. In addition, the