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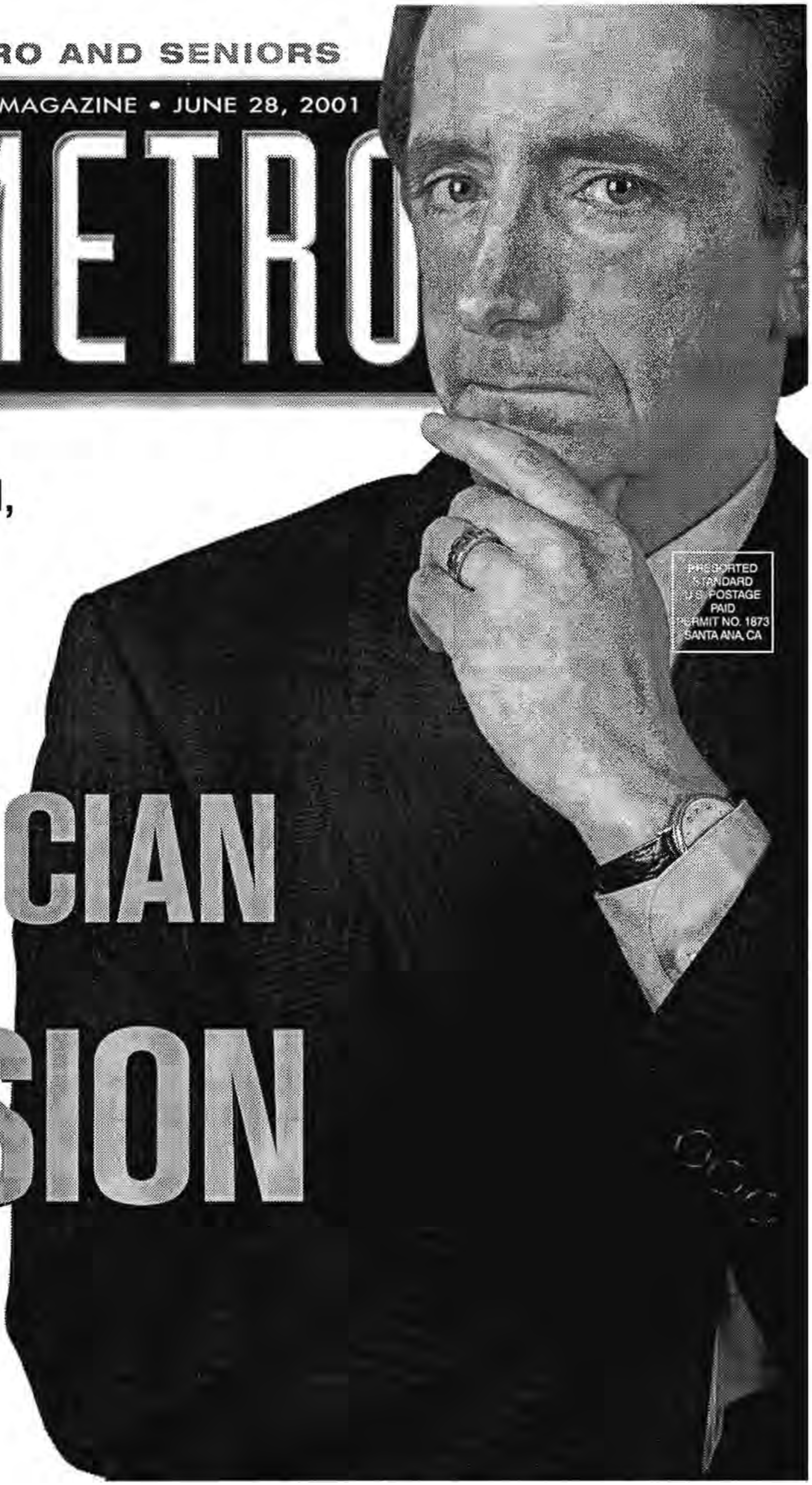

RETAILERS ON MAIN STREET: SEAL BEACH, GARDEN GROVE, SANTA ANA

MOTT ON YOUNG, PRETTY, STUPID 'REALITY' SHOWS

POLITICIAN WITH A MISSION

State Senator Joe Dunn Takes Aim at the Power Generators

ON A MISSION

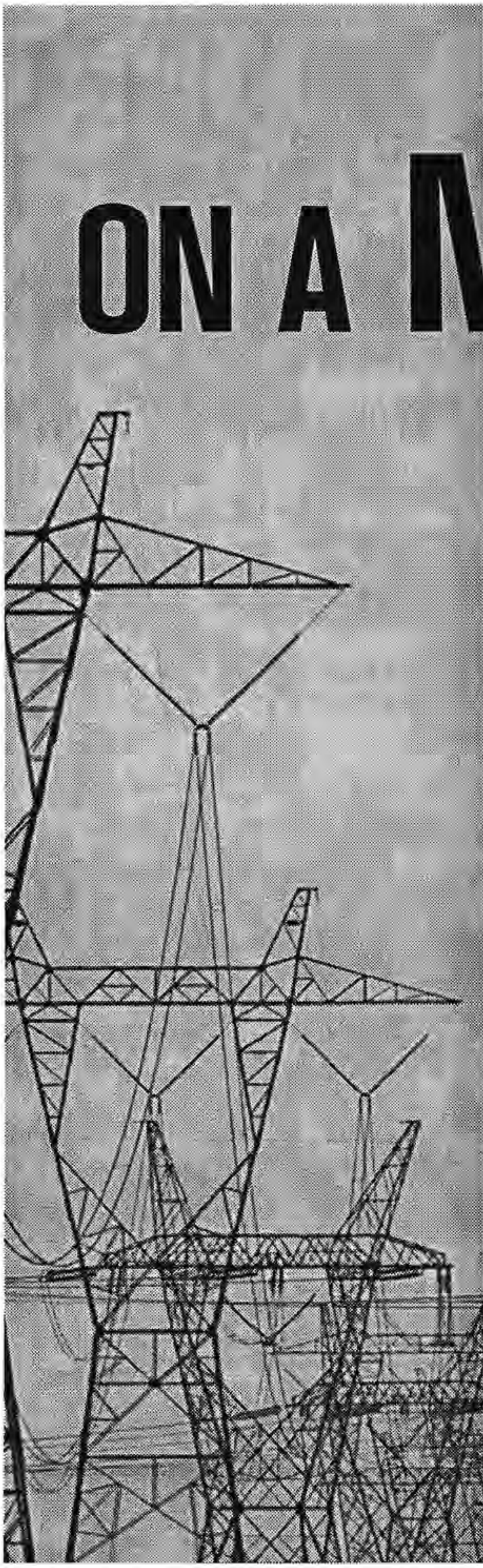

PHOTO BY MARK SAVAGE

State Senator Joe Dunn goes after the energy profiteers.

BY KEVIN O'LEARY

California's electricity crisis is an evolving circus. New twists and turns emerge on a regular basis. One week, summer blackouts appear inevitable, the next the governor announces the state has "turned the corner," locking up long-term contracts with producers. One week, the Bush Administration and federal regulators say there is nothing they can do to help California. The next, the new Democratic majority in the U.S. Senate announces hearings on the energy crisis and Republican lawmakers pressure the White House and the Federal Energy Regulatory Commission to OK round-the-clock price limits on electricity for California and other Western states.

Unique among Orange County elected officials, state Sen. Joseph Dunn (D-Santa Ana) holds a position of authority and power in the energy crisis. How he views the crisis may have an impact on the rates consumers and business ultimately pay and whether out-of-state energy companies are forced to reveal whether or not they violated anti-trust laws when electricity costs doubled and tripled over the past six months.

While the strain of the crisis is evident on many faces – including that of Loretta Lynch, president of the California Public Utilities Commission – Dunn is in his element. He says his former life was "excellent training" for his new role. Before being elected in 1998, Dunn made his living representing consumers who had been wronged by big corporations. He is a partner in the Newport Beach law firm Robinson, Calcagnie & Robinson, famous for winning multimillion-dollar settlements. One of Dunn's last big cases involved the state of California suing the tobacco giants. His side won.

Today, Sen. Dunn heads a special state Senate panel investigating price gouging and the electricity crisis. Dunn says five power generators – Duke, Dynegy, Williams, Reliant and Mirant – dominate the California wholesale market and unfairly exercise "market power" in a situation where genuine competition does not exist. The power companies in question have repeatedly stated that they have done nothing wrong.

On successive Fridays during May and June, OC METRO Magazine interviewed Sen. Dunn to learn how the state got into the crisis, what steps are necessary to keep the lights on this summer and what his investigation has uncovered about possible gouging by the energy companies.

What is interesting about Dunn is not only his investigation, but that he offers a brassy confrontational approach to solving the energy crisis that stands in sharp contrast to the complacent "free market" rhetoric of conservatives and the incremental, "muddle through it" approach of Gov. Gray Davis.

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The initial press coverage of the electricity crisis focused on the mess that former Gov. Pete Wilson and the state Legislature made of deregulation in 1996. Time magazine's Jan. 29 headline in a cover story read: "A crazy deregulation plan leaves California short of electricity." Orange County Register reporter Chris Reed gave this summary of the crisis at a lunch forum attended by Sen. Dunn and Lynch: "Californians are the victims of one of the worst public policy decisions in history."

That is certainly part of the story. We'd all be a whole lot happier – and Texas energy companies would be a whole lot less rich – if energy deregulation had never happened. But just as important, say Dunn and Lynch, was the decision by federal regulators in 2000 to abandon price controls on the wholesale market nationally and the way wholesale generators have taken full advantage of the price opportunities presented them. PUC chief Lynch gives this example: On the first Saturday in December 1999, a megawatt cost $24. On the first Saturday in December 2000, that price had jumped to $212.

"Why?" asks Lynch rhetorically. "Because they could. Until last fall it was not possible for energy sellers to spike the price in this way. But then the FERC lifted price caps on Friday, Dec. 8."

California left itself open to plunder in several ways. The 1996 deregulation bill (AB 1890) encouraged the big three utilities to sell off their generators and become distributors of energy produced by others. Next, the utilities did not purchase long-term contracts guaranteeing a certain price. The utilities chose to delay and the governor did not push them to act. Instead, people in positions of authority bet the spot market would stay low – bad decision. And finally, before Lynch joined the board in March 2000, the PUC handed off price tools to the federal regulators.

PUC CHIEF LORETTA LYNCH

A former courtroom attorney, Dunn offers this analogy. He says the way California went about deregulation is definitely part of the problem. But how the energy industry took advantage of the situation is just as critical. Dunn says, "A person is foolish when he leaves his car unlocked, but the crime is committed by the thief who steals the car."

Dunn does not know whether his special state Senate panel investigating alleged manipulation of the energy market or the joint investigation by the PUC and Attorney General Bill Lockyer will turn up criminal wrongdoing. It is too soon to tell and the law is complex. What is important, says Dunn, is bringing prices down to a sane level – and that requires a change in behavior by the power generators.

In the past several weeks, wholesale prices have suddenly dropped. The state purchased peak daytime electricity at less than $100 an hour. This after months when the wholesale rate of a megawatt-hour was rising to an average of $300 – up 10 times what it was at the beginning of 2000.

Will the lull in prices continue? No one knows. If wholesale prices continued at the same astronomical level as they had been for six months, the state could spend up to $70 billion for electricity in 2001. This according to Frank Wolak, a Stanford University economics professor. The cost two years ago: $7 billion.

During a crisis having the right person in charge makes all the difference. Gov. Davis has a reputation as a cautious, careful politician. A details person who moves incrementally, Davis rarely favors bold action. His approach to the energy crisis reflects his public persona. Gov. Davis says he has a plan, but most Californians are having trouble deciphering what it is. The governor maintains that securing long-term power contracts and conducting a campaign to shame the out-of-state energy producers into reducing their prices is now paying off. Recently, the Davis administration locked up 43 percent of the state's electricity needs with long-term deals, reducing dependency on the volatile spot market.

Another Point of View

Sen. Dunn offers an alternative way out of the energy morass. An independent thinker, Dunn was one of two legislators to vote against the state bailout in January. The other was state Sen. Tom McClintock, a hard-edged fiscal conservative. Dunn's reasoning: "If the utilities are nearly bankrupt and the state – with even deeper pockets – steps in to cover the cost of electricity, where is the incentive to sellers to lower their costs?" The liberal American Prospect recently compared using the state's general fund to buy energy on the spot market to "letting vampires into the blood bank."

Dunn's point: There is no shortage of electricity. We have not run out. But the margins of excess capacity are less than in the past, there is not true competition in the wholesale market, and these two facts allow generators to spike their prices.

Under the old regulated system, power generators were guaranteed a 10 percent return on investment and the keepers of the system made sure there was an excess of supply available. Given the nightmare that California is experiencing, that sounds like a good system. Investors got a guaranteed return and businesses and consumers could count on a constant, dependable and relatively cheap supply of electricity. It wasn't something you thought about.

But free market enthusiasts argued that the old system was inefficient and that prices could be lower if there was genuine competition. Competition will force prices down and eliminate inefficiency. That is the free market mantra made famous by Milton Friedman and other conservative economists. But Dunn says there is the problem when that line of thinking is applied to energy. In Econ 101 supply and demand graphs, the equilibrium is reached when supply equals demand. The price system encourages just enough widgets to be produced at a certain price so that they are consumed and inefficiency and waste are eliminated.

Nice in theory and often good in practice. However, electricity is a good example of being better off with a bit of excess supply. Why? Because if supply just equals demand that last bit of supply is vulnerable to extreme spikes in price. This is especially the case if too little competition allows suppliers to keep prices high without feeling "competitive consequence." To use economic jargon, there is not much elasticity in electricity demand. Conservation can only go so far. By contrast, you can decide to delay purchasing that picture frame. And this fact makes electricity a less competitive market than is the case with other commodities.

Newsweek's Robert Samuelson writes, "Many California power producers have recently made huge profits. But under deregulation they need to make big profits in periods of scarce supply to offset low profits or losses during periods of surplus supply. Otherwise they won't invest for the future. *Perhaps this volatility argues against deregulation.*" (italics added)

This is the crux of the argument against deregulation. As the body needs air and water, so business depends on plentiful, dependable power. Before it was a given, now supply and price are uncertain. It is hard to think of anything more anti-business than rolling blackouts and a five- to tenfold increase in energy prices.

Remember OPEC? Remember the Robber Barons? When cartels control supply they can artificially hold prices high, causing misery for consumers. The Texas wholesale energy companies and their North Carolina brother are an energy cartel in Dunn's eyes.

One of the curious facts to emerge in the investigation thus far, says Dunn, is that each of the Big Five generators has 19-plus percent of the wholesale market. Just under the 20 percent hurdle that sends up red flags to federal regulators.

A second curious fact. When the California utilities – Pacific Gas and Electric, Southern California Edison and San Diego Gas and Electric – were forced to sell off their gas-powered generators, all 23 were snapped up by the Big Five at four to five times their book value, according to Dunn. He says analysts were puzzled at the time why the wholesale generators wanted to pay so much for aging gas-fired plants. How did they justify the expense to their shareholders? Dunn and his committee would like to know.

An esoteric word lies at the center of the state Senate investigation: "market power." Dunn defines it this way: "The ability to set a market price without competitive consequence." Under normal market conditions, if one competitor raises prices dramatically, consumers rush to other sellers to find lower prices. But what if all the sellers raise their prices together? Dunn and other lawmakers suspect this is what has happened in the energy market. The energy companies say the price spikes are simply the market reacting to supply and demand.

Using round numbers, Dunn says California uses an average of 40,000 megawatts a day. Twenty thousand comes from the nuclear, hydroelectric and other assets that the three big utilities were allowed to keep. The other 20,000 megawatts are being supplied by the 23 gas-fired plants the utilities were forced to sell off and are now primarily owned by the Big Five generators.

Dunn says the Federal Energy Regulatory Commission defines "market power" according to a concentration of generating capacity. Market power might exist if any one company owns more than 20 percent of the generating capacity.

The question, says Dunn, is that when prices began to shoot up, why didn't the energy companies try to undercut each other to gain a greater market share? A famous experiment about collective behavior is called the "prisoners game." When two people are arrested and interrogated for a crime, what are the incentives for them to give each other up vs. hanging tough? Not being able to talk to one another, how can they trust each other? Self interest usually drives each of them to undercut the other.

STATE TREASURER ANGELIDES SIDES WITH DUNN IN THE ENERGY CRISIS.

In a fully competitive power market, business rivals should be undercutting each other to gain more market share and put their competitors out of business. Dunn's question: "What is it that allows these power generators to trust each other? Why are they not undercutting each other?" Investigators working for Dunn's panel and Attorney General Lockyer are looking to see if there is a paper trail that shows planning and cooperation between the power companies.

Did the generators conspire or collude together to drive prices artificially high? A spokeswoman for a trade group of major power suppliers says there have been no coordinated efforts to shrink supplies to increase profits. "There has been no collusion," says Jean Munoz of the Independent Energy Producers Association. If the evidence shows this collusion has taken place, then federal anti-trust laws and California's Unfair Business Practices Act come into play, says Dunn.

Dunn says there are two lessons to take from the energy fiasco. First, if an industry is going to be deregulated it is important to ensure that the assets are widely distributed. Second, put in place an exit strategy in case the experiment does not work as planned. "California deregulated without an exit strategy and we could end up bankrupting the California economy as a result."

Forcing a Showdown

"The key to solving the crisis," says Dunn, "lies in addressing its root cause, which I believe lies in the behavior of the wholesale generators. The Big Five generators – Duke, Dynegy, Williams, Reliant and Mirant based in Houston, Tulsa and North Carolina – it is their behavior that is the problem. (Dunn's committee has also issued subpoenas for records from Enron, a Texas-based energy marketing company with close ties to President Bush, and AES and NRG,

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two companies that work with Dynegy and Williams, and the Los Angeles Department of Water and Power.) I am not saying what they are doing is necessarily illegal. Only that they are charging sky-high prices because they could. Back in January, February and March their public proonouncements were that high natural gas costs were pushing their prices up.

"Now they have settled on saying 'prices are high because they can be and it's not illegal.' When the state bails out the utilities what message does that send? It simply reinforces the behavior of charging exorbitant rates because now the energy generators have even deeper pockets to go after.

"If there were a true shortage there would not be enough megawatts," Dunn says. "That is not the case." In May, PUC chief Lynch gave testimony to Dunn's committee that her investigators have found evidence of power generators cutting back supply and then suddenly increasing their production to nearly full capacity, allowing them to capitalize on the much higher rates. The energy companies say necessary maintenance at old plants is the cause of the temporary shortages of supply.

Dunn says the state has four options as the summer heats up. On one extreme, we can go back to a full regulated energy system. This is not likely and to work would require the cooperation of FERC, which has little intention of going this route. On the other extreme, we could completely deregulate the retail market for consumers and businesses.

Free-market advocates say we are in a "transition period." Assemblyman John Campbell (R-Irvine) says, "A competitive market with real consumer choice" is what we should be aiming for. Newsweek's Samuelson says electricity demand is artificially high because consumers and businesses have thus far been "insulated from cost increases." He says not passing the costs along violates the law of supply and demand.

Dunn wonders how small businesses will survive if their electricity bills suddenly skyrocket by 400 percent. Time Magazine begins its June 25 article "Has Bush Seen the Light?" with just this illustration. Congressman Duncan Hunter (R-San Diego) decided reality was making a mockery of free market gospel when the owner of a small metal shop in El Cajon showed him his December electric bill – $115,000 for the month, four times what he had been paying before the crisis. Hunter's reaction: "I came to the conclusion that this wasn't free enterprise."

From a macro-economic perspective Dunn says the free market perspective makes some sense, but at the micro-economic level it means businesses closing their doors and employees losing their jobs through no fault of their own. Los Angeles Times columnist Peter King put it this way. "That California's two major energy utilities have been turned into roadkill, that the state's collective energy bill had increased by something like $50 billion in a single year – these sorts of details were left unmentioned by the free-market spinners."

Third, we can "buy peace" says Dunn. In this appeasement mode, the state government continues to shell out billions of dollars that the bankrupt or near- bankrupt utilities can no longer afford. Gov. Davis may get lucky if we have a long, cool summer, if Californians conserve even more (PUC chief Lynch says California was already the second most efficient state in the use of energy before the crisis began) and if wholesale prices stay out of the nosebleed level. The recent decision by the FERC to impose round-the-clock price caps has the potential to dampen the crisis. But without luck, says Dunn, the fiscal bleeding goes on with "no end in sight."

Fourth, says Dunn, "in January we should have drawn a line in the sand and said, 'We can't buy power at these prices.'" Dunn says we must force the crisis to a climax before the state spends even more of the general fund. A surplus that was originally forecast at $10.3 billion has been sucked dry. So far the state has spent $8 billion from the general fund on the energy crisis, according to the Department of Finance. Now the state will have to make budget cuts in education, social services, transportation, infrastructure and a host of other programs.

To end the crisis, Dunn says it is not necessary to prove criminal wrongdoing or conspiracy by the power generators. He says for all its complexity a solution to the energy crisis is relatively simple. "What is necessary," says Dunn, "is to communicate to the wholesale generators that we are no longer willing to pay the prices they are charging for electricity."

But if we don't pay, won't the lights go out?

No, says Dunn.

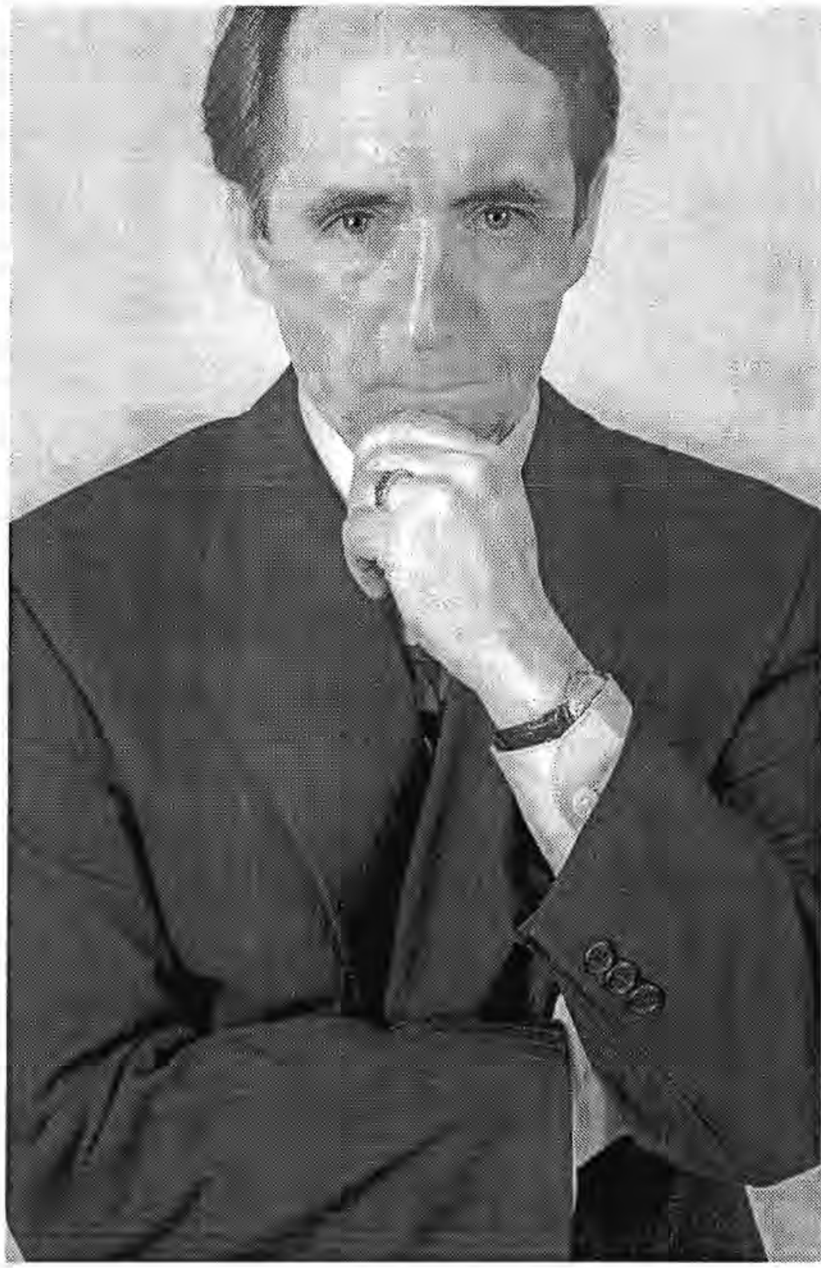

PHOTO BY MARK SAVAGE

Dunn says the governor needs to tell the energy companies that while we are willing to pay them a robust profit, we will no longer pay an outrageous fortune for our power. Pick a date, he says, and tell the generators, "As of July 15, California will begin to pay this much for power. That is a healthy profit, far in excess of the cost to produce the power. Ask your shareholders if they can live with that level of profit. Either accept that level of payment and continue to supply California with power or stop supplying power and turn out the lights. If you choose to turn out the lights I will use my emergency powers as governor to seize your plants in 24 hours."

Why is this a sane way out of the crisis?

Dunn says we need to send a strong message to the companies if we want to change their incentives. He says, "If I was a CEO of one of the power generators, I'd be charging whatever I could get away with. My obligation as a company officer is to make as much money for my shareholders as possible. If California is going to let me make astronomical profits, I will do so as long as possible. But if given a choice between a healthy return on investment and having the plants seized, I choose the former. And that is what I would communicate to my board and my shareholders."

Dunn is not alone in wanting to get tough with the power generators. State Treasurer Phil Angelides is also a strong proponent of the plant seizure option. In "a state of emergency," the governor is empowered "to commandeer or utilize any private property or personnel deemed by him to be necessary in carrying out the responsibilities hereby vested in him as chief executive of the state, and the state shall pay a reasonable value thereof."

The governor would issue an order to give the state temporary title to the plant and the plant would continue to operate as usual. Once the electricity crisis is resolved, the plant would be returned to the owner and lawyers and accountants would hash out what "reasonable value" the state owed.

The strength behind this logic is the short-term nature of the crisis. In 18 months, we will have many more power plants online and more competition among suppliers. For example, say three of the companies decide they will take the new profit plan but two don't, have their plants seized and sue in court and then win. Well, the case is tied up in court while the crisis is alleviated.

This is the economic equivalent of triage: California is a patient that is bleeding to death, the key is to stop the bleeding before it is too late. If the FERC order to limit prices does not avert extended blackouts, this course of action remains open to the governor, says Dunn.

Dunn says the recent decision by the FERC to place price limits on power is "certainly a helpful step but doesn't dramatically change our predicament. It does nothing to change the fundamental behavior of the market participants. We have to ensure that no market participant has 'market power' and the FERC order does nothing about this."

In the end, California's energy fiasco calls into question the Margaret Thatcher-Ronald Reagan push for deregulation. Gov. Wilson's chief of the PUC, Daniel W.L. Fessler, was a fan of Thatcher and followed the conservative British prime minister's model in deregulating California's energy markets. The British model has led to energy prices 70 percent higher than in the United States, poor service and periodic blackouts. Here in California, a summer filled with blackouts and spiraling energy costs could make the concept of public power attractive again.

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In the summer of 1979, when gas lines first formed in California, people on the East Coast made fun of those silly Southern California drivers and their freeways. A month later, the gasoline shortage hit the eastern seaboard and no one was laughing anymore. Dunn says he is often asked if the FERC is part of the problem, then why isn't the energy crisis a national phenomenon? He says, in fact, it is a national problem. For example, Oregon and Washington are in the same electricity mess that California is in, except none of their utilities has gone bankrupt. And the New York Times reports that New York City and most of the Northeast could be hit with rolling blackouts this summer.

Dunn quips, "This is not a California problem. Just like most things, California is first." OCM