Restructuring in the Rearview Mirror – a 10-Year Retrospective of California's Doomed Experiment with Electric Deregulation. By The Energy Overseer

DWR Caught Long in Power Market, but It Is Not the Only One

The striking reversal of power prices over the past two months has caught many power buyers in an awkward position. Having paid top dollar for supplies to protect against what was expected to be a summer of constraints and potential blackouts, they are now holding more energy than needed and must unload surpluses for whatever they can get.

The California Department of Water Resources has admitted a steadily increasing amount of surplus sales at substantially lower prices since May, confirming market reports that it has been selling off excess energy at a fraction of what it paid. Mention of DWR's surplus sales first appeared in CALIFORNIA ENERGY MARKETS' Western Price Survey on July 13 and was picked up with attribution by several newspapers.

From there, the story rippled through the mainstream media to Sacramento, where politicians critical of Governor Gray Davis' methods of energy crisis management demanded specifics.

In response to queries from Assemblymember John Campbell (R-Irvine), DWR this week said that so far in July it had sold 177,571 MWh of surplus power at an average price of $37/MWh, even though it paid an average $118/MWh to obtain 3.5 million MWh for the same period. Counting deliveries under long-term contracts, DWR's average cost of energy was $133/MWh in the first half of the month while its July daily spot-purchase prices fell to an average $82/MWh.

That 5 percent overage cost the state about $14 million, but that might not be the end of it. In the week following July 11, DWR reportedly was selling off about 20 percent of its energy and as much as 6,000 MW per hour during off-peak periods.

Most traders would chalk the losses up to the vagaries of the market and admit that everyone has days when they sell at a loss. Prices dropped significantly at the beginning of June with milder weather, higher than expected hydro flows in the Northwest, lower natural gas prices and increased generation availability. When the Federal Energy Regulatory Commission's price limits cemented the lower prices, it had adverse consequences for anyone who had bought summer futures contracts at what had been very high prices last spring.

DWR is not the only entity caught long. Walter Higgins, CEO of Sierra Pacific Resources, said that summer contracts bought by the two Nevada utilities under his command turned into a $200 million liability following the FERC order.

Speaking at our "Restructuring in the Southwest" conference last week in Las Vegas, Higgins likened the situation to an unfortunate twist on the fable of the "Grasshopper and the Ant." Higgins said, "Now we're wondering why we wanted to be ants."

Just about anyone that tried to lock in futures prices before summer hit has been hurt as well. Platt's, the energy information service of McGraw-Hill, this week said that across the US, spot power prices fell to half of the figures set in June futures contracts sold for July. The Palo Verde hub may have seen the most extreme shifts, with July spot prices averaging $67/MWh compared to futures contract price settlements of more than $160/MWh. Back in April, July deliveries were expected to cost as much as $575/MWh, Platt's said.

Although current spot prices are relatively contained, the forward market remains volatile and uncertain. Just this week, August contracts at the California/Oregon Border jumped $50 to $125/MWh--above the current cap-plus incentive level of $106/MWh. Volume is thin, but clearly someone believes there is still a chance of market fireworks in the months to come.

It's easy enough to use this issue to question the state's intervention in power markets. The DWR power buyers had to mount a steep learning curve after the agency was appointed the default energy buyer in mid-January, and even though the department's small hydropower management staff has since been bolstered by new employees, their inexperience shows. For the first six months, their mission was "buy, buy, buy" with the goal of securing enough power to prevent possible blackouts and avoid last-minute purchases by Cal-ISO. When the market turned, they found themselves long and were forced to unload their surpluses at a loss.

I'm not going to join the lynch mob. No one could have predicted the way that the power market tanked in early June, and few would have ventured to guess that FERC would effect the particular form of price controls that it did on the cusp of summer. The reported losses so far are minimal in a market the size of California's. Like many, I am concerned about the long-term costs of DWR's contract portfolio, but right now it is better to be slightly long than to be severely short.

If there is a lesson here, it is that commodity markets are by nature volatile and unpredictable. The mistake now would be to presume that the problem has been solved and the crisis is over.

We don't know for certain what will happen in the next few months. Extreme weather, generation problems and transmission outages all have a way of arriving at the same time and without much warning; in combination, they could send the region back into emergency mode **[Arthur O'Donnell].**

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