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Abstract

In his March 15 column in The Wall Street Journal, David Wessel drew some interesting comparisons between Indonesia's and California's power crises. He observed that the U.S. federal government and bond market will have assisted California on terms much more favorable than those the International Monetary Fund imposed on Indonesia. Obviously California is not facing the same issues regarding currencies and interest rates. Both governments, however, face the political challenge of deregulating retail rates for electricity.

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INTRODUCTION

At first I thought that drawing an analogy between the California and Asian power crises might be considered farfetched, until I saw David Wessel's March 15, 2001, "Capital" column in *The Wall Street Journal* entitled "California Shares Indonesia's Pain." In it, he wrote:

> Imagine a polyglot culture with a hot economy, much envied by the rest of the world, that suddenly runs into trouble.
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> Its shell-shocked leaders are inundated with advice from economic technocrats, many of whom insist that nothing bad would have happened had their earlier advice been heeded. Investments that seemed to be sure winners look imprudent in hindsight. Washington pressures the government to raise energy prices, dismissing local protests. The lights go out. The search for scapegoats begins.
>
> Indonesia 1997? Or, California 2001?[1]

It could be applied to either; even the same players are involved: California utility Edison International is at the center of the storm in its home state, but also in Indonesia, where it owns a 40% interest in the troubled Paiton I power project. Gas and energy marketer Enron Corp. features in the California story and in a brewing dispute with the Indian government over its Dabhol power project in Maharashtra State.

The Far Eastern Economic Review's recent characterization (in an Article entitled "Darkness at the End of the Tunnel") of Indonesia's energy markets as "a fool's paradise of unrealistic, below

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1. *See* David Wessel, *Capital—California Shares Indonesia's Pain*, WALL ST. J., Mar. 15, 2001, at A1.

world-market prices"[2] could be applied to California's transitional retail power rates: the result in both cases is bankrupt utilities. Both jurisdictions suffer from inadequate transmission capacity. And so on.

I. *WHAT WENT WRONG*

Something has obviously gone wrong on the road to the independent power nirvana we were all expecting. Some light was recently shed on the subject by the distinguished participants in a seminar sponsored by the Project Finance Committee of the New York City Bar Association, including the chair of the New York Public Service Commission and the former head of the California Commission. But perhaps the most telling comments came from Dr. Alfred Kahn, the grandfather of deregulation in the United States.

Confining myself to his published remarks, Dr. Kahn has much to teach us about the limits of deregulation of public services with elements of "natural" monopoly, particularly in the power sector. Ten years ago he wrote, prophetically:

> In short, we must find ways of protecting captive customers that do not involve either suppressing competition in markets where that is feasible or handicapping their suppliers in responding to it. . . . So long as we retain the mixed system, however, with its heavy overhang of sunk costs that companies are entitled to recover, it seems to me silly to permit simple gaming of it. . . . We must also find ways of truly transferring risk from ratepayers to investors. . . . I see no prospect of total reliance on unregulated competition in the electric utility field.

Think how energy regulators in developing countries must be reacting to the disaster in California: "What were they thinking?!" they must be asking themselves. "Why would we ever let that happen here?"

But the lessons here really do run both ways. The California experience threatens to thoroughly discredit deregulation and points up the urgent need for some rethinking, (Dr. Kahn suggests the right approach might consist of "reforming regulation to emulate competition.") We should not lose sight, however, of

2. *See* John McBeth, *Darkness at the End of the Tunnel*, FAR E. ECON. REV., Mar. 29, 2001.

the fact that there are elements of the underlying legal system in place there that would well serve policymakers elsewhere in arriving at a swift resolution of their own microeconomic problems.

I will not dwell here on issues of regulatory economics, which I would not be competent to address anyway. Suffice it to say that the California Commission's recent petition to the Federal Energy Regulatory Commission (or "FERC"), arguing market power played a role in the explosion of wholesale power prices in California, is surely not entirely without foundation in theory as well as common sense, as the FERC has itself acknowledged to a limited extent. As economist Paul Krugman recently wrote in the *New York Times*, to say that energy company executives did not exercise market power in California would be to imply they are either saints or bad businesspeople. Indeed, Krugman argues temporary wholesale power price caps would increase supply by discouraging gaming in the form of withholding capacity from the market to increase prices.

II. *THE RULE OF LAW*

In any event, I will focus on things lawyers know something about, namely rules, contracts, and courts. In the end, in the power sector context, the objective of these legal tools is the same, whether in Brazil, California, China, India, Indonesia, or anywhere else, namely to attract capital to the sector on a basis that serves the public interest in reliable, economic power supply. Most of my experience has been in the United States and in Asia, but I am sure that Latin America and other emerging markets, with high hopes placed today in deregulation, are anxiously watching developments in both regions and hoping to avoid treading in the same pitfalls.

Foreign investors in emerging markets take political risk for granted. They tend generally to regard local judicial systems as untried, or worse. This was probably not a significant factor in the decisions of energy companies to invest in California. But as David Wessel implied in his column in *The Wall Street Journal*, the current crisis in California has generated plenty of political risk.

Aside from basic public order (think of Exxon Mobil having to abandon its gas fields in Sumatra), a fundamental criterion for investors is that there be a "level playing field," i.e., that the same rules apply to all players, without favoring some over others due to extraneous considerations. Critics of privately negotiated projects such as the Paiton project in Indonesia or the Dabhol project in India complain of sweetheart deals favoring foreign and well-connected local investors. This is part of the impetus for the "power pool" version of deregulation of which California's is an example. Other jurisdictions around the world have implemented similar systems, and some countries in Asia have set this model as their ultimate goal.

On the other hand, attempts by policymakers to micromanage in advance the outcome of negotiations with and between private parties almost by definition will not work. In California, outcomes produced by rules adopted only five years ago have effectively been overturned because they did not meet rosy expectations. The result of going down this path is almost always to impose unnecessary costs on the public, whether as ratepayers or taxpayers.

Remember Dr. Kahn's injunction that investors, *not* the public, should bear the risk of their investments. Investors will do so where they believe they will have a fair shot at being rewarded for it; they do not need special favors, but being neither saints nor fools, they do tend to shy away from games where the end result is engineered to be "heads, they lose, and tails, the other guy wins."

A level playing field must be maintained by effective regulation. Effective regulation requires clear lines of authority over the activity in question. The federal system in effect in the United States is particularly prone to overlaps, or, worse, gaps in this regard. Governor Davis of California complains that he has no authority over out-of-state generators, while the FERC (somewhat shortsightedly, in my view) has proved less than sympathetic to California's plight.

Even centralizing governments, however (such as in China), can have difficulty imposing their will in the absence of local authorities effectively responsible for implementation. In some countries ministries operate as competing independent fiefdoms rather than being subject to central coordination. These failures of authority can impede economic development.

III. *THE COURTS*

An independent judiciary capable of enforcing rules, agreements, and its own orders underpins a system of laws. Again, countries vary greatly in the effectiveness of judicial enforcement mechanisms, and they are nowhere perfect. As I have stated, this has been an important issue for foreign investors in emerging markets. Critics of common law-based adversarial judicial systems overlook the ways in which they steer parties to resolution and finality, thus promoting future-oriented entrepreneurial activity.

IV. *BANKRUPTCY*

The ultimate involuntary business resolution procedure is a bankruptcy proceeding. It is especially effective in focusing parties' minds on what must be done to resolve a business impasse. Conversely, the lack of effective bankruptcy systems has clearly impeded efforts at Asian financial restructuring in the last few years. The threat (and use) of bankruptcy has been the single greatest incentive (other than the lights going out) driving a speedy solution to the California crisis. It may be the best example of the creative destruction that is said to be a virtue of a market system.

V. *EXPROPRIATION*

The ultimate *political* response to economic dislocation is to expropriate the means of production. The fear of this has somewhat receded in recent years, but it always lurks in the back of every entrepreneur's mind, especially in societies with a history of justifying such action. Even in societies that reject it in principle, it nonetheless remains the ultimate safety valve, however bounded with the requirements of a public purpose and fair compensation. Both emerging market governments' unwillingness to honor power purchase agreements and California's seizure of power contracts and effectively forced purchase of its utilities' transmission assets make clear that this remains *the* political solution *in extremis* to an economic crisis. All the more important that such drastic measures be subject to the rule of law.

VI. *THE ROLE OF LONG-TERM CONTRACTS*

It is axiomatic that the law fosters commerce when it promotes a stable allocation of risks to economic actors best able to manage them. This is particularly critical to the long-term capital investments required to maintain a reliable power supply. During the century or so when it was considered appropriate to regulate electric utilities, the balance was struck by permitting them to earn a reasonable return on their investments prudently incurred to meet their obligation to serve customers.

The first incarnation of "independent" power simply permitted utilities to shift some of their capital burden to less regulated generators, but to support it by purchasing the resulting power under long-term contracts that would replace the capacity additions in the utilities' rate base. This was just regulation one step removed.

This arrangement fell out of favor when the cost of financing new capacity fell below the agreed contract prices. Well before PLN, the Indonesian state utility, or Indian, or Chinese power authorities sought to renegotiate the terms of power purchase contracts, investor-owned utilities across the United States were doing the same thing. Of course, the trigger in Asia was a currency crisis that vastly inflated the cost of power in local currency under contracts effectively priced in dollars. The region has yet to recover.

The new model became the "merchant" generator selling into an unregulated market, usually organized into a "pool" or other form of exchange. The goal was to reduce rates through competition in supply, which through unregulated prices would find its "natural" balance with demand. When rates went up instead people protested.

Consider for a moment the design of the California Power Exchange, or CalPX. It claimed a monopoly of wholesale power transactions, prohibited long-term contracts of any kind, and decreed that all sellers would receive the highest price required to clear the market. The exchange was preempted, however, by the FERC from policing the gaming inevitably resulting from this structure.

The final irony is that the solution has been for the state to enter into—you guessed it—long-term power purchase contracts on behalf of the utilities. These contracts have resulted in average prices—surprise—substantially lower than those generated on the ill-starred CalPX. Moreover, the state's March 14 report on its contracting program states that it is giving priority to contracts "that result in construction of new power plants and offer long-term price stability."

Sound familiar? The state has effectively reverted to the regime in place immediately prior to deregulation, and in Asia prior to the recent financial crisis. It has contracted a mix of baseload and peak power and of terms, leaving some of its requirement uncontracted after five years, in the hope of capturing post-crisis price reductions.

Some of the contracts relate to particular plants and others are pure supply contracts from power marketers. Some provide fixed energy prices. Some are tolling agreements; some are subject to dispatch. The agreements contain other standard terms, such as termination rights.

Who knows, some of them might even support project financings of new generating capacity in California and neighboring states. Could this be the new old model? Generators such as AES, Duke, and Reliant, all perceived villains in California, actually contract forward most of their capacity. It is divested utilities such as SoCalEd and PG&E and marketers such as Enron who have been caught short in the California power market. (Enron has continued to prosper in the gas market, where it controls more physical supplies.)

VII. *THE ASIAN DILEMMA*

While California works its way out of its mess on a basis that might actually continue to attract investment (though I think the other shoe has yet to drop on forced rebates by generators), Asia appears to be left with failed projects and no near-term prospect of re-mobilizing foreign capital to meet infrastructure needs that continue to grow. Despite the apparent contrast, however, in both cases the solution will likely look similar, namely a partial reduction in the perceived excess in price.

The future in both cases should also look pretty similar: "Reforming regulation to emulate competition." In Asia, privatization and de-monopolization of state utilities. In California and elsewhere in the United States, the return of the power purchase agreement and other hedging devices. In both regions, vigilance to preserve competition, limits on the adverse impact of market power, and continued regulatory oversight to maintain quality and reliability of service.

CONCLUSION

In his March 15 column in *The Wall Street Journal,* David Wessel drew some interesting comparisons between Indonesia's and California's power crises. He observed that the U.S. federal government and bond market will have assisted California on terms much more favorable than those the International Monetary Fund imposed on Indonesia. Obviously California is not facing the same issues regarding currencies and interest rates. Both governments, however, face the political challenge of deregulating retail rates for electricity.

Wessel concludes:

> So now California confronts two conditions familiar to emerging markets. The first is an illness—in this case, flawed deregulation—that has grown more severe since symptoms first emerged and weren't promptly treated. If you swallow the right medicine, IMF doctors advise, there is a chance you'll get better. Refusing treatment means you'll be sick for a long time.
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> The second is the difficult process of distributing pain. In emerging-market crises, there's always talk about sharing the burden with private investors. But the ones who end up paying the bill are the people of the country itself. California is paying out-of-state generators much more for electricity than it is charging customers. Perhaps utility parent companies or the generators will be nicked, but the big tab will be paid either by California ratepayers or California taxpayers—and they're the same people. Sounds familiar.[3]

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3. Wessel, *supra* note 1.