OpEd on FERC's Soft Price Cap
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FERC's Order of Dec. 15

On December 8th "the Commission accepted a tariff amendment that replaced the existing $250 hard cap with a $250 soft cap, modeled after the Commission's proposed breakpoint." – Hebert Concurring.

This was the first ever test of the commissions soft cap. In the 99 page order, the outcome of the crucial test is not mentioned. Why? It was certainly a dramatic test. Was the commission was pleased with this performance?

Perhaps the commission was not pleased. This would speak well of the commission, because, in fact, the soft cap

- Failed to cap prices.
- Failed to improve reliability.
- Cost Californians over $1 billion in one week.
- Did the opposite of what Comm. Hebert predicted on Nov. 1.

In his Nov. 1 concurrence, Hebert said "price caps have little ability to constrain prices," and noted that the "staff suggests that there is a direct correlation between lower price caps and higher consumer prices." For these reasons, he was "gratified that the Commission today decides to reject the price cap proposed by the PX and ... by the ISO."

These are two useful scientific hypotheses because they are testable. If price caps have little ability to constrain prices, then removing them should have little effect. If low caps correlate with higher consumer prices, then raising the cap should give lower consumer prices.

The CA ISO tested Hebert's hypothesis. The ISO weakened its $250 cap nearly to the point of non-existence by applying FERC's soft-cap formula. Within 5 days prices reach $1500. They have not spent one hour below the old price cap since they were liberated. They now average about $500/hour day and night, just waiting for the next cold snap.

Hebert does not mention this intrusion of reality. But he has noticed. This time there are no words about price caps not constraining prices. "California ratepayers will benefit from the restructuring of the California energy market only when the market is allowed to operate without artificial restraints." $1500 is not high enough. "Timidity is no longer excusable." We Californians will be rewarded in due time if we are strong and endure yet higher prices.

> "If the Commission were true to its words, it would take the initiative now to eliminate the breakpoint and any other measure, whether hard, soft, or in-

> between, that threatens to inhibit generation entry and the precarious reliability of the California grid." – Curt Hebert

New generation must be encouraged, but is no cost too high? Let us take the simple step of looking at the price tag. How much are we paying to encourage investment?

In order to make our State attractive to generators our market must pay them a little more than long-run average costs, including all the carrying costs of capital. Under the old inefficient regulation we were surely paying too much. That was about $30/MWh. Now the price if gas is very high and that accounts for 20% of our production, so current long-run average prices are about $100/MWh. This is what we would have to pay under the old regulators. Now we have a soft cap that Comm. Hebert claims is inhibiting prices even at $1500/MWh. For ease of calculation and to be conservative let us say the prices only went to $1100, so this difference is only $1000/MWh. How much incentive would that give?

California's load averages over 25,000 MW, but only a bit over 10,000 MW is currently being produced by non-utility generators. Only this money is not recycled to help pay the consumer's bill. So the incentive payment per day, the payment that makes California look attractive to investors, is only $1000 x 10,000 x 24. That's only $240 million per day towards incentives. So how is this money used. We could say to new generators, "Invest in our state and we will give you 4 days of incentive, or about $1 billion." That would probably have quite an impact. Typically they would be thinking of building a 500 MW plant which costs about $250 million. With such an incentive they could pay cash for the plant and take a nice vacation with the other $710 million.

Let us say this would be enough incentive to interest some investors. With this technique we could have a new 500 MW power plant every four days. In the 100 days before FERC ends its soft cap and lets the market "operate without artificial restraints" we could have secured 25 new 500 MW plants. That's an increase of over 25% in our generating capacity enough to outlast three years of very fast demand growth. Plus we have 25 very satisfied investors who have already turned a profit of $710 on their investment. They could throw the plant away before it opened and would still make more than a 10% return over and above the normal rate of return on capital. Well actually they didn't invest any capital so it really gets quite confusing.

But the point to remember is that by holding prices down, or nearly down, to this level of $1100/MWh we are not giving investors enough incentive. And this will cause us to have too little supply and that means high prices. Surely we can fix this problem if we just stand back and let the market work its magic. Fortunately our federal regulators have shown us the way.