

Optionality is Key to California Energy Crisis



The power crisis in California and the Western United States that began to emerge last summer has undermined public confidence in the process and the promise of electricity

restructuring. The crisis, portrayed by the virtual and real bankruptcy of California's major utilities, massive State intervention, the specter of chronic Stage 3 alerts, and spiraling power prices across the West, ultimately manifests itself as a regional economy at risk. However, this is a crisis created not by a failure of competition, but by missteps in restructuring policy exposed by unfavorable market fundamentals.

Nothing in the California experience indicates that competitive markets, if allowed to work, will not produce the best long-run solution for consumers and the economy. Instead this experience provides a textbook example of how well-intentioned policies designed to "manage the market" can create perverse and costly mistakes when market fundamentals suddenly change. It also underscores two fundamental characteristics of power markets: they do not operate in a vacuum, but are inextricably linked to gas and environmental policy/markets; and uncertainty and risk dominate competitive markets.

The value of investments by energy producers and consumers can be substantially destroyed by unanticipated, unhedged volatility. Unmitigated uncertainty and risk can freeze an otherwise productivity-enhancing investment. Further, energy policy is easily frustrated by unexpected and dramatic changes in market conditions. Failure to fully account for those realities is the root of the crisis in the West and continues to create vulnerability to successive crises. Moreover, even those areas currently enjoying relatively more stable markets are at risk from rapid and unexpected change.

In a recent white paper, *The Path Forward*, ICF Consulting outlines a six-step analytical process designed to yield a

robust portfolio of policy and market options. Central to the process is the need to clearly define the amount of risk policy makers and market actors are willing to bear; understand the impact of uncertainty on performance; know what can and cannot be controlled; and construct a portfolio that balances the wide variety of available physical and financial hedges to maximize objectives. This is a process that applies equally to the design of public policy and to the development of a business strategy.

Optionality—the ability to quickly adjust to unexpected market and policy changes—is the key to success in the volatile world of competitive gas and electricity.

At a recent roundtable discussion, ICF Consulting explored the roots of the California crisis, the market outlook for the West, and the actions necessary for short-term stabilization and long-term success in volatile power markets. Those insights are summarized in a videotape of the roundtable and a newly available white paper, *The Path Forward in California and the West: The ICF Consulting View on Power Market Restructuring*.

In addition to measures to quickly address the lack of wholesale-retail pricing transparency and aggressive promotion of curtailment and other peak reduction programs, the *Path Forward* outlines a six-step analytical process designed to yield a robust portfolio of policy and market options.

To view or request copies of the *Path Forward* or the Roundtable videotape, please contact us at www.icfconsulting.com/energy.