



# Deregulation, Re-Regulation, and California's Energy Future

By Jim Chappell

---

September 1, 2003

This article appeared in the August, 2003 SPUR Newsletter, p. 12, and can be found online at <http://www.spur.org/>.

In 1996, Californians entered the new world of energy deregulation, with its promises of greater efficiency, robust competition, and lower prices. Instead, we were hit with the energy “perfect storm,” with its brownouts and blackouts, soaring wholesale power prices, insolvent utilities, criminal charges of market manipulation by out-of-state electricity trading firms, electric ratepayers now weighed down with above-market energy contracts, and a governor subject to a recall effort, in part because of his perceived bungling of the energy crisis. The country looks at California today as an example of what not to do.

The financial instability caused by the crisis, evidenced in spiking energy prices and the bankruptcy of Pacific Gas & Electric Company, took a big step towards resolution this past June, when a proposed bankruptcy settlement was announced. As we ponder San Francisco's energy future, it is worth looking at what did happen, the proposed settlement, and drawing some conclusions for public policy making.

## Background

Historically, three investor-owned utilities accounted for three-quarters of the electricity

sales in California—Southern California Edison (SCE), San Diego Gas & Electric (SDG&E), and Pacific Gas & Electric (PG&E). Some 38 smaller publicly owned utilities and co-ops accounted for the remaining quarter. The investor-owned utilities were regulated by the California Public Utilities Commission (CPUC), as well as other state, federal, and local agencies. Over the last 20 or so years, a series of federal actions began opening up the market to independent power producers to generate electricity and transmit it on the grid owned by the traditional utilities. Following the deregulation of the airline, telephone, and trucking industries, it was probably inevitable that political leaders would be encouraged to deregulate the vertically integrated power monopolies next.

## Assembly Bill 1890

1996's AB 1890 energy-deregulation measure was based on the theory that the regulated monopolies lacked market incentives to control costs and innovate, and that it was necessary to break them up and create competitive markets. It did a number of things:

- Incentivized the divestment of generation facilities to merchant generation firms, power companies that generate electricity for sale in the open wholesale power market
- Established the non-profit Independent System Operator (ISO) to manage the transmission grid

- Established a Power Exchange (PX) to auction power on a daily and hourly basis
- Allowed new independent unregulated electricity service providers (ESPs) to sign up customers and sell power, which they bought on the open market
- Relinquished responsibility for controlling the cost of power generation to the Federal Energy Regulatory Commission (FERC), which would be responsible for regulating the PX and ISO
- Limited the role of the CPUC to regulating retail rates
- Issued the State bonds to guarantee that the traditional utilities would recover their “stranded costs”—investments they had made under the old regulatory system that were perceived to be above market prices
- Enacted an immediate 10% retail rate reduction, and froze retail rate until the utilities had paid off their stranded costs

## What Happened?

The year 2000 has been described as a perfect energy storm. The combination of a drought in the Pacific Northwest, record low gas storage that created shortages of this critical fuel for power plants, and a faulty deregulation scheme led to unprecedented wholesale power prices by the winter of 2000. On top of that, predicted investments in new power plants following deregulation failed to take place while cutbacks in funding for utility energy efficiency programs reduced the surplus of power supplies that existed in the mid 1990s.

## The Uncertainty of Deregulation

Reliance on the spot market for last-minute wholesale power purchases was a further discouragement to investment and created huge opportunities to manipulate power prices. And as has become clear, with only five unregulated generating companies, there was ample opportunity for conscious withholding of power supplies by the ESPs to further drive up prices.

The CPUC required that all wholesale power purchases be made through the spot market, rather than through long-term contracts, which worked as long as prices were low. However, retail competition never took off; only two percent of residential customers ever switched providers. The legislated 10% rate decrease and

protection from rising retail rates encouraged customers to stay with the traditional utilities, and also discouraged conservation.

The utilities had lost their incentives to control power demand at the same time retail rates were frozen and they were required to purchase huge amounts of power on the spot market from suppliers who were able to withhold supplies just when they were needed most. This caused wholesale prices to spiral out of control with no possibility for the utilities to recoup their costs.

The difference between what they had to pay to purchase power and what they were allowed to sell it at caused SCE to run up \$6 billion in debt and PG&E \$13 billion. The State spent \$17 billion on power purchases in 2001 and has commitments to buy another \$42 billion of power over the next ten years. The PX went bankrupt and shut down. The ISO is under fire. The State became the primary power purchaser, locked into long-term power purchases at rates above the current wholesale market price.

Although a falling economy and conservation-inducing price incentives have pushed California’s 2001 energy crisis into the background at least for the moment, several unresolved issues from those dark days remain:

- Responsibility for planning for adequate power resources is fragmented between various state agencies, the investor-owned utilities, the ISO and merchant power plant developers
- Opportunities to develop renewable energy supplies is limited by the lack of creditworthy power purchasers
- Uncertainty remains as to whether direct access to the power supplies will be allowed or not

In April 2001, PG&E, supplier of electricity to 4.5 million customers in northern California, declared bankruptcy. PG&E listed an astonishing \$13 billion in debts, the largest utility bankruptcy in the country.

PG&E proposed a plan that would transfer its power plants and transmission lines to new companies that would be regulated by the Federal Energy Regulatory Commission (FERC) rather than the California Public Utilities Commission (CPUC). Those properties would have been used as collateral against loans to

repay debts. The CPUC countered with a legal challenge and its own competing reorganization plan, including continued State regulation.

## The Proposed PG&E Settlement

On June 19th, 2003, after nearly two years of rancorous politics and three months of closed-door negotiations, the CPUC staff and PG&E reached agreement on how the utility can exit bankruptcy. The PUC commissioners, five individuals appointed by the governor, will publicly review this settlement. If they agree with it, a vote of the board of directors of PG&E (among others) will follow, and it will finally be possible for PG&E to emerge from bankruptcy.

While the agreement in its entirety contains provisions for ratepayer protections, regulatory stability, environmental protections, and dismissals of pending litigation, some of the major points include:

- Retail electricity rates should begin dropping beginning January 1, 2004
- The CPUC would retain the ability to set electricity rates for PG&E customers
- PG&E will withdraw its proposed settlement plan to disaggregate their historic businesses and will remain a vertically-integrated utility subject to CPUC jurisdiction
- PG&E will emerge from Chapter 11 as soon as possible with an investment-grade credit rating
- PG&E will release claims against the CPUC
- PG&E's shareholders will receive value over nine years, including amortization of facilities
- PG&E will recover its prudently incurred costs and a return on investment in facilities, and on costs to be incurred for demand reduction and energy conservation under this agreement

The proposed PG&E agreement satisfies no one completely, but offers something for everyone, and is probably the best option for balancing the interests of power users, who want the lowest rates possible, with PG&E and debtors, who need to see many billions of dollars of debt paid. PG&E is unhappy that their transmission and remaining power-generation businesses will remain regulated by the CPUC, rather than by the federal government, which is considered more accommodating. The CPUC

and some consumer groups are unhappy that PG&E won't swallow a larger piece of the debt, instead paying much of it down through customers' bills.

## Public Benefits

The agreement has several sweeteners for California energy users and taxpayers which are worth noting:

- Power rates will fall more than 3% in 2004 and continue to fall through 2008
- The cost of purchasing power will come down as PG&E is again able to enter into long-term purchasing agreements financed with high-rated (hence cheaper) credit
- The future of over 140,000 acres of largely pristine watershed lands in the Sierra Nevada will be protected through new conservation easements—representing one of the largest conservation donations in the history of the state
- Millions of dollars will be contributed to support research and investments in clean energy technology
- PG&E shareholders will contribute nearly \$2 billion towards paying off the remaining debt
- Money received through ongoing litigation or negotiations with out-of-state generators who overcharged during the energy crisis will go towards reducing rates for consumers

Probably the most important aspect of the agreement is that the fiery rhetoric between the CPUC and PG&E can end. With policy experts already warning of a new energy shortfall on the horizon, a respite in the war is desperately needed so we can focus on the challenges that still remain. The CPUC should see its way clear to accept this agreement and move forward.

*Jim Chappell is president of SPUR.*