CALIFORNIA
BUDGET PROJECT

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WHAT DOES CALIFORNIA'S ENERGY CRISIS MEAN FOR THE BUDGET?

California's energy crisis has overshadowed deliberations over the 2001-02 fiscal year. At issue are amounts spent by the state to purchase power for customers of the state's electric utility companies and concern over how the crisis will affect the California economy and, in turn, state revenues. The following paper examines the budget implications of the state's energy crisis. This paper is based on discussions with legislative staff and state officials, as well as published documents and media reports. At the outset, it is important to note that the energy crisis is a moving target that changes daily, if not hourly, making it difficult to obtain up-to-the-moment information. The piece was drafted before Pacific Gas and Electric's (PG&E) filing for bankruptcy on April 6. It is unclear what impact the bankruptcy filing will have on payments due the state for power purchased on behalf of PG&E's customers or the state's ability to issue bonds to cover the cost of power purchases.

Why Is the State Buying Power?

The state entered the electricity business in response to suppliers' unwillingness to sell power to California's cash-strapped Investor Owned Utilities (IOUs).[1] Books could, and probably will, be written about the complex array of factors that led to the state's power crisis. In brief, wholesale price increases, supply shortages attributable to a number of factors, and elements of the state's deregulation law set the stage for the crisis. Earlier this year, PG&E and Southern California Edison (SCE) edged close to bankruptcy as the wholesale price of electricity far exceeded the amount the IOUs could collect from consumers under the rate cap established as part of deregulation. Independent audits of PG&E and SCE ordered by the California Public Utilities Commission (CPUC) document the transfer of billions of dollars of profits to the companies' parent corporations during the early days of deregulation. The audits also found that the utilities were allowed to recover billions of dollars from ratepayers for "stranded assets" – investments in facilities that regulators felt would be unprofitable in a competitive market – for power facilities that became immensely profitable as electricity prices skyrocketed. The audits also found that the amount utilities paid for wholesale electricity exceeded what they could recover from consumers by billions of dollars.[2]

Suppliers' reluctance to sell to the IOUs due to the companies' precarious financial position pushed the state into rolling blackouts in early January. The state stepped in with the goal of

[1] The three major Investor Owned Utilities (IOUs) providing electricity are PG&E, SCE, and San Diego Gas and Electric.
[2] The exact discrepancy is a matter of dispute. The widely quoted $12 billion shortfall represents the most generous (from the utilities standpoint) estimate of the amount the IOUs were unable to collect from consumers. Consumer advocates argue that the utilities should net out the amount the utilities received from selling the power they generate internally at inflated prices, as well as the amounts recovered for "stranded assets" that remained profitable in a high price environment. The audit of SCE estimates that the company had a $2.5 billion "net" shortfall as of December 31,2000, and the PG&E audit estimates a shortfall of $4.8 billion using a methodology recommended by TURN.

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stabilizing the market by using its solid credit rating and cash reserves to buy power on the spot market and negotiate more favorable prices than could be negotiated by the IOUs.

What Is the State Actually Buying?

The state, through the Department of Water Resources (DWR), is purchasing the "net short" – the gap between consumer demand and 1) power generated by the IOUs; 2) power generated by so-called Qualifying Facilities (QFs) under contract to the three IOUs (either renewable energy resources or cogeneration facilities operating under agreements with the IOUs); and 3) power purchased pursuant to "bilateral" contracts held by the IOUs. The net short is approximately 40 percent of the state's total demand for power.

Where Has the Money for Power Purchases Come From?

Funds for the state's power purchases have come from the General Fund and from amounts borrowed from the Department of Water Resources (DWR) and State Water Project (SWP).[3] General Fund moneys have come from the 2000-01 surplus. As of the end of March, the Governor had requested authority to spend $4.8 billion for power purchases. The Governor has been notifying the Legislature of his intention to make additional purchases of $500 million approximately every ten days.[4] As of March 28, authority for power purchases and amounts purchased include:

1. The Governor used emergency powers to authorize $345.1 million in purchases with funds from the SWP and DWR. Most of these funds were spent before the passage of SB 7X on January 19.
2. SB 7X authorized power purchases and appropriated $400 million for the initial "buy."
3. AB 1X authorized the DWR to enter into long-term contracts for the purchase of electric power and issue revenue bonds to finance power purchases. AB 1X also authorized $500 million to cover initial purchases.

The remaining $3.1 billion has come from the state General Fund pursuant to a series of deficiency letters using a process established by AB 1X:

> "The Department of Finance may authorize the creation of deficiencies for the appropriation made by Section 5 of the act adding this section. No deficiency may be approved under this section any sooner than 10 days after written notification of the proposed deficiency is given to the Chairperson of the Joint Legislative Budget Committee and the chairperson of the committee in each house that considers appropriations."[5]

The Administration has been requesting deficiency appropriations of $500 million approximately every ten days. The $500 million amount corresponds to the approximate

[3] The Governor also diverted $30 million from local parks projects to the Energy Commission to fund an incentive program to speed construction of generating capacity.
[4] The $4.3 billion figure represents expenditure authority, rather than actual spending. Not all of this amount has been spent due to the delay between the time a purchase has been made and the time the state cuts a check in payment of an invoice.
[5] Section 6 of AB 1X (Chapter 4 of 2001).

amount needed to cover ten days' power purchases. Whether the Legislature has the authority to block expenditure of funds is subject to dispute. Some senior legislative staff believe that the Legislature has no authority to block the Governor from spending additional funds based on the language contained in AB 1X.

How Are the Bonds Supposed to Work?

The revenue bonds authorized by AB 1X were intended to 1) provide capital for the state to purchase power and 2) smooth out the cost of power to consumers. Initially, the bonds were designed to acquire funds for power purchases to avoid the need to tap the General Fund. However, due to higher than anticipated prices and the length of time needed to put together the bond deal, most of the bond proceeds will be needed to repay the General Fund for amounts spent prior to the issuance of the bonds. The bonds were originally intended to subsidize the cost of power in the short term when prices are high, with the difference made up in the future when electricity costs are expected to decline. However, since such a large share of the bond proceeds will be required to repay the General Fund for previously purchased power, their ability to mitigate the impact of higher prices in the future will be limited.

The size of bonds needed to repay the General Fund for amounts already paid for power and to fill the gap between consumer electricity rates and the market price of power is uncertain. Since the details of the contracts between the DWR and suppliers are unknown, it is impossible to predict with any certainty how long the proceeds of the bonds will last. The Treasurer has estimated that a bond of $10 billion would cover costs of power and General Fund repayment through September 2001 at prices in the range of those recently reported in the media (25 cents/kWh). If the DWR can obtain a lower price, the proceeds of the bond will last longer. For example, the Treasurer has estimated that if power can be bought by the state at an average price of 15 cents/kWh, the proceeds of a $10 billion bond would last until June 2002. The Treasurer has been explicitly cautious that any estimate is just that: an estimate.

In recent days, the Governor's Office has informed the Legislature that a larger bond may be necessary to repay the General Fund and buy power going forward. Media reports have suggested that the state may issue as much as $14 billion of revenue bonds. However the Treasurer has cautioned that, "An issuance of significantly greater size would, in our opinion, result in a measurable size premium being paid to bondholders, ultimately increasing costs to borrowers."[6] If a $10 billion bond is inadequate to meet identified needs, it is unclear whether policymakers would authorize an additional bond measure or increase the cost of power.

AB 1X limits the size of the bond to four times the amount raised by the "California Procurement Adjustment (CPA).[7] However, the amount raised by the CPA can be adjusted by the California Public Utilities Commission (CPUC) by raising utility rates, as was done on March 28, 2001.

[6] State Treasurer Phil Angelides, March 7, 2001 memo to the Governor and Legislative leadership.

[7] AB 1x defines the CPA as "the difference between the generation related component of the retail rate and the sum of the costs of the utility's own generation, qualifying facility contracts, existing bilateral contracts, and ancillary services." Pursuant to AB 1X, utilities are to remit amounts received from ratepayers to the state as payment for power purchases.

How Will the General Fund Be Repaid?

AB 1x requires the General Fund to be repaid for power purchases out of amounts collected by utilities from consumers and the proceeds of the revenue bonds. AB 1X also states that the General Fund shall be reimbursed for interest earnings lost on amounts borrowed to purchase power.

When Will the General Fund Be Repaid?

In response to an order issued by the CPUC on March 27, PG&E and Edison began reimbursing the state for power purchased by the state. Edison made an initial payment of $43.5 million and PG&E made a payment of $61.8 million, a small fraction of the total amount spent by the state on behalf of the customers of the two utilities.

On April 4, State Treasurer Phil Angelides announced that the state had secured a $4.125 billion short-term loan to help finance power purchases until long-term revenue bonds can be sold by the state.[8] The bridge loan will cover 86 percent of the appropriations requested by the Governor as of the date of the loan. The bridge loan must be repaid by August 29, 2001.

The Department of Finance publicly maintains that the revenue bonds will be sold before the end of the 2000-01 fiscal year and that the General Fund will be repaid before the start of the 2001-02 fiscal year. Many believe that the bonds will not be sold in time for this to occur. The CPUC took several actions needed before the bonds could be issued on March 27, 2001, including 1) increasing rates to produce a sufficient revenue stream to repay the bonds; 2) establishing a process for calculating the CPA, and 3) requiring the utilities to immediately remit amounts collected from ratepayers for power purchased by to the state.

Before the bonds can be sold, the CPUC must allocate the revenues generated by the March 27 rate increase between the DWR and the IOUs. The state and the IOUs disagree as to how the funds should be divided, particularly with respect to the portion of the rate increase that is attributable to power generated by the IOUs or that is attributable to their ongoing contracts (i.e., the rate increase on power other than that purchased by the state). To the extent a larger share goes to the DWR, the need for a subsidy out of bond proceeds or the General Fund will be reduced. The allocation of rate revenues must be resolved before the AB 1X revenue bonds can be sold. Finally, the sheer complexity of the deal may cause delays due to the unprecedented nature of the transaction.

Several members of the Legislature believe that the bonds will not be sold until sometime in the fall of 2001. It is unclear how legislators will treat the amounts owed to the General Fund in the event the bond sale drags into the new fiscal year. At this point, the amount owed to the General Fund significantly exceeds the reserve proposed by the Governor for 2001-02. Thus, some mechanism would likely be needed to reconcile the spending plan to available resources.

How Will the Energy Crisis Affect the State's Credit Rating?

[8] Dow Jones Newswires, *California Gets $4.125 Bridge Loan to Buy Electric Power* (April 4, 2001).

On March 27, Standard and Poor's, one of the major credit rating agencies, placed California's AA bond rating on "CreditWatch" status. The announcement cited concern over the state's ability to maintain a budget reserve equal to 2 percent of expenditures in light of the state's role as a purchaser of power and related liquidity concerns. A downgrade of the state's credit rating would increase the cost of borrowing. State Treasurer Phil Angelides estimated that the last upgrade of the state's bond rating from AA- to AA saved the state $117 million in interest costs on bonds that had been authorized by the voters, but not yet issued.

Most of the bonds issued to provide financing for power purchases (the AB 1X bonds) will be revenue, not General Obligation, bonds with a twelve-year maturity. This means that they will be secured by and repaid out of a dedicated revenue stream. General Obligation debt, such as state-issued school bonds, are secured by the full faith and credit of the state, which means in practice that they have first call on the state's General Fund. While the revenue bonds would not directly compete with the state's ability to issue General Obligation debt, concerns over the state's long-term ability to repay energy-related debt could result in a downgrading of the state's credit rating, thereby increasing the cost of borrowing. It is also possible that the volume of debt issued would saturate the market, making it difficult to sell additional bonds. However, the downturn in the stock market may make bonds with their guaranteed yield an attractive investment alternative.

The state may also issue debt to purchase the transmission grid or other assets from the IOUs as a means of providing the utilities with cash to repay their outstanding debt. The status of negotiations over purchase of the grid varies from day-to-day. Media reports suggest that the state has reached a tentative agreement with Edison, but negotiations with PG&E may have broken down. The price of the grid has been estimated at $5 to $10 billion. Any bonds issued to purchase the grid would be revenue bonds backed by a portion of consumers' rates already dedicated to transmission costs. This component would go to the state, rather than the IOUs, if it purchases the transmission network.

The proposed revenue bonds would substantially increase the state's outstanding debts. A $10 billion bond sale to finance power purchases, for example, would increase the state's outstanding lease-revenue debt by 153 percent. The Treasurer's Office assumes that 80 percent of a $10 billion revenue bond would be tax-exempt debt and 20 percent would be taxable. The market for tax-exempt debt is limited to California investors (who seek the benefit of a California tax exemption, investors outside of California would not benefit from the exemption

How Will the Energy Bonds Affect the State's Debt Load?
(Dollars in Thousands)

	Issued as of 2/1/01	Authorized but Unissued 2/1/01	Under Discussion
Current Debt			
General Obligation	$19,210,451	$6,978,480	
Lease-Revenue (excl. energy)	$6,498,280	$2,308,544	
Proposed Energy Related Debt			
AB 1X Bonds		$10 - $14 billion	
Transmission Line Purchase			$6 billion or more

and thus would seek the higher yield of taxable debt). Bonds issued to finance purchase of the transmission grid would be taxable and could be marketed to a broader pool of investors.

What About Other Energy-Related Spending?

The Governor set aside $1 billion in his January budget for programs aimed at encouraging energy production and conservation. As of early April, the primary legislative vehicles for the incentive package were SB 5X (Sher), AB 29X (Kehoe), and SB 28X (Sher). SB 5X appropriates $1.039 billion for a range of energy assistance, conservation/efficiency, and educational programs. AB 29X appropriates $405 million for conservation/efficiency, renewable energy development, weatherization, and distributed generation technology. SB 28X allocates $53.3 million for a range of siting incentives. Several of the items contained in AB 29X and SB 5X are duplicative. More than a hundred special session measures have been introduced, along with a number of regular session bills. It is not clear whether the Governor intends to impose a $1 billion "hard" cap on energy-related expenditures at this time. None of the measures cited above or the Governor's budget specifically addresses the impact of rising energy costs on state buildings and facilities.

The state may also be at risk for damages with respect to energy contracts seized by the Governor under his emergency powers. PG&E and SCE held the contracts at issue at favorable prices. The Governor seized the contracts to avoid their sale by the Power Exchange to recover amounts owed to the Exchange by PG&E and SCE.

What Will the Energy Crisis Mean for the Budget Over the Long-Term

The most direct impact of the energy crisis will come from the impact of higher rates on consumer spending. Rising electricity costs will reduce the amount consumers have to spend on other goods. The Legislative Analyst has estimated that consumers' bills would rise by approximately $15 billion (from $25 billion to $40 billion, a 60 percent increase) if they were paying the market price of their power. The additional cost of power equates to approximately 1 percent of the more than $1.1 trillion California economy, a modest, but nonetheless significant cost increase. Taken in isolation, the increase in electricity would have a nominal impact on the state's economy. However, gasoline and natural gas prices have also increased in cost over the past year and the economy, as a whole, is slowing. Economists believe that rising energy costs could reduce state economic growth by as much as a percentage point, from 3–4 percent to 2-3 percent. Slower economic growth, in turn, would reduce state revenues.

A second potential impact is lost productivity due to rolling blackouts and downtime for businesses that signed agreements to shut down during acute electricity shortages. Many businesses experienced significant downtime during December and January. Estimates of lost productivity have ranged into the billions of dollars, however these estimates are "soft" in that businesses may have recovered lost sales and production at a later point in time. To the extent total economic activity was reduced by the shut downs, there will be a negative impact of unknown magnitude on state revenues.

Over the long-term, the rising cost of electricity and concerns over the reliability of the state's power supply could cause business to shift jobs and investment out of state. This would also

reduce economic and revenue growth in the future. The potential magnitude of such a shift is impossible to predict and could be mitigated by the fact that other states are experiencing power shortages and/or price hikes as well.

Finally, the timing of the state's energy crisis is particularly inopportune. While most of the traditional indicators of economic performance remain strong, the recent national economic slowdown and related dot-com shakeout have disproportionately affected high tech firms, including those based in California. Business investments are down and the drop in stock values has reduced the paper wealth of many households. To the extent much of the recent economic boom has been attributed to the wealth effect of the high-flying stock market of the late 1990s, the drop in stock prices has depressed consumer confidence and consumer spending. For the California economy and state revenues the potential impact is substantial. The Federal Reserve Bank of San Francisco (FRBSF) estimates that firms that made Initial Public Offerings (IPO) of stock in 1997–1999 lost $261 billion in market value between mid-February and late November of 2000.[9] The Department of Finance has estimated that 21 percent of 2000-01 General Fund revenues are attributable to taxes paid on stock options and capital gains, thus the fall in stock prices could have a significant negative impact of revenue collections.[10] The combined impact of consumer fears over a worsening economy and consumer fears over rising energy costs could prove worse than the impact of either factor alone on the economy and, in turn, state revenues.

What Are the Outstanding Questions?

1. When are the bonds authorized by AB 1X likely to be sold? How long will it take for the General Fund to be repaid out of the proceeds of the bonds?
2. What happens to repayment of the General Fund if the bond proceeds prove inadequate to cover the cost of power going forward?
3. Based on the long-term contracts the state has in place and the gap between supply and demand, if any, what are the chances that repayment of the General Fund will be delayed and what would that mean for the 2000-01 and 2001-02 budgets?
4. What impact will the issuance of revenue bonds for power purchases and, potentially, purchase of the transmission grid from the IOUs have on the state's ability to issue other debt?
5. What other costs will the energy crisis impose on the Budget? How much will be spent on incentives for generation and production?

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[9] FRBSF Economic Letter, *California IPO Wealth Effects: What's Left?* (December 8, 2000).
[10] Department of Finance, *Governor's Budget Summary* (January 2001), p. 77.