CALIFORNIA
▪ BUDGET PROJECT ▪

Budget Brief

September 1998

HOW WILL PROPOSITION 9, THE UTILITY RATE REDUCTION AND REFORM ACT, IMPACT CALIFORNIA CONSUMERS AND THE STATE?

INTRODUCTION

Proposition 9 on the November 1998 ballot requires utility companies to reduce electricity rates by 20 percent for residential and small commercial customers by revising the formula used to set electricity rates and prohibits utility companies from recovering the cost of certain unprofitable assets through the imposition of surcharges on consumers of electricity. Proposition 9 is sponsored by The Utility Reform Network (TURN), the Foundation for Taxpayer and Consumer Rights, and the Public Media Center.

Proposition 9 was drafted in response to the state's plan to deregulate the electric power industry. In order to increase competition in the power industry, the legislature enacted Assembly Bill 1890 (Brulte) in 1996. This bill provided the legislative foundation for the electricity industry restructuring commonly referred to as deregulation. AB 1890 gave California's three major investor owned utilities, Pacific Gas and Electric, Southern California Edison, and San Diego Gas and Electric, the opportunity to recover costs associated with energy sources that are unprofitable in the newly competitive electricity market. The bill froze rates and authorized the utilities to use the difference between the higher frozen rate and the actual cost of providing electricity to pay for unprofitable assets. AB 1890 also authorized the sale of up to $10 billion in rate reduction bonds to finance a 10 percent rate reduction for residential and small commercial customers. The bonds are secured by a surcharge imposed on consumers.

Proposition 9 would undo many of the provisions of AB 1890 that allow the utilities to recover the costs associated with transitioning to a competitive market. At this point, Proposition 9's impact on the market price of electricity is unknown, making a cost-benefit analysis difficult. Proponents of Proposition 9 claim that it will:

- Give individual and small business consumers an immediate rate reduction;
- Expedite the transition to a competitive utility market; and
- End consumer-funded subsidies for above-market energy generation sources, such as nuclear power plants.

However, opponents of Proposition 9 claim it will:

- Raise the market price for electricity;
- Expose consumers to fluctuations in electricity prices;
- Leave the state liable for $7 billion in rate reduction bond debt; and
- Reduce state tax revenues.

921 11th St., Ste. 502 ● Sacramento, CA 95814-2820
(916) 444-0500 ● FAX (916) 444-0172

Proposition 9 addresses a highly complicated and confusing issue. This analysis strives to explain a complex issue in simple language in order to give the public tools to understand and participate in this highly contentious debate. Doing so runs the risk of sacrificing some technical precision. We hope that what is lost in technical accuracy is made-up in comprehensibility.

BACKGROUND

For more than 80 years, roughly 80 percent of electricity service in California was provided by three electric utilities owned by investors and regulated by the California Public Utilities Commission (CPUC).[1] Under the old monopoly structure, the utilities were granted exclusive franchises to provide electricity service within a geographic area. The CPUC set standards for electricity service, authorized investment in power plants and transmission lines, and set electricity rates.

AB 1890 authorized a transition from the former monopoly structure to a competitive market. The legislation restructured the electricity market by "unbundling" three distinct functions of electricity service:

1. Generation of electricity;
2. Transmission of electricity along high voltage lines; and
3. Distribution of electricity to customers.

Previously, utility companies performed all three functions, under the oversight of the CPUC. Now these functions are performed partly by the utilities, partly through competitive businesses, and partly by new entities created by AB 1890.

Generation. Power plant owners now have the opportunity to sell electricity directly to end users, sell into a daily auction from which large customers or distributors may purchase electricity, or sell to brokers that have agreed to provide electricity for a group of small consumers. The major utilities will likely sell most of their power plants in order to comply with deregulation's goal of reducing their influence over the market. The new regulatory structure is intended to ensure that no firms can dominate the market and set prices. Daily auctions, known as the Power Exchange (PX), are designed to establish a reliable price structure that may be used throughout the electricity market.

Transmission. AB 1890 created the Independent System Operator (ISO) to ensure open and reliable transmission of electricity along California's grid of high voltage lines. The ISO is intended to ensure that no particular buyer or seller of electricity can block other firms' access to the transmission grid. Assets used for transmission will remain the property of individual utilities. The ISO collects fees for the usage of the transmission grid, which are billed to firms transmitting electricity.

Distribution And Customer Service. Moving electricity through a service area to customers, maintaining electricity lines, metering, and billing largely remain under the control of the utilities at this time. The CPUC will continue to regulate these functions. Private firms may provide metering and billing services in the future.

Transition Costs. Under the former monopoly structure, contracts to purchase power and investments in facilities to generate electricity required the approval of the CPUC. In the debate over deregulation, the utilities argued that some of their investments in power plants, fuel, or alternative sources of energy

---

[1] California Energy Commission, *Electricity Deregulation in California,* http://www.energy.ca.gov/restructuring.html (San Francisco, CA: 1998). The three major companies are referred to as "the utilities" in this document.

might not be recoverable in a competitive market. For example, the three major utilities have significant investments in California's two large nuclear generation plants, San Onofre and Diablo Canyon. At present, the cost of generating nuclear power exceeds the market price for electricity. Under the old monopoly structure, the utilities covered their costs through a rate structure approved by the CPUC. In a competitive market, utilities may not be able to recover investment in nuclear generation and other facilities that produce energy at above market prices. These unrecoverable costs are known as "stranded costs" or "transition costs."

AB 1890 created a transition period during which the utilities would have the opportunity to recover all or part of their transition costs. The transition period began January 1, 1998 and is scheduled to end in March 2002 or when the utilities have recovered all their transition costs, whichever comes first.[2] In order to make this possible, AB 1890 froze electricity rates at June 1996 levels for large commercial customers and 10 percent below June 1996 levels for residential and small commercial customers. AB 1890 authorized the utilities to use the difference between the higher frozen rates and the lower actual cost of providing electricity service toward paying down transition costs. Utilities will be forced to absorb or "write off" any investments in unprofitable assets that are not paid off by March 2002.

Rate Reduction Bonds. The 10 percent rate reduction for residential and small commercial customers was made possible by the sale of $7 billion in tax-exempt bonds used to refinance a portion of the utilities transition costs.[3] The tax-exempt bonds were issued through the state's Infrastructure and Development Bank with the understanding that they would be repaid through a charge included in electricity rates. In addition, the legislature pledged not to alter the repayment plan. The utilities obtained lower interest rates by utilizing the tax-exempt bonding capacity of the Infrastructure and Development Bank. The savings generated by the difference between the tax-exempt interest rates and the rates the utilities would have paid through traditional borrowing are used to finance the rate reduction.

WHAT DOES PROPOSITION 9 ATTEMPT TO DO?

Transition Cost Collection. Proponents of Proposition 9 argue that AB 1890 forces consumers to subsidize the utility companies' investments in unprofitable assets during the transition period. These organizations sponsored Proposition 9 in an attempt to move the provision of electricity service in California directly to a market-based system. Whereas AB 1890 provided a four-year transition period to allow the utilities to move from a monopoly structure to a competitive market, Proposition 9 immediately moves utilities to the competitive market with few protections.

Proposition 9 promises an immediate 20 percent rate reduction. In reality, consumers would potentially realize a rate reduction equal to the amount they currently pay toward nuclear-related transition costs.[4] Proposition 9 would prohibit utilities from collecting nuclear-related transition charges and allow collection of transition charges associated with non-nuclear generation facilities only if the utility could demonstrate to the CPUC that failure to recover these costs denies them a fair rate of return.

Rate Reduction Bonds. The initiative prohibits utilities from charging customers for repayment of rate reduction bonds. If this provision proves unenforceable, Proposition 9 requires utilities to give customers a credit equal to the amount they pay toward the repayment of the bonds. However, it is

[2] The transition period for some costs is longer.
[3] Letter from Mac Taylor, Legislative Analyst's Office, to California Attorney General Dan Lungren (January 26, 1998).
[4] Proposition 9 allows utilities to collect "reasonable decommissioning costs" associated with nuclear power.

unclear who would become liable for the over $8 billion in principal and interest of bond debt if the utilities are no longer able to collect these costs from consumers (see below).

HOW MIGHT PROPOSITION 9 IMPACT RESIDENTIAL RATES?

Proposition 9 requires electric utility companies to reduce the rates charged to residential and small commercial consumers by 20 percent. The reduction must be instituted no later than January 1, 1999 and would be measured against the rates in effect on June 10, 1996. In fact, the measure's potential impact on utility rates is more complex.

Transition Cost Estimates. Proponents of Proposition 9 claim it will reduce consumers' electricity bills by preventing utilities from recovering nuclear-related transition costs through the electricity rate structure. At this time, the amount of transition costs is unknown. Therefore, the amount consumers might save by eliminating these costs is impossible to ascertain. The market price of electricity, the operational performance of the above-market price generation sources, and various other factors determine transition costs. The market price of electricity is dependent upon many variables including the price of natural gas, western United States hydroelectric conditions (wetter years decrease the cost of electricity), and the availability of large generation sources. The amount of transition costs paid by any individual consumer varies depending on their utility company and their electricity usage.

Since July 1, 1998, electricity bills have been itemized to separately state charges for generation, transmission, distribution, public purpose programs, nuclear decommissioning, and the Trust Transfer Amount (TTA). The initiative only addresses two items in the formula used to establish rates: the generation charge and the TTA. The generation charge is primarily composed of the market price of electricity and transition costs. The TTA is the portion of customer rates set aside to guarantee repayment of the rate reduction bonds. Proposition 9 intends to eliminate the nuclear-related transition cost portion of the generation charge and the entire TTA. Proponents of the initiative claim that the savings could be higher than 30 percent. However, a number of factors are likely to limit potential savings and it is unclear whether the initiative would result in lower utility rates.

The Market Price Of Electricity Could Rise. AB 1890 states that electricity rates will be unfrozen on March 31, 2002 or "the date on which the commission authorized costs for utility generation-related assets and obligations have been fully recovered," which ever comes first. The rate freeze protects consumer electricity rates from normal seasonal and extraordinary changes in the price of electricity resulting from deregulation. By reducing the transition costs the utilities are entitled to collect, Proposition 9 would shorten the rate freeze period. When the rate freeze ends, consumer electricity rates will fluctuate based on the market price for electricity. If utilities abandon nuclear power, the market price for electrical energy in California could rise if there is a shortage of available power.[5] An increase in the market price of electricity would not necessarily increase electricity rates. If the initiative passes and lowers electricity rates by eliminating a portion of transition charges, the market price of electricity would have to increase in an amount greater than that savings to result in an overall rate increase. The amount and duration of any price increase is impossible to predict.

HOW MIGHT PROPOSITION 9 IMPACT CUSTOMERS OF NON-INVESTOR OWNED UTILITIES?

Customers served by non-investor owned utilities, such as the Los Angeles Department of Water and Power (LADWP) and the Sacramento Municipal Utility District (SMUD), do not currently pay transition

[5] Approximately 20 percent of California's current electricity supply is nuclear generated.

charges and therefore are not affected by Proposition 9. AB 1890 allowed the governing bodies of municipal utilities to decide if they would allow other electricity providers to do business in their service areas. Municipal utilities and their customers would be affected if the state became liable for repaying the rate reduction bonds (see below) and would also be affected by changes in state and local government revenues if Proposition 9 passes.

How Might Proposition 9 Impact State Revenues?

The Legislative Analyst estimates that Proposition 9 would produce state revenue losses in the "high tens of millions of dollars" and local government revenue losses potentially in the "tens of millions of dollars" annually through 2001-02.[6] The revenue impact is temporary, since the market would be deregulated in 2002 under existing law. Proposition 9 would impact state and local government finances in a number of respects:

- To the extent utilities experience higher costs due to the elimination of consumer payments for transition costs, their income would be reduced, thereby lowering state General Fund corporate income tax revenues.
- A rate reduction would reduce local government utility user tax and franchise fee revenues, since these amounts are generally levied as a percentage of electricity rates.
- Local government property tax collections would be lower due to a reduction in the value of nuclear power plants.
- State General Fund costs would increase to offset any reductions in property tax revenues received by schools and community colleges (approximately 52 percent of total property tax collections).
- State and local revenues losses would be somewhat offset by increased revenues from income tax payments from businesses that benefit from the rate reduction and from sales tax generated by increased consumer spending generated by lower utility bills.
- State and local governments would also realize cost savings attributable to any reduction in electric rates. The Legislative Analyst estimates that the state and local government savings could be in the "tens of millions of dollars" annually.
- The Legislative Analyst also estimates that the state would experience increased costs for legal proceedings related to the initiative of less than $5 million per year.

The CBP used a methodology developed by the Law and Economic Consulting Group (LECG) to examine potential changes to state and local government revenues as a result of the passage of Proposition 9.[7] This analysis used more recent estimates of nuclear-related transition costs issued by the California Energy Commission (CEC).[8] The methodology used by CBP produced a somewhat higher estimate of potential revenue losses of up to $200 million per year. Proponents argue that these estimates overstate potential revenue losses and that the measure would shift economic activity between sectors, rather than reducing overall state revenues. They further argue that any revenue losses would be minimized by economic activity spurred by increased consumer spending.

Mitigating Factors

---

[6] Legislative Analyst's Office, *Legislative Analyst's Office's Analysis of Measures on the November 3,1998 Ballot* (August 31, 1998).
[7] Law and Economic Consulting Group (LECG), *Preliminary Analysis of the Utility Rate Reduction and Reform Act* (Emeryville: December 1997). LECG was retained by Californians For Reliable Energy Service to perform this analysis. Californians For Reliable Energy Service opposes Proposition 9. For a more detailed explanation of the fiscal impact estimates used above, please contact the California Budget Project.
[8] California Energy Commission, *Preliminary Analysis of the Utility Rate Reduction and Reform Act* (Sacramento: July 1998).

Several factors could affect the impact of Proposition 9 on California:

- Nuclear power facilities could become profitable by making up for shortfalls in the supply of electricity. If the nuclear generators earned revenues by providing reliability services that fully compensated the utilities for generation costs, local governments would lose far less property tax revenues and would require a smaller backfill of lost Proposition 98 funds to local governments.
- Assuming new electricity generation sources step in to fill the void left by the utilities unprofitable sources, tax revenues from these new sources could offset some lost state revenue from ending transition cost collection.
- If Proposition 9 produced a rate reduction, the state's reduced energy costs for public facilities would help offset some lost tax revenues.
- If the courts enjoin portions of the initiative, lost utility revenues and the subsequent state fiscal impact would likely be lessened.
- If litigation regarding Proposition 9 stalled its implementation and transition cost collection continued, the amount of transition cost revenues foregone as a result of the initiative would be reduced. It is unclear if transition cost would have to be retroactively refunded if the initiative were implemented after a delay.

WHO IS LIABLE FOR RATE REDUCTION BOND DEBT?

The most significant impact of Proposition 9 stems from the state's potential liability for rate reduction bond debt. Some analysts argue that the state could be liable for repaying the bonds if Proposition 9 passes.[9] A special trust authorized by the California Infrastructure and Economic Development Bank for the three major utilities in California has already sold $7 billion in rate reduction bonds. These bonds were sold to finance a portion of the utilities' stranded costs over a 10-year period at a favorable interest rate and finance a 10 percent rate reduction for residential and small commercial customers during the rate freeze period. AB 1890 authorizes the utilities to collect the principal and interest payments for these bonds from the residential and small commercial customers that benefited from the rate reduction. The utilities are not responsible for repayment of the bonds, but merely act as collection agents for the special purpose trusts that were created to issue the bonds.

Proposition 9 would prohibit the utilities from collecting funds from ratepayers to repay the bonds. If this provision of the initiative proves unenforceable, the initiative states that utilities must give customers a credit equal to the amount they pay toward the bonds. Under either of these scenarios, the utilities would repay the bonds out of their own pockets.

In AB 1890, the state pledged not to limit the utilities' ability to charge consumers for amounts needed to repay the bonds. The California Infrastructure and Economic Development Bank, acting on behalf of the state, repeated the pledge in the Trust Agreements associated with the issuance of the bonds. Therefore the pledge is both statutory and contractual. By approving Proposition 9, voters actions could be construed as violating the state's pledge, thereby impairing the contractual rights of bond buyers. Both the state and federal Constitutions prohibit contract impairments without adequate provisions being made to protect property rights.[10] In order to protect bond holders' rights, some analysts believe the state could be held liable for repayment of the bonds while others believe the courts would simply nullify the bond repayment portion of Proposition 9, leaving the current repayment structure in place.

---

[9] Orrick, Herrington, and Sutcliffe LLP, *Proposition 9 Threatens Outstanding Bonds Issued To Finance Electric Utility Restructuring* (July 15, 1998). This firm served as bond counsel to the utilities in connection with the issuance of the rate reduction bonds. The potential for state liability is also referenced in a May 22, 1998 letter from Craig Brown, Director of the State Department of Finance, to Justice Robert K Puglia.

[10] United States Constitution, Article I, Section 10, Clause 1; California Constitution, Article I, Section 9.

State liability for retirement could require tax increases or expenditure cuts to fund the principal and interest payments. Proponents of Proposition 9 question whether the state had the authority to make the pledge, claiming it unconstitutionally restricts the actions of future legislatures.

ARGUMENTS IN FAVOR AND IN OPPOSITION

In Favor. Proponents of Proposition 9 claim that AB 1890 requires consumers to subsidize utility companies' investments in assets that are not profitable in a competitive market. They argue that:

- Transition charges and bond repayment surcharges constitute a tax levied on consumers. AB 1890 did not undergo the constitutionally defined process for enacting a tax and therefore is an illegal tax.
- Transition charges that subsidize nuclear power generation account for as much as 30 percent of residential electricity rates. Proponents contend that nuclear power is not essential to efficient and reliable electricity service in California and should be phased out without delay.
- The rate reduction authorized by AB 1890 is not a real rate reduction. Proponents liken AB 1890's rate reduction to refinancing a loan; the debt is not decreased, but merely spread over a longer period to reduce incremental payments.

In Opposition. Opponents argue that Proposition 9 would result in unintended consequences for the electricity market and the state's fiscal condition. They argue that:

- Proposition 9 breaks an agreement between the state, the utilities, and bondholders, and would make the state liable for the $7 billion in rate reduction bond debt, necessitating a combination of substantial tax increases and expenditure cuts.
- Failure to repay the debt could hurt the state's credit rating and lead to interest rate penalties on future borrowing.
- The initiative would produce a less stable electricity market and potentially less reliable electricity service.
- State and local governments would lose significant tax revenues under the measure.
- The utilities contend Proposition 9 will deny them a fair rate of return.

CONCLUSION

The complexity of this particular issue and the nature of the initiative process warrant careful consideration of Proposition 9. If enacted, any significant change would require subsequent voter approval. When evaluating Proposition 9, voters should carefully weigh several key policy considerations:

- Who should be liable for shouldering the costs of deregulation? Consumers? Utilities?
- Is the promise of reduced electricity rates worth placing the state at risk for reduced revenues and, potentially, repayment of the rate reduction bond debt?
- Is the initiative process an appropriate mechanism for addressing a highly complex area of public policy?
- Would passage of the initiative create instability and expose customers to fluctuations in the price of electricity?

The California Budget Project (CBP) neither supports nor opposes Proposition 9. This Brief is intended to help voters reach an informed decision. The CBP is a nonpartisan, nonprofit organization whose goal is to promote a better understanding of state fiscal issues in order to promote a healthy public sector based on a fair and equitable tax system. General operating support for the California Budget Project is provided by grants from the California Endowment, James Irvine, Ford, Annie E. Casey, and California Wellness Foundations and individual donations and subscriptions.