

## **An Overview: How We Got Here**

### ***Historical Look at California's Restructuring of Electricity Regulation***

#### **Influences Leading to the Legislature's AB 1890 of 1996**

The first tentative steps toward altering the way electric power keeps the lights on in California occurred in 1978. In that year, "...frightened by the nation's dependence on Middle Eastern oil, Congress forced utilities to buy electricity from companies willing to produce it with solar panels, windmills, farm waste or factory steam" (Los Angeles Times 12/9/00). Until that federal order, the nation's power companies produced electricity pretty much on their own, and from purely traditional sources such as owned-and-operated fossil-fuel and hydroelectric plants.

In the new environment created in 1978, tradition began to unravel. The utilities were obliged now to buy power as well as produce it. The utilities' cost of doing business soared in California, thanks in part to generous rates the producers of energy from alternative sources were allowed to collect from the three big utility companies that are regulated by the state Public Utilities Commission: Pacific Gas & Electric, San Diego Gas & Electric and Southern California Edison. Together the three serve up three-quarters of the power consumed in California.

As a result of the 1978 federal order, Edison, for one, has said that alternative-source contracts have added \$25 billion to its energy-buying bill since 1985 (LA Times). To provide some relief, a recent PUC decision has given the utilities a break on these contracts by capping the price they pay to providers.

The high prices, in turn, helped spur on the next step toward eventual deregulation. As the utilities passed on their new high costs to customers, industries heavily reliant on electric power complained they were being placed at a competitive disadvantage in national and world markets. As California was trying to weather a severe economic recession in the early 1990s, the complaints of one businessman, a cement-maker in Cupertino, were typical. Earl Bouse told reporters that energy costs were swallowing 25 percent of his income, with his PG&E bill running almost \$900,000 a month (San Jose Mercury News 12/1/00). Trade groups were reporting that retail energy costs in California were running 50 percent higher than in some other parts of the country. It was time, many industry leaders concluded, to see if they could cut the cord with the big three utilities and buy their electricity elsewhere (LA Times).

Meanwhile, the PUC itself was about to recommend change for the three utilities it regulates. In 1993, a 200-page report generated within the PUC, referred to as the "yellow book," spoke favorably of deregulation in response to complaints from industrial customers and to national trends that had seen the deregulation of airline, telephone and savings and loan industries. A year later, another PUC report emerged, this one called the "blue book," that openly declared the regulatory body's intent to "dissolve the old power monopolies and create an open market within two years" (SJ Mercury).

By then, going by the name of "restructuring," the call to deregulate the power franchises had also reached Sacramento. Versions vary on with whom and in what form the idea took root among elected state officials leading to the eventual unanimous approval of AB 1890 (Brulte), which placed in law the creation of a wholesale market for electric power in California for PUC-regulated utilities.

News media accounts on this point present, with minor variations, a sequential interpretation of events:

- Business leaders got the attention of the PUC in calling for the establishment of alternatives to power monopolies.
- This was followed by the PUC declaring its intent to deregulate.
- Those developments were followed by state lawmakers making the case that legislative action was required on an issue of this magnitude, and to mitigate some of the impacts the PUC actions would have on consumers and the environment.

The outcome was passage of AB 1890.

From the San Jose Mercury News: "[Former Governor Pete] Wilson was the driving force behind the historic change."

Philosophically in favor of the free-market aspect of a regulated industry and trying to cope with a deep recession, the governor "seized on deregulation to improve the state's economy." Others, too, were intent on having a say in shaping deregulation, not least the utilities themselves. The utilities were stuck with a list of so-called "stranded costs," largely the tens of millions they were required to invest in nuclear plants and the federally mandated contracts for alternative energy sources. If deregulation was to come, they wanted compensating relief from those financial burdens.

Complicating matters further, the major players were not in accord. PG&E and the big power users—manufacturers—favored one system; Edison favored a British model by which wholesale prices would be subject to a form of quasi-regulation.

In May 1995, Wilson stepped in as broker to resolve the impasse and in August a deal was struck: Power would be bought and sold through a pool (along the lines of the British model), but the big users could buy power outside the pool as well. And—the major carrot for the utilities—their stranded costs, mainly from nuclear power plant expenditures, would be compensated by rate-payers.

These negotiated steps are important because much of their content wound up becoming part of AB1890. In the Legislature, the road to the bill's enactment began with its introduction in the spring of 1996. Then-Assemblyman Jim Brulte carried the bill on behalf of fellow Republican Wilson and major business interests, and it fell to a self-described reluctant Senator Steve Peace, a Democrat, to steer the measure through conference committee hearings. Peace described his role as realizing he and fellow Democrats lacked the votes to defeat the deregulation bill, whereupon he set out to make it "friendly to consumers, workers and environmentalists."

Assemblymember Diane Martinez was, at once, both Peace's critic and a fellow member of his conference committee. She, too, signed off on the committee report, voted for the bill on the floor and was among those photographed with Wilson at the signing ceremony. She agrees with Peace that the bill was the preferred alternative to the version of deregulation that the PUC had in mind.

As reported by the Los Angeles Times, "there was another reason, besides Peace's persuasive powers, that the bill passed unanimously..." That reason was, the newspaper said, the 10 percent rate reduction written into the measure for the 27 million customers of the regulated big three utilities, and the freeze placed on rates that was supposed to last until the spring of 2002. In the end, the paper noted, the utilities made up whatever losses were in store for them from \$7 billion in revenue bonds, thus reducing, by the Times calculations, a 10 percent rate cut for customers to more like 3 percent.

Staff of the California Energy Commission give an alternative interpretation of the genesis behind AB 1890. In this view, it was not the desire of the business community, followed by the PUC, followed by the Legislature and Governor Wilson, that set the conditions in motion for electricity deregulation. Rather, the idea had percolated upward in all three venues at roughly the same time, based on discussions in Sacramento in which Daniel Fessler, who was the PUC's president in 1993-94 and a personal friend of Governor Wilson, often participated. Energy Commission staff recall discussion of the proposal in the Senate Energy, Utilities and Communications Committee, chaired by Senator Peace, in 1995.

Looking back on the principal driving forces for deregulation, Senator Peace's office characterizes the issue in yet another formulation, in part corroborated by the Congressional Research Service in a 1999 paper on deregulation. Under this version, the force that actually changed wholesale electricity distribution from a monopoly to a deregulated market did not emanate from AB 1890. Rather, it emanated from the federal government and from the PUC. Before the Legislature ever became involved, the PUC decided in 1995 to require its regulated entities to buy, rather than produce, a portion of the power they sold to the public. Making that possible were, in turn, federal regulations and specifically the Energy Policy Act of 1992, which "created a new class of private independent generators, subject only to the Federal Energy Regulatory Commission's jurisdiction, and allowed them to sell their power over utility transmission lines to wholesale customers in other areas."

By the time the conference committee chaired by Senator Peace met in August of 1996, the PUC's restructuring plan and its structural elements were a *fait accompli*, the senator's office has said. The Legislature could not have altered the terms of regulation at that point. If it did, Governor Wilson had declared he would veto any such bill.

What *is* attributable to AB 1890, said Peace's office, includes:

- A commitment to the continued flow of environmentally preferable power from renewable sources under a

\$540 million program.

- Recovery of stranded costs to run the utilities' two nuclear power plants.
- Establishment of oversight by the state of the key market entities involved in the buying, selling and distribution of wholesale power—the California Power Exchange, or PX, and the California Independent System Operator, or ISO. The oversight entity is the Electricity Oversight Board, or EOB.
- Modification for public benefit of the PUC version of the make-up and duties of the PX and ISO.
- Funded \$800 million in programs under the PUC to continue supporting investment in energy efficiency, conservation and demand-side management.
- In the new market-driven environment, allocated \$250 million to ensure continued investment in energy technology containing environmental benefits.
- Assured that stranded-cost obligations of large customers could not be circumvented to leave an undue burden on smaller customers.
- Established the rate freeze for utility customers.
- Set up a fraud-prevention function to protect small customers seeking alternative electricity service from electricity marketers.
- Continued provision for low-income customer assistance administered by the PUC.
- Set the 10 percent rate reduction for small customers.

Unfortunately, none of these embellishments to electricity deregulation prevented the present crisis. As the Los Angeles Times reported, electric power customers in California paid \$10.9 billion more in the summer of 2000 than the year before, with much of the money flowing out of state to suppliers enjoying profit increases of 600 percent. The newspaper encapsulated a series of "misjudgments" en route to the fullness of the crisis, including:

- "A gross underestimation of demand as the state's economy came to life after years of recession and ... burgeoning computer-based businesses ate up electricity at rates unheard of in the old economy.
- "A failure to anticipate that energy companies could easily exploit a mechanism designed to ensure the even flow of electricity. By holding back electricity and selling when the system was desperate, they could earn double the going rate.
- "A faulty assumption that deregulation would prompt more competition right away: Hundreds of companies were expected to service homeowners, but they didn't materialize."

Under the scheme that California devised and lived to regret, the Times reported, the price of electricity in California was effectively controlled—and without the ability of state authorities to prevent it—by a handful of plant owners who were unknown quantities in California until five years ago.