Restructuring in the Rearview Mirror – a 10-Year Retrospective of California's Doomed Experiment with Electric Deregulation. By The Energy Overseer

The Half-Baked Rate Freeze

We were talking about the worst cooks we'd ever met. Among the finalists in the bad-cooking Olympics nominated by my spouse was the mother of an ex-boyfriend who, no matter the dish, managed to burn the outside while leaving the middle bloody raw.

Her problem, aside from a chronic case of indifference, was that she took foods from the freezer directly to the pan or oven rack, then turned the heat as high as possible to get the chore out of the way.

A recipe for indigestion, if not food poisoning, and another unfortunate metaphor for the transition to a competitive electric power market in California.

For much of the past four years, we've been obsessed with the rate freeze as a key component of the transition period. Depending on your orientation, the freeze was either a way to protect consumers from price volatility during the transition or a way to prevent them from obtaining the immediate benefit of lower energy prices while letting the utilities collect their "stranded costs."

The freeze provides the ceiling by which we measure the "headroom" mechanism for utilities to capture stranded investments. Costs subtracted from freeze revenues equals headroom, described on bills as a competition transition charge (CTC). When the freeze ended, either by the statutory deadline of March 31, 2002, or sooner if utilities fully capture their amorphous estimates of stranded costs, the world would be different. Overall costs of utility service would be lower because the CTC goes away and competitive commodity energy prices prevail (the Legislature expected a 20 percent rate reduction to result). The barriers to retail competition would be blown away, allowing energy providers to really begin offering price-differentiated services.

Little did we know.

There seemed to be a race to this imaginary finish line. San Diego Gas & Electric declared itself the first utility to cross into a fully competitive market. Look what happened. Rather than providing deep discounts to consumers, the end of the freeze exposed them to the runaway power market. And that was even after a year of thaw, during which there was an interim cap on rates for San Diegans in summer 1999, which turned out to be a mild and moderate season compared to this year.

Most media accounts of the electricity crisis have declared consumers in Southern California Edison and Pacific Gas & Electric territory immune to the adverse prices because of the freeze. We know that is not entirely true. Some large power users on market-based contracts and anyone signed up for direct-access service are also exposed to some degree.

The incredible, some say inexplicable, rise in wholesale prices extends throughout the Western grid, leaving utilities and their customers from Montana to New Mexico exposed to the extent that they rely on spot power purchases.

Now we learn that PG&E and Edison ratepayers could already be on the hook for some of the unpaid power bills. In fact, by some accounts, the utilities may have already paid off their stranded costs and, in the words of a PG&E executive, "the conditions for ending the rate freeze may have occurred."

PG&E hosted a rather contentious media briefing this week to try to explain what is a very complicated situation and to provide context for an emergency filing about the rate freeze and cost recovery recently made to state regulators.

I'm not sure the effort was successful. Despite a direct statement from PG&E's senior vice president for regulatory affairs that "We are not proposing to end the rate freeze," the *San Francisco Chronicle* declared otherwise: "PG&E Pressures State PUC to Lift Freeze on Energy Rates."

Despite protestations that the emergency motion was being made to give regulators and parties a chance to determine what to do about the situation--without determining an outcome for energy-cost recovery--virtually every newspaper and wire service account of the session interpreted it as a filing "to recover from its customers billions of dollars in unpaid power costs," as described by the Dow Jones Newswires.

I'm not saying that's not what PG&E and its shareholders would like to do, but I was there and clearly came away with a sense that this particular filing was being made so that PG&E would not be forced by its interpretation of the law and CPUC rules to declare as much as a $2.7 billion uncollectible debt in its next quarterly report.

Perhaps people were confused by the fact that Edison on the same day made a far more direct attempt to pin the summer energy costs on ratepayers--despite whatever restructuring law AB 1890 says about not violating the freeze on rates.

Back to the tutorial. Under the complex transition accounting rules devised to accommodate AB 1890 are several tracking and balancing accounts through which revenues and costs flow for eventual reconciliation of the stranded-cost recovery effort. Two important ledgers are the transition cost balancing account (TCBA), which keeps tabs on outstanding stranded liability, and the transition revenue account (TRA), which tracks income above expenses and eventually transfers it into the TCBA for recovery by the utilities.

That was the theory. This summer's high energy prices changed things significantly. Because energy prices from the California Power Exchange (plus the related costs from the California Independent System Operator) were higher than the freeze, consumers saw a negative CTC--an amount that was not recovered in monthly bills. PG&E described it as paying $0.18/KWh for energy it could only charge customers at $0.055/KWh. The negative amount, called an undercollection, goes into the TRA and builds each month that wholesale prices exceed retail rates.

Meanwhile, the utilities are collecting the high CalPX prices for suddenly less expensive generation from nuclear plants, hydroelectric facilities and to some extent independent power contracts. An illustration of this premium: more than $850 million for nuclear power alone.

This money is not directly netted against the TRA undercollections but goes straight into the TCBA to pay down the stranded-cost liability.

According to PG&E, before the price spikes and plateau this summer, there was about $4 billion to be collected in its TCBA and a zero balance in the TRA. The premium income drove the TCBA balance down to $1.6 billion at the end of August, and high PX prices pushed $2.2 billion into the TRA. Numbers for September were not available, but figure about $250 million of excess revenues and $500 million of excess costs.

In a recent report to the US Securities and Exchange Commission, Edison reported a similar imbalance at the end of August: $1.329 billion in TCBA (to be collected) and $1.97 billion in undercollected energy costs. September was not yet accounted for.

Ordinarily, the passage of time would allow a netting out of these accounts, leaving each utility a few hundred million dollars shy of balance and more than a year of rate freeze to make up the difference.

So why are they getting so upset? Back to the statement that "the conditions for ending the freeze may have occurred."

Both utilities have plans on the table to either sell or place a premium market value on remaining generation assets. PG&E's hydroelectric assets are worth at least $2.5 billion, maybe more. Edison is attaching a $500 million premium to its hydro, plus it intends to sell its shares of the Palo Verde nuclear plant and Mohave and Four Corners coal plants for about $1 billion.

Accepting these valuations means that the two utilities have already paid off their stranded costs and, if AB 1890 is read literally, the transition period ended sometime during the summer and, along with it, the rate freeze.

Good news, yes? Maybe not. For one thing, our understanding of the value of the rate freeze changed this year. Nettie Hoge of The Utility Reform Network does not want to see consumers thrown into an unprotected, out-of-control power market. "I don't think anyone wants to see the freeze end under these conditions," she told me. Worse, if regulators declare that the freeze ended while wholesale prices were far higher than the retail bills, it is arguable that consumers will be liable for some of the outstanding costs retroactively. "It would be a catastrophe," Hoge said. "We're in San Diego and we don't know it."

PG&E and Edison have a related problem. Under commission rules, they must collect outstanding TRA balances during the rate freeze. Once the timer dings, they have to eat any unpaid costs.

That's what the two emergency motions are trying to do--to change the policy adopted by the CPUC in D99-10-057 and D00-03-058, a policy that squarely puts them at risk for the entire undercollection amount.

Each utility has a different strategy. Edison directly claims that restructuring law never meant that energy costs above revenues would be at risk, and it wants a straight-ahead reinterpretation by the CPUC to that effect. To make Edison pay for the power would be an unconstitutional taking, the utility claims.

PG&E's motion asks for a stay of implementation of the current policy and, oh, by the way, please change the language of policy to state that utilities can carry over costs "other than transition costs" beyond the freeze period.

A subtle difference, perhaps, but one that escaped most of my media colleagues and the president of the commission, who also seems to be interpreting the motions as merely seeking an end to rate-freeze protections for consumers.

So, is there a solution? One way might be to simply declare that the rate freeze extends to the March 2002 date set by AB 1890. Ratepayers are no worse off, the utilities get the chance to let undercollections balance out against overcollections, and everybody has time to work out the problems in the market or declare the whole thing a mistake.

The Legislature is going to be interfering with the market anyway once it returns, and this would at least give lawmakers something constructive to do while allowing them to take credit for shielding consumers.

Let's call it "The Thaw," a commonsense middle step between the frozen and cooked states. It is a compromise, to be sure, but it mediates extreme risks for both the utilities and ratepayers. Deciding exactly how to divvy up the costs and revenues is going to be a contentious proceeding under any circumstances--it's better to do it under a truce.

Otherwise, everyone is in for a really bad case of indigestion **[Arthur O'Donnell].**

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