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

Insecuritization

By the time the California Public Utilities Commission voted on a stopgap electric rate hike for Pacific Gas & Electric and Southern California Edison, financial markets were already punishing the utilities for the crime of diminished expectations. Up until Wednesday's issuance of a draft order specifying the terms of a 90-day $0.01/KWh increase, the market seemed to think that there was some chance that regulators would grant the utilities pretty much what they'd been asking for--complete recovery of their billions of dollars in energy cost undercollections and an end to the transition-period rate freeze.

With a little over an hour of market trading left Wednesday when the draft became public, investors sent the stock prices of the utility parent companies, PG&E Corp. and Edison International, plummeting. The trend accelerated after ratings analysts at Fitch warned that the regulatory response was inadequate and threatened to send the utilities' unsecured debt into junk-bond hell.

On a burst of pent-up sell orders from the night before, prices opened Thursday far lower and kept dropping to lows of $6.25/share for Edison and $8.875/share for PG&E. This was essentially half of the previous low point in the 52-week cycle for the two stocks and a mere fraction of the over $30/share price that set their yearly highs.

Then, almost at the minute that the CPUC approved its order, the stocks began a turnaround-- not recapturing all of the lost value but greatly mitigating the damage. The volume for the day was more than 20 million shares traded for PG&E and about 26 million for Edison.

What caused the turnaround?

Certainly it wasn't a change in heart by Fitch, which had immediately determined the CPUC response to be "wholly inadequate," applied below-investment-grade assessments to the utilities' bonds and also began reviewing all other components of their corporate families for fiscal weakness. Equities analysts joined in, with Prudential Securities actually tagging a "sell" sign on PG&E's stocks. That's an especially harsh response in a world where a downgrade to "neutral" ratings means: "Get out while you can."

The slight changes in the CPUC order to postpone an accounting offset to utility transition-cost accounts was also not a likely cause of optimism. All that did was delay a final reckoning of what the real utility losses might be.

Instead, it was the hint of a promise of state backing for some of the utilities' liabilities that prevented a complete panic in the markets.

Oh, you missed that part of the order? That's not surprising, as it was tagged on at the last moment and only fleetingly mentioned by commission president Loretta Lynch. But it instantly became the thread of hope for a relatively quick infusion of cash to the utilities and a promise of recovery for investors. PG&E even suggested it could take care of up to $7 billion in undercollections through "securitization."

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You've heard the word before. Securitization, like a vampire from the grave, has returned to the marketplace to suck money from consumers. As you might recall, securitization was a creature introduced to California by state Senator Steve Peace. While we cannot pin its resurrection directly on Peace, legislative sources pointed to the trail of slime running from his office in Sacramento.

Securitization of utility debts, in the form of "rate reduction bonds," was one of the biggest mistakes in the original restructuring law AB 1890. In essence, the state stood behind the issue of more than $6 billion in bonds to finance the mandated 10 percent rate discount for residential and small commercial customers over four years. In return, ratepayers were saddled with a repayment plan of 10 years that would require about $10 billion in monthly bill surcharges.

At the time these bonds were approved, it was estimated there would be a net benefit of about $1 billion to consumers. With the current rate hike order, it looks like the final year of rate reductions has dissipated like so many of the other promised benefits of a more competitive marketplace.

This financial sleight of hand put cash in the utilities' pockets and raised the ire of ratepayer advocates. Proposition 9, the failed but spirited challenge to restructuring, was intended to strike the bond obligation. Analysis of the law and securities documents, though, showed that the deal was "irrevocable." Even if citizens broke the contract by passing Prop. 9, the state would probably be on the hook for repayment.

That's what the financial community has been counting on. Some sense that the state of California is going to step in to assure the utilities of cost recovery. It's the whole restructuring scenario all over again. Probably the greatest failure of restructuring was that those creating the rules had made their first priority the viability of the utilities and recovery of "stranded costs" rather than the creation of a truly competitive market.

Saving the utilities has again become the top priority. Meanwhile, not only will ratepayers see an immediate cost increase, but through further securitization efforts, they/we could be tied to a repayment plan over which we'll have little say.

Right now, there are absolutely no details available about such a scheme. No dollar figures suggested and no sense of what the "asset" to be mortgaged will be or how the repayments would be collected.

All we know is that securitization has moved to the top of the pile as a "solution" to the crisis. The word from Sacramento is that legislation is being drafted. If passed, it would be signed by Governor Davis, confirmed a spokesperson for the governor.

The reasons are entirely political. In AB 1890 and related legislation SB 477, which worked out the terms of the rate bonds, the State Infrastructure and Development Bank was authorized to issue up to $10 billion in bonds on behalf of the utilities. Only about $6.3 billion in debt was actually sold. That means that up to $3.7 billion could be financed in relatively short order without much involvement by the Legislature--or the public, for that matter.

The plan might be palatable to the financial community because attorneys will make sure that the same "adequate provisions" language that gold-plated the original rate bonds will put the state at risk for ultimate recovery. The existing bonds are rated AAA, and analysts have said they are unaffected by the current turmoil.

In an early-Friday conference call, analysts from Fitch talked about securitization with some degree of skepticism. Even under the best of circumstances, Fitch's Rob Hornick said, it would take at least three months to float new bonds. In addition, any legal challenge would add delay and uncertainty.

California is a "politically contentious" state, noted analyst Lori Woodland. Ratepayer advocates, joined by Ralph Nader, are certain to put up a fight against new bonds.

But the biggest concern for Fitch analysts appears to be that they cannot say where the money for repayment will come from without substantial rate increases, and the idea--like the rate hike already approved--is just a Band-Aid applied to a major hemorrhage. "Our view is that it may have a positive effect for near-term liquidity," Hornick said. "But it doesn't solve long-term problems" **[Arthur O'Donnell].**

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