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CPUC PROPOSES COMPETITION FOR ELECTRIC UTILITIES AND OPEN ELECTRIC SUPPLY MARKET FOR CONSUMERS

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FESSLER'S OFFICE**

The California Public Utilities Commission (CPUC) today proposed an ambitious plan to reform the way it regulates electric services in California. As part of a two-track strategy for California, the Commission's proposal relies on competition and the discipline of markets to replace often burdensome, administrative regulatory approaches.

Beginning January 1, 1996, the Commission would allow California's large electric consumers to tap competitive power markets, rather than rely solely on the state's investor-owned utilities. All consumers of investor-owned utilities within the state who wished to would have access to these competitive markets beginning January 1, 2002. The CPUC's proposal envisions regulatory reforms designed to enable a utility to compete aggressively to retain and attract customers. In addition, the Commission proposes to replace the state's traditional regulatory framework with performance-based regulation that rewards the utility for superior performance.

The CPUC's comprehensive proposal envisions a measured approach, which neither threatens utility financial integrity nor allows costs to be shifted to residential consumers in response to increased competition. Earnings floors and ceilings will protect the financial integrity of utilities and avoid excessive profits and rates being paid by customers during the transition phase.

Stating that, "Prices for electric services in California are simply too high," the Commission's proposal seeks to put downward pressure on prices, encourage an efficient, environmentally sound

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electric services infrastructure, and enhance California's competitiveness.

The CPUC proposal caps a year-long, intensive study of regulatory reform it initiated in February 1993 with the release of its Division of Strategic Planning's report entitled California's Electric Services Industry: Perspectives on the Past, Strategies for the Future. In this report, the Division recommended a comprehensive overhaul of the Commission's regulation and proposed four reform alternatives.

The proposal released today is based on extensive informal review and comment by over 50 organizations and experts from across the nation and abroad. The proposal is subject to formal review and comment before the Commission adopts final policies in August of this year.

The proposal's first of two tracks taps the competitive market for electric generation in California by offering consumers voluntary, direct access to a range of generation providers, including the utility.

Initially, the Commission proposes to grant consumers who receive "transmission level service" of over 50 kilovolts direct access to competing power providers. The Commission proposes to expand eligibility gradually over six years, until all California consumers of electricity have the opportunity to choose among generation providers beginning January 1, 2002.

Under the Commission's proposal, any consumer, regardless of size, may continue to receive electric service from the utility at prices regulated by the Commission.

The second proposed reform shifts away from traditional ratemaking, which tends to base utility earnings on capital expenditures and recovery of expenses, toward a performance-based regulatory approach designed to reward the utility for efficient operations, management, and investment. The Commission anticipates that performance-based regulation will better equip utilities to develop the tools necessary to make the transition

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from government-directed regulation to an environment in which consumers and the discipline of the market will set prices and meet customer electric power needs.

California's three major investor-owned electric utilities currently have proposals for performance-based regulation before the Commission. A fourth, initiated by Pacific Power and Light, was approved earlier this year. CPUC staff and San Diego Gas & Electric have pioneered performance-based regulation in California with proposals made during the past year.

The proposal also envisions broader access to California's transmission network, and the development of an active electricity spot market and new, tailored products and services - including energy efficiency services - all of which promise to better meet electricity consumers needs.

Initial comments on the CPUC's proposal are due on May 20, 1994 with reply comments due on June 6, 1994. The Commission has scheduled a Full Panel Hearing on June 14, 1994 to hear public comment. If further hearings by the five commissioners are warranted by the nature and volume of public interest and comment, they will be noticed and held before the adoption of final rules anticipated in August 1994.

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California Public Utilities Commission

Proposal to Consider a Restructuring of California's Electric Services Industry

April 20, 1994

The Commission's Goals

- Put downward pressure on electric prices for California's residential and business consumers.
- Position California's investor-owned utilities to compete aggressively in what is an increasingly competitive electric services industry.
- Reduce costly administrative burdens imposed on all parties by California's current regulatory structure.
- Reform California's regulation to reflect and exploit the reality of increased competition in the electric services industry.

How does the Commission's proposal achieve these goals?

- It allows competition to flourish where it already exists by providing consumers direct access to generation markets.
- Where monopoly power persists, it shifts regulatory focus away from line-item accounting toward performance standards.
- It ensures that the utility has the regulatory flexibility necessary to market products and services and compete for market share.
- It ensures nonutility service providers have a fair opportunity to compete in the direct access generation market.
- It ensures that consumers who choose to continue to receive service from the utility do not unfairly bear the costs of increased competition.

The Commission's proposal has two parts.

Part One

Where competition exists, the Commission replaces economic regulation with the discipline of the market.

- On January 1, 1996, consumers who currently receive service at the transmission level (50,000 kilovolts or greater) may voluntarily choose to purchase electricity from alternative providers of generation services. These "Direct Access" consumers may purchase from nonutility power producers, utilities and, brokers, marketers, and other generation service providers.
- On January 1, 1997, consumers receiving service at the primary level may choose to become direct access consumers. Consumers receiving service at the secondary level may choose direct access by January 1, 1998. All commercial customers may choose direct access after January 1, 1999. All remaining consumers may choose generation services from alternative service providers after January 1, 2002.
- Investor-owned utilities continue to provide transmission and distribution service to direct access consumers in a non-discriminatory manner. Utility rates for these services will be based on performance.
- Any consumer may elect continue to be a "Utility Service" customer and continue to receive service from the utility in the traditional manner at prices regulated by the Commission.

Part Two

Where competition does NOT exist, the Commission's proposal replaces traditional cost-of-service regulation with performance-based regulation.

- Performance-based regulation provides stronger incentives for efficient utility operation and investment since utility prices and earnings are based on utility performance judged against a series of benchmarks instead of on utility costs.
- The Commission is currently considering separate proposals for performance-based regulation initiated by the three investor-owned utilities it regulates and the Commission's Division of Ratepayer Advocates. The Commission proposes to pursue performance-based regulation through the utility programs currently under review. The Commission's approach recognizes the different characteristics of the utilities and does not intend to impose a single type of regulation on California's investor-owned utilities.

- The proposals for performance-based regulation will provide utility investors with opportunities to earn returns that are, at a minimum, comparable to opportunities under cost-of-service regulation.
- Performance-based regulation offers utilities the opportunity to develop the skills and tools necessary to make the transition to an environment where consumers and market forces dominate.
- The Commission will not permit the shifting of costs from direct access consumers to the utility service consumers. Direct access consumers continue to pay their share of costs from past, prudent utility investments rendered uneconomic in the transition to a competitive market.

What the Commission's proposal does NOT do.

The proposal does not change the Commission's fundamental duty to protect consumers. The Commission will continue to ensure safe, reliable, reasonably-priced and environmentally sound electric service.

The proposal does not sacrifice the utility's financial integrity or opportunity to earn.

- Performance-based regulation replaces an outmoded regulatory framework.
- Regulatory reforms give the utility the flexibility to compete in the world of direct access.
- The utility will be compensated for uneconomic generating assets developed under the old regulatory bargain.

The proposal does not allow cost-shifting among different consumer groups.

When and how will the Commission issue a final policy?

Comments are due to the Commission on May 20, 1994. Reply comments are due on June 6, 1994.

The Commission will hold a hearing before all five Commissioners to hear comments on the proposal on June 14, 1994. It may choose to schedule additional hearings.

Adoption of a final policy and rules is anticipated in August 1994.

R.94-04-031

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**ORDER INSTITUTING RULEMAKING
ON THE COMMISSION'S PROPOSED POLICIES
GOVERNING RESTRUCTURING OF CALIFORNIA'S
ELECTRIC SERVICES INDUSTRY
AND
REFORMING REGULATION**

FESSLER, PRESIDENT OF THE COMMISSION, CONCURRING:

I join my colleagues today in initiating a vital dialogue respecting the future of the electric services industry in California. The attempt to harness the forces of competitive generation while at the same time aligning the interests of all classes of electric ratepayers and the shareholders of our state's investor owned utilities presents a daunting challenge. Notwithstanding the difficulty, I am persuaded that the challenges addressed by our proposal are, in large part, already upon us. This being so, our task as a society is to adapt to changed circumstances while preserving our social values and aspirations. I thus agree with Governor Wilson that the traditional goals entrusted to this Commission—the assurance that Californians will have access to reliable, least cost and environmentally sound electricity—endure as the bedrock of our policy. They are not candidates for amendment. As a consequence I believe it vital that our proposal be seen for what it is, an altered strategy for the pursuit of constant goals.

In this context I write separately to expose two concerns that will occupy my attention in the months to come. They are: (1) fear that we are about to entrust the well being of California ratepayers to market forces

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which are not containable within our geographic frontiers and may not be congruent with any established governmental jurisdiction; and (2) insistence that we not lose sight of the one feature of what is popularly known as the "English model" that may prove difficult for us to replicate and yet which may be responsible for the success that restructuring effort has accomplished to date. Both are ultimately reliability concerns. The first arises in a macro or industry wide focus; the second in the micro or transactional level.

In the broadest sense any reform must take into account the issue of governmental institutions and their future role in the public/private partnership which must also evolve with altered circumstances. In yesterdecade the industry was contained in vertically integrated utility operations conducted within clearly defined service territories all within the jurisdiction of a host state. In such a climate the primary role for regulating the monopoly provision of a vital necessary fell to the several states and posed little strain on the federal system.¹ Thus the match between economic activity and governmental oversight was precise and well understood. Today, much has changed and the erosion of the integrated monopoly occasioned by both technology and revised conceptual thinking undermines the most fundamental assumptions of a regulatory order which must be changed.

As an abstract proposition I endorse reliance upon the forces of competition and agree that they represent a superior disciplinary force than can be supplied over time by any system of governmental estimate or planning of which I am aware. But to say that the era of command and control has passed does not prompt the conclusion that the generation,

¹I make this statement aware that the movement of natural gas and electricity across states touched upon issues of interstate commerce with the consequent role of the Federal Power Commission and its modern successor.

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transmission and distribution of this vital commodity has passed beyond the interest of society or the governance institutions which it has created to guard those interests. Herein lies a problem which we must surmount. The forces of a competitive marketplace for generation which have eroded the integrity of service territories are neither contained nor are they containable within the State of California. This being said I do not see the solution in the expedient of shifting responsibility to the Federal Energy Regulatory Commission or any other instrumentality of our national government. I reach this conclusion because I deem the market for electricity to be governed by a transmission grid which embraces more than a dozen Western states, two Canadian provinces, and the Mexican states of Baja California Norte and Sud. To describe the market is to depict the political problem. We have no institution or combination of institutions which can easily and effectively monitor industry performance within this market nor police against discrimination, anti-competitive practices, or unfair dealing.

There is an even more pressing reliability concern with bilateral transactions which was the topic of a recent conversation with my colleague COMMISSIONER CONLON which focused on what is popularly termed the "British pool." To my mind the pool is the heart and source of the accomplishments of that reform. A subsequent note from COMMISSIONER CONLON memorialized the major points of our discussion:

To some extent, the pool could be considered as offering a 'bundled' service package of (1) a spot market for electricity, (2) a coordination of transmission services and access, (3) voltage support and system reliability, and (4) back-up power support in case of non-performance by energy suppliers. Absent a government-created pool, a consumer wishing to choose as energy supplier would have to undertake separate negotiations for each of these four services, and the consumer's choice of

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some of these services (such as the transmission path) may impose additional and unanticipated costs on other consumers. Although in the future each of these services may ultimately be separately packaged and priced competitively, it may be unrealistic that each will spontaneously be created during the transition period. Therefore, a pool may minimize transaction costs for those customers choosing direct access as well as eliminating the financial and operational risks that would otherwise be inherent in traditional bi-lateral arrangements between buyers and sellers.

While I may quibble with the assertion that the pool must be created by government, I agree with his observations and wish to develop my colleague's last point for it addresses the reliability issue.

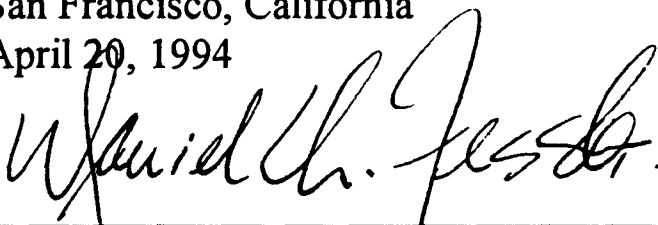
In a recent issue of the *Electricity Journal* I outlined my concern that the substitution of purchased power for generation additions financed, constructed, owned and operated by a utility necessitates that society shift trust in the reliability and availability of that portion of the system from status to contract.² This shift poses particularly pointed implications for me as the only borrowed contracts teacher on this or any other utilities commission. I questioned whether we have in California a legal infrastructure capable of providing timely, informed, principled and predictable declarations of rights and remedial orders when, through circumstance or choice, a party fails, refuses or defectively performs on a contractual undertaking. To the extent that the British pool divorces the arrangements for the physical generation, transmission and delivery of electricity from the contracts which attempt to apportion economic outcomes, my fears of a

²Fessler, FROM STATUS TO CONTRACT: RELIABILITY CONCERNS AND INFRA-STRUCTURE WEAKNESS, 6 *Electricity Journal* No. 7, p. 33 (1993).

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threat to the reliability in the face of inevitable contract failure are substantially reduced.³ Absent such a device, it is my position that we are ill-advised to shift reliance to bilateral contracting which will almost certainly feature parties legally domiciled in differing and distant jurisdictions. In the weeks and months to come I will be interested in the views of others as to whether these fears are factual or fanciful.

San Francisco, California
April 20, 1994



Daniel Wm. Fessler, *President of the Commission*

³Termed "contracts for differences," these private bilateral bargains have as their objective providing price stability over time to parties adverse to bearing the dictates of the spot market. They do not govern the actual physical transaction with respect to generation, transmission or delivery of electricity and thus the breach of a contract for differences occasions no threat to the security of supply. For practicable purposes, all physical transactions are done within the context of the pool. Delay or imprecision in providing a remedy for breach of a contract for differences is a serious matter to the immediate parties but poses little threat to the broader society. Indeed, the transparency of the cost of the commodity makes the calculation of consequential damages a rather straightforward proposition thus avoiding the burdens to the judicial system of having to devise equitable remedies at the insistence of a victim of breach for whom the damage remedy at law has proven inadequate.