November 21, 2001

Hon. Fred Keeley, Chair
Joint Legislative Audit Committee
Room 3152, State Capitol
Sacramento, California 95814

Dear Assembly Member Keeley:

This responds to your request that we provide a fiscal and policy analysis of Chapter 10x, Statutes of 2001 (SB 6x, Burton). This measure created the California Consumer Power and Conservation Financing Authority (hereafter referred to as the California Power Authority, or CPA). In follow-up conversations with Chuck Patillo and Tom Dresslar, we were specifically asked to discuss:

- The basic provisions of SB 6x and the stated intent of the Legislature as to how these provisions should be interpreted and implemented.
- The actions and activities thus far undertaken by the CPA and how they correspond to what the legislation intended.
- Any significant issues associated with the measure as enacted and implemented that may merit review and possible further attention by the Legislature.

We discuss each of these areas below after first briefly providing background information relating to the enactment of SB 6x and other public power authorities in the nation.

Principal Findings

Our principal findings are that:

- *First*, the CPA's activities and accomplishments thus far appear to have been consistent with the general intent of SB 6x, although they have been relatively limited in scope. This in part reflects the CPA's short period of existence.

- *Second*, the CPA's focus has significantly changed since we began this analysis. Specifically:

  - Initially, significant attention was given to building or otherwise acquiring peaker-type generation capacity to provide an adequate electricity reserve margin for next summer.

  - Recently, however, the CPA's interest and focus has shifted to demand-side solutions, such as increased conservation and interruptable programs, as a means to achieve an adequate power cushion during peak-demand periods next summer.

- *Third*, the CPA's required Energy Resource Investment Plan (ERIP) is still in its formative stage. Recently, however, the CPA has taken steps to accelerate its efforts to develop the plan.

- *Fourth*, key issues exist in several areas relating to SB 6x that may merit further review or attention by the Legislature. These areas involve:

  - Basic governance from the legislative perspective, given that it is not represented on the CPA and plays no direct role in the development or adoption of the CPA's energy investment plan.

  - The CPA's financial ability to both accomplish its energy-related objectives and pay for its own operations using the revenue bond mechanism provided for in SB 6x.

  - The CPA's power of eminent domain.

  - Whether the CPA should have a role in the financing of transmission facilities.

  - The basic philosophy and specific elements of the CPA's required energy investment plan for California.

- The future organizational and behavioral interrelationships between the CPA and the state's other energy-related agencies.

BACKGROUND

Over the last year or so, California has faced a rapidly changing electricity market and industry structure. Since California deregulated its electricity generation market in 1996 with the adoption of AB 1890, electricity market conditions and decisions by private parties have largely determined electricity-related pricing, production, and investment policies. This contrasts with the previous environment, where regulatory policies were a significant determinant.

As early as summer 2000, a noticeable tightening of electricity supplies was felt, with energy prices achieving historically high levels and some areas of the state experiencing power blackouts. The problem became worse during the winter as natural gas prices skyrocketed and electricity prices continued to stay high throughout the traditionally low-demand season of the year. Utility-related credit problems complicated the situation, as the state's two largest investor-owned utilities (IOUs) accumulated large debts due to the necessity of purchasing high-priced electricity while being faced with frozen retail rates. Additional blackouts ensued in many parts of the state, and soon after that, the state assumed the responsibility of purchasing the bulk of the state's electricity on behalf of the utilities. This was done through a combination of negotiated sales, purchases on the open "spot" market on which electricity is bought and sold on a daily basis, and long-term contracts. It was in this chaotic environment that the CPA was created by the Legislature and Governor to aid in providing stability and rationality to California's electricity market.

Power Authorities in Other States. A number of other public power authorities exist in the United States. When the CPA was being contemplated, the state-level entity that received the most attention and review in crafting SB 6x was the New York Power Authority (NYPA). Among the nation's various other large state public power authorities are such entities as the Grand River Dam Authority in Oklahoma, the Oklahoma Municipal Power Authority, and the Municipal Electric Authority of Georgia. Federal power authorities include the Southwestern Power Administration and the Bonneville Power Authority in the Pacific Northwest. These authorities and their roles in power markets are briefly described in Appendix A.

BASIC STRUCTURE AND CHARACTERISTICS OF THE CPA

Composition. The CPA is governed by a five-member board of directors, four of whom are individuals appointed by the Governor and confirmed by the Senate. The fifth board member is the State Treasurer. After the initial phase-in period, the board

members will serve staggered four-year terms. The chairperson of the board is appointed by the Governor, three board members constitute a quorum, and three affirmative votes are necessary for actions to be taken by the board. Board meetings are subject to the state's Bagley-Keene Open Meeting Act, and the California Public Records Act applies to all CPA records.

Oversight and Funding. On or before January 1 of each year, the CPA is required to submit to the Governor and Legislature, as specified, a report regarding its activities and expenditures. The CPA's operating budget—including its costs of personnel, administration, and overhead—is subject to review and appropriation in the annual budget act. These costs are to be funded from the proceeds of the revenue bonds that the CPA is authorized to issue under SB 6x (see below). The CPA is permitted to engage in sole-source contracts and is not subject to the normal competitive bidding process that applies to most state agencies. In addition, the contracted compensation for the CPA's chief executive officer and other contract personnel are not subject to any otherwise applicable provisions of the California Government Code and California Public Contract Code.

Auditor's Evaluation. The measure also provides that the Bureau of State Audits report on or before January 1, 2005 on the effectiveness of the CPA in achieving its intended purposes, and recommend whether there is a continued need for the CPA beyond its current January 1, 2007 termination date.

General Powers of the CPA

The CPA was created with the broad charge of assuring a reliable supply of power to Californians at just and reasonable rates, including planning for a prudent energy reserve. In addition, the CPA is charged with encouraging energy efficiency, conservation, and the use of renewable energy sources. In order to meet these goals, the CPA is authorized to purchase, lease, or build new power plants to supplement private and public sector power supplies, and is granted eminent domain powers. It may also finance energy conservation programs and renewable energy projects for businesses and consumers around the state. The financing for these projects is provided by $5 billion in revenue bonding authority, with any bonds issued being secured by the revenues generated from the specific projects being financed by the CPA. In addition, the CPA has also been given the authority to finance natural gas transportation and storage projects that have been recommended by the California Public Utilities Commission (CPUC), as well as to provide financing to retrofit old and inefficient power plants. Finally, the CPA is required to develop an energy investment plan for California (see discussion below).

SPECIFIC PROVISIONS OF SB 6X

The specific provisions of SB 6x fall into four areas—power generation facilities, conservation loan programs, natural gas infrastructure, and energy planning.

Power Generation Facilities

A key power granted to the CPA is to finance and/or build new electricity generation in the state. As noted above, the power generation provided by the CPA is to *supplement* existing generation and provide a *prudent energy reserve* for the state. The CPA has also made plans for investments in renewable energy projects, which is not specifically mandated by the bill. In addition, the CPA has been given the power to provide financing to retrofit and modernize existing plants in order to improve their efficiency and environmental performance.

The bill specifies that all electricity produced by plants financed by the CPA is to be provided to the market at "cost-based rates" and on a "least-cost basis."

Authority Has Wide Latitude. The statute appears to provide few direct limitations on the CPA in meeting its charge to provide for an adequate supply of power at just and reasonable rates. For example, there are no limitations regarding the number, size, and scope of the generation facilities that the CPA can finance. It is our understanding that when language of the sort included in SB 6x is involved, the courts have generally given it a fairly broad interpretation. Thus, subject to the overall requirement that the CPA *supplement* existing power supplies and do so on a *least-cost basis*, broad discretion is given to the CPA in meeting its mandate regarding electricity generation.

The CPA's Role Could Vary Widely. The latitude granted the CPA suggests, in turn, that its direct and indirect presence in California's energy market and the provision of electricity could vary widely, depending on market circumstances and on the orientation and philosophy of the CPA itself. For example:

- The CPA's role might be relatively limited if the electricity market proved stable in the future with adequate supplies and reasonable prices without outside intervention. This might be the case if investments by private and public electricity generators expand California's electricity capacity in line with basic underlying demand, plentiful supplies of out-of-state electricity are available when needed, extreme weather conditions do not result in skyrocketing electricity demand, sufficient long-term contracts exist to avoid short-term price volatility, and ongoing conservation efforts limit demand growth.

- Alternatively, the CPA's role could eventually prove to be much greater if electricity supply-demand imbalances and excessive prices were commonplace. Such factors as inadequate private and public investment in generation facilities, and dramatic price spikes due to excessive reliance on the spot market during supply shortages, could contribute to such an outcome.

As noted previously, the NYPA is the existing power authority that received the most focus when the CPA was first being considered. How the CPA's significance and role will ultimately compare to that of the NYPA is difficult to predict, however, in part due to their differing circumstances. The NYPA, which controls about 25 percent of the power produced in the State of New York, owns interests in hydroelectric, nuclear, and gas-fired generation and generally sells to a specified customer base. In contrast, the CPA's current role is limited to using its revenue bond authority to finance power plant projects that are sufficiently attractive economically to convince investors that the projects' electricity-related revenues under California's rate structure will cover their debt-service costs.

Projecting Power Needs. When making its plans for strategic investments in electricity generation capacity, SB 6x provides that the CPA shall utilize the forecasts for California electricity demand and supply made by the California Energy Commission (CEC) and the California Independent System Operator (CAISO). The CPA is not actually required to adhere to these forecasts under SB 6x. However, the CPA has indicated to us that at this point it does plan to do so. Should the forecasts of the CEC and CAISO differ, the CPA would presumably determine which of these, or some other, figures to use. (It should be noted, however, that the CEC is required to license any power plant over 50 megawatts (MW) of capacity. Thus, the CPA would presumably make sure that whatever forecast is used would provide sufficient grounds for the CEC to approve the facilities involved.)

The CPA has previously noted to us its concern that the electricity forecasts it uses recognize the uncertainties associated with predicting the decision-making behavior of unregulated power generators operating in California's new market environment. For example, under the new deregulated environment, generators are not required to provide electricity to California, but can instead sell to buyers outside the state or decide to not sell at all. It is appropriate that this factor be recognized in whatever forecast the CPA's plan relies on.

Where Will the Money for Debt Service Come From? Given that the CPA's projects are to be funded through revenue bonds, a flow of revenues will be needed to pay the debt service. These revenues will come from electricity sales and in some cases, capacity

charges to provide ancillary services. The latter assures payment for reserve electricity capacity, even if the generator does not actually produce any electricity for sale due to market conditions. In all cases, CPA projects will need to have some type of electricity sales contracts in place before the bonds can be sold since investors will demand a secure payment stream.

- ***What About Using the NYPA's Approach?*** The NYPA recently built peaker plants to address a potential shortfall in electricity this past summer. It is our understanding that the power from these plants was paid for by contracts to provide ancillary services. A NYPA-type financing approach may be an option for the peaker generation facilities that the CPA has been considering (see discussion below), provided an entity is willing to contract for such services. The most prominent electricity buyer in the state's current electricity market is the Department of Water Resources (DWR). Thus, the feasibility of contracts for CPA-related projects could hinge on the extent to which DWR is open to additional long-term contracts, or contracts for additional ancillary services.

- ***Individual Versus Master Power Contracts.*** Power contracts, in theory, could be structured either on a project-by-project or group basis. Regarding the latter option, there has been some discussion regarding a Master Purchase Agreement that CPA could enter into with DWR that would serve as a common or umbrella agreement that would cover all of the generation projects that are undertaken. However, we have been unable to verify exactly how this contract might work and whether investors would find that this mechanism provides adequate security for their bonds

Geographic Location Matters. Power reliability has been an especially critical concern in some parts of the state that have limited or inadequate transmission infrastructure. Specifically, seven areas north of Path 15 have been identified by the CEC as areas that could be short of power if a major generation asset was taken out of service. Therefore, a very important consideration for the CPA when deciding upon new peaker plants is how they will help address the local reliability problems present in some parts of Northern California. In addition, the CAISO has recently provided the CPA with a list of suggested sites for the location of those peakers which address the needs the CAISO sees as manager of the state's electricity grid. The CPA has worked toward addressing this issue by including CAISO transmission engineers and CEC permitting specialists in its internal review process for all new applications for power generation projects.

What Priority Should Renewable Energy Projects Have? As discussed below, the CPA has to date, signed numerous letters of intent for the financing of renewable energy power plant projects. While SB 6x does not preclude investments in renewable energy, it is unclear what priority the Legislature intended in this area. Again, this seems to be a subject over which the CPA has considerable discretion and latitude. The Governor has expressed his goal that renewables account for 17 percent of energy generation by 2005, and the CPA has indicated to us that it intends to work toward this goal. However, in deciding about the role of renewables, several key trade-offs exist and must be evaluated.

- ***Diversification.*** Investment in renewable energy generation provides for increased diversification of the state's fuel base, which some would argue is a positive argument in its favor. This, for example, may provide some security against major supply disruptions affecting individual power sources.

- ***Relative Costs.*** Another issue involves how the costs of renewable technologies compare to those of nonrenewable technologies, an important consideration given the CPA's charge to provide a least-cost supply of electricity. (The statute does not provide specific guidance regarding how least-cost supply is defined. A number of different definitions are possible, which would yield different outcomes. For instance, including environmental benefits and the mitigated risk from a diversified fuel portfolio would expand the number of projects that are considered viable under a least-cost standard.)

- ***Power Reliability.*** Another consideration involves the degree of reliability associated with certain renewable facilities (for example, wind and solar generation technologies), which may not be able to run at full force at the same time that power is needed. If reliability is a central concern, renewable investments must be carefully planned so that there are other resources available when the renewable resources are not. The CAISO has expressed some concern regarding managing the gird with a large proportion of renewable resources if careful planning for the contingencies inherent in these generation sources is not done.

- ***Contract Feasibility.*** Another important consideration involving renewable generating resources (as with peakers) involves the extent to which contracts can successfully be entered into for selling the electricity they produce. The DWR is the primary purchaser of electricity in the state and it is currently uncertain how much additional generation it can contract for under the existing rate schedule. It has indicated to the CPA in written correspondence that it may be able to contract for up to 1,000 MW in additional power from

renewable resources. However, this will presumably depend on the actual costs of the contracts and whether they can be paid for under the existing electricity rate schedule. If not, the feasibility of such contracts could involve negotiations with the CPUC as to whether customer rates can be raised so as to accommodate these contracts.

Given the above, an important decision of the CPA will involve determining how much of its financial resources to direct toward renewable technologies, taking into account the relative importance of fuel diversification, costs to consumers, reliability, and marketability.

Appropriate Reserve Margin. One of the CPA's responsibilities is ensuring an adequate reserve margin of electricity for the state. There has been considerable discussion regarding what an appropriate reserve level should be to avoid price spikes and supply shortages. Existing law does not specify what the reserve level should be. The CPA has indicated to us that it believes that 15 percent is an adequate target, since it was typical of what the utilities planned for before deregulation. In support of this level, the CAISO recently issued a report that indicates that a reserve at this level is adequate to promote a workably competitive market. It should also be noted that the reserve does not have to be comprised solely of new generation, but can also include targeted demand-side mechanisms for reducing electricity consumption.

Conservation Loan Programs

The second broad subject area covered under SB 6x involves renewable energy and conservation. Under SB 6x, the CPA essentially provides an additional source of funds for energy efficiency and renewable programs to supplement the funding for these purposes already provided by ratepayers and other existing funding sources. The ratepayer funding is done through a public goods charge on existing utility bills.

$1 Billion in Bond Funds Provided. Specifically, SB 6x authorizes the CPA to allocate up to $1 billion of its $5 billion in total bonding authority to make loans to programs that provide enhanced energy efficiency or renewable energy capabilities to California consumers and businesses. Under such programs, the CPA provides the financing, while the specific loan programs involved are designed and administered by the CEC, the CPUC, or a local publicly owned utility. Loans are authorized for a broad range of programs, ranging from the purchase of energy efficient appliances to the acquisition of renewable energy installations for business facilities. It should be noted that:

- These programs can be used to improve the state's electricity situation both by improving the energy efficiency of existing power-using facilities or directly reducing power usage.

- The $1 billion in authorized bonds is in addition to any of the remaining $4 billion in bonding authority directed to renewable power generation facilities discussed previously.

How Will the Bonds Be Paid Off? When revenue bonds for energy efficiency projects are used in *state government*, the electricity conservation savings that such projects produce are used to pay for the debt-service expenses on the bonds since utility costs are reduced. However, when the energy efficiency programs are targeted to directly benefit *consumers and businesses*, as under SB 6x, the expectation is that cost savings to consumers and businesses will be used to pay for the bonds. Presumably, this will be accomplished through the loan payments that the consumers and businesses benefiting from the program will be required to make to the state. As noted previously, the bonds will not be a general obligation of the state and their only security will be project-related revenues. Therefore, the loan terms will have to fully account for all factors, including the risk that the business or consumer may default on the loan.

Statutory Clarification Possibly Needed for Certain Demand-Side Programs. There has been some discussion regarding possibly using the bond funds designated for energy conservation programs to finance interruptible-type contracts with the CAISO and other entities. Under such contracts, the bond funds would be used to pay consumers for conserving electricity during critical peak demand periods. Since the current language of SB 6x specifically targets loan programs that require CEC approval, and given that interruptables do not fall into this category, the statute may require clarification to allow for demand-side reduction programs such as the interruptible programs referred to above. Of course, the feasibility of such contracts would also depend on the CAISO or other contracting agencies having the necessary credit to enter into them.

How Should Bond Funds Be Allocated Among Different Programs? Given that there are many different agencies throughout the state that administer renewable energy and energy conservation programs, the CPA will have to establish criteria and priorities regarding how this allocation should be done. The statute does not provide any specific guidance in this area.

Natural Gas Infrastructure

The third broad subject area dealt with in SB 6x involves the authorization granted the CPA to provide financing for natural gas infrastructure projects. However, the CPA is not given the same degree of discretion and autonomy in this area as in the power generation area. The statute mandates that the CPUC, in consultation with the CEC, submit a report that outlines a plan to provide adequate natural gas to the state. This report, which was due the week of November 12 to the CPA but has not yet been

submitted, is to focus on natural gas transportation and storage capacity issues. It also is to provide recommendations on related projects that the CPA could finance if they were deemed to be in the public's best interest. However, this authority granted to the CPA does not preclude the CPUC from directly instructing gas utilities to make needed infrastructure improvements.

What Projects Should Be Financed? The statute does not require the CPA to provide financing for projects recommended by the CPUC and CEC. Neither does it provide detailed criteria or priorities for the CPA to use in determining whether to allocate funds to natural gas projects at the expense of other priorities. Thus, the CPA will need to establish priorities and criteria to make decisions in this area. This includes the issue of whether to reserve financing assistance for projects that are not mandated by the CPUC, versus assisting mandated as well as nonmandated projects.

Energy Planning

The fourth broad topical area covered by SB 6x involves energy planning for both electricity and natural gas over the next decade. The CPA is charged with submitting an ERIP to the Governor and Legislature by mid-February. The plan is supposed to do the following:

- Address issues regarding the adequacy of energy supply, storage, reliability of service, grid congestion, and environmental quality.
- Take into account comparisons of the costs of various energy resources, including a comparison of the costs and benefits of demand reduction strategies versus additional supply generation.
- Consider the potential price volatility of fossil fuels, and the value of resources that avoid this price risk.
- Outline a strategy for cost-effective energy resource investments by the CPA, including changes to the existing expenditure authority of the CPA.

Senate Bill 6x provides that the ERIP is to be developed in consultation with the CEC and CAISO, and is to be approved by a simple majority vote of the CPA. The CPA is to use the plan to guide its investment decisions, and is responsible for ensuring that the plan is implemented. To that end, it is authorized to make necessary energy investments either on its own or in partnership with other participating parties. However, the CPA is not precluded from entering into contracts to achieve its energy-related objectives prior to the completion and adoption of the ERIP. The CPA recently hosted a two-day work session where both state agencies—including the CEC and

CPUC—and private parties made presentations regarding their potential contributions to the investment plan.

Exact Nature and Form of Plan Hard to Predict. Senate Bill 6x gives the CPA broad discretion regarding the ERIP's scope and coverage. Given this, and the relatively short 180-day time frame in which the plan is to be completed and adopted, it is difficult to predict exactly what the plan will look like. In theory, it could on the one hand take the form of a highly detailed, comprehensive assessment of the state's specific energy needs covering such topics as desired resource mix, number and characteristics of power plants, desired reserve levels, transmission plans, and natural gas infrastructure. Alternatively, the plan could in theory take the form of a more general, broad-based discussion of California's energy requirements and the necessary steps for achieving them.

As discussed below, the ERIP is in the developmental stage, with a rough draft outline completed and identification of broad topics to be covered. However, few specifics currently exist. Areas to be resolved include how the plan's policy proposals in the energy area will relate to the proposals and priorities of California's other energy-related entities such as the CPUC and CEC.

Considerations Regarding Other Provisions

Will Bonds Be Tax Exempt?

As noted earlier, the CPA is given the authority under SB 6x to issue up to $5 billion in revenue bonds to accomplish its objectives, including financing its investments and operating costs.

One subject about which we currently have unresolved questions involves what the tax status of such bonds will be. It is our present understanding that although such bonds will be tax-exempt at the state level, their tax status at the federal level will depend on the nature of the financing arrangements themselves. This apparently is due to such factors as the potentially complex nature of electricity generation facilities as "pure public benefit" entities. We understand that how the electricity generated from the CPA facilities is marketed could also influence the tax status of the bonds used to finance them. Another determinant may be whether the bond financing is used to purchase existing generation facilities from private corporations. We are hoping to clarify these issues in the future.

Eminent Domain—Language Merits Review

As indicated earlier, the CPA is granted the power of eminent domain, which allows it to acquire private property for public use. Among other things, this provision

provides the CPA with the broad power to take over privately operated power plants if appropriate criteria are met. Under eminent domain proceedings (also known as public condemnation), public agencies are allowed—under certain conditions and provided that fair compensation is paid to the owner—to take possession of private property for public use. The provisions granting eminent domain powers to the CPA raise certain procedural and administrative issues, as well as particular questions regarding electrical utility property. The presence of these factors may add a layer of complexity that may restrict the CPA's ability to exercise its eminent domain powers in an expeditious manner. Thus, streamlining the eminent domain process available to the CPA may merit consideration. Some options, which are discussed in greater detail in Appendix B, involve:

- The designation of the governing board for eminent domain purposes.
- How best to deal with the up-front payment required to proceed with eminent domain.
- The "more necessary use" requirement.
- The jurisdiction for establishing property valuation.

CURRENT IMPLEMENTATION ACTIVITIES

The statute that created the CPA became operative on August 13, 2001. Since then, the following has taken place:

- The CPA's board of directors, chief executive officer, and chief counsel have been appointed, six public meetings have been held, and approximately $1.5 million in loaned start-up funds have been allocated for the CPA's initial operations.
- A proposal has been submitted for the expenditure of the remaining $8.5 million of the $10 million loan.
- A Request for Qualifications (RFQ) for a financial advisor has been issued.
- The CPA received proposals and signed nonbinding letters of intent (LOIs) to provide financing for roughly 5,500 MW of new peaker and renewable electricity generation. (As discussed below, further contract development for the 3,200 MW of this total that is associated with peaker facilities has been suspended in the wake of the CPA's recent switch of focus to demand-side options for enhancing the state's electricity reserve position.)

- A two-day public forum and a variety of interagency meetings have been held with the CEC, CAISO, and the CPUC in conjunction with development of the ERIP.

Procedures and Processes. In addition, the CPA has adopted detailed protocol for selecting and handling generation proposals. Those projects selected by the board will need to have adequate site control, secured equipment, sufficient transmission access, and fuel access in the case of the peaking power projects to be operational. The CPA also is considering factors such as annual fixed costs, on-line date, location north of Path 15, and the experience of the developer involved when ranking specific proposals for possible approval. Lastly, the CPA has set out a detailed application process that includes as evaluators representatives from DWR, CEC, CAISO, and the Air Resources Board.

It should be noted that there have been recent media reports involving potential conflicts of interest by Navigant Consulting, Inc., a firm that has provided services to the CPA. In particular, Navigant assisted the CPA in evaluating applications for generation projects to be funded by the CPA's bonding authority. Some of these applicants also were clients of Navigant. Our understanding is that the CPA has since terminated its association with Navigant.

Generation Proposals. The CPA received proposals for over 24,000 MW of new electricity generation, including over 19,000 MW for peaking generation and 5,000 MW for renewable generation. It subsequently signed 48 nonbinding LOIs to provide financing for over 2,300 MW of renewable generation, and 31 LOIs for over 3,200 MW of peaker generation. As noted above, however, additional contract work associated with the 3,200 MW relating to the peaker facilities has been suspended. The CPA has indicated to us that, of this amount, it expects only the limited portion capable of alleviating localized reliability issues to eventually end up being financed, given the CPA's recent fundamental change of focus from augmenting generation to reducing demand as the preferred strategy to meeting peak-demand needs.

The 48 LOIs associated with renewable energy projects include wind generation, biofuel, landfill gas, and geothermal projects. Of these, those projects that can be available for summer 2002 will be given financing preference. In addition, to receive financing, renewable projects will need to prove cost competitive with other projects having a similar fuel source (for example, wind or solar). However, we understand that the progress on these projects has also been slowed somewhat recently. This is due both to the CPA's current concentration on demand-side issues and the current uncertainty regarding whether contracts will be available for this power.

Other Activities—The ERIP

The CPA has developed a broad draft outline of what its ERIP will cover. Proposed topics include conservation and load management, gas-fired generation, renewable energy, electric transmission and distribution, natural gas transmission and distribution, natural gas storage, and natural gas production in California. As indicated earlier, a two-day public work session was recently held to discuss various elements of the ERIP and review the potential roles of both state agencies and private parties in developing and completing the plan. During this session, the CPA Board approved the expenditure of up to $400,000 for out-source contracts to provide data and analyses for the plan.

CONSISTENCY WITH LEGISLATIVE INTENT

Our review indicates that the CPA's activities thus far are consistent with the basic purposes for which it was established, as described in SB 6x. As noted previously, SB 6x gives the CPA considerable latitude in determining how to pursue its charge of ensuring an adequate supply of reasonably priced energy, while at the same time considering such factors as the relative costs of different types of energy, the potential price volatility of fossil fuels, and the need for adequate energy reserves.

FISCAL EFFECTS OF SB 6X

The fiscal effects of the measure will depend on the particular actions that the CPA's board and executive officer take in carrying out their designated responsibilities involving financing power generation facilities and other matters.

Direct Fiscal Effects. The measure should involve no direct state costs. This is because the CPA's operating expenses are to be paid for through revenue bond proceeds whose debt service will in turn be funded through such sources as loan repayments from power facility owners, rate payments from consumers of electricity produced by CPA-financed projects, ancillary service charges on electricity users, or some other source related to CPA-financed projects. To the extent that California taxpayers purchase tax-exempt revenue bonds rather than taxable investments, state revenue reductions will ensue (see earlier section for discussion on tax-exempt financing).

In addition, the CPA was granted a $10 million loan from the General Fund in the *2001-02 Budget Act* to finance its start-up. It is presumed that the CPA will repay the General Fund when it sells its revenue bonds. However, based on our discussions with the CPA, it is not clear to us exactly when this will occur. This is because of uncertainties regarding exactly how the revenue stream to pay the debt-service on the bonds will be set up. To the extent that this delays the CPA in issuing its revenue bonds,

the General Fund may not be paid back the $10 million in the current year, and may even need additional General Fund resources in the budget year to continue operations.

Other Fiscal Effects. The measure also will likely result in various indirect and induced effects on state revenues and costs, depending on how the actions of the CPA affect such factors as power rates and investments in power facilities, and thus business profits, consumer spending, and production. The net impacts of these effects are unknown, but to the extent that CPA actions result in a larger and more stable supply of reasonably priced power, positive economic and revenue results could occur. In addition, state savings from lower power costs could result.

LEGISLATIVE ISSUES INVOLVING SB 6X

Based on the information provided above, our own review of SB 6x, and our discussions with other parties regarding the measure and its provisions, there are several areas that the Legislature may find merit its review and possible further attention. Six key areas are:

- ***Governance.*** The Legislature is neither represented on the CPA nor plays a direct role in activities associated with it that are critical to dealing with the state's near-term energy problems and long-term energy future. This includes the development and adoption of the state's energy investment plan.

- ***Financing Structure.*** The CPA's current focus on demand-side management and energy conservation highlights the question of whether SB 6x's revenue bond financing mechanism will enable the CPA to both fund the programs it desires and pay for its own operating expenses. This is in part because a secure and sufficient revenue stream to pay off the bonds must be established, and the CPA itself seems unclear regarding exactly how to provide for this.

  In theory, if the projects being financed make sufficient economic sense, the use of tax-exempt financing and absence of a private-sector profit margin will enable sufficiently high interest to be charged on the CPA's loans to both pay the bonds off and finance the CPA's operations. However, the CPA has yet to put forth hard data to demonstrate that this outcome will result for the projects it has in mind. The problem is complicated by the fact that the CPA currently has no financial officer to oversee and resolve this key issue. Should the current financing mechanism not prove viable, it would somehow have to be augmented for the projects to proceed and the CPA to stay in operation.

- ***Eminent Domain.*** As discussed previously, there are several areas in which SB 6x's language involving eminent domain may merit review to ensure that the CPA's eminent domain powers can be effectively used.

- ***Transmission Facilities***. The CPA was not given the authority to finance transmission line improvements. However, the current solvency issues surrounding the state's two largest investor-owned utilities raise concerns about the financing of major infrastructure improvements to the electrical transmission grid. The Pacific, Gas, and Electric bankruptcy proceeding raises further uncertainties regarding transmission grid upgrades in the near term. This raises the issue of whether the CPA should be looked upon as a viable vehicle for making transmission upgrades in the near term. This could include financing upgrades for Path 15, which links the northern part of California to the southern portion of the state and has been a particular bottleneck in moving electricity around the state through the grid. (It should be noted that there currently is a federal proposal for a $300 million upgrade to Path 15 involving a public-private consortium. The nature and status of this proposal should be a consideration in any decisions made by the state.)

- ***Energy Resource Investment Plan Will Merit Careful Review.*** Given the considerable latitude and discretion granted the CPA in developing and financing its ERIP, it will be important that the Legislature make plans to carefully review the adopted ERIP and its underlying assumptions. This is not only because of the significance of the energy-related policy decisions the plan may contain, but also because of the plan's implications for the state's other energy-related agencies that the Legislature oversees.

- ***Reorganization of the State's Energy-Related Entities.*** Senate Bill 6x states that nothing in the measure shall be construed as obviating the need for reviewing the roles, functions, and duties of other state energy oversight agencies and, where appropriate, changing or consolidating these roles, functions, and duties. The measure further states that to achieve such efficiencies, the Governor may propose a reorganization plan involving these agencies. (These entities include the CPA, CEC, CPUC, DWR, and Electricity Oversight Board.) To the extent that a reorganization plan is not forthcoming in the near future, the Legislature may wish to require that a reorganization plan be submitted at the time the agencies' budgets are being reviewed, to ensure that inefficiencies, unnecessary duplication, and conflicts of responsibility are avoided.

Should you have questions regarding the above information, please feel free to contact Keely Martin Bosler 319-8309 or David Vasché at 319-8305.

Sincerely,

Elizabeth G. Hill

Elizabeth G. Hill
Legislative Analyst

Enclosures

APPENDIX A

INFORMATION REGARDING SELECTED STATE AND FEDERAL PUBLIC POWER AUTHORITIES

The New York Public Power Authority (NYPA) is the largest state-owned public power enterprise, supplying approximately 25 percent of the power requirements of the state.

- The NYPA was established in 1931 by Governor Franklin D. Roosevelt, and was based on efforts that began in 1907 to control the state's hydropower resources.

- The NYPA acts as a public benefit energy corporation that finances its projects through bond sales and repays bondholders with the proceeds of energy sales.

- The NYPA operates 21 energy-generating facilities. These include:

  – Three hydroelectric facilities in western New York that, under state and federal law, sell power to municipalities, cooperatives, other states, and selected industrial consumers.

  – Two additional fossil fuel plants that sell power only to state and local government agencies in the New York City area.

  – Eleven gas turbine peaker plants that operate in the New York City area and are expected to be used only when output from base plants is exhausted. How these plants will participate in the energy market has yet to be determined.

- As a result of existing state and federal agreements governing energy sales, no direct competition exists between the NYPA and private energy providers such as Consolidated Edison at the present time.

The Grand River Dam Authority (GRDA) is an agency of the State of Oklahoma and was created in 1935 for the purposes of hydroelectric power production and flood control.

- The GRDA owns and operates three hydroelectric facilities and two coal-fired generating units.

- Like its New York counterpart, the GRDA serves selected classes of customers limited to municipal utility districts, electric cooperatives, and industries.

Many other state power authorities have been formed by existing municipal utility districts in order to take advantage of economies-of-scale opportunities. For example:

- The Oklahoma Municipal Power Authority (OMPA) was established in 1981 in response to difficult economic and financial circumstances for the state municipal utility districts.

- The OMPA purchased ownership interests in several private energy plants around the state to secure sources of power, and also constructed a hydroelectric plant.

- There exists no market in Oklahoma where OMPA competes directly with private energy producers, since the authority sells power only to its participating municipalities.

- The Municipal Electric Authority of Georgia (MEAG) was formed by 48 Georgia municipalities.

- The MEAG owns four generating plants and owns a share of the state's transmission grid along with the private utilities in the state.

- As with other state power authorities, there is no direct competition between the MEAG and the private utilities in the state.

Federal Power Authorities are generally restricted regarding the marketing of their energy production.

- The Southwestern Power Administration markets the power from 23 hydroelectric facilities only to rural electric cooperatives and municipal utility districts in Arkansas, Kansas, Louisiana, Missouri, Oklahoma, and Texas.

- The Bonneville Power Authority sells power to municipal and investor-owned utilities throughout the western United States.

APPENDIX B

EMINENT DOMAIN PROCEEDINGS

The key issue areas involving eminent domain that are raised by SB 6x include the designation of the governing board for eminent domain purposes, how best to deal with the up-front payment required to proceed with eminent domain, the valuation of seized property, and the "more necessary use" requirement.

The California Public Works Board Is the California Power Authority's Governing Board for Eminent Domain Purposes

For purposes of state government eminent domain proceedings, the Public Works Board (PWB) acts as the governing board and must adopt a resolution of necessity authorizing condemnation. This is the case except for such state entities as the Department of Transportation and the Department of Water Resources, which have been granted specific exemptions to this process. Therefore, if the California Power Authority (CPA) attempts to acquire property through eminent domain, the PWB would need to approve the condemnation. This, in turn, could slow the process, or even cause it to not come to fruition. (The CPA can, however, acquire, lease, or take title to property under its own powers using other means, which do not explicitly extend to eminent domain proceedings.)

Eminent Domain Actions Require Up Front Payment

The law specifies that when property is taken by eminent domain action the owner is entitled to just compensation. In order to ensure that the owner receives such compensation, a bond must be posted by the public agency initiating the condemnation proceedings when the process begins. As noted earlier, the CPA's major source of funding is expected to derive from the issuance of revenue bonds. However, it is unlikely that such bonds could be issued absent a tangible project that generates revenues sufficient to pay debt service on such bonds. In order to carry out such eminent domain proceedings, therefore, the CPA may require some alternative source of funds—at least on a short-term basis. Otherwise, its inability to acquire short term financing, through either the state itself or the financial marketplace, could hamper its ability to successfully engage in eminent domain activities.

"More Necessary Use" Requirement May Raise Complications

Under successful eminent domain proceedings, use by the state of the particular property at issue is implicitly deemed more necessary than alternative uses. Generally, this presumption of "more necessary use" by the state is rebuttable in an eminent domain proceeding. If the presumption of "more necessary use" were rebutted, then the property cannot be taken through eminent domain. Whether the presumption of "more necessary use" by the state has been rebutted would be determined as part of the eminent domain proceedings, and could last for an extended period of time. Given the CPA's sunset date of January 1, 2007, this raises issues of whether CPA-related eminent

domain actions would be timely. An alternative legal standard to the "rebuttable presumption" approach is termed "conclusive presumption." Under this approach, the presumption of "more necessary use" by the state would not be rebuttable, and thus, this standard might be a preferable one to invoke in the case of the CPA.

Property Valuation Is a Key Component of Eminent Domain

Much of the controversy in any eminent domain proceeding involves determining the value of the property being taken. Under the law, the owner of the property is entitled to just compensation, the determination of which is made by the appropriate body. Typically, the court in which the eminent domain proceeding takes place makes this determination. In situations involving utility property taken by a local public entity, however, the responsibility for making such a determination is assigned to the California Public Utilities Commission (CPUC). Under current law, property valuation involving eminent domain actions by the CPA would be assigned to a court. However, the Legislature is granted the power under the California Constitution to assign property valuation proceedings with respect to the CPA to the CPUC through statute. Such an action may merit the Legislature's review and consideration.