November 18, 2002

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative (File No. SA2002RF0022), the Ratepayer Revolt Initiative.

Background

California deregulated its wholesale electricity market—in areas served by the state's investor owned utilities (IOUs)—with the enactment of Chapter 854, Statutes of 1996 (AB 1890, Brulte). The legislation generally applied to the state's three main IOUs—Pacific Gas and Electric (PG&E), Southern California Edison (SCE), and San Diego Gas and Electric (SDG&E). This legislation established a "transition period" during which the retail electricity rates that the IOUs could charge their customers were frozen. The rates were frozen at levels that were intended to be high enough to allow them to both earn a normal rate of return and recoup their "stranded costs" (that is, their costs of previous investments that had become uneconomic due to the lower electricity prices anticipated from deregulation).

Accordingly, when wholesale electricity prices increased to historically high levels in 2000, PG&E and SCE were prohibited from passing along their increased wholesale costs to their customers, as each of these utilities, unlike SDG&E, was still operating under the statutory rate freeze when wholesale electricity prices increased dramatically. The IOUs' growing indebtedness led to credit downgrades, which complicated their ability to buy electricity. To address this problem, Chapter 4x, Statutes of 2001 (AB 1x, Keeley), authorized the state Department of Water Resources to assume a limited-term responsibility for purchasing electricity in the wholesale market on behalf of the state's three largest IOUs.

Prior to the implementation of AB 1x, both PG&E and SCE incurred losses as a result of procuring high-priced electricity during the rate freeze period. It is uncertain what amount, if any, of these losses will be ultimately recoverable from ratepayers through rate increases. Specifically, PG&E declared bankruptcy in April of 2001 and the bankruptcy court has not yet approved a bankruptcy plan that would govern what portion of these losses would be recoverable from ratepayers. In the case of SCE, a settlement agreement between SCE and the California Public Utilities Commission (CPUC)—whereby a portion of its losses is being recovered from ratepayers—is being challenged in the California Supreme Court.

Proposal

This statutory initiative provides that no electricity rate can be set at a level intended to generate revenues to offset losses the IOUs incurred while procuring electricity during the rate freeze period established under AB 1890. Accordingly, the measure applies to PG&E and SCE, since they had not recovered all of their stranded costs and were still subject to the rate freeze when electricity prices skyrocketed. In contrast, SDG&E had already recouped its stranded costs and was no longer affected by the rate freeze established under AB 1890 when the crisis hit. The initiative also specifies that any revenues collected *prior* to the enactment of this initiative by the IOUs for the purpose of offsetting these losses must be rebated to the ratepayers.

Fiscal Effect

One overarching factor that complicates estimates of the fiscal effect of this initiative is the pending court decisions regarding PG&E's bankruptcy and SCE's settlement agreement with the CPUC. These decisions could affect not only the definition of "losses" incurred by the utilities, but also what, if any, of these losses are recoverable from ratepayers. This, in turn, would affect the fiscal impact of this initiative on state and local governments.

We have identified the following three categories of fiscal impacts:

State Administrative Costs

The CPUC would incur administrative costs to implement the measure. First, the CPUC would incur significant consulting, legal, and other administrative costs to determine whether any charges imposed on ratepayers would be required to be rebated to ratepayers pursuant to the measure. In addition, the CPUC would likely incur significant costs to put a process in place to provide the rebates. This process would likely involve a restructuring of future rates.

Based on the correct funding mechanism for CPUC, these administrative costs would likely be funded through an increase in the fees collected from ratepayers. The increased administrative costs (one-time) could range from a few million dollars to several tens of millions of dollars.

Potential Reduction in Bank and Corporation Tax Revenues

To the extent that the initiative would result in a rebate to ratepayers and/or a limit on the future collection of utility revenues to offset IOU losses, the IOUs affected by the initiative would face reduced profits. This would likely reduce the level of state bank and corporation tax revenues. Based on the CPUC's estimates of losses incurred by PG&E and SCE during the rate freeze period, these state tax revenue reductions could total up to hundreds of millions of dollars, likely spread over several years. The amount of the reduction in state tax revenues is uncertain, however, as it depends on what IOU losses are ultimately determined by the courts to be recoverable from ratepayers.

Potential Reduction in Electricity Costs for State and Local Governments

To the extent that the initiative results in a lowering of retail electricity rates from what they otherwise would be (for example, due to a rebate being made to ratepayers by way of a rate reduction), there would be a cost savings to state and local governments within these IOU service areas. Given the uncertainty surrounding how the initiative would be implemented, the annual amount of such potential savings is unknown.

Summary

In summary, the initiative would have the following fiscal effects:

- One-time state costs of potentially low millions to several tens of millions of dollars for administrative costs associated with the implementation of the initiative.
- Potential state revenue losses of up to hundreds of millions of dollars, likely spread over several years, due to reduced bank and corporation taxes paid by the utilities affected by the initiative.
- Potential savings to state and local governments of an unknown amount due to potential reduction in retail electricity rates.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

B. Timothy Gage
Director of Finance