March 18, 2005

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. SA2005RF0054, Amdt. #2-NS), concerning the regulation of California's electricity market.

Background

Provision of Electricity Service. California electricity consumers generally receive their electricity service from one of three types of providers: investor owned utilities (IOUs), municipal utilities, and electric service providers (ESPs). The IOUs are utilities that have a defined geographic service area and a statutory obligation to serve customers in that area. The California Public Utilities Commission (CPUC) regulates the IOUs' rates and terms of service. The ESPs provide retail electricity service to customers who have chosen not to receive service from the utility that serves their area, but instead have entered into "direct access" contracts with ESPs. Under current law, ESPs are only required to register with the CPUC for licensing purposes; their rates and terms of service are not regulated by CPUC, as is also the case with municipal utilities. However, in practice, CPUC in regulatory proceedings has applied certain additional requirements to ESPs (discussed further below).

History of Direct Access. In 1996, California began the process of deregulating its electricity market. The ultimate purpose of deregulation was to allow competition in the electricity market and consumer choice of electricity providers. One of the key elements of deregulation was direct access, in which electricity customers could opt to receive electricity service from the provider of their choice. However, as a consequence of the electricity crisis, the state statutorily suspended direct access, preventing additional IOU customers from leaving IOU service and entering into contracts with ESPs. Under existing law, the suspension of direct access will continue until long-term electricity contracts signed on behalf of IOUs by the Department of Water Resources expire. The last of the contracts will expire in 2013.

Long-Term Procurement Process and Resource Adequacy Requirements. State law directs CPUC to create a long-term procurement process, through which IOUs can enter into long-term electricity contracts with wholesale generators of electricity. Pursuant to CPUC regulatory proceedings, both IOUs and ESPs are required to meet specified resource adequacy requirements to ensure that they will have enough electricity to meet projected demand.

Renewable Portfolio Standard. State law created a renewable portfolio standard (RPS) for California electricity providers. Under this standard, IOUs and ESPs are required to increase their share of electricity generation from renewable sources (such as solar or wind power) by 1 percent per year, up to 20 percent of total generation by 2017. A recent CPUC decision in a regulatory proceeding accelerated the RPS timeline to 2010.

Proposal

Overview of Measure. The initiative addresses five aspects of the state's electricity market: regulation of ESPs, direct access, the procurement process, the resource adequacy requirement, and the RPS.

Regulation of ESPs. The initiative would subject ESPs to CPUC "jurisdiction, control and regulation." However, the measure does not specify the extent to which CPUC would regulate ESP rates and terms of service. The measure does specifically provide that CPUC's regulation of ESPs include the enforcement of requirements related to energy procurement, resource adequacy, energy efficiency, demand response, and RPS. The commission currently regulates IOUs in these same areas.

Direct Access. The initiative would bar any customer currently receiving electricity service from an IOU from switching to an ESP. Customers currently being served by direct access contracts with ESPs could continue to receive electricity service from ESPs, effectively grandfathering in their direct access service. However, a direct access customer who returned to IOU service for more than a brief, specified period would be barred from thereafter returning to direct access service.

Procurement Process. The initiative would codify in law the long-term procurement process that CPUC has adopted for IOUs, and extend it to ESPs. Under the measure, IOUs and ESPs would be required to achieve "the best value" for ratepayers by maintaining a diversified portfolio of electricity from utility-owned generation and contract generation. Additionally, the first priority in procuring new generation would be from cost-effective energy efficiency and conservation programs, followed by cost-effective renewable resources. This "loading order" as it is known has been adopted by CPUC rulings relating to the procurement process.

Resource Adequacy Requirement. The initiative would require both IOUs and ESPs to show that they are able to meet peak demand with adequate reserves to ensure system reliability, as is currently required by CPUC.

Renewable Portfolio Standard. The initiative would accelerate to December 31, 2010, the timeline for IOUs and ESPs to meet the 20 percent RPS, consistent with a recent CPUC regulatory decision. Also, the measure clarifies that once electrical corporations have attained 20 percent of their procurement from renewable energy resources, they shall not be required to increase their procurement from such resources in the following year. Finally, the initiative states that the RPS requirement may be amended by a majority vote of both legislative houses, rather than by a two-thirds vote.

Fiscal Effect

State Administrative Costs to Implement Measure. The initiative could increase state administrative costs in two ways. First, it would increase CPUC's costs to the extent that it begins to regulate ESP rates and terms of service as a result of the measure. Second, it would increase CPUC's costs to the extent that ESP customers return to fully regulated IOU service and, under the measure, would be required to remain under such service. These costs to CPUC could range up to $4 million annually and would be funded by an existing surcharge on electricity usage. In areas in which the initiative codifies existing CPUC practices related to procurement, resource adequacy, and RPS, it would not increase costs to the state.

Uncertain Impact on State and Local Costs and Revenues. The primary fiscal effect of this measure on state and local governments would result from its effect on electricity rates. Changes in electricity rates would affect government costs (since state and local governments are large consumers of electricity) and revenues (since taxes received by governments are affected by business profits, personal income, and sales—all of which in turn are affected by changes in electricity rates).

However, it is not possible to determine the net effect of this measure on electricity rates (and hence state and local government costs and revenues), as the net impact would be influenced by several potentially offsetting factors. For example:

- To the extent that the measure increases regulatory certainty about the structure of the electricity market, the costs of electricity providers may decrease, which would be reflected in lower electricity rates.

- On the other hand, the measure's permanent ban on customers entering into new direct access contracts could result in higher electricity rates over the long term by limiting competition in the retail electricity market.

In either case, the impact on retail rates will be influenced by the specific structure of the regulations adopted by CPUC to implement the measure.

Summary

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

- Annual state costs of up to $4 million for regulatory activities of the California Public Utilities Commission. These costs would be fully offset by fee revenues.
- Unknown impact on state and local costs and revenues, as the measure's impact on retail electricity rates is uncertain.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance