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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

9-11

August 19, 1998

**To:** Board of Directors (Electric Industry Restructuring Ad Hoc Committee--  
Information)  
(Committee on Communications and Legislation--  
Information)

**From:** General Counsel 

**Subject:** Analysis of Proposition 9 - The Utility Rate Reduction and Reform Act

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### **RECOMMENDATION(S)**

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For information only.

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### **EXECUTIVE SUMMARY**

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Proposition 9, which recently qualified for the November 1998 ballot, would increase rate reductions for residential and small business customers of California's investor-owned utilities (IOUs) by an additional 10 percent, prohibit IOU recovery of "stranded costs" associated with nuclear generation, limit recovery of other stranded costs, and require that the IOUs (and not their customers) fund re-payment of tax-exempt rate restructuring bonds issued by the California Infrastructure and Economic Development Bank pursuant to Assembly Bill (AB) 1890, the comprehensive California electric industry restructuring legislation enacted in 1996. If enacted this November, the initiative would result in considerable litigation and uncertainty regarding California's ongoing restructuring of its electric utility industry.

California electric industry restructuring encompasses numerous, complex and technical issues involving billions of dollars. It is not certain whether this initiative, which would unravel only certain aspects of restructuring, will ultimately be sustained. Any bond rating agency uncertainty regarding repayment of these rate restructuring bonds, which were issued by a special purposes trust authorized by the state, may cascade onto financings by California public agencies. The boards of the Association of California Water Agencies and the California Municipal Utilities Association have voted to oppose Proposition 9.

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### **DETAILED REPORT**

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Metropolitan's board has previously been briefed on AB 1890, the comprehensive California electric industry restructuring legislation enacted in 1996. AB 1890, which was largely based upon a 1995 decision of the California Public Utilities Commission (CPUC), established two non-profit public benefit corporations, the California Independent System Operator Corporation (ISO) and the California Power Exchange Corporation (PX). California's restructured electric utility industry commenced operations under the ISO and PX on March 31, 1998.

In exchange for the IOUs' agreement to implement direct access, whereby IOU retail customers are afforded the opportunity to choose their energy supplier, AB 1890 also provided for IOU recovery of a non-bypassable Competition Transition Charge (CTC) on all retail customers until December 31, 2001. Funds collected under the CTC defray the IOUs' "stranded costs" associated with prior investments in power plants, including nuclear power plants, and high-priced power contracts. It is not anticipated that these resources will produce competitively-priced generation under prevailing market conditions.

Additionally, AB 1890 imposed a mandatory 10 percent rate rollback through 2002 for residential and small business customers of the IOUs, but permitted the IOUs to finance the rate rollback through funds realized from issuance of rate reduction bonds by a state-sponsored special purposes trust, the California Infrastructure and Economic Development Bank. AB 1890 provided that the bonds would "not constitute a debt or liability of the state or of any political subdivision thereof, other than the financing entity, and [would] not constitute a pledge of the full faith and credit of the state or any of its political subdivisions, other than the financing entity," and required that the bond contain a statement to that effect. AB 1890 also provided that the financing orders permitting issuance of the rate reduction bonds and the CTC amounts approved by the CPUC (which provide collateral for the bonds) are "irrevocable" and further provided that the state would "neither limit nor alter" the CTC or financing orders until the bonds are discharged. Approximately \$6 billion in rate restructuring bonds have been issued.

The Utility Rate Reduction and Reform Act, Proposition 9, has three primary goals: (1) Prohibition of any CTC recovery of costs associated with nuclear generation facilities and limited recovery of other CTC costs; (2) Mandatory 20 percent rate reduction for certain IOU retail customers; and (3) Imposition of the rate reduction bond repayment obligation on the IOUs, rather than their customers. Each of these goals is described in greater detail below.

Each of the three large California IOUs has invested in nuclear power plant facilities, and a substantial portion of their "stranded costs" is linked to such investment. Indeed, the California Energy Commission estimates that the IOUs' stranded nuclear investment costs may be as high as \$5.9 billion. Proposition 9 would prohibit IOU recovery of such costs through the CTC, and would limit unconditional CTC recovery to costs associated with renewable, non-nuclear generation facilities and Qualifying Facility (generally, small energy recovery and environmentally benign power plants) power purchase contract obligations. An IOU would be unable to recover the costs of other non-nuclear generation plants and related assets and obligations through the CTC unless it is able to demonstrate to the CPUC that denial of such recovery would "deprive it of the opportunity to earn a fair return." This aspect of Proposition 9 is one of the most problematic, in that three prior CPUC decisions approved IOU rate case settlements involving their nuclear investments, and specifically authorized IOU recovery of such costs under separate schedules. It appears doubtful that an appellate court would effectively nullify the prior CPUC orders for which appeal rights have long since lapsed and in which the IOUs would presumably assert a property interest.

Proposition 9 would also mandate that the IOUs provide an additional 10 percent rate reduction for their residential and small business customers beyond the initial 10 percent required under AB 1890 for an indefinite period. While such customers would clearly benefit from this provision if Proposition 9 was enacted, the IOUs would presumably seek to impose additional costs on or increase existing costs to their commercial, industrial, and wholesale customers such as

Metropolitan to compensate for the diminished revenues accruing from the minimum 20 percent rate rollback.

Finally, Proposition 9 would prohibit the IOUs from recovering the cost of rate reduction bonds from "any electric utility customer." The enforceability of such a provision is highly debatable. While AB 1890 expressly provides that the rate reduction bonds will not constitute a state liability, it also provides that the state will "neither limit nor alter" the CTCs nor the financing orders permitting issuance of the bonds. Proposition opponents argue that enactment of Proposition 9 would result in state liability for the bonds, notwithstanding their express disclaimer of such liability, because such enactment would constitute state impairment of a private obligation which impairment is prohibited under both the federal and state constitutions. Even if this provision of Proposition 9 is ultimately invalidated by the courts, it could have an unsettling or adverse effect upon bond rating agency review of subsequent California public agency financings because of a perception of increased risk accruing from such financings.

The California Municipal Utilities Association (CMUA) Board has voted to oppose Proposition 9. CMUA anticipates that enactment of Proposition 9 may cause the Legislature to revisit electric industry restructuring legislation. When AB 1890 was enacted, CMUA was able to persuade the Legislature to allow California's publicly-owned electric utilities the option of deciding for themselves when and whether to participate in the ISO and implement direct access. CMUA is rightfully concerned that, given the steady drumbeat for direct access in other states and at the federal level, it might not be successful in preserving such options if the Legislature again addresses restructuring. Additionally, CMUA believes partial repeal of AB 1890 will frustrate efforts to grandfather California's landmark electric industry restructuring in the face of proposed federal restructuring legislation. Finally, CMUA is concerned about the impact of Proposition 9 upon California public agency financings. Recently, the Association of California Water Agencies also voted to oppose Proposition 9 based upon its concern that its enactment would "throw California's emerging deregulated energy market into chaos," and could adversely impact local government financing of infrastructure improvements.

Proponents of Proposition 9 include Harvey Rosenfeld (who successfully spearheaded the insurance premium rollback initiative, Proposition 103), and consumer groups such as The Utility Reform Network and Consumers Union. Its opponents include the IOUs, the California Taxpayers Association, the California Chamber of Commerce, the California Organization of Police and Sheriffs, and the California School Employees Association. The latter groups have expressed concern that enactment of Proposition 9 would saddle the state with liability for the rate reduction bonds and thus reduce available funds for police protection and education expenses. The State Director of Finance has concluded that, if Proposition 9 was enacted and upheld, it would likely result in a net loss of as much as \$100 million in tax revenue to the state and local governments based upon diminished IOU income and lower utility rates subject to tax. This diminution would be partially offset "potentially in the tens of millions" by more discretionary consumer income available for spending or saving, and thus taxation.