

ATTACHMENT B

REGULATORY BACKGROUND

REGULATORY AGENCIES

The Federal Energy Regulatory Commission (FERC) regulates the transmission of natural gas, oil by pipeline, and the transmission and wholesale of electricity; licenses and inspects private, municipal, and state hydroelectric projects; and oversees environmental matters related to interstate commerce. FERC oversees wholesale electric rates and service standards, while retail electric sales (i.e., sales to end-user customers such as homes and businesses) are regulated by states, in California, by the CPUC.

The CPUC regulates safety, service standards, and rates paid annually to privately owned and operated natural gas, electric, telephone, sewer water, steam, pipeline utilities, and transportation utilities. In terms of the electric industry, the CPUC has maintained two economic goals: (1) to protect rate payers from excessive rates; and (2) to provide utilities revenue so that their facilities are managed adequately and their shareholders earn a reasonable rate-of-return. The CPUC sets electricity rates by balancing these principal goals. Restructuring will change the role of the CPUC in yet-to-be determined ways.

The California Energy Commission (CEC) is responsible for forecasting future energy needs and keeping historical data on energy; licensing thermal power plants with over 50 Megawatts (MW) generating capacity; promoting energy efficiency and conservation; developing renewable energy resources and alternative energy technologies; and planning for and directing state response to energy emergencies. The CEC has been given additional responsibilities in managing renewable resources and public-purpose programs and allocating CTC-exemptions under AB 1890.

REGULATORY HISTORY

Power plants and transmission lines in California have historically been constructed and operated by IOUs and municipal utilities with identified service areas. Under the oversight of the CPUC, IOUs construct new energy facilities, as appropriate, to respond to the needs of customers in their service areas. Because these electricity service providers are monopolies, they are closely regulated and most actions and operations are authorized or reviewed for reasonableness. Electricity costs to utility customers are determined through regulatory rate-making decisions of the CPUC, which sets "bundled" rates for the entire "bundle" of services (including transmission, distribution, metering, billing, and reliability), based principally on the costs of generating and delivering electricity for each applicable utility.

Competition in the electric utility industry has developed over the past two decades. Table B.1 outlines major regulatory actions that have recently affected the electric utility industry. The Public Utility Regulatory Policy Act (PURPA) opened the electricity industry to competition in 1978. Emerging at a time when the availability of future energy supplies was in question, PURPA was designed to create a market for innovative electric technologies that were either renewable or more efficient than the existing, large, centralized oil technologies. In 1992, the Federal Energy Policy Act (EPAct) established a long-term vision for the nation's electric services industry. EPAct envisioned greater market competition. States and regions were given the responsibility of implementing policies and programs aimed at achieving this vision.

In the early 1990s, the FERC mandated open access in wholesale electric transmission throughout the United States, which made it realistically possible for the first time for major U.S. electric customers to bypass their local utilities for cheaper providers and encouraged efforts by large California customers to bypass prevailing high IOU electric prices. On December 20, 1995, the CPUC issued its *Preferred Policy Decision*, D.95-12-063 as modified by D.96-01-009, describing its determination to embrace market competition in the provision of electric services and to offer retail customers choice and flexibility in energy services. This *Preferred Policy Decision* called for the establishment of a statewide independent system operator (ISO) to control and operate the state's electric transmission system, and the creation of a wholesale power pool, or "Power Exchange" (PX), as a market for electric power. The goals of the *Preferred Policy Decision* were, secondarily, to provide retail customers with greater choice in electric services and to foster price competition among energy generators, so as to achieve the primary goal of reducing the high IOU electric rates in California. Under this restructured electricity system, consumers would have greater control over the services they receive and the prices they pay. The deadline set for commencement of the new competitive ISO/PX electric market was January 1, 1998.

Under the *Preferred Policy Decision*, the CPUC directed two of the three IOUs, Southern California Edison Company (Edison) and Pacific Gas and Electric Company (PG&E), to submit a voluntary plan to divest at least 50 percent of their fossil-fuel generating resources. Prior to divestiture, the utilities must file applications for review and approval by the CPUC under Section 851 of the Public Utilities Code.

On September 23, 1996, the Governor of California signed into law Assembly Bill 1890 (AB 1890), which turned much of the CPUC's preferred market structure (described in its *Preferred Policy Decision*) into a legislative mandate requiring the restructuring of the electric utility industry in California. Specifically, the enactment of AB1890 mandates, among other things:

- mandatory unbundling of transmission, distribution, and generation service;

TABLE B.1: RECENT ELECTRIC INDUSTRY REGULATORY DECISIONS AND BACKGROUND INFORMATION

| <u>Regulatory Action</u> | <u>Date</u> | <u>Description</u> |
|---|---|---|
| Public Utility Regulatory Policies Act (PURPA) | 1978 | Initiated limited competition in the electric industry. Designed to create a market for innovative electric technologies including either renewable or more efficient systems. Conservation and rising costs were the basis of PURPA's enactment. Intended to reduce the demand for traditional fossil fuels. |
| Federal Energy Policy Act (EPAct) | 1992 | Goal was to promote greater competition in bulk power markets and to expand FERC's authority under the Federal Power Act to approve applications for transmission services and other related power services. EPAct encourages implementation by state and local governments. |
| CPUC issued report titled <i>California's Electric Services Industry: Prospectives on the Past, Strategies of the Future</i> | April 1992 | Concluded that current regulation is no longer compatible with circumstances facing the electric industry. Recommended four strategies for reform, including restructuring of the regulated electric industry. |
| CPUC Rulemaking and Investigation (R.94-04-031/I.94-04-032) | April 20, 1994 | The CPUC's vision for restructuring, identified in the Rulemaking, supports the following: <ul style="list-style-type: none"> • consumers should enjoy the benefits of a competitive electric industry; • California consumers should enjoy direct access to an efficient environmentally sound industry; • competitive electric services should contribute significantly to growth, productivity, competitiveness, and job creation for the state's economy; and, • California consumers should enjoy access to a basic and affordable package of electric services. |
| Assembly Concurrent Resolution (ACR) 143 | August 31, 1994 | Established the joint Oversight Committee on Lowering the Cost of Electric Services and overseeing electric restructuring policy proposals. The Committee is responsible for ensuring reliable supply of electricity. |
| CPUC <i>Preferred Policy Decision</i> (95-12-063, as modified by 96-01-009) | December 20, 1995, modified on January 10, 1996 | Identified the CPUC's preferred policy as consisting of a Power Exchange (PX), Independent System Operator (ISO), phased-in direct access, and other elements. |
| CPUC Roadmap Decision | March 13, 1996 | Procedural Plan for achieving transition to a restructured electric service industry serving California consumers. The decision focused on tasks that must be accomplished to meet the implementation goal of no later than January 1, 1998. |
| FERC Order 888 <i>Promoting Wholesale Competition Through Open Access Nondiscriminatory Transmission Services by Public Utilities</i> | May 1996 | <ul style="list-style-type: none"> • Established recovery of stranded costs; • defined mechanisms of achieving transmission access and specifies that any transmission utility must provide transmission services to others upon request; • defined Independent System Operator (ISO); • stated functional unbundling of transmission services should proceed. |
| Assembly Bill (AB) 1890 | September 1996 | Enacted electric utility restructuring much in-line with D.95-12-063 and removed the restructuring policy from CPUC review under the California Environmental Quality Act (CEQA). |
| CPUC Decision 96-12-075 | December 1996 | Halted preparation of Environmental Impact Report (EIR) for the electric industry restructuring. |

- the formation of a California Power Exchange (PX) by January 1, 1998;¹
- transfer of transmission scheduling, dispatch control, and responsibility for maintaining system reliability for the IOU systems to an Independent System Operator (ISO) by January 1, 1998;²
- a rate freeze and 10 percent residential rate reduction in 1998, financed through revenue bonds, and a policy goal of a 20 percent reduction for residential and small commercial customers in 2002;
- mostly non-bypassable Competitive Transition Charges (CTCs) to ensure recovery of uneconomic "sunk" generation costs which were previously incurred and found reasonable by the CPUC, but the recovery rate of which will be placed in jeopardy by the advent of the new, more competitive direct-access electricity market;
- phased-in direct access for all customers;
- some form of market valuation for utility-owned fossil generation by 2001, followed by an end to cost-of-service rate-making for most plants; and,
- funding of public purpose programs including renewable energy resource programs, energy efficiency programs, and research, development, and demonstration activities.

While AB 1890 does not mandate the divestiture of any generating facilities, it added Sections 362 and 363 to the Public Utilities Code. Section 362 authorizes the CPUC to allow plant divestment to mitigate market power. Section 363 requires that any plant a utility sells that remains on line shall be operated and maintained by the utility for two years after the sale under a reasonable operation and maintenance (O&M) agreement. AB 1890 will mean that those facilities will be operated according to market-based influences and will no longer operate under the traditional CPUC regulatory system. However, divestiture will better ensure that competitive market forces will dominate.

¹ The Power Exchange (PX) will act as a marketplace in which electric generators and suppliers will compete to meet customer needs for electric energy. FERC will have jurisdictional authority of the PX's operations. The PX will provide a market for electric power. Participation in the PX will be voluntary for all buyers and sellers other than IOUs. Until December 31, 2001, the IOUs and the owners of "must-run" generating facilities will be required to bid all of their generation into the PX. All IOU customers will be required to purchase electricity through the PX.

² The Independent System Operator (ISO) will coordinate the scheduling and dispatch of electricity and will ensure that reliability of the electric transmission system is maintained. The ISO will control and operate the state's transmission system to schedule delivery of electric power supplies and ensure that all standards for transmission service are met. The ISO will charge a FERC-regulated tariff to cover the cost of operating the system to ensure reliability. Any individual who meets the reliability standards established by the WSCC and CPUC can ship on the system.