

Demystifying The Deregulation of Electricity in California

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For many electricity purchasers, confusion still surrounds electricity deregulation in California. Many are asking "what's in it for me?" Others are bewildered and unable to evaluate offers from new "electricity service providers" that claim to produce big savings from current electricity bills. Before switching electricity providers, entering into a new electricity contract, or executing a long term contract, certain basic issues should be considered.

Deregulation began in California with the passage of Assembly Bill 1890 signed into law September 26, 1996. AB 1890 did not eliminate the traditional electricity tariff structure, but it did endorse new methods for buying and pricing electricity (which is only one portion of an electricity bill) as well as entering into electricity contracts. It also established a new Power Exchange ("PX") and Independent System Operator ("ISO"), both being governmental authorities. AB 1890 did not create immediate competition in all aspects of the industry. Competition will begin with the pricing of the electricity itself, as opposed to the cost of transmitting and distributing the electricity, and providing certain ancillary services such as metering and billing. New issues will continue to arise that are not addressed in the contracts that are executed today as deregulation is implemented in successive phases.

While deregulation is mandatory in the first few years for only six of the seven investor-owned utilities in California, these utilities actually represent over 80% of California's \$23 billion dollar electricity market. Electricity purchasers located within a municipal utility's service area (e.g., Los Angeles Department of Water and Power) must wait until their utility elects to opt into the deregulated environment before they can enter into the "direct access" arrangements discussed below.

NEW PRICING OPTIONS

In the past, the highly complex nature of the generation, transmission, and distribution of electricity has rarely involved written consumer contracts. Instead, most electricity consumers purchased electricity by simply calling their local utility and arranging a hook-up date. In effect, the tariffs filed with and approved by the California Public Utilities Commission ("PUC") established the "contract" between the utility and the customer. Since most consumers do not read those tariffs, they are unaware of what the new energy contracts should address.

Electricity Service Providers

The new electricity service providers ("ESPs") further complicate matters. While a current utility company is a known commodity, most purchasers are not equipped to judge a new provider's capabilities, including its ability to manage the many steps between the generation of electricity and the customer's meter. Consequently, a purchaser may not know what questions to ask the ESP or, more importantly, what representations, warranties and covenants these providers should have in their contracts. The initial rules of the PUC did not require proof

of financial, technical, or operational capabilities. Since the PUC is still developing those rules, a purchaser cannot rely solely on the provider's PUC registration status as evidence that the ESP is fully capable of performing the services it proposes. Financial and operational capabilities are only two of the issues that have emerged as the state moves further toward deregulation. Purchasers must therefore learn about the industry and ask important questions of any ESP they are considering.

Direct Access

The most dramatic change under the new law allows purchasers the choice of buying their power from their current utility (sometimes under new pricing arrangements), or from another entity under a "direct access" arrangement. Under direct access, the purchaser buys power directly from a power generator or from an ESP that buys power from others instead of generating the power itself. In this instance, a generator that enters into a direct access arrangement is also an ESP.

Unless the electricity is purchased "over the fence" (using a dedicated electricity line running directly between the generator and the customer), direct access arrangements will still involve a customer's local utility. Local utilities will continue to own and operate the local electricity lines that distribute the electrical power to the purchaser on behalf of an ESP. The new provider or the customer must pay a separately itemized charge for that distribution service.

The Independent System Operator

Direct access transactions may also involve utilities outside the purchaser's service area. If the ultimate source of the electricity (the generator from whom the electric service provider purchases the electricity) is located outside the purchaser's immediate distribution area, the ESP must use high voltage transmission lines to transport the power to the local distribution area. Separate itemized charges must be paid for those transmission lines.

Transmission line usage also requires the ESP to schedule in advance how much electricity it will need to transmit and at what times. Under the new law, the newly created Independent System Operator ("ISO") now handles that transmission scheduling, instead of the utility company that owns the transmission lines (although a transmission fee must still be paid to the owner of the transmission line). Since electricity usage tends to fluctuate and, more importantly, cannot be stored, scheduling transmission efficiently is critical. If the ESP fails to schedule sufficient transmission access, the power used by its customers will come from other sources. Someone will have to pay that other standby source a fee for that electricity, undoubtedly at a rate higher than the standard rate in the direct access agreement. Even if the provider agrees to absorb the cost of the alternative standby energy, its actual ability to do so might be overwhelmed if the ESP does not have sufficient knowledge and experience in the industry.

The Competition Transition Charge

New pricing options are also available to customers that do not switch from their current utility. Electricity rates for residential and small commercial customers (those with peak demands of less than 20 kilowatts) automatically decreased by 10% on January 1, 1998 and will decrease by another 10% on January 1, 2002. The new law mandated those reductions and created a state bank to issue bonds to finance the reductions. All other rates have been frozen at 1996 levels in order to allow recovery of what is called the Competition Transition Charge ("CTC"). During that rate freeze, electricity payments will be applied to both (i) the utility's cost

of electricity (as determined by the Power Exchange), and (ii) the CTC. As that Power Exchange price fluctuates, the amount of the transition charge will automatically adjust until all allowable transition charges are recovered. While short-term prices will be higher than in full competition, the transition period has been shortened from 10-15 years to 4 years, to benefit consumers in the long run.

The competition transition charge or CTC is designed to allow utilities to recover their "stranded costs" on an accelerated basis. These are costs for utility investments and long-term contracts that will no longer be competitive in the deregulated environment. Prior to deregulation, stranded costs were amortized and included as a component of the per watt electricity charge in tariffs approved by the PUC. If the utility companies were not allowed to recover these costs on an accelerated basis, they would have to continue to be added to electricity costs during the entire amortization period (resulting in higher electricity prices for more than four years).

Significantly, the CTC must be paid even if a customer switches from its current utility to an ESP. With few exceptions, the Competition Transition Charge will be charged to all customers that were being serviced by the utility when deregulation went into effect. Consequently, if a purchaser switches to a direct access contract and fails to use the right pricing mechanism, the total cost of electricity plus CTC could be higher than if they did not switch.

The Power Exchange

The Power Exchange ("PX") will set electricity prices through an electricity commodity exchange. Deregulated utilities must sell all the electricity they generate to the PX, then buy it back at the price established hourly by the PX through its bidding process. Cost is highest during hours of highest demand. While most utility customers will pay a price equal to the 24 hour average hourly price, some may elect to purchase power at the hourly PX rate because of their ability to use more power when the hourly rates are lower. This rate option requires an interval meter to measure the hourly electricity usage.

Aggregation

Purchasers with more than one business location also have the option of "aggregating" those locations into one bill with one ESP, a process expressly authorized by the new law. Companies such as retail stores, supermarkets, mini-marts, real estate management companies, landlords, hospitals or other businesses with several locations may increase their bargaining power by aggregating their electricity bills. Other benefits of aggregation include lower overhead costs associated with processing multiple bills. Aggregation may also be available through trade groups of related companies or through ESPs formed specifically to allow many separate companies to aggregate their electricity purchases. Effective aggregation requires extensive attention to contract detail in order to ensure not only cost savings but that the needs of each individual company are met.

DIRECT ACCESS CONTRACT ISSUES

While there are many issues to address in a contract with an electricity service provider ("ESP"), the following concepts should be considered as elements of any direct access contract:

Pricing terms should guarantee a total cost of electricity plus Competition Transition Charge that is lower than the local utility's price. One approach would grant a right to off-set future payments to the extent the pricing guarantee is exceeded, or an early termination right.

For customers who want more power during non-peak hours, timing of demand or hourly pricing should be used.

The contract should specify which party will be responsible for paying for standby power if the ESP fails to schedule adequate power for the purchaser.

All billing services that will be provided should be clearly explained. For example, will one bill do for all the customer's electricity related services, or does the customer want to receive a separate bill from the local utility for transmission, distribution and related services? Will usage information be provided electronically on an hourly basis?

Contracts should specify which party will be responsible for the cost of installing any new meters and electronic communications.

A remedies and termination provision should provide protection to the purchaser if the ESP defaults.

The purchaser should be allowed to switch to a different electricity service provider or back to the local utility company in its service area.

Parties entering into direct access agreements should also establish that the ESP:

- has entered into a service agreement with a scheduling coordinator ("SC") certified by the Independent System Operator (ISO) or that the ESP has obtained its own SC certification from the ISO;
- has not received any notices of violation or default under its contracts with local utilities or SCs; and
- has met the credit-worthiness requirements currently under development by the PUC.

Purchasers should also verify that the ESP has sufficient electronic interfaces to make all necessary communications with the utility company in the applicable service area, the source from which it purchases its power, and all transmission wheels between the point of generation and the local utility distribution system. It must also be able to communicate meter reading and usage data. Some of the above items may be addressed in agreement-specific representations and warranties.

Conclusion

Much like life, with the passage of AB 1890 nothing valuable is gained without effort. While purchasers that will benefit the most from deregulation are undoubtedly the largest electricity users with the greatest market power to negotiate cost-savings, any well-informed purchaser can reap benefits. More importantly, purchasers who enter direct access contracts without a full understanding of the risks involved may well increase their overall costs and generate contract disputes. Several consultants can provide audits of energy usage and new alternatives available under deregulation. Information is also available on the PUC website (<http://www.cpuc.ca.gov>) or the California Energy Commission website (<http://www.energy.ca.gov/restructuring>).

Regardless of what type of purchaser you are, keep the following in mind. First, if you are considering the purchase of electricity you should not make long term commitments since the benefits from deregulation will increase and evolve over time as additional measures are phased in. Second, be aware that residential customers and commercial customers with peak demands of less than 20 kilowatts already receive a 10% rate

reduction and will receive another 10% reduction in 2002. Third, Competition Transition Charges cannot be avoided by switching electricity providers. Finally, attention must be paid to reviewing and negotiating direct electricity contracts because the California Public Utilities Commission will no longer be creating the "contract" or tariff for the general public.

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Practice Areas

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