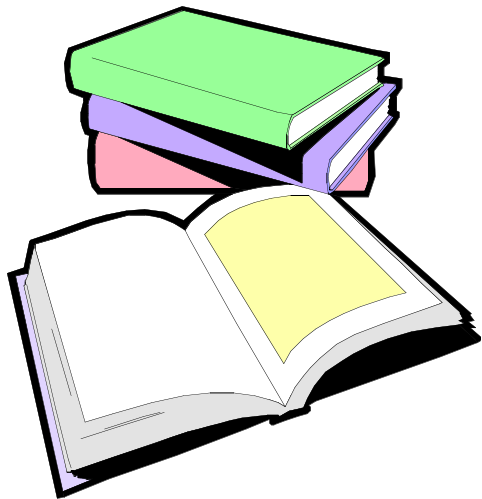


COOKING THE BOOKS

How PG&E and SCE hide assets, artificially inflate their power purchase costs, and want consumers to pay for it.



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EXECUTIVE SUMMARY

In 1996, the legislature passed AB 1890 and Governor Wilson signed it into law. Under the law, small consumers were promised a 10% rate reduction coupled with a multi-year rate freeze to be followed by 20% discounts. In return, the utilities received an opportunity to collect “stranded costs” for their uneconomic investments in power plants and obligations along with expected profits. This opportunity, however, included the explicit risk that some costs might not be collected by the end of the rate freeze. Four years after the passage of AB 1890, Southern California Edison (SCE) and Pacific Gas & Electric (PG&E) have been very successful at maximizing their collection of stranded costs from ratepayers. With the advent of higher-than-expected power prices in recent months, these utilities now argue that they never took a risk for the costs of power under the rate freeze and therefore should be compensated for money spent to buy power for its customers.

California’s electric utilities are seeking permission to force consumers to pay upwards of \$4 billion in costs associated with the upheaval in wholesale energy markets. This proposal comes at a time when these same utilities are collecting unprecedented amounts of stranded costs and receiving record revenues associated with power plants they own or have under contract. By asking consumers to pay for power costs while keeping all the benefits of high prices for themselves, the utilities conveniently forget the benefits they have reaped since the outset of deregulation.

The utilities’ claims of financial hardship do not square with the fact that revenues from other sources have increased dramatically at the same time as higher power purchase costs were incurred. TURN examined reports submitted by PG&E and SCE to the California Public Utilities Commission (CPUC) from 1997 through August of 2000 documenting their collection of stranded costs and their unpaid power purchase obligations. The findings are as follows:

- Since 1997, consumers paid PG&E and SCE over \$17.6 billion to be applied towards the collection of “stranded costs.” PG&E collected more than \$8.3 billion while SCE received over \$9.3 billion.
- The stranded cost collections of both utilities in 2000 exceeded their undercollections for power purchases. PG&E collected over \$2.25 billion between January and August while incurring uncollected energy costs of \$2.18 billion. SCE received \$2.53 billion during the same time period compared to \$1.97 billion in uncollected procurement expenses.
- Generation owned or contracted by PG&E and SCE produce substantial profits when energy prices are high. Between May and August of 2000, these generators netted almost \$1.4 billion for SCE and \$1.3 billion for PG&E. Since this money is credited to stranded costs, the average monthly collection of stranded costs was accelerated by 79% for PG&E and by 56% for SCE.
- Since none of the net revenues derived from generation are used to offset the power purchase undercollections, losses claimed by PG&E and SCE are hugely overstated.

- Corporate profits from the regulated utility during the rate freeze have been substantial. Since 1997, reported profits have exceeded \$1.8 billion for SCE and \$2.6 billion for PG&E.
- As a result of overly generous cost estimates, both utilities made significant profits from the operation of their nuclear power plants. PG&E made \$417 million in unreported profits from Diablo Canyon between 1997-99 and SCE realized \$276 million from San Onofre and Palo Verde during 1998-99.
- The issuance of \$5.5 billion in rate reduction bonds in 1997 allowed PG&E and SCE to repurchase substantial sums of their own stock and invest in unregulated generation assets in other parts of the country. None of the benefits from these investments are flowed through to consumers.

Based on these findings, TURN concludes that claims of possible “technical insolvency” are grossly inflated because they fail to consider the revenues associated with stranded cost collections and particularly those produced by utility generation during the first eight months of 2000. In fact, these revenues exceed the amount of uncollected costs incurred for power purchases by each utility.

Utility proposals to end the rate freeze retroactively and back-bill consumers for this summer’s power purchases represent the worst outcome for ratepayers and the best possible result for utility shareholders. These proposals would permit the utilities to realize all the rewards associated with higher energy prices while forcing consumers to pay for the accelerated collection of stranded costs.

If the utilities are permitted to end the rate freeze and back-bill consumers for power purchase undercollections, residential customers of PG&E and SCE could see their monthly bills double or triple. In addition, each customer would be forced to pay an average of between \$160-190 to compensate the utilities for power purchases going back to May.

This outcome would violate the core provisions of AB 1890 guaranteeing that costs incurred during the rate freeze may not be recovered after the freeze ends. The CPUC has reaffirmed this principle in five separate decisions since 1997. There is no reasonable interpretation of the law that permits these costs to be charged to customers. Instead, the utilities now seek to change the law by creating false panic and political hysteria. Their request must be denied.

TURN has a modest proposal – use stranded cost collections to offset power purchase costs. This simple accounting change eliminates the need to raise consumer bills and provides the utilities with opportunities to collect these costs until the 2002 statutory deadline for ending the rate freeze. It recognizes that utilities took an actual risk under the rate freeze that could lead to less than complete collection of stranded costs.

While it has become extremely clear that promises made by California’s utilities are only enforceable to the extent that shareholders continue to benefit, consumers deserve better from their elected leaders. Rather than blindly accepting the protests of PG&E and SCE, those charged with protecting the public trust should hold the utilities to their original promises.

DEREGULATION EXPLAINED

"SAN DIEGO - Governor Pete Wilson today signed historic legislation, AB 1890 by Assemblyman Jim Brulte (R-Rancho Cucamonga), which will break up California's utility monopoly, open the state's \$21 billion electricity market to competition and guarantee a 20 percent rate cut for residential and small business customers by the year 2002."

Governor Wilson press release, 9/23/1996

In September of 1996, Governor Pete Wilson signed AB 1890 into law. This bill, the product of last minute compromise and intense negotiation, sought to restructure California's electric utilities and create competition in the generation of electric power. The basis for this change was the assumption that "competition in the electric generation market will encourage innovation, efficiency, and better service from all market participants, and will permit the reduction of costly regulatory oversight."¹

Organizations representing the interests of small consumers were skeptical that deregulation and competition would provide tangible benefits for residential and small business ratepayers. In response to these concerns, proponents included an immediate 10% rate reduction for small consumers during a transition period in which rates would be frozen. Proponents further promised that this discount would increase to 20% after the rate freeze.

California's major utilities were primary architects of AB 1890. In particular, Pacific Gas & Electric (PG&E) and Southern California Edison (SCE) expended a great deal of resources to design and support the legislation. At the time, they argued that deregulation would expose them to risks never before assumed by a regulated monopoly. In order to prove the existence of this risk, PG&E created the concept of a multi-year rate freeze that would require the utility to live with the revenue it receives.

*"The reason that we're restructuring, the reason that we're moving this onto this generation field, is that rates in the state of California are extremely high. We have the third highest electric utility rates in the country. That's the hammer that began this process. Rates are too high, they must come down! Consumers are paying too much for electricity, they ought to be paying less!...Will the system work? It sure as heck better, because if it doesn't I made a great mistake coming back from that great state of Oklahoma to California. It was nice and safe and secure in Oklahoma, except for the occasional tornadoes, but there will be one heck of a tornado in California if this system that we are creating does not work."*²

CPUC Commissioner Richard Bilas

These same utilities now seek to end the rate freeze and break the promises that were made in 1996 and for several years thereafter. This report explains how their proposals would raise rates for consumers in order to compensate utility shareholders and why this result is completely at odds with the core principles of the deal that was so heavily promoted by PG&E and SCE only four years ago.

THE 10% AND 20% RATE REDUCTIONS

Financing a discount for consumers

The CPUC's original proposal to deregulate the electric industry, as articulated in its 1995 Preferred Policy Decision, did not contain any provisions guaranteeing immediate discounts for any consumers. When deregulation was taken up by the legislature, proponents decided to add a 10% rate reduction for small consumers in order to blunt criticisms that the move towards competition would only benefit large customers. As a means of financing this reduction, legislators considered the idea of issuing bonds backed by future ratepayer revenues. PG&E and SCE enthusiastically supported the idea and heavily promoted the concept of "rate reduction bonds" intended to lock in the 10% discount over four years. Over the objections of consumer advocates who argued that these bonds effectively enriched utility shareholders while forcing ratepayers to borrow in order to receive rate reductions, the legislature incorporated this idea into AB 1890.³

Both PG&E and SCE issued rate reduction bonds in December of 1997 in the amounts of \$2.901 billion (PG&E) and \$2.463 billion (SCE).⁴ Although these bonds were theoretically supposed to finance the 10% rate reductions provided to small consumers, the utilities used the proceeds to bankroll a series of acquisitions, stock repurchases and shareholder dividends.

For example, Edison International spent over \$2.4 billion between 1997 and 1999 to repurchase shares of its own stock. CEO John Bryson lauded the issuance of the rate reduction bonds, citing "direct recovery to us of nearly \$2.5 billion. On behalf of our shareholders, we get that cash up front at an accelerated rate and at far less risk."⁵ Similarly, PG&E repurchased \$1.2 billion worth of its own stock and spent \$1.59 billion to acquire over 5,100 megawatts of generating plants being divested by the New England Electric System.⁶

The promised 10% and 20% discounts

A central selling point for the package to deregulate California's electricity markets was the promise of lower rates immediately for small consumers. These reductions were heavily promoted to legislators, the media and public interest groups as proof that small consumers would benefit from deregulation at the outset.

In passing AB 1890, the legislature placed this promise into law, thereby providing residential and small commercial customers with a 10% rate reduction beginning in 1998. The ten percent reduction is guaranteed to these ratepayers until either March 31, 2002 or "the date on which the commission authorized costs for utility-related generation assets and obligations have been fully recovered."⁷ The legislature further promised that small consumers would receive "a cumulative rate reduction of at least 20 percent...not later than April 1, 2002"⁸

Although some critics were concerned that ratepayers might never see these reductions, or that they might evaporate over time, California's electric utilities publicly touted the statutory guarantees contained in AB 1890 as proof that opposition to the law was misguided. In April of 1998, PG&E CEO Bob Glynn forcefully argued that the reductions promised by law were neither illusory

nor temporary. In a speech before PG&E shareholders, he explained that

*"In January 1998, each of the utility's residential and small business customers got a 10 percent reduction in the rates they pay for electricity. Deregulation will save these utility customers, in aggregate, about \$400 million this year alone. Some adversaries seek to confuse customers about whether the reduction is real, how it was financed, and if it will stay. But at the end of the day, electricity rates are down 10 percent from where they were a year ago. And they are going to stay down for several years, and then they will go down again. With inflation at 3 percent, by the year 2001, electricity rates for this group of customers in real terms, will be about 20 percent lower than they are today. There is no product bought on a daily basis that has such a predictable downward price trajectory into the future. None."*⁹

STRANDED COSTS

What are stranded costs?

Prior to deregulation, vertically integrated monopoly utilities built and operated power plants to serve customers in their service territory. Investments in these plants were permitted to be recovered through rates so long as they were prudently incurred and continued to be "used and useful" in service to the public. Under this system, California utilities had a reasonable opportunity, but not a guarantee, to recover their total costs associated with nuclear power plants and contractual arrangements with non-utility generators.

When contemplating the prospect of deregulated wholesale electric markets, the utilities argued that some of their existing plants and contracts could be rendered uneconomical by new or existing facilities owned by competitors. If the utility plants were unable to cover their costs of operation, they would be forced to shut down. The fixed costs of these plants at the time of competition, along with expected profits from the investments, were considered potentially "stranded" since there would be no way to collect them by selling power at the market price.

Stranded cost treatment under AB 1890

California utilities insisted upon an opportunity to be paid these "stranded costs" as part of the transition to deregulation. Despite protests from consumer advocates, the legislature and the CPUC opted to give the utilities an "opportunity" to collect their stranded costs during a transition period. Under AB 1890, the utilities were offered "an opportunity to recover over a reasonable transition period, those costs and categories of costs for generation-related assets and obligations...that the commission, prior to December 20, 1995, had authorized for collection in rates and that may not be recoverable in market prices".¹⁰

Some utility proponents of the law recognized that it contained no guarantees of full recovery. Speaking before business leaders in 1997, PG&E CEO Bob Glynn noted that "one of the outcomes of that legislation is the opportunity for utility companies to obtain recovery of some — by no means all — of the costs of transition."¹¹

Other utilities, like San Diego Gas & Electric (SDG&E), argued to the CPUC that AB 1890 allows “utilities to recover all of their uneconomic costs associated with the transition to a competitive market.”¹² The CPUC explicitly rejected this interpretation, deciding that “in actuality, the utilities are merely allowed the opportunity to recover such costs, which are identified and determined by this Commission.”¹³

Collection of stranded costs under the rate freeze

In establishing a transitional rate freeze, the legislature and CPUC created a structure for allowing utilities to collect stranded costs. Rates for small customers were frozen ten percent below the levels in effect as of June 1996.¹⁴ The frozen rate permits the utilities to collect all costs associated with distribution, transmission, public purpose programs, and nuclear decommissioning. In addition to these amounts, the freeze permits between 5.4 and 6.5 cents per kilowatt hour to be used for energy procurement and stranded costs.¹⁵

Changes to various components included under the frozen rate can limit the recovery of other costs. For example, when PG&E sought and received a \$360 million increase in its distribution system revenues, this led to a decrease in the amount of funds available for energy procurement and stranded costs. Or when energy prices rise, the remaining amount dedicated for stranded cost recovery decreases.

Utilities at risk for costs not recoverable during the rate freeze

One clear principle established by the legislature and the CPUC was that, during the rate freeze, collection of all costs is not guaranteed. In AB 1890, the legislature declared that once the rate freeze ends, “the electrical corporation shall be at risk for those costs not recovered during that time period.”¹⁶

The CPUC reaffirmed this principle in subsequent implementation decisions and concluded that “AB 1890 does not permit the utilities to accumulate costs incurred during the rate freeze period for the purpose of affecting rates during or following the rate freeze period.”¹⁷ In particular, the CPUC rejected utility claims that any new costs incurred during the rate freeze would be eligible for recovery after its end. Declaring any such collections to be “unlawful”, the CPUC held that “nothing in [AB 1890] would lead us to conclude that the rate freeze merely represents a period during which ratepayers and shareholders will lend funds to each other.”¹⁸ The CPUC subsequently repeated this conclusion in five separate decisions.

California’s utilities are well aware of these CPUC rulings. In a recent filing with the Securities and Exchange Commission, PG&E admitted that “under a prior CPUC decision the Utility is prohibited from collecting after the transition period certain electric costs incurred during the transition period but not recovered from frozen rates during that period, including under-collected account balances relating to wholesale power purchases, such as power purchased from the CalPX and CAISO. The CPUC decision prohibits offsetting these specific under-collected amounts against over-collected transition costs.”¹⁹

CPUC DECISIONS ON COSTS INCURRED DURING THE RATE FREEZE

The CPUC has repeatedly concluded that no costs incurred during the rate freeze, apart from those granted specific exceptions in AB 1890, may be recovered after the freeze ends. Although PG&E has now sought to challenge the most recent of these rulings (D. 99-10-057) in state court, none of the previous decisions were challenged by any California utility. Key passages from the most relevant Commission decisions are quoted below.

D.97-10-057

"AB 1890 does not permit the utilities to change total rates in effect either during or after the rate freeze period to reflect revenues received or costs incurred during the rate freeze period with specified exceptions."

D. 97-11-074

"The rate freeze is just that - a freeze, rather than a deferral."

D.98-03-059

"We understand that the associated shortfall may not be the utility's fault. The statute [AB 1890], however, does not make exceptions on the basis of fault...AB 1890 does not permit the electric utilities to change rates after the transition period to recover costs incurred during the rate freeze period. The statute does not make exceptions for a circumstance where, because the Commission fails to approve of costs in time for their recovery prior to the end of the transition period, the utility is unable to recover such costs prior to the end of the transition period."

D.99-05-051

"As we stated in D.97-10-057 and other orders, AB 1890 does not permit a utility to carry over costs incurred during the rate freeze into the post-rate freeze period. Doing so would effectively permit the utility to charge rates at levels higher than those in effect on June 10, 1996 in violation of the rate freeze requirement of Section 368."

D.99-10-057

"AB 1890 allows recovery of transition costs by way of a nonbypassable surcharge, but also imposes certain risks with regard to the rate freeze. We may not overlook the law's intent in order to hasten the end of the rate freeze. We may not ignore the law even if no party objects to proposals that contravene it, or by finding that the law does not serve other regulatory objectives. No utility may carry over any costs from the TRA or the TCBA or any other account from costs incurred during the rate freeze period into the post rate freeze period."

Risk of higher energy costs causing transition cost undercollection was expected

PG&E and SCE now argue that they never took the risk of high energy prices. Instead, they claim that only stranded costs identified at the outset of the transition period were at risk. However, this interpretation is inconsistent with the law, previous statements made by the utilities themselves and common sense.

The current law on this point is very clear. In a 1999 decision, the CPUC rejected an interpretation of AB 1890 that would allow energy costs incurred during the rate freeze to be recovered from ratepayers. For the fifth time in three years, the CPUC reiterated that

“AB 1890 creates a rate freeze period during which the utility must live with the revenues it receives, which fluctuate according to sales. AB 1890 does not provide exceptions to the rate freeze on the basis that the utility may not have collected all the revenues it anticipated or failed to recover otherwise reasonable costs.”²⁰

Despite the numerous identical rulings from the CPUC over the past several years, SCE now argues that AB1890 “placed California’s electric utility companies at risk for recovery of their stranded costs, but did not place them at risk for recovery of the costs of procuring electricity for customers.”²¹ PG&E also makes similar claims about the limits to risks taken under the rate freeze.

These utility arguments are flawed because they ignore the linkage between transition cost collection and energy prices. The utilities claim that, in the event of high energy prices, their stranded cost collection could be put at risk. But periods of high energy prices actually lead to increased stranded cost collection (see “treatment of generation revenues” on page 12). Therefore, the utility is able to collect their stranded costs regardless of whether energy prices are high or low. If insulated from the costs of power purchases, then there is no possible risk to the utility.

Increases to any costs of providing current service, including the costs of procuring electricity during the rate freeze, are supposed to put transition cost recovery at risk. Despite current protestations to the contrary, this exact risk was understood and communicated to shareholders several years ago. PG&E acknowledged in its 1996 annual report that a change in “the market price of electricity” could “affect the probability of recovery of transition costs and result in a material loss.”²² In a 1999 filing with the Securities and Exchange Commission, PG&E noted that their future financial results could vary based upon “fluctuations in commodity gas and electric and ancillary service prices”.²³

Similarly, SCE repeatedly warned investors that recovery of transition costs could be threatened by “changes in prices of electricity and costs for fuel.”²⁴ Moreover, SCE disclosed that “if events occur during the restructuring process that result in all or a portion of the CTC being improbable of recovery, SCE could have write-offs associated with these costs if they are not recovered through another regulatory mechanism.”²⁵

In light of this well-understood risk, it is difficult to accept the argument that utilities did not anticipate the potential for volatile energy prices to reduce their ability to collect transition costs. As TURN shows in this report, maintaining the rate freeze in the face of higher energy prices increases stranded cost collection along with uncollected energy costs. Since the utilities admit that they are at risk for less-than-full collection of stranded investments, holding them responsible for energy costs means little more than a realization of that potential risk.

TRANSITION ACCOUNTING PRACTICES

THE TCBA AND TRA

In order to accurately track transition costs, the CPUC established two major accounts for handling revenues and expenses associated with the rate freeze. These two accounts are the **Transition Revenue Account (TRA)** and the **Transition Cost Balancing Account (TCBA)**. Understanding the relationship between these two accounts is critical to deciphering an accurate financial picture for the utilities during the rate freeze.

Explaining the TRA

The TRA represents a 'funnel' through which most expenses and revenues of each utility are reconciled. Revenue from the monthly bills paid by consumers goes into the TRA and is then used to pay the authorized costs of distribution, transmission, public purpose programs and nuclear decommissioning. The remaining amount of money left in the TRA is used to pay for the costs of purchasing energy from the PX to serve the needs of customers. Any money still in the TRA after energy purchases is called the "Competition Transition Charge" (CTC) and transferred to the TCBA so that it can be credited as "stranded cost" collection.

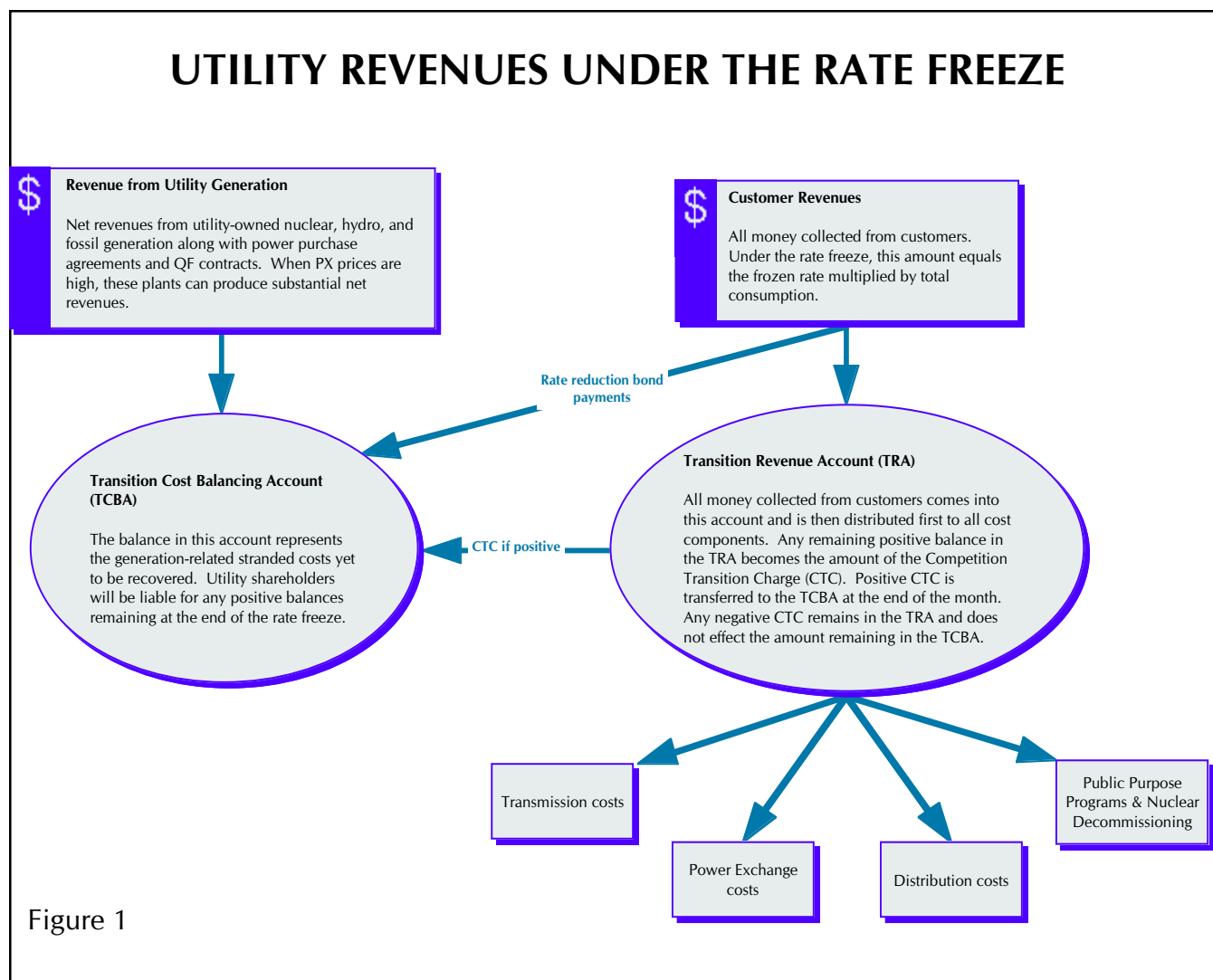


Figure 1

When PX prices were low through the first two years of the transition period, the TRA would typically have some money remaining at the end of every month and the CTC would be positive. When PX prices spiked this past summer, the balance in the TRA proved to be insufficient to cover the costs of power purchases. As a result, the TRA balance became negative. This was not the first time that the TRA was underfunded. PG&E experienced negative TRA balances in 7 of 29 months since January 1998.

PG&E and SCE are now claiming that they should be entitled to collect any cumulative negative TRA balances at the end of the rate freeze in order to “make them whole” for their losses. At the end of August 2000, the negative balances were as follows:

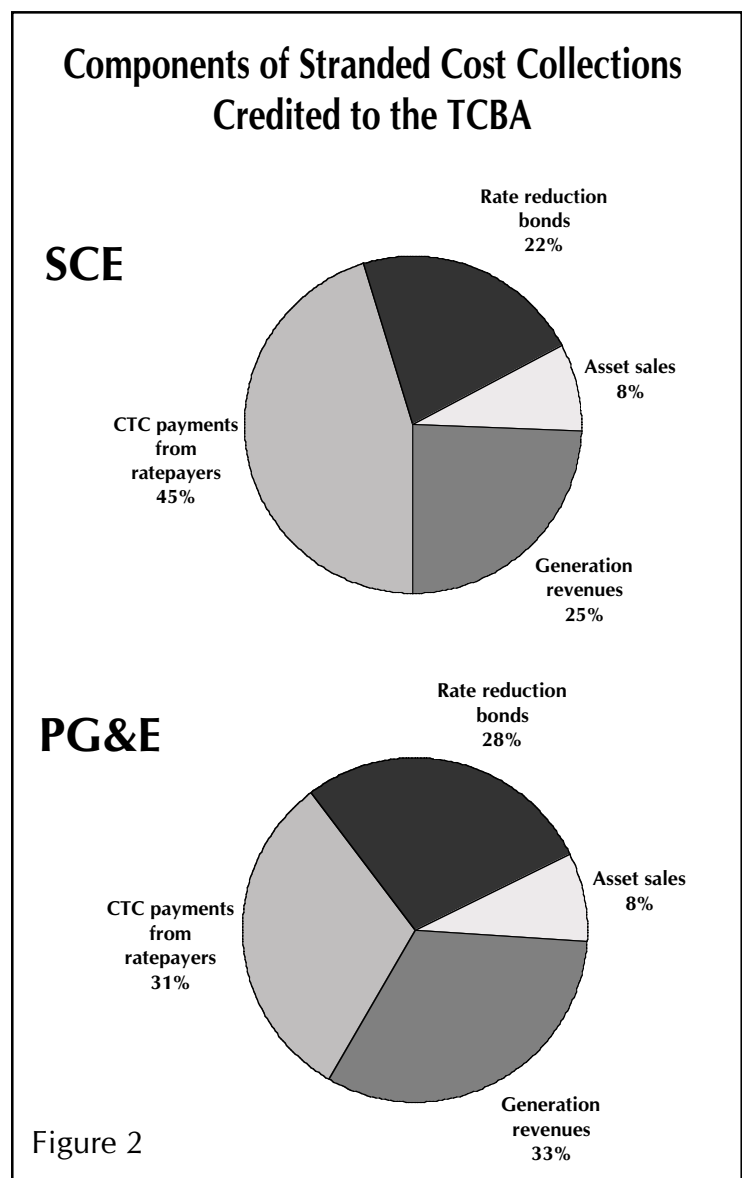
PG&E — \$2,179 million
SCE — \$1,971 million

In order to understand the degree of hardship, if any, that these “losses” impose on the utilities, they must be compared with the amount of stranded costs collected by the same utilities since the beginning of the rate freeze and throughout the course of 2000. Only by comparing such “losses” with the “profits” of cost recovery achieved during the transition period can the true financial picture be revealed.

Explaining the TCBA

The TCBA tracks the collection of stranded costs during the rate freeze. Every month, each utility places costs (debits) into the account and collects revenues (credits) from various sources. Debits include undepreciated sunk costs from nuclear power plants (recovered on an accelerated basis), losses on the sale of property, expected shareholder profits on those sunk costs, losses on the operation of utility owned or contracted generation, costs owed to other utilities or independent generators under pre-deregulation contracts, pension benefits and a variety of other expenses associated with the transition period.²⁶

Credits to the account come from several



sources. These include any CTC left over in the TRA at month's end, sales of utility-owned assets, net revenues on the operation of any generation owned or controlled by the utility, a credit for the 10% rate reduction provided to consumers, and payments from consumers to cover borrowing costs on the rate reduction bonds.²⁷ Figure 2 shows the breakdown of sources contributing to stranded cost recovery since the beginning of the rate freeze.

Examining the amount of credits flowing into the TCBA provides a reasonable estimate of the magnitude of stranded cost recovery by each utility. TURN has determined total recovery from 1997 through August of 2000 as follows:

PG&E — \$8,330 million
SCE — \$9,819 million

As stated above, these numbers need to be compared with any negative balances in the TRA.

Treatment of generation revenues

Although the CPUC encouraged utilities to divest themselves of generating facilities, PG&E and SCE still own or control a substantial amount of generating capacity through their regulated companies. Both continue to own and operate their nuclear power plants, hydroelectric facilities and some fossil generation. In addition, both utilities continue to receive power from various generators under contract and from inter-utility contracts signed before the onset of deregulation.

Generator Profits go directly to the utilities

Under current law, the output from all utility owned or contracted generation is resold into the Power Exchange. The net revenues are then credited to the TCBA (with some revenues credited at the end of the year). In times of low prices, the operation of this generation can result in net undercollections and therefore add to the amount of stranded costs in the TCBA. But during periods of high energy prices, the net revenues associated with this generation can be substantial.

It would seem logical to set up the ratemaking so that any profits from regulated utility generation would offset the costs of purchasing power for customers. In that way, these generators would provide some protection for consumers in the event of runaway market prices. But under current ratemaking, not only do these units provide no direct benefits to ratepayers in the form of lower energy procurement prices, they actually accelerate stranded cost collection and thereby hasten the end of the rate freeze.

During the first eight months of this year, **generation owned or contracted by SCE produced \$1.45 billion in net revenues** that are credited to transition cost collection. **PG&E's generation netted \$1.47 billion** during the same period.²⁸ Net revenues from these sources are directly connected to high wholesale energy prices.

Since under current ratemaking net revenues from these generators are deposited into the TCBA, they do not offset the costs of power purchases made by the utilities to serve customers. Those undercollections are tracked in the TRA. This specific undercollection is the subject of recent

media attention and has been used to argue that utilities are losing substantial sums of money due to the high market prices.

Failing to offset generator profits against power purchase costs dramatically overstates the magnitude of “losses”

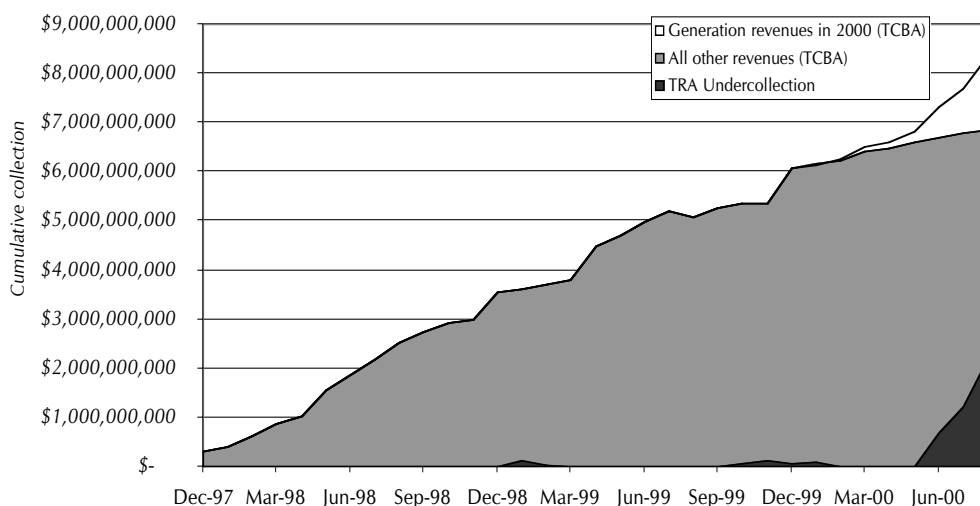
Failing to account for generator profits is like looking at one side of the income statement (costs) while ignoring the other side (revenues). The primary consequence of this accounting system is that power purchase costs incurred by the utilities are dramatically overstated. The second major consequence is that stranded cost collection during periods of high wholesale prices is significantly accelerated.

For ratepayers, this treatment of generation revenues represents the worst of both worlds. While utilities argue that uncollected power purchase costs in the TRA place them on the edge of financial ruin, the increased revenues flowing into the TCBA from their own generation pays down the remaining stranded costs far more quickly than would occur under lower prices.

The “double whammy” from this arrangement is that consumers not only get billed for the full cost of the power purchases but that the increased stranded cost collection by the utilities hastens the end of the rate freeze. As soon as the rate freeze ends, consumers may be forced to pay high market prices for their power. There are no benefits to the consumers from this arrangement.

Figure 3

PG&E Stranded Cost Collections (TCBA)
Compared with TRA undercollection



SCE Stranded Cost Collections (TCBA)
Compared with TRA undercollection

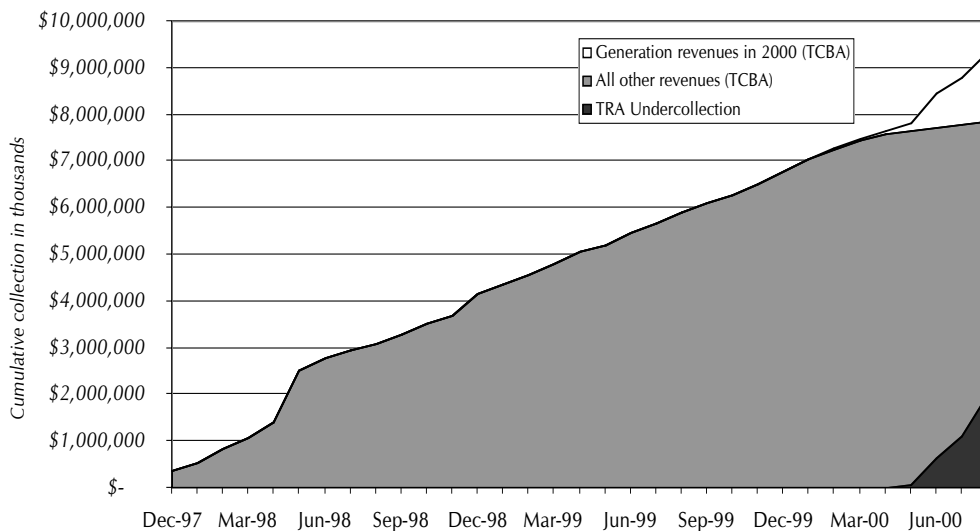
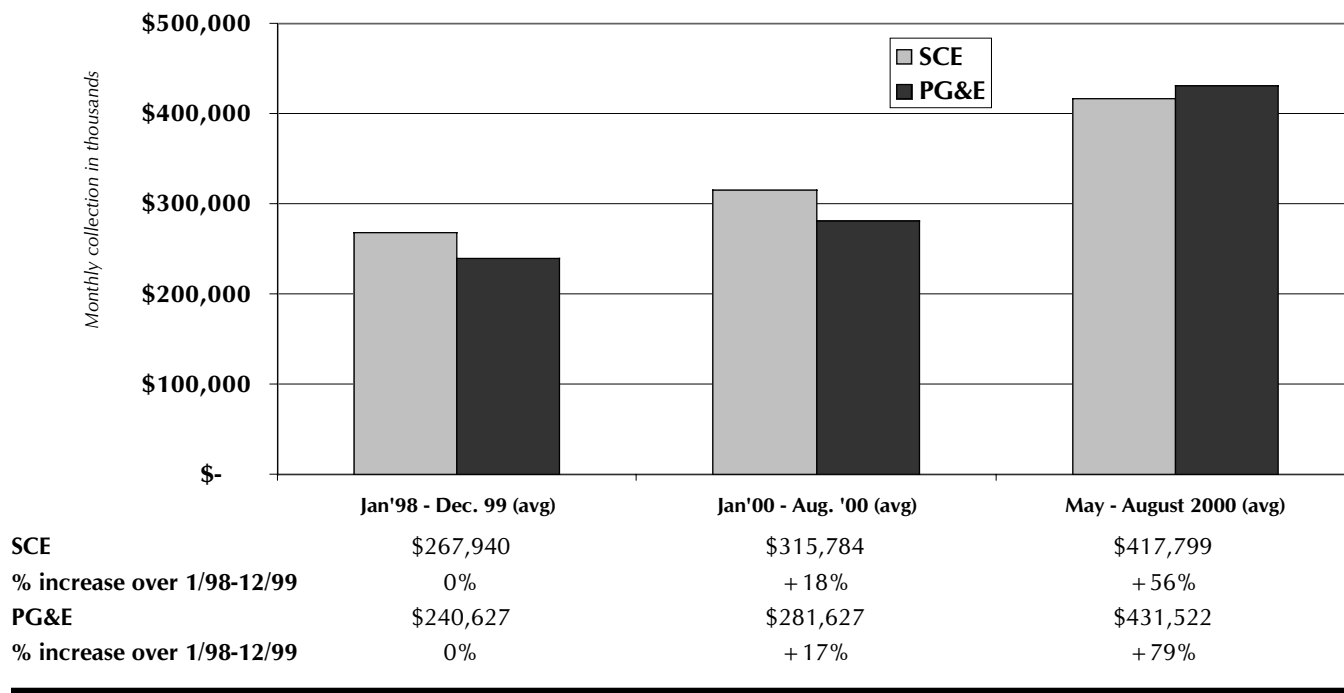


Figure 4

SCE/PG&E Stranded Cost Collections

High wholesale prices accelerate collection for utility shareholders



THE RATE FREEZE IN PRACTICE

Stranded costs

Since the outset of the rate freeze, consumers have been overpaying for their electric service in order to create an “opportunity” for utilities to collect stranded costs. In addition, the issuance of \$5.4 billion in rate reduction bonds in 1997 for these two utilities will require most ratepayers to pay back this financial obligation through 2007.

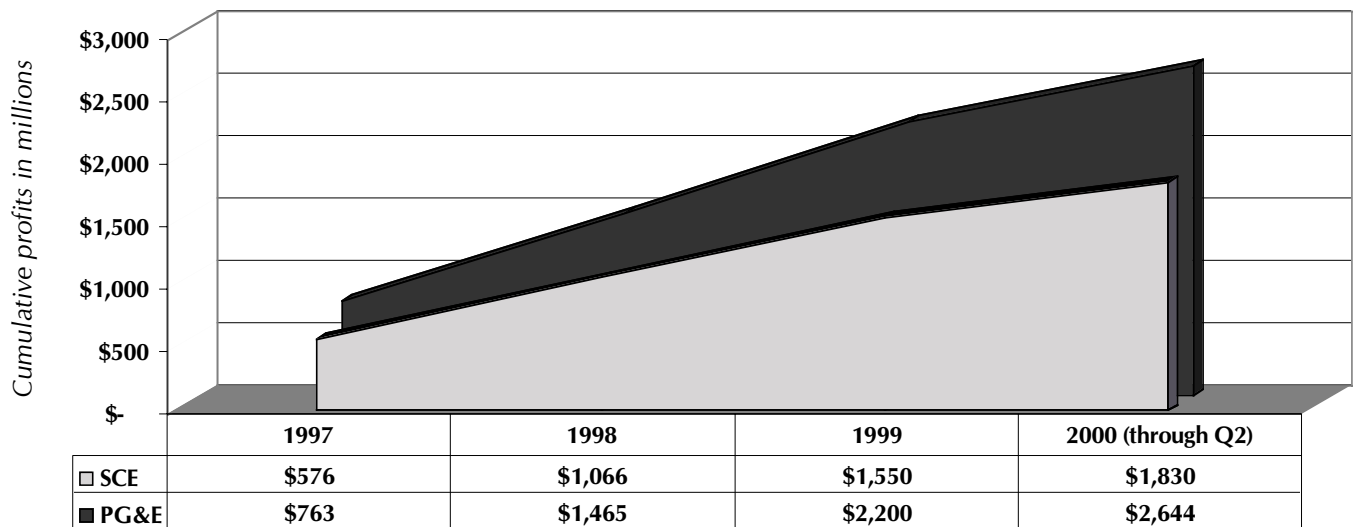
Both PG&E and SCE have been collecting stranded costs sooner than expected. The cumulative collection of stranded costs by utility is shown in in figure 3. Net revenues from generation in the year 2000 are highlighted to show the role that these revenues play in boosting stranded cost collection during periods of high energy prices.

Since the profits from utility owned or contracted generation flow into the TCBA, the effect of generation revenues on stranded cost collection is very pronounced. Figure 4 demonstrates the monthly average stranded cost collection enjoyed by the utilities since January of 1998 and shows that collections are up almost 20% per month for 2000 compared to the average for the past two years. The monthly differential increases with the high prices from May through August, causing collections to rise by 56% for SCE and almost 80% for PG&E.

Based on this recent data, it appears that SCE was incorrect a 1999 filing with the Securities and Exchange Commission when it stated that “more revenue will be available to cover transition costs

Figure 5

PG&E/SCE Profits After Deregulation



when market prices in the PX and ISO are low than when PX and ISO prices are high.”²⁹ In fact, data for year 2000 revenues indicates that very high PX prices lead to higher than average “transition cost recovery” due primarily to the profits from utility owned or controlled generation.

Utility profits

Both PG&E and SCE made substantial corporate profits over the course of the rate freeze. Figure 5 shows cumulative profits by the two utilities. These figures look only at profits (net income) from the regulated companies themselves and are based on corporate financial statements distributed to shareholders. Cumulative profits from 1997 through the second quarter of 2000 are as follows:

PG&E — \$2,644 million
SCE — \$1,830 million

These profits represent some of the substantial financial benefits accruing to utility shareholders in the wake of deregulation. But these figures do not include the long-term value to shareholders from the stock repurchases related to the rate reduction bonds as described earlier.

Nuclear power profits

Under policies established in 1996 and 1997, both SCE and PG&E receive a fixed payment for operating their nuclear power facilities. This payment, known as the ICIP (Incremental Cost Incentive Pricing), was intended to prevent the utilities from forcing ratepayers to cover increased costs associated with running plants like Diablo Canyon, San Onofre and Palo Verde.

Unfortunately, the prices set by the ICIP are too high and have led to large utility profits at the expense of ratepayers. According to data analyzed by TURN, SCE realized \$276 million in hidden profits during 1998-99 just from the operation of its nuclear power plants. This means that its

actual costs were 20% less than the price charged to consumers. Meanwhile, PG&E got \$417 million in profits from Diablo Canyon during 1997-99, which means that its actual costs were 28% less than the price charged to consumers.³⁰

These profits were not used to accelerate stranded cost recovery through the TCBA but went directly to utility shareholders. These profits should be taken into account when considering any claims of hardship associated with the rate freeze.

UTILITY PROPOSALS FOR ENDING THE RATE FREEZE AND SURCHARGING CONSUMERS

In response to the recent runup in energy prices, PG&E and SCE present two proposals that would violate the promises made to California consumers. These proposals are designed to insulate shareholders from any negative consequences stemming from the failure of deregulation by requiring that additional costs be borne by ratepayers. Ironically, these utilities suggest that consumers are well-served by measures that would dramatically increase rates and allow for an effective double collection of some stranded costs.

Ending the rate freeze early by valuing assets in the TCBA

Confronted with high wholesale power costs and apparent undercollections of their power purchase obligations in the TRA, PG&E and SCE now seek to end the rate freeze by declaring that all their stranded costs have been recovered and that the rate freeze is therefore over. In fact, PG&E and SCE assert that the rate freeze already ended this past August.³¹ In order to make this claim, both utilities seek to establish a value for their generating facilities in advance of their sale or transfer to unregulated companies. Since the CPUC has not approved these valuations, efforts to end the rate freeze must be decided in the coming year.³²

If the utilities are successful in ending the rate freeze retroactively, consumers are likely to experience massive rate increases similar to those inflicted upon the San Diego region this past summer. Monthly bills could triple, thereby forcing some ratepayers to choose between paying for either electricity or rent. The consequences would be so dire as to invite a ratepayer revolt.

PG&E and SCE cannot end the rate freeze until authorized to do so by the CPUC. So far, they are unwilling to concede that the Commission may reject their applications. Based on current law, and the best interests of ratepayers, they must not be permitted to declare a unilateral end to frozen rates.

Ending the rate freeze retroactively is bad policy

In their recent filings with the Securities and Exchange Commission, PG&E and SCE claimed that they had fully collected all their stranded costs. Their assertions do not hold up to scrutiny. In fact, the actual remaining balances in those accounts as of August 31 were \$1.6 billion for PG&E and \$1.33 billion for SCE.³³

The rate freeze would only end, consistent with utility claims, if the Commission approved the

valuation of hydroelectric and coal-fired generators and applied the credits retroactively to August. There is no indication that the CPUC is willing to allow such treatment.

These plants should not be valued retroactively because their ownership status is very uncertain. PG&E has filed to transfer their hydroelectric plants to an unregulated affiliate. SCE seeks to retain their hydroelectric plants and sell their coal plants to unregulated companies. Given the problems controlling the behavior of unregulated generating companies, and extraordinary wholesale energy prices, the Commission should conduct a thorough review before determining what to do, and how to treat any values associated with these plants.

Allowing the utilities to value and transfer these plants could leave ratepayers even more exposed to price shocks in the post-rate freeze world. The Commission should therefore defer action on allowing the sale, or transfer, of these plants until the long-term consequences for consumers can be considered.

Valuing hydroelectric generation in the TCBA is contrary to the terms of the TURN-PG&E settlement

Central to PG&E's claim of an early end to the rate freeze is their ability to credit \$2.1 billion to their TCBA to reflect the value of their hydroelectric generating facilities. They announced their intent to take the credit to the TCBA in a September 2000 filing with the CPUC.³⁴ If approved as requested, this credit could allow the rate freeze to end prematurely.

But PG&E's proposal contradicts a settlement agreement that the utility signed with TURN and other groups and submitted to the CPUC in August. Under this agreement, PG&E promised to use these proceeds to offset power purchase costs in the TRA. In a statement to their own shareholders, they pledged that

"The Utility would credit its Transition Revenue Account (TRA) the amount by which \$2.8 billion exceeds the book value of the utility's net investment in hydroelectric generation assets..."³⁵

Crediting these funds to the TRA would eliminate virtually all power purchase undercollections and bring the balance in that account close to zero. By deviating from the terms of its own agreement, and instead seeking to credit the value of its hydroelectric assets to the TCBA, PG&E contradicted its own stated commitment to TURN, the CPUC and its shareholders to use this money to offset the very same purchased power costs that it now seeks to pass on to consumers.

Collecting all TRA balances from ratepayers

In addition to ending the rate freeze early, PG&E and SCE seek to recover all power purchase undercollections from ratepayers. As of the end of August, **the bill for consumers would total \$2.17 billion for PG&E and \$1.97 billion for SCE. Each residential customer could then be back-billed for between \$160 and \$190 to pay the costs of electricity already consumed this past summer.**

Collecting costs incurred during the rate freeze from ratepayers after the end of the rate freeze would violate existing law. This scenario has been considered and decided by the CPUC. In its

ruling on whether these costs can be recovered from consumers, the Commission flatly determined that, consistent with AB 1890:

*"No utility may carry over any costs from the TRA or the TCBA or any other account from costs incurred during the rate freeze period into the post rate freeze period."*³⁶

More importantly, the utilities would be able to effectively overcollect their stranded costs. As discussed earlier, the revenues from utility generation are flowing into each utility's TCBA at a record pace. Ratepayers are not being given access to any of the benefits associated with higher prices. Meanwhile, all the power procurement costs would be billed to consumers at full price.

Utilities would thereby be able to harness 100% of the profits and pass along 100% of the losses. It is this type of "heads we win, tails you lose" scenario that is very attractive to shareholders but devastating to consumers.

THE UTILITY PROPOSALS REPRESENT THE WORST POSSIBLE OUTCOME FOR RATEPAYERS

If the CPUC, the legislature and the Governor permit PG&E and SCE to end the rate freeze and back-bill consumers for past power costs, consumers will experience the worst possible outcome. The end of the rate freeze will bring a substantial increase in prices for consumers that could mirror the hardship experienced in San Diego this past summer. Bills could double or triple, leaving ratepayers and local officials ready to revolt against the utilities, the legislature and the CPUC.

The alternative – net profits against losses

The better alternative is to direct the utilities to net their stranded cost collections recorded to date against their costs of buying power on behalf of consumers. Since times of high energy prices mean accelerated stranded cost recovery, PG&E and SCE should be forced to use these revenues to offset costs associated with power purchases. This simple accounting change would eliminate any "undercollections" to date. It would also reaffirm the fact that utilities assumed some risk during the rate freeze and particularly the risk that higher market prices for electricity would yield lower stranded cost recovery.

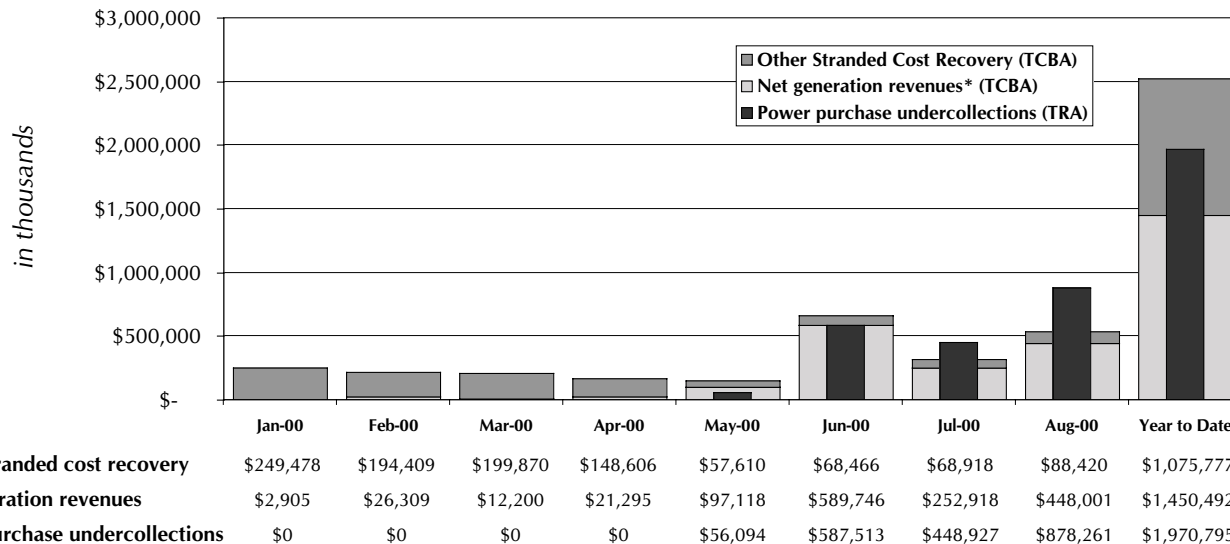
Netting profits against losses under the rate freeze is consistent with the original intent of AB 1890 and subsequent decisions by the CPUC. Under this approach, PG&E and SCE would retain an opportunity to collect their stranded costs through March 31, 2002. Although wholesale energy prices are currently very volatile, it is possible that a variety of factors could bring about lower prices in future months. These factors include intervention by federal regulators, changes in natural gas prices, corrective action against power sellers engaging in price manipulation, alterations to the market structure and lower winter demand.

Lower future prices would provide the utilities with an opportunity to collect their remaining stranded costs. It is also possible that they would fail to achieve full recovery. However, this risk was explicitly identified in AB 1890. Unless profits and losses are viewed together for purposes of determining total stranded cost collections, the utilities face no real risk.

Figure 6

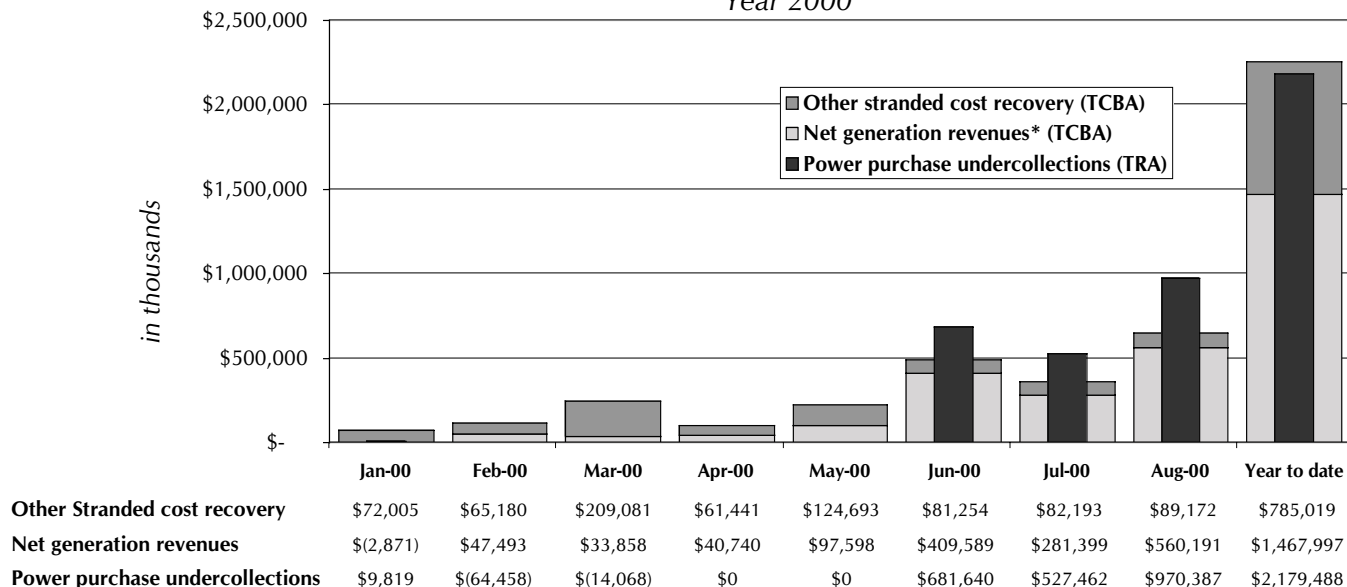
Southern California Edison

Power purchase undercollections vs. generation profits and other stranded cost recovery
Year 2000



Pacific Gas & Electric

Power purchase undercollections vs. generation profits and other stranded cost recovery
Year 2000



Utilities are not experiencing undue hardship (OR, “Look in the other pocket”)

As part of their campaign to persuade appointed and elected officials to approve their proposals for back-charging consumers, PG&E and SCE argue that they are currently facing severe financial hardships that threaten the financial viability of their companies. A recent article even suggested that, if they are not allowed to pass on power costs to consumers, PG&E and SCE could be “technically insolvent” in 2001.³⁶ This thinly-veiled threat of bankruptcy is the latest ploy designed to intimidate critics and force a resolution favorable to the interests of its shareholders.

TURN investigated the flows of money into both the TCBA and TRA in order to determine the magnitude of total net “losses” suffered by each utility. The results of this research are shown in figure 6.

These graphs show that net revenues from retained generation, along with other stranded cost recovery in the year 2000, exceed the amount of undercollections associated with power purchases. Revenues exceed costs by \$75 million for PG&E and by \$555 million for SCE. These figures are only for this year. Looking at these figures since the beginning of the rate freeze, an even more favorable picture emerges.

Figure 3 on page 12 also shows the magnitude of stranded cost recovery since the beginning of the rate freeze, the contribution made by generation profits in 2000, and the amount of power purchase undercollections in the TRA for each utility as of August 2000. These graphs illuminate the fact that the amount of uncollected costs in the current “crisis” is only a small fraction of the total stranded cost recovery received by both utilities over the past four years.

Corporate profits have been substantial

In addition to stranded cost recovery, it is important to consider the profits made by SCE and PG&E during this period. While these utilities like to complain about their current hardships, they fail to acknowledge that life under the rate freeze has been very good for shareholders. Since 1997, PG&E has reported profits of \$2.6 billion while SCE has reported profits of more than \$1.6 billion.

Utilities have reaped substantial benefits from deregulation thus far. Earlier this year, Edison International (the holding company of SCE) announced “record 1999 operating earnings.”³⁷ SCE provided more than 75% of the total corporate profits in 1999. Similarly, PG&E produced almost 90% of the net income for its holding company in 1999.³⁸

Moreover, PG&E invested a significant amount of the rate reduction bond proceeds into the acquisition of power plants in New England. These plants are likely to prove extremely profitable in the years to come with tight power supplies in that region. PG&E has also expended a great deal of effort to prevent the enactment of strict environmental standards in Massachusetts that might reduce the profitability of their coal-fired generation.

Utility profits need to be considered in the context of pleas for assistance by the CEOs. It is very hard to accept declarations of poverty or impending doom when corporate profits have been so strong for the duration of the rate freeze. Looking at the performance over the entire course of the “transition period” therefore serves to inform decisions relating to the current situation.

Technical insolvency is a red herring

Utility warnings about potential insolvency ignore not only past profits but also stranded cost collections received in the summer of 2000. Recent statements from the Chief Financial Officer of SCE support this view. In response to concerns about bankruptcy raised in the press, CFO Ted Craver disputed the speculation and argued that reporters and analysts must look at both sides of

the income statement. He said that the term ‘technical insolvency’ is misleading because looking only at power purchase undercollections “is not an accurate portrayal” and “says nothing about what we have to fund in the market.” According to Craver, reports explaining SCE’s financial picture using these numbers alone are “not an accurate portrayal.”³⁹

He went on to explain that

“Southern California Edison has some 37 balancing and memo accounts set up by the California Public Utilities Commission. What we have to fund is the net amount of all of them, plus whatever else is going on, and the net figure is considerably smaller than the \$1.97 billion [TRA undercollection]. It’s like picking out one line item on the balance sheet and saying this is all that matters. No accountant does that or looks at it that way.”⁴⁰

The current crisis is driven by utility efforts to explain their financial situation based on the status of one account alone. Meanwhile, other accounts under their control are benefiting from record revenues that more than offset the losses being claimed. It is akin to a situation in which one pocket is empty and another is full of cash. A reasonable person would check both pockets before assuming that they are penniless.

No reasonable person would claim to be bankrupt based solely on the balance in their checking account when they also possess substantial savings. No small business would declare bankruptcy based only upon their expenses without looking at all their revenues. But utilities are apparently different.

Charging customers for these costs violates the public trust and destroys the credibility of the utilities, the legislature and the CPUC.

When AB 1890 was passed, supporters made many promises about the benefits to consumers. The most important promise was that rates would immediately decline by 10% and that the discounts would grow to 20% after the end of the rate freeze. The other critical promise was that the utilities would be at risk to recover their stranded costs and energy procurement under the frozen rate.

If this deal is violated, consumers would inevitably lose faith in the integrity of the parties involved in the original law. These supporters, SCE and PG&E among the most prominent, banded together in 1998 to oppose efforts to reduce stranded cost recovery contained in California’s Proposition 9. Their argument at the time was that the rate freeze guaranteed 10% rate reductions through 2001 to be followed by a 20% reduction soon afterwards. After opposing Proposition 9 on the basis that it would threaten the viability of the rate freeze, PG&E and SCE now seek to end the rate freeze and foist the failures of deregulation onto consumers.

It has become extremely clear that promises made by California’s utilities are only enforceable to the extent that shareholders continue to benefit. Upon the realization of any risks accepted in a prior agreement, the utilities now demonstrate that they are the first to attempt to void their earlier promises.

Consumers deserve better from their elected leaders. We can only hope that today’s leaders will not blindly accept the claims made by the same companies that designed the rate freeze, sold it

on the premise that they would assume a risk, and then sought to destroy the deal as soon as their predictions turned out to be inaccurate.

TURN urges the CPUC, the Governor and the legislature to hold the utilities to their original promises. Otherwise, consumers will have nowhere else to turn for relief.

DATA SOURCES

Data used to calculate stranded cost collections, generation revenues, and TRA balances comes from monthly and annual TCBA reports filed by SCE and PG&E with the CPUC. Annual reports include the following:

CPUC Agreed Upon Special Procedures Audit of Transition Cost Balancing Accounts and Headroom Revenues for the six months ended June 30, 1998, Prepared by Mitchell & Titus and the Barrington-Wellesley Group, December 1998.

PG&E 1998 Annual Transition Cost Proceeding, A.98-09-003 (June 8, 1999)

PG&E 1999 Annual Transition Cost Proceeding, A.99-09-006 (September 1, 1999)

PG&E 2000 Annual Transition Cost Proceeding, A.00-09-___ (September 1, 2000)

SCE 1998 Revised Annual Transition Cost Proceeding, A.98-09-008 (April 8, 1999).

SCE 1999 Annual Transition Cost Proceeding, A.99-09-___ (September 1, 1999).

SCE 2000 Annual Transition Cost Proceeding, A.00-09-___ (September 1, 2000).

None of these filings contained confidential data. All records are accessible to the public. Data sheets used to produce the charts in this report are available upon request.

ENDNOTES

¹ Cal. Pub. Util. Code §330(e).

² *Remarks of Commissioner Bilas at "Buying Electricity Tomorrow: An Online Symposium"*, see <http://www.baypt.com/buying.htm>.

³ Cal. Pub. Util. Code §330(w) states that "§330(w) "It is the intent of the Legislature to require and enable electrical corporations to monetize a portion of the competition transition charge for residential and small commercial consumers so that these customers will receive rate reductions of no less than 10 percent for 1998 continuing through 2002. Electrical corporations shall, by June 1, 1997, or earlier, secure the means to finance the competition transition charge by applying concurrently for financing orders from the Public Utilities Commission and for rate reduction bonds from the California Infrastructure and Economic Development Bank."

⁴ "Agreed Upon Special Procedures Audit of Transition Cost Balancing Accounts and Headroom Revenues for the six months ended June 30, 1998", prepared for the CPUC Energy Division in response to D.97-11-074. See page III-34.

⁵ Interview with John Bryson, Edison Investor Relations Newsletter, August 1998.

⁶ Speech by PG&E CEO Bob Glynn to the 1999 Annual Shareholders Meeting, April 21, 1999; "PG&E Corp. Completes Largest U.S. Utility Asset Acquisition; Announces Landmark Alliance With High Tech Industry", Business Wire Press Release, September 1, 1998.

⁷ Cal. Pub. Util. Code §368(a).

⁸ Cal. Pub. Util. Code §330(a), §330(w).

⁹ Speech by CEO Bob Glynn before the 1998 Annual PG&E stockholder meeting, April 15, 1998, San Francisco, CA.

¹⁰ Cal. Pub. Util. Code §330(s).

¹¹ Speech of Bob Glynn before business leaders in Fresno, CA, on November 17, 1997.

¹² Decision 97-11-074 (November 19, 1997).

¹³ Decision 97-11-074 (November 19, 1997).

¹⁴ Cal. Pub. Util. Code §368.

¹⁵ The amounts vary by utility. Under the freeze, PG&E's rates allow 5.4 cents while SCE's rates permit 6.5 cents.

¹⁶ Cal. Pub. Util. Code §368.

¹⁷ Decision 97-10-057 (October 22, 1997) at 2.

¹⁸ Ibid at 16. ("The utilities propose retaining certain balancing accounts in order to permit rate changes after the rate freeze for costs incurred during the rate freeze period. Except for collection of certain costs set forth explicitly in AB 1890, we find such a scheme to be unlawful. We believe the legislature intended the utilities' revenues during the rate freeze period to be limited to the amounts collected from the rates that were in effect on June 10, 1996. AB 1890 does not state that utilities may accumulate balances associated with various costs or ratemaking mechanisms through the rate freeze period and then collect them at a later date. Nothing in the bill would lead us to conclude that the rate freeze merely represents a period during which ratepayers and shareholders will lend funds to each other.")

¹⁹ PG&E Corporation form 8-K, filed September 13, 2000.

²⁰ CPUC Decision 99-10-057.

²¹ SCE form 8-k filing, September 25, 2000.

²² 1996 PG&E Corporation Annual Report, page 11 (February 10, 1997).

²³ PG&E Corporation Form 8-k filing, January 20, 1999.

²⁴ SCE Form 10-Q for the quarterly period ended March 31, 1997. This warning appears frequently in SCE's filings with the SEC.

²⁵ SCE Form 10-k for fiscal year ended December 31, 1996.

²⁶ Although operating losses associated with utility-owned hydroelectric and most fossil units cannot be recovered if they persist over the course of a year, monthly losses can effectively add to stranded costs because they are offset against net revenues produced by the same generator in other months. The overall net revenues at the end of the year, minus any losses incurred over that period, are then credited to the TCBA.

²⁷ Net revenues from utility-owned hydroelectric and coal plants are credited to the TCBA only at the end of the calendar year. The revenues are tracked in memorandum accounts until the time of transfer to the TCBA.

²⁸ This data comes from the monthly TCBA reports filed by PG&E and SCE for the year 2000. Net revenues are determined by deducting incremental operating expenditures from PX/ISO revenues. These figures include monthly net revenues for QF contracts, nuclear plants, inter-utility contracts, fossil generation, RMR/non-RMR units and hydroelectric plants.

²⁹ SCE Form 10-k for the fiscal year ending December 31, 1999.

³⁰ This analysis was performed by Bill Marcus at JBS Energy for TURN using FERC Form 1 data and other publicly available sources.

³¹ PG&E Corporation Form 8-k filing, September 13, 2000 (“Mr. Glynn indicated that, if the value of the Utility’s hydroelectric generating assets, as reflected in the settlement agreement filed by the Utility and other parties on August 9, 2000, were to be credited to the transition costs, then such costs would have been fully recovered during August 2000.”); SCE Form 8-k filing, September 25, 2000.

³² According to prior Commission decisions, the rate freeze does not end as the result of estimates of generation value. In D.99-10-057, the Commission determined that “the end of the rate freeze shall not occur before the generation assets of each utility have been market values except, as the law or Commission determines otherwise.” In any case, the Commission retains the authority to determine the proper ending date for the rate freeze.

³³ These estimates come from two sources: (1) PG&E Corporation 8-k filing, September 13, 2000; (2) SCE Form 8-k filing, September 25, 2000.

³⁴ See line 8 of PG&E’s TCBA report for the month of August 2000 (submitted October 2, 2000).

³⁵ PG&E Corporation form 8-k filing, August 9, 2000.

³⁶ Decision 99-10-057 (October 21, 1999).

³⁶ “California Utilities’ losses on electricity pose risk of technical insolvency in ‘01”, by Rebecca Smith, Wall Street Journal, September 27, 2000.

³⁷ Edison International Investor Relations News, January 18, 2000.

³⁸ PG&E Corporation 1999 Year in Review, Financial and Statistical Reports.

³⁹ “Edison Intl CFO Disputes ‘Technical Insolvency’ Claim”, Dow Jones News Service, by Mark Golden, Oct. 3, 2000.

⁴⁰ Ibid.