

**Before the Public Utilities Commission of the State of California
Rulemaking 02-01-011 (Agenda ID #1722)
Rulemaking Regarding the Implementation of the Suspension of Direct Access
Pursuant to Assembly Bill 1X and Decision 01-09-060
Proposed Settlement and Order Regarding Departing Load
Served by Customer Generation**

**Comment of the Staff of the
Bureau of Economics and the Office of the General Counsel
of the Federal Trade Commission¹**

March 25, 2003

¹ This comment represents the views of the staff of the Bureau of Economics and the Office of the General Counsel of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner. The Commission has, however, voted to authorize the staff to submit these comments.

**Before the Public Utilities Commission of the State of California
Rulemaking 02-01-011 (Agenda ID #1722)
Rulemaking Regarding the Implementation of the Suspension of Direct Access
Pursuant to Assembly Bill 1X and Decision 01-09-060
Proposed Settlement and Order Regarding Departing Load
Served by Customer Generation**

**Comment of the Staff of the
Bureau of Economics and the Office of the General Counsel
of the Federal Trade Commission¹**

I. INTRODUCTION, BACKGROUND, AND SUMMARY

The staff of the Bureau of Economics and of the Office of the General Counsel of the Federal Trade Commission (FTC) appreciates this opportunity to present its views concerning the proposed decision of the Public Utilities Commission of the State of California (CPUC) establishing charges a customer must pay when the customer decides to reduce its demand for electricity by generating its own electric power (departing load served by customer generation). These charges are intended to defray the California Department of Water Resources' (CDWR) costs of procuring electric power on behalf of retail customers of the three major electric utilities in the State during the latter portions of the period of unusually high wholesale electricity prices in 2001 and 2002.² When these utilities faced

¹ This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission and the staff of the General Counsel's Office of Policy Studies. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner. The Commission has, however, voted to authorize the staff to submit these comments. Inquiries regarding this comment should be directed to John C. Hilke, Economist and Electricity Project Coordinator in the Bureau of Economics (801-524-4440 or jhilke@ftc.gov), or Michael Wroblewski, Assistant General Counsel for Policy Studies (202-326-2155 or mwroblewski@ftc.gov).

² The recoverable future procurement costs from departing load served by customer generation should include only those costs that would not be avoided by reducing the quantity procured.

severe financial difficulties in purchasing wholesale electric power,³ the State required the CDWR to assume the utilities' procurement responsibilities.⁴ In addition, the CDWR executed numerous long-term contracts to obtain future wholesale electric power supplies. Just recently, the three electric utilities resumed purchasing wholesale electric power for their customers,⁵ but, in the meantime, wholesale electric power prices in California declined below the prices that the CDWR agreed to pay in its long-term contracts. The proposed decision, among other things, addresses recovering these historic and above-market future costs.

The proposed decision (and the alternative decisions) establish the charges that customers must pay to defray CDWR's costs.⁶ These proposed charges apply to that portion of departing load (DL)

³ The retail electric utilities experienced financial distress because wholesale electric power prices were above the retail prices that these firms were allowed to charge their customers during extended periods in 2000 and 2001. *See, e.g.*, John C. Hilke & Michael Wise, "Who Turned Out the Lights? Competition and California's Power Crisis," 15 *Antitrust* 76-81 (Summer 2001).

⁴ The Governor's "state of emergency" Proclamation of January 17, 2001, and AB 1X required the CDWR to procure electricity on behalf of the retail customers in the service territories of Southern California Edison Company, Pacific Gas and Electric Company, and San Diego Gas & Electric Company. [Proposed Decision, Introduction.]

⁵ The CDWR's procurement authority ended on December 31, 2002. [Proposed Decision, footnote 5.]

⁶ There have been three proposals (in addition to the proposed settlement) for how these customer charges should be assessed. The proposed decision of Commissioners Wood and Brown and Administrative Law Judge Pulsifer is dated January 28, 2003. It generally adopts the provisions of the proposed settlement of October 17, 2002, except that the charges for departing load are higher than those proposed in the settlement. [Proposed Decision at 7, 15, Section VI.A.5.] The first alternative proposed decision (Commissioner Lynch) is dated February 13, 2003. It rejects the proposed settlement, adopts higher charges than the settlement, and includes an exemption from these charges for all small, ultra-clean distributed generation (DG) projects. The latter exemption is based on an interpretation of the California legislature's intent regarding such projects. [Alternative proposed decision, Section I, Section III.D., and Section IV.B.] The second alternative proposed decision

served by customer-owned generation (*i.e.*, DG) that is above the quantity level forecasted to depart. DL/DG customers would be exempt from the proposed charges up to an annual megawatt cap.⁷ This cap is based on the CDWR's planning estimates for DL/DG.⁸ Because the CDWR anticipated some DL/DG, it did not procure as much electric power as it otherwise would have done. The exemption is intended to avoid charging DL/DG customers for future costs that CDWR will not incur.

Under the proposed order, the CDWR's costs for affected DL/DG would be fixed and could be paid in one lump sum. This differs from the payment policy for other types of customers. For example, direct access customers⁹ will pay surcharges on future electric power prices,¹⁰ and bundled service customers¹¹ will have CDWR's procurement costs rolled into future electric power rates.

(Commissioners Peevey and Kennedy) is dated February 27, 2003. It rejects the proposed settlement in favor of a three-tiered approach to cost recovery. Small (under 1 MW in size), ultra-clean DG units are exempted. Large, ultra-clean DG units are partially exempted, up to a cap (3000 MW). Other DG units generally are not exempted.

⁷ Settlement, Section 6.2.

⁸ Settlement, Section 2.2.3 and Appendix A.

⁹ Direct access customers are customers that chose a new supplier under California's retail customer choice program and, thus, have reduced or discontinued their demand from retail utilities because they obtain electric power from independent suppliers. Acting in accordance with AB 1X, the CPUC suspended a customer's right to choose an independent supplier after September 21, 2001, and stated that it may suspend "all direct access contracts executed or agreements entered into on or after July 1, 2001." [Proposed Decision, Introduction.]

¹⁰ See <<http://www.cpuc.ca.gov/static/announcements/direct+access+surcharges.htm>>.

¹¹ Utility "bundled service" in the electric power industry generally refers to traditional electricity service in which a single utility provides (or obtains) electric power, transmission, distribution, and metering and billing services for customers in a franchise territory. When a direct access (customer choice) policy is in place, customers may obtain different services from different competing suppliers.

Our comment focuses on two policy issues affecting recovery of costs such as the CDWR's procurement costs. Other states may have similar cost recovery issues, such as recovering stranded costs of generation facilities that become uneconomical once customers can choose lower-cost independent suppliers. First, the CPUC may wish to assure itself that the exit fees charged to affected DL/DG customers are not disproportionately large and that they reflect the relevant costs and benefits of DL/DG to the region's electric power system within the context of other policies regarding DG. Second, the CPUC may wish to extend to all retail customers the fixed obligation, lump sum payment option offered to DL/DG customers. This option may reduce economic inefficiencies and distortions associated with surcharges (or excise taxes).

II. FTC EXPERIENCE IN THE ELECTRIC POWER INDUSTRY

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of customers. In this industry, the staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy, in addition to its review of proposed mergers involving electric and gas utility companies. In the course of this work, as well as in antitrust research, investigation, and litigation, the staff applies established principles and recent developments in economic theory and empirical analysis of competition issues. The Commission has issued two Staff Reports (July 2000 and September 2001) on electric power market restructuring issues at the wholesale and retail levels. The July 2000 FTC Staff Report established a policy

framework for increased competition in wholesale and retail electric power markets.¹² The September 2001 FTC Staff Report reviewed those features of state retail competition plans that have provided benefits to consumers and those that have not. It also provided analysis concerning whether states had sufficient authority to implement successful retail competition programs.¹³

On March 17, 1999, we filed a comment on CPUC Docket No. R.98-12-015, Distributed Generation and Competition in Electric Distribution Service. This comment emphasized the potential system benefits and costs of deployment of DG, including its potential importance in providing greater price responsiveness of demand in wholesale electric power markets if accompanied by real-time rates and metering. The latter is likely to help alleviate the exercise of market power in wholesale electric power markets by generators.

III. AVOID DISPROPORTIONATE BURDEN OF EXIT FEES ON CUSTOMER GENERATION

The CPUC may wish to scrutinize carefully the proposed exit fees and their administration to assure that they do not discriminate against DL/DG, because retail distribution utilities often have

¹² FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform (July 2000), *available at* <<http://www.ftc.gov/be/v000009.htm>>. This report compiles previous comments that FTC staff had provided to various state and federal agencies. The FTC staff comments are available at <<http://www.ftc.gov/be/advofile.htm>>.

¹³ FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform, Focus on Retail Competition (Sept. 2001), *available at* <<http://www.ftc.gov/reports/index.htm>>.

financial incentives to discourage customer generation.¹⁴ In general, economic efficiency is likely to be greater if DL/DG is not economically disadvantaged relative to utility bundled service as a result of exit fees, and if the externalities (costs and benefits) of DL/DG for the electrical power system are taken into account by policy makers.¹⁵ If governing policies economically disadvantage DL/DG, the result will be to discourage efficient investments in DG. We raise two concerns that may enable such discrimination.

One concern is the potential for overestimating a customer's DL/DG load that is no longer procured from the grid. An administrative determination that the customer's departing load equals the capacity of the customer's DG unit over all hours of the year neglects the fact that DG units may not operate all of the time, because, for example, a DG unit may not be economical to operate during periods of high natural gas prices.¹⁶ Consequently, assuming that a DG unit will operate at full capacity

¹⁴ At the most fundamental level, DL/DG is likely to reduce demand for both distant generation and transmission/distribution services, which is likely to negatively affect the profitability of these suppliers (at least in the short run). The benefits of DG for system costs and reliability may also redound to the benefit of generators, transmission suppliers, and electric power distributors. Under some circumstances the benefits of DG for these suppliers may more than offset the disadvantages for these market participants. If so, these suppliers' net incentives may shift, but the net incentives are uncertain.

¹⁵ These costs and benefits are discussed, for example, in the FTC staff comment to the CPUC of March 17, 1999, available at <<http://www.ftc.gov/be/v990004.htm>>; Consumer Energy Council of America, Distributed Energy: Towards a 21st Century Infrastructure (July 2001), available at <<http://www.cecraf.org/publications/DEOrder.PDF>>; The CPUC is also addressing DG issues in Rulemaking 99-10-025, Agenda ID #1638.

¹⁶ If DG owners face real time prices as many economists have advocated, DG owners may have strong incentives to buy from the grid when wholesale prices are low and reduce demand from the grid when wholesale prices are high, rather than operating the DG unit to meet the customer's demand for power at all times. DG owners have incentives to shed load in peak demand periods if they face real time prices or if they are allowed to bid into wholesale reserve markets (as proposed in the standard market design of the Federal Energy Regulatory Commission).

at all hours is likely to result in double payment by DG owners of the CDWR's procurement costs during periods when the DG unit is idle and the customer is buying its electric power from the local retail utility. Similarly, this administrative determination could result in exit payments when no cost recovery payment would be paid by a similarly situated bundled service customer, *e.g.*, when the customer is using little or no power from any source.

Second, the CPUC may wish to examine the period of time over which DL/DG customers may prorate Historical Procurement Charges (maximum of two years)¹⁷ compared to the time period allowed for recovery of these procurement costs from ongoing utility bundled service customers. If DL/DG customers are allotted a shorter payment period, this may be a form of discrimination.

IV. LUMP SUM CHARGES ARE LESS LIKELY TO DISTORT CONSUMPTION AND INVESTMENT DECISIONS THAN EXCISE TAXES (SURCHARGES)

The proposed settlement and proposed decision establish the financial burden for the CDWR's cost recovery as a fixed sum determined at the point of departure for DL/DG customers.¹⁸ The departing customer is allowed to pay off its obligation in one lump sum or to make the payment (plus interest) in installments. This approach avoids the distortions in consumption and investment decisions associated with ongoing rate surcharges. For example, a surcharge on electric power prices creates incentives to overinvest in machinery powered by fuels other than electric power. In a prior comment

¹⁷ Settlement, Appendix B.

¹⁸ Section 5.3.3 states: "At the election of a Departing Load customer, a Departing Load customer may prepay its total CDWR Shortfall Charge in one lump sum. The prepaid amount shall be based upon the total calculated CDWR Shortfall Charge attributable to the customer, discounted for net present value."

to the Federal Energy Regulatory Commission on optimal ways to collect “stranded costs,” we described how ongoing charges are likely to lead to economic distortions that are not in the public interest:

If possible, the method chosen [to recover stranded costs] should not distort the price signals that the economy relies upon to prompt efficient decisions about production, consumption and investment. The ideal method would have a neutral effect on . . . customers’ marginal price and output decisions. The lump sum approach is neutral in this sense, but the excise approach is not. The excise approach effectively increases the unit price of customer’s future services, and increasing its prices is likely to reduce how much it purchases. . .¹⁹

To avoid such distortions for direct access customers and utility bundled service customers as well as for DL/DG customers, the CPUC may wish to apply the lump sum obligation approach to all customers. These charges could still be prorated over an extended period to avoid a large one-time payment by direct access and utility bundled service customers, but removing the excise aspect of recovery of the CDWR’s historic costs could avoid harm to customers and associated economic inefficiencies.

V. CONCLUSION

In assessing the proposed settlement’s charges for DL/DG customers, the CPUC should assure itself that the exit fees do not serve as a vehicle to discriminate against DG investments. The proposed lump sum approach for recovering the CDWR’s procurement costs from DL/DG

¹⁹ FTC staff comment to the Federal Energy Regulatory Commission, Docket Nos. RM95-9-000 and RM94-7-001 (Aug. 7, 1995), *available at* <<http://www.ftc.gov/be/v950008.htm>>.

customers has attractive efficiency characteristics that the CPUC may wish to offer to ongoing utility bundled service customers (and to direct access customers).

Respectfully submitted,

David T. Scheffman, Director
John C. Hilke, Economist and Electricity Project
Coordinator
Bureau of Economics

Susan S. DeSanti, Deputy General Counsel
Michael S. Wroblewski, Assistant General Counsel
Federal Trade Commission
600 Pennsylvania Ave., N.W.
Washington, D.C. 20580

March 25, 2003