CALIFORNIA ENERGY MARKETS

The State's Position Has Improved, Due to Efforts by the Department of Water Resources and Other Factors, but Cost Issues and Legal Challenges Continue

Audit Highlights . . .

The Department of Water Resources (department) has renegotiated 23 power contracts with 14 suppliers to improve the energy delivery, financial, and legal aspects of these contracts. In addition, the investor-owned utilities are once again responsible for purchasing the net short.

- ☑ ***The portfolio better fits California's power needs due to changes in energy products and a reduction of forecasted demand.***
- ☑ ***Reported contract cost reductions were estimated at $5.5 billion on a nominal basis and based on assumptions at the time of the renegotiations.***
- ☑ ***Based on March 2003 market assumptions, replacement power costs, and discounting to present value, the department consultant currently estimates ratepayer savings as $580 million.***
- ☑ ***The legal terms and conditions of the restructured contracts significantly improved reliability, but the department remains restricted in its ability to assign contracts.***

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Department of Water Resources' response as of June 2004

The California Water Code, Section 80270, requires the Bureau of State Audits to conduct two financial and performance audits of the Department of Water Resources' (department) implementation of the power-purchasing program: the first due by December 31, 2001, and the second due by March 31, 2003. We completed the first required audit on December 20, 2001, and this audit fulfills the requirement for the second audit report. In this audit, we follow up on the department's actions with respect to the recommendations from our 2001 audit. To assist us in forming our conclusions related to the economic issues involved, we retained the services of an energy economics firm to perform various analyses.

Finding #1: With renegotiated contracts and a reduction in forecasted demand, the contracted electricity portfolio better matches California's needs and better tracks changes in fuel costs.

The department has renegotiated the terms and conditions of 23 long-term power contracts with 14 suppliers, representing over one-half of the total value of the portfolio. These renegotiated contracts contribute to the improved fit of the portfolio to the State's forecasted demand by converting significant amounts of nondispatchable power—power that the department was obligated to purchase regardless of the need—to power deliveries the department can use when needed. In addition, the renegotiated portfolio increases power deliveries in Northern California in 2002 and 2003 to meet demand. Further, the department was able to shift some deliveries of power from Southern to Northern California, which reduced the amount of surplus power projected in Southern California. The department also renegotiated for more capacity tied to tolling agreements—

☑ ***Even though the investor-owned utilities have resumed purchasing the net short, the department retains substantial responsibilities related to the long-term contracts.***

cost management arrangements that allow the department either to purchase the fuel needed for the power facilities under contract or to tie the fuel cost to the current cost of natural gas. However, most of the improvement in the fit of the power supply to the demand has resulted from significant changes in the demand forecast rather than from significant improvements in the power contracts. These forecast changes include reductions in the demand for power from the investor-owned utilities for a variety of reasons, including the ability of certain electricity customers to buy electricity from alternate suppliers.

We recommended that the department persistently and aggressively manage the long-term contracts to capture opportunities to improve the overall supply portfolio including opportunities to further improve the match of power deliveries from the contracts to California's power needs.

Department Action: Partial corrective action taken.

Since the April 2003 release of our audit, the department indicates it has renegotiated three power contracts and in its June 2004 one-year response to us, the department reported that with the new administration in place, it anticipates renewed renegotiation activity. The department indicates that the renegotiated contracts have improved the match of power deliveries to the State's needs by reducing the amount of must take power deliveries (power that must be purchased regardless of the power need).

Finding #2: While the renegotiation efforts will provide some savings to ratepayers, the department's portfolio still remains above market prices.

Throughout the energy crisis, the department and the governor's office reported both the contract costs and the savings in terms of the contract payments to suppliers. Thus, they reported that the estimated reductions in contract costs from the restructuring of the contracts totaled approximately $5.5 billion, which represents approximately 13 percent of the total original contract costs of $42.9 billion. These contract cost reductions were based on information available at the time of the renegotiations and were calculated using a negotiation model that the department used when evaluating the effect of different renegotiation options on the reduction in contract costs.

While this savings estimate reasonably reflects reductions in the nominal cost of the contract portfolio to the department, an alternative analysis would estimate the savings to the utilities' customers. With consideration of the replacement power costs and using the department's revenue requirement model, a department consultant estimated in March 2003 that the net savings to ratepayers in nominal terms is $1.5 billion. Also, because these savings will occur over the next 20 years, the department consultant estimated that the net present value of the future stream of savings to ratepayers is $580 million. These March 2003 estimates of customer savings are a function of economic, market, and dispatch assumptions used by the department consultant in its modeling and would change if those assumptions changed. Also, the department indicates that its revenue requirement model is not designed to value nonprice benefits resulting from the renegotiation efforts, such as the improved availability and reliability provisions in the contracts. Further, most of these contract cost reductions will result not from reducing the price per megawatt-hour of the power purchased but rather from shortening the length of the contracts or reducing the amount of power to be delivered. However, this reduction of contract length contributed to a department objective to shorten the time that it would have financial or legal responsibility for the contracts and, in the process, permit the utilities to procure energy themselves to meet the additional uncovered net short.

According to the department, the March 2003 estimate of savings to the consumer from the renegotiated contracts as of December 31, 2002, using its revenue requirement model, was made only at our request, and the department would not otherwise have made this calculation. In addition, the amounts are from its consultant's draft report, and had not gone through the department's ordinary standards of review. However, this is the only estimate the department provided to us of the savings to the consumer from the renegotiated portfolio as of December 31, 2002. Further, we observed that these forecasts are consistent with the forecasts prepared by the department consultant in establishing the department's revenue requirements and were also used in support of the revenue bonds that the department issued in October and November 2002.

We recommended that the department persistently and aggressively manage the long-term contracts to capture opportunities to improve the overall supply portfolio, including opportunities to achieve additional cost savings.

Department Action: Partial corrective action taken.

Since the April 2003 release of our audit, the department indicates it has renegotiated three power contracts and in its June 2004 one-year response to us, the department reported that with the new administration in place, it anticipates renewed renegotiation activity. The three renegotiated contracts have reduced contract costs by approximately $1 billion, in nominal terms. However, when considering the savings to consumers by taking into account the cost to replace the power that was eliminated through contract renegotiations, and by considering that the savings occur over time, the net present value (at 9 percent) of the total savings to customers is $322 million. The customer savings varies between approximately $24 million to $74 million from year to year through 2011, but we estimated the savings at approximately $29 million for 2003. The department's consultant calculated the total contract reductions and customer savings using market conditions at the time the three contracts were renegotiated, which is consistent with the methodology used in our audit report.

Finding #3: The renegotiated contracts improve the reliability and flexibility of the department's energy portfolio, but challenges remain.

Our review of the legal terms and conditions of the restructured contracts indicates that the renegotiations have generally resulted in improved terms over those in the original contracts. For example, we found that the restructured contracts have much stronger guarantees that the sellers will deliver the power promised under the contracts and build the new generation facilities promised in the contracts. As a result, the renegotiated contracts better meet the reliable energy goals of Assembly Bill 1 of the 2001–02 First Extraordinary Session (AB 1X) and thus better ensure the availability of electricity to satisfy consumer demand. These improvements are accomplished through stronger terms and conditions, such as termination rights for the State and penalty provisions when sellers fail to deliver energy or construct new generation facilities as promised under the contract. Changes in the type of energy products purchased under the contracts also increase the reliability of the department's contract portfolio. Both the stronger terms and conditions, and the product changes are likely to provide economic benefits to ratepayers. Another benefit from the renegotiations is that the State has entered into settlement agreements with suppliers. In most of these settlements, the suppliers agreed to cooperate with the attorney general's energy investigation and to make financial settlements to the State.

While the restructured contracts are better from a legal standpoint, significant risks remain for the department, particularly in the contracts that the State has not renegotiated. An area of continuing concern is the restrictions on the department's ability to assign the contracts to other parties, particularly to the investor-owned utilities. The investor-owned utilities have resumed purchasing the net short and have also assumed the day-to-day management and operation of the contract portfolio. However, the department remains legally and financially responsible for the contracts, until either the investor-owned utilities meet certain credit standards or suppliers decide to release the department from this obligation. As a result, the department continues to have significant ongoing legal and technical responsibilities for the management of the long-term contracts and could retain those responsibilities for the remaining life of the contracts.

We recommended that the department persistently and aggressively manage the long-term contracts to capture opportunities to improve the overall supply portfolio, including opportunities to improve the terms and conditions of contracts that have not yet been renegotiated. In regard to its continuing responsibility to manage the long-term contracts, the department should monitor the performance of power suppliers relative to their contractual obligations and promptly address and resolve any supplier deviations from contractual obligations. We also recommended that the department review the appropriateness of the investor-owned utilities' proposed annual gas supply plans for contracts with tolling agreements.

Department Action: Partial corrective action taken.

Since the April 2003 release of our audit, the department indicates it has renegotiated three power contracts and in its June 2004 one-year response to us, the department reported that with the new administration in place, it anticipates renewed renegotiation activity. The department reports that three contracts have improved terms and conditions. For example, one contract now includes anti-market gaming provisions and allows the department to assign it to a credit-worthy investor-owned utility. Another contract also includes a settlement of claims with the attorney general and other parties, which the department indicates is valued at approximately $1.5 billion. In addition, the Governor's Office reported in April 2004 that it reached a settlement with an energy company valued at approximately $282 million, of which $256 million will be refunded directly to the department and the investor-owned utilities.

To ensure that the investor-owned utilities exercise due care in the handling of the contracts, the department indicates that its staff and consultants conduct weekly internal coordination meetings as well as weekly conference calls with the investor-owned utilities. Further, the department and the investor-owned utilities work together to review the gas supply plans related to each of the gas tolling contracts. Additionally, for those contracts that are tied to new power plant construction, the department indicates that its staff and consultants are witnesses at performance demonstration tests, which are designed to ensure compliance with contract terms either before a power plant begins commercial operation or as an annual performance test of an existing power plant. Finally, the department states that staff periodically visits construction sites for new power plants to ensure that the progress is consistent with the contract.

Finding #4: Sales of surplus power have not significantly affected the cost of the power-purchasing program.

In our December 2001 audit, we indicated that in future years the department's long-term contracts would likely require it to purchase more power than would be needed during some hours. Those quantities would be expected to be sold as surplus and thus have the potential to increase the overall cost of power. In 2002 the department did sell surplus power, but these sales were not significant in proportion to its total purchases. Further, our consultant advises us that the costs from the sales do not appear unreasonable. Although the department's renegotiation efforts have reduced the potential for surplus power sales in future years, it is still likely that significant sales will occur, particularly in the years 2003 through 2005.

To monitor the efforts of investor-owned utilities to limit power sales, the department should routinely collect and analyze data (including settlement data from the California Independent System Operator) on power sales by the investor-owned utilities.

Department Action: Corrective action taken.

The department indicates that it negotiated with the investor-owned utilities and the California Independent System Operator to receive the information needed to monitor the investor-owned utilities' sales of surplus energy from the energy contracts. The department uses this information along with data from counterparties to the sales to ensure that sales of surplus energy are appropriate.

Finding #5: The department was not able to achieve coordinated dispatch of power supplies that could reduce costs.

The department was not able to achieve a coordinated dispatch of power supplies between the contract portfolio and the investor-owned utilities' generating facilities so as to minimize costs to ratepayers. The electric power that the retail customers of the investor-owned utilities purchase is obtained from a variety of sources, each with a different cost per unit of power delivered during different times of the day and week. As such, there is an opportunity each day to optimize this mix of sources to provide power at the lowest possible cost. However, the department has been unable to implement a coordinated dispatch of power sources with the investor-owned utilities. It attributes this inability, to some degree, to the investor-owned utilities' failure to share with the department information about the availability of their generating facilities and the terms of their third-party contracts, as well as to fluctuations in demand forecasts by the investor-owned utilities that make minimizing purchase costs more difficult.

Recognizing the California Public Utilities Commission's (CPUC) established role in overseeing the dispatch decisions of the investor-owned utilities, the department should routinely monitor resource scheduling and other data provided by each utility to ensure that dispatch decisions are consistent with established operating protocols and its fiduciary responsibility to bondholders.

Department Action: Corrective action taken.

As we had recommended, the department reports that it continues to receive all dispatch information from the investor-owned utilities on a daily basis. This information allows the department to compare actual dispatch of contract energy with projected dispatches and to determine whether there will be any significant deviations to the department's cash flow as a result of the investor-owned utilities' dispatch decisions.

Finding #6: The department will continue to face cost and legal challenges.

Substantial work remains to be done by others to restore California's electric markets to full health and to manage the power portfolio assembled by the department during its two-year tenure as power buyer for the State. Issues involving the creditworthiness of the investor-owned utilities must be resolved, plans must be made for the long-term governance of the utilities' power-procurement practices, and changes are needed in the power market structure to assure that the markets are effective and well monitored. Although California's power supply situation has improved over the past two years, accounting and credit issues have affected many companies in the power supply industry, raising questions regarding the further development of new supplies. Furthermore, substantial outstanding investigations and litigation associated with the power crisis are still unresolved. In addition to marketwide issues, the department's ongoing stewardship of the Electric Power Fund and the contract portfolio will be an important component of the State's power supply for years to come. The contract portfolio is likely to remain under department management for much of the next decade and will require continued vigilance to mitigate the potentially high costs of those contracts. Attendant upon those responsibilities will be the need for the department to manage its operating partnerships with the utilities to schedule and deliver the power and to procure fuel. In addition, the department will be responsible for the administration of bonds issued to finance the cost of the AB 1X power program. These remaining responsibilities carry substantial ongoing obligations to manage costs and risks and will require a sustained professional organization at the department to properly protect the State's interests.

We recommended that the department be alert for situations in which the credit standing of the investor-owned utilities may adversely affect the department's costs. Further, the department needs to maintain the capability to analyze conditions in electricity and gas markets. The department should also use the servicing agreements with the investor-owned utilities to monitor dispatch statements from the investor-owned utilities relative to their accounting statements to the department.

Finally, to fulfill its responsibilities for servicing the revenue bonds, the department should prepare revenue requirements filings for the CPUC and advise the CPUC when its regulatory oversight of the investor-owned utilities intersects with the department's responsibilities under the revenue bonds; act to mitigate risks, such as CPUC ratemaking practices, that may adversely affect bondholders; and perform financial and accounting activities necessary to support its obligations under the revenue bonds.

Department Action: Corrective action taken.

The department reports a variety of actions to address our recommendations. The department notes that it and the investor-owned utilities have determined that they can purchase gas at a lower cost under tolling agreements than having generators supply the gas needed to produce power. Since the investor-owned utilities act as the department's agent when making gas purchases, the credit standing of the investor-owned utilities has not affected the cost to purchase gas as the gas sellers are relying on the department's credit standing. Concerning the need to maintain capabilities to analyze conditions in the electricity and gas markets, the department subscribes to various gas and power market information services, participates in procurement review groups with each investor-owned utility, and is a member of a natural gas working group with the CPUC and several other state departments. Additionally, the department actively follows and monitors CPUC proceedings that may impact or change the operating agreements with the investor-owned utilities and that might be adverse to the department or its responsibilities under AB 1X, or be perceived adversely by the financial community. When such issues are identified, the department files memoranda or comments in these proceedings to preserve its rights and explain its position to the CPUC. Further, the department believes the implementation of several automated tools allows it to better monitoring dispatch statements from the investor-owned utilities. Finally, the department indicates that it continues to prepare the annual revenue requirement for the CPUC and perform the financial and accounting activities required to support the department's obligations under the revenue bonds.