CALIFORNIA
• BUDGET PROJECT •

BUDGET WATCH

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WHAT DOES CALIFORNIA'S ENERGY CRISIS MEAN FOR THE BUDGET?

California's energy crisis has overshadowed deliberations over the 2001-02 Budget. At issue are amounts spent by the state to purchase power for customers of the state's electric utility companies and concerns over how the crisis will affect the California economy and, in turn, state revenues. At the outset, it is important to note that the energy crisis is a moving target that changes daily, if not hourly, making it difficult to obtain up-to-date information. Much of the policy framework developed in the measures considered in a special session of the Legislature called to address the energy crisis was aimed at keeping the state's three major investor owned utilities (IOUs) – Southern California Edison (SCE), Pacific Gas and Electric (PG&E), and San Diego Gas and Electric (SDG&E) – out of bankruptcy. It is unclear what impact PG&E's recent bankruptcy filing will have on amounts owed to the state for power purchased on behalf of the utility's customers or the state's ability to issue bonds to repay the General Fund and pay for future power purchases.

Why is the State Buying Power?

The state entered the electricity business in response to suppliers' unwillingness to sell power to California's cash-strapped IOUs. Books could, and probably will, be written about the complex array of factors that led to the state's power crisis. In brief, wholesale price increases, supply shortages attributable to a number of factors, and elements of the state's deregulation law set the stage for the crisis. Earlier this year, PG&E and SCE edged toward bankruptcy as the wholesale price of electricity far exceeded the amount the IOUs could collect from consumers under the rate cap established as part of deregulation.

Independent audits of PG&E and SCE ordered by the California Public Utilities Commission (CPUC) document the transfer of billions of dollars of profits to the companies' parent corporations during the early days of deregulation. The audits also found that the utilities were allowed to recover billions of dollars from ratepayers for "stranded assets" – investments in facilities that regulators felt would be unprofitable in a competitive market – for power facilities that became immensely profitable as electricity prices skyrocketed. The audits also found that the amount utilities paid for wholesale electricity exceeded what they could recover from consumers by billions of dollars. The exact discrepancy is a matter of dispute. The widely quoted $12 billion shortfall represents a generous estimate (from the utilities standpoint) of the amount the IOUs were unable to collect from consumers. Consumer advocates argue that the utilities should subtract the amount they received from selling the power they continued to generate internally at inflated prices, as well as the amounts recovered for stranded assets that remained profitable in a high price environment. Advocates also argue that these calculations should take into account profits utilities made (and transferred to parent corporations) during the initial years of deregulation.

Suppliers' reluctance to sell to the IOUs due to the companies' precarious financial position pushed the state into rolling blackouts in early January. The state stepped in with the goal of stabilizing the market by using its solid credit rating and cash reserves to buy power on the spot market and negotiate more favorable prices than could be negotiated by the IOUs.

What is the State Actually Buying?

The state, through the Department of Water Resources (DWR), is purchasing the "net short" – the gap between consumer demand and 1) power generated by the IOUs; 2) power generated by so-called Qualifying Facilities (QFs; QFs use either cogeneration or renewable energy resources to generate power) under contract to the three IOUs; and 3) power purchased pursuant to "bilateral" contracts held by the IOUs. The net short is approximately 40 percent of the state's total demand for power.

Where Has the Money for Power Purchases Come From?

Funds for the state's power purchases have come from the General Fund and from amounts borrowed from the Department of Water Resources (DWR) and State Water Project (SWP). General Fund moneys have come from the 2000-01 surplus. By mid-April, the state had spent more than $5.0 billion for power purchases. The Administration has been requesting deficiency appropriations of $500 million approximately every ten days, corresponding to the approximate amount needed to cover ten days' power purchases.

How Are the Bonds Supposed to Work?

AB 1X, signed into law in February, authorized the DWR to enter into long-term power contracts and authorized the state to issue approximately $10 billion in revenue bonds to repay the General Fund and finance future power purchases. The bonds were intended to smooth the cost of power by subsidizing consumers in the short term while costs are high, with the difference made up in the future when electricity costs are expected to fall. However, since such a large share of the bond proceeds will be required to repay the General Fund for previously purchased power, the ability to mitigate the impact of higher prices in the future will be diminished.

In recent weeks, the Governor's Office has informed the Legislature that a larger bond may be necessary to repay the General Fund and buy power in the future. Media reports have suggested that the state may issue up to $14 billion in revenue bonds. AB 1X limited the amount of bonds that could be sold to four times the amount raised by the "California Procurement Adjustment" (CPA; the CPA is the difference between the generation-related component of the retail rate and the sum of the costs of the utilities' own generation, QF contracts, existing bilateral contracts, and ancillary services). However, the California Public Utilities Commission (CPUC) can adjust the amount raised by the CPA by raising utility rates, as was done on March 28, 2001.

How and When Will the General Fund be Repaid?

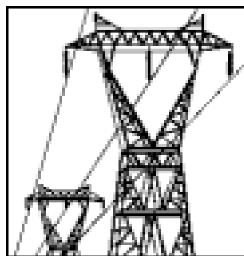
The state's General Fund will be repaid from the amounts collected by the utilities from consumers and from the proceeds of the revenue bonds. AB 1X, which authorized the bonds, also states that the General Fund shall be reimbursed for interest earnings lost on amounts borrowed to purchase power. In response to an order issued by the CPUC on March 27, PG&E and SCE began reimbursing the state for power purchased by the state.

The Governor's staff and the Treasurer have stated that they expect the revenue bonds to be issued before the end of the 2000-01 fiscal year and that the General Fund will be repaid before the start of the 2001-02 fiscal year. However, some legislators and other observers believe that the bonds will not be sold until sometime in the fall, particularly in light of the uncertainty introduced by PG&E's filing for bankruptcy. On March 27, the CPUC took several actions needed before the bonds could be issued including 1) increasing rates to produce a sufficient revenue stream to repay the bonds; 2) establishing a process for calculating the CPA; and 3) requiring the utilities to immediately remit amounts collected from ratepayers for power purchased by the state.

Before the bonds can be sold, the CPUC must allocate the revenues generated by the March 27 rate increase between the DWR and the IOUs. The state and the IOUs disagree as to how the funds should be divided, particularly with

respect to the portion of the rate increase that is attributable to power generated by the IOUs or to their ongoing contracts (i.e., the rate increase on power not purchased by the state). To the extent a larger share goes to the DWR, the need for a subsidy out of bond proceeds or the General Fund will be reduced. Finally, the size, complexity, and unprecedented nature of the proposed transaction are responsible for a portion of the delay.

It is unclear how legislators will treat the amounts owed to the General Fund in the event the bond sale drags into the new fiscal year. At this point, the amount owed to the General Fund exceeds the reserve proposed by the Governor for 2001-02. Thus, some mechanism will likely be needed to reconcile the spending plan to available resources. This could be accomplished by reducing spending to match available resources, postponing some spending decisions until the end of the Legislative session, or tying certain expenditures to sale of the bonds and subsequent receipt of the proceeds by the General Fund.



How Will the Energy Crisis Affect the State's Credit Rating?

On April 24, Standard and Poor's, one of the major credit rating agencies, downgraded the state's bond rating two steps from AA to A+. The effect of the change will be to increase the interest costs on state borrowing. In making the change, the agency stated, "In January, the state indicated that a resolution of the problem would entail a state General Fund contribution of less than $1 billion and that the problem would be resolved in a few months, at most, before long-term power contracts could be negotiated at substantially lower prices. Since then, the problem has escalated quickly. The state has spent more than $5 billion of General Fund monies to date for purchased power and is likely to face a summer of power shortages and uncertain power prices at rates substantially above those charged to retail customers."

Most of the bonds issued to provide financing for power purchases (the AB 1X bonds) will be revenue, not General Obligation (GO), bonds. This means that they will be secured by, and repaid out of, a dedicated revenue stream. General Obligation debt, such as state-issued school bonds, are secured by the full faith and credit of the state, which means, in practice, that they have first call on the state's General Fund in the event of a serious shortfall. While the revenue bonds would not directly compete with the state's ability to issue GO debt, concerns over the state's long-term ability to repay energy-related debt could result in a further downgrading of the state's credit rating, thereby increasing the cost of borrowing even more. It is also possible that the volume of debt issued would saturate the market, making it difficult to sell additional bonds. However, the downturn in the stock market may make bonds, with their guaranteed yield, an attractive investment alternative.

The state may also issue debt to purchase the transmission grid or other assets from the IOUs as a means of providing the utilities with cash to repay their outstanding debt. The status of negotiations over purchase of the grid varies daily. The Governor has announced that an agreement has been reached with SCE, but key legislators have expressed concern over the details of the agreement. If the state moves forward to acquire the transmission grid from the IOUs, the acquisition would likely be financed with revenue bonds backed by a portion of consumer rates already dedicated to transmission costs.

The proposed revenue bonds would substantially increase the state's outstanding debt. A $10 billion bond sale to finance power purchases, for example, would increase the state's outstanding lease-revenue debt by 153 percent. The Treasurer's Office assumes that most of the debt issued to finance power purchases would be tax-exempt debt. The market for tax-exempt debt is limited to California investors (who seek the benefit of a California tax exemption; investors outside of California would not benefit from the exemption and thus would seek the higher yield of taxable debt). Bonds issued to finance purchase of the transmission grid would be taxable

and could be marketed to a broader pool of investors.

What About Other Energy-Related Spending?

The Governor set aside $1 billion in his January Budget for programs aimed at encouraging energy production and conservation. Most of these funds were expended in two bills, SB 5X (Sher) and AB 29X (Kehoe), signed on April 11, 2001. These measures appropriate more than $850 million for a range of energy assistance, conservation/efficiency, and educational programs. More than a hundred special session measures have been introduced, along with a number of regular session bills. It is not clear whether the Governor intends to impose a $1 billion "hard" cap on energy-related expenditures at this time. Moreover, neither the Governor's Proposed Budget nor any of the bills signed to date addresses the impact of rising energy costs on state buildings and facilities.

What Will the Energy Crisis Mean for the Budget Over the Long Term?

The most direct impact of the energy crisis will come from the impact of higher rates on consumer spending. Rising electricity costs will reduce the amount consumers have to spend on other goods. The Legislative Analyst has estimated that consumers' bills would rise by approximately $15 billion (from $25 billion to $40 billion, a 60 percent increase) if they were paying the market price of their power. The additional cost of power equates to approximately one percent of the more than $1.1 trillion California economy, a modest, but nonetheless significant increase. Taken in isolation, the increase in electricity would probably have a minimal impact on the state's economy. However, gasoline and natural gas prices have also increased in cost over the past year and the economy, as a whole, is slowing. Economists believe that rising energy costs could reduce state economic growth by as much as a percentage point, from 3 to 4 percent to 2 to 3 percent. Slower economic growth, in turn, would reduce state revenues.

Over the long term, the rising cost of electricity and concerns over the reliability of the state's power supply could cause businesses to shift jobs and investment out of state. This would also reduce economic and revenue growth in the future. The potential magnitude of such a shift is impossible to predict and could be mitigated by the fact that other states are experiencing power shortages and/or price hikes as well.

Finally, the timing of the state's energy crisis is particularly inopportune. While most of the traditional indicators of economic performance remain strong, the recent national economic slowdown and related dot-com shakeout have disproportionately affected high-tech firms, including those based in California. Business investments are down and the drop in stock values has reduced the paper wealth of many households. To the extent that the recent economic boom has been attributed to the wealth effect of the high-flying stock market of the late 1990s, the drop in stock prices has depressed consumer confidence and consumer spending. The combined impact of consumer fears over a worsening economy and rising energy costs could prove worse than the independent impact of each factor on the economy and, in turn, state revenues.

What Are the Outstanding Questions?

The state's involvement in power purchases raises a number of important policy questions, including:

1. When are the bonds authorized by AB 1X likely to be sold? How long will it take for the General Fund to be repaid out of the proceeds of the bonds?
2. What happens to repayment of the General Fund if the bond proceeds prove inadequate to repay the General Fund and purchase power until electricity costs stabilize?
3. What impact will the issuance of revenue bonds for power purchases and, potentially, purchase of the transmission grid have on the state's ability to issue other debt?
4. What other costs will the energy crisis impose on the Budget? How much will be spent on incentives for generation and production?

Who in California Will Benefit from President Bush's Proposed Tax Cut?

President Bush has made his $1.6 trillion tax cut the major policy priority of the new administration. The House of Representatives has passed the first three parts of President Bush's proposed tax cut with only minimal debate. Taken together, HR 3, HR 6, and HR 8 will 1) reduce personal income tax rates and create a new 12 percent tax bracket; 2) partially eliminate the so-called "marriage penalty"; 3) increase the $500 per child tax credit to $1,000 by 2006; 4) expand the Earned Income Tax Credit for married couples; 5) modestly increase the Alternative Minimum Tax exemption for married couples; and 6) gradually repeal the estate tax. The Senate has endorsed a smaller reduction.

A new analysis prepared by the Institute on Taxation and Economic Policy (ITEP) for the California Budget Project finds one out of four (24.0 percent) – 3.458 million – California taxpayers would receive ***no*** benefit from the President's proposed income tax reductions. The analysis also shows that the wealthiest one percent of California taxpayers would receive half (49.0 percent) of the total benefits of the Bush tax cut received by California taxpayers. The poorest 20 percent of taxpayers would receive less than one percent (0.9 percent) of the benefits of the tax cut received by California taxpayers. The bottom 80 percent of taxpayers would receive just over a quarter (27.0 percent) of the total benefits that go to California taxpayers.

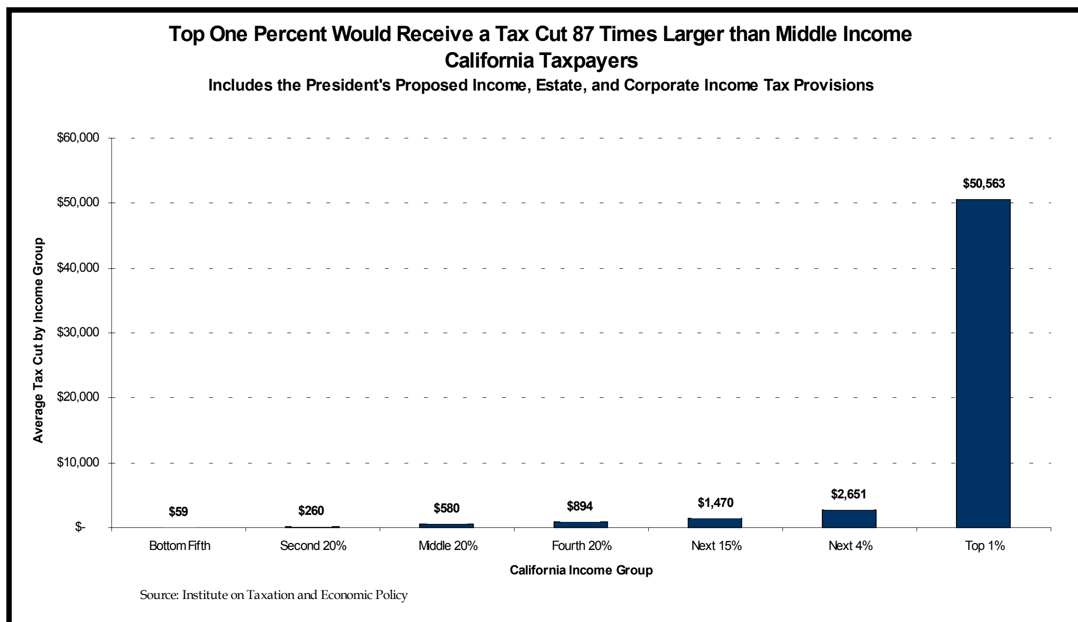
The ITEP study examined how the tax measures passed by the House, along with the modest corporate tax provisions contained in the Bush package, will affect California taxpayers at various income levels. The ITEP analysis shows that:

- The California taxpayer exactly at the middle of the income distribution would receive a $580 reduction when the tax cuts are fully implemented. Nearly all ($571) of this amount is attributable to the income tax proposals in the President's package.
- The wealthiest one percent of California taxpayers, with average incomes of $1,135,000 per year, would receive an average total tax cut of $50,563. Slightly less than half ($24,587) of this amount is attributable to income tax reductions; the remainder is attributable to the elimination of the estate tax and modest corporate tax provisions in

How Are the Benefits of President Bush's Tax Cut Divided Among California Taxpayers?

Income Group	Income Range	Number of Tax Returns (in thousands)	Average Income	Total Income Tax Cut (in millions)	Percent of Income Tax Cut	Estate & Corporate Tax Cut (in millions)	Percent of Estate & Corporate Tax Cut	Total Tax Cut (in millions)	Percent of Total Tax Cut	Average Income Tax Cut	Average Total Tax Cut
Bottom 20%	Less than $16,000	2,848	$9,700	-$164	1.3%	-$5	0.1%	-$169	0.9%	-$58	-$59
Second 20%	$16,000 - $29,000	2,848	$22,200	-$726	5.5%	-$13	0.2%	-$740	3.9%	-$255	-$260
Middle 20%	$29,000 - $46,000	2,849	$37,100	-$1,626	12.4%	-$26	0.4%	-$1,652	8.7%	-$571	-$580
Fourth 20%	$46,000 - $79,000	2,848	$60,500	-$2,502	19.1%	-$43	0.7%	-$2,545	13.4%	-$879	-$894
Next 15%	$79,000 - $165,000	2,136	$108,000	-$2,950	22.5%	-$190	3.3%	-$3,141	16.6%	-$1,381	-$1,470
Next 4%	$165,000 - $556,000	528	$233,000	-$604	4.6%	-$797	13.7%	-$1,401	7.4%	-$1,144	-$2,651
Top 1%	$556,000 or more	184	$1,135,000	-$4,524	34.5%	-$4,764	81.6%	-$9,288	49.0%	-$24,587	-$50,563
	ALL	14,398	$64,600	-$13,099	100.0%	-$5,838	100.0%	-$18,937	100.0%	-$910	-$1,315
Median California Taxpayer			$37,100							-$571	-$580

Source: Institute on Taxation and Economic Policy



the President's package.

- Put another way, the wealthiest one percent of taxpayers would receive an average total tax cut 857 times larger than that received by the poorest 20 percent ($50,563 versus $59), and 87 times larger than that received by middle income Californians ($50,563 versus $580).
- The distribution of the benefits from the repeal of the estate tax and the very limited corporate tax relief contained in the Bush package are particularly skewed. The top one percent will receive 82 percent of the benefits from the estate and corporate tax provisions – more than eight out of every ten dollars – while the bottom 80 percent of taxpayers will receive only 1.5 percent of the estate and corporate tax cuts.

Poor, Majority Non-White Schools Less Likely to Benefit from School Performance Awards

Schools with large shares of non-white and poor students are less likely to benefit from the Governor's Performance Awards (GPA) program, according to recent CBP analyses of the results of the 2000 Academic Performance Index (API). The CBP's analysis found that schools' performances on the Stanford 9 standardized test, used as the basis of the cash awards, was strongly associated with the percentage of poor students (as measured by enrollment in free lunch programs), the size of a school, the percentage of Latino enrollment, and share of teachers who hold full teaching credentials. In brief, the CBP found that:

- Over 80 percent of the variation in schools' 2000 API scores can be explained by the social and economic characteristics of a school's students, the size of the school, and whether its teachers are fully credentialed.
- Schools that were eligible for Governor's Performance Awards and School Site Employee Performance Awards had lower enrollment, lower percentages of non-white students, higher percentages of teachers with full credentials, and lower percentages of poor students than schools that were not eligible for these awards. Award eligible schools were also less likely to operate on year round schedules.
- Schools in the top five deciles that qualified for Governor's Performance Awards received $1,126 per point of API growth, compared to $973 for low-performing schools (schools in the bottom five deciles). The disparity is even greater between the top two and bottom two deciles, $1,423 per growth point for the top two deciles compared to $1,141 for the bottom two.

- Rankings of eligible schools for Certificated Staff Performance Incentive (CSPI) awards are determined by measuring a school's growth above their eligibility target, which favors schools with lower 2000 API growth targets, rather than absolute growth in API scores. Thirty-five elementary schools and eight middle schools would have received CSPI awards if the schools were ranked by their total 1999-2000 API growth. These schools were among the lowest performing schools in the state, and all fell in the lowest three deciles on the 2000 API. In addition, they were larger; had higher shares of poor, non-white students; and had fewer credentialed teachers than schools that will receive CSPI awards under current regulations.

The relationship between test scores and school characteristics are important, since more than $800 million in state funds will be allocated based on schools' API scores. More than three-quarters of the funds allocated to schools as part of recent accountability initiatives are targeted to reward schools that do well on standardized tests. In contrast, less than a quarter of the new funds are dedicated to preparing low-performing schools to do better. Based on these findings, the CBP recommends the following:

- ***Target resources toward low-performing schools.*** One approach is the Legislative Analyst's Office suggestion to replace the Governor's proposal to expand the school year for all middle school students with a $500 million block grant that would provide resources to districts with the lowest API scores and/or the highest concentrations of low income students. Districts could use the additional resources to fund a range of options to improve student performance.
- ***Provide incentives to attract the most experienced and qualified teachers*** to the lowest performing schools.
- ***Expedite efforts to include other indicators in the API***, in addition to the Stanford 9, in order to provide an accountability system that more accurately measures achievement of the state's educational goals.
- ***Align curriculum standards and the API.*** Until this occurs, testing will neither accurately measure students' progress toward learning the state's standards-based curriculum nor provide an incentive to schools to effectively teach to the recommended standards.
- ***Provide adequate resources*** to align curricula to the standards, train teachers to effectively teach the standards-based curriculum, and provide students instructional materials that are aligned to the standards.
- ***Investigate the connection between large and year round schools and low performance on the API.*** It is not clear whether large and year round schools have lower API scores due to their size, the year round schedule, or because these schools tend to house a greater share of low income or otherwise disadvantaged students. However, the finding that these schools are concentrated in the lowest performance deciles bears further examination into the potentially negative effect of these factors on student performance.
- ***Reform the Immediate Intervention/ Underperforming Schools Program (II/USP)*** so that it targets the lowest performing schools in the state. Strategies to do this include eliminating the requirement that schools must miss their growth targets, and funding all schools in the lowest two deciles first, and then, funding permitting, giving awards to schools in the remaining three deciles from lowest to highest.

For additional information on this topic, read *What Do the 2000 API Results Tell Us About California's Schools?* at www.cbp.org/brief/index1.html and *Certificated Staff Performance Incentive Awards Miss Their Target* at www.cbp.org/qhits/index1.html.

STATE STILL SUFFERS FROM A JOBS-HOUSING IMBALANCE

In *Locked Out: California's Affordable Housing Crisis* (May 2000), CBP identified the mismatch between job growth and increases in the supply of housing as a key element of California's housing crisis. The so-called "jobs-housing imbalance" refers to the differential growth rates of jobs and housing within a larger metropolitan area. The

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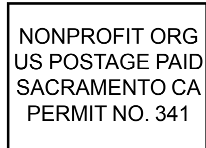

resulting mismatch forces families seeking affordable shelter to move farther and farther away from the communities in which they work.

Job growth has exceeded housing growth in nearly every part of the state since the economic recovery began in earnest in 1994. As reported in *Locked Out,* new jobs outpaced new housing units by as much as 16-to-1 from 1994 to 1998. While imbalances improved in some areas from 1998-99, in other areas the imbalances became even worse. The state as a whole added 3.8 jobs for each new unit of housing from 1998 to 1999, more than twice the 1.5-to-1 ratio recommended by housing policy experts. In the areas where imbalances improved, the change was due to a slowdown in job growth, rather than to an increase in housing construction.

Job Growth Exceeds Housing Growth in All of the State's Largest Counties

	Ratio of New Jobs to New Housing Units	
County	**1994-98**	**1998-99**
CALIFORNIA	**3.9-to-1**	**3.8-to-1**
Alameda	5.4-to-1	4.0-to-1
Contra Costa	2.2-to-1	3.4-to-1
Fresno	1.2-to-1	3.0-to-1
Los Angeles	9.4-to-1	8.5-to-1
Orange	4.7-to-1	4.7-to-1
Riverside	2.4-to-1	2.7-to-1
Sacramento	3.2-to-1	8.1-to-1
San Bernardino	2.9-to-1	4.2-to-1
San Francisco	15.8-to-1	7.0-to-1
San Mateo	10.8-to-1	9.7-to-1
Santa Clara	8.6-to-1	1.9-to-1
Ventura	2.3-to-1	4.6-to-1

Source: CBP calculations based on Department of Finance and Employment Development Department data

For more information on California's continuing housing crisis, see CBP's March 2001 report, *Still Locked Out: New Data Confirm That California's Housing Affordability Crisis Continues* at www.cbp.org/reports/index1.html.

The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low and middle income Californians. General operating support for the California Budget Project is provided by foundation grants and individual donations and subscriptions.

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