

# Executive Summary

**T**he purpose of pursuing competition in utility services is to replace the inherent inefficiencies of government regulation with the promised efficiency of market forces. In making that choice, the State has the opportunity and obligation to realign its oversight of these markets and to resolve notorious inter-agency disputes and overlaps.

As soon as feasible, California needs a keen and unified energy oversight agency, schooled in the economic dynamics and environmental sciences that permeate the public interest in this area. The State cannot reach this goal overnight. But the emerging markets provide for an evolutionary consolidation of authority in the California Energy Commission that could accomplish this long-sought objective with minimal disruption to public agencies and private concerns. The chart at the end of this summary illustrates this transition.

Despite the growing faith in the ability of markets to provide utility services, the State will maintain programs intended to make up for the possible failure of the market: to utilize the most energy-efficient construction techniques and to provide research, development and demonstration of efficiency technology, renewable resources and alternative fuels. These programs, however, can best be managed by a department and, to reduce the potential of government intervention into the market, are best separated from the agency charged with market oversight.

The emerging telecommunications market by itself presents an enormous challenge. The Public Utilities Commission is uniquely qualified to nurture competition and to redefine the public interest in this rapidly changing industry. Its chances of success in this endeavor would be greatly improved if telecommunications were to become its sole focus.

Deregulation of the transportation industry is nearly complete, but the State has yet to eliminate the PUC's jurisdiction in transportation and consolidate the functions related to licensing and safety of transportation service providers so as to streamline the role of government and better serve the public. That consolidation should occur immediately, as indicated in the organizational chart.

Investor-owned water companies may be the last monopolies of the sort the PUC was created to regulate. But water quality and water supply issues now dominate the finances of the State's relatively few private water companies. The economic regulation of those companies should be moved immediately from the PUC to the State agency more familiar with those challenges.

And finally, as more Californians receive utility service from competitive enterprises, California will need to enhance the role of the Attorney General in protecting consumer interests, bolster the credibility of public decision making and enlist cooperation in managing the public work force.

The findings and recommendations in this report do not assess or endorse the policy choices that have been made in PUC hearing rooms and the halls of the Legislature to replace monopoly utility services with competition and consumer choice. Rather, they offer a government structure that matches the market-oriented choices that have been made. Where feasible, the structure removes the economic regulator when the need for economic regulation ceases to exist. Where necessary, it provides for market oversight -- such as gathering detailed information and monitoring for potential market power abuses -- that is needed for investors and consumers to make decisions. Where appropriate, it preserves public policy goals that competitive markets may shortchange, including research and development and universal access to essential services.

The findings and recommendations represent what the Little Hoover Commission believes to be the best solutions at this time. The path to competition is both promising and unknown, and the recommendations offer a course for navigating the transition.

While the recommendations set some structural goals -- such as a single

energy oversight authority -- unforeseen particulars will define the ultimate shape and timing of these changes. The best strategy the State could craft would begin with a constant commitment to assess what has been done and to make needed course corrections.

Discussions of PUC reform are often stymied by a debate over the degree that the PUC can be changed without amending the State Constitution. If that issue persists, it should be resolved expeditiously by the appropriate authorities. The Little Hoover Commission makes its recommendations independent of that issue. The government structure advocated here should be pursued -- either statutorily, or if necessary by amending the Constitution.

After 10 months of research and analysis, with the cooperation of the agencies involved, and generous assistance from the regulated companies, consumer and environmental interests, the Little Hoover Commission has reached the following findings and recommendations:

## *Energy*

**Finding 1: As presently constituted, neither the Public Utilities Commission nor the California Energy Commission is well-designed to perform the state functions needed by competitive energy markets.**

The need and political consensus to reform the State's energy regulatory structure is increasing as energy markets undergo fundamental change. Because of the physical nature of electricity and natural gas and because of their importance to the economy and public welfare, some state oversight of a competitive energy industry may be essential. The agency will have to be focused on energy and expert on the economic forces and environmental issues that shape energy markets and public policies.

***Recommendation 1-A: During the transition, the Governor and the Legislature should divest the PUC of the obsolete regulatory functions governing generation and transmission facilities.***

The PUC's economic regulation of generation and transmission facilities will not be needed when competition begins and the transmission system is managed by the Independent System Operator, which is now slated for January 1998. The PUC will no longer need to conduct environmental reviews of new generation and transmission facilities and will not be in a position to monitor safety and reliability of new generation and transmission facilities.

***Recommendation 1-B: During the transition to competitive electricity markets, the Governor and the Legislature should divest the Energy Commission of obsolete regulatory and planning functions.***

The obsolete functions known at this time are the Energy Commission's economic forecasting and needs analysis associated with approving most generating facilities, its load management responsibilities and its periodic informational reports. As competitive markets develop, additional functions may prove to be unneeded, as well.

***Recommendation 1-C: During the transition to competition, the Governor and the Legislature should assign to the California Energy Commission the new functions needed to make competitive energy markets operate.***

In a competitive electricity generation market, the State will need a consolidated siting, environmental review and safety compliance authority for generation and transmission facilities. The State also will need to provide variations of functions already performed by the Energy Commission -- in particular, the gathering and disseminating of detailed market information, monitoring for possible market power abuses and representing the State in regional, national and international regulatory venues. The Energy Commission also should be given the ability to grant facility applicants the power of eminent domain on a case-by-case basis.

***Recommendation 1-D: The Governor and Legislature should amend the electricity restructuring act of 1996 to assign to the Energy Commission responsibility for enforcing safety and reliability standards concerning the transmission grid.***

The Legislature correctly realized the important role in a competitive market of making sure that a reliable system is maintained. It is unclear at this time how much of that responsibility will rest with federal authorities. To the extent that the State can play a significant role in system reliability, that function should be consolidated with other market-oriented oversight responsibilities. One potential model would rely on the Independent System Operator to make recommendations to the Energy Commission regarding standards, notify the Energy Commission of potential violations and investigate system failures. The legal authority, however, for setting and enforcing standards should be vested in the Energy Commission.

**Finding 2: The Energy Commission's dual responsibilities as an energy regulator and an advocate for alternative energy solutions are not compatible with its new mission of encouraging competition and consumer choice.**

Emerging competition requires that the linkage between regulatory and advocacy functions be reconsidered, along with the long-term need for advocacy programs. In competitive markets government cannot pick the market solution and it must be careful in how it tries to influence the decisions that producers and consumers make.

***Recommendation 2-A: The Governor and the Legislature should transfer from the Energy Commission to the Department of Conservation the public purpose programs concerning transportation fuel research, business development, public education and market transformation programs, including the setting and implementation of building and appliance efficiency standards.***

Placing these functions in a department will make two significant reforms: It will separate advocacy from oversight and it will enable more significant changes in how the programs operate to reflect new funding and market needs. At the same time, the move would preserve the important functions that have saved Californians considerable amounts of money and facilitated the advancement of other energy-related public policies, including clean air and responsible use of other resources.

***Recommendation 2-B: The Governor and the Legislature should amend the electricity restructuring act of 1996 to consolidate the administration of energy research and development programs in the Department of Conservation. The department should establish a broad-based advisory panel to set funding priorities, review applications and advise the department director on allocations.***

The advisory panel should include key legislators, representatives of environmental and consumer groups, and the home building and manufacturing industries. The director of the department should be instructed to explore other institutional arrangements for managing the research program, including a joint powers agreement involving energy policy officials and representatives from public and private universities.

**Finding 3: The PUC, while it will play a transitional role in nurturing competition, could jeopardize the success of the energy restructuring plans if it were to assume oversight of the competitive aspects of energy markets.**

The PUC will continue to have critical tasks in the transition to competitive energy markets, in redefining rate regulation of remnant monopolies and in facilitating the evolution of distribution services. How the PUC performs those tasks will greatly influence the success of competition. And how competition unfolds will, in turn, shape the ultimate structure of the State's energy oversight agency.

*Recommendation 3-A: The Governor and the Legislature should enact legislation establishing benchmarks and a time line for delineating when and how the PUC will eliminate economic regulation of competitive aspects of the market and when and how it will encourage competition for distribution-related services.*

While the Legislature should expeditiously divest the PUC of functions that will be obsolete with the advent of competition, other regulatory functions will become obsolete over time. Thresholds should be established in statute ahead of time determining when the PUC will cease regulating in a given arena. The benchmarks also will serve to better coordinate activities between the Energy Commission and the PUC.

*Recommendation 3-B: After the transition -- after all customers have access to competitive electricity providers and performance-based rate-making is instituted for distribution monopolies -- the Governor and the Legislature should transfer the PUC's remaining energy-related functions to the Energy Commission.*

The goal of the State should be a single agency with energy oversight authority. But the State should pursue this goal in a way that does not jeopardize emerging markets or compromise consumer protection. The first step is to consolidate those new functions over the expanding competitive market into a single agency. The second step is to consolidate the regulation of remnant monopolies at the Energy Commission. The precise timing and scope of the government restructuring will depend upon market developments.

**Finding 4: The State has a fractured and confused process for setting energy-related policies that results in conflicting public efforts with no clear venue for resolving the conflicts.**

Energy is so integral to the economy and a number of environmental and resource issues -- from transportation to air and water protection -- that more than one public agency always will impact the formation and implementation of energy policy. Many of the legendary conflicts between the Energy Commission and the PUC will end as the two agencies stop the regulatory activities that attempted to make the supply and demand decisions of the marketplace. Beyond the functions of these agencies, the advent of competition provides the State with both the opportunity and the need to establish a more effective and more accountable policy-making framework.

***Recommendation 4-A: The Governor and Legislature should enact legislation requiring the Energy Commission to annually appear before the Legislature to review the agency's performance toward meeting established policy goals and set specific goals for the Commission to pursue over the next year.***

This process would allow the Legislature to better monitor and more timely influence the direction of the oversight commission, provide an opportunity for better relationships to develop and discourage venue shopping.

***Recommendation 4-B: The Governor and the Legislature should enact legislation requiring the director of the Department of Conservation to biennially prepare an assessment of the department's existing energy-related programs and propose changes to eliminate obsolete programs, improve existing programs or create new programs.***

The document should be submitted to the Governor for approval and forwarded to the Legislature for consideration as statutory amendments or budget reallocations. The document should specify what actions would need to be taken by the department to accomplish the policy changes. It should also specify what actions other departments would have to take, if any, to make the policy recommendations work.

***Recommendation 4-C: The Governor and the Legislature should enact legislation requiring the Secretary of the Resources Agency to participate as a non-voting advisor in Public Utilities Commission proceedings concerning energy-related issues.***

A significant failing of the current policy making framework is the gap between the Energy Commission, the Public Utilities Commission and the State's executive. Providing for a member of the Governor's cabinet who

also oversees the Energy Commission to take part in the PUC's energy-related proceedings would bridge that gap. This arrangement will only be needed as long as the PUC retains jurisdiction over energy utilities.

## *Telecommunications*

**Finding 5: The fast-paced dynamics of the telecommunications industry, with its importance to the California economy and the complexity of new public policy issues, is not being adequately overseen by a commission that regulates numerous other essential business sectors.**

The trends in the rapidly changing telecommunications industry create complex policy choices involving conflicting public interests. Implementing these policy choices may be just as challenging -- given the need to infuse competition into monopolies in ways that are economically sound, legally correct and satisfying to a demanding public. Because PUC decisions will influence the economic health of the market, the timeliness and quality of its decision-making is paramount.

***Recommendation 5: The Governor and the Legislature should enact Legislation directing the PUC -- after the development of competitive energy generation markets -- to focus its attention solely on the development of competitive telecommunications markets by monitoring for possible market power abuses, overseeing telecommunications public policy programs such as universal service and identifying unfair business practices.***

A number of policy reviews in recent years have found that the PUC has too many responsibilities to adequately fulfill them all. Changes in technologies and emerging competitive utility markets have increased the Commission's workload. Successful oversight of the telecommunications revolution will rest in large part on the time and focus the PUC can bring to the job.

**Finding 6: As new telecommunications technologies and services emerge, the State does not have a systematic way for determining areas of public interest or the extent of government oversight that is necessary.**

Telecommunications has not changed overnight from a monopolistic service into a fully competitive market. Rather, competition has come gradually to different parts of the telecommunications network at different times. In the past, the PUC's role has been to use regulation to

perform price setting and other market functions in the absence of a competitive market. The competitive market raises the question of what regulations if any the PUC should impose. While the PUC has conducted numerous proceedings in an attempt to fairly usher competition into the market, even its supporters do not believe the PUC has done enough to predetermine when it will stop regulating.

***Recommendation 6-A: The Governor and the Legislature should enact legislation declaring clear standards for when telecommunications services are fully competitive, when they are vulnerable to possible market power abuse or when they are so affected by the public interest that government intervention is warranted.***

The PUC should be required to use those standards to establish the scope of its activities and routinely review the consequences of those activities. The standards should include a time line and the PUC should report to the Legislature on its progress. The goal is consistent and accountable progress toward aligning regulation with the markets.

***Recommendation 6-B: Beginning in the year 2000 and every five years after that, the Public Utilities Commission should undergo a sunset review to determine if the PUC is still needed.***

The sunset review will provide at least two benefits. The first would be to make sure that any basic function, or the PUC itself, has not outlived its usefulness and is no longer providing significant benefit to Californians. The second benefit would be to provide the Legislature with the opportunity to reassess the State's role in telecommunications and the best way to fulfill those roles.

**Finding 7: The State's practice of setting telecommunications policies on a case-by-case basis encourages market players to seek the same changes from the Legislature and the Public Utilities Commission. This venue shopping spurs occasional conflicts and confusion among government entities that could prove costly to nascent competitive markets.**

In telecommunications, as in energy, it has not always been clear when the Legislature will be the venue for establishing a policy, and when the Public Utilities Commission is the appropriate policy maker. While there is some public benefit to this tension, there is evidence that in telecommunications policy the relationship between Public Utilities

Commission and the Legislature has devolved. The rapidly changing telecommunications industry and its customers will be better served by some agreement in how major and minor policies will be set.

***Recommendation 7: The Governor and the Legislature should enact legislation requiring the Public Utilities Commission, as a precursor to the annual review and approval of its budget, to collaborate with the Legislature to review telecommunications policy directions and past performance and establish specific goals that the Commission will pursue in the coming year.***

While the PUC was intended to be insulated from day-to-day politics, it cannot operate in a vacuum. Over the long term, the legitimacy of fourth-branch commissions to chart significant policy changes is enhanced by routine reality checks from directly elected legislators. Similarly, while given the authority to make tough decisions day in and day out, the PUC's legitimacy will be enhanced by an annual public accounting of its progress.

## ***Transportation***

**Finding 8: Some of the PUC's transportation regulatory activities are remnants from an era when industry asked for government intervention as a shield against the rigors of competition. Those regulations, disguised as consumer protection, can have the effect of raising prices without a commensurate benefit to the public.**

The PUC is now pre-empted by federal law from regulating rates for railroads and trucks, but has yet to abandon rate setting for other carriers. Beginning in the 1930s, when the trucking industry asked for government protection against cutthroat competition, the PUC has gradually come to confuse protecting the industry with guarding the public interest. A number of the Commission's requirements discourage new market entrants and can lead to higher consumer prices.

***Recommendation 8: The PUC should cease all transportation-related activities.***

Policy makers at the federal and the state level have determined that competition, not regulators, should set prices for transportation providers. Preserving remnants of economic regulation -- such as issuing certificates of public convenience and necessity for new providers, posting tariffs and requiring detailed financial reports -- can reduce competition and increase consumer prices without providing significant consumer benefits.

**Finding 9: The PUC's transportation safety and insurance functions overlap with the duties of the California Highway Patrol and the Department of Motor Vehicles. The overlap results in unnecessary regulation and contributes to gaps in safety.**

As the PUC's role in economic regulation has been pre-empted at the federal level, it is no longer logical for the Commission to be responsible for imposing licensing and safety regulations on passenger carriers, household movers, railroads and other common carriers.

***Recommendation 9-A: The Legislature and the Governor should enact legislation transferring the safety and liability regulation of all commercial highway carriers to the California Highway Patrol and the Department of Motor Vehicles.***

Primary responsibility for transportation in California has long been vested in the Business and Transportation Agency, and departments within that agency are responsible for licensing drivers and enforcing safety laws. Common sense and economic realities prompted the Legislature in 1996 to move safety and licensing of truckers to the CHP and the DMV. Common sense dictates that the same functions for other transportation providers be transferred to those agencies as well.

***Recommendation 9-B: The Legislature and the Governor should enact legislation putting minivans that are used to carry passengers commercially under the same safety oversight as larger passenger vehicles.***

Shuttle vans provide an opportunity for economics and convenience to actually work in favor of the State's policies of discouraging single occupancy vehicles. The State should take advantage of this trend by providing shuttle passengers the same level of safety as those of other commercial passenger carriers.

***Recommendation 9-C: The Governor and the Legislature should enact legislation moving the PUC's consumer protection functions concerning household movers to the Department of Consumer Affairs. A sunset review should be performed to determine if there is a continuing need for this specialized oversight.***

The State has an enduring interest in making sure its citizens are not cheated or victimized by thieves. The State pursues this interest daily with generalized law enforcement and consumer protection agencies and

that protection may prove to be adequate in the case of household movers.

**Finding 10: As the PUC's role as a rate setter for railroads has been eliminated, it is left with railroad safety functions that are more related to the core competencies of transportation planners and accident investigators than to those of an economic regulator.**

The PUC has retained some jurisdiction over safety for both heavy rail and rail transit systems, even though the federal government has virtually pre-empted the states from creating their own safety programs. The public interest demands a continued state role in rail safety, but how the State can best fill that safety role is influenced by the place of rail in the State's overall transportation scheme.

***Recommendation 10: The Governor and the Legislature should transfer the PUC's rail planning and safety functions to the Business, Transportation and Housing Agency.***

The precise form the new consolidated program will take should be based on a thorough review of how to best link rail safety with statewide rail planning and how to best coordinate funding of safety projects within Caltrans to avoid the conflicts that have slowed projects in the past.

## ***Water***

**Finding 11: While the rates charged by private monopoly water providers still need government scrutiny, the greater public interest lies in ensuring adequate and safe drinking water supplies -- challenges that fall outside the PUC's expertise of thwarting monopoly abuse.**

Water companies in California face the dual challenges of meeting federal water quality standards and conserving water supplies to provide future customers. The PUC's focus on protecting customers by keeping rates as low as possible impedes companies from fulfilling these needs. These issues -- along with dramatic changes underway in the energy and telecommunications industries -- provide the opportunity to reconsider the State's choices for economic regulation of private water suppliers.

***Recommendation 11-A: The Governor and the Legislature should enact legislation transferring the economic regulation of the private water suppliers from the PUC to the State Water Resources Control Board.***

The State has more choices today for assigning the economic regulation of private water companies than it did at the dawn of the century when utilities shared the commonality of monopoly status. The State Water Resources Control Board has the procedural experience and the water expertise needed to address the primary concern facing California's water suppliers and their customers -- a safe and adequate supply over the long term.

***Recommendation 11-B: The State Water Resources Control Board should investigate and implement incentives for consolidating small water companies and for financing water quality and efficiency improvements to water systems.***

The State Water Board is the agency best suited to bring about these changes, but the opportunity provided by federal loans and the willingness of some larger systems to take over small, under-financed companies should be pursued by whatever agency has responsibility for regulating the private water industry.

## ***Consumer Protection***

**Finding 12: In competitive markets, as public decisions may be diffused, residential and small business customers may not be well-represented in a number of regulatory, legislative, administrative and judicial venues.**

The original purpose of the PUC was to protect consumers in the absence of a functioning market. The State's new strategy is to facilitate the market wherever possible -- policing those industries as it does others for antitrust behavior and consumer fraud. As utility services become competitive, the role of the PUC will shrink -- requiring other agencies, most notably the Attorney General, to play a larger role in consumer protection.

***Recommendation 12: The Governor and the Legislature should create within the Attorney General's Consumer Law Section an office of utility consumer protection. The office should represent consumer interests in legislative, administrative and judicial proceedings.***

The Attorney General in the past has relied more on the full-service regulatory strategy of the PUC to protect utility consumers. As the monopolies give way to the market, the Attorney General's role in this arena will naturally increase. To encourage cooperation, prevent

duplication and provide effective consumer protection, resources and expertise should be shifted over time to enable the Attorney General's Consumer Law Section to better fill this role. The legislation should specify that the unit will employ a combination of attorneys, engineers, economists and policy analysts and will be funded by reallocating a portion of the existing user fees assessed to fund the Public Utilities Commission and the California Energy Commission.

## ***Process and Management***

**F**inding 13: The PUC's procedures, even as amended by the Legislature in 1996, provide the least accountability to the public and the fewest assurances that decisions will be based on the factual record in precisely those cases where the greatest profits and the greatest public interests are at stake.

As the PUC participates in the development of competitive utility markets and its jurisdiction is curtailed to focus solely on telecommunications, the credibility of its decision-making procedures will be critical. The PUC envisions spending less time in the judge-and-jury role of a full-time regulator and more time setting policy -- defining the public interest and shaping the rules that market players and consumers will live by. Commissioners have asserted that policy making is legislative in nature, and when acting as legislators they should be given freedom to meet privately with stakeholders and among themselves. The Commissioners also asserted that they should retain freedom from expanded judicial review, effectively making their decisions final. Freedom, however, must be commensurate with accountability. It should not be granted in a way that erodes confidence in public decision making.

***Recommendation 13-A: The Governor and the Legislature should amend the Public Utilities Code to limit ex parte contacts after a proposed decision is issued in rule-making proceedings to meetings in which all the parties are invited to attend. All private meetings and discussions between Commissioners and parties with a matter pending before the Commission should be noticed and summarized for the public record.***

The Legislature in SB 960 made significant improvements in the PUC's decision-making process. That effort could be further advanced by increasing the accountability in policy-making proceedings, as well. The greatest conflict between the need for Commissioners to discuss issues with individual parties and the need to preserve the integrity of a fact-

based process from political lobbying comes after proposed decisions are issued. The integrity of the process will be further enhanced if the notification procedures are expanded to include substantive policy discussions between Commissioners and parties -- even if they are not based on the particulars of a pending case.

***Recommendation 13-B: As the workload of the PUC is reduced -- and as some of its functions are transferred to agencies more suitable to perform them -- the Legislature and the Governor should enact legislation requiring Commissioners to rely solely on open meetings to gather information and make public decisions.***

Even when acting in a policy-making capacity, Commissioners differ fundamentally from legislators: They are not elected and so are never held directly accountable to the public. And with a membership of only five, the effects of special interest lobbying are significantly more concentrated than in a 120-member legislature. As the number of market players increases, the importance of giving everyone a chance to speak -- and to listen to the arguments made by their adversaries -- will increase in importance. As its caseload is diminished by transferring some responsibilities to agencies better able to perform them, it will be more possible for the PUC to rely on an open decision-making process.

***Recommendation 13-C: The Governor and the Legislature should grant parties a right to appeal all PUC decisions, or the decisions of its successor agencies, to the court of appeal.***

Experience in other states suggests that the accountability provided by broader judicial review can be achieved without significant delays in the public process. To encourage uniformity of decisions and subject expertise, appeals should be restricted to the court located in the same city as the Commission, now the First District Court of Appeal in San Francisco. The standard of review should include a review of the facts to determine whether they support the Commission's decision.

**Finding 14: The Commission's reputation for hiring and promoting the best and the brightest is being undermined by the rigidity of civil service rules.**

The civil service system rigidly prescribes how managers will make decisions concerning job assignments, rewards and punishments. Keeping the PUC's energy focused on serving the public interest as it transforms itself for a post-monopoly future, will require the Commission to be able to tap the deep skills and full creativity of its staff.

***Recommendation 14: The PUC should apply to the State Personnel Board for permission to initiate a demonstration project. The project should allow for the creation of broader classifications and pay for performance. The Commission should initiate a labor-management council for anticipating, assessing and resolving labor-related problems that will result from the near-constant change facing the Commission.***

As the PUC's role radically shrinks, it is in a unique position to benefit from the flexibility that the Legislature already has granted to state agencies facing considerable changes and looking for ways to forge a partnership between management and labor that transcends the rigidity of the civil service rules. While the Energy Commission has a reputation for involving employees in changes, it also might benefit from the flexibility of a civil service demonstration project as it goes about redefining its mission to meet the needs of competition.



