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June 28, 1996

Docket Control Office
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Dear Sirs:

Please accept the following comments by San Diego Gas & Electric Company on ~~the~~ ACC investigation of restructuring the electric power industry. (Docket No. U-0000-~~95~~ 94-165)

SDG&E is prepared to participate actively in the upcoming workshops on these issues and is willing to share in the experience and progress of the restructuring efforts in California.

Sincerely,

Douglas Mitchell
Regulatory Policy Manager

San Diego Gas & Electric Company's Response For The Request For Comments On Electric Industry Restructuring

INTRODUCTION AND OVERVIEW

San Diego Gas & Electric Company (SDG&E) welcomes the opportunity to respond to the Arizona Corporation Commission Docket No. U-0000-95-165 investigating the restructuring of the electric industry. SDG&E has participated aggressively in similar proceedings in California and recognizes the value of this involvement. SDG&E has become a firm believer in the concept that even greater levels of competition can successfully be introduced in the electric utility industry through restructuring. Restructuring, with its unbundling of activities and associated costs, has the effect of introducing greater levels of choice to retail, commercial and industrial customers. Customer choice is the future of this industry.

CUSTOMER CHOICE

While many observers of restructuring activities would state that the process is being driven by "high costs", on closer examination these same observers might be persuaded that the reason is more basic. It is the absence of customer choice. Customers perceive the value of choice as critical in their ability to control energy costs.

During the hay-days of the electric utility industry (1920s to the early 1970s) customer choice was not an issue. The industry worked like a textbook example of a "natural monopoly": electric rates dropped as customers demand grew and regulation replaced competition as the best method of keeping rates low. The end of these golden years occurred with a confluence of events over a relatively short period of time. These events all seemed to occur in the mid-to-late 1970s. The first was the Arab oil embargo, followed a few years later by another run up in oil prices. During this same period, utilities with commitments to nuclear units began to realize the costs of these facilities were going to be way in excess of original projections. Meanwhile, technology improvements in gas turbines built in factories achieved lower capital costs and greater operating efficiencies than traditional custom built power plants. These new gas turbines became the new cost-effective benchmark for new generation. The total costs of building and operating these units were below the embedded cost of the massive base of existing generation even after accounting for depreciation. Ironically, at this critical juncture for the electric utility industry the Federal Government unleashed legislation that fundamentally altered the course of the industry. This legislation, the Public Utilities Regulatory Policy Act of 1978 (PURPA), is the root cause of the national restructuring discussions taking place today.

PURPA cracked the door open for customer choice. For the first time an effective challenge to the monopoly status of electric utilities was authorized by the Federal government. The demise of the electric utility as a monopoly was sealed at that time. The door of customer choice only will be opened farther through additional legislation such as the National Electric Policy Act of 1992, or the actions of power marketers as they seek new business.

PURPA effectively permitted a select group of large industrial customers (those with heat loads) to exercise customer choice through the development of cogeneration. These facilities, generally using new gas turbine technologies, provided multiple advantages to their owners. PURPA effectively divided customers into two groups: those that could benefit from customer choice through the cogeneration option, and those that could not. The customers denied the option of customer choice perceived the regulatory requirements permitting cogeneration as arbitrary and unnecessary. In some cases, it was their direct competitors that were being afforded the advantages they were being denied. The excluded group noted that electric rates from their host utilities were in many cases burdened by (1) high nuclear costs, (2) older, less efficient generators, and (3) a host of social programs that regulators levied on electric utilities. This realization combined with the inability to avail themselves to similar benefits contributed to the frustration that has spread to an ever increasing number of customers. It's no wonder these same customers are now participating in restructuring discussions, and many of them are demanding change.

Confirmation that the issue is choice and not simply price is best observed in the common attitudes of customers in Idaho and California. In Idaho, industrial customers which pay only 17 mills/kWh (but feel disadvantaged relative to other competitors in the same industry that have been able to negotiate special contracts with their host utility at even lower costs) are seeking industry restructuring as well as industrial customers in California which are paying 75 mills/kWh. The issue is clearly choice and not purely price.

A competitive energy marketplace allows all customers the right to determine their own "good deal". This transaction is defined when both sides are happy with the outcome. Satisfied buyers will tell you he would have gladly paid more and proud sellers say they would have taken less. Price is an important aspect of the deal, but only one of several. SDG&E believes a competitive energy marketplace is possible through restructuring.

THERE'S A BRIGHT LIGHT AT THE END OF THIS TUNNEL

....and it's not a train coming at you! De-regulated industries have demonstrated an uncanny ability of new entrants to provide innovative products and services at competitive prices. The deregulation of the telecommunication industry has created a host of new entrants, each offering its own unique brand of technologies, products, and services. Airline deregulation has broadened the range of options available to travelers through co-marketing with related and unrelated products and services. Even in the trucking industry, deregulation has spawned new services as several major carriers have transformed themselves into "logistics firms" offering warehousing and scheduling services, enabling their customers to adopt just-in-time inventory and manufacturing techniques. The scope and scale of many of these innovations were not forecasted as deregulation was implemented in these industries. Likewise, the innovations that will arise in the electricity industry cannot be foreseen. More assuredly and predictable, however, is that market innovations *will* occur, that new products and services *will* be developed. These innovations *will* be developed at an increasingly rapid pace, and new entrants *will* join in the fray.

One of the exciting prospects restructuring poses for the electric industry is that the market will broaden and deepen. While critics of restructuring worry about who will benefit and who will suffer, San Diego believes that all customers will find benefits in the restructuring of the electric industry. Every customer segment will be served through efficiency gains on an industry-wide basis or by specific products and services designed for mass or niche markets. Restructuring does not portend a zero-sum game between winners and losers -- San Diego's expectations are that benefits will become available for every customer and service provider.

San Diego long ago accepted the inevitability of the profound, fundamental change in the utility industry. Almost since the inception of PURPA, San Diego made a strategic decision to forego self-construction, -ownership, -operation of new power plants, choosing instead to rely upon the generating capacity coming available in our regional market. That decision, albeit contrary to the financial incentives found in traditional rate-of-return regulation, resulted in a return to financial health for the company, an increase in customer-satisfaction levels, and a now eight-year run as California's low-cost investor-owned electric company. This was accomplished without adverse impacts on system reliability, service quality or shareholder returns. Having turned to the marketplace to provide the electricity and natural gas commodities used to serve out retail markets, and having found that marketplace to be increasingly efficient and stable, San Diego is a leading proponent of further reforms in the energy marketplace. It is our firm belief that retail customers, no matter their class or location, will benefit from these further reforms.

We are not alone in advocating electric-industry restructuring. Other utilities that recognize "the customer always comes first" have made the necessary adjustments to adapt to the new paradigm. These utilities have recognized that the best response to power marketers approaching their existing customer with promises of lower-cost options is to match or beat those offers. Arizona has utilities already operating in this manner. This state appears well suited for the journey down the pathway to a more deregulated and restructured electric utility industry.

SAN DIEGO'S INVOLVEMENT IN THIS PROCEEDING

SDG&E commends the ACC on their insightful division of issues into the three Task Force topics. This division facilitates SDG&E involvement in that all its issues are contained in the System and Markets Task Force. More specifically, our involvement in this proceeding will be limited to:

- **Ensuring an Open Interstate Power Market** -- so that utility-owned and non-utility-owned generation resources in Arizona or California have continued access to sell into the broadest regional market.
- **Promoting an Unencumbered Transmission Network** -- that allows unrestricted mutual support among utilities to maintain reliable power in the region. This network should also permit the continued flow of non-firm economy energy transactions.
- **Supporting an Implementation Schedule similar to the one in California** -- so that customers in both states can receive the full benefits of competition offered by either Arizona or California energy service providers.

EMPHASIS ON REGIONAL CONSIDERATIONS

SDG&E also commends the staff for its extensive literature search on restructuring. This search included professional journals and excerpts from dockets on restructuring now in progress in other states. It should be expected that identifying successes and failures in other jurisdictions can help Arizona in its restructuring investigation. While SDG&E is subject to the restructuring rules and procedures developed and adopted in California, it does not propose that this be a template for restructuring efforts in Arizona. The appropriate solutions for Arizona will emerge from a blend of considerations that span the economic, environmental and consumer preferences unique to Arizona.

Regional electric power issues, however, are of utmost importance to SDG&E. This document will suggest policy issues for the ACC to consider at this early stage of the process. SDG&E will also offer more detailed comments and testimony as restructuring proposals become better defined.

SPECIFIC POLICY POSITIONS

ASSURING AN OPEN INTERSTATE POWER MARKET

SDG&E currently purchases over half its energy needs from outside its own service territory. A large portion of this energy is from generating sources in Arizona. In large part, these power purchases have afforded SDG&E to have the lowest average electric rates of any Investor-Owned Utility (IOU) in California. The continuation of this source of power is important to SDG&E. The policy, rules and procedures developed in Arizona for the restructuring of the electric utility industry should not impede this established flow of power that benefits both buyer and seller.

Power exchanges between Arizona utilities and SDG&E can generally be placed in one of three categories: (1) firm power purchases, (2) economy energy exchanges, and (3) emergency support transactions. None of these power exchange types should be foreclosed due to regulatory changes associated with restructuring.

Firm power purchases should remain available for negotiation both between parties within the state and with entities in other states. Power sources should include both utility-owned and independently-owned generators. The ACC should recognize the regional based need for potential new resources in Arizona under a restructured environment and adjust the licensing requirements for new generation additions accordingly.

Economy energy transactions can be either spot energy purchases or short-term "firm" purchases that provide notification provisions if the power cannot be delivered. Both transactions should not be inappropriately restricted due to restructuring. All parties should have equal access to this type of power with a competitive market clearing price being the sole determinant of which transactions are consummated.

SDG&E currently has Emergency Support Agreements with most of the electric utilities in Arizona. These mutual support agreements obligate both parties to help each other in emergencies. These agreements are important to the security of the electric power system and should not be impaired by decisions associated with restructuring.

PROMOTING AN UNENCUMBERED TRANSMISSION NETWORK

The scheduling and day-to-day operation of the transmission network need to remain responsive to regional economics and regional system security. SDG&E will vigorously oppose proposals that would tend to compromise these areas. The detailed procedures of operating protocols that define how transactions are prioritized in a constrained transmission situation are likely to be specified much later in the restructuring process. SDG&E has not observed any parties to this proceeding currently offering objectionable proposals. However, SDG&E will remain vigilant that undue constraints do not purposely or inadvertently creep into the ACC proposed rules and procedures for restructuring in this area.

SUPPORTING AN IMPLEMENTATION SCHEDULE SIMILAR TO CALIFORNIA'S

Creating a level playing field for competition in the energy services field should be a primary goal of the ACC. Only by increasing the number of potential suppliers can the "invisible hand of competition" envisioned by Adam Smith be allowed to benefit the citizens of Arizona. The California Public Utilities Commission in its deliberations on restructuring recognized that its sphere of influence extends only to those institutions over which it has direct legislative authority. The ramifications of a complete electric industry restructuring, however, spread beyond those boundaries. Cooperation with other state, municipal, and Federal agencies is needed. It is important the ACC recognizes the key role it plays in this larger picture.

Under current schedules, Arizona utilities and IPPs will be allowed to directly seek customers now residing in California beginning in 1998. This access will be permitted whether or not California utilities and IPPs will be able to offer reciprocal opportunities to the citizens of

Arizona. This situation is potentially injurious to California energy service providers and denies Arizona residents and businesses potential advantages provided by competition from this source of suppliers. This situation should not be allowed to exist.

Key utilities in Arizona have repeatedly stated in their Annual Reports that they are well prepared for further levels of competition. SDG&E believes these statements. The lower generation costs Arizona enjoys relative to California utilities provide a natural competitive advantage that could potentially be exploited by these utilities. While Arizona utilities may or may not seek additional customers in California, California utilities should also be afforded equal opportunities to offer services or power to Arizona customers.