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INTRODUCTION

Thank you for this invitation to address this honored group.

One of the topics I hoped to discuss today was the successful start-up of direct access and competition in California. Sadly, as you are all aware, California's start-up was delayed until no later than March 31st. The delay was needed so that the Power Exchange and Independent System Operator can finish necessary testing of their computer systems.

Needless to say I am greatly disappointed by the delay. However, this short delay should not distract us from either the major restructuring efforts that California has undertaken in the last two years, or the long-term benefits that competition should bring.

I have met with both Jeff Trainen, CEO of the ISO and Dennis Loughridge CEO of the Power Exchange, on their ability to meet the revised start-up date. Both were very confident that the PX and ISO will be up and running by the revised March 31st deadline. To avoid any further delay in starting Direct Access, the Commission will explore contingency plans if needed.

Finally, the delayed start-up should not overshadow the significant accomplishments that California has done in order to prepare for competition.
I might also add that many of these new energy service providers and merchant power plants.

In my comments today I would like to use what we have done in California as an example of the issues that other states will face as they undergo electric restructuring. My comments will focus on:

• The inevitability of electric restructuring; and,
• The issue of market power and stranded cost recovery as the two main issues of any debate on electric restructuring;

Finally, I have been asked to briefly comment on California's recently adopted rules establishing a code of conduct between regulated utilities and their affiliates.

THE INEVITABILITY OF ELECTRIC RESTRUCTURING

Let me begin by saying that it appears that electric restructuring is inevitable.

The initial belief was that only states with high electric rates would restructure.

California began its electric restructuring efforts in large part because our rates were 150% of the national average. Two of the main reasons for California's high rates are the high cost of California's nuclear power plants and the costs of above-market contracts to purchase energy that California's utilities, under the requirements of PURPA, had entered into in the early 1980's.
Two years after the adoption of our preferred policy decision, and only 15 months after the passage of Assembly Bill 1890, California has accomplished all of the following:

- A 10% rate reduction for all residential and small commercial customers that went into effect January 1, 1998;
- The issuance of almost $7.5 billion in rate reduction bonds to finance this reduction and retire utility debt;
- The auction and successful sale of 10,000 megawatts of power plants in California;
- Incentive pricing and accelerated depreciation mechanisms for 3 nuclear power plants;
- Mechanisms to calculate and recover stranded cost; and,

The unbundling of electric rates into their various components of transmission, distribution, generation, public purpose, and CTC.

Some of these items I'll discuss further in my speech.

Equally important, the marketplace has responded to the prospect of competition in California. California already has:

- 9,000 customers who have already signed-up to change their energy provider. This should be compared to New Hampshire’s pilot program, where only 16,000 people were even given the opportunity to choose.
- We have registered over 100 energy service providers; and;
- There have been announcements of plans for the construction of over 2,000 megawatts of new power plants. These new power plants will be merchant plants, responsible for recovering all of their costs from the competitive market place.
to Commission-sponsored efforts to promote competition in California for larger customers. They believed the same competition, with the ability to freely choose, would lower their electric rates.

In a competitive marketplace utilities should listen to their customers. As Stan Skinner, former CEO Pacific Gas & Electric once said; their company didn’t listen to their customers when they said that they wanted choice in the natural gas market, and once these customers had choice, they remembered that we were not originally supportive of that effort. PG&E was not going to make the same mistake on the electric side. They have listened to their customers and have been supportive of the Commission’s efforts to promote choice.

THE ISSUE OF MARKET POWER

After working on California's restructuring, I have concluded that once you have made the commitment to "customer choice" and competition, the major issues that need to be resolved are market power and stranded cost recovery.

It is the issue of market power I would like to focus on.

Throughout the entire debate over electric restructuring my main concern has always been ensuring a competitive market place is accomplished and preventing the abuse of market power. The potential for market power abuse is particularly a problem in the electric industry, where almost 100 years of regulation has resulted in the incumbent utilities controlling almost all of the existing generation, transmission, and distribution assets within their service territory. The incumbent utilities also start out with a captive customer base of 100% of the market. It is this captive market that Direct Access will now open up to full competition.

The issue of market power has essentially driven the debate over restructuring in cascading steps.
The problems of high-cost nuclear power plants and above market PURPA contracts are not unique to California. Many other states, and many utilities, face similar problems. It is also not surprising that those states with the highest electric rates — California, New York, Michigan, Pennsylvania, and almost all of the New England states — were the first states to seriously consider electric restructuring. These states, just like California, did not believe that they could remain competitive in today's global economy given their high electric rates. Energy costs can play an important role in economic development and attracting and retaining businesses.

Although the states with the highest rates were the first to consider restructuring, today that is no longer the case. I have often reminded people that Norway, a country which is 100% hydroelectric and has some of the lowest electric rates in Europe, restructured its electric industry soon after the United Kingdom did, and saw further reductions in their rates.

Today, almost every state is considering, or at least seriously studying, the issue of electric restructuring. Many of these states have electric rates that are at or below the national average.

Although it appears unlikely that there will be any federal legislation this year, the fact that there are ten bills addressing this issue being considered by Congress, shows that it is receiving national interest. The Clinton administration is also expected to introduce its own legislative proposal.

One reason for this interest in electric restructuring is the desire of customers for customer choice. In meetings that I have had with many industrial customers throughout the state, most of them expressed the same thought: "If I can choose where to purchase every commodity that I use in my business, why can't I have a choice when it comes to my electric supplier?" Many of these same customers had seen a large drop in their natural gas prices after 1985, in part due
California as well as some of the New England states, have addressed this issue through the divestiture of generation. We strongly encouraged both Pacific Gas & Electric and Southern California Edison to divest themselves of at least 50% of their fossil-fueled generation within California to address market power concerns. Both utilities have gone beyond what the Commission has asked them;

- Edison has sold off 7,500 megawatts of capacity for $1.1 bilion, $421 million above book-value, with an additional sale of 2,500 megawatts still under final negotiation.
- PG&E has sold off 2,500 megawatts to Duke Power for $501 million, about 30% above book-value. PG&E plans to sell off an additional 2,500 megawatts later this year.
- Finally, although not required to do so, San Diego Gas & Electric has announced the sale of its three fossil-fueled power plants.

The need to address horizontal market power, and the divesting of generating assets was a major issue in restructuring. In addition to California, we have seen power plant sales by Boston Edison, New England Electric, and announcements from Montana Power among others.

Having addressed market power issues in generation and transmission, it is logical that distribution would be the next step. Congressman Schaefer's bill, for example, includes metering and billing as "retail energy services" that should be subject to competition. California, on its own initiative, has opened up the utility billing function to competition for all customers (effective January 1, 1998) and the metering function (effective January 1, 1998 for large customers and for all customers one year later). We also developed safeguards to that the distribution utility could not use its proprietary information to its advantage in competing for customers.
The first problem was one of breaking up the existing utilities' control of both generation and access to the transmission system. The basic premise of FERC's Order 888 and California's creation of the ISO was to mitigate this vertical market power through open and non-discriminatory access.

Today, the concept of an ISO is being considered by most regions of the country from INDEGO and Desert STAR in the Western United States to the evolution of power pools—such as New England and P-J-M into ISOs.

After deciding to open up the transmission system, the concern then led to the utility's control of energy procurement for their captive customers. This was a market power problem in that the existing utilities were the major purchaser of energy in the marketplace.

In California this led to the further separation of the transmission scheduling and energy procurement functions of the electric system into two separate entities—the ISO and the Power Exchange—rather than having these functions combined into a single entity as the Commission had first proposed in its May, 1995 decision. I am personally surprised that more states have not chosen to adopt some form of a Power Exchange in their restructuring efforts.

I also believe that you should look at going further and require the establishment of separate transmission companies (TRANSCOs) rather than just ISOs. The ability of the TRANSCOs to own and operate is preferable to having an ISO that dispatches but does not own the system.

Once the issue of vertical market power was addressed, attention turned to the issue of horizontal market power. Horizontal market power occurs where the incumbent utilities hold the vast majority of the existing generation assets within their service territories. I wanted to avoid the problems faced by the United Kingdom's pool where two generators controlled the majority of generation.
access market itself could be dominated by the affiliates of the incumbent utilities.

It was for this reason that two of my colleagues proposed that the utility's affiliate be completely precluded from using the utility's name and logo, and that the affiliates be prohibited from selling in the utility's service territory for the first two years of competition.

My proposed alternate decision in this proceeding recognized the advantages that a utility affiliate may have, but would not have completely prohibited the utility's affiliate from offering service. My proposal would have allowed the use of the brand name and logo but would have limited the utility affiliate to a market share of no more than 20% of the direct access market (by volume of kilowatt hours sold) within the utility's service territory. This 20% "competitive cap" would be applied separately for each class of customer--residential, commercial, agricultural, and industrial. Exemptions would have been made for contracts already signed and the sale of renewable energy to residential customers.

This competitive cap would not have prohibited the affiliates from competing, but at the same time would have permitted entry of enough additional marketers to ensure a competitive market. enjoyed the benefits of competition.

The final decision adopted by the Commission, on a 4-1 vote with myself dissenting, does not contain any restrictions on either the use of the utility's name or logo (other than requiring a disclaimer that the affiliate and the regulated utility are not the same thing), and the decision does not contain any limitation on affiliate market share. Our adopted decision does require monthly reporting of the market share of the incumbent utilities' affiliates. Having
Finally, it was the issue of market power abuse that became the major concern in our recent decision on utility-affiliate relationships or "code of conduct." One of the major issues in that decision was our concern over a potential for market power abuse in the direct access retail market. The major concern was the advantages that an affiliate of an incumbent utility has in marketing to customers in the new competitive marketplace. This includes the ability of the affiliate to use the brand name, logo, and goodwill of the utility within the utility's service territory.

Results from other states which have allowed a utility affiliate to market within the utility's service territory show how powerful this advantage can be. Evidence from this proceeding showed that in pilot direct access programs in a number of states the utility affiliate routinely gathered the lion's share of the marketplace. It was not uncommon for the utility's affiliate to gain market shares as high as 80% of the direct access market. Even more interesting, in states which did not allow the utility's affiliate to use the name and logo of the utility, the affiliate's market share was significantly less. The advantages of the affiliate's use of the name and logo appeared to extend even beyond energy products. One of the California utilities gained an 80% share of the market for earthquake shut-off valves.

The only reason I can see for the affiliate's better success than its competitors is the ability of the affiliate to piggy-back off of the brand name, logo, advertising and name recognition of the sister utility. As my colleague Commissioner Bilas noted, referring back to the textbook on microeconomics that he authored as a college professor in 1971, brand name identification is a barrier to entry and if significant could lead to market power abuse.

My goal had always been to maximize the number of competitors in the new direct access market that we are creating. In my mind, it did not make sense to me to open up the electric market to competition if the newly created direct
short-sighted effort. As Bob Glynn, CEO of PG&E stated recently: “The choice between a guaranteed market for ½ of California or the ability to compete head-to-head in all 50 states is the easiest I’ll have to make in my career.”

Second, I believe that utilities will have to start making strategic choices regarding their operation. The decision by some utilities - such as SDG&E, to leave the generation business, may be as much a result of strategic business decisions as it is of regulatory policies. All utilities will have to make similar choices in the future. Is their expertise in generation, transmission, or distribution, wholesale or retail markets, or some combination of the above?

These are the decisions that will have to be made in the future by the utilities. State public utility commissions are also facing similar choices. Our own PUC has undergone a Vision 2000 process, identifying what our goals are, implementing a business plan, and adopting performance standards and goals.

In conclusion, I am again disappointed that we have not yet begun electric restructuring, but the signs are very promising that the market will begin soon.
reviewed some preliminary data filed by the utilities, I still remain very concerned about this issue.

The adopted decision contains a large number of structural and procedural safeguards designed to prevent market power abuses that may be caused by an incumbent utility's relationship with its affiliates. These safeguards address potential abuses not only in the direct access market but also in numerous other energy related markets as defined by the decision. The decision contains numerous safeguards designed to eliminate the ability of a utility to either cross-subsidize or confer any undue information sharing advantage to its affiliates in these competitive markets.

Although the rules are detailed, they are based on the two principles I have focused on in today's presentation—structural separation, and prevention of abuse of market power. Just as we have separated generation, transmission, and distribution, the affiliate decision ensures a proper separation between regulated and unregulated activities. As the monopoly provider of distribution services, the utility has monopoly control over valuable information—such as customer records and usage. All customers must also contact the utility because it is the monopoly provider of distribution services. Our adopted rules ensure that the affiliate does not have unfair access to this information and the customer leads it may generate.

THE GAS STRATEGY

Concern over market power and affiliate issues have also carried over to our Natural Gas Strategy Report. This report, prepared as a staff document by our Division of Strategic Planning, was released last week and lays out the problems and opportunities facing the natural gas industry. Accompanying the report was a Commission instituted investigation, similar to what we did in electric restructuring, to develop a Commission policy.
Given that some customers already can switch usage between gas and electricity, this is an issue the Commission will look at.

The Commission will be taking comments and holding hearings on the Gas Strategy later this year. It is our hope to have a final Commission policy adopted by the end of the year.

STRANDED COSTS

The last major issue in electric restructuring is of course stranded costs. Fortunately, this appears to be less controversial than first envisioned.

California, through AB1890, provided our utilities with a reasonable opportunity to fully recover their stranded costs by no later than March 31, 2002. Most other states also seem to be considering providing a reasonable opportunity for full recovery. Many utilities also seem to be working out negotiated agreements with regulators and interested parties regarding stranded costs.

Many states seem to be following California's lead in securitizing, through asset-backed bonds, a portion of each utility's stranded costs. Many states also seem to be using the market approach adopted by California, requiring the utilities to either sell or market value their generating assets. Under this approach, the gain on sale from some assets can be used to offset the cost of other uneconomic assets.

CLOSING THOUGHTS

In closing I would like to repeat the advice I recently gave to a gathering of utility CEOs at the Edison Electric Institute's annual meeting. "Do it yourself before someone else does it to you." Electric restructuring is happening and all stakeholders should be involved in the debate. While some utilities continue to oppose restructuring, or seek to keep it out of their service territory, this is a