



SMUD

SACRAMENTO MUNICIPAL UTILITY DISTRICT □ P. O. Box 15830, Sacramento CA 95852-1830, (916) 732-6160
AN ELECTRIC SYSTEM SERVING THE HEART OF CALIFORNIA

May 8, 1997
GM97-206

The Honorable John D. Dingell
Ranking Member
Commerce Committee Democratic Office
564 Ford House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Dingell:

On behalf of the Sacramento Municipal Utility District (SMUD), I am pleased to have this opportunity to respond to the questions posed in your letter of April 10, 1997.

Question 1

What are your biggest concerns about retail competition? If retail competition has been adopted by the state(s) you serve, or is under active consideration, what position have you taken and why?

As I am sure you are aware, California has not only determined to mandate retail competition, but has already taken substantial steps to implement that decision. The California legislation set a target date of January 1, 1998, to begin retail access. SMUD supported the California legislation at the time of its enactment, and continues to do so. In fact, SMUD has commenced a program to implement direct access ahead of this schedule. The SMUD program will begin this summer, and SMUD anticipates being the first utility in California to allow retail access.

By voluntarily starting direct access early, we believe we are being responsive to our customers' request for choice. We hope that the early entry will provide our customers with the opportunity to get the marketers' best pricing and service and will challenge SMUD to do the same. SMUD is offering the program initially to 100 MW of load and to both residential and commercial customers.

Jan Schori, General Manager

DISTRICT HEADQUARTERS □ 6201 S Street, Sacramento CA 95817-1899

In implementing its direct access program, SMUD has learned lessons, particular in the areas of consumer protection, and the impact of retail competition on residential customers.

First, restructuring the electric utility industry is expensive. It is estimated that establishing the Independent System Operator and the Power Exchange, the new market institutions which will help implement restructuring in California, is going to cost at least \$250 million dollars. SMUD itself is incurring over \$4 million dollars to implement the first phase of its direct access program this summer. These costs include programming and software costs for billing, energy scheduling and metering systems. SMUD is fortunate in having equipment which is capable of handling the increased transactions. The costs of acquiring or upgrading such systems for many small utility systems would be substantial enough to cause rate increases for all of their ratepayers. Mandates for direct access on schedules and terms that do not allow the states to weigh the costs of direct access against the benefits and phase it in accordingly would be a serious oversight.

Second, restructuring puts pressure on utilities to reduce expenditures for low-income, renewables, research and development, energy efficiency, and other public purpose programs. California has mandated a certain level of expenditures for public purpose programs. However, these expenditures are anticipated to be below historical levels. SMUD has adopted spending levels above the minimum required by law, but the pressures to reduce expenditures on public purpose programs are significant. Restructuring initiatives must ensure that expenditures for these public purpose programs continue.

Question 2

Do you believe Congress should enact legislation mandating retail competition by a date certain, and why or why not?

No. The factors which drive decisions on this issue vary widely from region to region, state to state, or even locality to locality. These factors may include existing costs of electric service, and whether or not there are sufficient alternative providers to ensure that competition will benefit the consumer. In addition, as noted in question 1, such mandates ignore the need to phase in costs of implementing direct access on a schedule which does not cause rate increases. It would be difficult for blanket federal legislation to take these factors into account. Therefore, I would not advocate a federal mandate for retail competition at this time.

Question 3

Some privately owned utilities assert that public power enjoys a broad range of tax related and other advantages which independently owned utilities (IOU) do not, and that these would unfairly benefit public power in a competitive retail marketplace. Do you agree? Do IOU's enjoy any benefits which public power does not?

For some time, this "level playing field" issue has served as a smokescreen, and diverted attention from efforts to answer the hard issues posed by electric utility industry restructuring.

It is my belief that fingerpointing on this issue has gone on long enough. Increasingly, studies have shown that each segment of the electric utility industry enjoys certain "advantages."

In a March 20, 1997 workshop on utility restructuring held by the Senate Energy and Natural Resources Committee, Chairman Frank Murkowski asked Elizabeth Moler, former Chair of the Federal Energy Regulatory Commission, whether tax-exempt financing for public power is a "special subsidy" that distorts the electricity marketplace. Chair Moler answered that there are many aspects of the current marketplace that could be described as "distortions" and she specifically mentioned the Two County rule and certain provisions of state tax. However, she said, those differences or distortions should not stop the move towards a more competitive industry. I share Chair Moler's view that these differences should not derail the restructuring debate.

While not noted in your question, a concern that I believe Congress should address is the impact of retail competition on existing tax-exempt revenue bonds through the "private use rules" enacted by the Tax Reform Act of 1986. Because publicly-owned systems are units of state and local government, we have historically issued tax-exempt revenue bonds for electric generation, transmission and distribution facilities. The private use rules limit sales of output or capacity to private entities from the tax exempt bond financed portion of these facilities to the lesser of 10% or \$15 million. The intent of the law, and subsequent rules issued by the Internal Revenue Service (IRS), was to make sure the benefits of tax-exempt financing did not go to profit-making entities or private persons.

If the private use limits are exceeded, the bonds become taxable thus raising costs to the municipal issuing agency and rates to its customers. Further, municipal bondholders would be exposed to substantial liability for taxes, interests and penalties from the bonds date of issuance. The IRS rules, adopted at a time when wholesale and retail competition did not exist in the electric utility industry, potentially impose a serious financial penalty and thus threaten public power's ability to participate effectively in a competitive environment.

One important current example of how the private use rules pose a barrier to retail competition for publicly-owned utilities is the question of participation in the California ISO. The purpose of the ISO is to ensure efficient use and reliable operation of the transmission grid, consistent with criteria established by the Western Systems Coordinating Council. While FERC strongly supports the ISO, and California municipal utilities want to participate, the penalties imposed by private use rules may prevent us from joining the ISO, thereby impacting the effectiveness of the California ISO.

While the long awaited IRS rules may provide additional guidance on private use restrictions, a legislative fix may be more appropriate. Any comprehensive Congressional restructuring legislation should address these private use restrictions that unfairly affect publicly-owned utilities. We will be seeking legislative changes to correct this issue.

Question 4

If Congress were to mandate retail competition, please provide any recommendations you have with respect to the following issues.

- A) Stranded Investment: How should IOU's stranded investment be treated? Does your company face anything similar and, if so, how should it be treated?**

Like many utilities, SMUD has its own "stranded investment." For example, SMUD must pay for the prudent decommissioning of a closed nuclear power plant, as well as approximately \$100 million in booked investments in programs to encourage energy efficiency investments by SMUD customers. The California restructuring law recognizes these investments, and authorizes their recovery. SMUD supported, and continues to support, the California restructuring legislation.

- B) Reciprocity: Should Congress consider provisions barring access to markets in states which have adopted retail competition by generators in states which have not? Which interests would this affect, and how?**

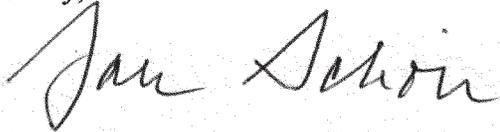
As stated above, in implementing retail competition, SMUD has faced the reciprocity problem first-hand. Today, while parent companies of large, vertically integrated investor-owned utilities fight retail competition in their home states, their subsidiary marketing companies are already competing to serve retail customers of SMUD and other utilities in California that are moving forward to allow retail choice. At the very least, this is inequitable. While SMUD opposes a federal mandate of retail competition, SMUD would support Congressional action to ensure that, as states make their own policy decisions, those who choose to allow retail competition will not be placing their utilities, and ultimately their ratepayers at a competitive disadvantage.

C) Local Distribution Companies (LDC): Should Congress require unbundling of LDC services in order to subject them to competition?

Congress should be cautious with respect to mandating competition for electric distribution services. It may be that certain LDC services can be unbundled effectively. For others, there may remain technological impediments. Also, as stated above, creating the necessary metering and billing infrastructure to implement competition is expensive, and unbundling distribution services will certainly add to those costs. Stranded costs related to these services will also increase. SMUD has not made a final decision on these issues in its own retail choice program, and advocates a cautious course of action on this issue.

If I can be of further assistance, please don't hesitate to contact me at (916) 732-6160.

Sincerely,

A handwritten signature in cursive script that reads "Jan Schori".

JAN SCHORI
GENERAL MANAGER