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COMMISSIONER

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IN THE MATTER OF THE COMPETITION)
IN THE PROVISION OF ELECTRIC)
SERVICES THROUGHOUT THE STATE OF)
ARIZONA.)

DOCKET NO. U-0000-94-165
NOTICE OF FILING

Staff hereby files its summary of the Regulatory Task Force Meeting (Working Group on Retail Electric Competition) held on June 1, 1995 in the above-captioned docket.

RESPECTFULLY SUBMITTED THIS 13th DAY OF JUNE, 1995.

For [Signature]

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Original and ten (10) copies of the foregoing filed this 13th day of June, 1995, with:

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Copy of the foregoing mailed this 13th day of June, 1995 to:

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**SUMMARY OF
THE REGULATORY TASK FORCE MEETING
(Working Group on Retail Electric Competition)**

JUNE 1, 1995

Docket No. U-0000-94-165

**Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007**

D R A F T

**SUMMARY OF REGULATORY TASK FORCE MEETING
JUNE 1, 1995
WORKING GROUP ON RETAIL ELECTRIC COMPETITION**

The Regulatory Task Force of the Working Group on Retail Electric Competition held its second meeting on June 1, 1995. The Task Force continued its discussion of stranded investment from its meeting on March 8, 1995, and discussed the role of regulation if retail wheeling is introduced, including performance based ratemaking and the utility's obligation to serve. Ms. Holly Koeppel of CNG Energy Services described the Federal Energy Regulatory Commission's Notice of Proposed Rulemaking on transmission access and stranded investment and a panel of seven attorneys discussed legal aspects of retail wheeling. In attendance were Commissioners Renz D. Jennings, Marcia Weeks, and Carl J. Kunasek, Corporation Commission staff members, members of the Task Force, and the general public. The appendix lists the participants in the meeting.

STRANDED INVESTMENT

The Task Force continued its discussion of stranded investment which began in the meeting of March 8, 1995. Major points made regarding stranded investment are listed below. These points are in addition to those presented in the report on the March 8 meeting.

- ◆ In general, stranded investment (attributable to the introduction of retail wheeling) could occur if customers leave a utility's system for another source of supply and if large numbers of customers pay market-based rates instead of higher regulated rates as a result of a utility's response to competitive pressures.
- ◆ Collection of stranded investment from consumers through exit fees or other mechanisms may not inhibit competition if the stranded investments are fixed costs or fixed transfer payments from consumers to utility shareholders. The consumers' choices of generators would not be affected; consumers will still be able to distinguish between utility and non-utility generators on the basis of price and the stranded investment will be paid regardless of which generator is selected.¹ However, payment of stranded costs to the utility would raise electricity prices above market prices.
- ◆ Collection of stranded investment from consumers through exit fees or other mechanisms would probably not encourage self generation. The only way a

¹ This proposition would not hold if the customers' stranded investment payment was based on current energy or power consumption in the form of a charge per kWh or per kW because the additional charge per kWh or per kW would cause prices to exceed marginal cost and cause the consumer to purchase less electricity. Further, this proposition would not hold if the customers' decisions on how much electricity to purchase were based on the average price of electricity (including the stranded investment charge) instead of the marginal price of electricity.

consumer could avoid the stranded investment charge is by disconnecting entirely from the grid (taking no back-up, maintenance, or supplemental power or energy from another source) and this is unlikely, based upon self generation experience in Arizona. Thus, in most cases, the stranded investment charge is a fixed cost that must be paid whether or not self generation is selected.

- ◆ Under traditional regulation, investors in utilities did not receive or anticipate a premium for the risk of retail wheeling, although normal business risk did include the potential loss of some customers (who may have gone out of business or moved, for example) and self generation.²
- ◆ As noted previously, the magnitude of stranded investment is uncertain and that magnitude could change over time. Thus, the amount of stranded investment may be negotiable.
- ◆ The proportion of stranded investment attributable to retail wheeling to be borne by utility shareholders versus utility customers or former customers is negotiable and a matter of policy. The Task Force generally felt that much of the stranded investment attributable to retail wheeling should be paid to shareholders.
- ◆ The allocation of stranded investment costs among customers or former customers should reflect those customers' responsibility for the investment which has become stranded and may also reflect whether the customer stays with the utility or leaves the utility for generation services.
- ◆ Utility collection of stranded investment from customers or former customers may be predicated on the utility's performance in achieving efficiency or other goals.³
- ◆ The time period over which stranded investment would be collected could be limited, for example, to a period of transition from a regulated environment to a competitive environment.
- ◆ If the collection of stranded investment from utility customers or former

² The risk of stranded investment associated with self generation may be managed by assessing customers who self generate charges reflecting special generation, transmission, or distribution installed to serve that customer that would not otherwise be collected.

³ This idea is proposed by Michael Burke, "Earthquakes and Utility Rates: Creating a Competitive Electric Utility Market," Pasadena, California: New Energy Ventures, Inc.

customers is stretched out too long, the benefits from a competitive marketplace will be delayed.

- ◆ Stranded investment could be negative, indicating that utility average prices are lower than long run marginal cost and that the market value of the associated assets is higher than book value. Such a situation could occur if, for example, natural gas prices increase greatly and if investments in generation are for gas-fired power plants. If electricity is priced at marginal cost, rates would be higher than they would be under traditional regulation, but the relatively high price would serve as a price signal to engage in additional demand side management and to search for less costly generation, such as renewables.
- ◆ Utilities can mitigate or offset stranded investment relative to current levels of wholesale and retail marketing by developing new markets, attracting new customers, maintaining existing customers, selling in newly opened out-of-state markets, reducing costs, changing the rate of amortization of existing assets, and selling assets (such as transmission facilities or customer data bases) whose market value is higher than book value.
- ◆ Stranded cost charges could vary from utility to utility and from state to state. Utilities with lower stranded cost charges levied on customers or former customers may have a competitive advantage relative to utilities with higher stranded cost charges.

THE ROLE OF REGULATION

Rate regulation would still apply in noncompetitive markets under the scenarios where there is either: a) limited competition (e.g. direct access to generators being practically available only to customers or aggregates of customers with a demand greater than 500 kW),⁴ or b) regulatory rejection of retail wheeling altogether. Further, regulation in noncompetitive markets may be used to improve the efficiency of producing and delivering electricity, thereby lowering costs to consumers. The Task Force discussed what would be regulated, the elements of performance based ratemaking, and the concept of an obligation to serve.

⁴ Even if competition generally exists, transmission constraints may restrict consumers in some localities from gaining access to the generators of their choice.

Task Force on Regulatory Issues -- Summary of Meeting of June 1, 1995

Table 1 summarizes the discussion of what activities would be regulated under the three broad options of full competition, limited competition, and no retail wheeling. The Task Force discussed the role of licensing energy portfolio managers. Licensing based on minimum standards of performance and financial resources may be desirable to protect smaller, less sophisticated consumers in the purchase of a necessity (i.e., electricity). However, some Task Force members argued that there would be little benefit to licensing energy portfolio managers serving large, sophisticated consumers who are knowledgeable about electricity and electricity markets.

For those activities which would be regulated, the Task Force discussed how regulation might be designed to promote economically efficient use of resources and to bring the benefits of today's lower long run marginal costs to all consumers,⁵ not just those who could choose among suppliers.

The Task Force noted possible differences in emphasis in regulation. One emphasis would be on regulating services in which the regulator would act as the agent for consumers and would contract with the utility for the provision of those services to the consumers. The contract would address such factors as prices and price adjustments (if any), quality of services, quantity of services, timing of supplies, special features such as DSM or renewables, and a term of performance. The other emphasis is on regulating the firm, i.e. the utility, its operating characteristics, (such as fuel mix), its costs and cost structure, its profits, and its accounting methods. This reflects features of traditional utility regulation.

To promote more efficient utilities under regulation, incentive or performance based ratemaking may be used.⁶ David Sappington developed ten guidelines for incentive regulation (summarized in Box A). These guidelines apply to regulation of both services and the firm supplying the services.

Performance based ratemaking for the noncompetitive market could promote economically efficient use of resources, bring the benefits of today's lower long run marginal costs to all consumers, and enable the utility to enhance its ability to compete if the transition to competition advances. Table 2 identifies major elements of performance based ratemaking, viewing that ratemaking as a contract between the regulators (on behalf of consumers without access to competitive suppliers) and the utility. The table also indicates the risks, incentives, and benefits which a particular component of the ratemaking "contract" might create.

⁵ At present, long run marginal cost is less than utility average cost in Arizona. In the future, long run marginal cost may be greater than utility average costs.

⁶ We use the terms incentive regulation and performance based ratemaking synonymously here.

Task Force on Regulatory Issues -- Summary of Meeting of June 1, 1995

Table 1. Activities which may be regulated.

Activities	Competitive Environment		
	(a) Full Competition	(b) Limited Competition	(c) No Retail Wheeling
Central Station Generation	siting; but not rates -- competitive market	siting; see column (c) for monopoly portion of market; no rate regulation in competitive portion of market	siting; part of rate regulation unless utilities divest generation
Transmission	line siting; federal rate regulation		
Generation & Transmission System Operation	regulation of ISO* (if any) to ensure impartiality and to set admin charges; if no ISO, regulation to ensure comparable access/pricing for transmission		if no ISO, costs & procedures reviewed in ratemaking; if ISO & poolco to promote wholesale competition, see columns (a) & (b)
Distribution	rates regulated; local siting ordinances apply		
Distributed Generation: on customer's site	not regulated-- competitive market	not regulated in competitive market; see column (c) for monopoly portion of market	not regulated, unless generation owned by utility (?)
Distributed Generation: to augment T&D	rates regulated -- part of monopoly system		
Retailing of kWh to end users	not regulated -- competitive market	not regulated in competitive market; rates regulated for monopoly service	rates regulated -- monopoly
Funding of mandated DSM	required payments on retailing or distribution services to finance mandated DSM		
Power Marketers	federal licensing; no rate regulation		
Energy Portfolio Managers	possible licensing, especially to serve smaller consumers; no rate regulation	in competitive market same as column (a); not applicable in noncompetitive market	not applicable

* Independent System Operator

Benchmarking prices is likely to be complex. The benchmark could be outside the control of the parties and may rely on the long run marginal costs of generic capacity additions developed by the federal government or other independent body, fuel price futures or indexes, or electricity price futures (when developed) or indexes. In addition, allowances must be made for area-specific cost elements (such as the number of customers per mile of distribution line). For customers of regulated services to benefit from today's marginal costs being lower than average cost, the benchmark cannot rely solely on average cost.

Uncertainty over how benchmark costs will change over time must also be considered in the contract. The table indicates several mechanisms for managing risk, including selection of a term for the contract.

The Task Force noted the following regarding a utility's obligation to serve:

- ◆ Providers of transmission and distribution services have an obligation to serve, as long as they are properly compensated.

Box A

Guidelines for Incentive Regulation

1. Use incentive regulation to better employ the firm's superior information.
2. Prioritize regulatory goals and design incentive regulation to achieved stated goals.
3. Link the firm's compensation to sensitive measures of its unobserved activities.
4. Avoid basing the firm's compensation on performance measures with excessive variability.
5. Limit the firm's financial responsibility for factors beyond its control.
6. Adopt broad-based performance measures where possible, unless their variability is excessive.
7. Choose exogenous performance benchmarks.
8. Allow the firm to choose among regulatory options, while recognizing the interdependencies among the regulatory options that are offered to the firm.
9. Promise only what can be delivered, and deliver whatever is promised.
10. Plan for the rare, unforeseen event, but minimize after-the-fact adjustments to the announced regulatory policy.

Source: David Sappington, "Designing Incentive Regulation," *Review of Industrial Organization*, vol. 9 (1994): 245-272.

Task Force on Regulatory Issues -- Summary of Meeting of June 1, 1995

Table 2. Elements of performance based ratemaking

Component of Ratemaking Contract		Risks/Incentives/Benefits	
		To Utility	To Customers
Bench-marking prices	To marginal cost (MC) for generation	ensures covering marginal cost, price could be < avg cost; long run MC appropriate to reflect costs of adding capacity	risk that utility MC > optimal
	To price index for generation	price could be < utility MC, avg cost	
	To average cost		price could be > MC
Uncertainty of Future Costs	Fixed price over term of contract	marginal cost could increase rapidly, adversely affecting utility	price stability, but could forego benefits of falling MC
	Price escalators tied to other market info	could alleviate risk of rapidly increasing MC	could reflect decreasing MC
	Contract re-opener	prevents extreme risks	prevents extreme risks
	Diverse portfolio of supply/demand resources	to hedge against rapid increases in MC	to hedge against rapid increases in MC
Term of Contract (see uncertainty above)	Short	allows frequent realignment of rates & costs	allows frequent realignment of rates & costs
	Long	may lock in some desirable features but risk that costs and rates diverge greatly	may lock in some desirable features but risk that costs and rates diverge greatly
Maximum/Minimum Power & Energy	Specified limits	makes longer term planning less risky	supplying unanticipated load growth may be expensive
	Supply all requirements	makes longer term planning riskier	
Minimum Quality & Reliability Standards		note: industry is self regulated with respect to many technical aspects of quality & reliability	may protect consumers; consumers desiring higher quality can contract separately
Rewards & penalties	For customer satisfaction	encourages attentiveness to customer needs	setting standards may be complicated
	For energy efficiency	incentive must be compared with profits of load building	to encourage DSM that is less costly than kWh & kW
	For productivity	encourages economic efficiency	setting standards may be complicated; customers could share savings

- ◆ Providers of generation (including back-up services) in a competitive market have the opportunity to serve and market price signals would work to match supply with demand; only in the absence of competition would providers of generation have an obligation to serve.
- ◆ Providers of generation services in a competitive market have an obligation to honor their contracts.

THE FERC NOTICE OF PROPOSED RULEMAKING

On March, 29, 1995, the Federal Energy Regulatory Commission (FERC) issued a Notice of Proposed Rulemaking and Supplemental Notice of Proposed Rulemaking (NOPR) on Transmission and on Recovery of Stranded Costs (Docket Nos. RM95-8-000 and RM94-7-001). Holly Koeppel, Director of Policy and Planning for CNG Energy Services in Pittsburgh, presented a summary of the NOPR to the Task Force. Among the issues are:

- ◆ The incentive for utilities which own transmission facilities to preclude others from fairly using those facilities must be overcome through regulation or divestiture of transmission facilities from vertically integrated utilities.
- ◆ Utilities that own or control transmission facilities must file tariffs offering service to third parties comparable to the services they provide to themselves and they must take service under the tariffs for their own wholesale sales and purchase of electric energy.
- ◆ Transmitting utilities must provide:
 - Network service (to use the entire network to provide generation from a specific source for a specific load).
 - Point to point service.
 - Ancillary services: reactive power/voltage control service, loss compensation service, scheduling and dispatching service, load following service, system protection service, and energy imbalance service.
- ◆ Transmission service must be functionally unbundled:
 - a utility must obtain transmission services for all of its new wholesale

Task Force on Regulatory Issues -- Summary of Meeting of June 1, 1995

sales and purchases of electric energy under the same tariff as that which it uses to offer services to others;

- transmission tariffs must include separately stated rates for transmission and ancillary services; and
 - a utility must rely on the same electronic network that its customers use to obtain transmission information.
- ◆ If the rates for ancillary services are capped, suppliers may not be adequately compensated for providing these services.
 - ◆ A poolco could serve as a clearinghouse with readily available spot price information; it would create a spot market; it would insure system reliability; it should be separated from interests in generation; and it could accommodate bilateral transactions.
 - ◆ The maintenance of reserves for system reliability could be a responsibility of an independent system operator.
 - ◆ The NOPR supports complete recovery of legitimate and verifiable stranded investment but because the magnitude of stranded investment is uncertain and because stranded investment can, in part, be mitigated, the actual amount of stranded investment is subject to negotiation.
 - ◆ Retail stranded investment is a state issue.
 - ◆ The FERC proposes that stranded investment would be calculated by subtracting the competitive market value of the power the customer would have purchased from the utility had the customer continued to take service under its contract from the revenues that the customer would have paid the utility.
 - ◆ The FERC will not allow states to use the interstate transmission grid as a vehicle for passing through any retail stranded costs.
 - ◆ To collect stranded costs, states may impose exit fees or a surcharge through distribution rates, they may allow recovery of stranded costs from remaining retail customers, or they may consider whether shareholders should bear some or all of these costs.

THE LEGAL SUBCOMMITTEE REPORT

The Legal Subcommittee distributed a summary of legal issues associated with retail wheeling. This summary may be further revised with input from additional attorneys. A copy of the revised summary will be made available at a later date.

A panel of seven attorneys discussed the major issues they perceived in a transition toward retail wheeling. The panel included representatives of investor owned utilities, rural electric cooperatives, independent power producers, industrial consumers, and residential consumers.

Among the points raised were:

- ◆ The complexity and legality of compulsory divestiture of generation, transmission, and distribution facilities by vertically integrated utilities.
- ◆ The regulatory and legal basis for permitting retail wheeling given exclusive (i.e. monopoly) certificates of convenience and necessity.
- ◆ The need for legislation permitting or requiring reciprocity among utility service areas since neither state regulators nor state legislators have comprehensive jurisdiction over existing service areas.
- ◆ The ability to engage in performance based ratemaking under Arizona law requiring that rates be set considering fair value.
- ◆ Creation of a "level playing field" where no generators have artificial advantages or disadvantages emanating from tax treatment, government financing, or regulation.
- ◆ A continuing need to serve low density, high cost areas at affordable rates.
- ◆ The potential for and consequences of degradation of electric service to rural or other areas.
- ◆ The Rural Utilities Service's and the federal government's responsibility to obtain repayment on the loans it made to rural electric cooperatives.
- ◆ Limitations on the ability of cooperatives to sell electricity to non-members.

Task Force on Regulatory Issues -- Summary of Meeting of June 1, 1995

- ◆ The existence of strong economic motivations by large industrial consumers to seek lower electricity costs and the creation of legal means to achieve lower costs.
- ◆ The relative importance of economic forces promoting competition and of legal barriers to competition.
- ◆ Equality of access to the benefits of competition for all types of consumers.
- ◆ Stranded investment as a transition issue.
- ◆ Cooperation or conflict between federal jurisdiction and state jurisdiction.
- ◆ Use of collaboration to negotiate resolutions to different positions on aspects of retail wheeling.
- ◆ Equity in the allocation of stranded investment to residential consumers.
- ◆ Uncertainty over whether energy portfolio managers will be able to economically serve small consumers, including residential consumers.

APPENDIX: PERSONS ATTENDING TASK FORCE MEETING, JUNE 1, 1995

Organization	Participants
Hughes Missile Systems	Patricia Taylor, Mike Shecton
Arizona Power Pooling Association	Charles Reinhold
ESI	Scott Getting, Rick Anderson
City of Phoenix	Bill Murphy, Barbara Kellogg, Paul Katsenes
Residential Utility Consumer Office	Marylee Diaz Cortez, Elaine Williams
Vision Power Service, Inc.	Mike Rowley
Arizona Utility Investors Association	Bill Meek
Citizens Utilities	Jeff Pasquinelli
Tucson Electric Power Company	Bradley Carroll, Harry Sauthoff, Mike DeConcini
Honeywell	Jeff Sutherland
Arizona Department of Commerce Energy Office	Stephen Ahearn
Brown & Bain	Michael Patten, Lex Smith
Morrison Knudsen Corporation	Bill Burtnett
Arizona Community Action Association	Jeff Schlegel (consultant to ACAA), Betty Pruitt
Arizona Public Service Company	Vicki Sandler, Barbara Klemstine, Gary Volkenant
Loral	Tom Heim
RMI	Alan Propper
Fennemore Craig/Cypress	Webb Crockett
Lewis & Roca	Robert Roos
Destec Energy, Inc.	Kenton Erwin
Arizona Association of Industries	Scot Butler
Snell & Wilmer	Thomas Mumaw
Diné Power Authority	Lydelle Davies
IBEW	Danny McKinney, Terry Miller
Intel	Phil Sarikas
Arizona Chamber of Commerce	Marc Osborn
Martinez & Curtis	Frija Wendel
Arizona Electric Power Cooperative	Patricia Cooper, Irena Callahan
Douglas C. Nelson, P.C.	Doug Nelson
Arizona Corporation Commission	D. Berry, K. Clark, R. Williamson, J. Alward, K. Nally, P. Breen, P. Bahl, R. James. Renz D. Jennings, Marcia Weeks, Carl J. Kunasek