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BEFORE THE ARIZONA CORPORATION COMMISSIONED  
(AZ CORP COMMISSION)

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

DOCKET NO. U-0000-94-165

**NOTICE OF FILING**

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing  
its Comments on Electric Industry Restructuring, in the above-referenced Docket.

RESPECTFULLY SUBMITTED this 28th day of June, 1996.

  
James P. Beene, Attorney  
Residential Utility Consumer Office

AN ORIGINAL AND TEN COPIES of the  
foregoing filed this 28th day of  
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**A Framework for  
Retail Electric Competition  
in Arizona**

**Initial Comments Submitted to the  
Arizona Corporation Commission  
by the  
Residential Utility Consumer Office**

**June 28, 1996**

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## **A Framework for Retail Electric Competition in Arizona**

### **A. Introduction**

The establishment of Docket No. U-0000-95-165 by the Arizona Corporation Commission and the Utilities Division's *Report of the Working Group on Retail Electric Competition* have resulted in the timely introduction to Arizona of the national debate about restructuring the electric industry. The Staff's *Request for Comments* is now providing an opportunity for all stakeholders in Arizona's electric industry to present their views.

The Residential Utility Consumer Office welcomes this opportunity to present a proposed *Framework for Retail Electric Competition* which looks at restructuring from the perspective of the residential consumer. RUCO presents these proposals as initial comments for consideration by the Commission and other parties and looks forward to active participation in ensuing discussions and proceedings.

In preparing these comments, RUCO has been assisted by Neil H. Talbot, an independent utility consultant based in Brookline, Massachusetts.

### **B. Executive Summary**

#### **1. Overall Objective**

- While the transmission and distribution of electricity in Arizona must remain regulated as natural monopoly services, RUCO believes that the generation and supply of electricity need not be permanently subject to economic regulation. A competitive power supply market should, however, be established before generation and supply are fully deregulated.
- RUCO believes that retail customer choice and competitive electricity generation and supply will, in time, best protect the consumer interest. With retail electric competition as the ultimate objective, RUCO would support an ACC initiative to begin the process of restructuring Arizona's electric industry in a reasonably expeditious and orderly manner.

#### **2. RUCO's Broad Concerns**

- RUCO has three broad concerns with regard to consumer protection and the establishment of competitive conditions in a deregulated electricity generation and supply industry:
  - residential consumers must be able to participate effectively in the competitive electric market;

- those consumers who are unable or unwilling to participate in the competitive electric market must have a satisfactory default option; and
- the Commission, together with regional associations and federal authorities, must ensure that deregulation of the electric generation industry does not lead to the exercise of market power by a few large suppliers.

These concerns are spelled out more fully in the following points.

- Participation by residential consumers in a competitive power market should be fostered by creating conditions under which utilities provide open access to their transmission and distribution systems, so that independent power producers and other competitive suppliers, power marketers and brokers can readily enter the supply market. Aggregators, who purchase electricity on behalf of groups of customers, should be encouraged. Municipal and rural entities should be considered as eligible to become aggregators. No special customer meters should be required when customers switch to a competitive supplier.
- For those residential consumers who are unable or unwilling to participate in the competitive market, service should be available under a Standard Offer that has reasonable terms and conditions. The right to provide Standard Offer service in an area for a five-year period should be awarded by the Commission to a supplier selected in a competitive process.
- In a regional industry now dominated by a small number of suppliers, deregulation must be accompanied by measures to ensure that no suppliers are able to exercise market power. Electricity generation and supply -- the packaging of generation and other services for consumers -- should open to new entrants such as independent power producers, marketers, etc.
- RUCO recommends that the ACC staff undertake or contract for a market study that would (a) determine the minimum conditions for effective competition in the Southwest regional electric generation market, and (b) recommend alternative measures necessary to achieve those conditions.

### **3. A Proposed Restructuring Agenda for Arizona**

- To test the implementation of retail electric competition in Arizona, RUCO would support the introduction of a retail competition Pilot Program. RUCO believes that the program could be introduced by about July 1, 1997 and last for a period of about 18 months. If the Commission decides to take this step, RUCO would recommend that Arizona's investor-owned electric utilities be required to file with the Commission by December 31, 1996 proposals regarding rate unbundling, appropriate restructuring to enable their affiliate generation to participate as suppliers in the competitive market, and other recommended features of a Pilot Program.

- While it would be unrealistic to expect that a Pilot Program will test or resolve all of the many issues involved in retail electric competition, RUCO believes that a program can be designed to force the industry, its customers and the ACC to answer some of the key restructuring questions that will have to be answered sooner or later. These questions include the unbundling of full utility rates and services into their component functions, broadly (a) the supply and (b) the delivery of electric power; an interim assessment of the level of stranded utility costs; the introduction of alternative suppliers to the market; familiarization of customers with the market alternatives; and the development of the information and control systems needed to handle larger numbers of suppliers and buyers
- In order to be most effective and equitable, RUCO believes that the Pilot Program should be open to all classes of customers; should not require special customer meters; and should have clear standards of conduct for suppliers.
- In parallel with the Pilot Program, it will likely be necessary for the Commission to hold further hearings to deal with electric industry restructuring issues as they arise. These issues will be suggested in part by the issues identified in the Pilot Program as well restructuring experience in other states. . **For a feasible transition schedule, see Attachment hereto.**
- Meanwhile, RUCO believes that the ACC, Arizona's utilities, and other stakeholders should work together expeditiously in regional forums and before the Federal Energy Regulatory Commission to draw the line between state and federal jurisdiction, and to ensure that the region's institutions for power supply transmission and coordination are modified to the extent necessary to create an open-access transmission system and competitive pooling arrangements.

**C. Key Features of the Proposed Framework**

**1. Customer Choice and Consumer Protection**

In almost all industries in the United States, competition is relied upon to maintain reasonable prices. New suppliers are encouraged to enter the market if they believe they can offer a service or product more efficiently than existing suppliers, can provide customers with better quality, or can introduce innovative new products and services. Customers who are dissatisfied with their supplier's price or quality are able to switch to another supplier, and frequently do so.

Among the regulated utilities, the electric industry is the last to remain fully under the control of monopolies which have exclusive franchises to provide service in their territories. RUCO believes it is time for Arizona to join the many other states that are questioning whether a monopoly structure is still necessary for the electric industry. The Commission and the legislature should consider whether electricity generation and supply -- the packaging of generation and other services for customers -- is still a natural monopoly,

or whether it has become an industry in which new entrants can and should be allowed to compete for customers' business. If this is the case, retail customer choice and competitive electricity generation and supply will best protect the consumer interest.

RUCO supports the Commission's initiative to consider restructuring Arizona's electric industry in an expeditious and orderly manner. Admittedly, many details of restructuring have to be worked out, but the testing of competition in the near term by means of a Pilot Program is a good way to force the utilities, new suppliers, customers and regulators to answer some of the key questions. In these Comments, RUCO will provide the Commission with its views on the design of such a Pilot Program and other transitional issues, as well as on the ongoing structure of the industry.

RUCO has three broad concerns with regard to consumer protection and the establishment of competitive conditions in a deregulated electricity generation and supply industry. Related to concerns regarding customer access and consumer protection, RUCO discusses in section 2 below the danger of excluding some classes of customers from the option of participating in the retail market, and in section 3 the need for default service for those customers who do not exercise that option. The danger of market power being exercised by large utility suppliers, is discussed in section 4 in relation to the design of the new industry structure.

Residential consumers must be able to participate effectively in the competitive electricity market. From the standpoint of all but the largest electricity users, the greatest danger in the restructuring of power supply is that some customers will capture the benefits of switching to lower-cost suppliers while the remaining customers remain captive and face the risk of being allocated a higher proportion of utility costs.

RUCO urges the Commission to adopt restructuring guidelines that will avoid this inequitable outcome and create a truly open and competitive market. The following guidelines are proposed by RUCO at this time.

## **2. Retail Access Eligibility for All Customers**

Residential customers should be eligible to participate from the outset in any Pilot Program or retail access phase-in. Members of each customer class should be eligible to participate in proportion to that class's share of consumption.

Furthermore, participation in the Pilot Program or phase-in should not be dependent on the customer having any special metering. Suppliers of customers who do not have hourly meters should be held responsible for their customers' estimated hourly loads based upon load shapes derived from load research studies or, simply, reflecting system average load shape net of the loads of all hourly-metered customers.

Without a requirement for special metering, the transaction costs of participation would be reduced to a level that would make the exercise of retail choice a practical alternative for all or most customers, who would be able to get the benefit of the cheapest

sources of electricity available. Clearly, however, to benefit from load management coupled with hourly pricing, a customer would have to have special hourly metering installed. Over time, RUCO expects that the cost of metering will decline and that load management will become more increasingly significant, leading to fuller utilization of existing capacity and a reduced need for new generating capacity.

The Commission should make every effort to encourage and support the aggregation of customers' loads by marketers, brokers or other suppliers, or by customers themselves or other aggregators acting on their behalf.

Municipal entities should ultimately be allowed to enter the market as aggregators on behalf of resident customers. Customer participation in such programs should be voluntary. Municipal utilities would not have to be formed, the distribution system would remain in the hands of the distribution utility which would continue to have the obligation to connect customers to the electric system.

Finally, every effort must be made by the Commission to ensure that customers are fully informed about their rights and choices in a retail wheeling environment under a Pilot Program or phase-in. They should understand that the service they obtain, and the bill they pay, will now be divided into two components -- distribution utility service and electric supply. The simplest situation -- and the one preferred by RUCO at least during the initial Pilot Program phase -- is one in which the distribution utility continues to take care of all aspects of service other than electric supply. For example, a customer should preferably receive only one bill, as is the case with telephone service where the local provider includes the long-distance charges in the bill irrespective of which long-distance company the customer has chosen. Likewise, it must be made clear to customers that reliability of supply is not at issue -- whatever choices they make, they will not have their power cut off if they pay their bills. Back-up power in the event of supplier failure should be the responsibility of the supplier, who would either provide it or purchase it from another supplier.

It should be made clear to customers that they can, if they wish, choose a supply package that can include different pricing schemes (energy charges, monthly customer charges, demand or hourly energy charges in the case of hourly metered customers, levelized billing, etc.), energy efficiency support, load management for hourly metered customers, power from renewable resources, etc.

### **3. Standard Offer Service**

While residential customers should be given every opportunity to participate in the competitive market, many customers may be unwilling or unable to exercise this option. For these customers, there must be a satisfactory default option. During the Pilot Program or initial phase-in period, the distribution utility should continue to provide full service to those customers who do not choose a competitive supplier.

Later, when more customers become available for retail access, it is likely that the concept of "the electric utility" will be evolving from the current full-service concept including both supply and delivery of electricity to something similar to that of the local gas distribution company, which is primarily responsible for delivering gas to customers and no longer has a gas purchasing or merchant role for all its customers. Likewise, the local electric distribution company would no longer provide electric supply to all its customers, but could continue to provide most other service including distribution of electricity, customer billing, and load balancing service within its distribution system.

At some point, the Commission should consider introducing a system in which the utility is no longer automatically the default provider. The Standard Offer electric service provider could, for example, be selected by the Commission in a competitive process. The provider could be chosen for a selected area -- such as a utility service territory or, in the case of large utility service territories, part of a service territory -- for a period of five years. At the end of that period, a provider for the next five years could again be chosen in a competitive process.<sup>1</sup>

#### **4. Proposed Market Structure**

This outline focuses on the ongoing structure of the market, rather than transitional issues which are discussed in connection with the Pilot Program and in RUCO's Comments on the Commission's detailed questions.

It seems clear that the transmission and distribution of electricity in Arizona must remain regulated as natural monopoly services, under the jurisdiction of the Federal Energy Regulatory Commission and the Arizona Corporation Commission respectively.

The challenge in creating a new competitive industry structure is to open the way for greater efficiency and innovation, which a competitive market can foster among power suppliers, while at the same time finding new ways to ensure that existing levels of reliability and efficiency of the bulk power system are not jeopardized. The existing system has been reliable, but reliability has come at too high a price.

While the generation and supply of electricity need no longer be subject to economic regulation, provided that a fully competitive market is established, the special nature of the integrated electric system must be reflected in the institutional structure of the bulk power market. Specifically, the nature of the generation and transmission network requires that the system be carefully and continuously coordinated to avoid supply disruptions. Further, since it takes some years to plan and build generating stations and transmission lines, some degree of coordinated planning is required to avoid imbalances and disruptions in the

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<sup>1</sup> As an alternative, if the Commission allows the distribution utility to continue to provide Standard Offer service through an affiliate, procedures would have to be developed to prevent the abuse of the affiliate relationship between the distribution utility and the Standard Offer affiliate, and the danger of a new build-up of stranded costs.

future. RUCO believes that this degree of planning can be achieved without the continuation of detailed integrated resource planning.

Competitive supply and customer choice can, RUCO believes, be combined with the minimum degree of system coordination and planning needed to ensure system reliability today and in the future. RUCO recommends that the Commission identify the different functions currently included in full utility service and determine how they should best be structured. The new electric industry could divide up and regulate the various functions as shown in Table 1 and described in the following text:

Table 1: Outline of A New Electric Industry Structure for Arizona

<u>Service</u>	<u>Provider</u>	<u>Regulated?</u>
Generation Supply	Independent Generators	No, Except for Antitrust Regulation and Affiliate Transactions
System Coord. & Reliability	Regional (SW?) Ind. System Op.	Yes, by FERC
Making a Spot Market	Regional (SW?) Power Mart	Yes, by FERC
Provide Retail Supply	Marketers & Brokers	No, Except for Registration with ACC
Aggregating Customer Demands	Aggregators	No, Except for Registration with ACC
Provide Distribution	Distribution Utility	Yes, by ACC
Making Futures & Options Markets	NYMEX	Yes, by Commodity Futures Trading Commission
Providing Transmission	Distribution Utility and/or Separate Transmission Utility	Yes, by FERC

RUCO proposes that the Commission consider moving toward an industry structure with the following features, determining whether each function can be performed on an Arizona-only basis, or should best be performed on a regional basis. It would be necessary

to define a convenient region. For example, a Southwest Region could be defined consisting of Arizona and New Mexico and possibly some adjacent areas.<sup>2</sup>

- Generation and Power Supply. The greatest change from the present system would be that the generation market, and the associated market for retail supply (*i.e.*, packaging generation and other services into supply contracts for customers) would no longer be a regulated monopoly, it would be open to all suppliers including independent power companies, marketers, brokers, etc. To the extent the utility companies continue to participate in the market, there would be rules regarding affiliate relationships and supply by the (generation) affiliate to the customers of the (distribution) utility.
- System Control and Coordination. An Independent System Operator (ISO) should control the dispatching of the transmission grid and generating units. While an ISO should control the switches, it should not, however, determine the generator dispatching priorities except for the overriding purpose of ensuring the reliable operation of the system. Currently, APS performs the system control function for much of Arizona. FERC's recent Order No. 888 raises the issue of ISO governance, which "should be structured in a fair and nondiscriminatory manner." In a competitive market, the governance of the ISO should not be controlled by any one group of stakeholder but should be open to independent power producers and others.<sup>3</sup> The authority of the ISO should extend over a region that is appropriate for purposes of system control and coordination. The ISO should purchase on a competitive basis the resources such as spinning reserves and reactive power that it needs to maintain system reliability. It would provide or be responsible for what FERC calls "ancillary services" such as those described above (dispatching, operating reserves, etc.) The ISO would be regulated by FERC.<sup>4</sup>
- Hourly Spot Market. A regional hourly spot market for electricity should be established. The purpose of this market would be to offer sellers and buyers the equivalent of the current system of economic dispatch whereby in any hour the most economical generating units are selected to run in preference to less economic units. RUCO suggests that participation in the spot market should be voluntary. RUCO

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<sup>2</sup> The Southwest Regional Transmission Association, which covers a larger region, perhaps provides an initial framework within which members could consider regional issues, the formation of regional entities and the relationships between regions.

<sup>3</sup> A recent filing with FERC by California's utilities proposes an ISO with a governing board selected from five classes -- investor-owned utility transmission owners, public power utilities, sellers, end-users and public members.

<sup>4</sup> APS believes that centralized dispatch in Arizona has no net economic benefit because it would provide a cost saving of only 1-2%. However, if an ISO is formed for purpose of creating an *independent* system controller, this cost saving could be regarded as a bonus. It is also possible that the saving would increase over time as the market expands.

believes that it would be most efficient to have only one such market in the region, operated by an independent Power Mart. All sales in an hour would be at the market-clearing price, *i.e.*, the highest price accepted by the Mart in that hour. The Mart would notify the ISO on a daily basis the dispatch order of the generators offered into the market for each hour, based upon ascending order of price.

- Bilateral Contracts, Both Physical and Financial. Buyers and sellers should be free to enter into bilateral contracts for specified amounts of electricity, physically committing specific sources of supply if they wish. They should also be able, if they choose to do so, to switch to spot market sources when they are cheaper, and include financial features in their contracts such as the incorporation of the spot market price as a reference price. The Power Mart operator should facilitate interactions of these types between the spot and contract markets.
- Standard Offer Service. For those customers who are unwilling or unable to access the competitive power market, RUCO proposes that Standard Offer service should be provided by suppliers selected by the Commission in a competitive process.
- Importance of a Balanced Market Structure. What structure is most likely to create a vibrant bulk power market that is both efficient in the short run and reliable in the long run? RUCO believes that the combination of an effective ISO, a voluntary Power Mart, and a bilateral contracts market could provide such a structure. Ideally, generators should find the spot and contract markets about equally attractive -- there should not be a strong preference for operating existing units or constructing new units either for the spot market, or for operation and construction under contractual commitments to specified buyers. Alternatively stated, even if there are contractual commitments that commit the output of a generator to a particular customer, the contracting parties should find the spot market sufficiently attractive to encourage them to substitute spot market power when it is cheaper than the nominated generator (assuming it is feasible to vary the output of that generator).
- Distribution Utility Services. For the most part, services other than those that are generation-related should initially continue to be provided by the local distribution utility. These include metering and billing services, load balancing, etc. Transmission service can also be contracted and paid for by the distribution utility and/or independent suppliers. Distribution system expansion would still be planned and implemented by the utility. Transmission system expansion would be planned by the Independent System Operator or other regional entity and implemented by the utilities (assuming they retain ownership).
- Prevention of Market Power. While the intention of restructuring is to deregulate the generation of electricity, the generation market must still be monitored to ensure that suppliers do not engage in anti-competitive practices. The anti-trust law is available to offer some protection to consumers, but RUCO doubts that it is sufficient to prevent abuse and/or provide prompt relief. The Commission, together with FERC and regional authorities, must ensure that deregulation of electric generation results in the creation of an industry with many suppliers in which a few large suppliers

cannot exercise market power. The enforcement of competitive conditions is the counterpart in a deregulated industry of price regulation in an industry that is a natural monopoly. To the extent necessary, limits must be placed on the size of suppliers, proposed mergers and acquisitions must be scrutinized carefully, and restrictions on entry, collusion, or other exercises of market power must be avoided. In the event of abuse, there must be procedures for prompt relief. Prevention is better than a cure, however, a consideration that leads to the following point.

- Utility Restructuring. In an industry now dominated by a small number of regional suppliers, deregulation must be accompanied by the opening up of electricity generation to new entrants such as independent power producers. Since this could be a slow process, consideration should be given to restructuring the existing vertically-integrated utilities. The utilities' proposals on this subject should be obtained. In addition, RUCO recommends that the ACC Staff undertake or contract for a market study which would (a) determine the minimum conditions for effective competition in the regional electric generation market, and (b) recommend the measures necessary to achieve those conditions.
- Futures and Options Market. Futures and options contracts based upon the spot market price at certain hubs such as Palo Verde can complete the market for electricity. These contracts, which are financial rather than physical contracts, provide hedges to buyers and sellers against adverse price movements, e.g., a buyer is covered and suffers no loss if the spot price next month exceeds a specified limit. The New York Mercantile Exchange is already making a market in these instruments. Regulation would be by the Commodity Futures Trading Commission with possibly roles for other agencies such as the FERC

#### **D. Desirability of a Pilot Program**

On the subject of retail electric competition, opinions in Arizona are mixed. Arizona Public Service Company, for example, believes that for legal and technical reasons, retail access should not be introduced before the year 2000 and then only for large customers. In these circumstances, Staff has identified a Pilot Program as a pragmatic option, and has requested comments on a number of features of such a program.

RUCO would support the introduction of a well-designed Pilot Program, which could be an effective way to move the retail competition debate forward at this time without raising the stakes too high. While the outcome of a Pilot Program could be to move Arizona in the direction of fuller retail access, it could, if retail access is not initially successful, result in changes to the design of the program, deferral of retail access, or even rejection of the whole idea of retail access.

In these initial comments, RUCO assumes that an expanded Phase Two retail access would ensue, with modifications based on the learning experience of the pilot and

experience in other states. This could lead to full retail access at some later date. This scenario is developed on a tentative basis in the **Attachment** to these Comments.

A Pilot Program could be introduced, RUCO believes, by July 1, 1997, depending on its scale and other factors.<sup>5</sup> The Pilot Program should be designed to force the industry, its customers, the ACC and FERC to answer some of the questions that have to be addressed in establishing a competitive electric generation and supply market in Arizona. As the New York Public Service Commission says in its May 20, 1996 Order on Competitive Opportunities, "We favor pilot retail access programs that do not impose inordinate complication or delay because they can be helpful for identification and correction of practical problems that have not yet been considered." A list of some of the issues that a Pilot Program can help to resolve is as follows;

- the unbundling of electric services and rates into generation/supply and delivery service, the latter including distribution, billing, transmission, and ancillary services for system coordination and control;
- coordination with FERC regarding delineation of federal and state jurisdiction of transmission for retail customers and the setting of *pro forma* open access transmission tariffs under FERC Order 888;
- interim measurement and treatment of stranded utility costs;
- consumer education and measures to deal with customer confusion;
- the formation of marketers, brokers, etc.,
- registration procedures and determining a code of conduct for generators and suppliers;
- development of a possible new role for municipal and other local districts as aggregators on behalf of town residents;
- the need for new metering and billing arrangements, balancing services and new information and control systems; and
- coordination of retail access with wholesale market developments such as power pooling and real-time pricing.

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<sup>5</sup> If the ACC determines that a pilot requires legislative authorization, the passing of such legislation and its requirements might affect the schedule.

However, too much should not be expected from any pilot program. There are a number of the questions that may *not* be finally resolved by a Pilot Program as such:

- the utility's ongoing role including its service territory franchise rights and its obligation to serve customers in that territory;
- final determination of the amount of utility stranded costs;
- final utility compensation for stranded costs;
- final market structure (although the Pilot Program can begin to define the roles of generators, marketers, aggregators and utilities);
- determination of long-term market prices (to build market shares, and, given that there is currently excess capacity in the generation market, suppliers will likely low-ball their initial offers);<sup>6</sup>

As an initial proposal, submitted to the Commission for purposes of discussion, RUCO proposes a Pilot Program that would have the following features.

1. Start Date. The Program could commence as soon as reasonably possible. A starting date of around July 1, 1997 should be feasible.
2. Period. A reasonable period might be 18 months. A much longer period might unnecessarily delay further progress.
3. Utility Coverage. The Commission should consider including retail customers of all investor-owned electric utilities including APS, Tucson Electric and Citizens Utilities.
4. Magnitude. Up to 2 - 4% of each utility's load is proposed.
5. Customer Coverage. Customers could be selected in various ways. One way would be for the Commission, in collaboration with municipal authorities, to pick one or more midsize cities in which customers of all classes would be asked to volunteer. Alternatively, the Program could de-emphasize geographic location and could be open to all classes of customers on a proportional basis. For APS, this would mean about 14,000 to 28,000 customers becoming eligible.

Large industrial customers could be invited to volunteer for the program, and the selection could be undertaken on a random basis from among the volunteers.

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<sup>6</sup> Low initial pricing can help to provide an incentive to customers to participate in the market, which is good. On the other hand, short-term market prices should not be used as a benchmark against which to measure longer-term stranded utility costs.

Residential and commercial customers could be selected in a manner that reflects either or both geographical selection and random selection.<sup>7</sup> For example, local government authorities could be invited to propose their areas as geographic areas within which customers would be eligible for the program unless they choose not to participate. From among the volunteer areas, on a random basis, areas representing up to 1 - 2% of residential and commercial loads could be selected. Then, from among the customers in the rest of the utility's service territory, customers could be selected at random from among those who volunteer, to make up the residential and commercial totals to 2 - 4% of each class's load.

6. Supplier Eligibility. Suppliers that meet certain criteria of financial soundness and business expertise should obtain from the Commission certification regarding their eligibility to provide power supply. While RUCO believes that certification procedures should not be onerous, suppliers should demonstrate (a) their capability from a financial, business and technical standpoint to provide supply service, and (b) a source of supply.<sup>8</sup>

Utilities that wish to register as suppliers should be required to do so through affiliates with different names separated by a Chinese wall from utility data, etc. -- all data provided by the distribution utility should be made available equally to all suppliers.

7. Utility Role. The utility would continue to provide delivery service to customers. This role should include a wide range of services, provided they are reasonably priced by the utility: distribution, transmission, administration, scheduling, balancing, generation reserves and other ancillary services.<sup>9</sup>
8. Metering. No special meters should be required for small customers, who, for purposes of their supplier's load responsibility, should be assumed to have customer class load profiles estimated from load research data.<sup>10</sup>

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<sup>7</sup> In this and certain other respects, RUCO has benefited from the design features of the retail wheeling Pilot Program currently being introduced by the New Hampshire Public Utilities Commission. Before the ACC makes its final decision on the design of a pilot program, it would be desirable to check with the New Hampshire staff, which has set up a special electric restructuring group headed by George McCluskey.

<sup>8</sup> The New Hampshire Commission requires a showing of reliability or stand-by source of power; the Pennsylvania - New Jersey - Maryland pool (PJM) is proposing a showing of a 20% reserve margin. RUCO is concerned that these provisions could be onerous for non-utility suppliers and would suggest that alternative market-oriented solutions to the reliability issue be developed.

<sup>9</sup> If a supplier is able to offer some or all of these services, it should be allowed to do so.

<sup>10</sup> In New Hampshire, the Commission Staff reports that procedures developed by Granite State Electric, an operating subsidiary of New England Electric System,

9. Real-Time Prices. For selected small customers who install appropriate meters, and for large customers who already have them, participation in an hourly spot market under a time-of-use or real-time rate should be considered. These customers will be able to benefit directly from load management.

## **E. Furtherance of Staff's Restructuring Objectives**

### **Introduction: Comparison of Models**

In its October 5, 1995 *Report of the Working Group on Retail Electric Competition*, Staff outlined certain alternative market structures. RUCO is proposing a modified version of the Combined Poolco - Bilateral Contracts Model in which the spot market is voluntary, not mandatory, and is run by a Power Mart separate from the Independent System Operator. In RUCO's proposals, the role of the utilities in the generation market has not been determined -- this role remains to be considered in a thorough market power investigation, which would address the question whether, in a deregulated generation business, utilities should be allowed to remain vertically integrated and, if so, under what conditions affiliate generation would operate.<sup>11</sup>

RUCO has recently had an opportunity to review the comments submitted to the Commission on May 20, 1996 by Power Resource Managers (PRM) and a White Paper prepared in July 1995 by Johnson Controls, Inc. entitled *The Retail Energy Services Company Model for Restructuring the Energy Services Industry: A Customer Focused Approach to Restructuring*. These proposals both strongly support retail competition, as does RUCO. PRM proposes a mixed model, with both bilateral contracts and a pool. PRM does not allow for *physical* bilateral contracts, however, in which a supplier designates energy for delivery to a particular customer. In the spectrum of opinion on this subject, in which APS is at the other end -- APS is proposing a market dominated by bilateral contracts -- RUCO finds itself somewhere in the middle, seeing value in both a "pool" (interpreted as a voluntary Power Mart) and bilateral contracts (physical as well as financial).

PRM, like RUCO, supports another means of providing more choice to customers, a role for municipalities as aggregators for their residents. PRM also believes that the distribution utility should continue to be responsible for customer service functions including distribution services, metering, meter reading, responding to interruption of service

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have proved to be very effective at tracking load responsibilities.

<sup>11</sup> For example, there could be a structural separation of utilities into three divisions: (a) distribution, regulated by the ACC; (b) transmission, controlled by the ISO and regulated by the FERC; and (c) affiliated power supply and marketing. The power supply affiliate, however, might not be permitted to supply electricity to its distribution affiliate or its customers except under certain conditions, e.g., that it sells and prices the power through the spot market.

complaints, new customer hook-ups and billing. RUCO agrees that this is both simple and reasonable, at least during the initial phase-in of retail access.

Johnson Controls' Retail Energy Services Company (RESCO) model provides a succinct and reasonable account of retail competition. By focusing on the retail end of the market, it provides a useful complement to the supply-oriented approaches such as the poolco model and the bilateral contract model. We will not address the many points of agreement between the RESCO model and what RUCO is proposing, but will consider some points of difference. First, the RESCO model includes several standardized bundles of retail energy services to be selected for customers in a bidding process run by the Commission. RUCO is proposing only one -- a Standard Offer which should probably be restricted to the supply of reliable power rather than a package.

Second, RUCO believes that the supply market structure issues are critical. While it is true that in theory either the poolco model or the bilateral contracts model can be consistent with the RESCO model, RUCO's view is that without *both* the Power Mart and bilateral contracts features of the market, the customer's choice will be diminished. Moreover, it may take some careful structuring to ensure that neither aspect of the market dominates the other.<sup>12</sup>

With these structural comparisons in mind, RUCO's proposal is designed to avoid certain pitfalls that could be encountered in restructuring. In its February 22, 1996 *Request for Comments*, Staff listed nine objectives which the introduction of competition should meet. RUCO believes that its proposals will further these objectives, each of which is discussed in turn.

### **1. Encourage the benefits of retail electric competition.**

RUCO's proposals are designed to phase in as much retail competition as possible, and to deliver the benefits of competition to consumers through a balanced market structure that ensures full opportunities for bilateral contracts, a spot market, and competitively provided Standard Offer service.

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<sup>12</sup> A recent article suggests that in the UK the apparent poolco structure masks a market structure that is dominated by bilateral contracts, a market in which the pool price is not a true market price and in which the pool price is largely irrelevant. Steve Thomas, *Electric Reform in Great Britain: An Imperfect Model*, Public Utilities Fortnightly, June 15, 1996.

## **2. Limit the potential harm to utilities and utility investors.**

The concern here is primarily related to stranded costs.<sup>13</sup> First, it is important to remember that utilities are not vulnerable to losses with respect to their transmission- and distribution-related assets, which will remain regulated.

Second, with regard to generation-related assets, there are potential gains as well as losses -- some assets may have market values in excess of book value, while others admittedly are likely to have market values below book value. In any event, stranded costs should be measured on a net basis.

Third, during the initial phases of restructuring the passage of time reduces stranded costs. For example, APS, under its recent Rate Reduction Agreement and Order, has an opportunity to recover on an accelerated basis the cost of certain regulatory assets during a period ending on June 30, 2004.

Fourth, if the net market value of the utilities' generation assets is below book value, *i.e.*, sales of the assets, or sales of the output from them at market prices, result in a loss in shareholder equity or income, the first line of inquiry is whether there is scope for mitigation. Only after the value of utility assets has been fully recognized should the Commission make a determination with regard to the amount of truly stranded costs.

Finally, FERC has decided that costs stranded as a result of open access at the wholesale level should be recoverable by the utility. As regards costs stranded as a result of retail access, the Commission's determination should take into account the potential harm to utilities and utility investors as well as other factors. Whatever the Commission's decision in this regard may be for a particular utility, recovery through distribution charges should be feasible.

## **3. Enable a wide range of consumers to participate in a competitive market.**

Under RUCO's proposals, all customers would be eligible for direct retail access. Moreover, RUCO has included features that should enable a large proportion of customers to access the market. Finally, for those customers who are unable or unwilling to shop around for electricity, Standard Offer service can be competitively provided.

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<sup>13</sup> Another concern might be the volatility of returns in a competitive industry. RUCO believes it is important for the restructured industry to avoid the kind of instability that would lead investors to demand a significantly higher rate of return.

#### 4. Limit the potential for decreases in electric system reliability.

RUCO's proposals are designed to ensure that electric system reliability is not jeopardized. In the short run, reliability remains the responsibility of the utilities. This responsibility should only be relinquished when an ISO or other entity is ready to operate and control the electric system. Furthermore, an active competitive market, coupled with a monitoring role played by the ISO, is structured to avoid shortfalls of capacity in the future.

However, RUCO acknowledges that issues of market structure and the role of bodies such as the ISO, as they affect reliability and other issues, still need to be worked out. For example, it is likely that the spot market will tend to reflect the *short-run operating costs* of generating units, particularly during off-peak periods. While it will be an economical source of power, including power that can be substituted for contracted generation, the spot market may not provide adequate recovery of *fixed* costs. By paying all sellers at the market clearing price in each hour, the spot market should cover the difference between the operating costs of the marginal (peaking or intermediate) generating and of the base-load units operating during that hour. It is unlikely, however, to provide full (peaking) capacity costs in addition. New construction of merchant generating units (those not committed to a particular buyer and therefore dependent on the spot market) is likely to be at a disadvantage, unless new units are so much more energy-efficient that they can cover their fixed costs in the spot market price.<sup>14</sup>

A solution to this problem could lie with the Independent System Operator.<sup>15</sup> In the market structure proposed by RUCO, the ISO is responsible for reliability of the bulk power system, acting in the interests of all suppliers and customers, whether they are selling or buying under contract or on the spot market. Short-term reliability is ensured by the ISO through its control of generator dispatch and transmission line loading. Long-term reliability depends upon the adequacy of the system's resources when load grows over time and facilities are retired or added to the system.

To ensure that both the amount and the location of resources are adequate, consideration should be given to authorizing the ISO to set a premium on the spot market price (a) during peak periods and (b) according to location, if it forecasts shortfalls in

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<sup>14</sup> This is unlikely to be the case in the near future. The current incremental cost of generating power in Arizona (say, 2 cents per kWh) would provide too small a margin over the fuel cost of an efficient new gas-fired unit (which might be 1.5 cents) to allow for recovery of the new unit's fixed costs (0.5 cent margin times optimistically 7,000 hours of operation per year would provide an annual contribution of \$35 per kW to fixed costs, an amount which would support fixed costs of under \$200 per year, less than half the cost of a high-efficiency unit).

<sup>15</sup> A Regional Transmission Group (RTG) could have a role in determining what new transmission capacity is needed and how it should be financed, owned and paid for.

capacity generally or in specific locations.<sup>16</sup> To support its forecasts, the ISO should be able to obtain notification of supplier plans from suppliers, and forecasts of distribution system loads from the distribution utilities. Any premiums determined by the ISO would be notified to the Power Mart and would be included in the corresponding hourly prices paid to generators and charged to customers.

**5. Limit the potential for market impediments such as:**

- (a) **exertion of market power by utilities which blunts competitive forces; and**
- (b) **high transaction costs for market participants.**

RUCO acknowledges that the Commission, FERC and other regulatory authorities will have to be vigilant to avoid the exertion of market power. Conceivably, antitrust considerations may result in the break-up the large regional power suppliers into smaller entities and the prevention of proposed mergers. The concern here might be the exercise of *horizontal market power*, i.e., the control of large shares of the generation business.

In the electric industry, *vertical integration* creates opportunities for abuse through favoring affiliated suppliers. With respect to transmission, independent control of the grid is designed to prevent this abuse. Potential problems with respect to vertical integration of generation and distribution are among the concerns that have led RUCO to propose an in-depth assessment of what it will take to create a competitive generation market in Arizona.

With respect to transaction costs, RUCO believes that a market structure containing competitive aggregators, marketers and brokers; a continuing role for the distribution (and transmission) utility; Standard Offer service for those customers who want it; and the provision of centralized services by the ISO and Power Mart; should be relatively economic to establish and quite efficient in its operation.

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<sup>16</sup> A market solution to this problem would be based on the development of extensive load management capability by customers over time under conditions of hourly or real-time pricing. The market would be cleared during peak hours by customer curtailments ("dispatching" of load management). This solution seems rather futuristic at this time, although by the time Arizona is expected to need new generating capacity the information revolution may have progressed to the point where it seems more realistic. At present, however, customers' hourly demands are insufficiently price elastic, and the real-time pricing and load control systems are insufficiently developed, to place much reliance upon this solution. The interim market solution is of course to depend primarily on bilateral contracts to fund new construction (incorporate capacity charges) and use the spot market more for economy energy, which is something like the current division between fixed costs and energy costs. However, primary reliance on bilateral contracts, as in the UK, would undermine the development of the spot market.

## **6. Encourage a variety of market developments.**

The combination of a bilateral contract market, a spot market, and competitive Standard Offer service, should give electricity suppliers considerable scope to offer competitive and differentiated services including DSM, load management, "green power," etc.

RUCO believes it is important to emphasize that competition will give far greater incentives to suppliers to *produce* electricity efficiently than is currently the case in a regulated utility context. Unlike the present cost-based system, every dollar saved by a supplier in reducing a generating unit's heat rate (the number of Btu's used to generate a kilowatt-hour of electricity), increase its availability factor, or improve its fuel mix, etc., goes to the supplier's bottom line.

## **7. Promote renewable resources.**

While the Commission's role is reduced in a competitive market compared with a regulated Integrated Resource Planning framework, competition will promote renewable resources if the price is right (which could be the case with certain wind power resources, for example) and/or buyers choose to buy their supplies from an environmentally responsive supplier (e.g., a supplier that undertakes to develop renewables up to a certain percentage of its energy supply portfolio). Other things being equal, a competitive market can unleash more innovation and economy in design and operation of renewable energy resources than a regulated market can.

Furthermore, opportunities exist in a competitive market to support renewable energy resources through such measures as tax credits and through setting regional or national emissions limits. The setting of limits on any of the pollutants emitted by power plants, coupled with an emissions trading scheme, as is already in place for sulfur dioxide, favors renewable energy resources which can be developed as part of a utility's or other supplier's compliance plan, or to free up emissions credits for sale.

## **8. Protect important public programs.**

RUCO would support, within reason, the provision of certain public programs, such as low-income DSM programs or the Universal Service Fund. These programs could be provided by the distribution utilities and funded through a non-discriminatory, non-bypassable System Benefits Charge payable by all distribution service customers.

## **9. Shield consumers who do not or cannot participate in the competitive market from rate increases attributable to competition.**

Nothing in the transition to a competitive structure *per se* should affect the allocation of distribution and transmission costs as between customer classes, but there is the danger of cost-shifting to captive customers when rates are redesigned. Unbundling of services and

rates should not be a license for cost-shifting by utilities. For example, service has always been provided to customers of a utility at the same rate, irrespective of location. Customers in remote areas, small towns, suburban areas, and cities have equal rates. That feature, which affects distribution costs and line losses, should remain in place.

With respect to generation costs, RUCO's proposals include an open market for marketers, brokers and aggregators, as well as competitive provided Standard Offer service, which should not only avoid rate increases for residential customers, whether or not they opt for direct retail access, but should lead to rate reductions if properly implemented.

## **F. Detailed Responses to Staff's Questions**

### **1. Affected Utilities. Which utilities should open their markets to competition?**

Pilot Program. RUCO proposes that the investor-owned utilities should participate in the Pilot Program.

Ongoing. Subject to the legislative or other steps that might be necessary, consideration should be given to opening the market to all customers including those of the rural electric cooperatives and municipalities including the Salt River Project.

### **2. Scope of Restructuring.**

#### **a. How much of the utilities' markets should be opened to competition?**

Pilot Program. Up to 2 - 4% of each utility's market.

Ongoing. Ideally, one hundred percent of the market should ultimately be opened up. However, there could be an intermediate phase. For example, if the Pilot Program affects 4% of the market on July 1, 1997, an additional 21% (total 25%) could be opened up on January 1, 1999 and 100% on January 1, 2000.

#### **b. Which consumers should be allowed to shop around for power and energy? Consider both geographic areas and consumer classes.**

Pilot Program. Up to two to four percent of each customer class. The selection process could be similar to that being implemented currently in the New Hampshire pilot, but various alternatives are available, as described in section D above and repeated here. One way would be for the Commission, in collaboration with municipal authorities, to pick one or more midsize cities in which customers of all classes would be asked to volunteer. Alternatively, the Program could de-emphasize geographic location and could be open to all classes of customers on a proportional basis. For APS, this would mean about 14,000 to 28,000 customers becoming eligible.

Large industrial customers could be invited to volunteer for the program, and the selection could be undertaken on a random basis from among the volunteers.

Residential and commercial customers could be selected in a manner that reflects either or both geographical selection and random selection. For example, local government authorities could be invited to propose their areas as geographic areas within which customers would be eligible for the program unless they choose not to participate. From among the volunteer areas, on a random basis, areas representing up to 1 - 2% of residential and commercial loads could be selected. Then, from among the customers in the rest of the utility's service territory, customers could be selected at random from among those who volunteer, to make up the residential and commercial totals to 2 - 4% of each class's load.

Ongoing. All customers in all areas.

- c. **Should utility customers served under existing contracts be eligible to participate in the competitive market prior to expiration of the existing contracts?**

Pilot Program. As a general rule, RUCO believes that if customers have freely entered into special contracts with utilities, the terms of those contracts are binding on them. Unless the contracts provide some kind of relief in case of changed regulation, these customers may not be able to participate.

Ongoing. The same appears to be true on an ongoing basis.

- d. **If divestiture were undertaken, how should it be accomplished?**

Pilot Program. In RUCO's opinion, divestiture does not directly arise in connection with the pilot program. If, however, a utility wishes to offer electricity supplies in the competitive market to its own distribution customers, it should be required to do so through an affiliate which does not have access to any information not provided equally to all its competitors, *i.e.*, is separated by a so-called Chinese Wall, and does not use the name of the utility in any way in its marketing.

Ongoing. RUCO has not reached a conclusion at this time regarding the desirability or otherwise of divestiture. *If*, however, divestiture takes place, the sale of generation assets by the utility has certain advantages.

First, it can allow sales of different assets to different companies, which would have the effect of reducing concentration in the generation market.

It also, of course, eliminates vertical integration, provided that the utility does not enter into a simultaneous agreement to purchase the output of the generating facilities from the seller or in any other way control their operation. There should be a prohibition on the supply of generation by the new companies to the distribution utility for a period of some years. These companies can sell power to the spot market or under contract with utilities in other areas or with customers direct. As a practical matter, it may also be necessary to allow the

purchasers or spun-off companies to compete, under appropriate conditions determined by the Commission, to provide Standard Offer service in all or part of the service territory of their former distribution utility.

Finally, sales of generating assets determine the market value of the assets for purposes of stranded cost determination.

The alternative of spinning off generation into one or more separate companies, none of which would have a disproportionate share of the generation market, could be considered, but does not resolve the determination of market values and stranded costs.

### **3. Term of Restructuring.**

#### **a. When should competition start?**

Pilot Program. As soon as reasonably possible, which could be by July 1, 1997.

Ongoing. If the Pilot Program is regarded as Phase One of retail competition, affecting up to 2 - 4% of the market, and lasting until approximately end-1998, Phase Two could bring competition to all other customers from January 1, 1999. This schedule assumes, of course, that the Commission and/or the legislature are determined to introduce retail competition as soon as reasonably possible.

A somewhat less ambitious schedule would provide that, if the systems are not in place to handle 100% of retail customers on January 1, 1999, Phase Two could involve some smaller number such as an additional 21-23% of the market, for a total of 25% at that time, with the remainder following a year later on January 1, 2000.

#### **b. If competition is in the form of a pilot or phase-in, how long should the pilot or phases run? Please describe the phases of a phase-in. Please consider that many larger customers of utilities are currently under contract and may not be able to shop around until those contracts expire.**

The first part of this question has been answered under *a.* above.

With respect to the contract issues, those customers who have contracted for utility supply for certain periods should, depending on the terms of their contracts, end up in the same position as customers who enter into new contracts *after* retail wheeling has been introduced. Note, however, that in the event of divestiture these contracts would have to be assigned to the companies which purchased generation assets from the utility, or to which those assets were spun off.

- c. **If competition is in the form of a pilot, how can the term of the pilot be set so as to avoid discouraging long term contracts signed under the pilot?**

Pilot Program. Industrial and commercial customers should at any time be allowed to enter into long-term contracts with the utility, with the understanding that such contracts might need to be assigned in the case of the break-up of the utility.

Residential customers, who might be vulnerable to misleading marketing by suppliers, should not be allowed to enter into contracts that extend beyond the period of the Pilot Program.

Ongoing. Once the market has become fully competitive, all customers must make their own choices about power supplies, including the default option of Standard Offer service.

**4. Services Available on a Competitive Basis. Which services should be available in a competitive market?**

- Distributed energy services at market based rates (serving multiple consumers located in proximity, and not requiring transmission service from others); this is distinct from on-site generation for just one customer.
- Central station generation services at market based rates (generation serving one or more customers located at a distance from consumers and requiring transmission service).
- Other services described in Sections 5, 6, 7 and 8.
- Other services (please describe).

Pilot Program. Suppliers on the market should decide what service packages they wish to offer. Perhaps it is simpler to think in terms of what is *not* still provided by the utility. During the Pilot Program, it seems reasonable to have the utility still offer a wide range of ancillary services such as metering, billing, system control, etc., as well as transmission and distribution delivery.

The remaining services that can be competitively provided include power supply and DSM/load management packages.

These competitively offered supply alternatives could, it would seem, include distributed energy services as described above that do not require delivery through the transmission system. If, however, the utility is relied upon for complementary distribution service, back-up power, etc., it would continue to provide these under regulated rates.

Supply service packages that rely upon the transmission system (as would normally be the case) should be competitively provided. Clearly, the distribution utility and transmission

owner would have to be compensated for the use of their systems according to regulated tariffs.

Ongoing. Over time, additional services could be competitively provided. These could include metering and billing, for example.

**5. Necessary Services. Utilities and perhaps other parties will have to address the services listed below. Please indicate how these services should be offered, measured (metered), and priced on an unbundled basis.**

- distribution service
- transmission service
- supplemental generation service
- imbalance service<sup>17</sup> (including accounting for losses)
- back-up (standby) service
- voltage control
- other ancillary services necessary for maintaining system reliability
- scheduling of supplies and demands
- repairs/ consumer complaints
- other necessary services -- please describe

Pilot Program. The distribution utility, to the extent possible, should remain responsible for the provision of all services, including distribution, supplemental generation service, imbalance service, back-up (standby service), voltage control and other ancillary services for reliability, and repairs/consumer complaints, unless provided by the independent power producer or other electricity supplier (which might be in a position to provide imbalance service, back-up, etc.). These services should be provided under regulated rates to all customers, regardless of whether they are utility full-service customers or direct access customers. The unbundling of rates and services into those that are utility-provided and those that are provided by other suppliers is, of course, a major undertaking; for purposes

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<sup>17</sup> Imbalance service applies in cases where the supplier provides, or the consumer takes, more or less power than scheduled, and there is an imbalance that has to be dealt with.

of the Pilot Program approximate cost allocations as between these services should suffice. This matter should be the subject of a compliance filing for each utility.

APS is concerned that the utilities will have a kind of maternalistic role because new suppliers will not take full responsibility for reliability, etc., and customers will revert to the utility if the supplier fails. The proper pricing of generation support services by the utility both for its own supplies and for those of independent suppliers could reduce this concern.

Furthermore, in the case of utility suppliers supplying customers with a full generation package in another utility's distribution service territory, this concern should not arise.

Ongoing. Adjustments should be made to unbundled rates, based on the experience of the Pilot Program. Ultimately, when gray areas such as "ancillary services" are more clearly defined, competitively determined generation prices will be reasonably distinct from regulated rates for transmission and distribution services. Imbalance services as between distribution customers will presumably continue to be provided by the distribution utility. Distribution losses should be the responsibility of the utility, which makes them up through its own generation or purchases and is compensated under ACC-regulated rates. Voltage control and other ancillary services such as reactive power, etc., will likely be the responsibility of the transmission system operator which will acquire them and recover them under FERC-regulated rates. Reliability should be provided through these new institutions and market structures that affect all generators equally, whether or not they are utility affiliates.

**6. Market Center Services. The market may benefit from the services listed below. Please indicate how these services should be offered and priced.**

- title transfer
- transaction confirmation
- establishing credit standards
- invoicing
- dispatching of transmission/generation
- exchanges/swaps
- interruption notification
- imbalance trades

Pilot Program. Dispatching of transmission/generation, exchanges/swaps and imbalance trades as between different distribution utility systems and other bulk power market participants will likely be the responsibility of the transmission system operator and/or

Power Mart, as may some of the other market center services listed. Pricing would be at FERC tariff rates.

Ongoing. Consideration should be given to increasing the range of competitively provided services over time.

**7. Spot Market Services. The market may benefit from the services listed below. Please indicate how these services should be offered and priced.**

- electronic bulletin boards for spot transactions/prices
- power pooling services
- coordination with futures/options markets

Pilot Program. Buyers who purchase electricity from the spot market should be charged for the services provided by the Power Mart. These could be included on a per-kilowatt-hour basis in the spot price. The provision and pricing of these services would be regulated by FERC. Coordination between the spot market and the futures/options market is, however, a service that might be provided by the New York Mercantile Exchange which would collect fees to pay for it from participants in the futures/options market as regulated by the Commodity Futures Trading Commission (CFTC).

Ongoing. The situation would presumably remain the same on an ongoing basis.

**8. Transmission Service. For a competitive market to work, utilities owning transmission facilities must provide transmission service. Please indicate how the following objectives would be met:**

- services must be provided consistent with FERC tariffs;
- utilities must accept power delivered to their transmission systems by other suppliers and offer wheeling services comparable to services they provide to themselves;
- all sellers supplying consumers must have interconnection agreements with owners of necessary transmission facilities.

Pilot Program. FERC-approved tariffs and practices will have to be developed by the utilities in order for the wholesale market, with or without retail customer participation, to be able to rely upon an open-access transmission system. To the extent that certain transmission, along with distribution, is found to be retail wheeling subject to state regulation, ACC-approved open-access tariffs and practices will have to be developed.

Ongoing. These issues will become increasingly important as retail competition increases.

**9. Recovery of Stranded Investment. Please indicate how the recovery (if any) of stranded investment should be accomplished. Address each of the following issues:**

**a. The definition of stranded investment.**

Pilot Program. Interim recovery of stranded costs, with true-up, could be based upon the difference between the current tariff rate and the corresponding estimated market price, expressed in cents per kilowatt-hour, for each customer class. The tariffs, and competitive market prices, of each customer class will depend on voltage level and load factor.

Ongoing. At some point in time, it would be desirable to estimate the total dollar value of stranded costs for each utility, based upon the difference between the market value of its generation assets and their regulated book value. At that time a final determination of stranded costs can be made.

**b. The fraction of stranded investment which should be recovered.**

Pilot Program. In order to provide an incentive to participants, stranded cost recovery should be limited to a percentage of stranded costs. It would be highly desirable in the ACC could set this general principle and negotiate a settlement with each utility.

Ongoing. The stranded cost recovery issue is a highly complex one. Opinions regarding the responsibility for recovery differ widely. Even among utilities, opinions are divided. While many utilities believe that 100% of stranded costs should be recoverable from ratepayers, others are willing to negotiate a settlement of stranded costs with other stakeholders. PacifiCorp is quoted as saying recently that "utilities should not expect to recover 100% of these costs from customers. Requiring that would retard competition, reward inefficiency and minimize the benefits customers would gain from competition."<sup>18</sup>

Stranded cost recovery in the longer run should be guided by several considerations, including:

- the nature of the specific items contributing to stranded costs, and the extent to which the utility was ordered to incur the expenditure by regulators;
- the desirability of removing impediments to the free operation of the electricity market within a reasonable period of time as a matter of economic and regulatory policy;
- the infeasibility of maintaining above-market prices or adders for stranded cost recovery for prolonged periods;

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<sup>18</sup> Edison Electric Institute, *Retail Wheeling and Restructuring Report*, June 1996, page 139

- an equitable dispensation of the matter taking into account the interests of utility investors and customers in a changing regulatory environment;
  - the risk assumed by utility investors and the risk premiums earned on utility investments in excess of returns on risk-free investments;
  - the financial impact of non-recovery on the utilities;
  - the need to put pressure on utilities to maximize the mitigation of stranded costs; and
  - the desirability of a negotiated settlement of the matter in preference to protracted disputes.
- c. **How the Commission will determine the amount of stranded investment, taking into account: revenues under traditional tariffed rates (or existing special contracts); actual utility revenues from customers who obtain discounted rates or obtain services from others; increases in net revenues from wholesale sales and additional retail sales, including the effects of price elasticity of demand; increases in the value of assets due to new pricing or competition; mitigation of stranded investment; and other relevant factors.**

Pilot Program. See RUCO's response to *a.* above

Ongoing. The final resolution of stranded costs must depend upon forecasts of sales, market prices, and utility cost-based rates. The procedure for estimating stranded costs will undoubtedly involve many judgments.

At this time, RUCO would like to emphasize one point. The cost responsibility for each customer class should, in an electricity market that is already becoming increasingly competitive, be determined on the basis of billing determinants, not actual current rates which may be discounted. In other words, no current or future shortfall in cost recovery from any customer class should be recoverable from other classes. If competitive conditions make it impossible for the utility to attempt to collect stranded costs from any class of customers because of the fear of losing their business, there is no alternative but for the utility to absorb these costs.

- d. **Preliminary estimates of the magnitude of stranded investment (please provide supporting analysis).**

Pilot Program. For each customer class, stranded costs are equal to tariff rates minus market prices. It is important to estimate market prices based upon contracted supplies, not the spot or short-term market rate, because at this time spot prices are lower than prices that would be demanded by sellers under contract for the term of the Pilot Program.

Ongoing. Each utility should be required to develop a methodology for estimating its stranded costs, which the Commission and other parties can review.

**e. The proper ratemaking treatment of negative stranded investment.**

Pilot Program. If any utility's tariff rates, which takes into account all its investments and costs, is below the market price level, the customers would have no incentive to participate in a Pilot Program.

Ongoing. Any negative stranded costs should be netted against positive stranded costs in the overall determination of a utility's level of stranded costs.

**f. From whom stranded investment should be recovered.**

Pilot Program. Interim stranded cost recovery should be by distribution charges on all electricity delivered to all customers.

Ongoing. To the extent that the Commission determines that stranded costs should be recovered from customers, recovery should if possible be equitably from all members of each customer class, through charges included in distribution tariffs by the distribution utility. It should not be permissible for any customer to avoid paying these charges. These charges should, in other words, be non-discriminatory and non-bypassable.

RUCO doubts, however, that exit fees can be imposed if a customer leaves the distribution area, or cuts off from the utility grid. If a customer reduces consumption by conservation or energy efficiency, or by self-generation, it seems to RUCO that in these circumstances the customer would also be able to reduce its exposure to stranded cost charges in proportion to its reduction of dependence on the utility system, although it would still have to pay regulated rates for any services such as standby service still taken from the utility.

**g. The mechanism for recovery of stranded investment.**

See RUCO's response to *f.* above.

**h. The time period over which stranded investment is to be recovered.**

Pilot Program. Interim stranded cost recovery should continue until a final determination of stranded costs has been made.

Ongoing. There should be some reasonable limit on the period of stranded cost recovery, which is a major impediment to the operation of the competitive market. At such time as a final determination with regard to stranded costs is made by the Commission, a maximum recovery period such as five years should be set.

**i. How utilities can mitigate stranded investment.**

With respect to their generation facilities, utilities will find themselves in the situation of other companies supplying a competitive market. As evidence of the importance of mitigation, RUCO notes that there have been a number of conferences in recent years aimed at electric utility companies and focusing on "how to get the most value out of your

assets.” Non-regulated companies frequently run into financial difficulties or are taken over by new management because they have failed to realize the full value of their assets.

Some assets such as real estate holdings may be undervalued by the Company and could be revalued if properly used or sold.

The elimination of operating inefficiencies can reduce the costs and increase the values of assets.

Some assets retained in rate base may no longer be efficient and would be shut down or sold off in a deregulated environment, which would create value.

Different combinations of assets may yield greater value, hence mergers, spin-offs, asset sales, etc.

One benefit of the sale of utility assets is that it gives innovative buyers the opportunity to pay the full value that they perceive in utility assets, which may be greater than utility management perceives.<sup>19</sup> In this way, stranded costs are mitigated at the same time as they are clearly determined (as the difference between the asset sale price and its book value).

## **10. Recovery of Costs of Commission-Mandated Utility Low Income, DSM, Environmental, Renewables, and Nuclear Power Plant Decommissioning Programs (“Mandated Programs”).**

- a. **How shall costs of mandated programs be recovered from participants in the competitive market?**

Pilot Program. In a Pilot Program, cost recovery of so-called “stranded benefits” would continue as it presently does in distribution utility tariffs.

Ongoing. RUCO believes that within reason distribution utility tariffs can continue to include cost recovery of certain public benefits. These could include the cost of a Universal Service Fund and low-income programs such as DSM programs targeted at low-income customers.

Investors in a deregulated generation market may not be willing to take on the risks related to nuclear power plant decommissioning costs and nuclear fuel waste disposal costs, in which case these costs may regrettable have to remain distribution utility obligations recoverable from all customers through charges included in distribution rates.

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<sup>19</sup> In takeover situations, the acquiring company typically pays a premium over the prior market value of the stock being acquired. Also, utility stocks sometimes have market values in excess of book values. Asset sales might realize some portion of these premiums.

During the next three years, RUCO notes that substantial DSM commitments have been made by APS under the Rate Reduction Agreement and Order. After the three-year period of that Order expires, RUCO believes that mandated DSM programs should be phased out and energy efficiency initiatives should become the primary responsibility of customers and those competitive suppliers who include energy audits, energy efficiency measures and load management features in their supply offers.

Environmental compliance with state and federal standards for power plant and transmission facility siting and operation will still be required. They should apply equally to independent power producers.

RUCO does not believe that the Commission should include any special costs or quotas for renewable energy resources in distribution charges in a competitive environment. It is possible that the market may offer impressive energy efficiency and "green power" packages. If these are regarded as inadequate, legislative initiatives at the federal and state levels could be considered.

**b. How shall the magnitude of the costs of mandated programs be determined?**

Those programs such as low-income DSM programs which the Commission determines should be continued, should be provided as regulated services with costs included in cost of service and incorporated in distribution utility rates. With rate unbundling, these cost could be separately identified in rate cases.

**11. Encouragement of Renewables.**

**a. How shall renewables be encouraged in a competitive environment? Please discuss such mechanisms as a requirement that x percent of energy sold in the competitive market must come from solar sources.**

RUCO believes that market forces, within the constraints imposed by compliance with environmental standards and emissions allowance quotas, will play an increasing role in bringing renewable energy resources to the market.

In the New Hampshire pilot program, some four of the approximately 30 suppliers competing for customers' business are offering "green power" packages.

RUCO anticipates that, over time, environmental restrictions and standards will tighten, and will be reflected in increasing costs of fossil-fuel burning plants. The relative economics of developing renewable energy resources (and DSM and supply-side efficiency) will improve. The market will respond by introducing a greater variety of renewable energy projects.

**b. How could progress in encouraging renewables be measured?**

While RUCO believes this should be primarily a concern of federal and state environmental agencies rather than the Commission, progress on the renewables front could presumably be measured by the percentage of energy derived from renewable energy resources.

**c. How could a renewables program be enforced by the Commission?**

RUCO believes that in a competitive market, the best way for renewable energy resources to be supported is through such measures as tax credits and through regional or national emissions limits.

The setting of limits on any of the pollutants emitted by power plants, coupled with an emissions trading scheme, as is already in place for sulfur dioxide, favors renewable energy resources which can be developed as part of a utility's or other supplier's compliance plan, or to free up emissions credits for sale.

**12. Pooling of Generation and Centralized Dispatch of Generation or Transmission.**

**a. Should pooling of generation or centralized dispatch of generation or transmission be mandatory or voluntary?**

It should be clear from RUCO's recommendations on market structure that, while all generators must accept centralized dispatch of the electric system by an ISO for reliability purposes, pooling through a Power Mart should be voluntary.

In summary, *reliability* affects all participants in the market and compliance with ISO directives must be mandatory, while *efficiency* is left to the choices of market participants.

**b. What technical requirements will be necessary to ensure reliable and efficient use of generation and transmission resources? Please propose specific requirements, if possible.**

Please see RUCO's general comments on market structure above. Clearly, numerous technical considerations have to be taken into account in setting up the operations of an ISO for reliability purposes. Likewise, the setting up of a Power Mart for economic efficiency purposes is a complex matter. And the relationships between the ISO, the Power Mart, and those entities responsible for owning, maintaining and adding to the transmission grid and power facilities will have to be worked out in detail.

- 13. Non-Public Service Corporations. How shall non-public service corporations such as municipal utilities be involved in a competitive market? For example, the service territories of Arizona utilities not regulated by the Commission may not be open to competition and Arizona utilities not regulated by the Commission may not be able to compete for sales in the service territories of the utilities identified in Section 1. Alternatively, an Arizona utility not regulated by the Commission may voluntarily participate in a competitive program if it makes its service territory available to competing sellers and if it agrees to all of the requirements of the Commission's competitive program.**

Pilot Program. RUCO suggests that Arizona public power entities who wish to, and are legally entitled to, participate as *suppliers* in the Pilot Program, should be permitted to do so provided they are willing to open their systems to other utilities on a reciprocal basis.

Ongoing. Ultimately, RUCO believes that the Commission and other responsible authorities should make direct retail access available to all consumers wherever they are located, including rural electric cooperative areas and municipal areas. This should be a condition on public power entities seeking to supply retail customers outside their areas. RUCO does not here consider whether this requires legislative approval.

RUCO believes, further, that municipal entities could play a valuable role as aggregators for customers in their areas. They could line up supplies from the market for participating customers. Customer participation should be voluntary, however. There is no need to condemn utility property in the area; the distribution utility would continue to provide distribution service.

- 14. Conditions for Returning to Utility Service After the Conclusion of a Pilot Program. If a pilot were adopted, please indicate what conditions are appropriate for returning to utility service after the conclusion of the pilot.**

All customers should have the right to return to utility service at the end of the Pilot Program.

- 15. Conditions for Returning to Utility Service. Please indicate what conditions (if any) are appropriate for returning to utility service if a competitive market is on-going.**

RUCO's proposals are intended to create a robust competitive market in which residential customers can freely choose to switch back and forth between Standard Offer service. The risk to the Standard Offer provider of a net gain or loss of customers should be minimal. When customers switch from one supplier to another, the gain of customers by one supplier is equal to the loss of customers by the other. The total demand on the

market, and the total amount of supply, are unaffected. Other things being equal, the shift might merely result in one supplier buying more on the spot or contract market, while the other supplier would buy less. Contractual obligations might, but might not, have to be modified to reflect the shift. For these reasons, and in light of the desirability of customers being able to exercise their supply choices, RUCO does not believe there should be any restrictions on customers returning.<sup>20</sup>

## **16. Administrative Requirements.**

- a. **A utility may require consumers obtaining generation from another entity to adhere to reasonable scheduling notification requirements, accept reasonable delivery points, adhere to reasonable metering requirements, and accept reasonable remote control requirements for interruptions or other purposes. Please specify what you consider to be reasonable.**

Pilot Program. No special customer meter should be required unless the customer wants to benefit from load management on a real-time rate. Distribution service would generally not be affected. Suppliers would need to make arrangements for use of the transmission system. They would have to notify the ISO of changes in supply arrangements, and have acceptable metering. Suppliers might also need to arrange for back-up power, if not provided elsewhere in the system, although a general market mechanism for providing reliability would be preferable. The customer should not, in any event, need to be interrupted in the event of supplier failure.

Ongoing. Monitoring and planning in a competitive market would be quite different than they are now. Utilities, if still in the generation business, would likely be in a similar position to that of other suppliers. They would be selling to the spot market and under bilateral contracts.

An ISO would monitor and control the transmission and generation system and would require notification of supplier plans to ensure consistency and would need to plan to avoid bottlenecks.

The distribution utility would need to plan its distribution system in coordination with the ISO's plan to develop the transmission system. Transmission construction would be by transmission owners, which might be distribution utilities or separate companies.

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<sup>20</sup> The California Public Utilities Commission has reached the same conclusion about the returning customer issue in its recent *Draft Policy Decision*: "we.. have given these recommendations (regarding return conditions) considerable thought and decided to reject them. In a mature commodity market, customers daily exercise a right of free entry and exit. The (utility) faced with an individual or entity wishing to return as a full service customer need only increase its purchases from the (spot market) Exchange."

**b. How should the utilities identified in Section 1 notify their customers of the adoption of a competitive program by the Commission?**

Pilot Program. Experience in New Hampshire suggests that the Commission should have a role in providing advance information to customers about restructuring, retail competition and the choices they are facing. Only after that should the utilities and other suppliers undertake a customer notification and education program under the guidance of the Commission. Flyers could be included in utility bills; radio and TV announcements could be made; and press releases and other publicity could be issued.

Suppliers will take the initiative in advertising their offers. Customers are likely to be bombarded with marketing materials. The Commission's role should be to provide customers with information on the key factors that they should take into account in making their decisions, e.g., the fact that distribution or delivery service will still be provided; customers can retain utility service if they wish; they are at risk for the pricing terms they sign up for, but not for reliability; they should carefully weigh pricing terms, payment terms, bonus payments, etc., along with other features of each package -- possible inclusion of energy advice and energy management services, special metering to enable customers to benefit from load management, and so on.

As suggested earlier, residential customers should be protected by a provision that supply contracts should not extend beyond the term of the Pilot Program.

Ongoing. By the time general competition is introduced, customer awareness of market alternatives will have increased as a result of the Pilot Program and the larger amount of marketing literature that they will have received or been exposed to in the media. Nevertheless, there could be a continued Commission role in providing the public with basic information, and monitoring misleading advertising.

**17. Impacts on Other Utility Customers. Please indicate how adverse impacts on rates or service quality for utility customers not participating in the competitive market could be minimized.**

Pilot Program. Non-participating customers should not be affected by the Pilot Program. They should, in any event, be held harmless.

Ongoing. The structure proposed by RUCO should ensure that customers who do not participate in the competitive market are not adversely impacted, and should indeed benefit from the spill-over of benefits from the competitive market and through competitive delivery of Standard Offer service.

**18. Reporting Requirements for All Sellers of Electricity to End Users. Please indicate what reporting requirements (to the Commission) are appropriate and who should file reports.**

Pilot Program. Sellers should register with the Commission and satisfy the Commission that they have the capability to participate in the electricity business in the state, and that their marketing materials (copies of which should be filed with the Commission) are not misleading. While RUCO believes that certification procedures should not be onerous, suppliers should demonstrate (a) their capability from a financial, business and technical standpoint to provide supply service, and (b) a source of supply.

Utilities that wish to register as suppliers should be required to do so through affiliates with different names separated by a Chinese wall from utility data, etc. -- all data provided by the distribution utility should be made available equally to all suppliers.

The Commission should set up a procedure for dealing with customer complaints; other parties should be able to file motions.

Ongoing. Similar certification of suppliers by the Commission could be appropriate on an ongoing basis.

**19. Certificates of Convenience and Necessity. Please comment on whether competitive sellers who supply electricity to an end user must obtain a Certificate of Convenience and Necessity from the Commission (unless the seller already has an applicable Certificate). Please describe whether any conditions on the certificate would be necessary.**

RUCO does not believe that Certificates of Convenience and Necessity should be required in a competitive market.

The issue of *need* should be determined by the developer, who is taking the risk. The issue of *environmental and siting permits* should be addressed by the appropriate state siting and/or environmental protection agencies.

A new power project's *impact on other users of the system* should be dealt with by notification and coordination with the ISO and transmission owners.