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

Attn: Docket No. U-0000-94-165/Docket Control

Dear Sirs/Madams:

The National Rural Electric Cooperative Association (NRECA) is submitting comments for filing for Docket No. U-0000-94-165. We have enclosed an original plus 11 copies. Also enclosed is an extra copy for our files. Please stamp this copy with the date and time received and return to us in the enclosed envelope.

If you have any questions regarding this letter, or if I can provide further information, please feel free to contact me at 703-907-5811.

Sincerely,

Susan N Kelly

Susan N. Kelly
Regulatory Counsel

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47

BEFORE THE
ARIZONA CORPORATION COMMISSION

In re Investigation of Retail Electric Competition) Docket No. U-0000-94-165

COMMENTS
OF THE
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

In response to the notice issued on August 28, 1996 by the Arizona Corporation Commission (Commission) seeking comments on a Proposed Rule implementing retail competition in Arizona, the National Rural Electric Cooperative Association (NRECA) submits the following comments.

I. INTRODUCTION

The Commission's Proposed Rule would, under R14-2xxx1.1, apply to Arizona Electric Power Cooperative (AEPCO), a generation and transmission (G&T) cooperative, and to a number of distribution cooperatives, most of whom purchase 100% of their power requirements from AEPCO. Rural electric cooperatives (RECs) are differently situated than the typical investor-owned utilities (IOUs) regulated by state public utility commissions such as this Commission. Because of this, Arizona's RECs will be differently affected by the Commission's

Proposed rule than will Arizona's IOUs. NRECA is filing these comments to highlight certain of these differences and to request that the Commission give these differences full consideration in promulgating its final rule in this docket.

For the Commission to understand fully how its Proposed Rule will affect the electric cooperatives in Arizona differently, the Commission must understand the cooperative segment of the electric utility industry. Cooperatives are different from IOUs and municipal utilities in several significant respects. NRECA therefore opens its comments with a thumbnail sketch of electric cooperatives, their business organization, economics, and mission.

A. Distribution Cooperatives

There are almost 1,000 rural electric cooperatives (RECs) in 46 states serving approximately 30 million consumers. Approximately 900 of these cooperatives are distribution cooperatives. They were organized by their member customers to provide electric service in their local areas. REC members thus are both customers and owners (the equivalent of stockholders). RECs did not become a feature of the electric distribution industry until the 1930s. At that time, the federal government undertook policy initiatives to bring electric service to vast unserved rural areas of the United States. RECs were organized to serve areas of the country with comparatively low customer densities which other utilities had effectively declined to serve as unprofitable. Even today, the average customer density of RECs is 6 customers per mile of distribution line, as compared to 35 customers per mile for IOUs and 48 customers per mile for municipal systems.

Distribution cooperatives are engaged primarily in the local distribution and sale of electricity, and are owned by the consumers they serve. Because of the less populated areas they serve, however, their facilities can be extensive, covering long distances. While the kWh sales by cooperatives amount to approximately 7.4% of total electricity sales in the United States, RECs own and maintain 45.7% of the United States' power lines. Ninety percent of rural electric customers are classified as residential, including farm and ranch operations. In 1995, such residential customers purchased 60% of the electricity sold by RECs. Large commercial and industrial customers comprise less than 1% of REC customers; in 1995, they accounted for 19% of sales. Small commercial and industrial customers comprise 9% of REC customers; in 1995, they accounted for 18% of sales[1]. Irrigation customers are approximately 1% of REC customers; in 1995, sales to irrigation customers were 2% of total sales. Other electric service comprised the remaining 1% of 1995 sales.

Distribution cooperatives are governed by boards of directors composed of consumer-owners, who are themselves chosen by the consumer-owners of the cooperative in open elections. The boards are responsible for the management of the cooperatives. They must balance the interests of the consumer-owners with business requirements, such as adequacy of revenues to recover costs, and ensure that the cooperative renders reliable and adequate service.

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1 For purposes of these statistics, a "large" customer is one requiring transformer capacity of more than 1,000 KVA; a small customer is one requiring transformer capacity of 1,000 KVA or less.

Most distribution cooperatives are "transmission dependent utilities" (TDUs). This means that they must depend on the transmission lines of neighboring utilities, often Federal Energy Regulatory Commission (FERC)-regulated IOUs, to obtain their power. The larger and more desirable end use customers served by these cooperatives are often within easy reach of the IOUs' own transmission facilities. RECs are therefore very concerned about retaining the loads of these end use customers in a more competitive environment.

Cooperatives located in 16 of the 46 states where cooperatives do business (including Arizona) are subject to retail rate regulation by state public utility commissions. The remainder are self-regulated by their consumer-owners through that most basic of controls: the right to vote out the current board of directors if the consumer-owner dislikes the business decisions that the board has made.[2]

B. Generation And Transmission Cooperatives

Recognizing the problems inherent in relying on outside sources for 100% of their power supply needs and the unwillingness of some suppliers to provide future growth requirements, many distribution cooperatives over the years banded together to obtain their own generation and transmission facilities. They formed umbrella "generation and transmission" (G&T) cooperatives to own and operate these facilities. Arizona Electric Power Cooperative, Inc. (AEPCO) is such a G&T cooperative. There are over 60 G&T

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[2] As discussed further below, cooperatives that have borrowed money under the Rural Electrification Act are subject to extensive federal oversight by the Rural Utilities Service (RUS).

cooperatives, and over 720 distribution cooperatives that are member-owners of a G&T cooperative.

Virtually all G&Ts share the same organizational structure, which may be unique in the electric industry. G&Ts are cooperatives which are owned by their member distribution cooperatives. Each member cooperative is represented on the G&T's board of directors, which votes on all important business decisions. Hence, the distribution cooperatives direct the governance of the G&T. Each member cooperative has a contract with the G&T, by which it pledges to purchase power supply from the G&T. These contracts are often called "all requirements" contracts, because the distribution cooperative generally pledges to purchase all of its power requirements from the G&T. The terms and conditions of these all requirements contracts are generally very similar, and in most instances are dictated by RUS regulations.

These contracts are important G&T assets as they form the basis for G&T long term financing of asset purchases. This is another feature of cooperative arrangements that makes them unique. Since G&Ts are not publicly-owned, they must finance generation through private or government financing. In either instance, the lender will look to the long-term contractual arrangements a G&T has with its members, and the revenue stream these contractual arrangements provide, as security for the loan.[3]

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[3] In this respect G&Ts are in the same position as an independent power producer that uses its contractual relationships to obtain financing.

Under this structure, the G&T and its distribution cooperatives are bound to each other by both ownership and contract. The G&T cannot dictate policy to its member distribution cooperatives; nor can the distribution cooperatives dictate the policies and actions of each other. Rather, the distribution cooperatives, acting in concert, govern the G&T.

Because of their unique ownership structure, the capital structures for cooperatives vary considerably from the standard utility model. Some G&T cooperatives have debt ratios of 100%; the median equity ratio of all G&Ts is 10%. Distribution cooperatives generally have higher equity ratios, but even many of them have less than 50% equity; the median equity ratio of all distribution cooperatives is 42.7%. Nor is the "equity" obtained through the sale of stock as is the case with an IOU; rather, each consumer-owner has a "capital account" with the cooperative to which retained dollars above costs are credited. This capital crediting process, and the ability to vote on the rates, makes it impossible for the cooperative to extract unjust "profits" from members, because the profits belong to the members.

It is difficult to generalize about the circumstances of G&Ts. Some are very competitive power supply providers for their cooperative members; others invested in high-cost generation facilities (in many cases, the same high-cost generation units for which IOUs are now seeking to obtain stranded cost recovery), and are therefore burdened with high-cost power that makes their rates less competitive.[4]

4 The Commission may have heard about the situation of Cajun Electric Power Cooperative, a G&T cooperative that is now in bankruptcy. It invested in a minority share in a large nuclear plant (River Bend) built by Gulf States Utilities Company, which saddled the cooperative with huge cost overruns resulting in uneconomic power. The Louisiana

C. REC Financing And Tax Status

Because of the unprofitable nature of the service areas RECs were created to serve, extraordinary financing measures were required for their creation. The Rural Electrification Administration (REA), now RUS, was established through federal legislation, the Rural Electrification Act (REAct),[5] to provide such financing. RECs still rely on RUS for a substantial portion of their financing. The amounts available for RUS loans in recent years, however, have decreased and the interest rates have been increased. The federal budget appropriation to finance RUS electric activities has fallen 57% since 1993. The total 1995 fiscal year budgeted cost to support funding for electric activities is $73 million.

RECs have increasingly supplemented their RUS financing with loans from other sources, including the National Rural Utilities Cooperative Financing Corporation (CFC), an entity RECs established to access sources of financing at market-based rates, and the National Bank for Cooperatives (CoBank). RECs also do a considerable amount of "self-financing." They do this by using funds provided by their consumer-owners through rates and investing those funds in activities that would otherwise require external debt financing. The consumer-owners are "repaid" through the process of capital credit rotation. In 1995, of the annual

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Public Service Commission would not permit Cajun to pass on the associated costs through its rates, leading to its bankruptcy filing. The largest creditor of Cajun is the United States government, through the Rural Utilities Service (RUS).

5 7 U.S.C. §§ 901, *et seq.*

capital requirements of distribution cooperatives, 30% came from RUS, 10% from private lending institutions, and 60% from internally generated funds.

Cooperatives that hold RUS loans must submit their operations to very detailed RUS oversight. RUS regulations, and the terms of the RUS mortgage and loan documents, specify the books of accounts that RUS borrowers must keep, and set out requirements for many aspects of REC business operations. RUS also reviews proposed changes to cooperatives' rates. Many of the RUS accounting requirements are much more detailed and complex than those private lenders would require. As RECs are required to respond with increasing quickness to changes in their markets brought about by increased competition, they are becoming concerned that their ability to react is adversely impacted by such regulations.[6] At present, however, the majority of the cooperatives in Arizona, including AEPCO, hold RUS loans.

Generally, RECs are not-for-profit cooperatives organized under Section 501(c)(12) of the Internal Revenue Code. They are therefore exempt from federal taxation as long as 85% of their revenues are derived from business with their members. Those cooperatives that are

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6 Under the holding of *Dairyland Power Cooperative*, 37 F.P.C. 12, 37 F.P.C. 495 (1967), *aff'd sub nom. Salt River Project v. FPC*, 391 F. 2d 470 (D.C. Cir.), *cert. denied*, 393 U.S. 857 (1968), cooperatives which are REA/RUS borrowers are not subject to the FERC's jurisdiction under Sections 205 and 206 of the Federal Power Act (FPA). A few G&T and distribution cooperatives have chosen to forego RUS financing and rely entirely on non-RUS financing. Certain of the cooperatives that have chosen not to use RUS financing are therefore FERC-jurisdictional, because they engage in activities covered by FPA Section 205 and 206 and are not exempted under the *Dairyland* exception.

tax-exempt are very concerned by changes in utility regulatory policy which might require them to engage in business transactions with third parties which may endanger their tax-exempt status.

D. Summary

Cooperatives are very different from the IOUs that the Commission regulates. As the Commission constructs retail competition policies that affect both IOUs and cooperatives, the Commission must keep the unique features of cooperatives in mind. NRECA urges the Commission to assess separately the impacts of its proposed retail competition rule on Arizona's cooperatives, and to adjust those policies as necessary to avoid damaging this small but vital sector of Arizona's electric industry.

At NRECA's 1996 Annual Meeting in Houston, Texas, held in March 1996, NRECA's members adopted a new resolution regarding retail competition issues. That resolution is enclosed as Attachment A. Among other things, it sets out seven standards by which NRECA's members instruct it to review retail competition plans. Those standards are: (1) all classes of customers must be treated equitably; (2) stranded costs should be borne by those who leave their current supplier; (3) all energy providers--not just utilities--should be subject to the same standards; (4) all consumers should have access to electric service; (5) safety and reliability must not be jeopardized; (6) exclusive delivery service areas must be maintained; and (7) the financial security insured by the all requirements contracts must be protected. NRECA urges the Commission to use these seven standards when evaluating how its Proposed Rule will impact on Arizona's cooperatives, both distribution and G&T.

II. COMMENTS

A. Legal Considerations Specific to Cooperatives

As discussed *supra*, virtually all distribution cooperatives, and most G&T cooperatives (including AEPCO) are tax-exempt, not-for-profit entities.[7] If, however, more than 15% of a tax-exempt cooperative's income comes from non-members, its tax-exempt status is endangered under the relevant IRS provisions. Cooperatives were formed as not-for-profit entities to supply electric service to their own customers. If the Commission fashions its retail competition policies in such a manner that cause cooperatives to lose their tax-exempt status, then taxes will be payable and the cost of service of the affected cooperatives will increase. Cooperatives should not have to forfeit their tax-exempt status due to Commission-imposed retail access requirements. Tax-exempt cooperatives should have the discretion to maintain their tax-exempt status.

Moreover, many Arizona cooperatives (including AEPCO) have substantial debt obligations to The United States Treasury because of their RUS loans. These obligations must be taken into account in their provision of retail service under any new Commission policy. For example, there is a legal question as to whether cooperatives can be required to give non-REAct beneficiaries the benefit of RUS financing rates in calculating their

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7 The remaining G&Ts are taxable entities, but are still not-for-profit cooperatives.

transmission/distribution rates. That financing was extended to benefit the cooperative's own consumer-owners, not third parties. As noted earlier, cooperatives were formed primarily to serve lower-density geographic areas deemed unprofitable by IOUs. To promote the expansion of electric service into these regions, the federal government, through the REA/RUS, made federal monies available to electric cooperatives. Extension of RUS financing to non-Act beneficiaries not only contradicts Congress' intent and RUS regulations,[8] but raises concerns about the future availability of such funds for RECs. The loss of such funds could endanger reliable electric service in rural areas.

Similarly, a reasonable rate of return on equity should be included in cooperatives' transmission/distribution rates to third party non-members. Third-party transmission customers did not contribute capital as the cooperatives' member-owners did, and have not invested the "sweat equity" that the member-owners have. Thus, it is appropriate, and only fair to those customer-owners that did invest in the cooperatives, to charge such third parties an appropriate equity return in their transmission/distribution rates.

Any Commission rule requiring Arizona's electric cooperatives to open their systems to retail competition must be carefully crafted to ensure that these concerns are addressed. Cooperatives are not vertically-integrated shareholder-owned entities, like IOUs are, and any rules applicable to them must be structured with these differences in mind.

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[8] "Loan funds may be approved for facilities to serve non-REAct beneficiaries only if: (1) The primary purpose of the loan is to furnish or improve service for REAct beneficiaries." 7 CFR § 1710.104(b).

B. Stranded Cost Recovery.

NRECA's members, as electric utilities with a duty to serve all customers in their service areas (either directly as a distribution cooperative, or indirectly as a G&T cooperative), support the general principle of retail stranded cost recovery. At the retail level, electric utilities, including cooperatives, incur costs to provide electric service under a "regulatory compact." They accept the obligation to provide reliable service at reasonable rates to all entities in a service territory, with such regulatory oversight as state and local government see fit to impose. In exchange, they obtain the right to charge and collect rates which give them an adequate opportunity to recover the costs of the investments they have made to serve their loads. This right should include the opportunity to recover the reasonable and prudent costs the utility has expended to ensure that service can be rendered in the future.

NRECA also supports the general principle that stranded costs should be recovered from those departing customers that cause the costs to be incurred. To do otherwise burdens other ratepayers with costs that they have not caused and should not have to pay.

If AEPCO's member distribution cooperatives are required to open their systems to retail competition, and certain of their distribution cooperative member-customers begin to purchase power from other sources, this will have an immediate impact on the financing arrangements of both the distribution cooperatives and AEPCO. First, the distribution cooperative's power requirements could well be substantially reduced. As explained in more detail in AEPCO's own comments being filed in this proceeding, such a reduction could well cause the distribution cooperatives to default on the covenants made in their mortgages held by the RUS. Putting this difficulty aside, such a reduction in power requirements by AEPCO's distribution cooperatives could render AEPCO, the supplying G&T, unable to recover its generation costs, stranding some percentage of them. If this Commission does not award AEPCO and/or its member distribution cooperatives sufficient stranded cost recovery under proposed R14-2xxx7 (and NRECA sees no guarantee of such an award in that section), then AEPCO in turn will have insufficient revenues to repay its debt obligations to its lenders.

The primary lender to AEPCO (and its distribution cooperatives) is the RUS, an arm of the United States government. Thus, any default by AEPCO will have a potential adverse impact on the U.S. Treasury, as has occurred in the case of Cajun Electric Power Cooperative discussed previously.

In other words, in the case of stranded costs incurred by a distribution cooperative affiliated with a G&T cooperative (such as AEPCO), the Commission would have to look at the distribution cooperative and its G&T as one economic unit to calculate the stranded costs to be recovered. Because of the "all requirements" power supply arrangements of G&Ts and their distribution cooperatives, both would incur stranded costs upon the loss of the distribution cooperative's customer. In fact, the G&T might well incur the bulk of the stranded costs, because it would have incurred obligations to generate/purchase/transmit the power to sell to the distribution cooperative, so that the distribution cooperative could in turn supply power to the end use customer.

The Commission in proposed R14-2xxx7E.3 notes that it will consider, inter alia, "the impact of partial or no recovery of Stranded Investment on the Affected Utility and its shareholders." The Commission should recognize that in the case of a cooperative, there is no separate class of "shareholders" to absorb the financial pain of unrecovered stranded costs. Cooperatives are owned by their member consumers. The ratepayer is in effect the shareholder. The only two places for stranded costs not paid by departing members to be recovered is from the remaining members or from the governmental and private lenders that financed the cooperative. This fundamental structural difference must be considered in dealing with the potential stranded costs of Arizona's RECs.

C. Universal Service

The past experience of NRECA's members teaches that when provision of electric and other utility services is left solely to competitive forces, rural areas with low customer density often go unserved. If service is provided by profit-making entities, it is at very high rates. This problem has been dealt with in the process of deregulation of the telecommunications industry under the rubric of "universal service." NRECA believes that any retail electric competition regime implemented by a regulatory agency should include comprehensive provisions to ensure electric service at reasonable rates to all customers, not just those in high-density areas which are profitable to serve and which therefore will draw numerous willing suppliers.

The only provision dealing in any manner with universal service in the proposed rule (and only then obliquely) is R.14-2xxx6.A, which deals with "Standard Offer" service. This section appears to impose a "supplier of last resort" obligation on Affected Utilities, including RECs. If the Commission, however, does not mandate that departing customers pay the associated costs they "strand," and does not mandate some form of universal service protection, then it should be ready to expect potentially steep increases in the cost of "standard offer" service by distribution cooperatives to their remaining bundled customers. "Standard Offer" service will be an expensive service reserved for high-cost "skim milk" customers -- those left after all the cream has been skimmed by other suppliers.

CONCLUSION

NRECA respectfully requests the Commission to (i) consider carefully the issues raised in these comments and in the comments of NRECA's members filed in this proceeding in fashioning its final retail competition rule; and (ii) refrain from adopting provisions its final rule that will have adverse financial or quality of service implications for Arizona's rural electric cooperatives and the consumer-owners they serve.

Respectfully submitted,

NATIONAL RURAL ELECTRIC
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September 11, 1996

NRECA 54th Annual Meeting Resolutions

Adopted at the
54th Annual Meeting
March 24 - 27, 1996
Houston, Texas

Power and Generation Committee (G)

RETAIL WHEELING/STRANDED INVESTMENT — We urge lawmakers to allow wholesale wheeling to be fully implemented and its results evaluated before rushing headlong into retail wheeling. We support wholesale wheeling provisions of the Energy Policy Act of 1992 and endorse its prohibition on the ability of the Federal Energy Regulatory Commission to mandate retail wheeling to ultimate consumers.

Mandated retail wheeling or electric utility deregulation without appropriate safeguards may result in the loss of certified service territory and/or load which could create stranded investment, or reassignment of costs to remaining consumers, degrade system reliability, negatively affect long-range planning and the ability to provide reliable service to remaining ratepayers at a reasonable cost. It could facilitate "cherry picking" of profitable load by predatory power suppliers, thereby increasing cost to residential consumers.

The National Rural Electric Cooperative Association should protect the interests of co-op consumer-owners by participating in federal discussions regarding wholesale and retail wheeling. In evaluating retail wheeling proposals, we believe that, at a minimum, the following tests should be applied:

- All classes of consumers should be treated equitably.
- Stranded costs should be borne by those who choose to leave their current supplier.
- All energy providers — not just utilities — should be subject to the same standards.
- All consumers should have access to electric service.
- Safety and reliability must not be jeopardized.
- Exclusive delivery service areas should be maintained.
- Protect the financial security insured by the all-requirements contract.

We will continue to oppose any retail wheeling that is detrimental to the best interests of electric cooperatives and their consumers. (96-G-1)