USDA

United States Department of Agriculture

Rural Utilities Service

Washington, DC 20250-1500

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Docket Control
Docket No. U-0000-94-165
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Ladies and Gentlemen:

The Rural Utilities Service (RUS), an agency of the United States Department of Agriculture (USDA), welcomes the opportunity to provide comments to the Arizona Corporation Commission (Commission) on its Proposed Rule -- Retail Electric Competition, Docket No. U-0000-94-165.

RUS applauds the Commission's efforts to identify issues in electric industry restructuring and to circulate early drafts of its proposals. RUS recognizes the Commission's efforts to maintain a structure that balances the interests of residential and business consumers in Arizona with the interests of electric utilities and the quality of the environment. We do, however, have concerns about several aspects of the proposal.

Our comments are divided into three sections. Section I provides an overview of RUS and the RUS electric loan program. Section II sets forth the basis for RUS' continuing interest in electric utilities in Arizona, including an overview of the structure and magnitude of the rural electric infrastructure in Arizona, and the RUS financial presence. Section III addresses issues of concern to rural consumers and to RUS.

The RUS program has a long history of supporting Arizona utilities, providing substantial benefits to Arizona consumers, including industrial consumers who provide jobs and residential consumers. A working relationship between the Commission and RUS can help ease the transition to retail competition to the benefit of all industry participants.

Questions about these comments may be addressed to Sue Arnold, Financial Analyst, Program Support and Regulatory Analysis, Rural Utilities Service, United States Department of Agriculture, 1400 Independence Avenue, SW, Mail Stop 1522, Washington, DC 20250-1522. Phone 202-720-0736; FAX 202-720-4120; e-mail sarnold@rus.usda.gov.

I. RUS AND RUS FINANCED ELECTRIC SYSTEMS IN ARIZONA

A. Rural Utilities Service

RUS is an agency of USDA. The Department of Agriculture Reorganization Act of 1994 established RUS as the successor to the Rural Electrification Administration (REA) with respect to electric and telecommunications loan program activities authorized by law, including the Rural Electrification Act of 1936 (RE Act). RUS also administers water and waste disposal programs in rural areas.

For 60 years, the Federal Government has promoted the development of dependable and affordable rural electric service through RUS, and its predecessor REA. In enacting the RE Act, Congress determined that the national interest would be served by subsidizing rural electric consumers. Since its original enactment, Congress has expanded the authority of RUS/REA through several amendments to the RE Act.

The mission of RUS is to serve a leading role in improving the quality of life in rural America by administering its Electrification, Telecommunications, and Water and Waste Programs in a service oriented, forward looking and financially responsible manner. As part of its mission, RUS, makes direct loans and loan guarantees to electric systems that serve rural areas and regulates certain activities of these systems.

B. The RUS Electric Program

RUS makes direct loans and loan guarantees to provide and improve electric service in rural areas, as these areas are defined in the RE Act. Direct loans are generally made to finance distribution and subtransmission facilities. These loans usually provide about 70 percent of the debt financing needed for electric facilities. The utility borrows the remainder from a supplemental private sector lender without a Federal guarantee. RUS direct loans bear interest at a variable rate that is tied to published indexes of municipal bond interest rates.

Loan guarantees are generally made to finance construction of transmission and generation facilities, and improvements to existing generation facilities. The interest rate is set by the lender and, because of the RUS guarantee, is generally favorable. Many systems obtain new RUS loans every 3 or 4 years to meet system needs. RUS is, in most cases, the majority noteholder.

Most RUS loans and loan guarantees are amortized over a period of 35 years and are secured by a mortgage or indenture on the utility's electric system, or, in the case of a public power authority or Native American tribal utility, by a lien on utility revenues.

II. RUS INTERESTS IN ARIZONA

A. RUS Financed Electric Systems in Arizona

RUS is actively involved in financing with eight electric systems in Arizona. Six of these systems are Affected Utilities as defined in Subsection R14-2-xxx1.1 of the proposed rule. The six are: Arizona Electric Power Cooperative (AEPCO), Trico Electric Cooperative, Duncan Valley Electric Cooperative, Mohave Electric Cooperative, Sulphur Springs Valley Electric Cooperative, and Navopache Electric Cooperative. In addition, Graham County Electric Cooperative, which paid off its outstanding RUS debt in 1992, still purchases its power from AEPCO.

The two RUS financed electric systems that are not Affected Utilities are Navajo Tribal Utility Authority and Tohono O'odham Utility Authority.

B. Structure of RUS Financed Systems in Arizona

The structure of RUS financed utilities in Arizona differs sharply from the structure of the typical vertically integrated investor owned utility (IOU). First, all RUS financed utilities in Arizona are non-profits. The Affected Utilities are cooperatives, owned and operated by the consumers they serve. The not Affected Utilities are Native American tribal utilities.

Secondly, because of their corporate structure, the customers of all RUS financed utilities in Arizona are, by definition, also its owners. Unlike IOU's, RUS financed utilities in Arizona are owned by individuals and firms that reside in Arizona. There are no profits shared with out of state investors.

Third, no RUS financed utility in Arizona performs all the functions of a vertically integrated utility. Only AEPCO is engaged in generation and transmission, and AEPCO does not sell at retail. The other seven RUS financed Arizona systems are distribution systems that sell primarily at retail. They do not generate power, and sales for resale represent only a very small portion of their total sales.

Finally, RUS financed utilities in Arizona, by virtue of their non-profit nature, are exempt from Federal income tax, provided that they meet IRS requirements. This tax exemption is a significant factor in electric rates. Certain levels of sales to outsiders could result in loss of the tax exemption.

C. RUS Financed Systems that are Affected Utilities

All six Affected Utilities are cooperatives. Five are joined together in the two-tiered organizational structure that is characteristic of most RUS financed systems. The first tier consists of four utilities, Trico, Duncan Valley, Mohave, and Sulphur Springs, which are distribution cooperatives providing electricity directly to individual consumers. These distribution cooperatives are owned by the individual consumers they serve.

The second tier is represented by AEPCO, which generates electricity and transmits it to the distribution systems that are both its owners and its customers. The distribution members of AEPCO are the four Affected Utilities that currently have outstanding RUS debt, plus Graham County Electric Cooperative, an Affected Utility that repaid its RUS debt, and Anza Electric Cooperative, which is located in California. AEPCO also sells power to the City of Mesa.

In addition to the owner/customer relationship, the distribution cooperatives and AEPCO are bound together by an all-requirements wholesale power contract that does not expire until December 31, 2020.

The sixth Affected Utility, Navopache Electric Cooperative imports its power into Arizona from Plains Electric Generation and Transmission Cooperative which is located in New Mexico. Navopache is a distribution member of Plains and is bound to Plains by an all-requirements wholesale power contract that expires December 31, 2025.

D. RUS Financed Systems that are not Affected Utilities

Navajo Tribal Utility Authority, obtains its power from IOU's and from the United States Department of Energy (DOE). Tohono O'odham Utility Authority obtains a small amount of its power from RUS financed sources (AEPCO and Trico), and the rest from IOU and DOE sources.

E. Rate, Sales and Consumer Data for RUS Financed Systems in Arizona

RUS financed systems serve significant loads in Arizona. For the residential sector, the most recent data available from DOE (Electric $ales and Revenue 1994, DOE/EIA-0540(94), Table 14), shows that in 1994, over 100,000 residential consumers in Arizona received electricity generated, transmitted and/or distributed by RUS financed electric systems. This calculation does not include electric customers of the City of Mesa, a partial requirements customer of AEPCO.

In other words, almost 6.5 percent of the residential consumers in Arizona enjoyed the benefits of RUS financed power. These RUS financed systems accounted for 4.6 percent of the revenues from sales to residential consumers and 4.5 percent of the MWh sold in the state.

For all sectors, Table 17 of Electric $ales and Revenue 1994 shows that, about 6.6 percent of all Arizona electric consumers received RUS financed power, accounting for about 5.8 percent of revenues and 6.7 percent of MWh sales for the state. Again electric customers of the City of Mesa are not included in this calculation.

F. Large Electric Loads in Arizona

Three of the distribution member systems of AEPCO, have significant mining loads. In 1994 Duncan Valley's mining loads accounted for approximately 96 percent of its energy sales. For Trico and Mohave, the figures are 22 percent and 15 percent, respectively. Following through to the wholesale level, mining accounted for 54 percent of AEPCO's sales.

These mines are served under long-term contracts, many of which were executed before the movement to competitive electric markets. Sudden loss of these loads would have disastrous effects on the ability of both the distribution cooperative and AEPCO's ability to serve residential consumers in sparsely populated or less profitable areas, and would compromise RUS efforts to improve the quality of life in rural Arizona.

G. RUS Loans to Arizona Electric Systems

Federal taxpayers through RUS hold over $382 million in outstanding debt to electric utilities in Arizona. Since RUS financed utilities in Arizona are either cooperatives or publicly owned, all the benefits of this Federal program flow directly to Arizona.

Most RUS borrowers obtain a new RUS loan every 3 or 4 years to meet their continuing financing needs. In fact, seven of the eight RUS financed systems obtained a new RUS loan in 1992 or later. Since these loans are amortized over a period of up to 35 years, the RUS debt will not be fully repaid until at least 2032, about 30 years after the Commission's proposed target date for full retail choice. RUS is the majority noteholder for these systems.

Moreover, over $248 million of this debt represents direct loans and loan guarantees to AEPCO. The feasibility of RUS loans to AEPCO depends on revenues from its member distribution systems.

Therefore, as part of the security for a loan or loan guarantee to a power supply borrower, RUS requires the power supply borrower and its member systems to execute an all-requirements wholesale power contract whose term is at least as long as the RUS loan. The wholesale power contract between AEPCO and its members runs through December 31, 2020. In short, revenues from member systems provide funds for repayment of AEPCO's outstanding $248 million RUS debt. Total RUS debt of AEPCO and its members is $333 million.

III. ISSUES

RUS comments on the Proposed Rule have two main goals:

- **To help ensure the continued availability of reliable electric service at reasonable cost to consumers in rural Arizona, and**

- **To maintain the stability of non-profit, RUS financed utilities in Arizona by protecting the security of outstanding Federal loans, and avoiding defaults and bankruptcies.**

RUS believes that certain aspects of the Proposed Rule would have disastrous effects on the RUS financed segment of the Arizona electric industry and its consumers.

Since the RUS financed segment of the Arizona electric industry consists of non-profits with owners residing in Arizona, the full benefits of RUS loans to Arizona utilities flow into Arizona. RUS trusts that the Commission will design a regulatory regime that does not penalize the intended beneficiaries of this effective Federal program.

A. Filing of Tariffs by Affected Utilities, Subsection R14-2-xxx2

RUS believes that the proposed June 30, 1997, deadline for filing tariffs to implement retail competition is too soon. This deadline would (1) limit Affected Utilities to only a few months after enactment of final rules to file tariffs that will have profound impacts on their futures, and (2) impose a severe hardship on small electric systems, who have fewer employees and resources.

- **Recommendation**

  RUS recommends that the deadline for filing tariffs be at least 18 months after publication of the final rule. Such a timeframe would allow the many small utilities in Arizona to thoroughly study the rules and develop the tariffs that will determine their futures. A longer timeframe will also allow the owner/customers of an Affected Utility that is a cooperative to be actively involved in the development of the tariff.

B. Competitive Phases, Subsection R14-2-xxx4

RUS finds several problems with the proposed Competitive Phases. Certain aspects would work a disproportionate hardship on small utilities that lack the resources to undertake rapid restructuring. Other aspects are either unclear or apparently conflicting.

B.1. <u>Milestones for Retail Choice</u>

The proposed milestones for retail choice are inequitable. The Proposed Rule would base the amount of demand required to be available for competitive generation supply on 1995 system retail peak demand. Systems whose demand is declining would suffer further disadvantage through this milestone. For example, because of the potential loss of large loads, one RUS financed system projects that its entire 1999 demand will be between 20 and 30 percent of its 1995 system peak demand. Under the milestone in the Proposed Rule, this system would be required to make available <u>all</u> of its retail peak demand by January 1, <u>1999</u>. There would, in effect, be no competitive phase-in for this utility.

Conversely, the milestones would confer an unfair advantage on a utility that is in the enviable position of experiencing load growth. Such a utility would be required to make available for competitive generation supply only a relatively small portion of its actual 1999 load in 1999.

- **Recommendation**

Small utilities must be offered a more flexible phase-in for retail competition that is free of inequitable milestones. RUS recommends specifically that these utilities be permitted to implement a retail choice plan by January 1, 2003, with intermediate milestones determined by the utility.

B.2. <u>Conflicting Requirements</u>

Several provisions in the Proposed Rule regarding existing contracts appear to conflict. Subsections R14-2-xxx4.A, B, and D set out strict Competitive Phases. Subsection R14-2-xxx4.F, however, states that "Consumers served under existing contracts are eligible to participate in the competitive market prior to expiration of the existing contract only if the Affected Utility and the consumer agree." Commission policies in cases where contract terms conflict with mandated Competitive Phases are not clear. Would, for example, the complete phase in by January 1, 2003, supersede contracts that expire after that date?

Subsection R14-2-xxx4.C restricts purchases of a single consumer to 20 percent of the available kW in a given year in an Affected Utility's service territory. This provision could present conflicts with the milestones for Competitive Phases and would work severe hardships on small utilities with highly concentrated loads.

- **Recommendation**

RUS recommends that these provisions be clarified, and that language concerning contracts be revised to clearly respect existing contracts.

B.3. <u>The RUS Wholesale Power Contract</u>

The Commission has failed to consider the unique nature of the RUS all-requirements wholesale power contract. As stated above, this contract represents security on about $248 million in outstanding RUS loans to AEPCO and does not terminate until December 31, 2020. Any retail choice regime that either undermines existing wholesale power contracts, or, indeed, wholesale power contracts executed in connection with future RUS loans, would (1) jeopardize the entire cooperative structure in Arizona, and (2) place the future of the RUS loan program in Arizona at risk.

Such uncertainty would drive up the cost of private sector capital for all RUS financed utilities in Arizona and cause higher electric rates for rural consumers in Arizona. Rural consumers in sparsely populated areas who have no choices because there is only one willing supplier would in effect be forced to subsidize the rates of consumers who do have choices.

- **Recommendation**

It is essential to the structure of cooperatives in Arizona and to the effectiveness of the RUS program, that the RUS all-requirements wholesale power contract remain unimpaired.

C. Services Required To Be Made Available by Affected Utilities, Subsection R14-2-xxx6

C.1. <u>Unbundled Services</u>

It could be difficult for small utilities to provide all the services listed in Subsection R14-2-xxx6.C. RUS suggests that utilities be offered the option of either providing these services or arranging for a third party to provide them. The Federal Energy Regulatory Commission (FERC) has adopted such an approach to ancillary services in its Order 888.

- **Recommendation**

The Commission should allow small utilities the option of either providing a full range of Unbundled Services, or arranging for a third party to provide them.

C.2. <u>Pricing</u>

Under any retail choice scheme, the Commission must allow a pricing structure that recognizes the inherent differences between classes of consumers and types of utilities. To do otherwise would unfairly penalize rural consumers in Arizona.

The Commission must recognize that, by definition, the rates of non-profits do not include a profit component or return on rate base. Additionally, in the case of an Affected Utility that is a cooperative, the owner/customers have contributed equity capital where nonmember retail choice customers have not. Tariffs for sales to members and nonmembers must reflect this difference and impute a return on rate base on sales to nonmembers.

The Commission must further respect the non-profits' exemption from Federal income tax. For example, a tax exempt cooperative can incur a tax liability if sales to nonmembers exceed the IRS threshold. Any tax liability imposed by Commission ordered retail choice must be included in rates charged to nonmembers only. The FERC Order 888 includes specific language that protects the tax exemption of cooperatives and publicly owned utilities and allows customer specific pricing. It is essential that the Commission must do the same.

Finally, RUS makes low cost loans to serve the rural consumers who are the stated beneficiaries of the RE Act. In other words, the RUS subsidy may be seen as an imputed component of revenue received from RE Act beneficiaries. Any retail choice plan that requires RUS financed utilities in Arizona to serve non RE Act beneficiaries must allow for higher rates to these non RE Act beneficiaries. To do otherwise would divert the RUS subsidy away from the rural consumers in Arizona who are its intended recipients.

- **Recommendation**

  The Commission should establish a mechanism for customer specific pricing that considers the corporate structure of non-profits and their tax status, and does not divert the RE Act subsidy away from its intended beneficiaries in Arizona.

D. Recovery of Stranded Investment of Affected Utilities, Subsections R14-2-xxx1.5 and R14-2-xxx7

RUS has concerns about the Commission's proposed methodology for determining and recovering Stranded Investment.

D. 1. Definition

RUS is puzzled by the proposed definition: "'Stranded Investment' means the verifiable net difference between the value of all the prudent jurisdictional assets under traditional regulation of Affected Utilities and the market value of those assets directly attributable to the introduction of competition under this Article."

FERC Order 888 uses a revenues lost methodology to determine the amount of Stranded Investment. The Commission's proposed book versus market approach is incompatible with a revenues lost methodology, and appears far more restrictive. While RUS is not in full agreement with the details of the FERC's methodology, it would facilitate calculations if the Commission adopts a revenues lost methodology that is compatible with the FERC's.

- **Recommendation**

RUS recommends that the Commission adopt a definition of Stranded Investment consistent with the revenues lost methodology in FERC Order 888.

D.2. Commission Decision Factors

RUS recommends some changes to the factors in Subsection R12-2-xxx7.E that the Commission will consider in determining appropriate Stranded Investment mechanisms and charges. RUS applauds the Commission for including the impacts of Stranded Investment on both customers that do not participate in the competitive market, as well those customers that do participate.

RUS also applauds the Commission's concern for the financial stability of the electric industry in Arizona by including the "impact of partial or no recovery of Stranded Investment on the Affected Utility and its shareholders." RUS urges the Commission to demonstrate equivalent concern for the financial stability of RUS financed non-profit utilities in Arizona. The Commission must consider the impacts of partial or no recovery of Stranded Investment on RUS as debtholder. Mitigating Stranded Investment exposure of IOU shareholders while exposing Federal taxpayers to the risk of loan defaults would (1) jeopardize the entire cooperative structure in Arizona, and (2) place the future of the RUS loan program in Arizona at risk.

- **Recommendation**

The Commission must consider the impacts of partial or no stranded cost recovery on the utility's ability to repay RUS loans. To do otherwise would have adverse effects on RUS financed systems in Arizona and on the ability of RUS to continue providing low cost financing in Arizona in the future. The impacts on the owner/customers of these non-profit Arizona utilities may be unintended, but could be devastating.

D.3. Deadline for Recovery

The proposed December 31, 2004, deadline for recovery of Stranded Investment is far too restrictive. Since certain customers will not be able enjoy the benefits of competition until current contracts expire, RUS recommends that this provision be amended to allow recovery until two years after the effective date of full competition under this Rule, or two years after expiration of any long-term contracts in effect on the date of the rule's publication, whichever is later.

- **Recommendation**

The Commission must demonstrate its respect for existing long-term contracts by extending the window for Stranded Investment recovery to two years after the contract's expiration.

E. Solar Portfolio Standard, Subsection R14-2-xxx9

RUS is puzzled about the intent of the proposed Solar Portfolio standard. While reducing dependence on traditional sources of generation in favor of renewables is certainly a laudable objective, limiting the renewables portfolio to new solar resources seems curious. Solar technology on a large scale is in its infancy, and, other types of renewables appear to offer comparable benefits at more reasonable cost. Furthermore, since some Arizona utilities will lose loads as a result of competition, a requirement to build new solar resources will substantially increase the amount of Stranded Investment.

To specifically order the construction and use of new solar resources that will only increase costs is inconsistent with the spirit of a Rule implementing retail choice.

- **Recommendation**

The issue of renewables and the issue of retail competition are distinct and different. RUS urges the Commission to recognize the difference by undertaking separate rulemakings. Specifically RUS recommends that the Commission proceed with its Retail Electric Competition Rulemaking, and postpone renewables for another rule.

Respectfully submitted,

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