0000065605

BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED

SEP 12 1996

DOCUMENTED BY

SEP 12 4 12 PM '96

DOCUMENT CONTROL

RENZ D. JENNINGS
Chairman
MARCIA WEEKS
Commissioner
CARL J. KUNASEK
Commissioner

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	))))	DOCKET NO. U-0000-94-165

Tucson Electric Power Company hereby submits its response to the first draft of Staff's Proposed Rule Regarding Retail Electric Competition.

RESPECTFULLY SUBMITTED this 12th day of September, 1996.

TUCSON ELECTRIC POWER COMPANY

By: _____

Bradley S. Carroll, Counsel for
Regulatory Affairs
Legal Department
220 West Sixth Street - P.O. Box 711
Tucson, Arizona 85702

Original and ten copies of the foregoing filed this 12th day of September, 1996 with:

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

. . .

. . .

Copies of the foregoing delivered this 12th day of September, 1996 to:

Gary Yaquinto, Director
David Berry
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Paul A. Bullis, Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

By: Sandra Waters
Sandra Waters
Legal Secretary

RECEIVED
AZ CORP COMMISSION
SEP 12 4 12 PM '96
DOCUMENT CONTROL

BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED
SEP 1 2 1996
DOCKETED BY

RENZ D. JENNINGS
Chairman
MARCIA WEEKS
Commissioner
CARL J. KUNASEK
Commissioner

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. U-0000-94-165

RESPONSE TO FIRST DRAFT OF PROPOSED RULE REGARDING RETAIL ELECTRIC COMPETITION

On Behalf of

TUCSON ELECTRIC POWER COMPANY

September 12, 1996

TABLE OF CONTENTS

I. Introduction and Overview of Process 1

A. Procedural History 1

B. Need for Further Study and Modification 2

1. The FERC Proceeding 2

2. The California Proceeding 3

C. Conclusion 4

II. Objectives of Retail Competition That Should Be Addressed 5

A. Develop an Electric Supply Market Which Allows Market Forces to Determine the Availability and Price of Competitive Electric Supply Products and Services 6

B. Ensure That All Market Participants Have Equal Ability to Compete to Provide Competitive Services 7

C. Ensure the Continued Reliability of the Generation, Transmission and Distribution Components of the Electric Supply and Distribution Business 8

D. Provide Equal Opportunities for All Customers to Access the Competitive Marketplace 11

E. Provide Mechanisms to Allow Continued Promotion of Socially Desirable Public Programs 12

F. Provide Options for Customers Who Cannot Participate in the Competitive Market, or Those Who Choose Not to Participate in the Competitive Market 12

G. Ensure Full Recovery of Prudent Investments Made Under the Current Regulatory Structure 13

III. Stranded Cost 13

A. General 13

B. Financial Implications 14

C. Quantification of Stranded Costs 16

D. Stranded Cost Recovery Mechanisms 17

E. Other Issues 18
IV. Legal Implications 20
A. The Rule Should Not be Implemented in its Current Form Because it Violates Due Process Rights Set Forth in the State and Federal Constitutions 20
1. The Rule is Vague and, Therefore, Violates Due Process 20
2. The Rule is Confiscatory and, Therefore, Violates Due Process 21
3. The Rule is Discriminatory in Violation of Equal Protection of the Law 23
B. The Rule Unilaterally Modifies, if Not Abrogates, the Regulatory Compact 23
C. The Rule is Askew With Existing Law 26
V. Specific Concerns 27
A. General Comments 27
B. Specific Comments 28
VI. Conclusion 40

I. INTRODUCTION AND OVERVIEW OF PROCESS

As an avid supporter of retail electric competition and an active participant in the Arizona Corporation Commission's ("Commission") inquiry into electric industry restructuring, Tucson Electric Power ("TEP" or "Company") appreciates the opportunity to provide its response to the first draft of Staff's Proposed Rule Regarding Retail Electric Competition ("Rule"). TEP is concerned, however, that the Commission has provided an insufficient amount of time to fully evaluate the Rule and determine its potential impact on the Company, its shareholders and customers. TEP further believes that the Rule, as currently drafted, will not result in an orderly transition to retail competition.

A. Procedural History

On May 20, 1994, the Commission Staff opened Docket No. U-000-94-165, *In the Matter of the Competition in the Provision of Electric Services Throughout the State of Arizona* ("Docket"), in order to study and consider electric industry restructuring for the State of Arizona. Since that time, TEP has been an active participant in that Docket. Following the introductory workshop that was held on September 7, 1994, a series of working group and task force meetings were held to identify the major restructuring options, implementation of the options and advantages and disadvantages of the options to the various interests represented. Task force meetings included a Legal Task Force which was established to identify the legal issues the Commission would be required to address prior to implementation of electric industry restructuring in the State. Those issues were summarized in the *Report of the Working Group on Retail Electric Competition*, dated October 5, 1995.

On February 22, 1996, Staff issued a *Request for Comments on Electric Industry Restructuring* which asked the participants to respond to 19 broad questions regarding electric industry restructuring. On June 28, 1996, more than 30 parties filed hundreds of pages of comments. Approximately three weeks later, Staff filed a summary of those comments and scheduled a one-day workshop to be held on August 12, 1996, to consider elements of two composite rules. Approximately 130 people attended that workshop where issues that easily required days of discussion were given (in some cases) minutes of attention. One week later, Staff issued a report summarizing the workshop and on August 28, 1996, issued the draft of a definitive Rule, providing interested parties only 10 business days to comment.

. . .

B. Need for Further Study and Modification

The first phase of this process was the identification of the major issues that needed to be addressed and the participants' views on how retail competition should be introduced. The Company commends Staff in bringing this initial phase to a conclusion by putting a draft Rule on the table. Rather than proceeding hastily toward the adoption of the Rule in its proposed form, the Rule should be carefully studied to identify the legal, financial, operational and regulatory problems presented by the Rule in its current form. A series of comments and technical conferences should be held in order to identify how the Rule should be modified to meet those concerns. Upon identification of the legal and regulatory issues, Staff and the Commission should seek whatever legislative and declaratory relief it needs in order to proceed. Once there is a form of Rule that addresses the aforementioned issues, it should be proposed to the Commission for final adoption.

As currently drafted, the Rule unnecessarily leaves major financial, legal and operational issues unresolved. By continuing the process that has been followed in other jurisdictions (and in Arizona to this point), many of these issues can be resolved and retail electric competition may be brought to Arizona quickly and efficiently. Competition dockets in other jurisdictions have recognized the need for careful consideration of the issues raised in electric industry restructuring:

1. The FERC Proceeding

The federal proceeding to facilitate competitive wholesale electric power markets was formally begun with the issuance on June 29, 1994, of the Federal Energy Commission's ("FERC") Notice of Proposed Rulemaking, in Docket No. RM94-7-000, *Recovery of Stranded Costs by Public Utilities and Transmitting Utilities* ("Stranded Cost NOPR"). Many parties filed comments in the Stranded Cost NOPR proceeding pursuant to FERC Regulations. While the Stranded Cost NOPR raised issues related to the recovery of utility costs that would be "stranded" as a result of a shift to a more competitive wholesale power market, that proceeding did not address, *per se*, open access principals. On March 29, 1995, FERC issued its *Notice of Proposed Rulemaking and Supplemental Notice of Proposed Rulemaking*, in Docket Nos. RM95-8-000 and RM94-7-001, *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities* ("Open Access NOPR"), IV FERC STATS. & REGS. Paragraph 32,514 (1995). FERC's Open Access NOPR proposed to apply the proposed access principles to public utilities that own and/or control

facilities used for the transmission of electric energy in interstate commerce. FERC consolidated the issued raises in the Stranded Cost NOPR into the Open Access NOPR. The two proceedings have continued as one since March 29, 1995.

Pursuant to its regulations, FERC requested that all interested parties file comments on the NOPR on or before August 4, 1995. Over 350 parties, individually and as members of joint filings, filed over 12,000 pages of initial comments in the Open Access NOPR. Approximately 150 parties filed nearly 4,000 pages of reply comments. During several days of technical conferences held in October 1995, representatives of all aspects of the electric industry presented views on the Open Access NOPR to FERC. FERC issued its Final Rule in Docket Nos. RM95-8-000 and RM94-7-001, ("Order 888") on April 24, 1996, more than one year after the issuance of its Open Access NOPR. Requests for rehearing of Order 888 were filed on or before FERC's deadline of May 24, 1996 and remain pending.

2. The California Proceeding

In April 1992, the California Public Utilities Commission ("CPUC") initiated a comprehensive review of current and future trends in the electric industry. This process produced a rulemaking proceeding (R.94-04-031) restructuring California's electric services industry and reforming regulation, which was issued on April 20, 1994 ("Rulemaking"). The Rulemaking was issued for extensive public comment and solicited comprehensive alternatives to the vision described in that document.

Since April, 1992, the CPUC has conducted public hearings throughout California. A week of evidentiary hearings on uneconomic assets has been conducted. Other regulatory bodies in western North America, federal agencies and legislators have been consulted about cooperative solutions to jurisdictional issues. A working group provided a report on sustainability of public purpose programs and numerous parties filed briefs on legal issues. On May 24, 1995, the Commission issued majority and minority policy preference statements.

On December 20, 1995, the Commission approved its proposed policy decision and in its press release, the CPUC states, "Because restructuring of California's electric services industry has widespread impact and the market structure requires the participation and oversight of the FERC, the CPUC will work over the next ***100 days*** (emphasis added) to build a California Consensus involving the Legislature, the Governor, public and municipal utilities, and customers. This Consensus would

then be placed before the FERC so that in a spirit of 'cooperative federalism' the CPUC and FERC could together implement the new market structure by January 1, 1998." Since December, 1995 the CPUC established seven working groups: Direct Access, Energy Efficiency and Demand-Side Management, Low-Income, Ratesetting, Renewable Energy, Research, Demonstration and Development and Western Power Exchange. The groups have been meeting at least once a month since the beginning of 1996 to resolve specific issues relating to the 1998 implementation deadline and each group reports meeting results and issues on the Internet.

Just recently the California Legislature passed a landmark restructuring bill which generally endorses major policies adopted by the CPUC, dictates some details of implementation, but leaves most for the Commission to determine at a future date. One major aspect left unresolved is how to accomplish direct access competition for customers, which is the subject for the Direct Access working group mentioned above. An important difference from the CPUC order, however, is that the legislation establishes a mechanism in which bonds will be used to pay off at least a portion of utilities' stranded assets so that residential and commercial ratepayers will receive a 10% rate cut by 1998 and work toward the goal of an additional 10% cut in 2002. The legislation also provides $540 million for renewables during a four-year transition to a competitive market through a non-bypassable system reliability charge.

C. Conclusion

The total time between the initial 1992 investigation and final implementation will be five years and eight months. Although TEP is not suggesting the Commission duplicate the California process, it illustrates the need for an appropriate time commitment for interested parties to work out details and legislative coordination to address these important issues. In stark contrast to the California processes, the Arizona proceedings do not give interested parties time to debate important topics or allow complex issues to be resolved. TEP believes that it is important to allow time to fully develop a plan that will work in Arizona and to avoid implementing a vague plan that will only cause delays because important issues were left for later.

Given the fact that as of June 28, 1996, the process in Arizona was at a point where participants were still providing comments on broad topics and issues and were given four months to do this, it is not fair or appropriate that the participants and the existing utilities are given only 10 days to evaluate and comment on a definitive Rule. If adopted, this Rule will dramatically affect a

multi-billion dollar industry and change a relationship between utilities, shareholders, regulators and customers that has existed for more than 80 years. Further, because of this pressure to finalize the Rule on an expedited basis, there are serious structural, legal, financial and operational problems that have not as yet been addressed by Staff (*see* below.) Although TEP is in favor of competition, the Company believes that it is essential that the Commission adopt a Rule that provides more answers than questions and is consistent in its application.

II. OBJECTIVES OF RETAIL COMPETITION THAT SHOULD BE ADDRESSED

TEP's original filing discussed various objectives in broad terms. Staff has also offered a set of objectives to guide the process which were included in its February 22, 1996 *Request for Comments on Electric Industry Restructuring*. TEP believes that a set of objectives which give clear guidance to the process of opening retail electric markets to competition must be agreed and followed. The following are the objectives that TEP believes must be attained prior to the onset of competition (excluding any of the legal ramifications that will be discussed in Section IV below):

A. Develop an electric supply market which allows market forces to determine the availability and price of competitive electric supply products and services;

B. Ensure that all market participants have equal ability to compete to provide competitive services;

C. Ensure the continued reliability of the generation, transmission and distribution components of the electric supply and distribution business;

D. Provide equal opportunities for all customers to access the competitive marketplace;

E. Provide mechanisms to allow continued promotion of socially desirable public programs;

F. Provide options for customers who cannot participate in the competitive market; and

G. Ensure full recovery of prudent investments made under the current regulatory structure.

In general, TEP believes that the Rule does not fully address these objectives and leaves out many details that are necessary in order to create a successful transition to a competitive electric market. Although the Rule gives some specific details about customer choice, competition phase-in and provisions concerning obtaining a Certificate of Convenience and Necessity ("CC&N"), details concerning Stranded Cost, reliability and rates are vague at best and add additional layers of regulation that do not exist today. Set forth below is a detailed analysis of the foregoing objectives.

A. Develop an Electric Supply Market Which Allows Market Forces to Determine the Availability and Price of Competitive Electric Supply Products and Services

TEP believes that a properly structured competitive electric supply business will provide consumers with more choices and more efficient prices than are currently provided under a regulated framework. In order for this to occur, however, the existing regulated, single source electric supply system must be changed. Implementing such a change to the electric supply business will not be successful unless robust markets for competitive products/services are created and monopoly products/services are clearly defined. In the transition period it is important to avoid chaos--unhappy customers, system failures, lawsuits and financial instability. The only way to minimize the potential for chaos in the transition period is to identify the key transition issues and to determine solutions to them prior to the implementation of competition.

One of the key transition issues facing consumers, service providers and regulatory agencies is to clearly define and differentiate which products/services are competitive and which are monopolistic. All consumers will need to understand difference between the products/services to be offered by the regulated supplier and by the competitive supplier. Otherwise, it is likely that consumers will not be able to properly evaluate options that they will inevitably be bombarded with under competition.

New competitors must understand the line between competitive and regulated services in order to develop and market their products.

Regulatory agencies will also need to understand the boundaries between monopoly and competitive products/services in order to properly oversee the portion of the business that continues to be regulated. A clear line between competitive and regulated services will also mitigate the difficulties that will occur in determining cost allocations for ratemaking purposes during the transition period and thereafter.

Existing regulated suppliers need to know which products/services are to continue to be regulated and which products/services are to be competitive in order to properly transform from single, bundled service providers to multi-product, unbundled service companies.

This is not a simple process. In California for example, the CPUC is going through an extensive process to decide which products need to be unbundled in order to allow competition to begin in 1998 and which products can be unbundled after the start of competition. TEP believes that

any retail competition process in Arizona must similarly identify the products/services that are be opened to competition and the timing thereof.

Due to the complexity of the electric supply business, there is a direct relationship between the time available to prepare for the unbundling of certain products/services for competition and the number of products and services that can be unbundled. The more time allowed for competition to take place, the more unbundled products/services can be made available.

B. Ensure That All Market Participants Have Equal Ability to Compete to Provide Competitive Services

As discussed above, the transition to a market which allows competition requires that competitive and monopoly services be specifically identified. Additionally, all suppliers, including the current regulated suppliers, must have similar abilities to compete in the sale of competitive products/services.

Ensuring a level playing field among competitors involves several concerns, including (i) allowing regulated utilities to compete on equal footing with unregulated suppliers, (ii) ensuring that regulated utilities do not subsidize their non-regulated business with their regulated business, and (iii) preventing certain quasi-governmental organizations from leveraging their advantageous positions in the provision of competitive services. These problems are multi-faceted and may require both regulatory and federal and state legislative changes as well as continued oversight.

TEP believes that most of the concern regarding allowing regulated suppliers to compete with unregulated suppliers (primarily IPP's, marketers, aggregators and other electric service providers) can be eliminated by clearly defining competitive and monopoly products/services and eliminating regulatory requirements imposed on regulated suppliers that are not required of other service providers (including any regulatory process requirements and pricing limitations/boundaries). Accomplishing these goals requires that equitable cost allocations for regulated services be determined and the establishment of some form of functional unbundling associated with the provision of such services occurs prior to the onset of competition. This unbundling of costs and functions must be combined with a requirement that regulated entities operate under a code of conduct which prevents affiliate abuse.

The issue of preventing quasi-governmental agencies from leveraging their advantageous positions in the competitive marketplace is a very complex one. TEP believes that, in addition to a

retail reciprocity provision, some mechanism must be developed which requires such entities to pay a charge on all power sold in the competitive market which approximates the value of their advantageous position. Such a surcharge should attempt to recover the value of income taxes not paid and lower capital costs associated with a 100% debt (no equity) capitalization. The funds generated from this surcharge should be used to mitigate the Stranded Cost of existing regulated entities and to the extent such funds exceed Stranded Cost, contributed to the funding of any mandated societal benefit charges.

TEP is also concerned that quasi-governmental agencies may choose to sell preference power (owned or purchased) to third parties or affiliates who will have free access to the competitive marketplace. This provides a "back-door" mechanism for quasi-governmental entities to access the competitive markets and undermines the efficiencies of the marketplace. TEP believes that some mechanism addressing this back-door access to the marketplace must be developed prior to the opening of competitive electric supply markets.

Access to customer usage data is an additional significant issue related to ensuring that all competitors have equal opportunity to compete in the provision of non-monopoly services. This issue has recently been subject to significant debate in California and must be addressed before competition can begin in Arizona. Customer information access may seem to be a simple issue; however, it involves many questions, including, but not limited to:

(i) How and what information should be shared;

(ii) How the customer determines shared information;

(iii) How billing is impacted and whether this service should be competitive or monopolistic; and

(iv) Who pays for the accessibility.

C. <u>Ensure the Continued Reliability of the Generation, Transmission and Distribution Components of the Electric Supply and Distribution Business</u>

Reliability is an extremely important issue which must be dealt with in the transition to a competitive environment. The outages which have been experienced in the Southwest this summer are a good illustration of the impact on American society of reduced electrical system reliability. There exists a concern that these outages may have been affected by attempts to push the system in order to facilitate the marketing of wholesale power. Although several other factors were involved,

both major outages were formally blamed on trees--which were likely not trimmed in order to save operating expenses. Competition will surely lead to additional decisions to cut costs, some of which may further erode reliability.

A change from the current regulated environment to a competitive environment requires consideration of reliability issues at the generation, transmission and distribution levels of the electric supply business. Current reliability mechanisms must be adapted to conform to the new environment. The vast majority of existing generation, transmission and distribution systems were built to facilitate the delivery of bundled generation supplies and dispatched and controlled by control area operators to customers who purchase bundled, firm electric service. In a competitive environment, all customers will have the ability to choose their power suppliers and ancillary services. This will require production, transmission and distribution systems that can simultaneously monitor and control endless numbers of potential power transactions.

For example, on the generation side of the business there must be a mechanism to ensure that suppliers actually produce the products that they sell (*i.e.*, firm power sales must be matched with firm resources).

Currently, oversight of generation reliability is primarily performed by the Western Systems Coordinating Council ("WSCC") and by the resource planning processes required by state regulatory commissions. This oversight succeeds under the existing industry structure. The WSCC develops reliability criteria for its members and the state regulatory commissions have the ability to monitor and control the performance of regulated suppliers. It is not reasonable to assume that these same organizations, as currently configured, will be able to provide the same level of oversight in a competitive electric supply environment.

The same concerns exist with regard to the transmission system. The WSCC and state regulators are currently the primary oversight for reliable transmission operation. FERC provides access and pricing regulation and oversight. Regional Transmission Groups have been formed to support FERC in these efforts and to enhance regional planning. None of these groups, however, oversee the transactions on the transmission system on a real time basis. This will likely become a problem with competitive electric supply markets as the number of short-term transactions dramatically increases. Therefore, mechanisms for ensuring reliable transmission system operation must be included in any proposed rule.

Distribution reliability may also be compromised. TEP is concerned, for instance, that distribution reliability may be compromised if a move to competition does not require market participants (customers and supply competitors) to both guarantee the promised level of reliability and to provide the facilities necessary to achieve this level of reliability. For example, in order to reliably serve the customer load, the unbundled distribution service provider may require that generation be provided in the load area for voltage support. Arrangements must be in place to implement such requirements.

These generation, transmission and distribution concerns are illustrated by considering the systems required to facilitate a customer who chooses to purchase a seemingly simple product, an interruptible power supply. In order to facilitate this process, the distribution company must have the abilities to track the generation supply, track the load and to curtail the load, all on a real time basis. These abilities are necessary so that the distribution utility can curtail the specific load when the supply is curtailed and to properly bill the customer and pay the supplier (if billing is set up with the distribution company as the pass through entity). This is problematic for several reasons including: (i) customers generally do not have real time meters; (ii) distribution facilities are not in place which allow the distribution company to curtail individual customers; and (iii) billing systems are generally not sophisticated enough to handle these special arrangements. Similar concerns exist for the transmission and generation suppliers.

Energy management systems, communication systems, billing systems and general system operations will have to be adapted before the expected significant increase in transactions. All of these issues are solvable but will require careful consideration and time for development and installation of new technologies. Until such issues are resolved and equipment is replaced, developed or adapted as necessary, any products/services opened up to competition must be deliverable with existing equipment (or that which is currently available and can be quickly added prior to provision of some competitive service).

TEP also believes that distribution system management and construction should be left to the distribution companies. Otherwise, it will be difficult to ensure that competing suppliers of such services will adhere to local system standards and properly coordinate their facilities with those of the local jurisdictional supplier (at least without reams of rules, standards and inspectors). The

. . .

equipment, personnel, procedures and long-term experience make these organizations best able to continue that role in the competitive environment.

Given the broad reliability concerns and complexities of the electric supply system discussed above, TEP believes that an unbiased third party independent system operator ("ISO") is required to facilitate generation and transmission reliability in a competitive electric supply market. TEP believes that the ISO must be developed and operational prior to significant opening of the electric supply market to competition to ensure that the reliability of the bulk power transmission and production systems is maintained. This ISO function both as an independent grid operator and an independent power pool operator. The ISO does not need to be a power pool in the sense that it dispatches generation but should act as a "clearinghouse" for all electric transactions. It should have the responsibility and authority for scheduling transactions on the transmission grid, as well as ensuring the reliability of the supply and transmission systems. In the course of conducting business it should establish and enforce standards, procedures and rules that are needed for the reliable and efficient operation of the transmission system and the supply market (assuring, for example that adequate spinning reserves are maintained).

The ISO should be fully operational when competition begins so as to clearly establish the responsibilities, authorities, standards and procedures that are critical to the reliability of the bulk power systems in Arizona and its effects on other systems in the west. The ISO should be a non-profit entity, with direction from a small board which is representative of the suppliers, customer groups and distribution companies. Owners would retain ownership of their transmission and turn over to the ISO its operating responsibility.

An additional issue is the responsibility for planning and building new transmission facilities to maintain the reliability of the interconnected transmission network. TEP believes that resolution of this very significant issue can be left to further discussion by the utilities, customers and the regulators. Competition can begin before this matter is settled, although it should be resolved soon thereafter.

D. Provide Equal Opportunities for All Customers to Access the Competitive Marketplace

In order for customers to have non-discriminatory access to markets for competitive services, all customers must have equal opportunity to access competitive markets. This requires that any

phase-in of competition allows all customer classes to access competitive markets in each phase-in period. This may be accomplished in a variety of ways, one of which must be selected prior to the initiation of competition.

Additionally, a state-wide plan is needed to educate small business and residential customers about new developments and the range of customer choices. Further, to accomplish equitable competitive access, one must consider the ability of consumers to acquire and pay for metering or other required facilities. This was a major consideration in affecting an orderly and equitable transition to long distance competition in the telephone industry.

E. Provide Mechanisms to Allow Continued Promotion of Socially Desirable Public Programs

TEP believes that socially desirable public programs, including low income subsidies/discounts, funding of mandated renewable resources and mandated demand-side management programs should be funded by all customers, including those who may bypass the local electric distribution entities. Such charges should be based on the cost of the programs specifically provided to customers in a given service territory.

F. Provide Options for Customers Who Cannot Participate in the Competitive Market, or Those Who Choose Not to Participate in the Competitive Market

Given the theme of customer choice, all customers should have the option to purchase services from other than the competitive marketplace. Accordingly, existing regulated suppliers should continue to offer service to such consumers at current prices through the phase-in period. When full competition is in place, however, the distribution company should be under no obligation to provide competitive services at regulated rates and it should not be required to maintain any facilities for such services. Distribution companies could continue to offer such services in the future at competitive rates. Further, any low income or other socially desirable programs should be provided for as discussed in E above.

A potential concern with the Rule is that it can be implied that a utility must have capacity and reserves for its monopoly service territory even if customers are not taking power from the utility. In other words, the existing utility must still fund and capitalize capacity that customers are not utilizing or paying for until they return to the utility's system. This problem can be mitigated by eliminating any residual service requirement the day a customer leaves the system.

G. Ensure Full Recovery of Prudent Investments Made Under the Current Regulatory Structure

In a competitive power market, utilities may be unable to fully recover the remaining costs of prior investments. Such costs are not new; rather they are costs incurred under the existing regulatory structure, which have not been recovered to date, as a result of regulated pricing mechanisms. Ultimately, an alternative recovery mechanism must be created. Consistent with the assurances and obligations that have existed under the traditional regulatory compact, a stranded cost mechanism must be established before the transition to competition is started. Legally, the prudence of such costs has already been established in prior regulatory proceedings. Section III below describes in detail the issues surrounding Stranded Cost.

III. STRANDED COST

A. General

Utilities have the legal right to recover the value of any investments and obligations that were prudently incurred under the current regulatory structure. Under the current regulatory structure, utilities are required to provide reliable electric service to customers within their designated service areas. The Commission oversees the investments by utilities on behalf of their customers, determines the prudency of such investments and ultimately sets the prices which utilities may charge for their services. This relationship between utilities and the Commission, often referred to as the "regulatory compact," provides utilities with a guaranteed customer base in exchange for regulated investment returns and prices.

Any difference between the expected future revenues under regulation and the expected revenues that would likely occur under total or partial competition results in "Stranded Costs." This potential revenue differential includes the cost of any of the following items that a utility may incur to serve customers within its designated service area including: (i) assets owned, leased or purchased by contract; (ii) services, materials and supplies owned or contracted; (iii) unrecorded liabilities (*e.g.*, fuel and purchased power contracts); (iv) operating and capital costs; (v) regulatory assets (costs whose recovery has been deferred for ratemaking purposes over longer periods than would be found in a competitive market); and (vi) amounts not yet recovered in the regulatory process (*e.g.* accrued post-employment healthcare).

. . .

Several other proceedings have already spent significant amounts of time and effort considering the issue of Stranded Costs and have determined that 100% Stranded Cost recovery is a required component of such significant regulatory change. The FERC, the CPUC and the California legislature are probably the most visible parties to come to this conclusion. These findings are further supported by a recent Supreme Court case involving changes to the regulatory requirements of savings and loan institutions. (*See*, United States v. Winstar Corporation, *infra*.)

B. Financial Implications

In establishing rules for quantifying and recovering Stranded Costs, the Commission needs to consider the potential consequences of ignoring the rights and obligations of all parties under the regulatory compact. As explained below, less than full recovery of Stranded Costs will likely have significant financial implications. If the Commission allows any part of the existing ratepayers' obligation to be repudiated, the remaining customers will likely face higher costs as the financial markets react adversely. Such a breach of faith will make it difficult for any party to finance future generating facilities. Further, concern for the financial viability of TEP may once again rise to critical levels.

Cost-based, rate-regulated utilities prepare their financial statements in accordance with the provisions of Statement of Financial Accounting Standards ("FAS") No. 71, *Accounting for the Effects of Certain Types of Regulation* ("FAS 71"). The primary purpose of FAS 71 is to reflect the effects of regulatory decisions in the financial statements of rate-regulated utilities. If the prices charged by a utility for all or a portion of its regulated operations were no longer subject to cost-based rate regulation, then such company would be required to adopt the provisions of FAS 101, *Regulated Enterprises - Accounting for the Discontinuation of Application of FAS 71* ("FAS 101"), for that portion of the operations for which FAS 71 no longer applied.

For TEP, the adoption of FAS 101 for all of the Company's regulated operations would result in an extraordinary net loss of $141 million based on the balances of regulatory assets and liabilities outstanding as of June 30, 1996 (as disclosed by the Company in its SEC filings). Since most of the Company's regulatory assets and liabilities are related to the Company's generating assets, the introduction of competition for generation services without a clearly defined Stranded Cost recovery mechanism would likely necessitate large additional write-offs for TEP.

. . .

Write-offs, beyond those addressed by FAS 101, may be required. Pursuant to FAS 121 ("Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of"), an electric utility would also have to determine whether or not its remaining plant assets would be recoverable through future expected market prices. If market pricing is not expected to allow the company to recover the cost of its plant assets, additional write-downs would likely be required.

The impact on electric utilities of large financial losses and an increase in business risk would likely be swift and severe. Public utilities financed most of their long-lived assets through the issuance of common stock and long-term debt securities. Utilities, in many cases, also entered into lease agreements that provided a long-term source of financing for generation and other utility assets. Since long-term debt and lease obligations represent contractual commitments, these obligations would not disappear even if the assets they financed become economically impaired. The impairment of assets due to a reduction in future expected cash flows, without either (i) a commensurate reduction in a company's debt and lease obligations; or (ii) a commensurate increase in cash flows from other sources (presumably from a Stranded Cost recovery mechanism), would weaken a company's ability to meet its future cash obligations. In fact, in certain circumstances, such obligations may be accelerated and become due and payable immediately. Such a weakening of financial prospects, combined with an increase in business risk, would have a material adverse effect on the cost and availability of capital to the company. Under such circumstances, the company's financial viability could be called into question. If the Commission truly desires continuity of transmission and distribution service, and fair and equitable treatment of investors who have made long-term capital commitments to provide reliable electric service, then it is imperative that the Commission establish clearly defined mechanisms for the full recovery of Stranded Costs prior to the introduction of retail competition.

All electric utility companies will be exposed to increased business risk and potential financial losses due to the planned introduction of retail competition. The consequences to TEP relative to other investor-owned utilities could be much worse. The affect would be to reverse virtually all of the financial progress TEP has made over the last five years. TEP's equity balance has increased $86 million from ($63) million as of December 31, 1993, to $23 million as of June 30, 1996.

. . .

The Company's senior debt securities are presently rated below investment grade at B+/BB- by the major credit rating agencies. These credit ratings serve to limit the market for the Company's long-term debt securities to the high yield market. Low credit ratings also serve to increase the cost of credit enhancements, such as letters of credit, which are necessary to ensure the continued marketability of the Company's variable rate debt securities. With limited prospects for the resumption of common dividends, the Company's ability to raise additional equity capital is also severely constrained. Under these circumstances, the Company is already faced with the challenging task of meeting scheduled debt maturities and refinancing other obligations as required or as warranted by market conditions.

During the period 1999-2003, approximately $250 million of the Company's long-term debt obligations will mature. Letters of credit supporting $805 million of the Company's long-term variable rate tax-exempt debt obligations are also scheduled to expire during the period 1999-2002. In the event that expiring letters of credit are not replaced or extended, the corresponding variable rate tax-exempt debt obligations would be subject to mandatory redemption. Losing this tax-exempt financing would likely increase the capital costs of TEP by approximately $15 million, or about 20%, annually. In addition, the Company is also obligated to refinance the debt obligations underlying the Springerville common facilities lease before the year 2000 and will have an opportunity to refinance the high coupon (14.50%) debt obligations underlying the Springerville coal handling facilities lease in the year 2002. As a result of such refinancings, the rental payments under each of these leases will be adjusted to reflect any change in interest payments.

In light of the substantial financial obligations of TEP and other utilities in the fulfillment of their public service obligations, and the public interest served through continued funding of "system benefits" and investments in transmission and distribution facilities, the Commission should ensure that a clearly defined Stranded Cost recovery mechanism is in place prior to the adoption of a rule implementing retail competition. It should also be noted that these investments have been already been deemed prudent in prior Commission decisions.

C. Quantification of Stranded Costs

TEP also believes that Stranded Costs must be clearly defined prior to the initial start date for any retail competition. Consistent with our proposed definition of Stranded Costs, TEP believes that the proper quantification may be achieved by computing the net present value of the future annual

differences between revenues under a continuation of regulation, and the amounts likely to be realized after the introduction of competition, using the current approved cost of capital as the discount rate. A specific time period over which Stranded Costs should be computed by every utility cannot and should not be ordered. Companies have different assets which have different investment and cost recovery horizons. A significant portion of the costs implicit in Stranded Costs are very long-term. Generating assets, for example, have life expectancies in excess of thirty years. Any attempt to arbitrarily set a Stranded Cost calculation time period for all assets together is inappropriate and will likely lead to significant under recovery. Costs were specifically incurred to serve customers over an extended period with a reasonable expectation of a fair opportunity for full recovery. Proper quantification of Stranded Costs should reflect the remaining life expectancy of the underlying assets and deferred costs.

When estimating the potential of Stranded Costs, the most difficult factor to project is the market clearing price for power. There is no single indicator appropriate for all markets. Moreover, there exists inherent uncertainty with respect to predictions of market price for power over any calculation horizon. Forecasts that project market prices too high will understate Stranded Costs, while estimates that are too low will overstate the calculation. Given such uncertainty, if recovery is through a continuing collection mechanism, as opposed to an initial recovery similar to that provided by the legislation in California, the Rule should provide for periodic recalculation and updating. Use of methodologies similar to fuel adjustment clauses may be appropriate to eliminate the potential for over or under recoveries which may result if Stranded Cost levels are determined using a market price estimate at a single point in time.

D. Stranded Cost Recovery Mechanisms

A variety of theoretical Stranded Cost recovery mechanisms are reasonable, including entry fees imposed on competing sellers, exit fees on departing customers and access charges on all end users based on energy consumption. TEP believes that the most efficient and effective means of collecting Stranded Costs is through a "wires charge" paid by every customer interconnected to the TEP system. This approach is consistent with the manner in which retail electric customers are aggregated in a utility's system-wide planning process. Another alternative may be a state-wide mechanism funded by a bond issue. Moreover, such an approach not only recognizes the societal benefits to be achieved from the transition to a competitive electric industry, but also reflects past

precedents set when similar considerations were made for recovering Stranded Costs in the natural gas and telephone industries. Another alternative method for recovery of Stranded Costs that TEP would support is a state-backed bond issue to fund Stranded Costs at the onset of competition.

The natural gas experience (which involved noticeably lower Stranded Costs than which exists for electric utilities) demonstrated that exit fees and similar customer specific charges can be so large (as well as difficult to quantify) as to stifle competitive choices.

E. Other Issues

Another concern that should be addressed by the Commission in considering Stranded Cost recovery is the potential effect that less than full recovery could have on state and local tax revenues. Utilities are among the most heavily taxed industries in any state. This includes sales taxes, revenue taxes, property taxes and income taxes. All such taxes are driven by either the value of the utilities' assets or revenues. To the extent that significant Stranded Costs are written off as unrecoverable, there will undoubtedly be a reduction in the property tax base. As utility service rates are lowered due to the effects of competition and reductions in rate base, there will be a corresponding reduction in tax collections. For example, PECO Energy, a major electric utility in Pennsylvania, has testified before regulators in that state that the potential impact of unrecoverable Stranded Costs on tax revenues to be as high as $500 million annually. If the introduction of retail competition causes tax receipts from utilities to decrease, the state, counties and municipalities will have to develop alternative revenue collection strategies in a relatively short time period. This may include increases in tax rates. TEP has not had adequate time to consider the magnitude of the potential effect of the Rule on Arizona tax revenues, but believes such loss would be significant.

The Rule should address and consider the implications for Arizona utilities which issue tax-exempt bonds on the basis of a limited certificated service territory. A utility financing with such bonds reduces significantly the capital costs of serving the retail customer. The capital costs are lower because the interest payment received by the bondholder from the utility is exempt from federal income taxes. Consequently, the bondholder accepts lower interest payments than if the interest on the bonds were taxable. TEP has approximately $575 million of such tax-exempt bonds. A tax-exempt bond generally has an interest coupon rate that is 70% of the coupon rate of a similar, but taxable bond.

. . .

The Internal Revenue Service ("IRS") allows tax-exempt bonds to be issued for the benefit of an electric utility provided certain conditions are met and maintained, including the condition that the utility's retail service territory is contained within two contiguous counties (*i.e.*, the "two-county" rule). Another condition is that each two-county asset financed with such bonds must be used solely to serve the utility's retail two-county customers, except during emergencies. This condition assures that the benefit of the lower cost, tax-exempt financing accrues to the local retail customers. An electric utility generally meets these conditions by (i) limiting its service territory within the designated two contiguous counties; (ii) except during emergencies, maintaining only inbound metered power flows into the two-county local transmission and distribution system; and (iii) except during emergencies, operating the generating facilities, financed with two-county bonds, in such a manner that power from such facilities flows only into the local transmission and distribution system.

Breaking any one of the conditions could eliminate future two-county financing for the utility and possibly force the utility to redeem all or a portion of outstanding tax-exempt, two-county debt. The loss of the cheaper financing would have a significant impact on the utility and its customers.

Two-county conditions can probably be satisfied under a competitive retail environment if sufficient effort is made to include such impacts in the Rule. IRS rules relating to two-county bonds should be thoroughly reviewed and analyzed within the context of retail wheeling considering the significant adverse impact of losing such financing. FERC, in Order 888, addressed the two-county topic and structured its rule to allow a two-county utility and their retail customers to maintain the financing benefits and yet still "open" transmission lines. The Commission should strive for a similar result by working within IRS guidelines.

Issues which should be reviewed include, but are not limited to, (i) if a two-county utility serves a retail customer through retail wheeling outside its two-county territory, is this a violation and, if so, how can the customers be protected from incurring the higher cost of taxable refinancing; and (ii) if the energy from a two-county utility's generating facility which is financed with tax-exempt two-county bonds is no longer needed to serve two-county retail customers because energy is supplied by other companies through retail wheeling transactions, would the two-county utility be precluded from delivering energy from that generating facility outside the two-county utility's service area in either wholesale or retail wheeling transactions.

IV. LEGAL IMPLICATIONS

A. The Rule Should Not Be Implemented in its Current Form Because it Violates Due Process Rights Set Forth in the State and Federal Constitutions

The Rule will not bring about retail electric competition in Arizona because it violates the constitutional requirements of due process. Ironically, if the Rule is enacted by the Commission, it will impede the actual implementation of retail electric competition, rather than enhance it, because it will be the subject of litigation for being vague, confiscatory, discriminatory and a breach of the regulatory compact between the state and its electric public service corporations.

As a proponent of retail electric competition, TEP believes that it is in the best public interest that the Rule be carefully re-crafted so that it clearly sets forth the terms and conditions of competition, provides for full and complete compensation for utility property rights that are taken, equally protects all utilities and either upholds or provides for the mutual modification of the regulatory compact. While the time it will take to correct the Rule may cause a temporary set-back in the aggressive schedule established by the Staff for its adoption, this needed step will save months, if not years, of litigation and delay in the actual effective date for retail electric competition in this state.

The federal and state constitutions each provide the protection and guaranty of due process of law. U.S. Const. amend. XIV; Ariz. Const. art. II, § 4. In Arizona, due process protections are broadly defined both substantively and procedurally. The courts have stated generally that the denial of due process, "is a denial of 'fundamental fairness, shocking to the universal sense of justice.'" Oshrin v. Coulter, 142 Ariz. 109, 111, 688 P.2d 1001, 1003 (1984). For the specific reasons set forth below, the Rule is neither fair nor just.

1. The Rule is Vague and, Therefore, Violates Due Process

The Rule is vague and, therefore, violates due process because it: (i) fails to provide for or give fair warning as to how many aspects of retail electric competition will be determined by the Commission; and (ii) grants broad discretion to the Commission to set terms and conditions for retail electric competition at a future date but lacks standards to restrict that discretion. *See* Cavco Industries v. Industrial Commission of Arizona, 129 Ariz. 429, 434, 631 P.2d 1087, 1092 (1981); ("Petitioners are correct in asserting that a vague statute may violate due process because it either fails to give fair warning or lacks standards to restrict the discretion of those who apply it.")

The Rule merely provides a skeletal sketch of how retail electric competition will be ushered in and then implemented in this state. Too many key factors are deferred to a later date, to then be determined at the discretion of the Commission. For one example, the Rule is vague with regards to the matter of "Stranded Cost." Section R14-2-xxx1 of the Rule incorporates unclear and ambiguous terms in its attempt to define Stranded Cost such as "verifiable net difference," "prudent jurisdictional assets," and "market value of those assets directly attributable to the introduction of competition." In Section R14-2-xxx7, the Rule states, "The Commission may allow recovery of unmitigated Stranded Cost by Affected Utilities." (Emphasis added). Nowhere in the provisions regarding Stranded Cost is there specificity as to the meaning of utilized terms or standards for how the Commission will employ its discretion in the future.

Equally vague is the Rule's treatment of the nature of future and present CC&N. While Section R14-2-xxx3 requires that any company intending to supply electric services (other than wholesale generation services) obtain a CC&N, the Rule does not explain what rights and obligations are attendant to the new (or old) CC&N. Indeed, it is unclear how the term "CC&N" is to be interpreted in the Rule or how the Commission will so define it when retail electric competition is implemented in the state.

In addition to these examples, the Rule leaves to future definition and determination many other issues including pooling of generation and centralized dispatch of generation or transmission (R14-2-xxx10); standards for setting rates (R14-2-xxx12) and quality of service issues. Until the Rule is clarified and put into its proper context, it will not meet due process requirements.

2. The Rule is Confiscatory and, Therefore, Violates Due Process

The manner in which the Rule would handle Stranded Cost and CC&N will, apparently, take away from the Affected Utilities property and property rights without just compensation. Such action by the state is unlawful confiscation and a blatant violation of due process rights. U.S. Const. amend. V; XIV; Ariz. Const. art. 2, §§ 4, 17.

TEP believes that Stranded Cost represents an aggregation of costs (the prudence of which has already been established) incurred for the provision of utility service under the obligation to serve in a regulatory framework, that are likely unrecoverable in a competitive market due to market prices that are below embedded costs. See *Responses To Questions Regarding Electric Industry Restructuring on Behalf of Tucson Electric Power Company* dated June 28, 1996 at 12. TEP further

believes that Stranded Cost, which is property of the utility, should be fully recovered by the utility when the state imposes retail electric competition. If it is not, then the state has caused the utility's property to be taken from it for a public use (retail electric competition) without just compensation. Maricopa County v Paysnoe, 83 Ariz. 236, 238, 319 P.2d 995 (1958) ("Private property can not be taken or damaged for public use without just compensation. This means that an infringement on the use of property which would diminish its value in whole or in part is a loss which must be compensated.")

Sections R14-2-xxx1 and R14-2-xxx7 of the Rule establish a framework that contemplates less than full recovery of Stranded Cost by a utility. Qualified standards such as "verifiable net difference" and "may allow recovery of unmitigated Stranded Cost" create significant uncertainty regarding the recovery of Stranded Cost. Moreover, it is unrealistic to assume that all recovery of Stranded Costs can be achieved and arbitrary to prohibit Stranded Cost recovery after December 31, 2004. *See* R14-2-xxx7.I. This is especially true when the Rule also states that recovery of Stranded Cost can only be made from those customers who are served "competitively," thereby setting the commencement of the recovery to begin no sooner than January 1, 1999. *See* R14-2-xxx4.A. and R14-2-xxx7.F.

The Rule also takes from a utility some, if not all, of the property rights embodied in its CC&N. For example, an existing CC&N provides an exclusive right to provide electric service in a geographic area. *See* James P. Paul Water Co. v. Corporation Commission, 137 Ariz. 426, 671 P.2d 404 (1983). Retail electric competition, by definition, envisions that such exclusivity will not exist. The courts have made it clear that non-tangible property rights such as a franchise (and a CC&N) of public service corporations must be compensated under the law. *See* City of Tucson v. El Rio Water Co., 101 Ariz. 49, 415 P.2d 872 (1966). However, the Rule does not address, and therefore, does not provide a mechanism for the compensation for the loss of the value of the CC&N. Until the Rule does so, it will violate the due process rights of the Affected Utilities.

The Rule also contemplates that other utilities will have the right to use TEP's distribution system for their own competitive purposes. This also constitutes a "taking" of property and property rights that are now exclusively owned by TEP. The TEP distribution system was constructed and financed to serve TEP's customers in good faith reliance upon the terms and conditions of the CC&N issued by this Commission. The economic value of and ability to use the distribution system

is diminished if other utilities are allowed to use it to serve TEP's current (but by then former) customers. Again, the Rule only provides for the taking of TEP's property without any accompanying provision for compensation.

3. The Rule is Discriminatory in Violation of Equal Protection of the Law

The Rule does not afford all utilities equal protection and, therefore is discriminatory. Ariz. Const. art. II, § 13. The Rule cannot fully afford equal protection to the Affected Utilities until such time as the jurisdiction of the Commission is expanded to include all electric utilities that do business in the state. For example, Salt River Project, municipally-owned and tribal-owned utilities are not within the definition of public service corporation subject to Commission jurisdiction (*See* Ariz. Const. art. XV § 2), not within the definition in the Rule of Affected Utilities and, consequently are not subject to the obligations of the Rule. It appears, however, that these excluded utilities are able to participate in retail electric competition under the Rule (to the extent permitted by federal law). Although Section R14-2-xxx11 of the Rule attempts to restrict the activities of non-Affected Utilities, without jurisdiction by the Commission over them, it is unclear if this section would be enforceable in the courts. Further, reference in that section to various "service territories" would appear to have little meaning if (i) the Commission has no jurisdiction over the non-Affected Utilities; and (ii) there are no longer exclusive certificated service territories under the Rule. Additionally, there will be no equal protection under the law and no reciprocity for the Affected Utilities in situations where electric providers that have no certificated service territory, such as the Western Area Power Authority (or some tribal utilities), apply for a CC&N in Arizona to provide retail electric service. Moreover, the "invitation" by the Rule to voluntarily consent to the jurisdiction of the Commission is a proposition that must be determined by the courts and not the Commission. Because the exemption of municipally-owned utilities from the jurisdiction of the Commission is established by the Arizona Constitution it cannot, therefore, be changed merely by the enactment of the Rule.

B. The Rule Unilaterally Modifies, if Not Abrogates, the Regulatory Compact

The Regulatory Compact has been explained by the Arizona Supreme Court in Application of Trico Electric Co-operative, Inc., 92 Ariz. 373, 380, 377 P.2d 309 (1962), as follows:

> In the performance of its duties with respect to public service corporations the Commission acts as an agency of the State. By the

> issuance of a certificate of convenience and necessity to a public service corporation the State in effect contracts that if the certificate holder will make adequate investment and render competent and adequate service, he may have the privilege of a monopoly as against any other private utility.

Thus, the state and the Affected Utilities have entered into a compact, evidenced by a CC&N, with mutual obligations and benefits. Simply stated, as long as the utility provides competent and adequate service, it is entitled to the monopolistic right to serve customers in a "certificated" service territory. Indeed, the courts have stated that it is the duty of the Commission to protect the monopoly rights of a public service corporation that is upholding the regulatory compact. Id. It is in good faith reliance upon the Regulatory Compact that utilities continue to invest in plant to serve new customers. It is in reliance upon the Regulatory Compact that utilities serve all qualifying customers within their certificated service territories. However, through the Rule, the Commission would be unilaterally modifying or abrogating the Regulatory Compact. In fact, Stranded Cost is an unfortunate by-product of the modification of the Regulatory Compact.

The Rule forges new and uncharted territory in its attempt to (i) award non-exclusive CC&N; (ii) permit retail electric competition in areas currently certificated to utilities that are providing adequate and competent service; and (iii) change the rights of existing CC&N. There is no present constitutional or legislative authority for the Commission to change the terms of the Regulatory Compact of its own accord. There is no legal precedent for the Commission negating the effect of a utility's CC&N without a showing of the inability to provide adequate service. Further, the Commission has never stated (and the Rule does not refer to) any legal source for its ability to alter the Regulatory Compact.

To the extent that the CC&N of any Affected Utility is modified or abrogated as a result of the Rule, the Commission will have done so in violation of due process rights. Further, the courts have firmly stated that before a CC&N can be modified, amended or abrogated, notice and a hearing must be afforded to the holder thereof. *See* A.R.S. § 40-282; James P. Paul Water Co., supra; (A CC&N holder is entitled that he be given the opportunity to contest any amendment); Application of Trico Electric, supra; (The revocation or recission of all or a portion of a CC&N requires strict compliance with due process requirements of notice and an opportunity to be heard). The Rule does

. . .

not provide for a hearing (and apparently will be enacted without a hearing thereon) yet will change the CC&N, in violation of due process.

The United States Supreme Court recently issued an opinion that reinforces the integrity and honor of agreements made with the government, such as the Regulatory Compact. In United States v. Winstar Corporation, 116 S.Ct. 2432 (1996), three financial institutions brought claims against the United States for breach of contract (and other constitutional violations) as a result of the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), which changed existing rules by limiting the application of special accounting treatment to the acquisition of failing savings and loan institutions. In finding that the government did breach its existing agreements with the institutions as a result of the consequences of FIRREA, the Supreme Court said:

> Just as we have long recognized that the Constitution 'bar[s] Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as whole,'[cite omitted] so we must reject the suggestion that the Government may simply shift costs of legislation onto its contractual partners who are adversely affected by the change in the law, when the Government assumed the risk of such change. Id. at 2459.

The Rule will unilaterally shift the burdens of the Regulatory Compact onto the Affected Utilities in the same way that FIRREA shifted costs to the financial institutions in the Winstar case.

TEP is also concerned with an additional aspect of the Regulatory Compact that affects it and other utilities that have entered into a rate settlement with the Commission that includes a rate moratorium. Specifically, the Commission and TEP are bound to honor the terms thereof (including the implied covenant of good faith and fair dealing) but the Commission, by implementing retail electric competition before the rate moratorium is over, will be unilaterally changing the regulatory and economic assumptions upon which the settlement was made. Indeed, if the reality of the implementation of retail electric competition in Arizona had been known during the negotiations of the settlement agreement with TEP, then the terms thereof would certainly have been different than they are presently. TEP would propose, therefore, that it be required to phase-in retail electric competition after its rate moratorium is over.

. . .

. . .

C. The Rule Seems is Askew With Existing Law

The Rule seems to suffer from isolationism. As detailed herein, there are many instances where the Rule is contrary to, or inconsistent with, the terms and provisions of the federal and state constitutions, statutes, judicial precedent and mandated procedure. These flaws cause the Rule to be arbitrary and vague.

By way of example, the Rule will cause Affected Utilities to change their rates independent and apart from any rate case hearing that analyzes the utilities' rate base, return on investment and other financial indicators. The Rule's procedure (or lack thereof) is contrary to the requirements set forth in the case, Scates v. Arizona Corporation Commission, 118 Ariz. 531, 578 P.2d 612 (App. 1978). Although the courts have specified instances, such as emergency interim rate relief, where the hearing requirements may not apply, the circumstances contemplated in the Rule does not fall within any recognized exception to the Scates doctrine.

Also, the Rule improperly infuses the business judgment of the Commission into the internal affairs of TEP. To illustrate, the Rule mandates that specific percentages of the total retail energy sold competitively by the Affected Utilities be generated by solar resources. *See* R14-2-xxx9. The law is clear that the Commission is not the party to exercise control over the internal affairs of a utility. *See* Southern Pacific Co. v. ACC, 98 Ariz. 339, 343, 404 P.2d 692, 694 (1965) (Commission does not have power to manage corporations; management power is incident to ownership); Corporation Commission of Arizona v. Consolidated Stage Co., 63 Ariz. 257, 161 P.2d 110 (1945). By dictating how much of a utility's energy will be generated by solar resources and setting deadlines for this to be accomplished, the Commission is acting beyond the scope of its jurisdiction.

TEP respectfully submits that the solution to these and the other problems identified herein, can be found in a careful and thorough edit of the Rule. TEP does not anticipate that this will be a protracted process, but it will take time and resources. However, this truly is a situation where the additional time taken to clarify, cross-reference and correct the Rule now will be in the best public interest and the best use of the resources of the Commission and the interested parties. TEP recommends that the Commission look first to obtaining legislative (and constitutional) reform prior to attempting to implement retail electric competition or seeking declaratory judgment from the courts regarding its authority to enact the Rule.

TEP also submits that in order for the Rule to mesh with state constitutional and statutory standards, at least the following provisions would have to be modified from their current form:

(i) Ariz. Const. art. XV, § 2--to change the definition of public service corporation to include municipal corporations and tribal corporations;

(ii) A.R.S. § 40-281 and 282--to change the scope and procedure regarding certificates of convenience and necessity; and

(iii) A.R.S. § 40-203--to expand the circumstances and procedure by which the Commission can prescribe rates, rules and practices of public service corporations.

To implement the Rule, in its current form and amid an existing framework of federal and state regulation, will be to invite successful legal challenges to the Rule and to abandon the notion of retail electric competition in Arizona in the foreseeable future.

V. SPECIFIC CONCERNS

A. General Comments

Overall TEP believes that the Rule Staff has proposed is a good first step towards developing a comprehensive plan for the transition from a regulated electricity market to a competitive electricity market. Many of the sections have components that are in-line with moving towards competition. However, most sections do need more definitions and/or details to fully explain and communicate the Rule's intent. Below are some overall comments and a list, by section, that asks for clarifications or points out specific issues that will need to be addressed before the Rule is adopted as the "Final Plan."

One general observation is the Rule's vagueness on issues that relate to more than one entity or to a future action or event. For instance, the Rule uses the word "may" in several cases where it would be more appropriate to have a definitive answer. The section on Stranded Cost is particularly unclear about whether Stranded Cost will be recoverable or not. Stranded Cost is a major issue and the Rule should be explicit in this area. Due to the major financial implications discussed in Section III, a clear message to the companies, their customers and investors is essential in order to eliminate undue anxiety over the financial affects of the Rule.

The Rule's vagueness would also allow a future Commission to treat existing entities differently at a time when a level playing field is most important. Examples of this type of

. . .

uncertainty can be seen in the Recovery of Stranded Cost, Services Required to be made Available, and the Competitive Phases sections.

Other sections that need more detail are Competitive Services, Unbundled Service Tariffs and the entire Rates section. As pointed out in Section II, TEP feels that competitive services need to be clearly defined for a smooth transition to competition. In addition, rate development for products/services, whether the product/service is competitive (*i.e.*, market based) or monopolistic (*i.e.*,. cost based), must be consistent and clear for all market players. Additionally, the tariff requirements appear to be nothing more than regulation for competitive products/services and the rate section appears to be nothing more than price cap regulation. All these sections need further development in order to meet both the Commission's original objectives and TEP's objectives listed in Section II.

There are several specific sections in the Rule that TEP has major concerns about. The first is the buy-through section. The buy-through section should be eliminated. A buy-through program seems to serve no particular purpose when retail competition is to start soon thereafter.

The other issue in the Rule which TEP has some concern with is the Solar Portfolio Standard. Although TEP agrees that it is important to promote renewable energy, setting strict standards for all electric providers could stifle market entry if the requirement is too lofty. Until costs are more in-line with alternative resources, the 1%-2% requirement is likely to limit the number of competitors that will choose to compete in the Arizona market. Placing the burden on a multitude of suppliers also increases the potential for gaming the requirement, increases the need for oversight and may reduce the effectiveness of renewable resource development (due to the small size of the requirement for each supplier).

B. <u>Specific Comments</u>

- **R14-2-xxx1. Definitions.**

1. The definition of "Affected Utilities" should be changed to "Jurisdictional Utilities" to reflect that these are the utilities that the Commission presently has jurisdiction over and that may be subject to additional or different requirements than new entrants. The Rule needs to make a clear distinction between the provisions of the rule which require only Jurisdictional Utilities to comply with a provision versus provisions that are to apply to all energy providers in the new competitive market. Therefore, TEP proposes that a new definition be added for "Licensed Providers" which

would encompass all providers that will be authorized to provide energy services in Arizona pursuant to Commission authority.

4. We assume that the "designated area" in the definition of Standard Offer applies to the current regulated supplier in a given CC&N territory.

6. System Benefits should only include decommissioning costs for customers of utilities which would incur such costs.

- **R14-2-xxx2. Filing of Tariffs by Affected Utilities.**

TEP believes that competition should start in the year 2000 (see below). However, regardless of when competition starts, the definitive tariff should be filed six months prior to the effective date of competition. The current requirement would have the tariff filed 18 months prior to the start of competition. During that time, there could be significant changes in the definitions of competitive and monopoly services, as well as the requirements for Standard Offer Service which would result in modifications to the tariffs. TEP believes that the various types of service and at least broad pricing parameters should be determined prior to the requirement to file tariffs. Further, assuming the Rule is adopted at the end of this year, six months is insufficient time to evaluate all the changes that will be required to ultimately implement competition.

- **R14-2-xxx3. Certificates of Convenience and Necessity.**

General

TEP believes that a different term should be used such as a "License to Serve." The term CC&N as used currently in the electric energy statutes in Arizona, implies an exclusive service territory or monopoly service territory. Further, there may be confusion because there are different requirements under the Rule for "Affected Utilities" that hold a CC&N versus those new providers that obtain a CC&N.

B.3. TEP does not support a tariff requirement for competitive services once competition is fully implemented. If such a requirement is deemed to be necessary during the transition to competition, we agree that it should be a universal supplier requirement.

E.1. This provision requires that new entrants comply with IRP rules. Only four of the "Affected Utilities" are required to comply with the IRP rules, the rest are not. The IRP rules should be eliminated if the generation portion of the electric supply business becomes competitive. The market will determine the need for new generation and any mandated renewable resource or solar

requirement. Therefore, TEP proposes that the IRP process be eliminated when retail service territories are opened to competition.

♦ **R14-2-xxx4. Competitive Phases.**

General

TEP does not support a retail competition plan which allows competition to begin prior to there being solutions for several significant items which are discussed throughout these comments. There is a need for additional time to work out the legal, operational and other issues surrounding the transition to competition, and the Commission must honor the current moratorium agreements with existing utilities such as the rate settlement with TEP that calls for a rate moratorium until the year 2000. Therefore, TEP supports a start date for competition which is no earlier than January 1, 2000.

E.1. TEP agrees that the selection of a methodology for determining which customers can access the market in various phases can be made later in the process. However, we also believe that the method of selection should be consistent state-wide in order to avoid discrimination claims between the customers in the different service territories across the state.

G.3. As discussed above, TEP does not support the buy-through mechanism. Further, if a buy-through is included as a portion of the retail competition plan, Stranded Cost recovery, among other items, would need to be addressed and appropriate charges allocated to buy-through customers.

♦ **R14-2-xxx5. Competitive Services.**

A.1. As discussed in Section III, TEP believes that competitive and monopoly services must be clearly defined and priced prior to the onset of competition. It is not clear what "distributed energy services at market based rates" are. A list of the specific services should be provided so that services are consistent between energy providers.

B. As discussed above, TEP does not support a tariff requirement for competitive services.

♦ **R14-2-xxx6. Services Required to be made Available by Affected Utilities.**

A. As discussed in Section III, TEP believes that the obligation to serve should terminate at the time a customer elects to procure competitive service. Therefore, during a phase-in period utilities would only have the obligation to serve customers who have not chosen or been offered access and such obligation would end when the final group of customers is allowed access to the

market. Thereafter, the local distribution service provider may still be required to offer some sort of general service tariff but prices under such a tariff should be based on the available market cost of such services (so that the distribution company is not required to own assets for such service). This same logic should apply to any ancillary services that may be required.

The Rule would eliminate TEP's additional concern that the language in the Rule regarding the Commission determining that competition has been "substantially implemented" is too vague. If there are not concrete measures or specific rules which determine when competition is deemed to be substantially implemented, the Affected Utilities will be forced to hold capacity and reserves without compensation for customers that they are not serving. This will be a particularly difficult issue as such utilities will also need to do everything in their power to sell any freed-up capacity and reserves in the wholesale market.

F. The providing utility should be allowed recovery of the cost of providing such information.

♦ **R14-2-xxx7. Recovery of Stranded Cost of Affected Utilities.**

A. Under the Rule, utilities are expected to take steps to diminish Stranded Cost exposure. TEP agrees that utilities should be required to demonstrate reasonable measures to mitigate Stranded Costs. The problem is to determine what is reasonable for any given company. What actions particular companies take will depend on their specific situations and relevant market conditions. Mitigation efforts should be evaluated on a case-by-case basis.

The Rule identifies accelerating depreciation and expanding markets as ways to mitigate Stranded Costs. It must be noted that Stranded Cost will be mitigated by accelerating depreciation only if regulators correspondingly authorize the inclusion of such expanded capital recovery in rates. Without the proper synchronization of increased depreciation accruals with increased rate recovery, Stranded Cost will not be mitigated; rather, it will be absorbed by utility investors.

With respect to expanding wholesale or retail markets, such activity may not necessarily mitigate (at least to any significant extent) Stranded Cost. It is generally believed that in a competitive market, the clearing price for power will approach long-run marginal costs. For companies with incremental cost close to, or above, market, the expansion of wholesale or retail sales may not have a mitigating effect.

. . .

Other approaches to mitigating Stranded Cost may include asset sales, renegotiating uneconomic contracts, pursuing economic development projects and constantly attempting to lower marginal costs. What constitutes appropriate mitigation for any utility should consider all relevant facts and circumstances. Under no circumstances should a utility be forced to sell assets to mitigate stranded costs. It should also be noted that mitigation efforts themselves may lead to additional costs that may become stranded.

B. The Rule states that the Commission may allow recovery of unmitigated Stranded Cost by Affected Utilities. There should be no question about whether Stranded Cost is recoverable. The traditional regulatory compact between public utilities and the customers they serve is unquestionably clear. It is an agreement, sanctioned by the state, granting the exclusive right to serve the public interest in a specific geographic area. In return, the utility assumes two obligations not imposed on competitive entities: (i) the obligation to serve; and (ii) the regulation of prices and earnings. The obligation to serve carries an obligation to invest in and maintain plant, or enter into contracts, to assure sufficient supply to meet all customer demands.

Under the regulatory compact, utilities were provided some assurance as to the limits of their business risk, which correspondingly resulted in limited rates of return. Utility investments in assets and obligations were incurred in good faith and in expectation that a reasonable opportunity would be provided to achieve the designated returns. Now, in the face of competition, with customers being given the opportunity to select their own power supplier, those investments and obligations may not be dismissed. (See also Section III, above.)

C. The Rule states that utilities may file estimates of Stranded Costs, and that such estimates must be supported by appropriate market analyses. TEP believes that 100% Stranded Cost recovery is required and that the methodology for determining such costs should be consistent for all Commission regulated utilities. Before any estimate of Stranded Cost can be made, there must be a clear definition of the term itself, an indication of the measurement horizon, and clarification with respect to what constitutes the relevant market. Consistent with our proposed definition of Stranded Cost, TEP believes that the proper quantification may be achieved by computing the net present value of the future annual differences between revenues under a continuation of regulation, and the amounts likely to be realized after the introduction of competition, using the current approved cost of capital as the discount rate. (See Section III, above.)

D. The Rule allows utilities to request Commission approval for Stranded Cost recovery under a variety of methods from those customers opting for securing competitive sources of power. TEP believes that the Commission has the responsibility to use its authority to facilitate a smooth transition to competition, including providing for the assurance of, and uniform method for, recovery of Stranded Costs. In developing an appropriate mechanism for recovering stranded costs, we believe the following objectives should apply:

(i) The charge should promote economic efficiency and the evolution of competition;

(ii) Any Stranded Cost recovery mechanism must be fair to stockholders and equitable toward all for whom the underlying costs were intended to benefit, including those that leave the system;

(iii) Stranded Cost should be recovered in its entirety within a reasonable time period, certainly before the transition to retail competition is complete;

(iv) The recovery burden should not significantly expand the existing administrative burdens on the Commission or affected utilities;

(v) The mechanism should be sufficiently flexible to incorporate changes in assumptions or unanticipated events in the process of transitioning to retail competition; and

(vi) The charge should be simple and understandable to customers and not impede their choice for power supply or other competitive services.

A variety of methods of Stranded Cost recovery are theoretically available, including entry fees imposed on competitive market participants, exit fees on departing customers and access charges on all customers in the jurisdictional service territory. TEP believes that the most efficient and effective means of collecting Stranded Costs is through a "wires charge," paid by every customer in the jurisdictional service territory, and updated annually, until such costs are fully recovered. Another alternative method for recovery of Stranded Costs that TEP would support is a state-backed bond issue to fund Stranded Costs at the onset of competition. (See also Section III, above.)

F. TEP proposes an across-the-board wires charge as explained in D above.

H. The Rule states that the Commission may order revisions of Stranded Cost estimates. The Company concurs with that procedure, so long as such estimates are consistent with the TEP positions stated herein and changes in estimated Stranded Costs are reflected in the recovery

mechanism such that we are given a reasonable opportunity to fully recover such amounts prior to completion of the transition to competition.

I. The Rule states no further Stranded Cost recovery after 2004. As noted in Section III, a significant portion of the costs implicit in Stranded Costs are very long-term. Generating assets, for example typically have life expectancies in excess of thirty years. Any attempt to arbitrarily set a Stranded Cost calculation time period is inappropriate, and will likely lead to significant under recovery. The rule arbitrarily sets the time frame five years to coincide with the implementation of competition as the Rule is currently written. For many utilities this time-frame may not be realistic.

Overall Implications

The Rule states that each company shall maintain its books and records in accordance with Generally Accepted Accounting Principles ("GAAP"). The restructuring proposals in general, and Stranded Cost recovery issue in particular, have potentially significant accounting implications. TEP believes that the rules addressing accounting matters must be broader and more clear.

As an electric utility involved in interstate commerce, TEP maintains its books and records in accordance with the FERC Uniform System of Accounts ("USoA"). As an investor-owned utility it is also required to follow GAAP principles as promulgated by the Financial Accounting Standards Board ("FASB") in public financial statements filed with the Securities and Exchange Commission. The USoA and pronouncements of the FASB are broadly based on the same accounting concepts and economic principles; however, in the case of any conflict, the USoA takes precedence over the FASB for financial accounting purposes.

The traditional cost-based ratemaking process followed by regulated utilities is a phenomenon not present in nonregulated businesses. To fulfill their public responsibilities, regulators prescribed accounting rules and practices that were different in many respects from those used by other types of businesses. Over the years, such differences were accepted by the accounting profession and financial community for publicly reporting the results of utility operations and activities. In most instances, the same accounting principles that apply to unregulated businesses also apply to utilities. The differences that exist are solely attributable to the ratemaking process. By having the power to determine the costs upon which rates are based, regulators such as the ACC can create economic impacts that must be appropriately considered in accounting and financial reporting.

The single most significant factor producing different accounting principles and procedures by utilities is the ability of regulators to create assets by deferring to future periods (and therefore presumably recoverable in future rates) certain current costs which would otherwise be charged to expense under GAAP by unregulated businesses. With the authority to identify the types and amounts of costs to be recoverable in rates, regulators have been able to provide the necessary assurance to the financial community that such costs deferred were, in fact, assets recoverable in the future.

As a rate regulated entity, TEP prepares its public financial statements according to FAS 71. The underlying premise of FAS 71 is that regulated enterprises should account for the economic effects that result from the cause-and-effect relationship of costs and revenues in the rate-regulated environment. FAS 71 defines what constitutes a regulated entity and contains standards of accounting for the effects of regulation. One such standard is the basis for which a regulator can create an asset by deferring for future recovery, a current cost that would otherwise be charged to expense. For that to occur, both of the following criteria must be met:

(i) It is probable that future revenue in an amount at least equal to the capital cost will result from inclusion of that cost in rates; and

(ii) Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

As long as the above criteria are met, assets may continue to be reflected in a utility's books and financial statements. As soon as either is not met, the corresponding asset must be written off.

As competition has surfaced in the utility industry, the ability of regulators to create assets by deferring costs to the future has become increasingly suspect. Accordingly, additional accounting standards have been issued by the FASB to address emerging concerns over accounting by regulated entities. These include FAS 90, *Regulated Enterprises-Accounting for Abandonments and Disallowances of Plant Costs*; FAS 92, *Regulated Enterprises-Accounting for Phase-In Plans*; FAS 101; and FAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of.* Both FAS 90 and FAS 92 contain criteria for permitting certain plant-related costs to be deferred for future rate recovery. Costs not meeting such criteria may not be

. . .

deferred, and must be written off. FAS 121 amends FAS 71 to clarify that existing regulatory assets should be written off if they are no longer considered probable of recovery.

The thrust of FAS 101 is that, when an enterprise ceases to meet the criteria of FAS 71, either in part (*i.e.*, an operating division or product line) or in total, it must discontinue its application and eliminate the assets on its books that were created by regulators. As an example, in 1993 US West determined it no longer met the criteria under FAS 71 to continue considering itself a regulated entity for accounting purposes. Accordingly, it removed all regulatory assets from its books and, in connection therewith, sustained a $3 billion, after-tax reduction of retained earnings.

Utilities following FAS 71 must continually assess whether they remain regulated entities under definition criteria contained in the Standard. FAS 101 includes the following examples of situations that may warrant discontinuation of FAS 71:

(i) Deregulation;

(ii) A change in the regulator's approach to setting rates from cost-based ratemaking to another form;

(iii) Increasing competition that limits the enterprise's ability to sell utility services or products at rates that will recover costs; and

(iv) Regulatory actions resulting from resistance to rate increases that limit the enterprise's ability to sell services or products at rates that will recover costs if the enterprise is unable to obtain relief from prior regulatory actions through appeals or the courts.

In developing rules for the transition to retail competition, particularly with respect to the issue of Stranded Cost quantification and recovery, the Commission needs to be cognizant of the accounting requirements of both the FERC and FASB. If the accounting rules to be issued by the Commission are unclear, or inconsistent with such requirements, TEP may be forced to write off hundred of millions of dollars of assets and find itself in the same dire financial straits it was in just a few years ago. Less than adequate recovery of Stranded Cost may totally negate the progress achieved by TEP in its financial restructuring.

- **R14-2-xxx8. System Benefit Charges.**

TEP generally agrees with the concept of a systems benefits charge but, as with charges for Stranded Costs, we believe that it should be a wires charge which all customers pay.

♦ **R14-2-xxx9. Solar Portfolio Standard.**

TEP believes that setting strict standards for all electric providers could stifle market entry if the requirement is too lofty. Until costs are more in-line with alternative resources, the 1%-2% requirement is likely to limit the number of competitors that will choose to compete in the Arizona market. Placing the burden on a multitude of suppliers also increases the potential for gaming the requirement, increases the need for oversight and may reduce the effectiveness of renewable resource development (due to the small size of the requirement for each supplier). TEP supports the inclusion of a renewable resource surcharge in the Systems Benefit Charge which should be utilized to fund any mandated renewable resource requirements. See also the general discussion above.

Additionally, TEP feels that the Solar Portfolio requirement is too source specific and should be expanded to a renewable resources standard. The solar requirement should not be additive to the IRP renewable requirements either, as this will place undue burdens on companies that will no longer continue to be regulated generation suppliers if the electric supply market is opened to competition. Maintaining this requirement will unduly burden the suppliers that would have to comply with both requirements.

♦ **R14-2-xxx10. Pooling of Generation and Centralized Dispatch of Generation or Transmission.**

As discussed in Section II above, TEP advocates that an ISO be a required component of a competitive electric supply market. The Company believes that such an organization is required to maintain reliability and to provide some order for the transition to a competitive market and thereafter.

♦ **R14-2-xxx11. In-State Reciprocity.**

The Rule provides that non-Affected Utilities' service territories shall not be open to competition, nor shall such companies be allowed to compete in the service areas of Affected Utilities, unless they voluntarily open their areas to other competing sellers. A leveling of the playing field between existing regulated utilities and other entities willing and able to provide comparable services is critical in achieving an orderly and equitable transition to retail competition. The above proposed reciprocity provision of the Rule (one to which TEP agrees in concept) addresses only one requirement necessary to achieve such parity. There are others. First, existing utilities will be at a distinct disadvantage if they are held to the obligation to serve, while their

competitors are not. The obligation to serve is not compatible with a competitive market. It creates the potential for non-utility competitors to target only the best, most profitable customers with tailored rates intended to maximize profits. The utilities would then be left to serve all remaining customers, profitable or otherwise, with average cost rates. Such rates may then increase due to the loss of margin contributions from departing customers.

Second, the ability of regulation to achieve public policy objectives (*i.e.*, low income ratepayer assistance programs, etc.) may be reduced under competition. TEP strongly supports such programs but believes that each such program cost must be borne by all market participants, or removed as an obligation of utilities and transferred to a governmental function or program.

Third, the Stranded Cost of existing investor-owned utilities must be fairly addressed. Utilities must be given a reasonable opportunity to fully recover such amounts in conjunction with, and prior to the completion of, the transition to retail competition.

Another obstacle that must be overcome is the fact that some of the potential competitors of utilities do not have to reflect in rates some of the costs that the utilities presently incur and must be recovered. Income taxes are one such cost. Under present rules, co-ops, public power districts, and municipalities are tax exempt. Moreover, their capital costs are typically less than those of investor-owned utilities because they do not have common stockholders for which market returns must recovered and because their bonds contain lower coupon rates reflecting not only their tax-exempt financing but also their self-regulated status.

Finally, there is no mechanism contained in the Rule to prevent parties that do not offer up reciprocity from competing through the "back-door" by selling power or services to competitors which are allowed to compete in the open market. There has been a proposal authored by at least one government agency to set up a regulated utility subsidiary as a solution to leveling the playing field. TEP believes that forming a regulated subsidiary does not address the major issues concerning leveling the playing field as the taxes proposed to be paid on the profits of such subsidiary are minor relative to the value of the parent entities' subsidies. The potential for the subsidies and competitive advantages of these parties to cause distortions in competitive market outcomes is significant. It is questionable whether all of the factors presently slanting the playing field can be eliminated by Commission Rule. Undoubtedly, there will have to be changes in legislation at the state and federal level.

♦ **R14-2-xxx12. Rates.**

B. In general, it appears that the Rule and this section specifically is promoting "regulated competition." If a service is deemed competitive, then there should be no regulatory requirements for that service. Additionally, the Rates section requirements appear to be establishing price cap regulation, not de-regulation.

C. If these contracts are for competitive services, there should be no requirement to file such contracts with the Commission.

D. Consistent with our responses above there should be no filing requirement for competitive service contracts and, therefore, no time limitations associated therewith.

♦ **R14-2-xxx13. Service Quality, Consumer Protection, Safety and Billing Requirements.**

K. There needs to be more flexibility in this area, for instance a customer might be willing to have lower rates in exchange for bi-monthly meter reading.

♦ **R14-2-xxx14. Reporting Requirements.**

The industry is moving towards a competitive environment and electric service providers will cut all possible costs. The reporting requirements that this Rule proposes appears to be burdensome for a competitive industry. The goal is to make the industry more cost efficient and reporting has a time and cost value associated with each report. TEP is not in favor of regulating a competitive industry. The Commission may require reports for Standard Offer services or other services defined as monopolistic, but any competitive service offerings will be controlled by the marketplace.

F. It is unrealistic for the Rule to require workshop participation from competitive suppliers.

♦ **R14-2-xxx15. Administration Requirements.**

In general, TEP believes that administrative requirements should be minimized for competitive suppliers and for the portion of an existing regulated utility's business or subsidiary that is participating in the competitive market. New competitive services should be free from regulatory reporting mechanisms. A general consensus between Staff, affected utilities and new suppliers, should be formed before the Rule is finalized regarding reporting requirements.

. . .

. . .

VI. CONCLUSION

In TEP's June 28, 1996 *Response to Questions Regarding Electric Industry Restructuring*, the Company stated:

> TEP believes that the Commission and the utilities must work together to ensure that the transition to full competition maximizes the benefits to customers without unduly harming the utilities and their shareholders. To this end, the parties must first resolve some of the major issues to create an atmosphere where all energy providers can compete equitably. This includes developing an equitable recovery mechanism for stranded investments, resolving the public power issue and determining appropriate industry structure. Until these issues are resolved, it will not be possible to create an equitable and efficient marketplace.
>
> Although the Commission has held workshops, and we encourage that more workshops be held to discuss the comments filed in this Docket, it should consider holding public hearings on the major issues. Legislative issues should also be identified as it does not appear that the Commission will have all the necessary authority to create a fully equitable and efficient marketplace without legislative changes. Finally, the Commission should start working with each electric utility in the interim to discuss the tools necessary for the utility to be properly positioned for competition.

Unfortunately, the process (or the lack thereof) that has been undertaken by Staff since June 28, 1996, and the resultant Rule that has been proposed, have not accomplished any of the objectives identified by TEP (and others) necessary to bring about retail electric competition in Arizona in the orderly and equitable manner as described above. Other jurisdictions, including California and FERC, have spent considerable time to study the issues, build consensus and seek meaningful input through technical conferences and public hearings.

TEP has identified in Sections II, III and IV hereinabove, the primary objectives of retail competition that must be addressed in any proposed rule, as well as the primary stranded investment and legal implications that must be resolved prior to the adoption of a definitive rule. TEP has also provided some specific comments on the provisions of the Rule. Because these primary issues remain unresolved vis-à-vis the Rule, TEP urges Staff not to rush the adoption of the Rule, but follow the leads of other jurisdictions to resolve the major issues. TEP, therefore, proposes that before a rule is tendered to the Commissioners, the parties work together to build consensus, perhaps using the proposed Rule as a platform in order to bring an orderly transition to competition in Arizona. The issues left unresolved by the Rule are threshold to a system that can be implemented

optimally, legally and equitably. TEP commits to actively participate in the development of such a solution.

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

. . .

** TOTAL PAGE.045 **