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September 11, 1996

James Matthews  
Executive Secretary  
Arizona Corporation Commission  
1200 W. Washington  
Phoenix, Arizona 85007

Re: Docket No. U-0000-94-165, Proposed Rule -- Retail Electric Competition

Dear Mr. Matthews:

Enclosed please find the comments of Destec Energy, Inc. on the Commission's proposed rule in the above-referenced docket. A Destec representative will attend the Commission Workshop scheduled for September 18, in this docket.

Sincerely,

Barry N.P. Huddleston  
Regional Manager, Regulatory Affairs  
Destec Energy, Inc.  
2500 CityWest Blvd., Suite 150  
Houston, Texas 77042

Arizona Corporation Commission  
DOCKETED

SEP 12 1996

DOCKETED BY



BEFORE THE ARIZONA CORPORATION COMMISSION

In re: Proposed Rule on Retail  
Competition

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Docket No. U-0000-94-165

Arizona Corporation Commission

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Comments of Destec Energy, Inc.

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Destec Energy, Inc. ("Destec") is a subsidiary of The Dow Chemical Company ("Dow"), a New York Stock Exchange company ("NYSE: ENG"), and a leading independent power producer based in Houston, Texas. Destec has interests in 22 operating projects with a total rated equivalent capacity of 4,886 megawatts of electricity and over three million pounds per hour of steam. In addition, Destec currently has four international projects representing approximately 1,100 MW under construction or in advanced stages of development. Destec also owns approximately 120 billion cubic feet of proven natural gas reserves.

Destec's experience and resources includes the ability to develop, design, engineer, construct, permit, finance, acquire fuel supplies, own, operate and maintain non-utility generation projects. In addition to power which Destec currently markets for Dow from Dow's Texas and California facilities, Destec has formed Destec Power Services, Inc. ("DPS"), a FERC-certified energy marketing company organized to respond to significant market and regulatory changes underway in the United States. DPS is currently participating in the wholesale electric market in California and Texas, and is actively seeking areas for expansion. Destec was one of the first non-utility members of the Western Systems Coordinating Council ("WSCC") and the first independent power producer member of the Electric Reliability Council of Texas ("ERCOT"), as well as a member of the Western Systems Power Pool ("WSPP"). Destec is also a member of the Board of Directors for the Western Regional Transmission Association ("WRTA").

Destec offers the following comments on the Arizona Corporation Commission's Proposed Rule in the hope that they will provide the Commission with some guidance as the industry undergoes significant changes to a market driven structure. Copies of these comments are being provided to all persons on the service list.

In general, Destec applauds the Commission in its attempt to realistically accommodate the changing electric industry. It is Destec's belief that whatever changes do occur in the electric industry, occur within the industry itself. These changes can only be helped or hindered by regulators -- and, delaying the inevitable will not work to the greater good of the vast majority of electric customers in Arizona. It is clear that major portions of the industry are no longer "natural" monopolies, if they ever were. Regulation is, and was always intended to be, a substitute for the marketplace when market forces are insufficient to lead to efficient supply and demand decisions. Fortunately, the very nature of the industry is changing. The role of policy-makers now must be to objectively separate the functions within the electric industry which do not require regulation from those that do: only then will the public interest truly be served.

With regard to § R14-2-xxx4, Destec recommends a deliberate **but aggressive** "phase-in"--commencing no later than January 1, 1998. Destec supports the Commission's contemporaneous access for all customer classes, as well as the "set-aside" contained within the Proposed Rule for residential customers. However, there would seem to be no physical, financial, or other reason to delay access to the benefits of competition beyond 1998. More specifically, Destec would recommend that § R14-2-xxx4(A) be modified to accommodate access for 25 percent of the 1995 system peak demand by January 1, 1998; § R14-2-xxx4(B) should be modified to accommodate access for the remaining 75 percent of customers, as measured by 1995 system peak demand (for a total of 100 percent, in aggregate), by January 1, 2000; and, §§ R14-2-xxx4(C) and (D) should be deleted. Such a timeline will be more likely to ensure that Arizona is able to design its own transition rather than be subject to federal designs.

Destec recommends that § R14-2-xxx4(F) be modified to allow, at the customer's discretion, "conversion" of existing full services contracts to "transportation-only" contracts. This change would accommodate buy-through service, as well as direct access service; and, would ensure that competition reaches all customers -- including those that happened to negotiate long-term contracts during the period during which they had few "real" alternatives to the regulated, vertically-integrated utility.

Destec supports the Commission's Proposed Rule § R14-2-xxx4(G). However, it is not clear from the text whether buy-through tariffs are "required" or "permitted." § R14-2-xxx4(G)(2) permits such tariffs, but § R14-2-xxx4(G)(3) appears to require that 5 percent of the system peak have such tariffs available by January 1, 1998. Destec would recommend that such tariffs be required for 25 percent of the system peak demand as of January 1, 1998.<sup>1</sup>

Destec supports the Commission's directive to Affected Utilities contained within § R14-2-xxx7(A), and further recommends that the Commission look with a jaundiced eye on Affected Utility claims for stranded cost recovery. Destec does not believe that the established system of rate regulation constitutes a "guarantee" to utility shareholders of a return on investment -- nor does Destec believe that legal or economic justification exists for providing stranded cost recovery. There is no requirement that utility customers pay prices in excess of competitive alternatives -- simply to compensate shareholders for inefficient or uneconomic past investments. However, Destec does recognize that separate and different treatment is likely appropriate for certain "regulatory assets," including contractual obligations incurred pursuant to Commission order or review.

The regulatory process can deprive utilities of property rights by setting rates too low, which can amount to confiscation. However, in a situation where a utility plant is no longer as valuable as it was at one time due to proliferation of cheaper alternatives, it is not the duty of the regulatory process to make the utility whole. In rejecting a railway utility's claim to rates based on its cost of property, as opposed to the diminished value set by the competitive market, the United States Supreme Court was unsympathetic, stating:

The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.

<sup>1</sup> As contained within the Proposed Rule, and supported by Destec, buy-throughs should not be considered as meeting the requirements of Subsections R14-2-xxx4(A) or R14-2-xxx4(B).

*Market St. Ry. Co. v. Railroad Comm'n of State of California.*<sup>2</sup>

Further, as noted by Professor Robert Michaels:

“Economists have theorized extensively about competition in the 220 years since Adam Smith. In all that time, they never got around to inventing stranded investment, or preparing policies to deal with it.”

“There is no argument for stranded investment compensation that makes economic sense...”

**“If producers in an unregulated industry made stranded investment claims like electric utilities, nobody would take them seriously. It turns out that there is nothing special about electricity that warrants a different reaction. Stranded investment claims are an attempt to win from regulators and captive customers what utilities cannot win in a competitive market.”** [emphasis added]

“Even if stranded investment were theoretically sound, efficient implementation is so problematic that the world might be better off without it. Beyond the fact that it can only bring inefficiency, there is also no basis in equity for stranded investment recovery.”<sup>3</sup>

If, pragmatically (and politically) the Commission must ultimately allow stranded investment recovery by the utilities in Arizona, Destec supports a market-based approach to quantification of potential stranded investment. Such an approach is eminently preferable to attempts to quantify such costs using a lost revenue approach, or any attempt to administratively determine stranded investment. Because of the complexities in any administratively-determined stranded cost number (regardless of whether utilizing a lost revenue or valuation approach), only the market itself can accurately value what, if anything, is stranded.

In addition, Destec recommends that § R14-2-xxx7(D) be modified to **only** allow recovery of unmitigated stranded costs via a “non-bypassable access fee.” Such a fee provides the mechanism most likely to **not** distort the market-based purchase decisions of customers following the onset of customer

<sup>2</sup> 324 U.S. 548, 567, 65 S.Ct. 770, 780, 89 L.Ed.2d 1171, 1182 (1945).

<sup>3</sup> See Professor Robert Michaels, “Unused and Useless: The Strange Economics of Stranded Investment,” *Electricity Journal*, October 1994, pp. 13, 20, 21, and his letter reply, March 1995.

choice options. Consistent with the Commission's Proposed Rule § R14-2-xxx7(I), Destec supports a date-certain for the "sunset" of stranded cost recovery mechanisms.

Destec recommends that § R14-2-xxx10 be deleted in its entirety. In the absence of a Poolco, a forward market in electricity will develop once competition is underway. By allowing buyers and sellers to commit today to prices for future deliveries, a forward market shifts market price volatility risk from ratepayers to the market, and, at the same time, sends accurate signals about the need, or lack of need, for new investment. Further, by permitting investors to lock in on future costs and revenue streams, a futures market lowers the capital cost of new investment.

Poolco is the antithesis of a viable forward market. Typically, price determination in a market is concentrated among transactions calling for physical delivery in a future period. This is called a "forward market." Transactions calling for delivery during the most current delivery period (i.e., spot market) allocate what is left over -- the unplanned for. Prices determined in this "leftover" or "incremental" market are not the basis by which forward prices are determined. Poolco forces all transactions and price setting into this current market, thus preventing the development of a viable forward market. Without the future price transparency which arises from a forward market, there is no reasonable means of determining when new capacity is needed.

In the future, Destec sees that electricity will be delivered to the customer through a transmission and distribution system that will remain regulated, but will be available to all suppliers on a fair and equal basis. The cornerstone of this future is the transformation of existing, dispersed transmission assets into an ISO, charged with maintaining the integrity of Arizona's electricity supply system -- it may, however, be true that a regional ISO is more appropriate given the dynamics of the Southwestern transmission grid.<sup>4,5</sup> The ISO will have responsibility for network coordination, which involves

<sup>4</sup> Destec thanks the Competitive Power Coalition of New England for its vision as enunciated in *A Blueprint for a Competitive Electricity Supply System in New England*, issued January 5, 1996.

<sup>5</sup> Destec does not favor any form of "market-making" Poolco as implied in the Proposed Rule. An ISO does not entail "economic" dispatching or other market-based decision-making. Rather, an ISO maintains the integrity and safety of the system - to accommodate market activity.

operating the transmission network to accommodate transactions of market participants and for supplying those services required to maintain (or even enhance) system reliability.

The ISO will provide transmission delivery services at FERC-approved rates. The ISO will **not**, however, perform any role attempting to ensure economic efficiency through centralized dispatch of generating units. Instead, market participants, including generators, aggregators, and consumers, will nominate (schedule) transactions through the ISO which reflect their commercial interests for dispatching generation and load. The ISO will then schedule these transactions, consistent with maintenance of system reliability. A state Commission-regulated Disco will continue to provide physical distribution delivery services.

Ideally, the ISO will be a completely independent entity, having no corporate relationship with any market participant. The ISO may consist of the same personnel and use the same facilities that now operate as the transmission network(s) of the Arizona utilities.<sup>6</sup> However, unlike the network of today, market participants will have no authority over the ISO, and therefore, there may be no need for cumbersome voting and governance rules like those currently used by many North American Electric Reliability Councils (NERC). The ISO also will act in accordance with engineering criteria and operational protocols established by organizations such as the NERC and the Western System Coordinating Council (WSCC) and with good utility practice.<sup>7</sup>

It is Destec's vision that the ISO will own no physical assets; instead it will lease (or otherwise obtain a concession to) Arizona's utility transmission facilities from their current owners for a specified period of time, thereby acquiring operational control over the transmission network. Having leased the assets to the ISO, the owners would receive a return on their investment built into the lease agreement.

<sup>6</sup> If personnel from incumbent utilities are utilized to staff the ISO, codes of conduct which ensure independence of actions may be required. In any case, no common economic interest should exist between the ISO or its employees and any market participant.

<sup>7</sup> NERC and WSCC membership and governance rules may need to change further to reflect the increasing number and diversity of market participants.

As part of its role ensuring the reliability of the transmission network, the ISO will need to contract to call upon resources to provide ancillary services not directly provided by the market participants. Through these contracts the ISO will have **physical control** over the assets needed to maintain system reliability.

In addition, to ensure that no "rogues" exist, the ISO will monitor all transactions and any deviation from quantities nominated for transmission by market participants. For such deviations, the ISO would charge the appropriate market participant for the costs of using the transmission network, for the supply of ancillary services provided by the ISO, and for any balancing of supply and demand that remains at the end of a billing period.

The ISO, in conjunction with other interested parties, will perform the "planning function" and determine what new transmission facilities will be required in the region. Construction of these new transmission facilities could be competitively bid, privately undertaken, and leased back to the ISO. The ISO would also be responsible for maintaining the transmission network. The ISO would schedule maintenance of the transmission network in such a way to minimize total costs, while maintaining system reliability. Maintenance services could also be competitively bid.

Finally, our "vision" envisions a commercial market in kilowatt hours, where electricity will be bought and sold through *voluntary* forward and spot markets, rather than through a state-regulated, administratively-determined resource procurement process. The forward market for electricity, where market participants make their own commitments to buy or sell electricity for future delivery, would permit hedging against price and delivery uncertainty, and would allow discovery of future prices -- which is necessary to guide investment decisions in new supply or demand resources. The spot market would allow buyers to purchase electricity for near-term delivery in as short a time period as fifteen minutes, and, thus, ensure the instantaneous availability of electricity at prices that reflect real-time supply and demand.

With respect to §§ R14-2-xxx12, R14-2-xxx14, and R14-2-xxx15, Destec believes that the Commission's role in this brave new world is to ensure that electric consumers receive reliable, lowest-cost power. In the industry of the future, that role can best be filled by relying on the marketplace to discipline suppliers of services. Whatever reporting requirements are imposed on certificated suppliers/aggregators should conform with those adopted by the FERC for power marketers selling at market-based rates. Companies which are engaged in competitive enterprises should not be required to submit to "random" audits per § R14-2-xxx15(F), nor any reporting and/or accounting requirements which are not consistent with those required in the normal course of business. Entities competing in this new industry will likely be operating in several, if not numerous, other jurisdictions (including federal) and should not be subject to requirements specific to each state. Texas PUC Rule § 23.19 is attached as an example of a "conforming" reporting requirement; Destec recommends that a similar approach should be used in Arizona for companies certificated under the Proposed Rule.

Destec appreciates the effort expended by the Commission in drafting this Proposed Rule, and looks forward to participating in upcoming Workshops and discussions.

Respectfully submitted,

A handwritten signature in cursive script, reading "Barry N. P. Huddleston".

Barry N. P. Huddleston

- (a) Purpose. This section describes the procedure by which persons intending to do business in Texas as power marketers or exempt wholesale generators (EWGs) may register with the commission.
- (b) Definitions.
- (1) "Power marketer" means a person that becomes owner of electric energy in this state for the purpose of buying and selling the electric energy at wholesale; does not own generation, transmission, or distribution facilities in this state; and does not have a certificated service area.
  - (2) "Exempt wholesale generator" means a person that is engaged directly, or indirectly through one or more affiliates, exclusively in the business of owning, operating, or both owning and operating all or part of one or more facilities for the generation of electric energy and selling electric energy at wholesale in Texas and that does not own facilities for the transmission of electricity, other than essential interconnecting transmission facilities necessary to effect a sale of electric energy at wholesale.
- (c) Dates.
- (1) A power marketer or EWG becomes subject to this section on the date that it first buys or sells electric energy at wholesale in this state.
  - (2) No later than 30 days after the date it becomes subject to this section, each power marketer and EWG shall register with the commission or provide proof that it has registered with the Federal Energy Regulatory Commission (FERC) or been authorized by the FERC to sell electric energy at market-based rates.
- (d) Whether or not it has registered with the FERC, each power marketer or EWG shall
- (1) State the type of service to be provided in Texas; the address of the power marketer or EWG; the name, address, and telephone number of the person to whom communications should be addressed; the names and types of business of the owners (with percentage of ownership); and the names and addresses of each affiliate which is a public utility, or an affiliate of a public utility, under the jurisdiction of the commission.
  - (2) Describe any transmission facilities in this state, other than interconnection facilities, which any affiliate owns or controls.
  - (3) Identify each certificated service area for the retail sale of electric power in this state owned or controlled by any affiliate.
  - (4) Identify each affiliate which owns, controls, or operates a generator in this state or providing electric energy for sale in this state.
  - (5) Describe the location of each facility used to provide service. Power marketers should state the location of each office from which they carry on their business. EWGs should state the location of each generation facility providing electric energy for sale in Texas.
  - (6) Provide a copy of any applicable policy or procedure statement of the power marketer or EWG concerning sales to or purchases from affiliated Texas utilities.
  - (7) Submit a copy of all information supplied to the FERC in connection with filing or registration as a power marketer or EWG.
  - (8) Submit an affidavit by an authorized person that the registrant is a power marketer or EWG.
- (e) Each power marketer or EWG shall report any material change in the information provided in response to this section, within 30 days of the change.
- (f) The Secretary of the Commission shall maintain a list of power marketers and EWGs doing business in Texas.

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221 Adopted new section. Effective September 21, 1995. (TR 9/8/95)