



0000065646

BEFORE THE ARIZONA CORPORATION COMMISSION  
AZ CORP COMMISSION

Arizona Corporation Commission

DOCKETED

OCT 7 4 51 PM '96

OCT 7 1996

DOCUMENT CONTROL

RENZ D. JENNINGS  
CHAIRMAN  
MARCIA WEEKS  
COMMISSIONER  
CARL J. KUNASEK  
COMMISSIONER

DOCKETED BY *RT*

IN THE MATTER OF THE COMPETITION  
IN THE PROVISIONS OF ELECTRIC  
SERVICES THROUGHOUT THE STATE OF  
ARIZONA

*94*  
DOCKET NO. U-0000-~~95~~-165

EXCEPTIONS OF  
CITIZENS UTILITIES COMPANY

On October 1, 1996, the Arizona Corporation Commission ("Commission") Staff ("Staff") filed a proposed Order that would issue for publication and comment A.A.C. Article 16, rules to govern the introduction of retail electric competition in Arizona. Citizens Utilities Company ("Citizens" or "Company") has reviewed the proposed Order and submits the following exceptions:

Citizens is an enthusiastic advocate of rapidly transitioning the electric industry to an environment that is more competitive and driven by customer needs. However, the success of this transition, and the future of the electric industry in general, will be dependent on the rules that are drafted to guide utilities in this new environment. It is particularly troubling, therefore, that a limited comment period extending only through December 4, 1996, is contemplated to review the significant and far-reaching changes being proposed. Even within the limited time constraint, Citizens has been able to identify issues of constitutional law, policy direction, and practical implication, which will cause Staff's proposal to fail unless material revisions to the proposed rules are made.

First, the provisions regarding stranded cost recovery are of questionable legality. They also suffer from numerous deficiencies that conflict with one of the Commission's identified objectives in this docket, namely that the introduction of competition should limit the



1 generation assets. As an alternative, such entities would have the option of retaining all  
2 generating assets for entry into the power market. With the auction establishing an objective  
3 frame of reference for determining stranded costs,<sup>3</sup> Citizens' proposal envisions the  
4 refinancing of stranded costs through low-cost state obligation bonds. Finally, stranded costs  
5 would be recovered through a statewide Investment Recovery Fund Surcharge.

6  
7 **PROPOSED RULE A.A.C. R14-2-1607**

8 The provisions to address the recovery of stranded investment, as set forth in A.A.C.  
9 R14-2-1607, have been revised from Staff's informally circulated draft to address stranded  
10 costs arising from sources other than generating assets. The provisions nonetheless remain  
11 deficient in several respects.

12 **The proposed rule erroneously concludes that the Commission retains the**  
13 **discretion to disallow recovery of unmitigated Stranded Cost by Affected**  
14 **Utilities (Sections B and E).**

15 A.A.C. R14-2-1607(B) states that "the Commission may allow recovery of unmitigated  
16 Stranded Cost by Affected Utilities." Similarly, Section E suggests that stranded cost  
17 recovery would be determined on a utility-by-utility basis only after the Commission balanced  
18 numerous competing stockholder and customer interests.

19 Each of these sections proceeds on the faulty premise that the Commission has the  
20 discretion to disallow prudently incurred costs. Instead, the well-settled standard is that the  
21 Commission must allow utilities a reasonable opportunity to recover prudent investments and  
22 expenses associated with the provision of utility service. Disallowance of these investments  
23 and expenses is not only unconstitutional, but it also violates the regulatory compact between  
24 regulators and utilities.

25 With respect to the unconstitutional nature of any stranded cost recovery disallowance,

26  

---

<sup>3</sup> The difference between the proceeds from the auction and the total net book value, plus the difference between original purchase power contract prices and prices obtained in the auction, would constitute stranded costs for generation and purchased power contracts.

1 such action would violate the Fifth Amendment to the U.S. Constitution's proscription against  
2 a governmental taking of private property without just compensation, and cases decided  
3 thereunder. While the standard traditionally applied is the effect of regulation and not the  
4 method employed, a regulatory structure that precludes a utility from recovering a necessary  
5 cost of doing business is indeed a taking.

6 Disallowance of stranded costs would also violate the regulatory compact between the  
7 regulator and the utility. Utilities have made expenditures and investments pursuant to their  
8 statutory and regulatory obligations with the express understanding that they would be  
9 allowed to recover them and earn a reasonable return on them, provided they were prudent.<sup>4</sup>  
10 Now that the costs have already been incurred for the benefit of the public, the proposed  
11 rules would have the effect of changing the terms of the bargain by depriving utilities (and  
12 their investors) of the ability to recoup their costs. Well-settled precedent has established  
13 that the Commission cannot renege on its end of the bargain after the utilities have fulfilled  
14 their commitment.

15 It is not the intent of these comments to present a full analysis of the legal arguments  
16 underlying the above points. Should the need arise, comments at a later stage of this  
17 proceeding will discuss the legal impediments to the discretionary balancing approach to  
18 stranded cost recovery set forth in the proposed rules. For the purposes of these exceptions,  
19 the Company merely intends to place the Commission on notice that any proposed rules that  
20 stray from the full cost recovery standard described above are legally infirm. Finally, any  
21 rulemaking that provides less than full recovery of stranded cost is assured to delay any  
22 benefit of competition due to legal actions that would be initiated by utility investors and the  
23 utility industry to block such rules.

24  
25  
26  

---

<sup>4</sup> Proposed rule A.A.C. R14-2-1601(8), which sets forth definitions for the Article, expressly recognizes that in order to qualify as "Stranded Investment", the expenditure must be prudently incurred.

1        **The proposed rules would base the calculation of stranded costs on**  
2        **estimates, instead of allowing for the auction process proposed by**  
3        **Citizens (Section C).**

4        In Section C, the proposed rules would rely on estimates to calculate stranded costs.  
5        While there is language in the rules suggesting a degree of precision in these estimates  
6        (namely, "fully supported by analyses and by records of market transactions undertaken by  
7        willing buyers and willing sellers"), the proposal would require utilities, other participants and  
8        ultimately the Commission to engage in speculation about a component worth billions of  
9        dollars in Arizona.<sup>5</sup> So that there can be no misunderstanding, Citizens is not reluctant to  
10       project its level of investments or costs because it retains some measure of control in this  
11       area. Predicting stranded costs is an entirely different matter, since it would require utilities  
12       to speculate about the market price of energy and capacity, two components over which they  
13       exert no measurable control.

14       To avoid this shortcoming, Citizens in its June 28, 1996 filing proposed an auction  
15       process to determine in a far more precise manner the level of stranded costs. Under  
16       Citizens' proposal, there could be no dispute about the amount of stranded costs because  
17       the approach would be market-based (rather than relying on very limited market transactions  
18       to support estimates ultimately determined by an administrative agency, as the proposed  
19       rules currently read). Accordingly, the proposed rules should be revised so that utilities will  
20       not be forced to prognosticate market prices. The rules should incorporate a more reliable  
21       method of determining market value, such as that proposed by Citizens.

22        **The mechanism in the proposed rules to recover stranded cost is applied**  
23        **to a limited customer base instead of being applied to all customers**  
24        **statewide.**

25        Citizens and Staff both recognize that a mechanism needs to be put in place to  
26

---

<sup>5</sup> Under the framework contained in the draft proposal, there would be an insufficient market for the kinds of transactions Staff foresees for willing buyers and sellers.

1 recover stranded costs. Citizens and Staff differ, however, on the customer base to which  
2 such a mechanism would be applied. The Staff proposal would limit the universe of potential  
3 contributors to "customer purchases made in the competitive market using the provisions of  
4 this Article." Conversely, Citizens proposes "a state mandated, non-bypassable [Investment  
5 Recovery Fund] Surcharge collected at a dollars per kWh basis on all distribution company  
6 ("DISTCO") deliveries as a separate line item on the bill."<sup>6</sup>

7 Citizens believes that stranded cost recovery from the statewide customer base is  
8 superior to the limited universe of customers described in the draft rules. First, statewide  
9 recovery "recognizes that the stranded costs are the result of the regulatory compact and that  
10 all investments made by utilities in the past were approved by state regulators as being the  
11 most appropriate option for the state at the time the decisions were made."<sup>7</sup>

12 Second, spreading the cost across all customers statewide would lessen the burden  
13 on those who would bear the brunt of the charge under the draft rule. If stranded cost  
14 recovery follows Staff's proposal, there is a very real concern that it would be detrimental to  
15 smaller customers and those with low load factors because they may not be attractive to  
16 serve in a competitive market.<sup>8</sup>

17 Third, determining stranded costs at one time (as Citizens has proposed through the  
18 auction process) and then spreading those costs across all customers is a fairer, simpler and  
19 more accurate approach than the continuous updating of the stranded cost calculation, as  
20 proposed in the rules.

21 Finally, if the proposed rules became effective as currently written, they would have  
22 a chilling effect on competition by serving as a substantial market barrier to those seeking  
23 to obtain the benefits of competition.

---

24  
25 <sup>6</sup> Citizens' June 28, 1996 Comments, p. 21 (emphasis added).

26 <sup>7</sup> Id.

<sup>8</sup> Citizens believes that small customers and other "undesirables" should have the right to select their supplier, and not vice versa.

## THE NEED FOR REDUCED REGULATION

### CITIZENS' POSITION

In offering its June 1996 proposal, Citizens noted that it could not predict whether the costs associated with higher rates of return related to a free market would be less than the costs under the current regulated electric utility environment. The Company did conclude, however, that without reduced regulatory burdens, the savings projected by advocates of competition could not be realized:

[F]uture benefits will not be realized unless the present degree of regulation is decreased or the regulatory process is streamlined. If the overall regulatory and compliance burden placed on the future portions of the industry - both regulated and unregulated - equals or exceeds the present level, then many of the benefits of restructuring will be lost.<sup>9</sup>

### THE PROPOSED RULES

Instead of relaxing or eliminating altogether regulatory oversight over a competitive electric marketplace, the proposed rules retain for the Commission virtually the same degree of control that exists today. Perhaps the language in A.A.C. R14-2-16033(E)(1) best underscores the concern Citizens has in this area. That provision, which describes one of the obligations of an electric service provider holding a Certificate of Convenience and Necessity, states that such a company "shall comply with all Commission rules, orders, and other requirements relevant to the electric service and relevant to resource planning."

It is clear from that excerpt that if the proposed rules were adopted, the Commission would continue to be involved in every facet of the operations of an Affected Utility as well as the operation of other market participants, including even resource planning. The point is that there should be fewer and fewer "rules, orders and other requirements" as competition takes hold. Moreover, if competition is to flourish, the Commission must be prepared to stand back and let the market work.

The reference to continued Commission oversight of electric resource planning is

---

<sup>9</sup> Citizens' June 28, 1996 Comments, pp. 4-5.

1 another troubling matter. Under Citizens' proposal, DISTCOs would have the obligation to  
2 connect, not the obligation to secure supply. In other words, DISTCOs would serve as the  
3 conduit for the supply obtained thorough a retail company (RETAILCO) or a generation  
4 company (GENCO). If a customer fails to obtain the requisite amount of power from one of  
5 those two sources, the DISTCO's only obligation would be to obtain whatever power may be  
6 available at the spot market price.

7 In Citizens' view, resource planning should be a function controlled by the competitive  
8 markets. The market would dictate how much generation should be built and the mix of  
9 generation alternatives. The risk/reward relationship of building new generation would be  
10 governed by competitive market forces. Continued regulatory oversight of the resource  
11 planning process has no place in a competitive market and raises the possibility of above-  
12 market costs being placed on the back of electric utilities at a time when there is intense  
13 pressure to reduce their exposure to stranded costs.<sup>10</sup>

14 Along the same lines, the proposed rules include a detailed set of regulations in A.A.C.  
15 R14-2-1609 relating to the Solar Portfolio Standard. That provision would establish a  
16 regulatory requirement that Electric Service Providers in Arizona must derive at least 1/2%  
17 of the total retail energy sold competitively from new solar sources by January 1, 1999, with  
18 the total increased to at least 1% by January 1, 2002. Reporting requirements and penalty  
19 provisions are also included. Citizens believes that the competitive markets should dictate  
20 the extent to which a company's generation portfolio would be devoted to solar energy. As  
21 stated in its proposal, Citizens believes that such programs should be funded by taxes or a  
22 statewide wires charge instead of appearing as a component of an electric bill.

23 A.A.C. R14-2-1612 on rates poses another concern. While market-determined rates  
24 for competitive services are deemed to be just and reasonable according to A.A.C. R14-2-  
25 1612(A), the provisions of that rule require each utility to file tariffs with maximum rates for  
26 those services. It also establishes a minimum rate as the marginal cost. The inconsistency

---

<sup>10</sup> Citizens' June 28, 1996 Comments, p. 5.

1 between the provisions is apparent and underscores the problems of "regulated competition."  
2 If market-based rates are to be the standard, no artificial cap or rate maximum or minimum  
3 should be imposed by the regulator. Viewed in another perspective, the imposition of a rate  
4 maximum is tantamount to a vote of no confidence in competitive markets and suggests that  
5 electric industry restructuring in Arizona is doomed to failure. It is not reasonable to subject  
6 power sellers to the risks of competition while depriving them of market-based rewards for  
7 being efficient.

8 There are numerous other instances in the proposed rules of a pervasive regulatory  
9 presence. These include: (1) reporting requirements in A.A.C. R14-2-1603(E)(3) and R14-2-  
10 1614; (2) accounting requirements in A.A.C. R14-2-1603(E)(2); (3) working groups overseeing  
11 reliability and safety issues in A.A.C. R14-2-1613; and (4) administrative requirements in  
12 A.A.C. R14-2-1615. While some of these rules may be needed to manage the transition to  
13 a competitive market, the general tone of the proposal is that the role of the regulator will be  
14 significantly expanded well after so-called competition takes hold. For those looking for signs  
15 of streamlined regulation and regulatory forbearance, the proposed rules fall far short of the  
16 mark.

## 17 MISCELLANEOUS MATTERS

### 18 JURISDICTION

19 Any electric industry restructuring proposal must recognize the jurisdictional limitations  
20 of the states under our federal system. Through the enactment of the Federal Power Act,  
21 Congress established a comprehensive legislative scheme for the regulation of electric  
22 energy transmission and wholesale power sales in interstate commerce, and conferred upon  
23 FERC exclusive jurisdiction over such transmission and sales. Since the transmission  
24 facilities of electric utilities in Arizona are connected to the interstate grid, all transmission  
25 that uses those facilities is subject to exclusive federal regulation under the Federal Power  
26 Act.

Based upon the foregoing, pooling and dispatch arrangements for transmission and

1 between the provisions is apparent and underscores the problems of "regulated competition."  
2 If market-based rates are to be the standard, no artificial cap or rate maximum or minimum  
3 should be imposed by the regulator. Viewed in another perspective, the imposition of a rate  
4 maximum is tantamount to a vote of no confidence in competitive markets and suggests that  
5 electric industry restructuring in Arizona is doomed to failure. It is not reasonable to subject  
6 power sellers to the risks of competition while depriving them of market-based rewards for  
7 being efficient.

8 There are numerous other instances in the proposed rules of a pervasive regulatory  
9 presence. These include: (1) reporting requirements in A.A.C. R14-2-1603(E)(3) and R14-2-  
10 1614; (2) accounting requirements in A.A.C. R14-2-1603(E)(2); (3) working groups overseeing  
11 reliability and safety issues in A.A.C. R14-2-1613; and (4) administrative requirements in  
12 A.A.C. R14-2-1615. While some of these rules may be needed to manage the transition to  
13 a competitive market, the general tone of the proposal is that the role of the regulator will be  
14 significantly expanded well after so-called competition takes hold. For those looking for signs  
15 of streamlined regulation and regulatory forbearance, the proposed rules fall far short of the  
16 mark.

## 17 MISCELLANEOUS MATTERS

### 18 JURISDICTION

19 Any electric industry restructuring proposal must recognize the jurisdictional limitations  
20 of the states under our federal system. Through the enactment of the Federal Power Act,  
21 Congress established a comprehensive legislative scheme for the regulation of electric  
22 energy transmission and wholesale power sales in interstate commerce, and conferred upon  
23 FERC exclusive jurisdiction over such transmission and sales. Since the transmission  
24 facilities of electric utilities in Arizona are connected to the interstate grid, all transmission  
25 that uses those facilities is subject to exclusive federal regulation under the Federal Power  
26 Act.

1 Based upon the foregoing, pooling and dispatch arrangements for transmission and  
2 generation of electricity are also subject to FERC jurisdiction. While states may engage in  
3 collaborative efforts to assist the decision maker with regard to pooling and dispatch  
4 arrangements, the ultimate determination on such matters rests exclusively with the FERC.  
5 Sections A and C of A.A.C. R14-2-1610, Pooling of Generation and Centralized Dispatch of  
6 Generation or Transmission, are consistent with the federal scheme because they merely  
7 commit the Commission to "conduct an inquiry" and "work with other entities" on pooling and  
8 centralized dispatch issues.

9 If Section B were enacted, however, the Commission could be exceeding its  
10 jurisdictional authority. That provision would empower the Commission to "support  
11 development of spot market or independent system operator(s) for the transmission system."  
12 FERC has jurisdiction over the transmission system and, depending on what is meant by the  
13 vague phrase that would permit the Commission to "support development", action by the  
14 Commission could improperly intrude on federal authority. The proposed rules should be  
15 revised to remove this provision.

### 16 17 **LEVEL PLAYING FIELD**

18 The scheme adopted by the proposed rules would be more onerous for Affected  
19 Utilities, such as Citizens, than for other market participants. For instance, A.A.C. R14-2-  
20 1606 contains numerous requirements regarding services to be made available by Affected  
21 Utilities. No corresponding provision can be found for other market participants. In addition,  
22 the Solar Portfolio Standard is added to existing renewable requirements for Affected Utilities  
23 only.

24 If Affected Utilities are to compete effectively, the new industry framework should not  
25 be more burdensome for them than it is for their competitors. The benefits of competition  
26 cannot be fully obtained unless a level playing field is maintained for all market participants,

1 and that level playing field must be apparent to the customer who would purchase energy in  
2 such a market. The proposed rules should be revised accordingly.

3  
4 **DUPLICATION OF EFFORT**

5 A.A.C. R14-2-1613(N) proposes that the Commission establish, by separate order, a  
6 working group to monitor and review system reliability and safety. Staff's proposal would add  
7 a redundant layer of regulatory oversight for both system reliability and safety.

8 The adequacy and reliability of the interconnected transmission system is within the  
9 purview of the Western Systems Coordination Council ("WSCC") and the National Electric  
10 Reliability Council ("NERC"). Committees of technical and operational experts have already  
11 been formed and are presently functioning to establish appropriate planning and operating  
12 criteria for interconnected system operations and to analyze all significant problems that may  
13 arise. Annual reports are currently being provided to the Department of Energy through the  
14 NERC for each of the seven reliability regions, including the WSCC.

15 Further, the existing Commission rules require electric systems to be constructed in  
16 accordance with the National Electric Safety Code, the recognized standard throughout the  
17 country. A network of industry experts continually reviews and periodically revises and  
18 updates this standard to address changing needs for safeguarding the public. Other existing  
19 federal and state statutes already cover employee safety.

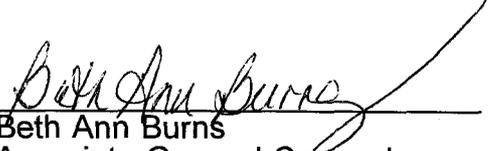
20 The addition of yet another working group, chaired by a Commission staff person, is  
21 not expected to provide additional value and will certainly increase regulatory cost.  
22 Therefore, A.A.C. R14-2-1613(N) should be deleted.

23  
24 **CONCLUSION**

25 While Citizens is an enthusiastic advocate of rapidly transitioning the electric industry  
26 to a competitive environment, the proposed rules raise serious legal, policy, and practical

1 issues, as outlined herein. Citizens urges the Commission to carefully consider the true  
2 significance of restructuring the electric industry in Arizona and, at a minimum, hold an  
3 evidentiary hearing in this matter and revise the rules in accordance with these exceptions  
4 so that the undertaking will be successful.

5  
6 Respectfully submitted,

7  
8   
9 Beth Ann Burns  
10 Associate General Counsel  
11 Citizens Utilities Company  
12 2901 N. Central Avenue  
13 Suite 1660  
14 Phoenix, Arizona 85012

15  
16 Original and ten copies of the foregoing  
17 filed this October 7, 1996 with:

18 Docket Control Division  
19 Arizona Corporation Commission  
20 1200 West Washington Street  
21 Phoenix, Arizona 85007

22  
23 Copies of the foregoing mailed or hand  
24 delivered this October 7, 1996 to:

25 Jerry Rudibaugh  
26 Chief Hearing Officer  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, Arizona 85007

Gary Yaquinto  
Director, Utilities Division  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, Arizona 85007

Paul Bullis  
Chief Counsel  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, Arizona 85007

  
Jane Allen  
Administrative Assistant