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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

IN THE MATTER OF THE FILING OF THE STRANDED COST OPTIONS AND IMPLEMENTATION PLAN OF CITIZENS UTILITIES COMPANY	DOCKET NO. E-01032C-98-0474
IN THE MATTER OF THE FILING BY CITIZENS UTILITIES COMPANY OF UNBUNDLED AND STANDARD OFFER SERVICE TARIFFS PURSUANT TO A.A.C. R14-2-1606.	DOCKET NO. E-01032C-97-0774
IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. RE-00000C-94-0165

NOTICE OF FILING

Staff of the Arizona Corporation Commission hereby files the testimony of Lee Smith in the above-mentioned dockets.

RESPECTFULLY SUBMITTED this 20th day of June 2000.

Christopher C. Kempley
Janice Alward
Attorneys, Legal Division
Arizona Corporation Commission
(602) 542-3402

Original and ten copies of
the foregoing document filed
this 20th day of June, 2000 with:

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Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

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Copy of the foregoing mailed
this 20th day of June, 2000 to:

Craig Marks
Citizens Utilities Company
2901 North Central Avenue, Ste 1660
Phoenix, Arizona 85012

Scott Wakefield
RUCO
2828 N. Central Ave., Suite 1200
Phoenix, Arizona 85004

Copy of the foregoing will be
mailed the 21st day of June, 2000 to:

All Parties Of Record in
Docket RE-00000C-94-0165

Marvin Lustiger
5105 North 79th Place
Scottsdale, Arizona 85250-7237

By: _____

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

IN THE MATTER OF THE APPLICATION OF CITIZENS UTILITIES COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY.	)	DOCKET NO. E-01032C-98-0474
IN THE MATTER OF THE APPLICATION OF CITIZENS UTILITIES COMPANY OF UNBUNDLED AND STANDARD OFFER SERVICE TARIFFS PURSUANT TO A.A.C. R14-2-1601 ET SEQ.	)	DOCKET NO. E-01032C-97-0774
IN THE MATTER OF COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA	)	DOCKET NO. RE-00000C-94-0165

DIRECT

TESTIMONY

OF

LEE SMITH

CONSULTANT

LA CAPRA ASSOCIATES
BOSTON, MASSACHUSETTS

June 20, 2000

TABLE OF CONTENTS

Page

Retail Access Provisions 2

Stranded Cost Mitigation and Rate Reductions 2

Rate Unbundling in the Settlement 4

Other Transition Costs 8

Q. What is your name and business address?

A. My name is Lee Smith, and I work for La Capra Associates, 333 Washington Street, Boston, Massachusetts.

Q. On whose behalf are you testifying in this proceeding?

A. I am testifying on behalf of the Arizona Corporation Commission ("Commission") Staff.

Q. Please describe your background and experience.

A. I am a Managing Consultant and Senior Economist at La Capra Associates. I have been with this energy planning and regulatory economics firm for 16 years. Prior to my employment at La Capra Associates, I was Director of Rates and Research, in charge of gas, electric, and water rates, at the Massachusetts Department of Public Utilities. Prior to that period, I taught economics at the college level. My resume is attached as Exhibit LS-1.

Q. What is the purpose of your testimony?

A. I am testifying in support of the Settlement signed by Citizens, the ACC Staff, and the Residential Utility Consumer Office ("RUCO"). My testimony will discuss the opening of retail access, the stranded costs and the mitigation of stranded costs, rate unbundling provisions, and treatment of potential other transition costs.

Q. What does the proposed Settlement accomplish?

A. All customers will receive direct retail access to competitive services. All customers will pay a CTC that will ensure that the Company collects its power supply costs, and also ensure that retail access will not have any detrimental impact on customers who continue to purchase from the Company. Customers will receive unbundled bills that inform customers as to how much their bill will decrease (i.e. their shopping credit) if they choose an alternative supplier.

I. RETAIL ACCESS PROVISIONS

Q. Does the Settlement provide Citizens' retail customers with open access in a timely manner?

A. Yes. Provisions two through four of the Settlement provide for open access to all customers, without phase-in. If an Order is issued before September 1, 2000, the Citizens' system will be open for retail access by December 1, 2000. If an Order is issued after September 1, 2000, but before September 30, 2000, Citizens will attempt to open access within four months of the final Order in this case, if that order does not occur before. If the Settlement has not been approved by September 30, 2000, Citizens has the right to withdraw from the agreement.

II. STRANDED COSTS MITIGATION AND RATE REDUCTIONS

Q. Since the Company owns almost no generating assets, why may it have generation transition costs, or stranded costs?

A. Stranded generation costs are the difference between embedded costs and avoided costs. The Company is served by an all requirements power supply contract with APS. The majority of power is supplied through Schedule A, which contains a large fixed demand component. If load decreases due to retail access, the Company is unable to sell these kWhs; it simply does not purchase them from APS. It also does not avoid this demand charge. Embedded power costs, which reflect the demand charge, will generally be higher than avoided costs, which currently do not reflect any avoidance of demand costs. Unless there is a CTC, the only way that the Company could recover this demand charge would be through increasing the rates to other customers.

Q. Are the Company's stranded costs determined entirely by this demand charge?

A. No. The situation is actually more complicated than that. CUC is supplied with power from APS through three separate schedules. The pricing terms vary dramatically. Schedule A, as described above, contains a large demand component and a relatively low

energy charge. If load decreases due to retail access, Citizens' only avoids energy charges on Schedule A, so the demand cost per kWh sold increases. However, a number of other changes to power purchasing occur, some of which have offsetting effects. The amount of power which can be purchased at the off-peak price of Schedule A changes; the amount of power which is purchased on Schedules B and C, which have low or avoidable demand costs and generally high energy prices, will also decrease. As a result, the amount of costs that Citizens will avoid depends on how much load chooses alternative suppliers, and on the shape of that load.

Q. Does the Settlement reflect both mitigation of stranded costs and rate reductions to customers?

A. Yes. Due to two renegotiations of its power supply contract with APS, stranded costs have been greatly reduced from the Company's initial filing. The Company has already decreased its rates once to reflect the effect of the first renegotiation of its power supply contract with Arizona Public Service. Also, as noted in Provision 6 of the Settlement there has been a second renegotiation of the contract with APS that provides additional mitigation. After January 1, 2002 Citizens will be able to reduce its contract demand obligation to reflect lost load. This renegotiation may bring about a further power cost reduction which will be passed through to customers.

Q. Will there still be some "stranded costs" even after the Company is allowed to reduce its demand?

A. Yes. The reduction in the demand obligation may occur after the Company's generation load has decreased. This means that during each year as additional load leaves, the capacity obligation will be higher than the actual load until the next time (May 1 of the following year) that the demand obligation can be reduced.

. . .

. . .

Also, from the inception of retail access until May 1, 2002, in order to keep existing customers whole, departing customers must pay a CTC that reflects the difference between their original charge and the costs avoided as they leave. If the demand charge were the only cost component that changes, the CTC would equal the original demand cost divided by the full load.

After May 1, 2002, there would be no further capacity cost obligation associated with departing customers who had been counted when the capacity obligation for the next year was determined. However there might be some excess capacity cost obligation associated with customers who left after January 1 but before May 1, and if additional customers left from May 1 through December 31, they would also create new excess capacity costs.

Q. How does the Settlement provide for the collection of stranded costs?

A. A CTC shall be computed, for each year of the transition period, that will provide for recovery of the difference between generation revenues that would have been paid by departing customers and the costs that will be avoided as load departs. This provision ensures that Standard Offer customers will not pay more than they would have absent retail choice.

III. RATE UNBUNDLING IN THE SETTLEMENT

Q. Does the Settlement result in rates that will inform customers of what they pay the utility for each service, so they can compare different providers?

A. Yes. The Company has previously computed distribution, metering and billing, system benefits, and generation rates. The current generation component will be further divided into a transmission component, a CTC, and a shopping credit. Class CTCs should be set for each class equal to the difference between the embedded generation rate (not including transmission) and the avoided cost.

Q. Given the restructuring of the contract with APS, why does the CTC need to reflect the power contract interactions you described above?

A. Because the capacity obligation cannot be reduced until 2002, there will be stranded costs at least until that time. Any load that leaves before this time will result in changes in average power costs because of the demand charge and differential reductions on the various power schedules. Moreover, it does not appear that the demand obligation will be reduced prospectively. Therefore, each year there may be some stranded costs associated with load that chooses alternative suppliers during the year.

Q. What are the Generation Transition Costs ("GTC") defined in the Settlement?

A. The GTC, according to Provision 7a, is the "positive difference between generation rate revenues that would have been paid ...and the costs that will be avoided as a result of this load loss." To determine how many costs it will avoid if a certain amount of load chooses an alternative supplier, the Company will need to perform a simulated dispatch of their full load and also of their load decremented by the load that they expect will choose an alternative supplier.

Q. How will the Company calculate its Competitive Transition Charges ("CTCs") and the shopping credits?

A. The estimated GTC will be divided by the amount of projected lost load. This same CTC will then be applied to all customers. This method of unbundling the generation component of rates will collect the Company's stranded cost and at the same time prevent rate changes to Standard Offer customers. The shopping credit will be the difference between the full generation rate and the CTC. Thus the shopping credits are based on the Company's avoided cost. For individual classes, the shopping credits should be determined by adjusting the system average avoided cost to reflect differences in class load factor.

...

The shopping credit will differ for each class. However, I expect the average shopping credit at the retail level to be about 3.8 cents. The Company has estimated its avoided costs at about 3.6 cents, based on generation level sales. This needs to be increased by line losses to be at the retail customer level.

Q. This method of establishing shopping credits is unique to Citizens. Please explain why you find it appropriate?

A. The method is consistent with the cost causation of stranded generation costs for Citizens. Generation owning utilities' stranded costs should be measured relative to the market price of generation; this represents the price at which they can sell power that is no longer purchased by their distribution customers. As noted above, Citizens cannot sell power that is no longer purchased by its distribution customers; its stranded costs should be measured by comparing its loss in revenues to its avoided costs.

C. Reconciliation

Q. What happens if the percentage of load that chooses an alternative supplier is different from that projected?

A. In this case, the actual cost for the decremented load, and the cost decrement per kWh, will be different from that projected. The actual decremented cost per kWh may also vary from the projection if the load choosing alternative suppliers had a load shape that was different from the average load.

Q. What will the impact be of these errors in projection?

A. They could result in the Company under or overcollecting. They could also result in Standard Offer customers receiving increases or decreases in rates as a result of retail access.

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. . .

Q. If the CTC has over or undercollected the annual GTC, how will this be addressed?

A. There is a potential for considerable variability between the projected GTC and the after-the fact computation of the correct GTC. It will vary because of the amount of load that leaves, the shape of that load, and changes in APS' charges. This is the rationale for allowing a reconciliation mechanism. However, if the GTC could increase significantly the potential for an increase in the CTC could have a very chilling impact on competition.

Q. Does the Settlement place any bounds on changes in the CTC due to reconciliation?

A. Yes. Provision 7 b limits the annual increase to the CTC to 2 mills per kWh. If the reconciliation amount would cause the CTC to increase by more than this amount, some of that amount must remain in the reconciliation account, with carrying charges. Provision 7 g allows the parties to accelerate recovery of the CTC balance if the amount in the account exceeds $3 million and is expected to continue growing. This seems to be a very unlikely eventuality, but both Company and ratepayers are protected by this provision.

D. PPFAC

Q. The Company's rates include an energy adjustment clause. How and why does the Settlement propose to modify this clause?

A. The Settlement provides for modification of the PPFAC, to ensure that Standard Offer customers are not affected by retail access. The CTC and the energy adjustment clause could lead to the double collection of some costs if some accommodation is not made. Without modification, the energy adjustment clause would increase to collect all power supply costs, while the Company will be collecting revenue from retail access customers intended to prevent standard offer customers from paying higher power costs because of retail access. WAPA transmission charges are removed from the PPFAC and put into a separate and transparent rate component. Finally, the revised PPFAC will be adjusted each year simultaneously with the annual CTC adjustment. Currently the factor is

adjusted only when the balance of under or overcollections reaches $2.6 million. This could result in the PPFAC changing at a different time than the CTC, and would result in an inconsistency between the CTC and Standard Offer rates.

Q. What do you recommend regarding the PPFAC?

A. The clause should be modified to reflect the contribution to power costs that will result from CTC revenues. These should be subtracted from total power costs to determine the amount that must be paid through the PPFAC.

Q. Does this mean that the power supply costs paid by standard offer customers will not change at all?

A. No, it does not. For instance, if APS' energy charges increase because of an increase in fuel cost, the energy adjustment clause would increase. This might, in turn, have an impact on the CTC, as both embedded costs and avoided costs would increase. Standard offer customers would, however, be protected from rate increases due to a change in load.

IV. OTHER ISSUES AND OTHER TRANSITION COSTS

Q. Has the Company requested an allowance for transition costs other than costs created by the APS contract?

A. Yes. The Settlement describes the establishment of a deferred account, a Competitive Transition Deferral Account ("CTDA"), to accumulate costs associated with the transition to competition. These could include new systems and process necessary for retail access, stranded costs associated with the competitive provision of metering and billing services, consumer education, possibly divestiture of the APS Power Service Agreement, participation with the Arizona Independent System Administrator, and carrying charges on deferred balances in the CTDA. Provision 11 and Appendix A of the Settlement limits deferred transition costs to those that have been rate-of-return tested. Collection of any such transition costs is dependent on the Company demonstrating that

failure to collect them would lead to an underecovery of costs. In other words, if the Company was making more than its allowed rate of return, due to either revenue growth or cost reductions, it would not be allowed to defer these costs for separate collection.

Q. How would these costs be collected?

A. The parties agree to support Citizens' recovery of legitimate, prudently-incurred transition costs. Transition costs will not be included in rates until the Commission has determined that they meet the appropriate criteria.

Q. Are there any other issues associated with regulatory assets or transition costs?

A. Yes. The Company has deferred DSM expenses that it proposes to recover. The amortization amount currently allowed in rates is only sufficient to cover carrying charges on this amount. In order to avoid an increase in rates, the Company will utilize the refund associated with the renegotiation of the APS contract toward a reduction of the outstanding DSM balance, and retain the current amortization amount in rates (Provision 9). The lower principal amount will mean that the same amount of amortization will allow recovery of the DSM balance.

Q. Please describe Provisions 12 and 13.

A. These provisions address the difficulties associated with divesting the APS contract and with acquiring Standard Offer generation through competitive purchase. It is expected that divesting the APS contract may increase stranded costs. With the revisions to the APS contract, it is unlikely that customers will be better off because of divestiture. Provision 12 provides the Company with latitude regarding the divestiture of the APS contract. Likewise, if as a result of a competitive auction, Citizens choose a supplier other than APS for Standard Offer generation, it would continue to be obligated to pay demand charges to APS. Therefore, Provision 13 requests a waiver of the requirement for competitive market purchase of Standard Offer generation.

Q. What are your conclusions?

A. This Settlement is consistent with the Electric Competition rules. It will open up retail access and provide benefits to ratepayers. I recommend its approval.

Q. Does this complete your direct testimony?

A. Yes, it does.