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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 First Set of Comments on the Commission's Proposed Rule Regarding Retail Electric Competition.

RESPECTFULLY SUBMITTED this 7th day of November, 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 sent via Federal Express this 7th day of November, 1996 to:

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

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BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

FIRST SET OF COMMENTS ON PROPOSED RULE

REGARDING RETAIL ELECTRIC COMPETITION

On Behalf of

TUCSON ELECTRIC POWER COMPANY

November 8, 1996

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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 Company ("TEP" or "Company") hereby submits its first set of comments to the Commission's Proposed Rule Regarding Retail Electric Competition ("Rule") as follows:

I. INTRODUCTION AND TEP'S ALTERNATE PROPOSAL

A. Introduction

TEP believes that competition is the right path and that rules are necessary to make it a reality in Arizona. However, the Commission has not taken sufficient time to develop the Rule and to determine its potential impact to the state, Arizona utilities, consumers and shareholders. Rather than merely criticize the Commission's efforts, or the Rule itself, TEP has prepared comments that explain its position and proposes an alternative proposal for the adoption of rules that will transition the electric industry in Arizona to a competitive marketplace.

The first phase of this rulemaking process identified major issues that needed to be addressed and elicited views on how retail competition should be introduced. The second phase should provide for the Rule to be carefully studied to resolve the legal, financial, operational reliability, pricing and regulatory problems presented by the Rule. A series of comments should be submitted thereon 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 the appropriate legislative and declaratory relief that is required to proceed. It is only after this second phase is completed that the Rule should be adopted.

As currently drafted, the Rule unnecessarily leaves major financial, legal and operational issues unresolved until some future time. By following the rulemaking process that has been followed traditionally in Arizona, as well as in other jurisdictions, the Rule will, when adopted, already have resolved these issues such that retail electric competition may be brought to Arizona quickly and efficiently.

B. Alternate Proposal

In order to get this rulemaking proceeding back on the right track now and still meet the deadlines in the Rule, TEP proposes that the Commission, rather than adopting the Rule at this time, issue a Statement of Policy ("Policy") that contains all of the substantive provisions of the Rule including the various time frames and deadlines stated therein. The Policy should require that all workshops and inquiries be held in the first half of 1997 with definitive rules proposed in the third quarter of 1997 for adoption before the end of that year. Tariffs could be filed by the end of the first quarter of 1998 and competition could commence in 1999 as currently contemplated.

This process is a more reasonable and comprehensive approach than implementing the Rule at this time (when all who are affected thereby realize that it will have to be changed later). It has the features of: (i) putting the utilities and public on notice that the Commission will implement competition; (ii) permitting Staff and the interested parties to attempt resolutions of major issues of concern; (iii) maintaining the original deadlines established by the Commission in the Rule; and (iv) avoiding the delay in implementation of the Rule occasioned by litigation over its terms and the manner in which it was adopted. TEP, therefore, respectfully requests that the Commission reject the Rule at this time, issue the Policy and begin workshops as soon as practicable.

C. 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. Comments to the draft rule were submitted on September 12, 1996 and Staff conducted a one day workshop on September 18, 1996 to discuss the comments. Less than two weeks later, Staff submitted the Rule to the Commission. The Commission authorized that a Notice of Proposed Rulemaking be forwarded to the Secretary of State on October 9, 1996. By Procedural Order dated October 11, 1996, the Commission *requested* that comments on the Rule be filed by November 8, 1996 and that any rebuttal comments be filed by November 27, 1996, despite the fact that the record in this matter will be open at least until December 4, 1996. Consequently, in response to the Commission's request, the Company has prepared this First Set of Comments and will provide its Second Set of Comments (which will primarily address operational, reliability and pricing issues) before the close of the record in this docket.

D. 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 Regulatory Commission's ("FERC") Notice of Proposed Rulemaking, in Docket No. RM94-7-000, *Recovery of Stranded Cost by Public Utilities and Transmitting Utilities* ("Stranded Cost NOPR"). Many parties including the Commission 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 principles. 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 Cost 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 issues raised 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, including the Commission, 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.

Even given this intensive schedule and allotted time, FERC was forced to delay the implementation of Order 889, the Open Access Same-Time Information System ("OASIS"). The OASIS is the computer system behind the concept of equal access to transmission information. The technical requirements proved to be greater than originally anticipated and utilities could not install and train employees in time for the original implementation requirement. The original date for OASIS implementation was November 1, 1996, but FERC moved this date to January 1, 1997 to give utilities more time to work out the technical requirements and to hire and train staff.

E. 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) concerning restructuring of 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, and Governor Wilson, signed H.B. 1890, a landmark restructuring bill which generally endorses major policies adopted by the CPUC. This dictates some details of implementation, but leaves most for the CPUC 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 percent rate cut by 1998 and work toward the goal of an additional 10 percent cut in 2002. The California legislation also provides for renewables and certain other social-policy programs during a four-year transition to a competitive marketplace through a non-bypassable charge of $540 million imposed on customers of investor-owned utilities and a proportionate non-bypassable charge imposed on customers of muncipally-owned utilities.

F. Conclusions

The total time between the initial 1992 review in California and final implementation of its rules is 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 an ambiguous, less than adequate 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 four months later and with 14 pages of text, that the Commission is at a point that it is ready to adopt 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 strongly supports competition, the Company believes that it is essential that the Commission adopt a Rule that provides more answers than questions and is consistent and equitable in its application.

II. STRANDED COST

A. Introduction

Stranded Cost represents the most significant issue facing TEP, the Commission and the other parties to this Electric Industry Restructuring Docket. The transition from a regulatory model based on one vertically-integrated utility providing full electric service under a single bundled rate in a specific geographic area, to a direct access market in which customers can readily choose any energy supplier will undoubtedly require recognition of significant transition costs. Consistent with the assurances and obligations that have existed under the traditional Regulatory Compact, a mechanism must be created <u>before</u> the industry transition begins, such that a reasonable opportunity is provided for the full recovery of Stranded Cost prior to completion of the evolution to retail competition. In order to achieve a smooth and efficient transition to a competitive electric marketplace, the Commission must establish a framework which ensures the full recovery of Stranded Cost and provides price stability for consumers. The only effective method of achieving this transition is for the Commission to find that all prudent, verifiable and legitimate Stranded Cost is recoverable, to develop a general set of guidelines to define Stranded Cost and appropriate recovery mechanism and to authorize recovery of Stranded Cost from all customers that stand to benefit from a competitive electric industry.

Following is a discussion of: (i) the traditional Regulatory Compact and why recovery of Stranded Cost is an essential element of that compact; (ii) a recommended methodology for quantifying and recovering Stranded Cost; (iii) identification of the key accounting and financial implications associated with Stranded Cost; and (iv) other relevant information that should be considered by the Commission in addressing this most important issue. Following that discussion are TEP's specific comments with respect to R14-2-1607 of the Rule, "Recovery of Stranded Cost of Affected Utilities."

B. Background

The traditional Regulatory Compact between public utilities, the customers they serve and the state 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, utilities assumed two obligations **not imposed** on other 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 the plant, or enter into contracts to assure sufficient supply to meet all customer demands for utility service. Virtually every major investment decision utilities have made to date has been in recognition of, and reliance upon, this Regulatory Compact.

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 implicit in the prices they were allowed to charge for service provided. 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. With the emergence of competition, some of the embedded costs traditionally recovered through regulated rates will be totally or partially unrecoverable. The difference between expected future revenues under regulation and the expected revenues that would likely occur under total or partial competition constitute "Stranded Cost." Stranded Cost may take a variety of forms, including: (i) assets owned, leased or purchased by contract; (ii) services, materials and supplies owned or contracted; (iii) unrecorded liabilities (*i.e.,* fuel and purchased power contracts); (iv) operating and capital costs; (v) regulatory assets (costs for which 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 (*i.e.*, accrued post-employment healthcare costs).

Similar electric industry restructuring proceedings around the nation have already spent considerable time and effort addressing the issue of Stranded Cost and have determined that full recovery thereof is an essential requirement for an efficient, equitable transition to competition. In its Order 888 promoting wholesale competition through open access transmission service, the FERC clearly recognized that full recovery of stranded wholesale costs is not only a legal obligation of regulators, but also is necessary to achieve an efficient transition to competition. Other states considering retail competition have also recognized the potential for Stranded Cost and the need for their full recovery. Utility investors are entitled to a reasonable opportunity to recover the capital they provided in good faith. Clearly, the rates of return granted under the traditional regulatory paradigm never contemplated this significantly increased business risk.

C. Definition of Stranded Cost

A key consideration in addressing the issue of Stranded Cost is just how it is defined. Stranded Cost should not be viewed simply in terms of categories of costs, but rather as revenue requirements that a utility has lost the opportunity to collect as a result of existing customers obtaining power from alternative sources. In connection therewith, TEP believes the following to be an appropriate definition of Stranded Cost:

> An aggregation of costs (the prudence of which has already been established) incurred for, or in anticipation of, the provision of service under a regulatory framework, that are likely unrecoverable in a competitive market for power with prices based on marginal cost.

The above definition is similar to that appearing in R14-2-1601, No. 8 of the Commission's Rule; however, several key distinctions are noteworthy.

First, the Commission's definition refers to "the value of all the prudent jurisdictional assets and obligations. . ." It is unclear whether such definition would result in a reconsideration of the prudence of past investment decisions. TEP strongly believes that the consideration of Stranded Cost should not include ex-post prudence reviews of costs that are already being recovered in the utilities' rates. The fact that recovery is already being allowed is sufficient assurance of prudence. TEP has already been required by the Commission to write off $564 million, including $428 million of the cost of its Springerville and Irvington generating facilities. The utilities should not have to revisit prudence issues, simply because some costs now recovered in rates would, in the future, be included in a Stranded Cost charge.

A second concern of TEP with respect to the Commission's proposed definition of Stranded Cost is that it tends to focus on the difference in values of assets and obligations under traditional regulation as compared with their values after the introduction of competition. It is unclear what specific assets and obligations are included and whether the definition is limited to balance sheet accounts. Stranded Cost is not limited to generation assets. Utilities have considerable investments in regulatory assets that may become strandable under competition. In addition, generation-related operating expenses *(i.e.,* fuel expenses, including mine reclamation costs) may also be considered as a Strandable Cost. Moreover, some Strandable Costs are not presently reflected in the Company's financial statements, such as the $81 million relating to the Springerville excess capacity deferrals and $19 million for employees' post-employment healthcare relating to services already provided. Equally unclear in the definition is the basis by which "market value" will be established.

One possible method to calculate Stranded Cost is the difference between future revenues under regulation and competition scenarios, rather than differences in market values of utility assets. This eliminates the need for an asset-by-asset determination, and more correctly recognizes that utilities have made multiple investment decisions under the Regulatory Compact with the expectation of revenue streams from customers to cover the costs of such investments. Moreover, in a direct access power supply market, TEP will continue to serve customers using a portfolio of resources; accordingly, Stranded Cost should be considered on a portfolio basis.

D. Quantifying Stranded Cost

Any method of attempting to quantify Stranded Cost is necessarily speculative and highly uncertain because it requires identification of all relevant resources (both recorded and unrecorded) and offsets, customer demand and predictions of the market clearing price for power over long periods of time. As an example, factors affecting the market clearing price for power (clearly the most critical variable in quantifying Stranded Cost) include: customer demand, market structure, generation and transmission capacity availability, generation fuel mix and costs, interest rates and inflation, developments in technology and new laws and regulations.

A method that would accomplish this quantification would be to quantify stranded assets as the net present value of future annual differences in revenues under a continuation of regulation, versus the amounts likely to be realized after the introduction of competition, using an appropriate discount rate. In general, the resulting amount reflects the difference between the utility's embedded generations costs and the market's marginal costs for supplying power, plus the generation-related

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portion of the utility's regulatory assets, both recorded and unrecorded. Such method effectively recognizes both above-market and below-market assets.

A specific time period over which Stranded Cost should be computed by every utility cannot, and should not, be ordered. Companies have different assets with different investment and cost recovery horizons. A significant portion of the investments implicit in Stranded Cost is 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 of time with a reasonable expectation of a fair opportunity for full recovery. Proper quantification of Stranded Cost should reflect the remaining life expectancy of the underlying assets and deferred costs.

E. Stranded Cost Recovery Mechanism

In developing an appropriate Stranded Cost mechanism, TEP recommends that the Commission consider the following objectives:

1) The mechanism should promote economic efficiency and the evolution of competition.

2) 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.

3) Stranded Cost should be recovered in its entirety within a reasonably short time period.

4) The recovery burden should not significantly expand the existing administrative burdens of the Commission or affected utilities.

5) The mechanism should be sufficiently flexible to incorporate changes in assumptions or unanticipated events in the process of transitioning to retail competition.

6) The relevant charge should be simple and understandable to customers and not impede their choice of power supply or other competitive services.

A variety of Stranded Cost recovery mechanisms are available, 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 recovering Stranded Cost is through a non-bypassable "wires charge" paid by every customer interconnected to the TEP distribution system, whether power is supplied by this Company or an alternative supplier. The intent is to spread the costs of transition over a broad base of customers that have access to the benefits of a more competitive environment. Such a charge would appear as an explicitly detailed separate line item on customer bills. However, it should be easy to administer and easy for customers to understand. This approach is consistent with the manner in which retail electric customers are aggregated in the Company's system-wide planning process. Moreover, this approach not only recognizes the societal benefits to be achieved from the transition to a more competitive electric industry, but also reflects past precedents set when similar considerations were made for recovering Stranded Cost in the natural gas and telephone industries.

TEP believes that the imposition of a system-wide wires access charge as described above should afford the Company a reasonable opportunity to fully recover its Stranded Cost. The possibility does exist, however, that some customers may attempt to avoid the charges by leaving the system or through self-generation. For any customers opting to self-generate, it is likely they will purchase back-up service from their host utility. They could be allocated a share of Stranded Cost as a component of the standby service charge. Finally, new consumers connecting to TEP's distribution system should pick up their fair share of transition costs in the same manner as if they had been served all along. Otherwise there may be too great an incentive for customers to seek bypass by appearing as if they are "new" customers.

The starting point for developing a Stranded Cost charge is the present value of Stranded Cost at the beginning of the transition period, computed in the manner previously described. Such amounts should then be amortized as an annuity based on the same discount rate over that period to arrive at an annual Stranded Cost recovery requirement. TEP believes that the annual requirement should be allocated to customer groups in the manner in which the related costs underlying current rates have been allocated, and then collected from customers in the form of an energy charge based upon their actual usage or a fixed monthly customer charge. The Commission should not revisit the cost allocation methodologies currently used to assign costs to the different customer rate classes, but such factors should be periodically revisited to identify changes in customer usage characteristics and to ensure that there is no cross-subsidization between customer classes. In addition, the customer charges could be periodically revised to reflect changes in sales forecasts and estimates of the market clearing price for power.

F. Accounting and Financial Implications

In establishing rules for quantifying and recovering Stranded Cost, the Commission needs to consider the potential consequences of ignoring the rights and obligations of all parties implicit in current rates established under the Regulatory Compact. Less than full recovery of Stranded Cost will likely have significant accounting and financial implications.

As a rate regulated entity, TEP prepares its public financial statements according to Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* ("SFAS No. 71"). The underlying premise of SFAS No. 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. SFAS No. 71 defines what constitutes a regulated entity and contains standards of accounting for the effects of regulation. One such standard addresses the method by 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:

1) 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.

2) 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 of the above is not met, the corresponding asset must be written off. To illustrate the extent to which regulatory assets impact the financial reporting by a public utility, as of June 30, 1996, TEP's balance sheet included nearly $257 million in deferred regulatory assets.

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 standards include SFAS No. 90, *Regulated Enterprises-Accounting for Abandonments and Disallowances of Plant Costs*; SFAS No. 92, *Regulated Enterprises-Accounting for Phase-In Plans*; SFAS No. 101, *Accounting for Discontinuation of Application of SFAS No. 71*; and SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of.* Both SFAS Nos. 90 and 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. SFAS No. 121 amends SFAS No. 71 to clarify that existing regulatory assets should be written off if they are no longer considered probable of recovery.

The following illustrates how these new Standards have affected TEP. Although the Company was granted authority by the Commission in previous rate cases to defer for future rate recovery certain excess capacity costs associated with Springerville Unit No. 2 (the unamortized balance of which totaled $81 million as of September 30, 1996), such deferrals failed to meet the criteria set forth in SFAS No. 92; therefore, they have been charged in their entirety to expense for financial reporting purposes. No corresponding regulatory asset is reflected on the Company's balance sheet.

Utilities following SFAS No. 71 must continually assess whether they remain regulated entities under definition criteria contained in the Standard. SFAS No. 101 includes the following examples of situations that may warrant discontinuation of SFAS No. 71:

1) Deregulation.

2) A change in the regulator's approach to setting rates from cost-based ratemaking to another form.

3) Increasing competition that limits the enterprise's ability to sell utility services or products at rates that will recover costs.

4) 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.

The thrust of SFAS No. 101 is that, when an enterprise ceases to meet the criteria of SFAS No. 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. For TEP, the adoption of SFAS No. 101 would result in a net charge against retained earnings totaling some $139 million, based on the balances of regulatory assets and liabilities as of September 30, 1996.

To the extent that Stranded Cost is not adequately addressed in this Electric Industry Restructuring Docket, write-offs beyond those required under SFAS No. 101 may be necessary. Pursuant to SFAS No. 121, a utility subject thereto would also have to determine whether or not its remaining plant assets would be recoverable through expected future market prices. If market pricing is not expected to be fully compensatory, additional write-downs of the relevant assets to reflect the expected revenue levels will also be required.

The impact on utilities of large financial losses and substantially increased business risks would likely be swift and severe. Public utilities financed most of their property, plant and equipment through the issuance of common stock and long-term debt securities. Many utilities 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, such obligations do not disappear even if the assets that they financed become economically impaired. The impairment of assets due to a reduction of future expected cash flows, without either (i) a commensurate reduction in the company's debt and lease obligations; or (ii) a corresponding increase in cash flows from other sources (*i.e.,* the Stranded Cost recovery mechanism), would severely diminish that company's ability to meet its future cash obligations. Moreover, in certain circumstances, such obligations may include provisions whereby they become accelerated and are due and payable immediately. Such a dilution of financial expectations, combined with the significantly increased business risk, would undoubtedly have an adverse effect on the cost and availability of capital to the company, leaving future financial viability in serious doubt.

All electric utilities will experience the effects of increased business risk and potential for severe financial adversity with the introduction of competition in the generation segment of the industry. However, the consequences to TEP relative to other investor-owned utilities may be significantly greater. Virtually all of the financial progress the Company has been able to achieve during the last five years could evaporate. Although TEP has succeeded in building its equity capital by $189 million since December 31, 1993, the Company's balance of equity capital was only $126 million as of September 30, 1996.

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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 percent, 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 percent) 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.

Another likely adverse consequence of less than full Stranded Cost recovery affecting utilities' ability to raise capital is the potential reduction in the available bondable property. Utilities issuing mortgage bonds pledge their investments in utility plant assets as the underlying collateral. Typically, mortgage indentures include a plant-to-bonds ratio in excess of one. That means, for every $1 in bonds, something in excess of $1 in plant assets is required as security. For TEP, the ratio is approximately 1.6 - 1. TEP's ability to issue additional bonds is directly affected by the available unbonded utility property. To the extent that Stranded Cost is not fully recoverable and as a result, TEP is forced to write-off a portion of the cost of its plant assets, the Company would be faced with a reduction of bonding capability.

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 the FASB and the potential financial consequences to TEP, as well as the other utilities in the state, if the recovery mechanism is inadequate, or the accounting rules to be promulgated by the Commission otherwise result in large financial write-offs. In TEP's case, less than adequate recovery of Stranded Cost would likely reverse the substantial progress achieved by TEP since its financial restructuring and would reduce the Company's ability to refinance maturing debt and expiring letters of credit.

G. 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. The various taxes include sales taxes, gross receipts taxes, franchise 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 Cost is written off as unrecoverable, there will undoubtedly be a reduction of 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. As an example, PECO, a major supplier of electricity in Pennsylvania, has informed regulators in connection with that state's inquiry into the introduction of retail competition that the potential impact of unrecoverable Stranded Cost on tax revenues may 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 situation 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 the exposure to be significant.

In addition to the likely reductions in state and local tax collections if less than full Stranded Cost recovery is achieved, there are other tax-related matters that must be addressed in this proceeding. As more fully explained later herein, various providers of electricity in Arizona are treated differently for tax purposes. This creates an unlevel playing field. There will also be the issue of establishing proper nexus; that is, determining which state is entitled to various taxes when electricity is generated in one state and consumed in another. This issue is especially contentious in our industry where the actual flow of electricity is not always identifiable due to laws of physics. Many tax issues will only be resolved by legislation and/or litigation.

H. Stranded Cost Rule - R14-2-1607 - Recovery of Stranded Cost of Affected Utilities

1. 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 Cost. The problem is to determine what is considered reasonable for any given company. Those actions taken by particular companies that might constitute mitigation will depend on their specific circumstances and relevant market conditions. Mitigation efforts should be evaluated on a case-by-case basis.

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

The Rule also identifies the offering of a wider scope of services for profit as another means to mitigate Stranded Cost. It is unclear whether this suggested action is intended to include only energy-related activities or is all-encompassing, covering any business activity the utility and/or its affiliates may choose to enter. TEP believes that profits from activities that are unrelated to the provision of electricity in Arizona, that do not require use of the assets that were acquired to serve electric customers in Arizona, and that are potentially strandable, should not be considered as a source of funds to offset Stranded Cost. To the extent profits are derived from energy-related activities and used to reduce Stranded Cost, these services should be governed by the market, not by regulation.

Other approaches to mitigating Stranded Cost may include asset sales, renegotiating uneconomic contracts (as TEP has already done in recent years by renegotiating certain fuel supply agreements), pursuing economic development projects and continually attempting to lower marginal costs (as TEP has done through corporate re-engineering, its Voluntary Severance Plan and similar cost-reduction efforts). It must also be noted that mitigation efforts themselves may lead to additional costs that may become stranded. What constitutes appropriate mitigation for any utility should include consideration of all relevant facts and circumstances. Although, as stated above, asset sales may have a mitigating effect, under no circumstances should a utility be <u>forced</u> to sell or otherwise divest assets to mitigate Stranded Cost.

2. The Rule states that the working group established to address Stranded Cost shall consider a number of factors, including the time period over which Stranded Cost may be recovered. Delays in recovery could postpone realization of the benefits of competition and cause a greater risk of not recovering the costs to the detriment of the utilities and its remaining customers.

3. The Rule requires utilities to file estimates of unmitigated Stranded Cost along with certain market information. As previously noted, the single, most significant variable affecting the quantification of Stranded Cost is the market clearing price for power. TEP recommends that, as part of its charge in this proceeding, the Working Group also consider just what constitutes "market price." The scope of this inquiry should include an appropriate definition of the market and identification of its participants; the nature of market transactions and pricing methodology; and the time period over which such price is to be determined.

4. Part J of the Rule states that Stranded Cost may only be recoverable from customer purchases made in the competitive market. It further states that any reduction in sales attributed to self-generation shall not be used to calculate or recover Stranded Cost. As previously noted, TEP believes that an across-the-board end user charge is the most effective, efficient and equitable way to provide a reasonable opportunity for utilities to recover Stranded Cost prior to the completion of the transition to retail competition. With respect to customers that may opt to self-generate, TEP strongly believes that they still should bear their fair share of the Stranded Cost burden. Such an approach is consistent with regulatory precedents established for recovering Stranded Cost in the natural gas and telephone industries.

In addressing stranded pipeline costs the FERC determined that all gas transportation customers should participate in sharing the cost burden of the transition to competition, even if the costs were largely sales-related and certain transportation customers were never a sales customer of the pipeline. The FERC's rationale was that it is appropriate to charge transportation customers for sales-related stranded investment because all of those users will benefit from the move to competition.

The philosophy of spreading across-the-board those cost changes to be recognized during the transition of an industry from one characterized by regulated monopolies to one occupied by competitive market participants can also be seen in the FCC's ordered methodology for recovering costs applicable to the interstate portion of non-traffic sensitive plant. To address the potential for uneconomic bypass and unrecovered Stranded Cost, the FCC implemented an end user subscriber line charge. In connection therewith, every residential customer connected to the public telephone network pays a $3.50 per month fee, regardless of whether any long distance calls are made.

The justification for recovering retail Stranded Cost from all users of the electric system is no different from the underlying across-the-board approach used in the other industries cited above. The costs involved were incurred under a bundled service regulatory regime and are legitimately recoverable from all customers.

III. LEVEL PLAYING FIELD ISSUES

In its previous filings with the Commission, TEP has been a strong proponent of leveling the playing field for energy providers consisting of existing regulated utilities, cooperatives, government agencies and all new entrants. As the Rule is currently drafted, the core level playing field issues have not been addressed or resolved. There are many problems that arise concerning industry restructuring and how different corporate entities can compete fairly with each other. TEP's responses have been consistent in that the Company believes that these issues need to be addressed before the Commission heads down a path from which it cannot retreat. TEP's comments filed on September 12, 1996, summarized these issues as the following:

> 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 continued to discuss the importance of eliminating the advantages public utilities have over investor-owned utilities. TEP believes that, if these entities are planning to participate in the competitive market, 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, lower capital costs associated with a 100 percent debt (no equity) capitalization and any preference power advantages. 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 with lower cost power that undermines the efficiencies of the marketplace. TEP believes that a mechanism similar to the surcharge mentioned above, or perhaps the same charge, must be developed prior to the opening of competitive electric supply markets.

TEP, as well as other parties, identified that there exist peculiarities with various utility providers which could hinder competition. Specifically, the Rule exempts SRP and potentially the cooperatives because of these peculiarities. Further, it is unclear as to whether the cooperatives could compete for customers outside of their service territory while preserving the integrity of their own service territories under the exemption. To the extent that the cooperatives take advantage of this exemption, this would leave only TEP, Arizona Public Service Company and Citizens Utilities to participate. The result of this type of market structure would only frustrate customers and energy providers because of the obvious inequities regarding customer choice and customer information.

Access to customer usage data is a significant issue related to ensuring that all competitors have equal opportunity to compete in the provision of non-monopoly services. If public entities are not required to comply with the reciprocity requirement or the Rules, yet are able to form marketing subsidiaries, the market structure would be distorted in their favor.

In addition to the above issues, the Company believes the following two issues help solidify TEP's comments concerning level playing field issues. These are: (i) the Rule is not strong enough concerning reciprocity; and (ii) The Rule needs to change A.R.S. §§ 40-203 and 281 in order to deal with differences between existing regulated utilities and new entrants into the market.

The question of reciprocity is at the heart of leveling the playing field issue. To help provide an example of this, reciprocity was a key component in the recently approved FERC Order 888.

There was much debate in the final order about the reciprocity requirement for all transmitting utilities which includes investor-owned utilities, cooperatives, municipals and public power entities. FERC stated on page 370 that:

> We conclude that it is appropriate to require a reciprocity provision in the Final Rule pro-forma tariff. These provision would be applicable to all customers, including non-public utility[1] entities. . . .that own, control or operate interstate transmission facilities and that take service under the open access tariff. Any public utility[2] that offers non-discriminatory open access transmission for the benefit of customers should be able to obtain the same non-discriminatory access in return.

FERC continues on page 373 to explain:

> In response to arguments raised by publicly-owned and cooperatives, we are not prepared to revise or eliminate the reciprocity condition. Our reason is simple and compelling. We are undertaking this Rule and imposing significant responsibilities on public utilities to ensure the Nation's transmission grid is open and available to customers seeking access to the increasingly competitive commodity market for electricity. While we do not have the authority to require non-public utilities to make their systems generally available, we do have the ability, and the obligation, to ensure that open access transmission is as widely available as possible and that this Rule does not result in a competitive disadvantage to public utilities. Non-public utilities, whether they are selling power from their own generation facilities or reselling purchased power, have the ability to foreclose their customers' access to alternative power sources and to take advantage of new markets in the traditional service territories of other utilities. . . . [W]e will not permit them open access to jurisdictional transmission without offering comparable service in return.

TEP agrees with FERC's justifications and believes that they genuinely apply to the current situation concerning the Commission's Rule. TEP's comments on the NOPR that remained in Order 888 were published in the Final Order and are consistent with the Company's comments filed in this Docket. In Order 888, TEP was quoted, "without such access to all eligible customers, reciprocity will fail to achieve true 'comparability.'"

Similarly, no true reciprocity or comparability will occur unless all energy service providers in Arizona have equal access to all customers. Without these two qualities, a robust, efficient and competitive market will not be achieved. The Commission and its Staff have the same responsibility

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[1] Non-public utilities are non-jurisdictional utilities, which can include publicly-owned utilities. FERC defines publicly-owned utilities in Order 888 footnote 479, (e.g. Blue Ridge, SMUD, Salt River, Oglethorpe).

[2] Public utilities include FERC jurisdictional utilities, including all Investor Owned Utilities.

that FERC has in providing a structure that minimizes market distortions and to draft a set of rules that require a provision for reciprocity. As stated above, FERC concluded that it was appropriate to require reciprocity to include non-jurisdictional utilities.

IV. LEGAL ISSUES

A. Introduction

The Rule contains numerous legal issues; some of which have been pointed out to Staff repeatedly and ignored, and others which have been created recently by minor adjustments that Staff has attempted to make. But cosmetic changes alone will not remedy the various legal defects contained in the Rule. The Commission must correct the foundational breaches of constitutional, statutory and regulatory standards that cause the Rule to be unfair, unlawful and unwise. To ignore these problems for the sake of expediency in adopting the Rule, is to abdicate to the courts the Commission's duty to regulate public service corporations and to determine how and when competition in the electric retail industry will be implemented. Thus, the infirmities which plague the Rule include:

1) The Rule is vague.

2) The Rule is confiscatory.

3) The Rule is discriminatory.

4) The Rule unilaterally modifies, if not abrogates, the Regulatory Compact.

5) The Rule goes beyond the Commission's current authority to act.

6) The Commission has failed to comply with the Arizona Administrative Procedures Act ("APA") in developing the Rule.

As TEP pointed out in previous filings with the Commission in this Docket, the Rule will not bring about retail electric competition in Arizona because it violates the constitutional requirements of due process and equal protection.

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 <u>clearly</u> sets forth the terms and conditions of competition, provides for <u>full</u> and <u>complete</u> compensation for utility property rights that are taken, <u>equally</u> protects all utilities and either <u>upholds</u> or provides for the <u>mutual</u> <u>modification</u> of the

Regulatory Compact and is adopted in compliance with statutory requirements. While the time it will take to correct the Rule may cause a temporary setback 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.

B. Analysis of the Legal Issues

The federal and state constitutions each provide the protection and guaranty of a) due process of law (U.S. Const. amend. XIV; Ariz. Const. art. II, § 4); and b) equal protection of law (U.S. Const. amend. XIV; Ariz. Const. art. II, § 13). 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). Also, the equal protection clause of the state and federal constitutions require that all members in a given class be treated equally and that the classification itself be reasonable and not arbitrary or capricious. Pastore v. Arizona Dept. of Economic Security, 128 Ariz. 337, 341, 625 P.2d 926 (App. 1981). As set forth below, the Rule is neither fair nor just.

1. The Rule is Vague.

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 general rules and regulations of the Commission have the force and effect of law and are as equally binding as are statutes. Gibbons v. Arizona Corporation Commission, 95 Ariz. 343, 347, 390 P.2d 582 (1964). The courts have consistently held that a law is unconstitutionally vague if: (i) it fails to give a person of ordinary intelligence a reasonable opportunity to know what the law does, so that he may act accordingly; or (ii) if it allows for arbitrary and discriminatory enforcement by failing to provide an objective standard for those who are charged with enforcing or applying the law. Bird v. State, 184 Ariz. 198, 908 P.2d 12 (App. 1995); In re Maricopa County Juvenile Action

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No. JS-5209 and No. JS-4963, 143 Ariz. 178, 183, 692 P.2d 1027, 1032 (App. 1984); Grayned v. City of Rockford, 408 U.S. 104, 92 S.Ct. 2294, 33 L.Ed.2d 222 (1972).

The Rule, being merely a *framework* of what the finished product should be, does not give a person of "ordinary intelligence" a reasonable opportunity to determine what its consequence will be on key matters impacting the Affected Utilities. This fact is reinforced by the statements of the Commissioners at the October 8 and 9, 1996 Open Meeting as they deliberated on the Rule.[3]

Although the Commission may view the Rule as merely a loose framework, the fact is that the Rule, once adopted becomes effective law, which will immediately govern the conduct of the utilities and the citizens of Arizona. Indeed, any person not in compliance with the Rule, may be subject to statutorily imposed fines, penalties and liability. *See,* A.R.S. § 40-421 *et seq.* As currently drafted, the Rule only provides a skeletal sketch of how retail electric competition will be ushered in and then implemented in this State. Too many key factors are now unclear or not addressed, or have been deferred to a later date to then be determined at the discretion of the Commission. It is unjust and unfair to enact a vague Rule that does not sufficiently define conduct that is required or proscribed--especially when those affected by the Rule are subject to fines, penalties and other liability based upon their non-compliance with the Rule.

For example, the Rule is vague with regards to the matter of "Stranded Cost." R14-2-1601 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 R14-2-1607, 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 R14-2-1603 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

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[3] Reporter's Transcript of Proceedings, ACC Docket No. U-0000-94-165, October 8, 1996 at 34, 117 and 126, October 9, 1996 at 50, 51 and 52.

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 (R14-2-1610); standards for setting rates (R14-2-1612) and quality of service issues.

Because these and other aspects of the provision of electric service are not specified, reasonable minds are not put on notice of how the Rule will affect them. A Rule, once enacted is <u>law</u> and must meet due process requirements at the time of adoption. This cannot be deferred for eventual development and achievement at an unspecified later date. Until the Rule is clarified and put into its proper context, it will not meet due process requirements.

To justify the vagueness of the Rule, the Commission has rationalized that the Rule is a broad framework similar to its competition rules in the telecommunications industry. (*See,* A.C.C. R14-2-1101 et. seq.; Tr. October 8, 1996 at 30.) However, the Commission does not appreciate the drastic distinctions between the scope of federal and state regulation of the two industries. The electric industry does not have a federal framework governing competition such as the Telecommunications Act of 1996. This act provides many standard procedures and policies nationwide applicable to competition. This act also preempts non-conforming state laws and regulations. In short many of the gaps that are present in the Commission's loose-fitting telecommunications rules are filed by federal law. There is no such law to flesh out the skeletal provisions of the Rule. Thus, while the Commission's telecommunications competition rules may be workable, they function in tandem with the federal act (and FCC rules). There is no such companion for the Rule and it must be viewed on a stand-alone basis.

2. <u>The Rule is Confiscatory.</u>

The manner in which the Rule would handle Stranded Cost and a 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 and 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.")

R14-2-1601 and R14-2-1607 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. However, the Commission has already ruled on the prudence and cost recovery of assets invested in by Affected Utilities. Ariz. Const art. 15. sec. 3 and A.R.S. § 40-203 authorize the Commission to set the rates to be charged by the Affected Utilities. There is a presumption in the law that investments made are prudent, which can only be set aside by clear and convincing evidence to the contrary. Missouri ex rel. Southwestern Bell Telephone Co. v. Missouri PSC, 262 U.S. 276 (1923); West Ohio Gas Company v. Ohio PUC, 294 US 63 (1935); A.A.C. R14-2-103.1 ("All investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made.") During the course of the ratemaking process for the Affected Utilities, the Commission has already determined the prudence of the costs and investments of the utility which have been included or precluded from rate base calculations.

Prior determinations by the Commission as to the prudence of investments in specified assets are res judicata, or in other words, conclusively settled matters that cannot be reversed by subsequent or collateral proceedings (such as the Rule). *See,* Mountain States Telephone and Telegraph Company v. Arizona Corporation Commission, 124 Ariz. 433, 604 P.2d 1144 (App. 1979); Yavapai County v. Wilkinson, 111 Ariz. 530, 534 P.2d 735 (1975); Arizona Public Service Company v.

Southern Union Gas Company, 76 Ariz. 373, 265 P.2d 435 (1954). Consequently, investments that have already been determined to be prudent and under the Rule are Stranded Costs and should be unconditionally and fully recoverable by the Affected Utilities.

The Rule is also confiscatory because it precludes any recovery of Stranded Cost after a limited time period. *See,* R14-2-1607.I. 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,* R14-2-1604.A and R14-2-1607.F. It is unreasonable to set that which is bound to be such a short time frame for the recovery of what is likely to be millions, if not billions of dollars of Stranded Cost. By doing so, the Rule is virtually guaranteeing that some Stranded Cost will not be recovered, thereby resulting in the confiscation of property of the Affected Utilities.

The Rule also confiscates some, if not all, of the property rights embodied in the Affected Utilities' 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.

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3. The Rule is Discriminatory.

The Rule does not afford all utilities equal protection and, therefore, is discriminatory. (Ariz. Const. art. II, § 13.) From its initial provisions on through the last, the Rule is unlawfully discriminatory because it does not provide for the equal treatment of all members of a recognized class, namely, electric utilities doing business in the state. Garcia v. Arizona State Liquor Board, 21 Ariz. App. 456, 520 P.2d 852 (1974). The Commission, as an agent of the state, must comply with the equal protection clause of the state and federal constitutions in rendering decisions and enacting rules. Bank of Arizona v. Howe, 293 F. 600, 606-7, (Ariz. 1923). However, the disparate treatment afforded Salt River Project ("SRP"), cooperatives and municipal and tribal-owned electric companies on the one hand, and the "Affected Utilities" on the other, demonstrates that there are unreasonable inequalities built into the Rule. The Rule cannot fully afford equal protection to the Affected Utilities and never will until such time as the jurisdiction of the Commission is expanded to include all electric utilities that do business in the state. Gusick v. Boies, 72 Ariz. 309, 234 P.2d 430 (1950) ("The guarantees provided by the federal and state constitutions apply equally to all and they cannot be denied to any one person without weakening the rights of all.")

For example, like SRP, 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 R14-2-1611 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 or SRP's proposed regulated subsidiary), apply for a CC&N in Arizona to provide retail electric service. Moreover, the "invitation" by the Rule for utilities not regulated by the Commission to *voluntarily* consent to the jurisdiction of the Commission is a proposition that must be determined by the courts or legislature and not the Commission. This was made clear during the Commission's deliberations of the Rule when representatives of SRP and the Commission Staff stated on the record that SRP could not voluntarily submit itself to the jurisdiction of the Commission. Tr. (October 8, 1996) at 46-47. Because the exemption of municipally-owned utilities from the jurisdiction of the Commission is established by the Arizona Constitution and the exemption for tribal-owned utilities springs forth from federal law, expanding the jurisdiction of the Commission to include them cannot, therefore, be changed merely by the enactment of the Rule.

The Commission has inserted a provision into the Rule that would allow cooperatives to modify the requirements of the Rule (presumably including exemption therefrom), "so as to preserve the tax exempt status of the cooperative or to allow time to modify contractual arrangements pertaining to delivery of power supplies and associated loans." *See,* R14-2-1604.H. In prior pleadings submitted to the Commission in this Docket, TEP has presented valid reasons (such as its rate settlement with the Commission and its two-county financing requirements) for it also to be allowed to request a modification to or exemption from the Rule. By singling out the cooperatives for this preferential treatment and ignoring TEP and other Affected Utilities with similar concerns, the Commission has unreasonably discriminated among and against Affected Utilities.

4. 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 a 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 the 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 after affording the utility due process. 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.

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.

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. Consequently, the Regulatory Compact will be quite different from the agreement originally struck with TEP and carried through for these many decades.

5. The Rule Goes Beyond the Commission's Current Authority to Act.

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 beyond the Commission's authority. The Commission can only exercise those powers that can be derived from a strict construction of the state constitution and implementing statutes. Rural/Metro Corporation v. ACC, 129 Ariz. 116, 629 P.2d 83 (1981); Williams v. Pipetrades Industry Program of Arizona, 100 Ariz. 14, 409 P.2d 720 (1966).

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 (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 do not fall within any recognized exception to the Scates doctrine. In this regard the Rule will also ignore the established principle that a utility is entitled to a fair return on the fair value of its property devoted to public service. Arizona Corporation Commission v. Arizona Water Company, 85 Ariz. 198, 203, 335 P.2d 412 (1959). Just and reasonable rates meet overall operating costs and produce a reasonable rate of return on the utility's assets. Scates v. Arizona Corporation Commission, supra, at 534. The Rule will, in essence, freeze the rate base and rate of return for the Affected Utilities at the time of determining Stranded Cost, while ignoring the increases in cost and value that will occur over time in the future. This will deprive the Affected Utilities of the opportunity to earn a fair rate of return. If rates are set such that the utility does not have the opportunity to earn a fair rate of return, the rates are confiscatory and unlawful. Bluefield Water Works and Improvement Company v. Public Service Commission of West Virginia, 262 U.S. 679, 694, 67 L. Ed 1176 (1922).

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,* R14-2-1609. 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); State of Missouri ex rel. Southwestern Bell Telephone Company v. PSC, 262 U.S. 276, 289 (1922) (The commission is not the financial manager of the corporation and may not substitute its judgment for that of the directors of the corporation); Appeal of Public Service Co. of New Hampshire, 454 A.2d. 435, 437 (N.H. 1982) (The right to manage the utility is not surrendered by devoting a business to public use). 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. In fact, the Arizona Attorney General has issued an opinion, applicable in this instance, that the Commission does not have the authority to compel public service corporations to make decisions regarding day-to-day operational matters. *See,* Op. Ariz. Atty. Gen. No. I79-099. ("There are no statutory or constitutional provisions mandating joint or cooperative fuel oil purchases by public service corporations furnishing electricity, nor are there any such provisions requiring the Commission to order such purchases, either by rule or by special order.") Similarly, there is no legal authority for the Commission to order where or when the Affected Utilities will obtain their power or how it will be generated.

Finally, TEP 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:

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

2) A.R.S. §§ 40-281 and 40-282 - to change the scope and procedure regarding Certificate of Convenience and Necessity ("CC&N").

3) 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.

6. The Commission has Failed to Comply with the Arizona Administrative Procedures Act in Developing the Rule.

Based upon the Commissioners' comments during their deliberation of the Rule, it appears that the Commission is determined to enact the Rule by the end of 1996, to be effective in January 1997. This fast-track schedule apparently does not contemplate that the Rule will be certified by the Arizona Attorney General pursuant to the APA, A.R.S. § 41-1001, *et. seq.* Specifically, A.R.S. § 41-1044 requires that any rule adopted by the Commission is subject to review and certification by the Attorney General for form, clarity, competency and compliance with appropriate procedures. *See,* also A.R.S. § 41-1057. TEP does not believe that the Rule, in its current state, would be certified by the Attorney General because it is vague, beyond the scope of the Commission and does not meet due process requirements. A rule that is rejected by the Attorney General does not become effective. In Arizona Corporation Commission v. Woods, 171 Ariz. 286, 830 P.2d 807 (1992) the Arizona Supreme Court held that the Attorney General did not have to certify rules promulgated by the Commission that were ratemaking in nature. The Rule, however, reaches far beyond mere ratemaking issues in its scope. This is evidenced by the language of Commission Decision No. 59870, which authorized that a Notice of Proposed Rulemaking for the Rule be forwarded to the Secretary of State. In the Conclusions of Law set forth in that decision, the Commission found that it had authority for the Rule under the following non-ratemaking statutes:

1) A.R.S. § 40-321 (adequacy of service).

2) A.R.S. § 40-322 (standards of service).

3) A.R.S. § 40-336 (require safety devices).

4) "Arizona Revised Statutes, Title 40, generally" (which includes matters such as CC&N).

The Rule impacts property rights, contract rights, corporate structures, constitutionally defined jurisdictional issues, internal management decisions and even the future configuration of the electric industry. Although ratemaking is one aspect impacted by the consequence of the Rule, it is not the sole or main focus of the Rule. Certainly, the intent of the Attorney General's review of rules promulgated by the Commission is to set a check and balance in those areas where the Commission does not have exclusive jurisdiction, in other words, non-ratemaking matters. TEP does not believe that the Woods case contemplates that rules impacting a wide variety of regulatory issues (the vast majority of which are non-ratemaking) should not be subject to the check of the Attorney General. Consequently, TEP believes that the Rule is not within the exception set forth in the Woods case and should be submitted to and certified by the Attorney General.

The APA also requires that rules of administrative agencies be promulgated with an opportunity for notice and comment. One of the requirements is that the Commission file an economic (consumer) impact statement. *See,* A.R.S. §§ 41-1021 and 1024(C). This statement is designed to give notice of the economic impact, both positive and negative, of a proposed rule. Unfortunately, the economic impact statement composed by the Commission Staff in connection with the Rule is incomplete and, therefore, inadequate.

On or about October 1, 1996, the Commission Staff circulated an Economic Impact Statement ("EIS") in connection with the Rule. The EIS incredibly ignored the hundreds of pages of comments submitted by utilities to the Commission that detailed the negative economic impact that the Rule will have on the Affected Utilities and others. Instead of incorporating these comments, the EIS merely states that the possible costs to the Affected Utilities would be items such as "additional record keeping and billing costs associated with deliveries of electricity." To include these matters and ignore the enormous effect of loss of shareholder value and Stranded Cost trivializes the whole purpose of the EIS. In fact, the forced write-off of portions of investments in assets will have a significant impact on: (i) shareholders who, in light of these write-offs, will lose value of their investments; (ii) ratepayers who will be assessed either higher rates or additional fees to compensate to some degree for Stranded Cost; and (iii) citizens of the state who, when the Affected Utilities' tax base is lowered, will lose substantial property tax revenues. A one-sided EIS does not provide the public with the degree of notice (and subsequent analysis) that was intended in the APA. Accordingly, in order to comply with the statutory procedural requirements, the Commission should expand the analysis in the EIS to reflect both the positive and negative impacts of the Rule.

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. 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.

V. TWO-COUNTY FINANCING

The Pima and Apache County Industrial Development Authorities have issued approximately $673 million of outstanding tax-exempt "local furnishing" bonds which benefit TEP's retail customers by reducing significantly the capital costs of serving such customers. The Rule could potentially imperil the tax-exempt status of these bonds and the related customer savings of at least $11 million annually. The Rule should address and consider the implications for TEP and other

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Arizona utilities which issue tax-exempt bonds on the basis of "local furnishing" (that is, a limited certificated service territory). "Local furnishing" bonds are also referred to as "two-county bonds."

Interest on conduit revenue bonds issued after 1968 by, or on behalf of, state or local governments to finance facilities for privately-owned businesses may be excluded from gross income for federal income tax purposes only if substantially all bond proceeds are used to provide one or more of the types of exempt facilities listed in section 142(a) of the Internal Revenue Code of 1986 (the "1986 Code"). Section 142(a)(8) provides an exemption for "facilities for the local furnishing of electric energy or gas." Section 142(f) states that this "local furnishing" exemption applies only to facilities which are part of a system providing service to the general populace in an area not exceeding the larger of (i) two contiguous counties; or (ii) one city and a contiguous county (*i.e.*, Consolidated Edison Company of New York which provides electric service to New York City and one contiguous county). Treasury Regulations clarify that an otherwise qualifying "local furnishing" system will not be disqualified by reason of its interconnections with other utilities for the emergency transfer of electricity, or because the system includes facilities located outside the area which they serve. Treas. Reg. § 1.103-8(f)(2)(iii)(d).

Internal Revenue Service ("IRS") rulings have provided further interpretations of these "local furnishing" provisions. In general, these rulings have allowed electric utilities to qualify if their facilities have been built no sooner or larger than necessary to meet the needs of the general populace in the utility's local service area and if either of two additional conditions is satisfied:

1) Except possibly during emergencies, the total amount of electricity generated by facilities connected directly to the utility's local grid, together with the amount of electricity generated by the local utility's interest in remote generating facilities (whether or not directly connected to the utility's local distribution grid) during each year (or, in one case, each six months) does not exceed the total amount of electricity consumed in the qualifying local service area. Ltr. Rul. 9447031 (August 25, 1994); Ltr. Rul. 9233004 (May 18, 1992), modified by Ltr. Rul. 9244007 (July 1, 1992); Ltr. Rul. 8915021 (January 12, 1989).

2) Except during emergencies, actual metered flows of electricity at each interconnection point between the local utility's system of wholly-owned facilities which are directly connected to its local distribution grid at all times are inbound to the local system. Under this approach, electricity is disregarded unless it is generated at (or transmitted through) facilities which are wholly-

> owned by the local utility and which are directly connected to the utility's local distribution grid. Ltr. Rul. 8508050 (November 27, 1984); Ltr. Rul. 8410037 (December 5, 1983); Ltr. Rul. 8319017 (February 7, 1983), modified by Ltr. Rul. 8322008 (February 22, 1983).

TEP's retail electric system provides service to the general populace in portions of only two contiguous counties, Pima and Cochise. However, the total amount of electricity generated by TEP's facilities each year exceeds the total amount of electricity consumed in TEP's service area. Therefore, TEP has not attempted to qualify for the "local furnishing" exemption on the basis of (1) above.

There presently are only four interconnection points between TEP's wholly-owned electric facilities which are directly connected to TEP's distribution grid and the facilities of neighboring utilities: the South Substation, the Vail Substation, the Saguaro/Tortolito Substation and the Springerville Substation. None of TEP's electric facilities located within the boundaries of these four interconnection points were built sooner or larger than necessary to meet the needs of TEP's local distribution grid. Since 1982, when tax-exempt "local furnishing" bonds first were issued for the benefit of TEP, actual metered flows of electricity always have been inbound at each of these interconnection points, except during emergency circumstances. Therefore, since at least 1982, improvements to TEP's wholly-owned, directly-connected facilities have qualified for Federal tax-exempt "local furnishing" financing.

Presently, TEP has approximately $575 million of outstanding tax-exempt "local furnishing" debt. The interest rate on this debt is reset weekly to track current short-term tax-exempt rates. During 1996, the interest rate on these tax-exempt bonds has averaged approximately 3.5 percent. During this same period, the short-term weekly interest rate on taxable debt of similar credit quality has averaged approximately 5.4 percent. The lower cost tax-exempt debt saves the Company's retail customers approximately $11 million annually. In addition, $98 million of currently outstanding tax-exempt debt obligations were issued by the Pima County Industrial Development Authority in conjunction with TEP's sale and leaseback of Irvington Unit 4. This tax-exempt financing structure also benefits TEP's retail customers. Any legal or regulatory development which jeopardizes TEP's ability to meet the "local furnishing" requirements could result in a loss of these savings and impair the progress the Company is making at improving its capital structure and financial strength.

TEP believes that the “local furnishing” conditions can be satisfied under a competitive retail environment if sufficient effort is made to anticipate and provide for such issues in the Rule. IRS rules relating to “local furnishing” 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 “local furnishing” topic and structured its rule to allow a “local furnishing” utility and its retail customers to maintain the financing benefits and yet still “open” transmission lines.

The Energy Policy Act of 1992 (P.L. 102-486) amended the Federal Power Act to allow neighboring electric utilities, as well as nonutility generators, to apply to FERC for orders requiring electric utilities to use their transmission facilities to wheel electricity for the applicant. Recognizing that this change might result in unintended, adverse consequences to customers of utilities that have taken advantage of tax-exempt “local furnishing” financing, Congress provided relief. The Energy Policy Act also amended section 142(f) of the 1986 Code to provide relief in connection with tax-exempt “local furnishing” bonds if non-emergency outbound flows of electricity occur by reason of FERC orders issued pursuant to section 211 or 213 of the Federal Power Act.

On April 24, 1996, FERC issued Order 888 concerning electric industry restructuring, direct access and related issues. Just as Congress in 1992 was concerned that mandatory wheeling of electricity might unfairly jeopardize the tax-exempt status of utilities' bonds, on pages 374 and 375 of Order 888, FERC expresses its intent that the tax-exempt status of utilities' bonds not be disturbed by the new reciprocity rules:

> [W]e recognize that Congress has determined that certain entities in the bulk power market can utilize tax-exempt financing by issuing bonds that do not constitute "private activity bonds" [ftn] or by financing facilities with “local furnishing” bonds. In both circumstances, Congress has entrusted the IRS with the responsibility for implementation and for determining what uses of the facilities are consistent with maintaining tax-exempt status for bonds used to finance such facilities. It is not our purpose to disturb Congress' and the IRS' determinations with respect to tax-exempt financing.

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> [W]e believe we must ensure that the reciprocity requirement will not be used to defeat tax-exempt financing authorized by Congress. Therefore, we clarify that reciprocal service will not be required if providing such service would jeopardize the tax-exempt status of the transmission customer's (or its corporate affiliates') bonds used to finance such transmission facilities. [ftn][4]

In an analogous situation, this Commission has shown its resolve to preserve for Arizona customers the benefits of federal tax-exemption. In response to the draft rule circulated on August 28, 1996, Arizona's electric cooperatives submitted comments dated September 12, 1996, pointing out that implementation of the draft rule could endanger the cooperatives' federal tax-exempt status under section 501(c)(12) of the 1986 Code. In particular, the Arizona cooperatives pointed out that page 499 of FERC Order 888, at footnotes 499 and 500, expressly provides that a cooperative is not to be required to provide any service that would jeopardize its tax-exempt status. This footnoted provision was intended to create relief for cooperatives that is comparable to the relief expressly provided and more thoroughly discussed by FERC Order 888 in connection with tax-exempt bonds. In paragraph H.1. of Rule R14-2-1604, this Commission rightly proposed a modification to the draft rule, authorizing cooperatives to request the Commission to modify the schedules described in R14-2-1604(A-D) so as to preserve the tax-exempt status of the cooperatives. However, Rule R14-2-1604 provides no similar relief in connection with transmission service that could jeopardize the tax-exempt status of "local furnishing" bonds or tax-exempt bonds issued for municipally-owned utilities.

Implementation of the Rule could endanger the tax-exempt status of interest on "local furnishing" bonds issued (and to be issued) for TEP if the Rule causes the Company to violate the "local furnishing" requirements specified in IRS rulings. If the Rule were to specify an obligation to serve outside of the two-county area that exceeds any contractual obligation between a willing buyer and a willing seller, such additional obligation could result in a violation of "local furnishing" requirements. This source of low-cost financing could be lost, for example, could be lost if TEP

[4] On pages 376 and 377 of Order No. 888, FERC directs each "local furnishing" utility to include a provision in its transmission tariff, which commits the utility not to contest the issuance of FERC orders under section 211 of the Federal Power Act if it appears that the provision of transmission service otherwise would jeopardize the tax-exempt status of any of the utility's "local furnishing" bonds.

became obligated to serve a customer outside of its existing two-county service territory under the proposed retail wheeling provisions.

Another issue related to the "local furnishing" requirements is the potential stranding of assets financed with tax-exempt two-county bonds. For example, both Springerville Unit 2 and Irvington Unit 4 were financed for TEP with tax-exempt "local furnishing" bonds. The energy from a "local furnishing" utility's generating facility, which is financed with tax-exempt two-county bonds, might no longer be needed to serve the utility's historic retail customers if their energy requirements are supplied by other companies from locally-based retail wheeling transactions. Absent relief, it is possible that the "local furnishing" utility would be precluded from delivering energy from that generating facility outside the utility's service area in either wholesale or retail wheeling transactions.

In either case, if the Rule fails to properly address these or related issues, the Company and its customers could be adversely affected by the loss of low cost financing or the stranding of assets financed with tax-exempt "local furnishing" bonds. TEP and its retail customers would be unfairly penalized.

There are several ways the Commission could address these "local furnishing" issues in a modified Rule. One option would be to include a provision, similar to that provided for electric cooperatives, that would authorize TEP and other "local furnishing" utilities to request the Commission to modify the schedule described in R14-2-1604(A-D) so as to preserve the tax-exempt status of interest on such bonds issued and to be issued for these utilities. Another option would be to research the issues further and to include specific language in the Rule which supports the preservation of "local furnishing" debt in a retail wheeling environment. For example, specific language could be included that clearly limits the obligation to serve outside of a "local furnishing" utility's existing service area. Finally, should these two options prove insufficient, the Commission should include in its definition of recoverable Stranded Cost any increase in financing costs or the cost of any assets stranded because of "local furnishing" requirements.

As described above, FERC Order 888 directs that a utility is <u>not</u> to be required to provide any transmission service that would jeopardize the tax-exempt status of interest on its "local furnishing" bonds. Although § 142(f)(2) of the 1986 Code provides relief from the loss of tax-exemption penalty if transmission service is provided pursuant to a FERC order which is issued under § 211 or

213 of the Federal Power Act, no federal income tax relief is available in connection with transmission service provided pursuant to a rule or order of this Commission. For the same reasons that it was appropriate for this Commission to modify the Rule to protect the tax-exempt status of cooperatives, the Rule could be modified to authorize TEP and other "local furnishing" utilities to request this Commission to modify the schedule described in R14-2-1604(A-D) so as to preserve the tax-exempt status of interest on such bonds issued and to be issued for these utilities.

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.
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> 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, has 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 the FERC, have spent considerable time to study the issues, build consensus and seek meaningful input through technical conferences and public hearings. Instead, Staff has proposed a Rule without studying the specific issues raised concerning the Rule, without attempting to build any kind of consensus and leaving the technical conferences and public hearings for some future time. Additionally, it seems the Commission is unclear as to how it wants to proceed on some of the major issues. For example, when the Rule was first proposed on October 1, 1996, SRP was not included. After the Working Session of the Open Meeting held on October 8, 1996, SRP was included under certain circumstances. These kinds of issues should not be decided "from the seat of the pants." They need to be thoroughly examined before being codified in a Rule that has the force and effect of law.

TEP has identified herein many of the primary objectives of retail competition that must be addressed in any proposed rule, as well as the primary Stranded Cost and legal implications that must be resolved prior to the adoption of a definitive rule. TEP will also file a second set of comments at a later time to address issues such as reliability, operations and pricing. Because these primary issues remain unresolved vis-à-vis the Rule, TEP urges the Commission not to rush the adoption of the Rule, but follow the leads of other jurisdictions to resolve the major issues first. TEP, therefore, proposes that before a rule is adopted by the Commission, 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 a threshold to a system that can be implemented optimally, legally and equitably.

Finally, if the Commission is concerned that if it does not adopt this Rule there will be a delay in bringing retail electric competition to Arizona, TEP urges the Commission to consider not adopting the Rule in favor of a Statement of Policy that would preserve the Commission's time frame while permitting the major issues to be addressed prior to the adoption of a definitive rule.