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COMMISSIONER

5
6 IN THE MATTER OF COMPETITION
7 IN THE PROVISION OF ELECTRIC
8 SERVICES THROUGHOUT THE
9 STATE OF ARIZONA.

DOCKET NO. U-0000-94-165

NOTICE OF FILING

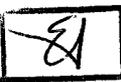
10 The Residential Utility Consumer Office (RUCO) hereby provides notice of filing
11 the Reply Comments on the Commission Staff's draft rule on electric industry restructuring,
12 in the above-referenced Docket.

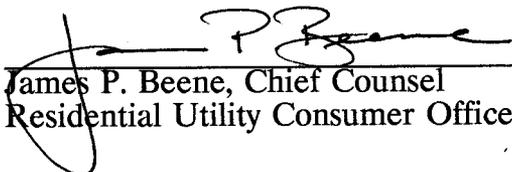
13 RESPECTFULLY SUBMITTED this 27th day of November, 1996.

14 Arizona Corporation Commission

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18 
James P. Beene, Chief Counsel
Residential Utility Consumer Office

19 AN ORIGINAL AND TEN COPIES of the
20 foregoing filed this 27th day of
21 November, 1996 with:

22 Docket Control
23 Arizona Corporation Commission
1200 W. Washington
Phoenix, Arizona 85007

24 COPIES of the foregoing hand delivered
25 this 27th day of November, 1996 to the
following:

26 Jerry Rudibaugh, Chief Hearing Officer
Hearing Division
27 Arizona Corporation Commission
1200 W. Washington
28 Phoenix, Arizona 85007

1 Paul Bullis, Chief Counsel
Legal Division
2 Arizona Corporation Commission
1200 W. Washington
3 Phoenix, Arizona 85007

4 Gary Yaquinto, Director
Utilities Division
5 Arizona Corporation Commission
1200 W. Washington
6 Phoenix, Arizona 85007

7 COPIES of the foregoing mailed
this 27th day of November, 1996
8 to the following:

9 Barbara Klemstine
Arizona Public Service Co.
10 Law Department, Station 9909
P.O. Box 53999
11 Phoenix, Arizona 85072-3999

12 Thomas L. Mumaw, Esq.
Steven M. Wheeler, Esq.
13 Snell & Wilmer
One Arizona Center
14 400 East Van Buren
Phoenix, Arizona 85004-0001

15 C. Webb Crockett, Esq.
16 Fennemore Craig
Two North Central Avenue, Suite 2200
17 Phoenix, Arizona 85004-2390

18 Michael A. Curtis
Martinez & Curtis, P.C.
19 2712 North 7th Street
Phoenix, Arizona 85006
20 Attorneys for Arizona Municipal Power
Users' Association

21 Walter W. Meek, President
22 Arizona Utility Investors Association
3030 North Central Avenue, Suite 506
23 Phoenix, Arizona 85012

24 Rick Gilliam
Land and Water Fund of the Rockies
25 2260 Baseline Road
Boulder, Colorado 80302
26

27

28

1 Charles R. Huggins
Arizona State AFL-CIO
2 110 North 5th Avenue
P.O. Box 13488
3 Phoenix, Arizona 85002

4 David C. Kennedy
Law Offices of David C. Kennedy
5 100 West Clarendon Avenue, Suite 200
Phoenix, Arizona 85012-3525

6 Norman J. Furuta
7 Department of the Navy
900 Commodore Drive, Building 107
8 P.O. Box 272 (Attn: Code 90C)
San Bruno, California 94066-0720

9 Thomas C. Horne
10 Michael S. Dulberg
Horne, Kaplan & Bistrow, P.C.
11 40 North Central Avenue, Suite 2800
Phoenix, Arizona 85004

12 Barbara S. Bush
13 Coalition for Responsible Energy Education
315 West Riviera Drive
14 Tempe, Arizona 85252

15 Sam Defraw (Attn: Code 16R)
Rate Intervention Division
16 Naval Facilities Engineering Command
200 Stovall Street, Room 10S12
17 Alexandria, VA 22332-2300

18 Rick Lavis
Arizona Cotton Growers Association
19 4139 East Broadway Road
Phoenix, Arizona 85040

20 Steve Brittle
21 Don't Waste Arizona, Inc.
6205 South 12th Street
22 Phoenix, Arizona 85040

23 Ajo Improvement Company
P.O. Drawer 9
24 Ajo, Arizona 85321

25 Columbus Electric Cooperative, Inc.
P.O. Box 631
26 Deming, New Mexico 88031

27
28

- 1 Continental Divide Electric Cooperative
P.O. Box 1087
- 2 Grants, New Mexico 87020
- 3 Dixie Escalante Rural Electric Association
CR Box 95
- 4 Beryl, Utah 84714
- 5 Garkane Power Association, Inc.
P.O. Box 790
- 6 Richfield, Utah 84701
- 7 Mohave Electric Cooperative, Inc.
P.O. Box 1045
- 8 Bullhead City, Arizona 86430
- 9 Morenci Water and Electric Company
P.O. Box 68
- 10 Morenci, Arizona 85540
- 11 Louis A. Stahl, Esq.
Lisa D. Duran, Esq.
- 12 Streich Lang
Renaissance One
- 13 Two North Central Avenue
Phoenix, Arizona 85004-2391
- 14 Beth Ann Burns
Citizens Utilities Co.
2901 N. Central Avenue, Suite 1660
- 15 Phoenix, Arizona 85012
- 16 Bradley S. Carroll
Tucson Electric Power Co.
P.O. Box 711
- 17 Tucson, Arizona 85702
- 18 Terry Ross, Vice President
Center for Energy and Economic Development
7853 East Arapahoe Court, Suite 2600
- 19 Englewood, Colorado 80112
- 20 Peter Glaser
Doherty, Rumble & Butler, P.A.
1401 New York Avenue, N.W., Suite 1100
- 21 Washington, DC 20005
- 22 Richard S. Shapiro, Senior Director
Enron Capital & Trade Resources
1400 Smith Street, Suite 1405
- 23 Houston, Texas 77002
- 24
- 25
- 26
- 27
- 28

1 Albert Sterman, Vice President
Arizona Consumer Council
2 2849 E. 8th Street
Tucson, Arizona 85716

3
4 Calpine Power Services Company
50 West San Fernando
San Jose, California 95113

5
6 Jack Haenichen
Arizona Department of Commerce
3800 North Central Avenue, Suite 1500
7 Phoenix, Arizona 85012

8 K. R. Saline & Associates
P.O. Box 30279
9 Mesa, Arizona 85275

10 Robert S. Lynch
2001 North Third Street, Suite 204
11 Phoenix, Arizona 85004-1472

12 Dan Neidlinger
Neidlinger & Associates, Ltd.
13 3020 N. 17th Drive
Phoenix, Arizona 85015

14 Russell E. Jones
15 O'Connor Cavanagh Molloy Jones
One E. Camelback Road, Suite 1100
16 Phoenix, Arizona 85012-1656
Attorneys for Trico Electric Cooperative

17 John Jay List, General Counsel
18 National Rural Utilities Cooperative
Finance Corporation
19 2201 Cooperative Way
Herndon, Virginia 21071

20 Sue Arnold, Financial Analyst
21 Program Support and Regulatory Analysis
Utilities Service
22 United States Department of Agriculture
1400 Independence Avenue, S.W.
23 Mail Stop 1522
Washington, DC 20250-1522

24 Wallace F. Tillman, Chief Counsel
25 Susan N. Kelly, Regulatory Counsel
National Rural Electric Cooperative Association
26 4301 Wilson Boulevard
Arlington, Virginia 22203-1860

27

28

1 David X. Kolk, Ph.D.
Power Resource Managers, L.L.C.
2 2940 Inland Empire Boulevard, Suite 123
Ontario, California 91764

3 Debra S. Jacobson, Manager
4 State Regulatory Affairs
Southwest Gas Corporation
5 P.O. Box 98510
5241 Spring Mountain Road
6 Las Vegas, Nevada 89193-8510

7 Ellen Corkhill
American Association of Retired Persons
8 5606 N. 17th Street
Phoenix, Arizona 85016

9 William D. Baker, Assistant Secretary
10 Electric District No. 6
Pinal County, Arizona
11 P.O. Box 16450
Phoenix, Arizona 85011

12 Sheryl A. Taylor
13 Ryley, Carlock & Applewhite
101 North First Avenue, Suite 2700
14 Phoenix, Arizona 85003-1973

15 Douglas C. Nelson, P.C.
7000 North 16th Street
16 #120-307
Phoenix, Arizona 85020

17 Nancy Russell
18 Public Interest Coalition on Energy
2025 North 3rd Street, Suite 175
19 Phoenix, Arizona 85004

20 Jessica Youle
Jana D. Alfano
21 Salt River Project Agricultural
Improvement and Power District
22 P.O. Box 52025, PAB 300
Phoenix, Arizona 85072-2025

23 and
24 John Christian
Glenn Carter
Jennings, Strouss & Salmon
25 One Renaissance Square
Two North Central Avenue
26 Phoenix, Arizona 85004-2393

27

28

1 Barry N. P. Huddleston
Regional Manager, Regulatory Affairs
2 Destec Energy, Inc.
2500 City West Boulevard, Suite 150
3 Houston, Texas 77042

4 Karen Glennon
19037 North 44th Avenue
5 Glendale, Arizona 85308

6

7 By Cheryl Fraulob
Cheryl Fraulob
8 Legal Secretary

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

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Reply Comments of
Residential Utility Consumer Office

on the

Arizona Corporation Commission Staff's
Proposed Rule on Retail Electric Competition

November 27, 1996

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SUMMARY

- In RUCO's opinion, the Draft Rule is premature and should be rejected or at best be regarded as a Draft Policy Statement. An issue resolution phase of these proceedings should be commenced.
- The Commission should carefully define distribution utilities as regulated utilities, contrasted with competitive providers which provide those services that the Commission determines can be competitively provided.
- The Draft Rule should comprehensively address the problem of market power.
- The Draft Rule does not deal adequately with the issue of market structure.
- Standard Offer Service on a permanent basis should be an integral part of restructuring; it does not give rise to serious problems of the kind alleged by some parties.
- Buy-through should be eliminated from the Draft Rule.
- The solar portfolio standard could prove costly to ratepayers, and the proposed system benefits charge should be limited in scope.
- Competitive electricity suppliers should not be subjected to onerous regulation as envisioned in the Draft Rule.
- The stranded cost provisions of the Draft Rule should not be altered to provide for guaranteed recovery of stranded costs by utilities.
- The Draft Rule raises serious legal issues and concerns regarding in-state reciprocity. Customers of public systems should be able to participate in the competitive market.
- Retail competition will bring clear benefits to customers and to the state economy.

ISSUES RAISED IN RUCO'S COMMENTS

1. The Draft Rule is Premature

A number of parties agreed with RUCO's position that the Draft Rule is premature. A phase of "due deliberation and decision on the issues," as proposed in RUCO's comments, is needed. Arizona Public Service calls for the prompt scheduling of evidentiary hearings. The reclassification of the Draft Rule as a draft Policy Statement by the Commission at this time, as proposed by Citizens Utilities Company, followed by evidentiary hearings, could be the least contentious solution.

Arizona Community Action Association, Arizona Consumers Council and Arizona Citizens Action in their joint filing, while recognizing that a number of issues still need to be resolved, proposed that working groups or workshops could best resolve these issues, rather than delaying the adoption of the Draft Rule followed by "long, protracted evidentiary hearings." Asarco, BHP Copper and Cyprus (ABC) also supports adoption of the proposed rules, but identifies a number of issues that should be addressed by working groups. RUCO is of the opinion, however, that the Draft Rule should be no more than a Draft Policy Statement by Commission Staff. The coalition consisting of the Arizona Association of Industries *et al.* accepts the Draft Rule as a framework, but agrees that evidentiary hearings should be held so long as this is consistent with maintaining or accelerating the phase-in schedule.

2. There Must be Proportional Retail Access for All Customer Classes on the Same Time Schedule

Several parties appear to agree with RUCO's position on proportional access. In a short letter, Intel, Allied Signal and Air Products note how important it is not to "impede the ability of customers, utilities, and other power suppliers to participate" and point out that "(e)xcluding any party diminishes the ultimate goal of a vibrant competitive market. Any decision which limits competitive choice to less than all customers will result in unfairness and leave excluded customers at a competitive advantage."

However, the parties have not fleshed out their proposals sufficiently to ensure that proportional access is achieved. RUCO proposes that the Commission's policy should be unequivocal on this issue. Furthermore, complementary features of restructuring -- such as ease of formation of aggregators and assurances that no special customer metering will be required -- are necessary to make proportional access a reality.

3. The Distinction Between Distribution Utilities and Competitive Electricity Suppliers Should be Clarified

The Cooperatives (AEPCO, Duncan, et al.) have proposed that Distribution Services be more clearly defined (see their comments at page 6). This seems to be a reasonable proposal that complements RUCO's definition of Distribution Utilities.

4. The Commission Should Periodically Determine Which Services are Competitive and Which are Not

RUCO further reiterates that there is a blurred line between customer services that can be competitively provided and those that cannot. The Distribution Utility should offer distribution and distribution-related services that are classified as non-competitive by the Commission from time to time.

5. The Draft Rule Should Comprehensively Address the Problem of Market Power

This issue remains undeveloped in most comments filed. This is a surprising oversight. In RUCO's view, the premise of economic deregulation is that generation services can now be offered competitively in Arizona. This premise needs to be kept in mind in the context of Commission monitoring of the early phases of retail competition, and review of any proposed mergers, affiliate deals, and the continued provision of generation by vertically integrated utilities. In other words, issues of horizontal market power, vertical market power, and affiliate transactions all need to be addressed.

6. The Draft Rule Does Not Deal Adequately With the Issue of Market Structure

Surprisingly, this issue was not addressed in most of the comments filed. SRP, however, noted the need for a clearing house to determine real-time prices. The Power Mart proposed by RUCO would perform this function, among others.

7. Standard Offer Service Must be Permanently Available

The Cooperatives oppose the continuation of Standard Offer Service on the grounds that it would lead to uneconomic duplication of capacity -- competitive electricity suppliers would have to line up resources to provide for their customers' loads, and the utility also has to line up resources *just in case* those customers return to Standard Offer Service. Movements of customers back and forth could be motivated by an attempt to game the system by larger customers.

While the concern is a genuine one, the problems identified are not as serious as they are presented to be, nor are they insuperable. These are the kinds of problems that are avoided by an appropriate *market structure*. The lack of development of market structure issues is a weak feature of the Draft Rule and most of the comments on it.

First, it is important to keep in mind that, within any state or region, any customers who switch from one supplier to another free up the same amount of resources as they now require from their new suppliers. The total resource requirement remains the same; what changes is the contractual arrangements. Anticipating this problem, supply contracts can be written flexibly by including various options, for example.

Second, the new market structure should be sufficiently competitive to accommodate the needed contractual rearrangements. The market structure proposed by RUCO includes *both* bilateral contracts and a spot power market. Resources freed up when customers leave a supplier and select Standard Offer Service will either be committed by the supplier under new contracts to the Standard Offer supplier, or will be channelled through the spot market and will be available to the Standard Offer supplier who can supplement contractual sources with spot market energy.

Third, RUCO has proposed that an ISO should be created that has responsibility for system reliability. One of the ISO's concerns will be that aggregate generating resources are sufficient to provide reliably for aggregate demand.¹ The ISO's intervention in the market -- *e.g.* by contracting for supplementary resources when it anticipates a shortfall -- need not be primarily concerned with suppliers' specific contractual arrangements, so long as the aggregates are in balance.

Finally, as a last resort, if the initial phases of retail competition reveal any tendency of large customers to play the system by switching back and forth between Standard Offer service and alternative providers, the Commission should be authorized to limit switching to and from Standard Offer service for customers above a certain size, who could be required to enter into Standard Offer contracts of certain minimum duration, for example.

RUCO agrees with Arizona Community Action Association, Arizona Consumers Council and Arizona Citizens Action that Standard Offer rates should be presented to customers on an unbundled basis, so that customers can identify the items that they are paying for.

¹ Transmission resources are of course also critical; as a general rule, similar considerations apply -- transmission capacity freed up when a customer switches is available to be committed to the Standard Offer provider or other new provider of the customer's load. In some cases, switching may involve changes of transmission charges imposed under the comparable, open access tariffs filed with the FERC. Since the total of electricity flows is likely to remain the same, changes in transmission tariffs are likely to offsetting.

8. The Franchise to Provide Standard Offer Service Should be Competitively Bid

As stated in RUCO's earlier comments, standard offer service could initially be provided by the utility but in the long term it would be desirable to have competitive bidding for standard offer service.

9. Buy-Through Should be Eliminated

Buy-through received mixed reviews. The Environmental Group is in favor of buy-throughs for renewable resources, but notes that the Draft Rule as written leaves too much discretion in the hands of utilities and "leaves the door open for a utility to unjustly discriminate among customer classes," which is RUCO's essential concern.

Any buy-throughs should be at the option of the customer and should be included within the retail access proportions of the customer class.

10. Should Special Provisions for Solar Power Have a Place in the Draft Rule?

The Environmental Group argues for "vigorous promotion of clean power technologies," and would like to see larger minimum percentages of solar energy mandated. RUCO is concerned about the potential cost of the solar portfolio standard as incorporated in the Draft Rule, *i.e.*, without any reference to cost or market pricing. RUCO's preference is for market solutions including provisions for "green power" offerings to retail customers by competitive suppliers who receive certification that their resources meet certain environmental standards.

The Commission should determine whether marketers offering green power meet appropriate standards. Regulatory Assistance Project and others are developing proposed criteria for green power. But RUCO does not believe that other marketers should have to provide environmental disclosure, as proposed by the Environmental Group.

All generators would, of course, be required to meet existing and future applicable state and federal environmental standards for siting and operating power plants and transmission facilities.

As an exception to RUCO's preferred market orientation, where the distribution utilities identify distribution system savings that could result from "distributed generation," it would make sense for the utility as part of its general regulated rates to provide support for such generation. This would, in effect, be a blend of the regulated distribution market and competitive suppliers who would have to decide if the support provided by the distribution utility is sufficient to make the project economical. Such projects could be part of green power offerings, which could provide further support for them from customers.

The Center for Energy and Economic Development shares RUCO's concerns regarding the cost to ratepayers and the Arizona economy that might result from the adoption of the solar portfolio standard.

11. Competitive Electricity Suppliers Should Not be Subjected to Onerous Regulation by the Commission

RUCO expressed concern that the Draft Rule's regulation of electricity providers would be onerous. Economic deregulation of generation is the primary objective of restructuring -- economic discipline should be provided by the competitive market place, not by the Commission.

Pacific Gas & Electric's subsidiaries Vantus Energy Corporation and Vantus Power Services (collectively Vantus) have expressed similar concerns over excessive regulation. Vantus argues that "the proposed rule will not achieve retail competition" because of the burdensome nature of the certification requirements for electricity providers. RUCO is in broad agreement with this objection to the Draft Rule, as stated in our earlier comments, especially with respect to tariff filings, which should not be required.

12. The Conditions for Recovery of Stranded Costs by the Utilities Should be Tightened Up

The utilities argue that any disallowance of stranded cost recovery violates the regulatory compact, would be an unconstitutional "taking" and so forth. These assertions do not deal with underlying problem that the regulatory compact -- if indeed it was clear enough to be regarded as carrying contractual commitments and constitutional protection -- was based upon the premise that the utilities were operating in conditions of natural monopoly.

The question now is, since the premise of natural monopoly no longer applies, how should state authorities deal with stranded costs? Regulation was supposed to mimic competitive conditions. It failed to do so -- regulated rates are significantly higher than market prices today. There are now *two* standards that regulators could turn to -- (high) rates based upon embedded costs, and (low) rates based directly upon competitive market prices.

It seems to RUCO that the transitional treatment of stranded costs should be based on some compromise between these two rate standards, rather than on either one to the exclusion of the other. Considerations of incentives for utilities to mitigate stranded costs and get the most value out of their assets support some reference to market prices when transitional charges are being set.

Citizens Utilities opposes any reduction of stranded costs by offsetting revenues from collateral services that utilities can sell. APS has a similar concern. RUCO believes it is reasonable to offset revenues from those diversified services that help the utilities to spread their overhead costs and increase the value of their assets. For example, engineering services offered by the utility to new clients in the U.S. and internationally can help employ staff no longer needed to plan and implement generation expansion plans. Some utility assets may have greater value than their current use to provide utility service. Some assets could also be put to additional uses; e.g., utility rights of way might have value for other purposes in addition to carrying power lines. Finally, of course, stranded costs should be net of the excess of market value of some assets over their depreciated book values, and net of any excess of *future* output values over future market prices.

13. The Proposed System Benefits Charge Should be Limited in Scope

Arizona Community Action Association, Arizona Consumers Council and Arizona Citizens Action in their joint filing, refer with approval to other states in which system benefits charges are in excess of the 2% charge that they favor. RUCO believes that the regulations should not specify a specific target percentage, but rather provide the Commission with clear limits regarding the types of benefits to be covered.

14. and 15. The In-State Reciprocity Provisions Should be Simplified; The Draft Rule Raises Serious Legal Problems

The legal concerns are broad. APS states that "The Commission can not 'go it alone' in either authorizing or implementing retail electric competition." Trico Electric Cooperative declares baldly that "The Commission has no legal right to adopt such rules before the Arizona Constitution and statutes are amended to permit retail competition."

Several parties were concerned about the reciprocity issues as they affected public power entities such as SRP, and the partly related issues of the extent of the Commission's authority to set rates, etc.

RUCO believes that the reciprocity provisions are unrealistic in that they require unanimous consent from Affected Utilities before SRP can participate in the market.

SRP and other public entities must -- sooner rather than later -- be able to compete, and their customers should have the right to choose their own suppliers.

Level playing field issues are discussed below.

OTHER ISSUES RAISED BY PARTIES

1. Demonstrable Benefits of Retail Competition

APS is skeptical about the benefits of retail competition as proposed in the Draft Rule, as opposed to wholesale competition for example. The lack of a showing of net benefits from implementing the Draft Rule is a concern expressed by Arizona Community Action Association, Arizona Consumers Council and Arizona Citizens Action in their joint filing, which also raises the issues of potential increases in costs and risks, and decreases in quality of service.

RUCO believes that a properly structured competitive market will bring substantial benefits to consumers in the form of lower prices and wider choice of energy services. While these benefits cannot easily be quantified, consider the fact that, if there were a competitive market today, customers would be paying market prices for electricity. It is obvious that most customers are paying higher prices today for regulated electric service. As a first approximation, the difference between current rates and competitive prices represents the savings that could be achieved. It is hard to imagine any competitive market that would result in cost *increases* compared with current levels.

APS argues that "competition by its very nature creates winners and losers." The fact is, however, that the principal losers in a competitive market are high-cost producers. Winners include low-cost producers and, potentially, all customers. Shifting of tax revenues can, it is true, create inequities, and this problem needs to be considered by the legislature.

Increases in risk could result if there is price volatility in the market or if reliability is jeopardized. Contractual alternatives can shift the risk or price volatility to suppliers or brokers. RUCO expects that in a competitive market customers will be offered alternatives such as fixed rates *versus* rates that fluctuate with market conditions.

As regards decreases in quality of service, we must distinguish between distribution service and generation service. Distribution service, which has given rise to most quality of service problems in the past -- local power outages, billing concerns, etc. -- will still be regulated. There is no reason why distribution service should suffer any quality impairment. As regards generation service, customers will have choices and contractual remedies. Concerns about the overall reliability of the supply system should be taken care of by an ISO empowered to monitor and anticipate any reliability problems and taken necessary steps to avert them.

RUCO agrees with Arizona Community Action Association, Arizona Consumers Council and Arizona Citizens Action that Standard Offer rates should be no higher than current rates. This can be assured by competitive bidding for Standard Offer franchises, coupled with appropriate level of recovery of utility stranded costs. (If the wires charge for stranded cost recovery is set no lower than the level of stranded cost recovery included in

current rates, then Standard Offer rates, or the alternative generation rates available in the market place, when coupled with distribution tariffs, might be no lower than current rates.)

RUCO has attempted to develop proposals that would, as desired by Arizona Community Action Association, Arizona Consumers Council and Arizona Citizens Action, "stimulate the development of a viable competitive market for residential and low income consumers." Regarding the specific proposal for "postage stamp" distribution rates, RUCO believes that this is no more than a continuation of existing *distribution* rate policies, which the Commission should not change.

Generation services should be available and equally priced regardless of location. Red-lining should be prohibited. System line losses, which are greater for delivery to rural areas, should be a responsibility of the distribution utility, which can recover them from customers on an equal basis irrespective of location.

2. Level Playing Field Issues and Equitable Considerations

These issues arise with respect to participation in the competitive market by SRP and other public power entities that have preferred tax status. The investor-owned utilities are concerned about the manner in which the tax-exempt status of public power entities tilts the playing field. An interim solution to this problem could be by setting stranded cost levels for investor-owned utilities somewhat higher than they otherwise would be, *i.e.*, by setting the market prices lower.

Tucson Electric Power proposes something similar on a continuing basis -- a continuing wires charge for power delivered from SRP to customers in the service areas of investor-owned utilities.

SRP, on the other hand, argues that the Draft Rule "demonstrates a protectionist attitude" and that nearly 700,000 customers of SRP and municipal utilities would be excluded from the market.

RUCO agrees that all customers should be able to participate in the competitive market. But RUCO is not opposed to taking all sources of power including public power into account in estimating market price levels for purposes of determining the level of stranded costs for transitional cost recovery purposes for investor owned utilities. This would give investor-owned utilities partial protection by means of a wires charge during the transition period. This kind of provision could be part of an intergovernmental agreement, which SRP believes would be a constitutional means of providing choice for all electricity consumers.

However, the imposition of any permanent wires charges payable by customers would be burdensome. The long-term resolution of this issue will depend on the legislative

redefinition of the status and functions of public power entities if and when they sell electricity in a competitive power market. Should income from SRP's sales outside its area be taxable, for example?

3. Obligation to Serve

SRP is concerned that the Draft Rule is silent on the subject of the obligation to serve. RUCO believes that utilities should still have the obligation to *deliver* electricity. During the transitional period, utilities would also have the obligation to provide full utility service (Standard Offer Service) to all customers in their areas. Later, if and when the power supply component of Standard Offer Service is competitively bid, the company awarded the franchise to provide Standard Offer power supply should have the obligation to serve.

CONCLUSION: RUCO'S PROCEDURAL RECOMMENDATION

RUCO proposes that the Draft Rule be rejected, or at best reclassified as a Draft Policy Statement. In the New Year, the Commission should, in RUCO's opinion, institute an issue resolution phase of these proceedings which would include evidentiary hearings.