BEFORE THE ARIZONA CORPORATION COMMISSION

RENZ D. JENNINGS
CHAIRMAN
MARCIA WEEKS
COMMISSIONER
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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

NOTICE OF FILING AND RESPONSES TO LEGAL ISSUES

Staff of the Arizona Corporation Commission ("Staff") hereby provides Notice of the filing of its Responses to the Comments filed by various interested parties in the above- captioned docket. As part of these Responses, Staff has also prepared a brief discussion of the legal issues raised by the parties in this case, which is included as a part of this Notice.

STAFF'S RESPONSES TO LEGAL ISSUES

In reviewing the Comments filed in this matter by the various interested parties, Staff believes it is appropriate to respond in a general way to several of the concerns raised by the parties over legal matters arising from the Commission's consideration of the Proposed Rules. Most of the legal comments concerned similar issues, and so Staff has organized its response in a topical manner, rather than by party.

A. <u>The Commission Has the Legal Right to Promulgate These Rules.</u>

One primary overriding comment made by the parties is that the Commission has no legal right to adopt the rules as set forth in Decision No. 59870. This argument follows several lines of reasoning, the three primary ones being that the rules modify or abrogate the regulatory compact; the rules are in violation of the Arizona Administrative Procedures Act; and that the Commission does not have the authority to issue, modify or delete a Certificate of Convenience and Necessity without some legislative change.

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1. <u>The Rules Are Not an Unlawful Modification or Abrogation of the Regulatory Compact.</u>

The basic argument made by the parties regarding the regulatory compact is that there is some sort of "contract" between the state and the incumbent monopoly electric utility, wherein the utility is obligated to supply electricity to all customers who require it at a reasonable cost, and in return, the state agrees to provide the utility with the exclusive right to serve all customers within a defined territory. The argument goes on to assert that since the Proposed Rules would change the exclusive nature of electric service, the rules unilaterally abrogate or at least modify this contract, and thus the Proposed Rules cannot be passed.

The essential problem with this argument is that it is not clear that any such "contract" has been formed. Generally, a party asserting the formation of a contract by statute must overcome a presumption against such formation, and courts will be cautious both in identifying a contract within the language of a regulatory statute, and in defining the outlines of any contractual obligation. <u>Nat'l R.R. Passenger Corp. v. Atchison, Topeka, and Santa Fe Ry. Co.</u>, 470 U.S. 451, 466, 105 S.Ct. 1441, 1452 (1985). "[A]bsent some clear indication that the legislature intends to bind itself contractually, the presumption is that 'a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise.'" <u>Id.</u> at 465-66, 105 S.Ct. at 1451 (quoting <u>Dodge v. Bd. Educ. of City of Chicago</u>, 302 U.S. 74, 79, 58 S.Ct. 98, 100 (1937)). In promulgating these Proposed Rules, the Commission is exercising the legislative discretion flowing from its plenary ratemaking authority. <u>See</u> <u>Simms v. Round Valley Light & Power</u>, 80 Ariz. 145, 294 P.2d 378 (1956). The question as to whether particular legislation creates a contractual right begins with an examination of the statute itself. <u>Nat'l R.R. Corp.</u>, 470 U.S. at 465-66, 105 S.Ct. at 1451. However, a search of the Arizona Constitution reveals no such intent on the part of the State to bind itself. Indeed, the Constitution expressly disfavors monopolies: "[m]onopolies and trusts shall never be allowed in this State . . . ." Ariz. Const. Art. XIV, § 15.

Furthermore, while the parties cite <u>Application of Trico Electric Co-operative, Inc.</u>, 92 Ariz. 373, 377 P.2d 309 (1962) for the proposition that "the state in effect contracts" with a monopoly utility, that language in Trico is clearly dicta. Additionally, other cases refer to regulated monopoly as public policy rather than a contractual relationship. See Ariz. Corp. Comm'n v. Super. Ct., 105 Ariz. 56, 59, 459 P.2d 489 (1969) (regulated monopoly held to be public policy of Arizona); Winslow Gas Co. v. Southern Union Gas Co., 76 Ariz. 373, 385, 265 P.2d 442, 443 (1954)(referring to Arizona's public policy of controlled monopoly); James P. Paul Water Co. v. Ariz. Corp. Comm'n, 137 Ariz 426, 429, 671 P.2d 404, 407 (1983)("It is well established that Arizona's public policy respecting public service corporations . . . is one of regulated monopoly over freewheeling competition.").

In addition, it is well established that any alleged contract is subject to modifications in the law. The parties seem to find the source of the regulatory compact in both the Arizona Constitution and the statutes concerning public service corporations. The Constitution clearly provides for changes in the law concerning public service corporations; see Ariz. Const Art. XV, §3. Further, any statutes concerning public service corporations may be changed at any time as well. If indeed the Constitution and the statutes have created a contract such as the parties claim, then this possibility for changes in the law must also be a part of that contract.

2. The Rules Do Not Violate the Administrative Procedures Act.

The next argument made by the parties is that the Commission in adopting the Proposed Rules in this manner is violating the Arizona Administrative Procedures Act ("APA"), A.R.S. §41-1001 et seq. There are two prongs to this argument, one being that the rules will clearly not be certified by the Attorney General's office, and the other being that because the Economic Impact Statement ("EIS") accompanying the Proposed Rules are somehow inadequate, interested persons are not given an adequate opportunity for notice and comment as required in the APA. Both prongs are without merit.

Staff believes that the rules are not subject to Attorney General certification, as they are quite plainly a manifestation of the Commission's ratemaking authority. Clearly, the adoption of the Proposed Rules will have an impact on rates, something even all the commentators seem to recognize. Such an impact on rates has been recognized as grounds for the Commission's authority to exercise its plenary ratemaking authority through the adoption of rules. Ariz. Corp. Comm'n v. State ex rel. Woods, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992). Where rules, such as these, are an exercise of that ratemaking authority, the Attorney General does not have the authority to review and reject them. State ex rel. Corbin v. Ariz. Corp. Comm'n, 174 Ariz. 216, 219, 848 P.2d 301 (Ct.App. 1992).

Further, the Commission is expressly exempted pursuant to A.R.S. §41-1057 from the requirement of submitting an EIS as set forth in §41-1055. Under §41-1057, the Commission is merely required to adopt substantially similar review procedures for its rules. This is what Staff has done in this case in preparing the EIS forwarded to the Secretary of State as part of the rulemaking package. Staff's EIS thus meets the requirements of the APA.

3. The Adoption of These Rules Does Not Issue, Modify or Delete Any CC&N.

Another argument raised by various parties in this proceeding is that the Commission has no authority to enact the Proposed Rules because the legislature has not afforded the Commission the authority to issue competitive CC&Ns as is contemplated by the rules. According to this argument, the Commission has no authority to promulgate the Proposed Rules until the legislature grants to the Commission the authority to grant competitive CC&Ns.

This argument ignores the simple fact that the adoption of the Proposed Rules does not grant to any potential competitor the right to provide electric service. Pursuant to the Proposed Rules, CC&Ns may be granted to applicants after going through an application process which includes public notice of the application and an opportunity for a hearing. See A.A.C. R14-2-1603. No CC&N is granted merely by the adoption of the Proposed Rules, and any CC&N granted under this Proposed Rules is expressly conditional upon numerous factors set forth in the rules. Therefore no additional legislative authority is required for the Commission to promulgate the Proposed Rules.

Furthermore, the courts have recognized that the Commission does have the authority to determine when competition is in the public interest and to issue competitive CC&Ns. Arizona v. People's Freight Line, 41 Ariz. 158, 166-67, 16 P.2d 420, 423 (1932); Winslow Gas Co. v. Southern Union Gas Co., 76 Ariz. 383, 385, 265 P.2d 442, 443 (1954). Thus, while Staff welcomes a role for the legislature in clarifying this authority, Staff believes such authority already exists.

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B. The Adoption of the Proposed Rules Does Not Violate Due Process.

Several parties in their comments have observed that the Proposed Rules as written violate due process because they are impermissibly vague. They argue that the Proposed Rules defer resolution of too many issues, such as stranded cost and the nature of CC&Ns under the rules, and do not give the affected parties fair warning as to how these and other aspects of the rules will be determined by the Commission.

A statute or rule is impermissibly vague in violation of due process if a) it fails to give a person of ordinary intelligence a reasonable opportunity to know what the law is in order to plan accordingly, or b) it allows arbitrary or discriminatory enforcement by failing to provide an objective standard. Bird v. State, 184 Ariz. 198, 908 P.2d 12 (Ct.App. 1995).

The Proposed Rules as written do not violate this standard. First, in regard to stranded cost recovery, the rules set up a process for utilities claiming to have incurred stranded costs to seek recovery of those costs. The rules set forth several factors for the Commission to consider in determining a utility's stranded cost, and allow the requesting utility to recover the appropriate amount. The rules thus give the utility an opportunity to know what the law is so it can plan ahead, and sets forth an objective standard which the Commission must follow in doing so. As for CC&Ns, once again it is clear to a person of ordinary intelligence that under the Proposed Rules, all new CC&Ns will be competitive CC&Ns, and that under the rules there is a clear standard for granting such CC&Ns. Thus Staff does not agree that the Proposed Rules are impermissibly vague in violation of due process.

C. The Proposed Rules Do Not Violate Equal Protection.

Some parties argue that the rules as proposed do not allow for equal treatment of all members of a recognized class, that class being all entities that provide electric services. The claim is made that the Proposed Rules treat incumbent monopoly public service corporations differently than they treat such potential competitors as the Salt River Project, municipal corporations, tribal authorities and non-utility generators. According to these comments, these other entities are not subject to any of the obligations of the Proposed Rules, but are still allowed to reap the benefits of the rules. Such unequal treatment, it is claimed, violates equal protection.

What these comments fail to recognize is the serious difference between the incumbent monopoly providers and other potential entrants. Equal protection is satisfied if all persons in a class are treated alike. Baseball Liquors v. Circle K Corp., 129 Ariz. 215, 630 P.2d 38 (Ct.App. 1981), cert den. 454 U.S. 969, 102 S.Ct. 515. Legislation which applies to members of a class, but not to nonmembers of that class, will be upheld under equal protection if the classification is not arbitrary and there is a substantial difference between those within the class and those without. Farmer v. Killingsworth, 102 Ariz. 44, 424 P.2d 172 (1967). In this instance, there is one clear difference between the incumbent monopoly providers, and all others: the incumbents' monopoly status. To treat all parties identically under the rules would fail to recognize the incumbents' ability to use their current monopoly status to inhibit the competition these rules are designed to encourage. These Proposed Rules recognize that electric competition is not a race that begins with all entrants beginning at the starting gate; rather, the incumbents have a significant head start and a full head of steam. The Proposed Rules treat the incumbents differently because they ARE different. This does not violate equal protection.

D. Passage of the Proposed Rules Does Not Constitute an Unconstitutional Taking.

Another argument put forth by several parties is that the property rights of regulated utilities enjoy constitutional protection, and therefore the Proposed Rules if adopted would constitute an unconstitutional taking of this property. The primary focus of these comments s that because under the Proposed Rules the Commission possibly may not allow recovery of a utility's entire stranded cost claim, this constitutes a regulatory taking of the utility's property without compensation. Another argument is that the rules confiscate the exclusive rights inherent in existing CC&Ns without compensation Staff believes such claims are premature at this time.

The Proposed Rules as written do not take anything; they do not deny any utility recovery of any stranded cost, nor do they grant any new CC&N. What the rules do is set forth a framework wherein a regulated entity claiming to have stranded costs may come before the Commission and seek recovery of those costs. The rules also establish a process wherein potential new entrants may apply for and receive a CC&N. Mere adoption of the Proposed Rules will not result in any property being taken. Furthermore, in order for a taking to be unconstitutional, it must be done without compensation. The law is well-settled that takings claims are not ripe until the plaintiff has been denied compensation. Pub. Serv. Comm'n of New Mexico v. City of Albuquerque, 755 F.Supp. 1494, 1498 (D.N.M. 1991). If a state provides an adequate procedure for seeking just compensation, the property owner cannot claim a violation until it has used the procedure and been denied just compensation. Williamson Co. Regional Planning Comm'n v. Hamilton Bank, 473 U.S. 172, 195, 105 S.Ct. 3108, 3121 (1985).

Any property that a utility believes has been taken once competition has been implemented under the Proposed Rules is essentially a stranded cost. The Proposed Rules allow for stranded cost recovery, and set forth a process wherein utilities can seek recovery of these costs. Thus it is clear that the Proposed Rules do not constitute an unconstitutional taking of any utility property.

E. Conclusion.

Staff believes that the adoption of the Proposed Rules is within the Commission's authority, does not violate due process or equal protection, and does not constitute an unlawful taking of utility property. Staff believes that the comments provided by the parties in this matter, while instructive and helpful in clarifying issues, do not set forth adequate reason for the Commission to decline to adopt the Proposed Rules as written.

RESPECTFULLY SUBMITTED this 27th day of November, 1996.

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Staff Responses to Comments on the Proposed Rule on Electric Industry Restructuring

Docket No. U-0000-94-165

November 27, 1996

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Introduction

In Decision No. 59870, dated October 10, 1996, the Commission began the formal rulemaking process to introduce retail electric competition. A procedural order was issued on October 11, 1996 requesting that written comments on the proposed rule be filed by November 8, 1996. The procedural order further requested that Staff and other parties file written responsive comments by November 27, 1996. Staff's responsive comments are presented in this document. We do not attempt to address every point raised by commenters, but we address most of the points that were raised.

Staff wishes to make several general points in response to the comments received on November 8, 1996.

1) The proposed rule has **not** sent an adverse signal to investors. The prices of Pinnacle West Capital Corporation (of which Arizona Public Service Company is a subsidiary) and Tucson Electric Power Company stock are at or near their 52 week highs. Figure 1 shows broad trends since mid summer. The stock market in general (as measured by the S&P 500 index) and utility stocks in general (as measured by the NYSE and DJ utility indices) have exhibited steady or slightly rising prices. Pinnacle West has risen and TEP stock has increased substantially, even though the Commission has issued a draft rule on restructuring.

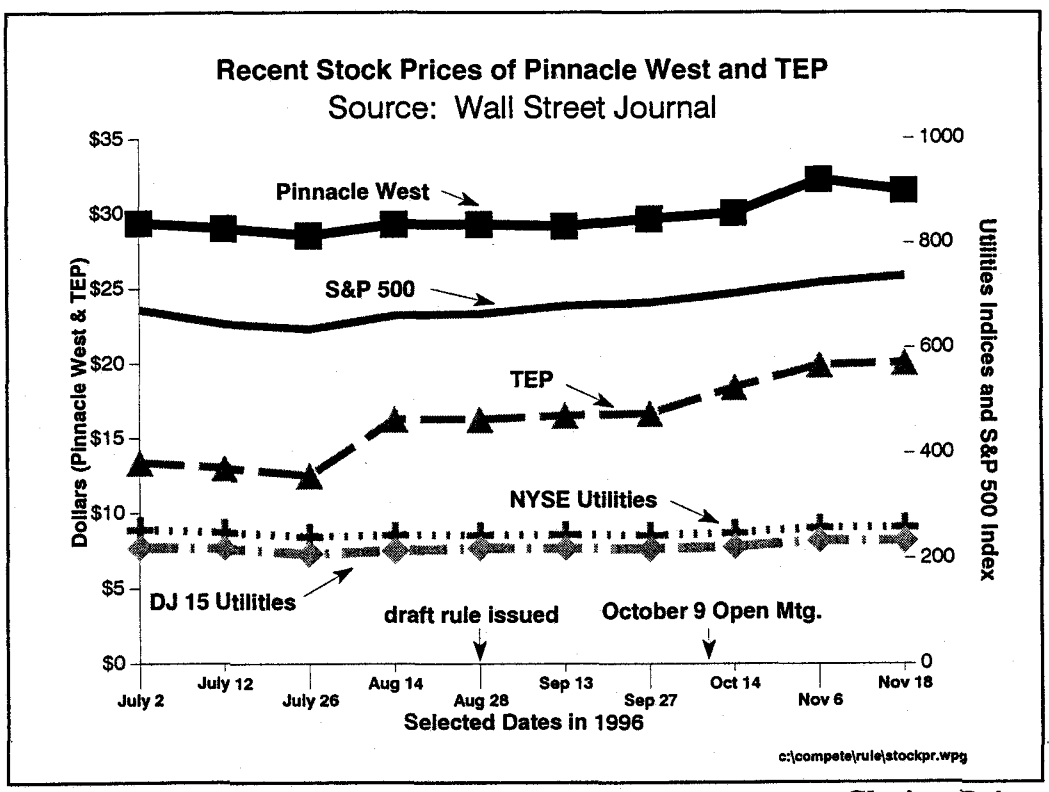

Figure 1 Closing Prices

2) There is nothing to be gained by delaying a decision on the time frame for introducing competition. The timeframe in the proposed rule establishes deadlines and provides for issues to be discussed before utilities file tariffs and before the Commission acts on specific rate proposals. Doing away with the current deadlines may only encourage a slowdown in introducing competition.

3) The competitive market in electricity will evolve; problems and solutions that are perceived today could very well be irrelevant in a few years. Therefore, the proposed rule to introduce retail electric competition is general and builds in procedures for dealing with the evolution of the market (e.g., working groups and hearings). Specific solutions to today's perceived problems should not be set in the rule because many will have to be undone later.

4) Salt River Project's (SRP's) status is a conundrum. The Commission has no regulatory jurisdiction over SRP. The Legislature may change SRP's status, in which case the rule might apply to SRP. Alternately, SRP may enter into an agreement with the Commission and other incumbent utilities that sets up a framework for competition similar to that established for regulated utilities. The rule also provides for this eventuality.

This response addresses specific matters raised by each of the commenters. Legal issues are discussed in the notice of filing.

Based upon the comments received, Staff recommends that one clarification be made to the rule. As initially drafted, R14-2-1607(A) requires that "The Affected Utilities shall take every feasible, cost-effective measure to mitigate or offset Stranded Cost by means such as expanding wholesale or retail markets, or offering a wider scope of services for profit, among others." For ease of administering this section of the rule, Staff recommends that R14-2-1607(A) be revised to state that "The Affected Utilities shall take reasonable measures to mitigate or offset Stranded Cost by such means as expanding wholesale or retail markets, or offering a wider scope of services for profit, among others."

Staff believes that several other proposals are not necessary but the proposed changes would not be detrimental as indicated in the discussion below. Finally, most proposals should be rejected as described in the text below.

Arizona Public Service Company

Process

Arizona Public Service Company (APS) proposes that the Commission hold evidentiary hearings in early 1997 before establishing a rule to introduce retail electric competition. APS complains that the proposed rule is incomplete and leaves many issues to be decided later.

Staff believes that scrapping the proposed rules and stepping back to debate issues that have already been discussed may very likely stall the introduction of competition. Without a timeline firmly in place, utilities have no incentive to resolve issues in a timely manner. Additionally, important issues cannot be finally resolved without experience in events which have not yet occurred (e.g., the competitive market price of electricity which is needed to estimate stranded costs). A good strategy in such an uncertain world is to leave one's options open and not decide issues that can be decided better later, when more information is available.

Economic Impact Statement

APS argues that the Economic Impact Statement is "legally inadequate and fails to support adoption of the Proposed Rules." Staff believes that due to the enormous amount of uncertainty that exists today, the Economic Impact Statement prepared by Staff provides a reasonable summary of probable impacts and an extensive analysis as advocated by APS would not be justified.

Staff's analysis is qualitative. It does not attempt to quantify costs or benefits because there is not sufficient information to produce reliable quantitative estimates. Our analysis is based upon traditional economic theory and the principles of supply and demand. It also draws extensively from input provided at the restructuring workshops. Many concrete examples were provided at these workshops that were quite useful in analyzing the possible affects of competition and likely market responses.

Although the Commission is exempted from A.R.S. Section 41-1051 et seq., pertaining to the Governor's Regulatory Review Council (see A.R.S. § 41-1057(2)), Staff made a good faith effort to provide an Economic Impact Statement substantially similar to the procedures required in the Article. A reasoned response was provided for each issue addressed in A.R.S. §41-1055. In addition, Staff explained the method used to produce the Economic Impact Statement in section C, including a list of the information gathering activities employed in our analysis. Finally, we concluded that the restructuring policy proposed is preferred to other alternatives analyzed, including maintaining the status quo.

Stranded Costs

APS recommends three changes in the proposed rule regarding stranded cost. First, APS addresses (p. 8) the definition of stranded cost (R14-2-1601(8)). APS wants to delete the word "net" and to delete the term "value" and substitute "recorded costs of the assets and obligations." Further, APS wants to substitute "used and useful" for "necessary," pertaining to furnishing electricity. APS is also concerned that stranded costs refers only to assets and obligations created prior to the adoption of the article.

Staff believes that the word "net" is essential -- it reflects the fact that some assets will have market values greater than regulated values and that some assets will have market values less than regulated value. The Commission should not just allow a utility to recover stranded costs only for those assets whose value has decreased without offsetting that gross stranded cost with increases in the value of other assets.

Substituting "recorded costs of the assets and obligations" for "value" is not necessary. APS' point can be dealt with in the stranded cost working group to obtain input from other parties; this may be an issue on which consensus can be reached. Staff believes the rule should be general so as to permit stranded cost calculations reflecting the individual circumstances of a given utility.

The proposed rule restricts stranded cost to those assets and obligations acquired or entered into as of the date of adoption of the proposed rule. The Commission should not sign a blank check for bad investments that occur in the future. If an obligation was incurred prior to adoption of the article and extends after the date of adoption of the rule (e.g., a coal purchase contract starting in 1990 and ending in 1999), that entire obligation (for the minimum time period over which the utility is obligated to make purchases or payments) could be considered for inclusion in the calculation of stranded cost. However, Staff expects utilities to renegotiate unfavorable contracts to help mitigate stranded costs.

Second, in R14-2-1607(A), APS (p. 9) wants to replace "every feasible, cost effective [mitigation] measure" with "reasonable [mitigation] measures..." Staff believes this proposed change may be more workable than the initial wording and would support such a change if it were clear that the Commission is serious about having utilities actively work to offset stranded costs through mitigation measures. APS further proposes deletion of the examples of types of mitigation. Staff believes that the examples provide additional clarity to the intent.

Third, APS wants clarification on the nature of the proceedings and manner in which stranded costs will be recovered (p. 10). In particular, APS wants prompt review by the Commission of stranded cost recovery proposals. In addition, APS wants the rule to indicate that the factors listed in R14-2-1607(I) pertain only to recovery mechanisms and not to the recoverability of stranded costs. APS wants to remove R14-2-1607(I)(8) pertaining to the period over which stranded cost charges may be recovered.

Staff believes that the Commission will give prompt attention to requests for stranded cost recovery. However, not knowing the nature of the utilities' filings or the nature of other parties' analyses, no specific time limit should be imposed now. Staff also believes that changes proposed by APS to R14-2-1607(I) are unnecessary. As written, R14-2-1607(I) states that the list of factors is to be considered by the Commission in determining mechanisms and charges for recovery of stranded cost, but not the magnitude of stranded cost. The Commission cannot consider stranded cost recovery mechanisms and charges in a vacuum as proposed by APS. The inclusion of R14-2-1607(I)(8) is necessary to indicate that a stranded cost recovery charge is for a fixed time period to be determined by the Commission after having reviewed data provided by utilities and other parties. Stranded cost recovery for *an indefinite time period* is precluded by R14-2-1607(I)(8).

<u>Obligation to Serve</u>

APS (p. 10) wants clarification that an affected utility has an obligation to provide service and plan for generation resources during the phase-in period for those customers not eligible for access. R14-2-1606(A) indicates that affected utilities have an obligation to provide standard offer service until the Commission determines otherwise. Staff believes that no change in the proposed rule is needed.

<u>Reciprocal Opportunities</u>

APS (pp. 10-12) states that the rules do not support reciprocal opportunities for affected utilities to fairly compete for sales with out-of-state utilities and that the rules are incomplete regarding jurisdictional and nonjurisdictional utilities. APS proposes several specific changes:

- CC&Ns should be granted only to entities that would thereby become subject to or agree to be subject to the Commission's jurisdiction. APS' proposal should be rejected because it may exclude some possible approaches to including SRP in the competitive market.

- Applicants for CC&Ns should also be required to provide a detailed description of the degree to which the applicant has provided or is willing to provide comparable access to competition from Arizona to its existing non-Arizona service area or to its existing and future customers outside Arizona. Staff believes that this is inconsistent with the Commerce Clause of the United States Constitution; it is further unclear what the Commission could lawfully do with such information.

- R14-2-1604(A), (B), and (D) should be modified to add "from certificated electric service providers" after the word "supply" to indicate that only Commission certificated providers can compete in Arizona. APS' proposal should be rejected because it may exclude some possible approaches to including SRP in the competitive market.

- Rewrite R14-2-1611(B) to read: "An Arizona Electric utility subject to the jurisdiction of the Commission as of the effective date of this Article and which is not an Affected Utility may voluntarily participate under the provisions of this Article ...." APS' proposal should be rejected because it may exclude some possible approaches to including SRP in the competitive market.

- Rewrite R14-2-1611(C) to read: "The Commission shall pursue, on its own or in cooperation with the Joint Legislative Study Committee on Electric Industry Competition established by House Bill 2504 (1996) legislation to address the role of electric utilities presently unregulated by the Commission in a competitive market. The Commission shall further make available, as appropriate, Staff assistance to the Legislature if the Legislature requests such assistance for the purpose of determining the proper role of electric utilities presently unregulated by the Commission in a competitive market." Staff does not oppose this language.

- Rewrite R14-2-1611(D) to read: "An Arizona electric service provider not subject to the jurisdiction of the Commission as of the effective date of this article may participate in competitive generation supply pursuant to this Article if and only if it becomes subject to or agrees to be subject to full regulation by the Commission in the same manner as an Affected Utility." APS' proposal should be rejected because it may exclude some possible approaches to including SRP in the competitive market.

<u>Overlooked Issues</u>

APS asserts (pp. 12-13) that metering and scheduling technology necessary to allow thousands of APS customers to have retail access does not currently exist. Commenters disagree on this issue, but Staff notes that the proposed start date for competition in 1999 allows time for advancements in metering and scheduling. Further, the first phase of competition could be structured to introduce competition in those areas or to those consumers where metering and scheduling problems could be minimized.

APS also objects to the Commission's expectation that rates for standard offer service will not increase, relative to existing rates, as a result of allowing competition. Any rate increase proposed by an Affected Utility for Standard Offer service must be fully justified through a rate case proceeding (R14-2-1606(B)(2). The Commission's expectation is the Commission's expectation. The rule does not preclude justified rate changes.

Solar Portfolio Standard

R14-2-1609 contains a solar portfolio standard, requiring suppliers of electricity in the competitive market to obtain a minimum amount of electricity from solar technologies. APS suggests that the solar portfolio standard might not even result in any increased solar capacity in Arizona. APS goes on to suggest in a footnote that the proposed rules do not require that the solar resources "even be used to serve Arizona consumers." Staff agrees that there is a possibility that no new solar capacity will be built in Arizona, but the purpose of the standard is to promote solar power regardless of the location of generation facilities. Staff believes that economics favor Arizona locations for new solar facilities serving Arizona consumers. Because out-of-state solar resources would need to acquire transmission rights to transmit solar electricity into Arizona for use by the competitive customers in the phased-in competition program, out-of-state resources would probably be more expensive. In addition, since Arizona has the most plentiful supply of sunshine resources in the nation, it is unlikely that an Electricity Service Provider would want to build a solar plant, for instance, in the State of Washington unless the cost of solar generated electricity produced there (plus the cost of transmission to Arizona) were less than a comparable plant in Arizona. The double credit provision for early solar electricity generation is designed to encourage the installation of the solar facilities in Arizona.

With regard to APS' contention that there is no requirement that the solar resources be used to serve Arizona consumers, R14-2-1609(A) defines the solar portfolio standard as a percentage "of the total retail energy sold competitively..." The obvious reference is for electricity sold competitively in Arizona to Arizona consumers as part of the phased-in competition program. However, if there is a need for clarification, Staff would not object to the addition of the phrase "to Arizona consumers" after the phrase "sold competitively."

APS suggests that the solar portfolio requirement will act as a market barrier against new entrants or limit the market suppliers in Arizona. This outcome is unlikely. The cost of a blend of solar power plus conventional power is likely to be less than current electric rates ("Staff Discussion of the Proposed Rule on Electric Industry Restructuring," October 4, 1996, p.18). We expect that solar power will be provided largely by companies specializing in solar power and that all electric service providers will be able to obtain solar power from these companies.

APS has claimed that the Commission has failed to provide any cost/benefit analysis demonstrating customer benefits from the Solar Portfolio Standard. The costs and feasibility of the solar portfolio standard are discussed in the "Staff Discussion of the proposed Rule on Electric Industry Restructuring," docketed on October 4, 1996, pp, 17-26. The benefits cannot be quantified with any precision. The qualitative benefits are:

- Solar power provides a hedge against future fossil fuel price increases. Large fossil fuel price increases have occurred in the last 30 years[1] and they may occur again.

- Decreases in the prices of solar technologies can be accelerated through economies of scale in manufacturing and through technological innovations. Both of these processes will benefit from increased demand for photovoltaics and solar thermal resources caused by the rule.

- Applications of cost effective uses of solar power (e.g. photovoltaics in remote locations or in places where line extensions are very costly) have only begun to be explored. The solar portfolio standard will accelerate searches for such niche applications.[2]

- The solar portfolio standard will induce manufacturers, distributors, electric service providers and consumers to better manage price and performance risks associated with solar technologies, thereby lowering the transaction costs associated with the introduction of new technologies.[3]

- The solar portfolio standard will give greater prominence to solar power and lead electric service providers to look for and develop "green markets" in which they seek out consumers who are willing to pay more for including some solar power in their mix of generation resources. Thus, society benefits because a consumer demand has been met that otherwise may not have been as well served.

- Electric service providers will gain needed skills in the procurement, installation, and operation of new solar technologies.

APS claims that an alternative proposal that it made in its September 12, 1996 comments would: be far less costly, guarantee between 25 and 50 MW of new solar generation, not serve as a market barrier, and not raise certain legal issues. The proposal would have the Commission levy a fixed fee on all kWh delivered to customers in Arizona starting in June 1997. The money

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[1] *The Electric Industry in Arizona: Staff Report on Resource Planning*, October 1996, Docket No. U-0000-95-506, pp, D-6 through D-14.

[2] *The Electric Industry in Arizona: Staff Report on Resource Planning*, October 1996, Docket No. U-0000-95-506, pp. B-32 to B-34.

[3] On transaction costs, see David Berry, "You've Got to Pay to Play: Photovoltaics and Transaction Costs," *The Electricity Journal*, March 1995 (42-49).

Staff believes that there is nothing to be gained by delaying a decision on the time frame for introducing competition as proposed by TEP. The timeframe in the proposed rule establishes deadlines and provides for issues to be discussed before utilities file tariffs and before the Commission acts on specific rate proposals. Doing away with the current deadlines may only encourage a slowdown in introducing competition. Further, Staff recommends that adoption of the rules not hinge upon whether all parties agree to a particular resolution of an issue because any party then has veto power over the Commission's actions.

Stranded Cost

TEP incorrectly states (pp. 24, 26) that the rule indicates that the Commission "may" allow recovery of unmitigated stranded cost by utilities. R14-2-1607(B) states that the Commission "shall" allow recovery of unmitigated stranded cost by affected utilities. TEP also misstates the rule regarding the time period for recovery of stranded cost because, TEP claims, the rule precludes any recovery of stranded cost after a limited time period (p. 27). R14-2-1607(I) has no such statement in it. The proposed rule only requires the Commission to specify the period to which the stranded cost recovery mechanism applies.

TEP argues (p. 6) that stranded cost must be fully recovered prior to the completion of the transition to full competition. It is not clear that such a pace is desirable when the impacts of stranded cost recovery on retail electric prices and on competition are unknown. The Commission must consider multiple factors in resolving stranded cost issues, as described in R14-2-1607(I).

TEP is concerned that the proposed definition of stranded cost (R14-2-1601)(8)) would result in reconsideration of the prudence of past investment decisions (p. 8). Staff expects that, in general, such reconsideration would not be undertaken, but cannot rule out reconsideration of the prudence of past investments in every circumstance.

TEP states that it is unclear what specific assets and obligations are included in stranded cost and whether the definition is limited to balance sheet accounts. TEP states that stranded cost is not limited to generation assets and may include regulatory assets and operating expenses. Staff believes that the definition (R14-2-1601(8)) is clear on these points: the calculation of stranded cost will not consider only generation assets, and can include purchased power contracts, regulatory assets, fuel contracts, etc.

TEP proposes a particular method for quantifying stranded costs (p. 9). This proposal should be made at the time a stranded cost recovery request is made and in the stranded cost working group. Staff believes that the Commission should not require a specific method or methods before it has experience with the consequences of calculations using actual data.

TEP states (p. 10) that a specific time period over which stranded costs are computed should not be ordered. The proposed rule does not specify a standard time period, but leaves this to be determined on a case by base basis (R14-2-1607(I)). Under the proposed rule, utilities will be free to propose specific methods for stranded cost recovery that are compatible with their circumstances.

TEP (p. 17) states that it is unclear whether mitigation of stranded costs includes only energy related activities or is all-encompassing, covering any business activity the utility and its affiliates may pursue. TEP believes that profits from activities that are unrelated to the provision of electricity in Arizona and that do not require use of assets 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. Further, TEP fears that costs of mitigation activities could become stranded (p. 17). The Rule (R14-2-1607(A)) speaks of every feasible, cost-effective measure to mitigate or offset stranded costs by means such as expanding wholesale or retail markets, or offering a wider scope of services for profit, among others. Staff interprets the rule as including all activities, including non-energy-related activities, as part of mitigation. An affected utility's losses due to stranded cost are to be offset by that company's gains in other activities. Further, there cannot be any recoverable stranded costs associated with mitigation since those costs would not be necessary to furnish electricity to consumers in its service territory *and* be incurred prior to the adoption of the Article.

TEP states (p. 18) that the working group on stranded cost should consider how the market price of power should be determined. Staff agrees that this is an appropriate topic of discussion. No change in the rule is necessary.

The rule indicates that any reduction in electricity purchases resulting from self generation shall not be used to calculate or recover any stranded cost (R14-2-1607(J)). TEP argues (p. 18) that consumers who self generate should pay for stranded costs. However, self generation has been available to consumers for years and no stranded cost recovery has been imposed on such customers. Therefore, Staff believes that no change in R14-2-1607(J) is necessary.

TEP argues (p. 27) that the rule does not provide for compensation for the loss of value of its Certificate of Convenience and Necessity. This is incorrect because the value of TEP's CC&N resides entirely in TEP's ability to collect revenues to cover its costs (including the cost of capital) as authorized by the Commission. By recovering stranded cost, TEP will be compensated. There is no other source of revenues associated with the CC&N beyond the ability to charge for service at Commission-approved rates; thus, the CC&N has no value beyond the ability to collect Commission-authorized revenues.

"Level Playing Field" Issues

TEP complains that "level playing field" issues have not been addressed or resolved (p. 19). TEP further proposes (p. 20) that quasi-governmental utilities (such as SRP) be assessed a surcharge to offset the alleged advantages of these utilities. Staff believes that these issues are important in determining the proper role of SRP, but that it is not necessary to resolve these issues prior to implementing competition in the service areas of utilities over which the Commission has jurisdiction. The rule provides for legislative resolution of these issues (R14-2-1601(1)) and for agreement among the quasi-governmental utility and other affected utilities (R14-2-1611(D)).

TEP (p. 20) states that it is unclear as to whether cooperatives could compete for customers outside of their service territory while preserving the integrity of their own service territories as a result of the schedule modification provision of R14-2-1604(H). The specifics of modifications to the schedule for implementing competition will vary from case to case, and the Commission could, as part of its order on schedule modifications for cooperatives, explicitly preclude a cooperative from selling competitively outside its own service territory prior to allowing competition inside its service territory.

TEP further states (p. 29) that singling out the cooperatives for preferential treatment (by modifying the implementation schedule) discriminates against TEP. The schedule modification procedure in R14-2-1604(H) for cooperatives is a response to the fact that cooperatives are entirely tax-exempt and that competition may affect that tax exempt status detrimentally; in contrast, TEP has only a few tax exemptions. TEP is not in the same situation as the cooperatives, and, thus, the rule is not discriminatory.

TEP concludes that the rule is not strong enough concerning reciprocity and that legislative changes are necessary. Staff believes that the rule adequately deals with reciprocity regarding level playing field issues. SRP will not be competing for customers outside its service territory until it is treated in a manner substantially the same as affected utilities such as TEP.

Taking of Distribution Property

TEP argues (p. 27) that its distribution property is taken without compensation as a result of other utilities using TEP's distribution system. This is incorrect because the rule requires other electric service providers to pay TEP for the use of its distribution system (R14-2-1606(C) and (G)).

Effect of the Rate Moratorium

TEP states (pp. 30-31) that, in its 1995/96 rate settlement with Staff (resulting in Decision

No. 59594), had it known that retail electric competition would be implemented, it would have sought different terms in its settlement. This argument should be rejected. The Commission has actively pursued analysis of restructuring since 1994 in Docket No. U-0000-94-165 and TEP participated in these activities. Further, there is no guarantee that Staff would have reached an agreement with TEP under different terms than those specified in the agreement.

Two County Financing

TEP states (p. 36) that it enjoys tax exempt financing for Springerville Unit 2 and Irvington Unit 4 (p. 40) and that such tax exempt financing may be jeopardized by the proposed rule. TEP further indicates (p. 38) that its tax exempt status can be maintained in a competitive environment if "sufficient effort is made to anticipate and provide for such issues in the Rule." TEP (p. 39) appears to want removal of a requirement to open its territory to competition in order to protect this tax exempt status, pointing to the schedule modification in R14-2-1604(H) for cooperatives. However, cooperatives are entirely tax exempt and the rule does not automatically give cooperatives any modifications to the rule; it only allows cooperatives the opportunity to request schedule modifications and cooperatives must propose methods to enhance consumer choice. Further, the benefits of modifying the implementation schedule must be greater than the costs. In TEP's financial situation, it is not clear what impact, if any, loss of tax exemptions would have.

TEP further states (pp. 39-40) that low cost financing could be lost if TEP became obligated to serve a customer outside of its existing two-county service territory under the proposed rule. The rule in no way obligates TEP to serve customers outside its traditional service territory. TEP seems to be satisfied if "specific language could be included (in the rule) that clearly limits the obligation to serve outside of a 'local furnishing' utility's existing service territory." (p. 40). No such language is necessary because no such obligation is assumed under the rule.

Citizens Utilities Company

Citizens Utilities Company (Citizens) starts its comments with a statement of its support of the Commission's efforts "to move the electric utility industry . . . toward a more competitive marketplace." This positive statement of support is quickly followed by a series of arguments that, in essence, would likely delay the start of the competition that was intended by the proposed rule. Citizens says that the Commission should consider the proposed rule as a "starting point for the further development of comprehensive rules." Further, Citizens says that the rule is "impermissibly vague," fails to provide sufficient detail, and is "contrary to the basic principles of due process." Citizens also states that the "proposed rules do not resolve several key issues."

In response, Staff recognizes that implementation of the rule will evolve and that revisions to the rule or additional rules may have to be developed as more information becomes available. Solutions to today's perceived problems should not be hard-wired into the rule because they may have to be undone later. Rather than delay the start of competition, Staff recommends the parallel process approach that is contemplated in the proposed rules. While utilities and competitors prepare their organizations for the January 1, 1999 start date, interested parties and the Commission will address the major issues that have not yet been resolved. To do otherwise, as Citizens suggests, would be to fall into the delay trap that would allow those opposed to competition to drag out any resolution of the issues and indefinitely stall the competitive effort in Arizona.

Public input has been obtained for over two years and public input will be obtained through working groups, workshops, and hearings envisioned in the proposed rule:

- *An introductory workshop was held on September 7, 1994.* One hundred eighteen representatives from utilities, consumer organizations, other power suppliers, and others attended the workshop. The workshop was summarized in a Staff Report dated October 1994.

- *A series of nine working group and task force meetings were held in 1995 which addressed restructuring options, implementation of the options, and advantages and disadvantages of the options.* Fifty-one groups were represented on task forces which focused on systems and markets, regulatory issues, and energy efficiency and environmental issues. Members of the task forces included representatives from utilities, consumer organizations, other power suppliers, and others. This work was summarized in a "Report of the Working Group on Retail Electric Competition," dated October 5, 1995.

- *A request for comments on electric industry restructuring was issued in February 1996.* Comments were filed by 31 parties on June 28, 1996. Commenters included consumer groups, Arizona utilities, other suppliers, and other parties. Staff prepared a summary of the comments in July 1996.

- *A workshop was held on August 12, 1996 to explore and obtain feedback on a small number of options for introducing retail electric competition.* One hundred thirty workshop participants included representatives from utilities, consumer organizations, other power suppliers, and others. Staff summarized the workshop in a report dated August 19, 1996.

- *Requests for comments on a draft rule to phase-in retail electric competition were issued.* The requests were sent out on August 28, 1996 and comments were due September 12, 1996. Comments were provided by 30 utilities, consumer organizations, other power suppliers, and others.

- *A workshop to discuss a revised draft rule was held on September 18, 1996.* Ninety individuals attended the workshop including representatives from utilities, consumer organizations, other power suppliers, and others.

- Through the use of working groups and future hearings on specific issues, interested parties will also have the opportunity to express their views and participate in the process. Staff believes that, with the cooperation of the various stakeholders, the key issues will be clarified, details will be developed, and adequate time will be allowed for preparation for the January 1, 1999 start date.

Further, with regard to due process, the Commission is following the rulemaking process required of it, beginning with Decision No. 59870, dated October 10, 1996.

Citizens states that key issues will be handled by working groups and expresses concern that the "scope of the issues assigned to these working groups is enormous." Staff agrees that the assignments of the working groups will be difficult. Staff has had experience in collaborative working group processes over the past few years, and feels that with clear, unmovable start dates for competition and for filing various tariffs, the parties will work to resolve many issues in time to prepare for competition. If resolution cannot be reached, or where the rule requires it, the Commission will decide matters using hearings.

Citizens states that "provisions of the rules must be known with certainty before utilities can make long-range decisions" on various issues. Staff believes that Citizens is unrealistic. As noted above, hard-wiring certain issues will almost certainly prove to be a mistake. The market and conditions will rapidly evolve; new issues will arise, old ones will evaporate, and new solutions will have to be developed. This is what one would expect to happen in a competitive market characterized by new entrants and technological change. Citizens will have to abandon its traditional approach to planning and become more flexible and responsive to changing conditions if it hopes to succeed in a competitive market. Certainty in rules will give a false sense of security to some but it will not change reality.

Citizens suggests that the proposed rules should be reclassified as a General Statement of Policy. Staff believes that this recommendation is a mistake. It surrenders the Commission's desire for competition to the "delayers." Having a firm, unmovable start date in a rule will do more to galvanize action than any Commission policy statement.

Citizens recommends that the proposed rules should be revised to ensure utilities a reasonable opportunity for full recovery of stranded costs. Citizens states that the rules "do not specify a generic mechanism to be used for recovery of stranded costs." Staff believes that the existing proposed rule wording ensures that utilities have a reasonable opportunity for full recovery of stranded costs. Rather than developing a generic mechanism for recovery of stranded costs, the proposed rule allows for evidentiary hearings for each utility on the unique aspects of each utility's stranded cost situation.

Citizens states that "To the extent that the Commission's proposed rules would put utilities at risk to under-recover stranded costs, the rules would violate" the regulatory compact between the Commission and the utility. Staff believes that the proposed rules would allow utilities a reasonable opportunity to recover stranded costs.

Citizens expresses concern that the Commission may take actions that would not allow Citizens to recover the full costs of FERC-approved wholesale power purchase contracts. It is unclear why Citizens would draw such a conclusion. If such costs are legitimately stranded costs, then the rule provides for recovery of these costs.

Citizens suggests that the rules be modified "to ensure that revenues from collateral services are not improperly allocated to offset stranded costs." Staff believes that it would be improper for the Commission to force consumers to pay for stranded costs while an affected utility enjoys high profits from new competitive or other collateral activities. Citizens seeks an extraordinary privilege in which consumers pay for Citizens' uneconomic assets and obligations while Citizens enjoys high profits from new ventures.

Citizens suggests that the "Commission should act to maintain a level playing field with regard to affected utilities and utilities not subject to the Commission's jurisdiction." Staff believes that the proposed rules do just that. The major issue in the category of "level playing fields" has to do with SRP. Legislation or multiparty agreements may be necessary to deal with SRP and level playing field issues.

Arizona Electric Power Cooperative, Inc., Duncan Valley Electric Cooperative, Inc., Graham County Electric Cooperative, Inc., and Sulphur Springs Valley Electric Cooperative, Inc.

Arizona Electric Power Cooperative, Inc. (AEPCO), Duncan Valley Electric Cooperative, Inc., Graham County Electric Cooperative, Inc., and Sulphur Springs Valley Electric Cooperative, Inc. (cooperatives) addressed several issues. The cooperatives request that they be excluded from the definition of affected utilities. Staff disagrees because doing so will exclude consumers served by cooperatives from the benefits of competition.

Competitive Phases

The cooperatives would substitute for R14-2-1604(H), which allows for modifications of the implementation schedule for cooperatives, a requirement that the cooperatives file a report describing the status of the efforts to address and resolve tax exemption and contractual and federal financing issues. Staff disagrees because this proposal will exclude consumers served by cooperatives from the benefits of competition and dilute incentives for the cooperatives to introduce competition.

Transmission Capability

The cooperatives fear that transmission capability may preclude their ability to open the required percentage of their markets to competition. Staff notes that because the total demand exhibited by the consumers in the cooperatives' retail service area will, initially, be about the same as it was under traditional regulation, new transmission constraints should not pop up immediately. Further, if new market entrants install distributed generation, transmission constraints could be relieved.

The cooperatives propose that a new definition be added for available transmission capability ("the meaning accorded it by Federal Energy Regulatory Commission Order 888 ...). The phrase "subject to Available Transmission Capability" would then be added to the beginning of R14-2-1604(A), (B), and (D). FERC Order 888 requires transmission providers to describe their method for determining available transmission capability posted on the transmission provider's OASIS (open access same time information systems). If sufficient transmission capability may not exist to accommodate a service request, the transmission provider will respond by performing a system impact study (Section 15.2 of the pro-forma tariff). System impact studies are described in Section 32 of the pro-forma tariff. If transmission upgrades are needed to supply a service request, the customer must reimburse the transmission provider for the facilities study and, if the customer wants the facilities, he or she will have to pay for them. Staff believes that the cooperative's proposal incorrectly gives the impression that the transmission provider is not obligated to conduct system impact studies or facilities studies as required by the FERC. Therefore, Staff recommends that the wording of the proposed rule not be changed as suggested by the cooperatives.

The cooperatives also propose to add language to R14-2-1604 that states that "Any consumer which elects to participate in the competitive market shall pay all costs attributable to such election including but not limited to special metering costs and any costs required to relieve transmission or distribution constraints." These costs should be covered by rates charged for unbundled services; no change in the rule is needed.

Standard Offer Service

The cooperatives are concerned that they will have to provide generation and other resources for consumers who may wish to obtain standard offer service after having left the utility's generation service. The cooperatives propose deleting R14-2-1606(A) regarding the duration over which standard offer service is provided and address the subject in workshops. While the topic is appropriate for workshop discussions, Staff believes that, for consumer protection purposes, it is desirable to retain the standard offer requirements of R14-2-1606(A).

Distribution Service

The proposed rule defines distribution service as the delivery of electricity to a retail consumer through wires, transformers, and other devices that are not classified as transmission services subject to the jurisdiction of the Federal Energy Regulatory Commission; distribution service excludes meters and meter reading. The cooperatives propose to change this to read that "distribution service means the delivery of electricity to a retail consumer through wires, transformers, and other devices that are classified as local facilities not subject to the jurisdiction of the Federal Energy Regulatory Commission; distribution service excludes meters and meter reading." The FERC recognizes that there is a fuzzy boundary to local facilities and provides a seven part test to determine whether facilities are local.

Stranded Cost

The cooperatives propose that Arizona wait until surrounding states have implemented competition so that Arizona utilities will be able to mitigate their stranded costs by selling into other states. Staff believes that this proposal should be rejected. If every state followed such as policy no competition would ever be introduced. Further, California is scheduled to start competition in 1998, thereby giving Arizona utilities a new market.

The cooperatives also propose deleting some of the factors in R14-2-1606(D) and (I) because they believe that stranded cost recovery is required by law. Staff believes that the Commission must consider all the factors listed so as to take into account impacts of stranded cost recovery mechanisms on consumers and on the market in general.

In-State Reciprocity

The cooperatives propose that affiliates of non-Affected Utilities be prohibited from competition unless they meet the conditions described in R14-2-1611. The cooperatives propose to include affiliates along with the Arizona electric utilities which are not Affected Utilities. This proposal appears to be aimed at SRP and Staff feels that the proposed changes would not adversely affect the ability of SRP to compete if other problems are adequately addressed.

Prohibitions on Cooperative Activities

In supplemental comments filed on November 25, 1996, the cooperatives asserted that they are statutorily prohibited from participating in the competitive market under A.R.S. Section 10-2072A and A.R.S. Section 10-2138A.

A.R.S. Section 10-2072A first states that a cooperative is expressly prohibited from constructing electric distribution lines that duplicate existing electric facilities of any other person. The proposed rule does not require and does not envision duplication of distribution lines -- distribution service will remain as a monopoly service of incumbent utilities, including distribution cooperatives.

This statute next states that a cooperative is expressly prohibited from supplying electric energy to any consumer which is already receiving central station service, has been connected to the lines of any other distributor of electric energy, or is located within one-half mile of the lines of any distributor of electricity. One solution to this prohibition is for cooperatives that wish to sell electricity competitively outside their traditional service territories to consider new organizational structures that would legally permit them to sell electricity competitively outside their traditional service territories. Another solution is for distribution cooperatives to offer only the distribution service they provide today in their service territories and not enter the market as a competitive seller of energy in other areas. Distribution cooperatives have no generating facilities from which to sell electricity outside their service territories.

A.R.S. Section 10-2138A states that a generation and transmission cooperative is expressly prohibited from constructing electric distribution lines and is expressly prohibited from supplying at retail electric energy directly to any consumer. The first clause is not an issue because incumbent utilities which provide distribution service will continue to provide that distribution service. Generation and transmission cooperatives do not provide distribution service today. The second clause prohibits AEPCO from selling electricity at retail. One solution to this prohibition is for AEPCO to consider new organizational structures that would legally permit it to sell electricity competitively. Another solution is for AEPCO to sell only wholesale power and energy as it does today. The proposed rule does not require AEPCO to become a retailer; it does require that consumers in the service territories of *distribution* cooperatives have access to competing suppliers.

Staff, therefore, believes that the cooperatives are incorrect when they state the statutes are inexorably at odds with the proposed rules. AEPCO's member cooperatives are not statutorily prohibited from seeking replacement markets for the loads they will lose -- indeed they will lose none of their current distribution services and they will lose no generation services. AEPCO may lose generation sales in the wholesale market but it has remedies available for making replacement sales as indicated above. Thus, Staff believes that no change in the rule is necessary and that cooperatives should not be able to prevent their current customers from the taking advantage of the benefits of competition.

Trico Electric Cooperative, Inc.

Trico Electric Cooperative, Inc. (Trico), in addition to its legal comments, proposes several revisions to the rule (pp. 4-5).

First, Trico proposes that cooperatives be deleted from the definition of affected utilities (R14-2-1601(1)). Staff disagrees. The consumers located in the service areas of the cooperatives should be able to benefit from competition. In a related recommendation, Trico proposes replacing R14-2-1604(H), on schedule modifications for cooperatives, with a status report from cooperatives that would be filed by December 31, 1997. Again, Staff disagrees because Trico's proposal will exclude consumers served by cooperatives from the benefits of competition.

Second, Trico indicates that some of the factors to be considered in the recovery of stranded cost (R14-2-1607(D) and (I)) should not be considered because, in Trico's view, all stranded costs are recoverable. Staff disagrees: effects of stranded cost recovery on competition and on consumers are important factors in stranded cost recovery mechanisms and should not be ignored by the Commission.

Third, Trico proposes that the rule include a new provision that "No duplication of existing electric facilities shall be permitted under this Article and no Certificate of Convenience and Necessity shall be granted by the Commission to an Electric Service Provider that will adversely affect the rights of an Affected Utility except to render services described in R14-2-1605 or R14-2-1606." This language would ban competition by not allowing new facilities to be built in the market. The proposal should clearly be rejected.

Fourth, Trico proposes that the rule contain a new section that states: "Any provision of this Article which, if complied with by an Affected utility, would constitute a breach of an existing contract by such Affected Utility which is in effect on the date this Article is adopted, shall not apply to such Affected Utility." The proposed rule disallows unilateral breaking of existing contracts between utilities and consumers (R14-2-1604(F)), so Trico's language is not needed to address this issue. Trico's proposal also would squelch competition. A utility could refuse to renegotiate a contract and use that refusal as the basis for not having to implement competition. Thus, Trico's proposal is an invitation to prevent competition. Staff believes that, as the market is restructured, utilities will have to actively seek to modify existing contracts with suppliers. In some cases, it may even be desirable to break some contracts and pay damages because, in the long run, the benefits will outweigh the costs. Further, if state regulators employ a policy of promoting competition, changes in federal law may follow dealing with the supply contracts and mortgages of cooperatives; without this state push, the federal government may have less motivation to modify existing law.

Salt River Project

Inclusion of Salt River Project in the Competitive Market

Salt River Project (SRP) believes that all Arizona residents deserve the opportunity to choose their electric energy provider and participate in the competitive retail electric market. Staff agrees.

SRP states that "The Commission's Rules Do Not Give All Customers In This State The Right To Choose Their Electric Energy Provider." Staff believes that this statement is correct. The rules do not make provisions for competition in the service territories of utilities not regulated by the Commission. The rules do provide a framework for implementing competition in the service territories of utilities regulated by the Commission and several means by which nonjurisdictional utilities may participate.

SRP states that "The Commission's Proposed Regulation Of Political Subdivisions And Municipal Corporations Is Unconstitutional." The rules do not propose regulation of nonjurisdictional utilities in their service territories. They apply to affected utilities and energy service providers authorized to do business in currently regulated service areas. The rules also explicitly state that SRP would not be considered an Affected Utility unless existing law changes (R14-2-1601(1)).

R14-2-1611(D) provides one method by which SRP may participate under the provisions of the rule. However, SRP expressed concern about having to obtain consent from the Affected Utilities. A concern is that some utilities will bar SRP's entrance by refusing to agree to allow SRP to participate. By withholding approval of SRP's participation, an affected utility would forego sales opportunities in SRP's service territory and would invite resolution of issues by other parties, perhaps with little input from affected utilities. Thus, there are incentives for affected utilities to work with SRP to agree on competitive "rules of the road."

SRP also states that "There Are Solutions That Constitutionally Provide Choice For All Arizona Electric Customers." Staff agrees. SRP proposed an intergovernmental agreement to allow it to participate in competition under this Article. The idea has merit and may be a means of establishing adequate enforcement of nondiscriminatory rates. The concerns of other utilities over level playing field issues must be considered in any resolution of SRP's status. Further, there must be an objective party who can resolve disputes over whether electric service providers have fair, nondiscriminatory access to SRP's distribution system. If the Commission does not have this authority, some other party must take on this responsibility; other electric service providers may also want to be involved in the creation of this independent party.

Stranded Cost

SRP desires that stranded cost recovery issues be resolved before the rule is adopted. As noted above, the rule provides for resolving stranded cost issues through working group activities and through Commission hearings on stranded cost. Without the framework of a time table in place, there is little incentive for some parties to pursue resolution of stranded cost issues. Further, some stranded cost issues may not be resolved by consensus; the Commission may have to solve a particular problem itself and the proposed rule allows for this outcome.

SRP also proposes including the costs of implementing the transition to retail choice in stranded costs (p. 6). This proposal should be rejected -- new market entrants will not be able to recover their sunk costs in the market entry process from consumers who do not select them, and neither should incumbent utilities.

System Reliability

SRP states (p. 6) that the proposed rule fails to adequately address reliability issues raised by restructuring. SRP proposes that reliability standards and practices should be established by the National Electric Reliability Council (sic) and the Western Systems Coordinating Council to ensure reliability and that these standards must be incorporated into any proposed rules. Of course, the rule cannot require the North American Electric Reliability Council (NERC) or the Western Systems Coordinating Council (WSCC) to do anything. However, R14-2-1613(K) does require electric service providers to comply with applicable reliability standards and practices of WSCC and NERC.

Obligation to Serve

SRP states that the rule is silent regarding any obligation to serve (p. 6). The rule requires incumbent utilities to provide standard offer service and various unbundled services such as distribution service (R14-2-1606).

Availability of Real Time Pricing

SRP believes that real time pricing information is needed in a competitive market (p. 7). Staff agrees. This information could be provided by an independent system operator (R14-2-1610) or may develop in the marketplace anyway.

Out of State Utilities and Reciprocity

SRP criticizes the rule (p. 7) because it does not provide for the negotiation of multi-state compacts addressing reciprocity issues. Multi-state compacts probably have to be entered into by the Legislature and may require federal government approval. Thus, it is not appropriate to include them in this rule.

Residential Utility Consumer Office

Pace of Competition

The Residential Utility Consumer Office (RUCO) begins its comments by asserting that the introduction of competition is too leisurely and that the proposed schedule will be overtaken by events. RUCO proposes an alternative schedule (p. 1) with no special customer metering (p. 2):

- A pilot program from July 1997 to December 1998.
- 25% of load open to competition from January 1999 through December 1999.
- Full competition by January 1, 2000.

Staff believes RUCO's schedule could invite some unintended consequences which are less likely to occur under the schedule in the proposed rule:

- It is uncertain whether existing meters will be adequate for competitive service, in that incumbent utilities and other electric service providers will need data on consumption. It may be possible to make reliable kW inferences from existing meters, and RUCO assumes that existing meters will be adequate. However, if new meters must be installed for hundreds of thousands of consumers, several years may be needed to complete the installations, and the proposed rule allows time for meter conversions. RUCO's small pilot may not provide sufficient information on metering needs.

- "Tracking" software will have to be developed, tested, and installed to ensure proper recording of usage data, proper billing information, and proper transfer of data among electric service providers. Massive problems could ensue from too rapid a move to full competition.

- Incumbent utilities will need time to mitigate stranded costs so that consumers and shareholders do not bear a needlessly high burden in paying these costs. The proposed rule allows more time for mitigation of stranded costs than does RUCO's proposal.

Proportional Retail Access for All Customer Classes

In the "Staff Discussion of the Proposed Rule on Electric Industry Restructuring, " filed in Docket Control on October 4, 1996, Staff discussed potential participation in the first phase of competition (pp, 10-11). The demands for APS and TEP could break out approximately as follows, assuming that APS' demand is 4000 MW and TEP's is 1500 MW:

- residential (15% of 20% of base year demand) = 120 MW for APS (or about 40,000 customers at 3 kW per customer), and = 45 MW for TEP (or about 15,000 customers at 3 kW per customer) in the first phase.

- large commercial and industrial demand (50% of 20% of base year demand) = 400 MW for APS, and 150 MW for TEP in the first phase. This could serve a few or several dozen consumers, depending on the utilities' specific programs and on which consumers can shop around, given existing contract commitments. Further, consumers, such as chain stores, individually under 3 MW could aggregate their load and be considered over 3 MW for the purposes of this calculation. However, no single consumer could receive more than 160 MW (if located in APS' territory) or 60 MW (if located in TEP's territory).

- smaller commercial and industrial consumers are eligible for at least 280 MW of service in APS' territory and at least 105 MW in TEP's territory in the first phase. *Note that residential and smaller commercial and industrial demand in the competitive market could be greater if the large commercial and industrial demands do not meet the upper limit of 50 percent.*

RUCO criticizes the proposed rule as giving too little opportunity for residential and small commercial consumers to participate in the competitive market during the early phases. In particular, RUCO proposes that during the phase-in there should be a set-aside for each customer class reflecting that class's share of demand during the base year (p. 2). Thus, if residential consumers account for 50 percent of the demand in the base year, 50 percent of the demand during a phase-in year should be reserved for residential consumers. RUCO further argues that there should be no shifting of responsibility for stranded costs between customer classes (p. 2).

RUCO's proposal overlooks the likely patterns of interest in competition and could unintentionally slow down competition. Some industrial and commercial consumers are more likely than residential consumers to participate in the competitive market in the first few years. If a large part of RUCO's residential set-aside goes unsubscribed, the amount of electricity sold in the competitive market will be reduced and some commercial and industrial consumers who would like to participate in the competitive market may be prevented from doing so by the upper limit on their level of participation.

The relative interest of different consumer classes in the competitive market in the early years is unknown. However, the proposed rule balances the need to ensure significant residential and small commercial participation with the likely rapid participation of larger commercial and industrial consumers, thereby reducing the chances of unsubscribed competitive demand. Further, the proposed rule is not as rigid as RUCO's proposal and does not put an upper limit on residential and small commercial participation.

Distinctions Between Distribution Utilities and Competitive Electricity Suppliers

RUCO indicates (p. 2) that distribution service should be a monopoly service. The proposed rule (R14-2-1605(B)) leaves distribution service as a monopoly service provided by incumbent utilities (except those utilities which do not provide distribution service, such as AEPCO).

RUCO also argues (p. 2) that distribution utilities should be defined as those public service corporations franchised by the Commission to provide, within their specified service areas, such services as are found by the Commission to be non-competitive for the time being. Further, RUCO states (p. 3) that other electric service providers should be defined as electric service providers who are licensed to provide one or more electricity services deemed to be competitive by the Commission. RUCO does not explain what advantages its proposal will create. The proposal appears to be a tautology.

Periodic Determination of Competitive and Noncompetitive Services

RUCO wants the Commission to investigate which services should be competitively offered before making a determination of which services are competitive and to make such investigations from time to time as the market changes (p. 3). No party to date has argued that any service treated in the proposed rule as a competitive service (R14-2-1605) should not be competitive. If the non-competitive services (distribution service and services required by the Federal Energy Regulatory Commission to be monopoly services) can be beneficially offered competitively in the future, the Commission may investigate such issues and revise the rule as appropriate. No change in the proposed rule is needed at this time. Situations in which services turn out to be less competitive than anticipated are discussed in the following section on market power.

Market Power

RUCO is concerned about the market power resulting from vertically integrated utilities participating in the competitive market. This market power could be manifested in affiliate transactions, horizontal market combinations, and use of existing relationships between distribution utilities and their customers, according to RUCO (p. 4). RUCO proposes several steps to deal with market power:

- Distribution utilities should make load research and other customer class data available to all competitive electricity suppliers.

- Vertically integrated utilities should be divested or at least functionally separated (apparently into generation, transmission, and distribution companies).

- Recovery of stranded cost should be linked to utility corporate restructuring.

- Periodic assessments of the state of competition should be conducted, using standard tests such as the Herfindahl index.[4]

- Rules for transactions between distribution utilities and affiliated electric service providers should be established.

Staff believes that the proposed rule adequately addresses market power issues. The proposed rule deals with market power in the following ways:

- Vertically integrated utilities must offer transmission, distribution, and ancillary services in an unbundled manner at regulated, nondiscriminatory rates (R14-2-1606(C), (E), and (G).

- An independent system operator may be established and one of its purposes could be to counter the market power of vertically integrated utilities over the transmission system (R14-2-1610).

- All electric service providers must provide customer data upon authorization by the customer (R14-2-1606(F)).

- Distributed generation, allowed in R14-2-1605(A), may counter abuse of control over the transmission and distribution system by enabling consumers and suppliers to partially or completely bypass the transmission and distribution systems.

Divestiture of vertically integrated utilities may be difficult to implement, but it can be considered later if market power does not appear to have been successfully countered. Functional

[4] The Herfindahl-Hirschmann Index measures concentration in a market by using the sum of the squares of market shares for the firms in the market. The higher the index, the greater the concentration. Two firms with 50 percent of the market each would result in an index of 2500+2500 = 5000. A market with five firms having 20 percent of the market each would have an index value of 5 x 400 = 2000.

separation of utility operations into generation, transmission, and distribution activities will essentially be accomplished with unbundled tariffs (R14-2-1606(C)).

Staff agrees with RUCO that periodic reviews of the state of the market need to be made to assess competitiveness. The reports required under R14-2-1614 and the filing of large contracts under R14-2-1612(C) will provide information on market developments. However, Staff strongly cautions that simple mechanisms for analyzing market power such as the Herfindahl index, are rapidly becoming outdated. Transaction cost economics, developed over the last 15 years, has demonstrated that activities that may appear at first glance to be anti-competitive are, in fact, risk management tools that enable buyers and sellers to better deal with the risks of imperfect information, opportunism (especially opportunism associated with large, investments to serve consumers), and poor performance. A sophisticated Commission review of market power can and should be undertaken, and the rule provides for an information base for such a review. The rule could be revised to require the Commission or the Staff to engage in the review. Adding this requirement to the rule would not constitute a substantive change because the Commission could undertake the study anyway on its own.

Linking recovery of stranded cost to utility corporate restructuring has merit and the proposed rule enables consideration of this factor in both the working group (R14-2-1607(D) and in determination of stranded cost charges (R14-2-1607(I)). RUCO should pursue this approach in the Working Group and at the stranded cost hearings, as provided for in the proposed rule.

Requiring distribution utilities to make load research and other customer class data available to all competitive electricity suppliers may be unenforceable. Neither the Commission nor other parties will know whether all such data have been made available and are correct. Further, the requirement to give away expensive load research data may deter distribution utilities from doing these studies. The proposal should be rejected.

Rules for transactions between distribution utilities and affiliated electric service providers may be necessary in the future. However, at this point we do not have sufficient experience to know what problems these rules are to solve and how the rules might best solve the problems. The rules could be revised later when the Commission has more information.

<u>Market Structure</u>

RUCO proposes that a power mart be established as a spot market for electricity. The power mart would work in conjunction with an independent system operator. RUCO believes that a spot market should have a more central role in a restructured market than the rule explicitly provides for (p. 5).

Staff believes that a spot market is a market clearing device -- allocating short-term excess supply or demand on the basis of prices. Many commodity markets function using bilateral contracts and spot markets used in conjunction with financial hedges such as options. Spot markets are not necessarily the principal means by which transactions are made. The specific development and use of a spot market in electricity is best left up to the market. The market has already responded with numerous spot markets (e.g., at Palo Verde, at the California Oregon border, and at mid Columbia). The New York Mercantile Exchange has developed a futures market in electricity. All of these developments are intended to enhance the market's ability to clear. They do not constitute a large fraction of transactions. Staff believes that no specific spot market structure should be required by regulators.

A spot market is not, as RUCO suggests, a good means to counter market power. Spot markets can be manipulated and subject to perverse forces -- well known examples are Bunker Hunt's unsuccessful attempt to corner the silver market and the effect on copper prices of Sumitomo's speculative losses.

Permanent Standard Offer Service

RUCO proposes (p. 6) that standard offer service be made available permanently because some consumers may never be able to exercise market choices effectively. RUCO further proposes (p. 7) that standard offer service be put out to bid by the Commission for five year periods starting in 2000.

The inability of a significant number of consumers to ever shop around is unknown. The rule provides for the Commission to consider the need for standard offer service in the future when more information is available (R14-2-1606(A)). RUCO's proposal for bidding raises three problems:

- Bidding processes directed by regulators have sometimes been costly and not very effective, as evidenced by the cumbersome process and sometimes perverse results of some required resource bidding programs.

- If a bid must be conducted to identify the best (however best is defined) standard offer provider, it suggests that potential bidders for standard offer service could directly bid, as aggregators, to consumers; the bidding process may not be necessary.

- It is not clear that large numbers of consumers will be unable to shop for electric service. Those consumers who need information or assistance could get such information or assistance from consumer organizations, community action agencies, the Commission, and RUCO, for example. A bidding process for permanent standard offer service may be unnecessary.

Elimination of the Buy-Throughs

RUCO is concerned that buy-throughs will be used by larger consumers and that stranded costs associated with buy-throughs will be shifted onto other consumers. RUCO recommends that buy-throughs be eliminated from the rule (p. 7). If buy-throughs are retained, RUCO recommends that they be part of retail access and used only if requested by the customers.

The proposed rule simply states that an affected utility may engage in buy-throughs with individual or aggregated consumers. A buy-through effective prior to the start of competition must be approved by the Commission (R14-2-1604(H)) as is currently the case in the absence of the proposed rule. A buy-though is one tool available to incumbent utilities for providing competitive service after competition starts. Any limits on competitive service to large consumers during the phase-in also apply to buy-throughs and any stranded cost recovery would apply to competitive buy-throughs too. Staff believes that if buy-throughs are used, they will be used in response to customer requests. Elimination of the buy-through provision would not materially affect the situation.

Solar Power

RUCO is concerned about the cost of the solar portfolio standard. These costs have been analyzed in the "Staff Discussion of the Proposed Rule on Electric Industry Restructuring," filed in Docket Control on October 4, 1996, pp. 17-26. RUCO states that wind power would be cheaper than solar power. The purpose of the solar portfolio standard, however, is to promote a specific type of renewable resource and not renewables in general, some of which are already cost effective in a wide range of applications. Further, Arizona has mostly Class 3 wind regions, which are not currently cost effective resources, and Arizona wind resources are best in the winter when their value is less than it would be during peak summer demand. Further, in order to get wind resources from other states, there would be a need to transmit electricity over long distances (probably from Texas or Wyoming) which can be costly and subject to bottlenecks.

Onerous Regulation

RUCO (p. 8) asserts that the proposed requirements to file tariffs and obtain Certificates of Convenience and Necessity are onerous. Staff disagrees. The Commission and its Staff have reviewed dozens of Certificate applications (and accompanying tariffs) for telecommunications companies. These reviews serve several purposes that benefit consumers with moderate administrative cost:

- Potential suppliers with poor performance records in other jurisdictions, with little understanding of how to supply electricity, or with insufficient financial resources to serve consumers can be weeded out before Arizona consumers are damaged.

- Tariff filings provide evidence of a supplier's ability to provide services and ensure that a supplier does not provide unauthorized services (e.g. distribution service). Further, tariff filings make information available to the public on the types of services available.

RUCO (p. 8) also desires that suppliers submit summaries of existing and projected customer loads to an Independent System Operator rather than to the Commission. If electric service providers supplied load data only to the independent system operator, the Commission would be hampered in its ability to monitor the progress of competition. RUCO's proposal should be rejected.

Stranded Cost Recovery

RUCO wants the rule to indicate that there is no guarantee of recovery of stranded costs and that the Commission should make a determination regarding the amount of stranded costs that should be recoverable by each utility (pp. 8, 9). The rule allows recovery of unmitigated stranded cost (R14-2-1607(B)) and for the determination of the magnitude of stranded cost (R14-2-1607(I)). Staff expects that the Commission will ultimately consider a wide range of estimates of the magnitude of stranded cost offered by affected utilities, Staff, RUCO, consumer groups, and other intervenors. The Commission must also consider several factors regarding mechanisms and charges for recovery of stranded costs (R14-2-1607(I)). Staff believes that no change in the rule is needed on this matter.

Second, RUCO wants greater emphasis on mitigation of stranded costs, but RUCO does not indicate how this emphasis is to be provided.

Third, as indicated previously, RUCO wants to include a utility's corporate restructuring into functional units or separate companies as a factor in consideration of stranded cost recovery. RUCO can pursue this approach in the working group and hearings on stranded cost via R14-2-1607(D) and (I) which allow consideration of additional factors beyond those listed.

On page 9, RUCO indicates that stranded costs should be recovered from all customers. Costs are only stranded when competitive market prices are below traditionally regulated rates. Consumers served in non-competitive markets will pay for all prudently incurred costs and so, in that case, there is no stranded cost. Stranded costs will be recovered from participants in the competitive market as the Commission sees fit under R14-2-1607. Thus, RUCO's proposed objectives are already incorporated in the rule.

Scope of System Benefits Charge

RUCO makes two proposals regarding system benefits charges (p. 9). First, system benefits charges should be charged to all customers. Staff notes that system benefits charges are automatically included in the rates for noncompetitive bundled service so no separate calculation needs to be made. Such charges could be broken out on the consumer's bill. All purchases made in the competitive market are subject to system benefits charges (R14-2-1608). Thus, RUCO's proposal is satisfied by the rule as written.

Second, RUCO proposes that system benefits charges should be limited to low income support. Staff disagrees. Other important programs must also be funded -- nuclear power plant decommissioning, renewables, demand side management, and environmental programs as approved by the Commission.

<u>In-State Reciprocity</u>

RUCO states that the conditions in R14-2-1611(D) are unrealistic. This section of the proposed rule allows SRP to voluntarily participate in the competitive procedures established by the rule if, among other things, SRP can obtain agreements from other affected utilities for the terms of its participation. It is unknown whether this option will work. There are mutual gains from an agreement between SRP and incumbent, regulated utilities. The rule recognizes that one way to include SRP is to set up a framework for achieving agreement on many difficult issues regarding level playing fields and enforcement of fair access to consumers. It may be more beneficial for SRP to reach agreement with affected utilities than to have a solution imposed from outside.

Arizona Consumer Organizations

The Arizona Community Action Association, the Arizona Consumers Council, and Arizona Citizen Action combined their comments as "Arizona Consumer Organizations," (ACO). ACO supports the proposed rule as a reasonable framework for moving forward with retail electric competition and recommends adoption of the rule as now written. They believe that low income and residential consumers will benefit from competition (under appropriate circumstances).

However, ACO wishes to use the workshop processes and hearings envisioned by the proposed rule to pursue specific goals not explicitly embodied within the proposed rule:

- ♦ Development of a voluntary rate cap for residential and low income consumers as part of the standard offer tariffs.

- ♦ Postage stamp distribution rates to increase opportunities for aggregation and decrease the potential that remote areas will have high, unaffordable rates.

- Ensuring that stranded costs associated with one customer class not be recovered from any other class.
- Continuation of and sufficient funding for important system benefits programs.
- Separate accounting for nuclear power plant decommissioning funds.
- Increases in the solar portfolio standard after December 31, 2001.
- Disaggregated consumer bills for standard offer service.

In addition, ACO has proposed several clarifications to the proposed rule. Staff does not oppose such clarifications. These clarifications do not constitute substantial changes to the rule. They are:

- Clarifying that buy-throughs count toward limitations on eligible demand for large customers in the first two phases.
- Clarifying that stranded cost recovery and system benefits charges apply to buy-throughs used in the competitive market.
- Adding previously compensated risk to the list of factors in R14-2-1607(D) and (I) which otherwise is included implicitly.

ACO also proposes that new revenue opportunities that will be available under competition, including assets whose market values will increase substantially under competition, be included in the lists in R14-2-1607(D) and (I). Staff believes that these new revenue opportunities are included in the factor "the degree to which the Affected Utility has mitigated or offset stranded cost." Further, the definition of stranded cost (R14-2-1601(8)) indicates that all prudent jurisdictional assets and obligations necessary to furnish electricity be included in the calculation, meaning that those assets whose market value is above regulated value can be used to offset stranded costs.

Public Interest Coalition on Energy

The Public Interest Coalition on Energy (PICE) consists of the Arizona Association of Industries, the Arizona Food Marketing Alliance, the Arizona Multihousing Association, the Arizona Hotel and Motel Association, the Arizona Retailers Association, and the National Federation of Independent Business.

PICE recommends adoption of the proposed rules. PICE also stated that "the Commission and Legislature should seek to design a system based on reciprocity among utilities within Arizona. However, the absence of such resolution should not delay the introduction of competition from power marketers or out-of-state utilities as generation suppliers. Similarly, the Commission should not interfere with any non-public service corporation which voluntarily participates in competitive, comparable programs by making its service territory available to competing sellers."

Vantus Energy Corporation and Vantus Power Services

Vantus Energy Corporation and Vantus Power Services (Vantus) are affiliated with Pacific Gas and Electric Company. Vantus believes that the proposed rules impose on non-utility electric marketers and service providers burdensome regulatory regimes that prevent many potential electric service providers from entering the Arizona market. In particular, the requirements for Certificates of Convenience and Necessity and tariff filings are viewed as onerous.

Staff disagrees. Similar certification and tariff filing requirements are employed by the Commission in telecommunications services and these requirements have not prevented market entry. Vantus appears to be laboring under the impression that long, involved hearings will be necessary to implement the Certification and tariff filing requirements. This is not the intent of the rule and it has not been the practice of the Commission in telecommunications services. Further, Vantus believes that it will be required to make public confidential information. Typically, the Commission allows companies to provide proprietary information on a confidential basis. Contracts which must be filed under R14-2-1612 may be filed confidentially (R14-2-1615(C)). Further, information in regular reports may be filed confidentially (R14-2-1614(C)).

Moreover, reviews of tariffs and Certification requirements serve several purposes that benefit consumers with moderate administrative cost as discussed previously.

Vantus is also concerned that a complex procedure will be needed to change the maximum price in a tariff. Many market entrants will probably set a maximum price that is unlikely to be constraining in the foreseeable future.

In sum, Staff believes Vantus' concerns are unfounded.

Destec Energy, Inc.

Destec Energy, Inc. proposes a more rapid phase-in. However, Staff believes that the complexity of unbundled rates, standard offer service, mitigation of stranded cost, selection processes, system reliability, metering, and other issues make a more rapid start up infeasible.

Destec also proposes that customers may unilaterally convert existing full service contracts to "transportation only" contracts. Staff believes that existing contracts should not be changed without mutual consent of the utility and the customer since utilities could be seriously damaged if unilateral changes were made and stranded costs could increase.

Destec recommends that buy-throughs be required if customers demand it. Doing so prior to the implementation of competition would simply accelerate the date on which competition starts and raise the same problems listed above. After competition starts, utilities will offer buy-throughs if it is competitive to do so.

Destec is concerned that the Commission has determined the efficacy of stranded cost recovery before considering the issue. However, the rule requires the Commission to consider several factors in the recovery of stranded cost (R14-2-1607).

Finally, Destec disagrees with the solar portfolio standard. As discussed elsewhere, Staff believes that this standard is necessary to promote the public benefits of solar power.

Intel Corporation, Allied Signal, Air Products and Chemicals

Intel Corporation, Allied Signal, and Air Products and Chemicals submitted a joint filing. The three companies support the proposed rule. They believe that it is imperative that "all customers, utilities and other power suppliers" be allowed to participate. "Any decision which limits competitive choice to less than all customers will result in unfairness and leave excluded customers at a competitive disadvantage."

Asarco Inc.; BHP Copper, Inc.; Cyprus Bagdad Copper Corporation

Asarco Inc., BHP Copper Inc., and Cyprus Bagdad Copper Corporation ("ABC") support adoption of the proposed restructuring rules. ABC mentioned six important features of the proposed rule:

- The proposed rules provide a workable framework to phase in competition.
- The proposed rules establish achievable outside dates for the phase-in.
- The proposed rules establish guidelines for promoting broad-based participation in the benefits of retail competition.
- The proposed rules establish working groups to address the details of implementation.
- The proposed rules recognize the importance of WSCC and NERC standards in maintaining system reliability.
- The proposed rules allow for the possible inclusion of SRP.

ABC expresses concern that the portion of the rules related to SRP's voluntary participation in competition could lead to a situation where the approval of other utilities is unnecessarily withheld. Therefore, ABC recommends that the Commission monitor the progress of discussions between SRP and other utilities. ABC states that if SRP wants to participate in competition, and is willing to open its territory to other utilities, the Commission should do everything it can to make certain that any barriers to full and open competition are removed. Staff is willing to monitor the progress of negotiations if SRP and other parties feel that doing so would not interfere with the negotiations. Staff does not believe a change in the proposed rule is necessary to accomplish this goal.

Finally, ABC does not agree with every feature of the proposed rules, but realizes that the rules "represent a balancing of interests within a framework which advances the public interest."

Center for Energy and Economic Development

The Center for Energy and Economic Development (CEED) has refiled comments that were originally filed with the Commission on June 27, 1996 and September 11, 1996. CEED takes no position on restructuring, per se. CEED believes that restructuring should be fuel and resource neutral.

Staff disagrees that restructuring should be resource and fuel neutral. The Commission, over the last few years has encouraged the utilities it regulates to diversify their energy portfolios to include renewable energy resources. Since the publishing of the California Blue Book in 1994 and the resulting national debate over restructuring, a number of utilities have balked at making any significant plans to use renewables. Their stated reason for hesitation is their fear that inclusion of renewables will put them at a competitive disadvantage. Such concern is understandable. Staff believes that a blending of renewables into the electricity generation mix is an important step toward a new fuel mix that will evolve in the 21st Century. In order to avoid placing regulated utilities at a disadvantage and to truly create a "level playing field" for *all* Electric Service Providers, the solar portfolio standard will require every supplier of competitive electricity to provide solar-generated electricity.

CEED believes that the solar portfolio standard should be rejected. CEED's position is that no information has been produced concerning the costs of the solar standard, that costs would be high, and that "there is no economic reason that could possibly justify" the costs of the solar portfolio requirement.[5] These costs have been analyzed in the "Staff Discussion of the Proposed

[5] CEED cites analyses that have been criticized by the National Renewable Energy Laboratory: "The NREL analysis finds that the conclusions of the CEED/RDI study are based on faulty data and assumptions regarding the comparative economics of coal and renewable energy development. After correcting for these errors, NREL finds that a modest growth path

Rule on Electric Industry Restructuring," filed in Docket Control on October 4, 1996, pp. 17-26. Staff believes that there will be a minimal net increased costs to customers. At 1/2 of 1% of competitive electricity sold, the "blended" cost to customers of 0.5% solar and 99.5% competitive resources will be less than current tariffed rates. The customers will see their electric bills drop, while a portion of their electricity is guaranteed to come from solar.

CEED contends that environmental quality will improve with restructuring, because lower rates will lead to increased electrification, which will reduce emissions of pollutants. CEED claims that a national cap on sulfur dioxide pollutants guarantees that "retail competition, thus, cannot lead to an increase in sulfur dioxide emissions."

Staff responds that CEED's contention is not necessarily true. If, by electrifying some end uses or processes, natural gas fuel is displaced by coal-generated electricity, the net result would be significantly higher levels of air pollution. If the pollution were to impact metropolitan non-attainment areas or sensitive areas such as the Grand Canyon, the resulting clean-up costs or mitigation measures could become a significant economic burden on Arizona's citizens and on the state economy.

CEED contends that, because of the sulfur dioxide emissions cap, retail competition cannot increase sulfur dioxide emissions. That statement is not necessarily true either. According to Resource Data International, due to the availability of Powder River Basin coal and the bonus allowances offered in Phase 1 of the sulfur dioxide control program, there has been an overcompliance in sulfur dioxide emissions.[6] So, due to this overcompliance, the air is cleaner than it would otherwise be. Retail competition could reverse this trend toward cleaner air, causing polluters to push emissions up to the cap provided by law. Because so many polluters are "banking" pollution allowances and are obtaining so many bonus allowances, we could actually see a situation where, in the future, the pollution gets worse because, in spite of more stringent limits in the year 2000, those who banked allowances in the 1990s will start to "spend"

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of renewable resource development would essentially cost the nation little more than projected electricity market costs for coal-fired generation, even before considering the environmental benefits that would accompany this development" [Blair Swezey and Yih-huei Wan, "The True Cost of Renewables: An Analytic Response to the Coal Industry's Attack on Renewable Energy," National Renewable Energy Laboratory, October 1995, p 1]. Staff believes that if NREL's estimates are correct, the solar portfolio standard in the proposed rules establishes the "modest growth path of renewable resource development" suggested by NREL. Staff agrees with NREL that the costs would be little more than a comparable path using coal and would result in a cleaner environment.

[6] "RDI: Industry can't depend on trading allowances to reduce NOx and CO2," *The Energy Report*, April 22, 1996, p. 325.

those allowances just as the electricity market in the U.S. is becoming fully competitive, and worldwide, there is a significant increase in polluting fossil fuel use, such as massive burning of coal in China. Finally, to the extent that nuclear facilities become economically infeasible in a competitive market, nuclear-generated electricity will have to be replaced by some other fuels. If those fuels produce air pollutants, air quality will worsen.

CEED claims: "At least for the foreseeable future, renewable resources will not represent a substantial part of the electricity generation mix no matter what action the Commission takes." CEED believes, based on the studies it has funded, that "renewable resources are likely to play only a minor role in the nation's energy portfolio for the foreseeable future." CEED further contends that "with open and direct competition in electricity, generation from renewable energy could shrink to just 1% of U.S. electricity in 2010." CEED's study estimated renewables as providing 2 percent of the current U.S. electricity supply. So, competition by CEED's calculation, would cut relative renewable use in half over the next 14 years.

Staff agrees that, at least for the next five to ten years, the role of renewables in the country's energy portfolio will be small. That is understandable for any new technology which is just beginning to gain acceptance. Because of the substantial subsidies which have cemented the market leadership position of the oil, gas, coal, and nuclear industries in the U.S. energy sector, renewables will have a difficult time establishing a competitive position. This is one reason that Staff believes that a nominal 1/2 of 1 percent market share of Arizona's competitive electricity sales is an important start in blending solar resources into a more diverse energy portfolio.

Staff believes that if CEED's estimates are correct, those estimates are pressing evidence that solar technologies need encouragement in the proposed rules. Without such encouragement, Staff believes that electricity providers will, because of competitive pressures, only concentrate on the lowest-cost technologies in the short run. Although this may seem to be prudent at this time, it ignores the longer term impacts of resources and prices and will delay or foreclose the opportunity for development of renewable technologies. Staff believes that the solar portfolio standard is needed in part as a hedge against the possibility that fossil fuel prices will increase dramatically.

The utility industry has already been through a similar "lemming-like" dash toward a technology that was supposed to be "too cheap to meter" and that offered "unlimited energy from breeder reactors." Fortunately, U.S. utilities didn't follow the "put all your eggs in one fuel basket" approach with nuclear power such as occurred in France. We need to maintain a mix of generation technologies: oil, gas, coal, nuclear, and renewables. Staff contends that 1/2 to 1 percent of electricity generation from solar resources is both reasonable and prudent. It requires electricity suppliers to learn how to install and operate new, promising solar technologies that will offer fuel resource diversity, protection from fuel cost escalation or fuel shortages, and that will offer inherently clean generation that will not need costly future additions of scrubbers or other pollution-mitigation equipment. The Navajo Plant scrubber program is an important example of a facility that appeared to make economic sense when it was built, but now must be retrofitted with costly pollution equipment to meet environmental concerns that were raised long after the plant was designed and built.

CEED contends that, due to dispatch reasons, any gains in renewables will tend to displace growth in natural gas. Staff disagrees. Once renewables are installed, they should be operated as "must run" facilities whenever their fuel source (in this case, sunlight) is available. The reason is simple: they have no fuel costs, so they should operate whenever possible. Unlike many gas plants which are only dispatched for peaking operations, renewables should be considered as resources that fit somewhere between peaking and intermediate power plants. So, although part of the time renewables will replace some gas peaking resources, at other times their use will replace electricity from coal or oil intermediate plants.

CEED also claims that coal will remain the baseload fuel of choice, capturing half of all electric generation in 2010. If CEED's contention is correct, there should be no fear by CEED's sponsors that this new, developing technology will be a major threat to the use and transport of coal. Obviously, having 1/2 to 1 percent of electricity in Arizona generated by solar presents almost an insignificant impact on other fuel marketers. In fact, since electricity use in Arizona is expected to grow at 2 percent per year or more, the 1/2 of 1 percent to 1 percent standard will only capture a portion of new annual electric demand, leaving the existing electricity market untouched and allowing competing fuels to expand market share also.

In sum, Staff believes that the solar portfolio standard is not designed to make solar a "substantial part of the electricity generation mix" as CEED implies. It is designed to allow an opportunity for both utilities and other Electric Service Providers to learn how to procure, install, and operate solar resources on a small scale in order for the utility or supplier to prepare for the future, when renewable prices are expected to be lower and conventional generation prices are expected to be higher. The intent is just to get a minuscule amount of solar into the generation mix. In the first phase, solar would only provide 1/2 of 1 percent of a maximum of 20 percent of the market. That is a maximum of 1/10th of 1 percent of the electricity generated in Arizona in 1999 and 2000. That is a <u>very</u> small and insignificant amount of electricity. Even in the first year of phase two (year 2001), the solar percentage would only be 1/2 of 1 percent of a maximum of 50 percent of the market, or, 1/4 of 1 percent of all Arizona electricity sales. This, of course, assumes that half of Arizona's customers seek a competitive supplier.

The Environmental Group

The Environmental Group, which is comprised of the Land and Water Fund of the Rockies, the Grand Canyon Chapter of the Sierra Club, and the Grand Canyon Trust, supports the Commission's movement toward increased competition in the electric system. The Environmental Group believes that competition should only be instituted under conditions which will "enhance the environment as well as the interests of all consumers."

The group contends that competitive electricity markets will be driven by short-run price considerations, which will threaten investments in energy efficiency and renewable energy. Also, a focus on short-run prices is likely to increase the use of the older, dirtier power plants because they are cheaper to operate. Staff agrees with the Environmental Group's concern. It is likely that utilities, in order to be competitive, will want to run older, more polluting plants. This is one reason that the proposed rule has the solar portfolio standard. The standard will require utilities and other Electric Service Providers to install or purchase some new solar resources.[7]

Staff agrees with the Environmental Group that Arizonans appear to overwhelmingly favor the use of renewables. That is one reason that provisions were drafted to require inclusion of solar customers with 10 percent or more solar generation in the earliest competition phases. Also, the proposed rules give Electric Service Providers credit for solar installed on customer premises. This provision, along with the bonus provision for early solar applications, will encourage the early introduction of green pricing programs in 1997 and 1998, well before competition starts.

The group supports the concept of a *non-bypassable* system benefits charge to fund energy efficiency, renewables, and low income programs. The group believes that the definition of "system benefits" needs to be clarified. Specifically, the group suggests that the rule needs to clarify that "investments in technologies or other strategies for reduction of power plant emissions" constitute environmental programs under the system benefits definition. Staff believes that the definition of system benefits is adequate as is; the current definition would include

[7] The Environmental Group provided testimony on the current state of development of various solar technologies. For instance, the testimony projects that future parabolic dish solar systems are estimated to "generate power at around 7-8 cents/kWh in hybrid applications." Staff's estimates of future solar costs are similar to those of the Environmental Group. One reason that Staff recommended the modest 0.5 percent solar portfolio percentage was to allow the solar industry to expand its production facilities in a reasonable manner in order to meet the increased demand resulting from the proposed rules. By 1999, when the rules are in effect, the solar dish industry should be well on its way to producing solar equipment at the predicted price.

The group quoted two Arizona surveys that showed that Arizona citizens overwhelmingly favor development of renewables. One study, by APS, showed that 87% of respondents were in favor of continued renewables development. The other, a 1995 Cambridge survey, showed that approximately two-thirds of Arizonans are willing to pay an extra three dollars per month for clean electricity and one-third are willing to pay over $10 per month.

strategies for reduction of power plant emissions as well as any other Commission-approved environmental programs.

The group suggests that nuclear decommissioning should be considered a stranded cost rather than a system benefit. Staff believes that placement of nuclear decommissioning costs in system benefits is a better choice. Stranded costs will probably have a finite period over which recovery will be allowed by the Commission. If the Commission determines that the recovery period should be very short, it could be too brief to fully recover decommissioning costs. Second, nobody really knows how much decommissioning will eventually cost. There still is no federal long-term nuclear waste facility. It is entirely possible that existing nuclear plant owners could be spending the next two or three decades (or centuries) guarding the nuclear waste. The important point is that nuclear power plant decommissioning be conducted safely and that there be sufficient funds to accomplish that goal. By leaving nuclear power plant decommissioning costs in the category of system benefits, the Commission can monitor utilities' use of the funds and ensure that they are put toward nuclear power plant decommissioning. If the costs are mingled with stranded cost recovery, utilities may not actually use the funds for that purpose, especially if they feel that they did not receive all the stranded cost recovery they requested.

The group strongly supports the provision of the rule (R14-2-1604(E)(3)) that guarantees that customers who get 10 percent of their energy from solar will be eligible for the early phases of competition.

The Environmental Group also supports the buy-through concept, but says that the utility is left with the discretion of whether or not to allow the buy-through. The group suggests an addition of the following wording to R14-2-1604(G).:

1) "At the request of individual or aggregated consumers, an Affected Utility will facilitate Buy-throughs from renewable energy resources (i.e. photovoltaic, solar thermal, wind, and geothermal)."

2) "In no event shall a Buy-through result in an inequitable shifting of costs to consumers not participating in the Buy-through."

Staff believes that buy-throughs constitute one type of contract a utility could use once competition starts and, hence, the first item adds nothing to the rule, except the recognition that some consumers may wish to purchase "green power." With regard to the second item, stranded cost recovery will be dealt with by the Commission under R14-2-1607; buy-throughs are just one of many techniques to provide competitive service starting in 1999.

The group suggests that the Systems Benefits Charge is insufficient, because, according to the Environmental Group's analyses, several utilities are not currently spending enough to achieve Commission-approved renewables goals. The group asks the Commission to clarify the proposed rules to ensure that utilities collect a sufficient amount in the System Benefit Charge to meet the megawatt goals for the year 2000 as specified in Decision No. 58643. Staff believes that the levels of "system benefits" set by the Commission in previous (and future) rate cases should not be altered as a result of this rule. In previous rate cases, the Commission established methods for recovering the costs of demand side management, renewables, nuclear power plant decommissioning, and other programs. The proposed rule is intended to ensure that these programs continue and that the utilities' costs are recovered.

The group is concerned that the solar portfolio standard's percentage rate is too low. The group quotes two National Renewable Energy Laboratory reports that claim that solar thermal technologies produce electricity today at 10.5 cents/kWh and that the current cost of photovoltaic generated electricity is 21.8 cents/kWh. This is in contrast to Staff's estimates of 30 cents/kWh. Finally, the group cites 1996 photovoltaic installed costs by the Sacramento Municipal Utility District at $5.36/Watt. This is less than the $6.00/Watt estimate used by Staff in its analyses. The group therefore suggests that section R14-2-1609(B)(2) be modified to show that only an *increase* in the solar portfolio be allowed when the standard is re-evaluated in 2001.

Staff disagrees with the proposal to change the solar portfolio standard. There is insufficient information at this time to set future policy, and R14-2-1609(B) should not be altered in the absence of this information. Staff agrees that NREL's estimated solar electricity cost numbers are probably appropriate for large solar installations. However, since the early solar portfolio projects will be modest in size, Staff feels that it is important to be conservative in estimates. This has resulted in the modest and conservative 1/2 of 1 percent initial solar portfolio standard. Staff agrees with the Environmental Group and NREL that solar costs in the 1999-2003 time frame will be significantly lower than current costs. If this cost reduction occurs as projected, there will be a natural tendency to increase the solar standard in 2001. If not, it may be appropriate to freeze the standard at 1/2 of 1 percent for a few years.

The group recommends that the Commission include in R14-2-1613(H) a set of disclosure rules which require specific disclosures on customer bills. Included would be the supplier's portfolio generation mix by fuel source, the supplier's portfolio emission rate information, and, if the customer has contracted for renewables, a verification that the renewable electricity has been generated. This may be a meritorious proposal and it can be discussed in the workshop on unbundled services and standard offer services. It is not clear at this time whether such information would be credible or comprehensible to justify a change in the rule.