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FROM: Gary Yaquinto *gy*
Director
Utilities Division

DATE: December 13, 1996

RE: STAFF REPORT FOR STAFF RESPONSES TO REPLY COMMENTS ON THE
PROPOSED RULE ON ELECTRIC INDUSTRY RESTRUCTURING
(DOCKET NO. U-0000-94-165)

Attached is the Staff Report for Staff Responses to Reply Comments on the Proposed Rule on Electric Industry Restructuring.

GY:KEC:djg

Originator: Kim E. Clark

Attachment: Original and Eleven Copies

Arizona Corporation Commission
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**Staff Responses to Reply Comments on the
Proposed Rule on Electric Industry Restructuring**

Docket No. U-0000-94-165

December 13, 1996

Staff Responses to Reply Comments on Electric Industry Restructuring

On October 10, 1996, the Arizona Corporation Commission (Commission) began the formal rulemaking process to introduce retail electric competition. As part of the rulemaking process, comments on the proposed rule were to be filed by November 8, 1996 and reply comments were to be filed by November 27, 1996. Staff's response to the comments received on November 27, 1996 are presented in this document.

Because many of the issues raised in the reply comments have already been responded to by Staff, our responses will focus on comments and issues not previously addressed.

Rural Utilities Service

The Rural Utilities Service (RUS) has several concerns related to tariff filings and whether waivers will enable them to resolve potential problems with the introduction of competition. RUS recommends that cooperatives be allowed to file tariffs 18 months after publication of the final rule and that the waiver provision be modified so that a waiver will be granted if a cooperative identifies potential adverse impacts of competition. RUS also recommends that the rules clarify that small utilities will be offered flexibility in the phase-in schedule. These recommendations should be rejected. The waiver provision in the rules provides adequate assurance that cooperatives may request needed variations or exemptions.

In addition, RUS has recommendations regarding the establishment of tariffs, such as the treatment of new tax liabilities that result from competition, and these would be appropriate topics for the working group on standard offer tariffs and unbundled services.

The Irrigation and Electrical Districts' Association of Arizona

Many of the issues raised by the Irrigation and Electrical Districts' Association of Arizona (IEDA) have already been addressed. But the IEDA has some suggestions regarding the in-state reciprocity section (R14-2-1611) that are worthy of consideration. The IEDA suggests current wording in the rules may embroil jurisdictional fights and proposes rewording R14-2-1611 subsection D. The rewording would allow non-jurisdictional utilities to voluntarily file unbundled and standard offer service tariffs and to voluntarily open its service territory to competing sellers. These filings would serve as authorization for such service providers to utilize the Commission's rules concerning complaints related to their participation in the competitive market. Although Staff believes the proposed rules as written do not attempt to assert jurisdiction over non-jurisdictional utilities, IEDA's suggested rewording may add clarity. Thus Staff does not object to rewording the rules for clarification.

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Tucson Electric Power Company

Tucson Electric Power Company's (TEP's) comments were submitted in two parts, with the first part filed on November 8, 1996 and the second part filed on November 27, 1996. Different topics were covered in each filing. The second filing focused on operational, reliability, and pricing issues. TEP proposes that unbundling of distribution services be postponed until 2002 to allow operational issues with generation competition to be sorted out first and to allow time to prepare for "complete competitive product and service unbundling."

TEP identifies a number of operational issues to be resolved. This is a good first step toward implementing change and Staff believes that the issues would be appropriate topics for the working groups. Some of TEP's perceived issues may evaporate as the market evolves. For instance, with regard to unbundled distribution services, TEP states that "Energy management systems, communication systems, billing systems and general system operations will need to undergo significant changes and improvements before the number of independent system transactions dramatically increase." By requesting a delay in unbundling competitive products and services, TEP appears to assume that market developments will not help to facilitate these changes.

Staff believes that TEP's proposal should be rejected for two reasons. First, Staff believes the time line in the proposed rule for introducing competition in these services is both reasonable and feasible. Second, by eliminating competition in metering, meter reading, billing, and information services from the onset of competition, competition will be unduly restricted. Energy service providers will not have the freedom to customize services for their customers and innovations in customer service will be stifled.

Arizona Public Service Company

Arizona Public Service Company (APS) in its reply comments provides testimony from four consultants. The consultants primarily emphasize their criticisms on the general approach to implementing competition. Because Staff has already responded to these issues, we will focus on comments regarding the Economic Impact Statement.

Elliot Pollack presents testimony on the Economic Impact Statement. In his testimony, Mr. Pollack presents an analysis of several possible impacts of competition. He concludes that "the Proposed Rules could reduce state and local tax revenues by almost \$1 billion over the five year period 2003-2007." Mr. Pollack's testimony is artificial and misleading. His analysis overlooks possible sources of increased revenues, such as revenues from generation back-up, load following, reserves, voltage support, and information services. It overlooks beneficial impacts

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of lower energy costs. Reducing electricity costs will help industry in Arizona to become more competitive and thus increases in economic activity are likely. Benefits from increases in new jobs and in the state's gross national product apparently were also overlooked in Mr. Pollack's analysis. Furthermore, a variety of new energy service providers in Arizona are likely to produce taxable revenues.

With regard to the effect of property values on state and local taxes, some assets may decrease in value (such as uneconomic generation facilities), but some assets are expected to increase in value (for example transmission and distribution facilities). In addition, it is possible that facilities may shut down, but it is also likely that new facilities will locate to Arizona. Unfortunately, potential increases in property values were not included in Mr. Pollack's analysis.

A useful quantitative economic impact analysis must be supported by reliable data. Since such reliable data are not available, one should not be misled by APS' illustrations that give the impression that a reliable quantitative analysis can be performed. Given the data, only qualitative analysis are justified.

Staff believes that a reasonable approach is to state possible impacts and the likely direction of change, but attempting to produce quantitative estimates would not be justified without better information. Staff made a good faith effort to provide a reasonable qualitative summary of the likely impacts of competition and therefore disagrees with APS' conclusions regarding the Economic Impact Statement.

Arizona Utility Investors Association

The Arizona Utility Investors Association (AUIA) makes several recommendations regarding aggregation, standard offer tariffs, stranded costs, the solar portfolio standard, and reciprocity. Most of the issues raised by AUIA have been addressed in previous comments, with the following exception.

AUIA is concerned that the exclusion of aggregators from the definition of Energy Service Providers will confuse consumers. Moreover, AUIA is concerned that municipalities, who wish to serve as aggregators, may "side step" into the electricity market. Hence AUIA recommends that municipal aggregation be proscribed. Staff believes the definition of energy service providers is sufficiently clear that marketers and brokers, and therefore aggregators are included. Amending the rule to proscribe municipalities from aggregating consumers should be rejected because it would inhibit the ability of municipalities to compete.

Residential Utility Consumer Office

The Residential Utility Consumer Office (RUCO) essentially summarized its previous comments, with the exception that the benefits of competition were elaborated on a bit more. RUCO believes that a properly structured market will bring substantial benefits. Admitting that it would not be easy to quantify these benefits, RUCO uses the difference between current rates and market prices as an approximation of the potential benefits. Staff believes this analysis is roughly correct, recognizing the limited scope of the discussion.

Arizona Consumers Organizations

The Arizona Consumers Organizations represents the Arizona Community Action Association, the Arizona Consumers Council, and Arizona Citizens Action. The Consumers Organizations believe the proposed rules should be adopted as written and the adoption should not be delayed. They believe evidentiary hearings are not necessary and would limit the opportunity for some parties to fully participate in the process. However, they believe evidentiary hearings will be needed in the future for issues such as stranded costs and standard offer and unbundled services. Staff agrees.

The Consumers Organizations address several issues, primarily regarding consumer protection. One of the issues pertains to buy-throughs. They are concerned that buy-throughs will result in inequitable cost shifting. The Consumers Organization recommends that buy-throughs be subject to stranded cost recovery, systems benefits charges, and the limitations on large customer participation during the phase-in period. As previously stated, Staff does not oppose clarifying that buy-throughs count toward limitations on eligible demand for large consumers, and that stranded cost recovery and system benefits charges apply to buy-throughs used in the competitive market.

Nordic Power of Southpoint I, Limited Partnership

Nordic Power of Southpoint I, Limited Partnership (Nordic Power) "supports market-based rates with customer choice in the most expeditious manner reasonably feasible." Nordic Power proposes that the phase-in begin no later than January 1, 1998. For reasons previously described, Staff believes that 1999 is the earliest date that is reasonably feasible.

Nordic Power is concerned that the intergovernmental agreement recommended by Salt River Project (SRP) may allow major utilities to carve out service territories if customers and competitive power service providers are left out of the process. Staff agrees that other parties should have the opportunity to provide input into intergovernmental agreements and expects that if such an agreement is being entertained, the Commission will seek that input.

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Also, with regard to the obligation to serve, Nordic Power states that competitive power suppliers would be eager to have the obligation to serve any of the customers that the utility decides not to serve. Further, Nordic Power believes that "any stranded cost recovery should be accomplished only after the working group makes its recommendations on the efficacy of stranded costs and their impacts on retail competition, and public hearings are held." Staff anticipates that new competitors will be eager to acquire customers, but also recognizes that utilities will need definition of their responsibilities.

Nordic Power also believes the utilities have misconceived the monopolistic nature of their CC&Ns. The premise of Nordic Power's legal argument is that "The Arizona Supreme Court has said that Arizona is a regulated monopoly state and the monopoly is tolerated only because it is subject to the vigilant and continuous regulation by the Commission and is subject to rescission or amendment at any time when the public interest would be served." These arguments would be appropriate topics for the legal issues working group.

Nordic Power believes that the Economic Impact Statement properly identifies the benefits of competition and refers to several benefits for all customers and communities. They expect that lower electric rates will mean economic growth which includes new jobs, increased personal income, and additional tax revenues for local and state governments. Staff agrees.

Enron Capital & Trade Resources

Enron Capital & Trade Resources (ECT) suggests that competition should begin in 1998, rather than in 1999. Staff disagrees. Two years offers a practical, but aggressive schedule, in which to address all of the unanswered questions that need to be resolved. Two years will allow for evidentiary hearings, working group deliberations, and time to review successful programs as well as problems in other state restructuring efforts.

ECT says that a failure to use a "net" stranded cost approach, as advocated by APS, could result in a situation where "ratepayers would be required to pay the *higher* of cost or market." Staff agrees.

ECT speaks against any Commission mandated entity to determine a "market-clearing price." ECT warned that those utilities with market power will manipulate the market clearing price to their advantage. According to ECT, a liquid market based on bilateral transactions is more likely to establish competitive spot prices. Staff agrees.

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ECT suggests the following rule changes:

1. The Commission should allocate standard offer customers among all the licensed providers.
2. There should be more extensive unbundling of distribution.
3. The Commission should eliminate the filing of maximum tariffs and streamline the requirements on electric providers.
4. The Commission should leave renewable power purchase decisions to the marketplace.

Staff disagrees. Each of the above suggestions have been previously discussed, debated, and found to be problematic.

Phelps Dodge Morenci, Inc.

Phelps Dodge Morenci, Inc. (Phelps Dodge) disagrees with the contention that cooperatives should be exempted from competition. To do so, Phelps Dodge says, would mean that rural customers will be prevented from receiving the lowest possible price of electricity. Staff agrees.

Phelps Dodge says that any recovery of stranded costs must be on a "net" basis. Staff agrees.

Phelps Dodge claims that the large industrial customers, such as itself, over the course of a long-term power contract, may repay the entire capital cost (or more) of the facilities used by the utility to provide it power. Phelps Dodge says that to charge such a customer for stranded costs would be punitive.

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, repeated a number of recommendations that were included in earlier comments, such as setting the Solar Portfolio Standard percentage as a floor that could be increased, but not reduced. Staff does not believe that this change is necessary.

The Environmental Group responded to the November 8 comments of the Center for Energy and Economic Development (CEED) that no information about solar costs had been produced. The Environmental Group cited the October 4, 1996 "Staff Discussion of the Proposed Rule on Electric Industry Restructuring" as a source of the solar cost information. The Environmental Group mentioned that Staff's conservative 30 cents/kWh figure was higher than a similar solar electric number (12-20 cents/kWh) in a 1995 CEED study.

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The Environmental Group evaluated the APS alternative proposal to Staff's Solar Portfolio Standard. In response to the APS proposal, the Environmental Group concludes that "There appear to be no resource cost advantages to such a proposal." Staff agrees.

Finally, the Environmental Group commented on RUCO's suggestion to eliminate certification of competitive energy suppliers. The Environmental Group rejects RUCO's suggestion and requests Commission approval of the certification requirements as stated in the proposed rule.

The Grand Canyon Trust

The Grand Canyon Trust suggests three changes to the proposed rule. First, the Trust recommends that the minimum requirements for solar generation be returned to the original proposal: 1 percent in 1999 and 2 percent in 2000. The Trust suggests that these figures should be a minimum and that any adjustments should be upward. Second, the Trust recommends a separate line item for nuclear decommissioning costs rather than including decommissioning in system benefits charges. Further, the Trust suggests that the system benefits charges must be large enough to ensure reasonable funding for the environmental, DSM, low income, and renewables efforts that are to be funded by the systems benefit charge. Third, the Trust suggest modification of the rules to require that customer bills accurately reflect how the electricity is generated. Staff believes that some of the Trust's comments have merit. A number of the issues can be handled administratively or through proposed working groups without the necessity of including additional wording in the rules. The higher solar portfolio standard would have a large cost impact that Staff believes is excessive.

Asarco, Inc., BHP Copper, Inc., and Cyprus Climax Metal

Asarco, Inc., BHP Copper, Inc., and Cyprus Climax Metal (ABC) commented on reliability concerns by stating that the two summer outages (in July and August, 1996) resulted from a government-owned entity that didn't do its job. "In fact, there is reason to believe that a privately owned entity facing not only regulatory oversight but possible discipline by the market, might well have met the responsibilities which the Bonneville Power Administration failed to meet." Staff agrees.

ABC believes that the rule properly addresses reliability. ABC also says that "the potential impact of competition on reliability is sometimes overstated by those who hope to delay competition." Staff agrees. The Electric System Reliability and Safety Working Group is already looking at numerous potential reliability impacts resulting from competition. There is general agreement in the group that all of the reliability issues can be properly addressed. The difficulty will be in determining which organizations are responsible and how those organizations will be compensated for their reliability services.

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ABC disagrees with APS that the word "net" in the definition of stranded cost is superfluous. "If, as APS claims, the word 'net' is merely superfluous, no harm will come from retaining the word in the definition of stranded cost." Staff agrees.

ABC commented on a Citizens Utilities Company (Citizens) proposal to begin collecting stranded costs from all customers immediately. ABC says: "Under Citizens' proposal, consumers would pay twice for stranded costs." Staff agrees that Citizens' proposal should be rejected.

ABC commented on SRP's argument that the proposed rules would preclude SRP's customers from choosing their own supplier. ABC says that this claim is untrue. ABC correctly points out that, since SRP is not regulated by the Corporation Commission, SRP could offer its customers choice today if it desires to do so. Staff agrees.

ABC points out that RUCO's opposition to buy-throughs does not make sense. RUCO argues that "it opens up the danger that part of the utility's power supply will be ear-marked for favored customers." ABC correctly states that a buy-through, by definition, is not from the utility generation resources, but a use of the "utility's transmission and distribution system to gain access to the wholesale market." Staff agrees with ABC that RUCO's concern is based on a misunderstanding of the buy-through option.