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BEFORE THE ARIZONA CORPORATION COMMISSION

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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

Staff of the Arizona Corporation Commission hereby files the reports submitted by the following working groups in the above-captioned matter:

A. Customer Selection

B. Legal Issues

C. Stranded Cost Recovery

RESPECTFULLY SUBMITTED this 30th day of September, 1997.

ARIZONA CORPORATION COMMISSION

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Copy of the foregoing mailed this 1st day of October, 1997 to:

All parties on the service list for Docket No. U-0000-94-165

By: _____

REPORT TO THE

ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE COMPETITION

IN THE PROVISION OF ELECTRIC SERVICE

THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. U-0000-94-165

Submitted By

The Legal Issues Working Group

September 30, 1997

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THROUGHOUT THE STATE OF ARIZONA

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TABLE OF CONTENTS

EXECUTIVE SUMMARY ES-1

INTRODUCTION 1

PART 1 - SCOPE OF THE COMMISSION'S AUTHORITY 2

1.1 Whether the Commission may authorize "electric service providers" (as defined in the Rules) to offer generation, billing and collection, metering and meter-reading services and other information services on a competitive basis in areas where such services were previously exclusively provided by "Affected Utilities." 2

1.2 Whether the Rules may require Affected Utilities to serve all customers as the "provider of last resort" if Affected Utilities no longer have the exclusive right to serve such customers? 9

1.3 Whether the Commission may lawfully compel Affected Utilities to make their distribution and other facilities available to competitors on demand 12

1.4 Whether the Commission may regulate entities as "Electric Service Providers" under the Rules that are not defined as "public service corporations" under the Arizona Constitution. 14

1.5 Whether the Commission may streamline procedures for complying with statutes that regulate public service corporations. 14

PART 2 - RATES AND RATE MAKING 16

2.1 Cost Allocation and Separation Issues. 16

2.2 Confidentiality. 17

PART 3 - STRANDED COST RECOVERY 18

3.1 The legal procedures (hearing and/or utility filings) necessary to determine Affected Utilities stranded costs; legal procedures necessary to vary the annual level of stranded cost recovery, change the total amount of stranded cost recovery or change

the mechanism by which stranded costs are recovered. 18

3.2 The legal standards relevant to stranded cost recovery mechanisms. 21

3.3 The legal standards governing stranded cost recovery mechanisms (*e.g.*, non-by passable CTC or exit fee). 22

3.4 The ACC's powers to "true-up" any initial stranded cost estimates to eliminate possible over/under recovery of stranded cost amounts. 22

3.5 Legal standards for "securitizing" or using public funding mechanisms for the recovery of stranded costs. 23

3.6 Whether Arizona recognizes a "regulatory compact" as a binding contract that affects the recovery of stranded costs or limits the ACC's power to amend regulations affecting public service corporations. 23

3.7 Whether the ACC has awarded stranded cost recovery for telecommunications providers or for gas LDC's in Arizona. 23

PART 4 - ACC POWERS/PROCEDURES 24

4.1 Stranded Cost Proceedings. 24

4.2 Affiliated Interest Rules. 24

4.3 Non-PSC's. 25

4.3.1 Antitrust Principles. 26

4.3.2 In-State Reciprocity. 27

4.4 Resource Planning Issues. 30

PART 5 - NON-PSC'S 31

5.1 Municipal Corporations, Non-PSCs with Federal Interests. 31

5.2 Relations Between Non-PSC's and PSC's. 32

PART 6 - FERC ISSUES 33

6.1 ACC's Exclusive Jurisdiction. 33

6.1.1 In view of FERC Orders 888, 888-A, 889, 889-A, FERC decisions, case law, the U.S. Constitution and the various Federal acts, what exclusive (or concurrent) jurisdiction may the ACC exercise in the context of competitive electric energy services, whether in wholesale and/or retail transactions considering the interstate nature of the transmission lines? . 33

6.2 FERC's Exclusive Jurisdiction. 36

6.2.1 In view of Rules 888, 888-A, 889, 889-A FERC decisions, case law, the U.S. Constitution and the various Federal acts, what exclusive (or concurrent) jurisdiction may FERC exercise in the context of competitive electric energy services, whether in wholesale and/or retail transactions within Arizona considering the interstate nature of the transmission lines? 36

6.3 FERC Approvals. 39

6.3.1 What actions taken in Arizona or involving Arizona public utilities to move to retail competition in the electric industry (including any formation of an ISO) will require FERC approvals and what criteria will FERC apply? 39

6.4 Jurisdictional Separation of Distribution-Transmission Lines. 42

6.4.1 The FERC has issued criteria and decisions to assist in determining what is a distribution line and what is a transmission line so as to assert appropriate FERC jurisdiction over transmission lines. What are the criteria, how should they be applied, and what FERC actions are required to confirm that determination? 42

PART 7 - FEDERAL ISSUES 44

7.1 Two-County Rule. 44

7.1.1 What is it, how does it affect a utility in a competitive environment, and what resolution is possible? 44

7.2 Federal Rural Electrification Act (and resulting mortgages, interlocking all-requirements contracts, and related issues). 47

7.2.1 What is it, how does it affect a cooperative in a competitive environment, and what resolution is possible? 47

7.3 Western Area Power Administration. 51

7.3.1 What affect will its presence, system, contracts, policies and Federal constraints have on the adoption of retail competition in electric supply? 51

7.4 Interstate Reciprocity. 51

7.4.1 In view of the Commerce Clause of the U.S. Constitution, what can Arizona require of out-of-state entities to compete in Arizona markets? 51

PART 8 - ANTI-TRUST ISSUES 54

8.1 State Action Immunity Doctrine. 54

8.2 Application of Traditional Antitrust Principles. 55

PART 9 - SUGGESTED CODE CHANGES 55

9.1 Federal Statutes. 55

9.2 The Arizona Constitution. 56

9.2.1 Whether Constitutional amendments are required either to allow or facilitate competition in generation supply and other electric services. 56

9.3 Arizona Statutes. 60

9.3.1 A.R.S. § 40-281 60

9.3.2 A.R.S. §§ 40-201 and 40-202 61

9.3.3 Rate Statutes 61

9.3.4 A.R.S. § 40-204 62

9.3.5 A.R.S. §§ 40-221 and 40-222 63

9.3.6 A.R.S. § 40-284 63

9.3.7 A.R.S. § 40-285 64

9.3.8 A.R.S. § 40-301 et. seq. 65

9.3.9 A.R.S. §§ 40-321, 40-322, 40-331, 40-332 and 40-334 65

9.3.10 A.R.S. § 40-341 et. seq. 66

9.3.11 A.R.S. § 40-360 et. seq. 66

9.3.12 A.R.S. § 40-401 et. seq. 67

9.3.13 Title 10 67

9.3.14 Non-Regulated Activity by Utilities 68

9.3.15 A.R.S. § 48-1515 68

Exhibit A Maricopa County Superior Court Cases Involving Electric Restructuring

Appendix A List of Working Group Participants

Appendix B Chronology of Group Process

Appendix C Special Open Meeting Minutes

Appendix D Comments of Participants

ARIZONA CORPORATION COMMISSION'S
ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP
EXECUTIVE SUMMARY

INTRODUCTION

The following summarizes the attached final report of the Commission's Legal Issues Working Group (the "Working Group" or "group"). Appendix A is a list of the members of the Working Group.

Working Group participants prepared the report through a series of drafts compiled from oral comments at public meetings and from written comments from the participants. These participants are largely responsible for the focus and content of the final report.

The Working Group designated participants ("Reporters") to collect written comments and contributions from participants. The Working Group assigned Reporters by subject-matter and the Reporters incorporated material into a report format. The Reporters' work was collected into a single draft report and participants were given an opportunity to suggest changes and additional material for the final report. The Reporters are responsible for the balance and comprehensive nature of the work in the final report.

The Working Group's Reporters are as follows:

Steven M. Wheeler	***Nature of Restructuring in General and Stranded Cost Recovery.***
Bradley S. Carroll	***Rights and Duties of Public Service Corporations and Antitrust Issues***
Lawrence V. Robertson, Jr.	***Scope of Restructuring***
Beth Ann Burns	***Rates and Ratemaking***
C. Webb Crockett	***ACC Powers/Procedures***
Jessica J. Youle	***Non-PSC Issues***
Patricia E. Cooper	***FERC Issues and Federal Issues***
Douglas C. Nelson	***Taxation Issues***
Michael M. Grant	***Legislative Issues***

The Legal Division excised incorrect or redundant material from the draft and further summarized the Reporters' comments. Participants were given opportunity to comment on a second and third draft of the report. A chronology of the group's activities is attached to the Report as Appendix B. The minutes of the group's meetings are collected in Appendix C.

The report consists of Nine Parts, representing issues that the Working Group identified. The Working Group did not identify legal issues that may affect the matters discussed in the reports of other working groups involved in electric restructuring.

The attached Appendix D contains participants' separate comments regarding the Report.

PART 1: SCOPE OF THE COMMISSION'S AUTHORITY

This part summarizes the legal arguments for and against the Commission's power to adopt the Rules. Part 1.2 contains comments for the Commission to consider in addressing electric utilities' obligations to serve customers in a competitive environment.

PART 2: RATES AND RATEMAKING

This part identifies legal issues relating to cost allocation and confidentiality of information under competition.

PART 3: STRANDED COST RECOVERY

This part identifies the issues to be decided in a stranded cost proceeding. It also identifies standards in the Rules that certain Affected Utilities have challenged as unreasonably vague. This part identifies legal arguments that may affect stranded cost recovery mechanisms and stranded cost "true up" proceedings.

PART 4: ACC POWERS/PROCEDURES

This part identifies procedural issues that the Commission may face with respect to stranded costs, affiliated interests, non-public service corporations, antitrust, intergovernmental agreements, in-state reciprocity, and resource planning.

PART 5: NON-PSCs

This part discusses the various entities that operate as public service corporations outside the Commission's jurisdiction. The part discusses the laws that affect the relationships between these entities and public service corporations.

PART 6: FERC ISSUES

This part identifies the exclusive powers of the Federal Energy Regulatory Commission ("FERC") and the Arizona Corporation Commission. It identifies initiatives involving competition that may require FERC approval, such as establishment of an independent service organization ("ISO"). This part discusses the factors that may determine the jurisdictional separation of distribution and transmission.

PART 7: FEDERAL ISSUES

This part explains tax-exempt financing under the "Two-County" rule. This part explains how FERC has addressed this rule with respect to open access for transmission services. This part discuss the potential effect of the Rural Electrification Act's upon electric cooperatives in a competitive environment. This part discusses what Arizona may require of out-of-state entities under the Commerce Clause of the U.S. Constitution.

PART 8: ANTI-TRUST ISSUES

This part explains why utilities will not have state-action immunity from anti-trust laws to the extent the utilities provide competitive services.

PART 9: SUGGESTED CODE CHANGES

This part identifies the arguments for and against the need for legislative changes to facilitate competition. It identifies the state statutes that the group discussed.

REPORT OF THE ARIZONA CORPORATION COMMISSION'S LEGAL ISSUES WORKING GROUP

INTRODUCTION

The Arizona Corporation Commission ("Commission") established the Legal Issues Working Group (the "Working Group") pursuant to A.A.C. R14-2-1616 to identify, analyze and provide recommendations to the Commission on legal issues relevant to Title 14, Chapter 2, Article 16 of the Arizona Administrative Code (the "Rules"). *See* A.A.C. R14-2-1601 to -1616, "Retail Electric Competition." This report ("Report") identifies and analyzes legal issues which the Commission should consider in evaluating modifications or additions to the Rules and relevant Arizona statutes.

This Report discusses regulatory policy regarding industry restructuring only to the extent policy explains or defines a legal issue that is relevant to the Rules. This Report does not recommend any policy over other policy choices that are available to the Commission.

The working group considered a number of amendments to the existing Rules, additional rulemaking as well as legislative and constitutional changes. Some participants believed that any amendments to the Rules were unnecessary. The working group did not reach unanimity for recommending any particular action. The working group's observations regarding legal issues in the Report are contained in sections entitled "Comment."

The Report refers to the Commission's Legal Division as "Staff." References to "Affected Utilities" are intended to encompass the utilities defined in A.A.C. R14-2-1601(1).[1] "Consumer" refers primarily to potential high-volume purchasers of electric generation services.

PART 1

SCOPE OF THE COMMISSION'S AUTHORITY

1.1 Whether the Commission may authorize "electric service providers" (as defined in the Rules) to offer generation, billing and collection, metering and meter-reading services and other information services on a competitive basis in areas where such services were previously exclusively provided by "Affected Utilities."

ANALYSIS

SUMMARY OF ARGUMENTS REGARDING AUTHORITY AND "REGULATORY COMPACT"

Certain Affected Utilities have filed actions in the Maricopa County Superior Court, alleging that the Commission does not have constitutional or statutory authority to adopt the Rules.[2] These Affected Utilities maintain that the Arizona Constitution and the Legislature, pursuant to its power under article XV, section 6, created a policy of "regulated monopoly" for electric utilities. These arguments also rely on judicial decisions that refer to Arizona's policy of "regulated monopoly" as being Legislative in origin or, alternatively, the result of a regulatory contract.

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[1] Two affected utilities, Morenci Water and Electric and Ajo Improvement Company, serve Morenci and Ajo. References to Affected Utilities throughout the report may not reflect these utilities' positions.

[2] Those cases are listed in the attached Exhibit "A" to the Report. The Residential Utility Consumer Office filed an action to challenge the Rules and has voluntarily dismissed the action.

Some Affected Utilities maintain that regulated monopoly for distribution and generation results in a "regulatory compact" between utilities and the state. These Affected Utilities maintain that their certificates of convenience and necessity, authorized pursuant to A.R.S. § 40-281, grant the Affected Utilities exclusive rights to deliver electric service, including generation and retail transmission, within their service territories.

Some participants maintain that competitive pricing unlawfully delegates to the market the Commission's duty to determine just and fair rates based upon the "fair value" of a public service corporation's assets. These utilities also maintain that the Rules violate the Arizona Constitution, article XV, § 14, which requires the Commission to determine "fair value" of a utility's assets. Other participants maintain that competitive pricing is within the Commission's constitutional powers to "prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected..." by public service corporations. Ariz. Const. art. XV, § 3.

Arguments in support of the Rules maintain that the State of Arizona has not entered into a regulatory compact favoring perpetual monopolies. These participants cite a decision of the Maricopa County Superior Court as denying a regulatory compact with respect to a telecommunications PSC, *U.S. West Communications, Inc. v. Arizona Corporation Commission, et al.*, Mar. Co. Sup. Ct. Cause No. CV95-14284 (May 6, 1997). These participants maintain that no Arizona case expressly uses the term "regulatory compact." These arguments maintain that Section 40-281 is intended to prevent unnecessary duplication of lines and facilities within distribution areas; it does not address competitive pricing of services, like generation, that are separable from distribution monopolies.

Participants in support of the Rules maintain that, in a monopoly setting, fair value is used to determine rates artificially, as if the rates were set in a competitive market. If rates are based upon a competitive market, then the Commission's fair value determination has been accomplished more directly and accurately than in the non-competitive setting.

The Working Group's consensus is that the Courts or perhaps the Legislature ultimately will determine whether the Commission must have legislative or constitutional authority to promulgate the Rules, although some participants recommended that the Commission should work with the Legislature to obtain authority to adopt and implement the Rules. In the meantime, the Commission should clarify that the Rules do not affect the exclusivity of distribution services under existing certificates of convenience and necessity. The Rules should also distinguish between certificates for distribution monopolies and certificates for other services that are unbundled or separated from distribution services.

ARGUMENTS BY AFFECTED UTILITIES

Affected Utilities maintain that the Arizona Supreme Court expressly recognized the existence of a regulatory compact in *Application of Trico Electric Cooperative, Inc.*, 92 Ariz. 373, 377 P.2d 309, wherein the court stated:

> By the issuance of a certificate of convenience and necessity to a public service corporation the State in effect <u>contracts</u> that if the certificate holder will make adequate investment and render competent and adequate service, he may have the privilege of a monopoly as against any other private utility.

92 Ariz. at 380-381 (emphasis added). *See also City of Tucson v. Polar Water Co.*, 76 Ariz. 404, 265 P.2d 773 (1954) (CC&N recognized as a "contract" between the state and utility); *New England Coalition on Nuclear Pollution v. Nuclear Regulatory Comm'n*, 727 F.2d 1127, 1130 (D.C. Cir. 1984) ("the very nature of government rate regulation" is "a

compact whereby the utility surrenders its freedom to charge what the market will bear in exchange for the state's assurance of adequate profits.").

These utilities maintain that "regulated monopoly" is Arizona's legislative policy for regulating electric utilities. They maintain that this policy was created by, and therefore may only be modified by, the Arizona Legislature, not the Commission. In support of this position, the utilities cite cases such as *Tonto Creek Estates v. Arizona Corporation Commission*, 177 Ariz. 49, 56, 864 Ariz. 1081, 1088 (Ct. App. 1993), which states that "[t]he concept of regulated monopoly arose from the Legislature in granting the Commission authority to issue certificates of public convenience and necessity to public service corporations."

The Utilities argue that Arizona courts have determined that the "contract" is one creating a constitutionally protected "vested property right" (*Trico,* 92 Ariz. at 381) and that the Corporation Commission is under a duty to protect the exclusive right to serve electricity in the region where the utility renders service, under its certificate (*Trico,* 92 Ariz. at 387). The court in *Trico* held as follows:

> We hold that the Corporation Commission was under a duty to Trico to protect it in the exclusive right to serve electricity in the region where it rendered service, under its certificate.

92 Ariz. at 387 (emphasis added). Twenty years later, the Arizona Supreme Court strengthened and reiterated this view in *James P. Paul Water Company v. Arizona Corporation Commission*, 137 Ariz. 426, 671 P.2d 404 (1983). In that decision, the Supreme Court reaffirmed the exclusive right to provide service under a CC&N, 137 Ariz. at 429, and branded as clearly unlawful the Commission's attempt to certificate a competitor promising lower rates:

> . . . the Commission lost sight of its obligation to respect *Paul*'s expectation, as a certificate holder, of an opportunity to provide service as needed.

137 Ariz. at 431.

Affected Utilities maintain that the elements of this regulatory compact are long-standing, clear and obvious. A public service corporation is required to serve those within its territory, to make extensions and improvements to meet future demands, to subject many of its business transactions to prior Commission approval and to limit its revenues and income to those established by the Commission.[3] In return, the utility is granted a monopoly for exclusive service rights therein and the constitutional guarantee of just and reasonable rates that allow it to recover its cost of service and earn a fair return on the fair value of its properties. Electric public service corporations in this state have committed billions of dollars of private capital to meet their collective obligations in reliance on this compact. *Cf. United States v. Winstar Corp.*, 116 S.Ct. 2432 (1996) (government financially responsible to regulated business for economic injury suffered by change in regulatory policy).

The Affected Utilities maintain that the history of the regulatory compact in America has been well chronicled. *See, e.g.,* Sidak and Spulber, "Deregulatory Takings and Breach of the Regulatory Contract," 71 *N.Y.U. Law Review* 851 (1996); George L. Priest, "The

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[3] Pursuant to A.R.S. § 40-321, *et seq.*, the Legislature purports to give the Commission the authority to order a public service corporation to provide specified services in an approved manner to customers within the utility's service area. Moreover, A.A.C. R14-2-202(C) forbids a public service corporation from abandoning service within its territory without express Commission approval. Thus, once a utility becomes a regulated public service corporation, it apparently cannot "get out of the business" without Commission approval.

Origins of Utility Regulation and the 'Theories of Regulation' Debate," 36 *J.L.& Econ.* 289 (1993).

ARGUMENTS BY CONSUMERS AND STAFF

Potential consumers maintain that a certificate of convenience and necessity does not provide, in effect, that a public service corporation may "corner the market" on electric service. Arizona court decisions refer to regulated monopoly as a public policy, rather than as a contractual obligation. *See Ariz. Corp. Comm'n v. Superior Court*, 105 Ariz. 56, 59, 459 P.2d 489 (1969); *Winslow Gas Co. v. Southern Union Gas Co.*, 76 Ariz. 383, 385, 265 P.2d 442, 443 (1954); *Pacific Greyhound Lines v. Sun Valley Bus Lines, Inc.*, 70 Ariz. 65, 71, 216 P.2d 404, 408 (1950); *Corp Comm'n v. Pacific Greyhound Lines*, 54 Ariz. 159, 177, 94 P.2d 443 (1939).[4] The law does not recognize monopolistic pricing as a vested property right. *See Columbia Steel Casting v. Portland General Electric*, 103 F.3d 1446 (9th Cir. 1996); *F.T.C. v. Ticor*, 504 U.S. 621 (1992).

The Affected Utilities' interpretation of Section 40-281 also frustrates the Commission's authority, which is derived from the Arizona Constitution rather than from a legislative delegation. "Where the Constitution has said that public service corporations shall be governed by the Corporation Commission in a given respect, it is the last, the highest, and controlling fundamental law as to that matter." *State v. Tucson Gas, Electric Light and Power Co.*, 15 Ariz. 294, 301, 138 P.781, 784 (1914). In the event of a conflict between the Commission's constitutional authority and a state statute, the Constitution will

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[4] The Legislature recently added Section 40-281(D) to provide that Section 40-281 should not be construed as "granting <u>or having granted</u>" an exclusive franchise or monopoly to any telecommunications corporation. If Section 40-281 never granted exclusive rights to telecommunications companies, then it follows that the statute never granted the rights to other public service corporations.

prevail. *Ethington v. Wright*, 66 Ariz. 382, 394, 189 P.2d 209, 217 (1948); *Tucson Gas*, 15 Ariz. at 301, 138 P. at 784; *State ex rel. Corbin v. Ariz. Corp. Comm'n*, 174 Ariz. 216, 219, 848 P.2d 301, 304 (App. 1992).

The Commission's rate making power includes adoption of rules that prescribe the classifications and methods that will be used to determine rates and charges. *See Consolidated Water Util. Ltd. v. Ariz. Corp. Comm'n*, 178 Ariz. 478, 483-85, 875 P.2d at 137, 142-44 (App. 1994); *Woods,* 171 Ariz. at 294, 830 P.2d at 815; *Ethington*, 66 Ariz. at 392, 189 P.2d at 216 (Commission's "full and exclusive power" extends to "*making rules, regulations, and orders concerning such classifications, rates and charges by which public service corporations are to be governed....*" (emphasis added)).

Some participants maintain that Arizona's Constitution prefers competition and disfavors monopolies.[5] These participants cite a decision of the Maricopa County Superior Court as denying a regulatory compact with respect to a telecommunications PSC, *U.S. West Communications, Inc. v. Arizona Corporation Commission, et al.*, Mar. Co. Sup. Ct. Cause No. CV95-14284 (May 6, 1997). The Rules follow this principle and apply traditional rate regulation only to natural monopolies, such as companies that erect electric distribution lines, to prevent harm to the public from monopolistic pricing. Services that become separable from the natural monopoly, like electric generation, are eligible for pricing in the competitive market. The Commission's rate making function may change as a particular service becomes less essential or integral to the public service performed by

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[5] Article XV, § 15 provides, in pertinent part, that "[m]onopolies and trusts shall never be allowed in this State...."

the company. *See Mountain States Tel. and Tel. Co. v. Ariz. Corp. Comm'n*, 132 Ariz. 109, 116, 644 P.2d 263, 270 (App. 1982).

The changing nature of the electric industry has led one court to conclude that, while vertically-integrated electric monopolies may have been tolerated in the past, future generations should not be bound to a policy based upon the technological limitations of another time. *See Appeal of Public Service of New Hampshire*, 141 N.H. 13, 676 A.2d 101, 104 (1996). The same court, applying a state constitutional prohibition against monopolies similar to Arizona's, held that competition in electricity should be affirmed "with all doubt resolved against the perpetuation of monopolies." *Id.*, 676 A.2d at 105. The *New Hampshire* court upheld retail electric competition despite utilities' arguments that 80 years of statutes and court decisions granted them exclusive franchises.

COMMENT

None.

1.2 Whether the Rules may require Affected Utilities to serve all customers as the "provider of last resort" if Affected Utilities no longer have the exclusive right to serve such customers?

ANALYSIS

A.A.C. R14-2-1606 provides that Affected Utilities will provide electric service ("Standard Offer Tariffs") to all customers within a class in their utility service areas until the Commission has determined that (1) all consumers in the class have the opportunity to purchase power on a competitive basis and (2) all stranded costs pertaining to that class have been recovered. The Affected Utilities' obligation to supply electric generation will cease when stranded costs are fully recovered and competitive pricing is fully available to customers.

Affected Utilities maintain that A.A.C. R14-2-1606 requires incumbent utilities to continue providing electric services to all customers within their utility service areas even though they no longer possess the exclusive right to provide such services (*e.g.*, generation, billing and collection, meter-reading, etc.). This obligation to serve will not terminate until some indefinite time in the future. The Affected Utilities maintain that no other "electric service provider" has a similar obligation. Several utilities have claimed that the traditional utility obligation to serve is legally dependent upon the concomitant *exclusive* right to serve. *See, e.g., James P. Paul Water Company* and *Tonto Creek Estates*, supra. Affected Utilities claim that the burden to plan for and serve (at regulated rates that do not explicitly provide for the recovery of associated costs) these customers is inconsistent with the free market regime envisioned by the Commission and unlawfully harms the Affected Utility's competitive position.

Affected Utilities maintain that the Rules should not impose an obligation to serve in situations where the exclusive right to serve no longer exists, or at least should establish more definite criteria for terminating an affected distribution utility's obligation to supply electric generation.[6] The Affected Utilities maintain that the Rules should explicitly provide for full recovery of all costs incurred in meeting this obligation.

For example, the Commission could classify customers by the size of their load. Customers purchasing 1MW or greater could be classified so that the obligation to serve

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[6] The "opportunity" to participate in competitive pricing does not mean that customers have actually availed themselves of the opportunity. The Rules probably require that the opportunity be available in a meaningful way. The FCC dealt with a similar issue in *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, Inter LATA Services in Michigan*, CC Docket No. 97-137, Memorandum Opinion and Order (Released August 19, 1997).

would cease when that customer is able to purchase generation from another supplier. If that customer returns to the affected distribution utility, the customer remains in the competitive marketplace notwithstanding the customer's decision not to choose another supplier. The obligation to provide competitive services may continue for customers purchasing lesser amounts during the transition until all customers in each class have the opportunity to receive competitive services such as generation.

The Commission could define the point at which all customers of a class have the opportunity to participate in the competitive market by using some presumptive time provisions. For example, customers of a class will presumptively have the opportunity to participate at least by a certain date, such as January 1, 2003, as provided in A.A.C. R14-2-1604(D). The Commission could extend the date upon a finding of extraordinary circumstances, including the Affected Utility's failure or inability to make all its customers available for competitive generation. The Working Group consensus is that clarification would be appropriate.

At least one Affected Utility suggests that linking the obligation to serve to "full" recovery of stranded costs might be too inflexible. This objection suggests that stranded cost recovery might extend beyond the time that all customers have the opportunity to purchase competitive power. Many participants maintain that the Commission should consider addressing this possibility in amendments to the Rules. *See* R14-2-1606(A).

The working group found that the Commission may not regulate entities that are not "public service corporations" as defined in article XV, § 2 of the Arizona Constitution. *See* *Rural/Metro Corp. v. Arizona Corporation Commission*, 129 Ariz. 116, 117, 629 P.2d 83, 84 (1981).

COMMENT

A. **The Commission may consider clarifying the point at which all customers of a class have the opportunity to participate in the competitive market.**

B. **The Commission may address whether the obligation to serve should be linked to stranded cost recovery that extends well beyond the point at which all customers of a class have the opportunity to participate in the competitive market.**

C. **The Commission may explicitly state in the Rules that the reasonable costs of meeting the obligation to serve will be recoverable in rates.**

D. **The Commission may not regulate corporations that do not conduct activities described in article XV, § 2, Arizona Constitution.**

1.3 **Whether the Commission may lawfully compel Affected Utilities to make their distribution and other facilities available to competitors on demand.**

See the analysis and comments contained in Section 1.1.

The Rules contemplate that electric service providers (particularly generators) who desire to sell to customers within the existing certificated areas of electric utilities will have access to the distribution facilities of the Affected Utilities subject to terms and conditions and rates to be established by the Commission. Several of the utilities have argued that this provision represents an unlawful "taking" of a private utility's property (*see Loretto v. Teleprompter Manhattan CATV Corp.,* 450 U.S. 419, 102 S.Ct. 3164, 73 L.Ed. 2d 868 (1982); *GTE Northwest, Inc. v. Public Utility Commission of Oregon,* 321 Or. 458, 900 P.2d 495 (1995)) that is not authorized by any specific Arizona constitutional or statutory provision.

The Commission Staff maintains (1) the Affected Utilities will be compensated for access to their distribution lines and for the power produced through their generation plants; (2) a regulatory taking has not occurred since the Affected Utilities will continue to

use of their property, albeit under competition; and (3) a monopoly is not a property interest under the Takings Clause of the state or federal constitutions, see *Tennessee Electric Power Co. v. Tennessee Valley Authority*, 306 U.S. 118, 141 (1939); *Law Motor Freight, Inc. v. Civil Aeronautics B'd*, 364 F.2d 139, 144 (1st Cir. 1966) ("[F]reedom from competition is not constitutionally protected.").

Some participants maintain that A.R.S. § 40-331 and/or A.R.S. § 40-332 authorize the Commission to compel Affected Utilities to "wheel" power from other sellers of generation to customers capable of being served from existing distribution facilities, upon a determination that the "public convenience and necessity." These participants cite to article XV, § 10, which provides that "[a]ll electric, transmission...corporations, for the transportation of electricity,...for profit, are declared to be common carriers and subject to control by law."

Working Group members disagree as to whether A.R.S. § 40-331 and/or A.R.S. § 40-332 apply only to circumstances in which an Electric Service Provider ("ESP A") seeks to use the facilities of an Affected Utility ("Affected Utility B") in order to serve ESP A's own customers outside of Affected Utility B's traditional service area. The Affected Utilities maintain that the statutes do not permit ESP A to use Affected Utility B's facilities to directly compete for Affected Utility B's customers. The participants also disagree as to whether these statutory provisions authorize the use of an Affected Utility's facilities by non-public service corporations that are not and can not be regulated by the Commission.

COMMENT

None.

1.4 Whether the Commission may regulate entities as "Electric Service Providers" under the Rules that are not defined as "public service corporations" under the Arizona Constitution.

ANALYSIS

The Rules regulate as an "electric service provider," any "company supplying, marketing, or brokering at retail any of the services described in R14-2-1605 or R14-2-1606." A.A.C. R14-2-1601(V). The Arizona Constitution allows the Commission to regulate "public service corporations" which are defined, in relevant part, as "[a]ll corporations other than municipal engaged in furnishing... electricity for light, fuel, or power...." Ariz. Const. article 15, § 2. As the Commission moves toward competitive pricing, it may classify certain services as less essential to a public service. The Commission may eventually classify services or "electric service providers" as being outside the Commission's regulatory authority. See analysis in Part 1.1. *See also, Rural/Metro Corp. v. Arizona Corporation Commission*, 129 Ariz. 116, 117, 629 P.2d 83, 84 (1981) (ACC may not regulate entities that are not "public service corporations" under article XV, § 2 of the Arizona Constitution.)

COMMENT

None.

1.5 Whether the Commission may streamline procedures for complying with statutes that regulate public service corporations.

ANALYSIS

The Rules provide that "electric service providers" may offer competitive generation and other services under less stringent rate procedures than for Affected Utilities that provide exclusive services in their existing territories. For example, rates for competitive generation service are deemed to be just and reasonable to the extent they are "market

determined." *See, e.g.,* R14-2-1612(A). Electric service providers file a tariff for each service that sets the maximum rate and terms and conditions that will apply. A.A.C. R14-2-1603(B).

Certain Affected Utilities maintain that the Rules should require an electric service provider for competitive generation to follow the established Commission procedures for rate filings and rate changes, including the extensive cost of service, financial and other information required by A.A.C. R14-2-103. These arguments maintain that the Constitution's fair value provisions mandate such procedures for all services, including competitively priced services. Section 1.1 summarizes the "pro" and "con" arguments on this position.

Some Affected Utilities maintain that legislative changes should be made to streamline procedures in at least the following areas: confidentiality of utility information on file with the Commission (*e.g.,* A.R.S. §§ 40-204 and 40-367), existing provisions regarding rate filings and tariffs (*e.g.,* A.R.S. §§ 40-248, 40-250, 40-361, 40-365, 40-367), standards relating to rate discrimination and preferences (*e.g.,* A.R.S. §§ 40-334, 40-374), requirements for Commission approval for financings and sale of assets (*e.g.,* A.R.S. §§ 40-285, 40-301, *et seq.*), annual reports, etc.

Certain participants also maintain that the Commission should modify existing rules, particularly to the affiliated interest rules (A.A.C. R14-2-801, *et seq.*), the resource planning rules (A.A.C. R14-2-701, *et seq.*), the depreciation and rate filing rules (A.A.C. R14-2-102 and 103), and the customer service rules for electric utilities (A.A.C. R14-2-201, *et seq.*).

Staff and consumers maintain that the Commission may exercise its ratemaking powers and streamline procedures to facilitate competitive pricing. This includes

streamlining procedures for utilities to comply with statutes governing public service corporations.

COMMENT

None.

PART 2

RATES AND RATE MAKING

2.1 Cost Allocation and Separation Issues.

ANALYSIS

In the interest of leveling the playing field between non-regulated utility activities and small businesses, some participants suggested that the rules should (1) preclude utilities from cross-subsidizing their unregulated activities with funds received from ratepayers under Commission authorized rates; (2) establish accounting procedures and standards to prevent cross-subsidization by requiring the utilities to assign direct and indirect costs to the unregulated activities; and (3) require the unregulated activities to pay fair market value for the use of utility personnel, services, and equipment and to pay royalties for any intangible benefit gained through affiliation with the utility.

Some participants maintain that the existence of cross-subsidization would suggest that regulated rates are too high. The Commission could address cross-subsidization through orders to show cause. The consensus of the group is that the Commission has sufficient power to deal with cross-subsidization through rate making orders. These participants did not see a need to change the Rules at this time.

COMMENT

None.

2.2 Confidentiality.

ANALYSIS

A participant suggests that A.R.S. § 38-431.02, *Notice of meetings*, be amended to provide that documents and other information related to a public body's discussions or consultations on negotiations, bids, or proposals for power and energy transactions, for the purchase or sale of fuel, or for the construction, ownership, or operation of generation or transmission facilities would not be public records, except that any contracts executed by the public body would be public records unless otherwise exempted by law.

The commenter also suggests amending A.R.S. § 40-204 to provide that information related to negotiations, bids, or proposals for power and energy transactions, for the purchase or sale of fuel, or for the construction, ownership, or operation of generation or transmission facilities would not be open to public inspection, unless ordered by the Commission for good cause shown.

The Working Group generally agreed that confidentiality procedures will have to be scrutinized at some time. The Working Group sharply disagreed over whether such a review should take place before or after competition commences.

COMMENT

The working group did not reach a consensus regarding what information should be confidential, although the group agreed that some confidentiality should be given to information that the Commission requires to be filed for regulatory purposes. In that regard, the Commission may provide by rule that commercially sensitive/proprietary information would be kept confidential unless, upon notice to the utility that would be affected by disclosure, extraordinary circumstances justify disclosure.

PART 3

STRANDED COST RECOVERY

3.1 The legal procedures (hearing and/or utility filings) necessary to determine Affected Utilities stranded costs; legal procedures necessary to vary the annual level of stranded cost recovery, change the total amount of stranded cost recovery or change the mechanism by which stranded costs are recovered.

ANALYSIS

If a utility claims stranded cost recovery in conjunction with a rate case, the issue would be subject to the same general filing and/or hearing requirements attending other claimed costs. Similarly, the legal procedures associated with changes to total amounts of stranded costs, annual levels of recovery or mechanisms by which stranded costs are recovered may be subject to the same limitations as recovery of other costs in a rate case. If the Commission establishes a stranded cost recovery mechanism, subsequent *changes* to the recovery balance or other details of the plan may be resolved in an abbreviated proceeding similar to fuel or other adjustment clause mechanisms. *See, e.g., Scates v. ACC,* 118 Ariz. 531, 578 P.2d 612, *appeal after remand,* 124 Ariz. 73, 601 P.2d 1357 (1978). *See also,* A.A.C. R 14-2-1607(L).

The elements of proof for stranded cost recovery under the Rules would be generally as follows:

A. Prove the value of jurisdictional asset or obligation which was:

I. prudent,

ii. acquired or entered into[7] prior to adoption of the Rules under the traditional regulation of Affected Utilities.

B. Prove that the market value of the asset or obligation

i. decreased,

ii. as a direct consequence of competition.

C. Prove that the utility mitigated the stranded cost by every reasonable measure related to the provision of regulated electric service which was

i. feasible, and

ii. cost-effective.

The burden of proof with respect to "prudence" may, in many cases, already have been addressed in prior Commission proceedings. Moreover, many of the costs that would fit within the stranded cost category for Affected Utilities have been (a) explicitly approved by the Commission, in some cases after expensive prudence reviews[8], (b) subject to review and not challenged by parties in previous rate cases, or (c) required by federal law or Commission order. Most Working Group participants agreed it would be unnecessary and unduly expensive and time-consuming to require a utility to "re-litigate" issues previously reviewed and/or resolved by the Commission. In addition to the presumption of prudence, the Commission may employ traditional principles of *res judicata*, *stare decisis*, and regulatory estoppel to prevent unwarranted re-litigation of previously decided matters. The Working Group's consensus is that the Commission may review prior

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[7] "Acquired" includes duties existing under law as of the date the Rules were adopted.

[8] One participant noted, as an example, that the prudence review of the planning and construction of the Palo Verde Nuclear Generating Station cost approximately $40 million. The result of that review was reflected in a rate settlement agreement approved by the Commission in Decision No. 57649 (December 6, 1991).

prudence determinations that were materially influenced by extraordinary circumstances, such as fraud or concealment.

The Commission's regulations provide that "all investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made." *See* A.A.C. R14-2-103(A)(3)(l).

Certain Affected Utilities believe the standard for utility "mitigation" measures in the Rules is unlawful, unreasonable, and overly vague. The utilities maintain that the Rules may be interpreted as allowing the Commission to require utilities to expend potentially unlimited amounts of private capital and other resources to pursue ill-defined business ventures outside ACC jurisdiction. Other participants comment that Affected Utilities should be required to use any revenues that are generated by or from the use of personnel, assets or the credit of the utility to mitigate stranded costs. These participants maintain that ratepayers should receive the benefit of revenues generated by the regulatory assets, personnel or credit of the utility.

The consensus of the Working Group is that the Commission may inquire as to the efforts that utilities have undertaken to reasonably mitigate stranded costs through cost reductions, efficiency improvements, market expansion and/or the development of new products and services related to the provision of traditional utility service. Staff suggests that the Commission may clarify the level of mitigation that is "reasonable" by borrowing mitigation concepts from another body of law, like commercial lease law or public condemnation law.

COMMENT

A. **The Commission may accept prior prudence determinations as binding for stranded cost proceedings absent extraordinary circumstances, such as fraud or concealment.**

B. **Although some participants believe no change to the stranded cost recovery provisions is required, most participants agree that the Commission should clarify the mitigation standard in the Rules to define "reasonable" mitigation efforts that relate to the provision of regulated utility service.**

3.2 The legal standards relevant to stranded cost recovery mechanisms.

ANALYSIS

A.A.C. R14-2-1607(J) provides that stranded costs may only be recovered from "customer purchases made in the competitive market." Participants disagreed whether this provision means that stranded costs can only be recovered in the price for competitive services. These arguments maintain that such a construction is inconsistent with A.A.C. R14-2-1607(H). They maintain that "stranded costs" are, by definition, are costs that can not be recovered in the competitive generation market. Participants disagree whether A.A.C. R14-2-1607(J) conflicts with A.A.C. R14-2-1607(H).

The Working Group's consensus, with the exception of Consumers (who maintain that the Rules are sufficient to determine stranded costs), is that the Commission should more precisely define stranded cost recovery mechanisms. The Rules should be amended to the extent the first sentence in R14-2-1607(J) may be read as limiting the classes of customers or services that the Commission may designate for stranded cost recovery.

COMMENT

See the discussion above.

3.3 The legal standards governing stranded cost recovery mechanisms (*e.g.*, non-by passable CTC or exit fee).

ANALYSIS

The Rules provide that customers who are not eligible to receive competitive generation services do not, by definition, create "stranded costs" and therefore will not pay a stranded cost fee. Further, the Rules do not allow stranded cost recovery from purchases in non-competitive or monopolistic markets. These restrictions may require stranded costs to be recovered through an exit fee or some other non-usage-sensitive mechanism. The preferred mechanism for stranded cost recovery is outside the scope of the Working Group's review. Depending upon the Commission's interpretation of R14-2-1607(J), certain mechanisms may require amendment or waiver of the Rules.

COMMENT

See the discussion in Section 3.2 above.

3.4 The ACC's powers to "true-up" any initial stranded cost estimates to eliminate possible over/under recovery of stranded cost amounts.

ANALYSIS

The consensus of the Working Group is that the ACC is not legally required to "true-up" any reasonable initial stranded cost estimates any more than it is legally required to true-up reasonable estimates of other costs used in setting rates. However, the Commission may "true-up" stranded costs.

COMMENT

None.

3.5 Legal standards for "securitizing" or using public funding mechanisms for the recovery of stranded costs.

ANALYSIS

The participants did not study the legal issues associated with "securitizing" or public funding mechanisms for the recovery of stranded costs.

COMMENT

None.

3.6 Whether Arizona recognizes a "regulatory compact" as a binding contract that affects the recovery of stranded costs or limits the ACC's power to amend regulations affecting public service corporations.

ANALYSIS

This issue engendered considerable disagreement among the Working Group participants. The arguments regarding a "regulatory compact" are discussed in Part 1.1.

COMMENT

None.

3.7 Whether the ACC has awarded stranded cost recovery for telecommunications providers or for gas LDC's in Arizona.

ANALYSIS

The Commission traditionally prescribes rates to *avoid* stranded costs for any public service corporation, through rates charged to the utility's remaining customers (telephone) or recoupment of lost sales margins in rates (gas) or by a combination of both. With respect to gas LDCs, FERC Order No. 888-A, issued March 3, 1997 (starting at page 488, *et seq.*), and the Commission's 1990 Decision No. 50575 contain stranded cost recovery principles. FERC did not require a showing of prudence or mitigation and the ACC's decision did not interfere with this pattern.

COMMENT

None.

PART 4

ACC POWERS/PROCEDURES

4.1 Stranded Cost Proceedings.

See the analysis in Part 3.1.

The nature of a stranded cost proceeding will depend, in part, on (1) the methodology for determining the amount of recoverable stranded costs; (2) who will pay the stranded cost; and (3) the recovery mechanism (i.e., a surcharge on all ratepayers to be paid into a common fund, a meter charge, a rate surcharge, etc.).

Also, the Working Group's consensus is the Commission may implement automatic adjustment clauses in appropriate contexts to allow stranded costs to be adjusted based upon changed circumstances. Adjustment clauses have been approved in other contexts in the past and would obviate the need for utilities to make supplemental applications to the Commission to recoup their stranded costs. *See, e.g., Scates v. ACC*, 118 Ariz. 531, 578 P.2d 612, *appeal after remand*, 124 Ariz. 73, 601 P.2d 1357 (App. 1978).

COMMENT

None. See comment to Part 3.1.

4.2 Affiliated Interest Rules.

The Commission's rules relating to public utility holding companies and "affiliated interests" (*See* A.A.C. R14-2-801 through R14-2-806), apply to Class A investor-owned utilities under the jurisdiction of the Commission. A.A.C. R14-2-802(A). Although most utilities entering the competitive market will likely meet the definition of a "Class A investor-

owned" utility, some entities seeking to enter the competitive market in Arizona may not be Class A utilities. The Commission may revise the Rules to address the issues relating to the affiliated interests of companies not falling within the scope of the Commission's existing affiliated interest rules. The Commission's regulatory powers may be limited for entities that are not public service corporations.

COMMENT

None.

4.3 Non-PSC's.

The Commission may regulate only a "public service corporation" ("PSC") as defined in article 15, § 2 of the Arizona Constitution. The same provision expressly excludes municipal entities from the Commission's jurisdiction. Some participants maintain that intergovernmental agreements may be used to coordinate, but not regulate, competitive pricing for non-public service corporations. Certain participants maintain that the agreements may not allow the Commission to assert regulatory powers over such entities.

Alternatively, other participants maintain that existing rules, statutes and the Constitution must be amended to bring non-public service corporations, namely municipal corporations, under the jurisdiction of the Commission, or some other independent agency.

For-profit subsidiaries of non-PSCs may be subject to the Commission's jurisdiction. Some question exists whether the Commission may, in such instances, use its affiliated interest rules to regulate the for-profit affiliate's transactions with the non-PSC. The Commission regulates affiliated interest transactions of PSCs in A.A.C. R14-2-801 through -806. The Commission's power to regulate affiliate transactions of a non-public service

corporation may be found in article 15, § 3 of the Arizona Constitution, which provides that the Commission may require a public service corporation to report information about, and obtain permission for transactions with, its parent, subsidiary, and other affiliated corporations. *See Arizona Corp. Comm'n v. State*, 171 Ariz. 286, 830 P.2d 807 (1992).

COMMENT

None.

4.3.1 Antitrust Principles.

Non-PSCs and PSCs will be subject to the traditional oversight of the Federal Trade Commission ("FTC") and other federal and state agencies in the area of anti-competitive actions. The FTC is a law enforcement agency with statutory authority over a variety of industries, including the electric power industry. The FTC enforces the FTC Act (15 U.S.C. §§ 41-58) and the Clayton Act (15 U.S.C. §§ 12-27) which prohibit, among other things, "unfair methods of competition," "unfair or deceptive acts or practices," and mergers or acquisitions that may "substantially lessen competition or tend to create a monopoly."

In some instances the federal antitrust law's definition of "person" or "parties" embrace cities and municipalities, so that they will be subject to antitrust enforcement actions. 17 McQuillin *Municipal Corporations* (3rd Ed. 1990) 534, citing *Lafayette v. Louisiana Power & Light Co.*, 431 U.S. 963, 98 S. Ct. 1123. Generally, whether actions of a municipality violate the antitrust laws is a question of the extent to which the actions taken are authorized or directed by the state pursuant to state policy. *Id.* Thus, the Commission and the Courts may have jurisdiction over anti-competitive behavior affecting

PSCs, depending upon the activities undertaken and the nature of the entity which is the perpetrator of the anti-competitive behavior.

COMMENT

None.

4.3.2 In-State Reciprocity.

The Rules address in-state reciprocity between non-PSCs and PSCs for purposes of competition. A.A.C. § 14-2-1611. Further, A.R.S. §§ 11-951 through 954 authorize the Commission and municipal subdivisions of this State to enter into intergovernmental agreements ("IGAs") to jointly exercise any powers common to the contracting powers. A.R.S. § 11-952(A). Some interested parties maintain that such IGAs could be used to facilitate competition between PSCs and non-PSCs by controlling some of the practices of the non-PSCs through contractual rather than regulatory means.

Some participants maintain that IGAs may not be used to limit the exercise of an entity's regulatory power. Some participants believe that IGAs could permit municipalities, or other "public agencies" as defined in A.R.S. § 11-951 to enter into agreements with the Commission so that the separate governmental agencies would agree to exercise their individual powers in a parallel and consistent manner. However, none of the participants addressed whether an Affected Utility, electric service provider, customer or other person may enforce such an agreement. The proposed form of such an IGA was not available for comment.

A.A.C. R14-2-1611(E) provides as follows:

> If an electric utility making a filing under R14-2-1611(D) is an Arizona political subdivision or municipal corporation, then the existing service territory of such electric utility shall be deemed

> open to competition if the political subdivision or municipality has entered into an intergovernmental agreement with the Commission that establishes nondiscriminatory terms and conditions for Distribution Services and other Unbundled Services, provides a procedure for complaints arising therefrom, and provides for reciprocity with Affected Utilities.

An IGA would generally address the respective operations of the Commission and the political subdivision or municipality, so that their efforts to establish competition in electric generation are coordinated. An IGA would be based on the general authority of A.R.S. § 11-952, and deal with the joint exercise of the parties or their respective authorities to regulate electric operations within their respective jurisdictions. Specifically, A.R.S. § 11-952(A) provides:

> If authorized by their legislative or other governing bodies, two or more public agencies by direct contract or agreement may contract for services or jointly exercise any powers common the contracting parties and may enter into agreements with one another for joint or cooperative action . . . .

Staff maintains that an IGA between two governmental entities to agree to jointly exercise their respective authorities is authorized by A.R.S. §§ 11-951 through 11-954. An IGA will not be used to limit the exercise of an entity's regulatory power in the public interest. The IGA may "confirm that separate governmental entities will exercise their powers in a parallel and consistent manner." Some participants cite, as an example, the IGA entered into by the Commission with the Federal Power Commission that was approved by the Arizona Supreme Court in *Garvey v. Trew*, 64 Ariz. 342, 170 P.2d 845 (1946).

Staff maintains that the general provisions of an IGA "will consist of the powers of the respective state political subdivisions and will explain how the political

subdivisions will coordinate the exercise of their respective political powers." One party agrees with the general scope of the agreement as described by the Commission. Another believes that the IGA should address whether there is "equal protection of the law for PSCs and non-PSCs."

Another participant points out that an IGA will not create an independent regulatory entity with jurisdiction to assure fair and equitable treatment of PSC's and consumers' purchases in municipal corporations' territories.

Other participants maintain that the IGA statutes only permit public agencies to exercise jointly held powers. Therefore, so the argument goes, the Commission may only enter into IGAs with entities which have the same type of regulatory powers as the Commission. This group of interested parties take the position that non-PSCs do not have "joint power and authority" with the Commission; thus, no IGAs may be entered into with such governmental non-PSCs. There appears to be no dispositive case law in Arizona on the issue, although *Garvey v. Trew*, 64 Ariz. 342, 170 P.2d 845 (1946) and Op. Atty. Gen I84-135 shed some limited light on both sides of the issue. These participants also maintain that the IGA may not be used to give the Commission power over municipal corporations since it is specifically denied such power under article XV, section 2 of the Arizona Constitution.

Some participants claim that the Commission has used IGAs in the past when it agreed with the public utility commissions on some Indian reservations that the Commission should set the rates for telephone service on the reservation, even though the utility commission on the reservation had power to do so. In short, as with many of the issues facing the Commission, there is no bright-line answer to the issue of how to deal

with the in-state reciprocity issues, but the IGAs may be a viable mechanism to facilitate reciprocity, at least in part.

COMMENT

None.

4.4 Resource Planning Issues.

The Commission provides for resource planning and oversight. See A.C.C. R14-2-701, *et seq.* The need for full, formal generation resource planning will likely decrease once competition is implemented and fully underway. As with any competitive market, supply and demand factors may provide optimum market efficiency, and an equilibrium will be reached at some point in the future.

Resource planning ensures that the public is not left without adequate supply, even for a short period of time. Historically, construction of generation and distribution facilities required far-reaching resource planning. Advances in technology has progressively reduced lead-time, thereby permitting quicker response to changes or shifts in demand. Competitors want an adequate supply, as well as facilities, to meet the anticipated demand. Competitors want their resource planning information to be confidential.

Resource planning is monitored by federal (such as FERC) and state (such as the Commission) authorities. As competition commences, the Commission may consider additional rulemaking to deal with confidentiality concerns or to protect Arizona's public from periodic shortages. Oversight may be provided by an independent system operator as well as consumer organizations.

COMMENT

None.

PART 5

NON-PSC'S

5.1 Municipal Corporations, Non-PSCs with Federal Interests.

ANALYSIS

Within Arizona, many different kinds of "non-PSCs" operate as electric utilities. These include municipal utilities (owned/operated by a city or town), electrical districts, irrigation districts, agricultural improvement districts and power districts. General governing authority for the municipalities and the districts is found in Article 13 of the Arizona Constitution, A.R.S. Title 48 (districts) and A.R.S. Title 9 (municipalities). Tribal utilities are non-PSCs that are not generally regarded as municipal corporations. Some non-PSCs provide electric service within a defined and exclusive service territory; others provide electric service within the service territories of existing PSCs and other non-PSCs.

A variety of federal interests affect PSCs and non-PSCs. For example, cooperatives' (PSCs) and municipal corporations' (non-PSCs) contract for federal preference power; the federal government has a considerable interest in Tribal activities; federal proprietary interests exist for facilities used by certain districts under federal reclamation law; and the federal government guarantees, funds or otherwise authorizes financing obligations of certain PSCs, cooperatives and municipal corporations.

Two parties commented that federal interests might complicate Commission jurisdictional issues and should be researched. The ACC Staff believes a federal interest in a non-PSC does not preclude the non-PSC's ability to offer a competitive generation supply.

COMMENT

None.

5.2 Relations Between Non-PSC's and PSC's.

ANALYSIS

Some participants maintain that the new Rules allow both non-PSCs and PSCs to provide competitive generation (but not distribution) service to customers within each other's service territories, subject to certain conditions. One commenter believes the Rules do not allow such competition. In the context of non-PSC, certain statutes were identified by parties as potentially restricting the authority of PSCs and non-PSCs to compete with each other. No participant identified any Arizona law that would preclude non-PSCs from providing access to their distribution systems and service area customers. (One commenter cited A.R.S. § 9-516 as preventing the Commission from granting CC&Ns over a municipality's service area under certain circumstances.) Another participant maintained that the Commission can authorize PSCs to provide competitive generation to customers in non-PSC territories. Four parties pointed out that Arizona law does not require non-PSCs to provide access to their distribution facilities.

Three parties raised issues relating to the impact of Title 9 on the ability of the Commission to authorize competition among PSCs and non-PSCs. One of these parties asserts that A.R.S. § 9-516 prohibits the Commission from authorizing a PSC to compete with "municipal corporations." However, by its express terms, A.R.S. § 9-516 is applicable only to cities and towns, not the full panoply of municipal corporations or other non-PSCs. A second commenter believes Title 9 gives cities and towns the exclusive right to provide electricity within their boundaries. Several commenting parties believe A.R.S. § 9-516

imposes a condemnation requirement on cities and towns in order for them to compete with PSCs. Commission Staff believes this statute does not require such condemnation to offer "competitive generation supply."

One party identified A.R.S. § 48-1515 and "similar statutes" as possibly having an anti-competitive effect on certain special taxing districts (non-PSCs) if improperly construed as restricting expansion of an existing district, rather than limiting creation of new districts. A.R.S. § 48-1751 also may limit an electric district to selling only surplus energy outside its service area.

Title 40 (relating to PSCs generally), Title 10 (relating to PSC cooperatives) and franchising statutes were raised by various parties as limitations on the general ability of PSCs to compete with each other, as well as with non-PSCs. The impact of these statutes is more fully addressed in Section 12 of this report.

COMMENT

None.

PART 6

FERC ISSUES

6.1 ACC's Exclusive Jurisdiction.

6.1.1 In view of FERC Orders 888, 888-A, 889, 889-A, FERC decisions, case law, the U.S. Constitution and the various Federal acts, what exclusive (or concurrent) jurisdiction may the ACC exercise in the context of competitive electric energy services, whether in wholesale and/or retail transactions considering the interstate nature of the transmission lines?

ANALYSIS

FERC's jurisdiction is limited by its enabling law and only includes public utilities. It has indirect jurisdiction over transmitting utilities through complaints which may be brought pursuant to §211 of the Federal Power Act. It has no jurisdiction over municipals, PMA's or RUS borrowers who were brought into open access only through reciprocity concepts.

The Energy Policy Act of 1992 forbids FERC from ordering "retail wheeling" or direct access to power supply by retail customers, leaving such orders to the states' discretion. *See* 16 U.S.C. § 824k(h). FERC has affirmed that it is a state decision to permit or require retail wheeling and has left it to state regulatory authorities to deal with any stranded costs or stranded benefits occasioned by retail wheeling on facilities or services used in local distribution. (62 FR 12274, 12409). Further, in 888-A FERC clarified that "states have the authority to determine the retail marketing areas of the electric utilities within their respective jurisdictions" along with the authority to determine the end user services those utilities provide. (62 FR 12274, 12279).

Additionally, exclusive jurisdiction has been reserved to the states (and therefore the ACC) over the following matters: the provision and pricing of retail sales of electric energy (as opposed to unbundled transmission) and the siting of transmission and distribution lines. While states retain jurisdiction over local distribution lines, FERC claims to be the final arbiter of their definition (see discussion in §8.4 below).

FERC and state commissions each have jurisdiction over separate aspects of a retail wheeling transaction: FERC has jurisdiction over rates, terms and conditions of unbundled retail transmission in interstate commerce by public utilities while state

commissions have jurisdiction over local distribution facilities, the rates for services using those facilities to make a retail sale, and the service of delivering electric energy to end users (62 FR 12274, 12279,12372) even if there are no identifiable local distribution facilities. Thus, in all cases, states have the means to ensure that customers do not avoid their responsibility for stranded costs or benefits.

Nevertheless, FERC has further indicated in 888-A (and the Federal Power Act supports such interpretation) that FERC and a state have concurrent jurisdiction to order stranded cost recovery when retail customers obtain retail wheeling in interstate commerce from public utilities in order to reach a different generation supplier.

If the state regulatory authority is not authorized to order stranded cost recovery for direct retail access, FERC may permit a utility to seek a customer-specific surcharge to be added to an unbundled transmission rate. (Order 888, FERC Stats. & Regs. at 31,824-26; and 18 C.F.R. 35.26). FERC will not interfere if the state agency has such authority and has, in fact, addressed such costs, regardless of whether it has allowed full, partial or no recovery.

FERC will be the primary forum for recovery of stranded costs caused by "retail-turned-wholesale" customers, such as the creation of a municipal utility system to purchase wholesale power on behalf of retail customers who were formerly bundled customers of the historical utility power supplier (e.g., by annexing retail customers of another service territory). 18 C.F.R. 35.26. FERC will not intercede in every instance of municipalization, but only in cases where the new wholesale entity uses FERC-mandated transmission access to obtain a new power supply on behalf of retail customers that were formerly supplied power by the utility.

Additionally, FERC in 888-A deems transmission line siting as a state-exclusive function and will not interfere in a state's decision and jurisdiction over such issues. FERC will not encroach on the following areas: state authority over local service issues including reliability of local service; administration of integrated-resource planning and utility buy-side and demand-side decisions, including DSM; authority over utility generation and resource portfolios; generation siting; and authority to impose non-by passable distribution or retail stranded cost charges along with charges for social or environmental programs. (Order 888 and 18 C.F.R. 35.27)

COMMENT

None.

6.2 FERC's Exclusive Jurisdiction.

6.2.1 In view of Rules 888, 888-A, 889, 889-A FERC decisions, case law, the U.S. Constitution and the various Federal acts, what exclusive (or concurrent) jurisdiction may FERC exercise in the context of competitive electric energy services, whether in wholesale and/or retail transactions within Arizona considering the interstate nature of the transmission lines?

ANALYSIS

FERC appears to have staked out exclusive jurisdiction in unbundled state retail transactions and requires utilities to implement any state retail access experiments under the Order 888 pro forma wholesale tariffs. Where specific provisions are inapplicable for service to unbundled retail customers, e.g, filing of individual service agreements and requirements for customer deposits, public utilities must seek a waiver of those tariff provisions. (New England Power Company, et al., 75 F.E.R.C. P61,008 (1996).

FERC rejected retail transmission tariffs filed by Portland General Electric ("PGE") and Washington Water Power ("WPP") to implement retail competition experiments in Washington, Idaho and Oregon. WPP's tariffs had been approved by the Washington and Idaho state regulatory commissions and PGE's were submitted to Oregon's. However, FERC noted that no state authority had requested FERC approval of any of the separate retail tariffs or variations from the 888 pro forma tariff (to accommodate any special needs of a state retail access program) and so rejected the tariffs without prejudice. FERC left the door open to the state commissions for such requests, instructing that the separate retail tariff or variations from the pro forma tariff sought should still be consistent with FERC's open access and comparability principles.

WPP argued that the retail experiments did not constitute unbundling within the meaning of Order 888, because WPP had simply removed the energy component from its current bundled retail tariff and included non production costs for transmission, distribution and general expenses. FERC disagreed and found instead that the tariff included the "separation of products that we have determined creates unbundled retail transmission of power that is within our exclusive jurisdiction." Citing Order 888, FERC noted. "When a retail transaction is broken into two products that are sold separately,...we believe the jurisdictional lines change.....When a bundled retail sale is unbundled and becomes separate transmission and power sales transactions, the resulting transmission transaction falls within the Federal sphere of influence." *The Washington Water Power Company*, Docket No. ER97-960-000 (Issued Feb. 25, 1997); 78 F.E.R.C. P61,178; 1997 FERC LEXIS 306.

In its proposed retail tariff, PGE had used the pro forma tariff adding stranded cost recovery charges, service agreements and local distribution provisions to it. Nevertheless, it was rejected since the Oregon Commission had not made a specific request that PGE be allowed such variance from the open access compliance tariff.

FERC uses *PGE* to explain that absent FERC approval of a specific state commission request, the open access tariff must be used for all unbundled retail transmission, including pilot or experimental programs. In such programs, state commissions may "determine the rates jurisdictional to them by establishing a bundled delivery price (including stranded costs) and then subtracting the utility's open access tariff rates for transmission and ancillary services." *Portland General Electric Company*, Docket No. ER97-1112-000 (Issued March 3, 1997); 78 F.E.R.C. P61,219; 1997 FERC LEXIS 579.

FERC casts "buy-sell" transactions in a similar jurisdictional model. Where "an end user arranges for the purchase of generation from a third party supplier and a public utility transmits that energy in interstate commerce and resells it as part of a 'nominal' bundled retail sale to the end user," FERC says the retail sale is actually the functional equivalent of two unbundled sales (one transmission, and the other the sale of power) and that FERC has exclusive jurisdiction over the transmission component. FERC has acknowledged that in such a transaction there would also be an element of local distribution which would be subject to local jurisdiction. (Fed. Reg. Vol. 61, No. 92, p. 21,620).

FERC will also assert exclusive jurisdiction in a holding company or other multi-state situation where a state regulatory agency decision, e.g. on stranded cost recovery, could

result in an inappropriate shift of disallowed costs to affiliated operating companies in other states. (62 FR 12,274, P12,409)

In short, FERC claims that "matters of interstate commerce, including the vast integrated electric system that supply the nation's industrial, commercial and residential customers are the responsibility of the Federal government." (Statement by Elizabeth A. Moler, Chair, FERC, before the Energy and Natural Resources Committee, United States Senate, March 30, 1997.) As made clear by FERC Orders 888 and 888-A, 889 and 889-A, this includes all transmission transactions, coordination services and agreements, independent system operators, regional power pools, and power exchanges.

COMMENT

None.

6.3 FERC Approvals.

6.3.1 What actions taken in Arizona or involving Arizona public utilities to move to retail competition in the electric industry (including any formation of an ISO) will require FERC approvals and what criteria will FERC apply?

ANALYSIS

The majority of the current rules will not require FERC approval. A commenter indicated that FERC cooperation would only be needed in delineation of transmission and distribution lines and perhaps for stranded costs imposition. However, FERC's very recent decisions in *PGE* and *WPP*, as discussed in §8.2.1 above, provide that the ACC and public utilities must, in conformance with those decisions, detail and seek FERC pre-approval of all unbundled retail tariffs that deviate in any way from the Order 888 open access compliance tariffs filed, including those which add stranded cost recovery charges,

distribution charges, service agreements, etc. Further, the ACC and public utilities must propose and seek approval of the delineation of transmission and distribution lines as discussed below.

Additionally, any proposal for ISO creation (whether state or regional), relevant ISO procedures (including transfer of operational control of FERC jurisdictional facilities), transmission pricing, access fees, tariffs, expansion, or enforcement will also require FERC pre-approval. *Pacific Gas and Electric Company, et al.,* Docket Nos. EC96-19-000 and ER96-1663-000 (Issued November 26, 1996).

In Orders 888 and 888-A, FERC has issued specific guidance for formation of an ISO which apply *only if the ISO is also a control area operator.* These FERC principles include:

1. The ISO's governance should be structured in a fair and non-discriminatory manner.

2. An ISO and its employees should have no financial interest in the economic performance of any power market participant. An ISO should adopt and enforce strict conflict of interest standards.

3. An ISO should provide open access to the transmission system and all services under its control at non-pancaked rates pursuant to a single, unbundled, grid-wide tariff that applies to all eligible users in a non-discriminatory manner.

4. An ISO should have the primary responsibility in ensuring short-term reliability of grid operations. Its role in this responsibility should be well-defined and comply with applicable standards set by NERC and the regional reliability council.

5. An ISO should have control over the operation of interconnected transmission facilities within its region.

6. An ISO should identify constraints on the system and be able to take operational actions to relieve those constraints within the trading rules

established by the governing body. These rules should promote efficient trading.

7. The ISO should have appropriate incentives for efficient management and administration and should procure that services needed for such management and administration in an open competitive market.

8. An ISO's transmission and ancillary services pricing policies should promote the efficient use of and investment in generation, transmission, and consumption. An ISO or an RTG of which the ISO is a member should conduct such studies as may be necessary to identify operational problems or appropriate expansions.

9. An ISO should make transmission system information publicly available on a timely basis via an electronic information network consistent with the Commission's requirements.

10. An ISO should develop mechanisms to coordinate with neighboring control areas.

11. An ISO should establish an ADR process to resolve disputes in the first instance.

FERC has not issued specific guidance for non-control area operator ISO's. Presumably, their hallmark would be independence with respect to governance and financial interests to ensure that the ISO is independent and would not favor any class of transmission users.[9]

FERC does not require ISO's. In Rule 888-A, FERC said it does not believe it "appropriate to require public utilities or power pool to establish ISO's, preferring instead to allow time for functional unbundling to remedy undue discrimination."

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[9] In an order on the proposed PJM ISO FERC stated: "The principle of independence is the bedrock upon which the ISO must be built if stakeholders are to have confidence that it will function in a manner consistent with this Commission's pro-competitive goals." Order 888-A, FN219, citing *Atlantic City Electric Company, et al.*, 77 F.E.R.C. P61,148 (1996).

COMMENT

None.

6.4 Jurisdictional Separation of Distribution-Transmission Lines.

6.4.1 The FERC has issued criteria and decisions to assist in determining what is a distribution line and what is a transmission line so as to assert appropriate FERC jurisdiction over transmission lines. What are the criteria, how should they be applied, and what FERC actions are required to confirm that determination?

The answer is unclear. FERC recognized in Order No. 888 that once retail service was unbundled, there would be a need to draw a distinction between facilities used for transmission and those used for local distribution[10] so as to leave states with authority over the service of delivering electric energy to end users. Toward that end, FERC has adopted a case-by-case methodology in delineating between "transmission" and "distribution" facilities regulated by FERC and those left to the States. FERC has not established a "bright line" test. Guidance will develop as FERC issues decisions.

Order 888 requires public utilities to consult with state regulatory agencies before filing any transmission distribution classifications and/or cost allocations (for such facilities to be included in rates) with FERC. If those classifications and/or cost allocations have state regulatory support, if the state regulators have specifically evaluated the seven indicators and any other relevant facts, and if the state's recommendations are consistent with the principles of Order 888, the Commission will defer to them. FERC has said it hopes to use this mechanism to take advantage of state regulatory authorities' knowledge and expertise concerning the facilities of the utilities they regulate. (Order 888 Introduction/Summary, Fed. Reg. Vol. 61, No. 92, P21541).

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[10] *Washington Water Power Company,* FN8.

In Order 888, FERC provided seven local distribution indicators for states to use in the evaluation process:

1. Local distribution facilities are normally in close proximity to retail customers.

2. Local distribution facilities are primarily radial in character.

3. Power flows into local distribution systems; it rarely, if ever, flows out.

4. When power enters a local distribution system, it is not reconsigned or transported on to some other market.

5. Power entering a local distribution system is consumed in a comparatively restricted geographical area.

6. Meters are based at the transmission/local distribution interface to measure flows into the local distribution system.

7. Local distribution systems will be reduced voltage.

FERC added that it would consider jurisdictional recommendations by states that take into account other technical factors that the state believes are appropriate in light of historical uses of particular facilities. Order 888-A reaffirmed that approach and the tests to distinguish between state and Federal jurisdiction (Fed. Reg. Vol. 62, No. 50, P12,372). The order also recognized that the test does not resolve all possible issues, but is designed for flexibility to include unique local characteristics and usage. (Rule 888-A, 62 Fed. Reg. 12,274, P12279).

FERC approved such a specific state recommendation in *Pacific Gas and Electric Co., et al.,* Docket No. EL96-48-000 (Issued October 30, 1996); 77 F.E.R.C. P61,077; 1996 FERC LEXIS 1975. *Pacific Gas* accepted a delineation of certain lines of three major California utilities as part of that state's electric industry restructuring. The

utilities reserved the ability to change the initial delineation as uses of the facilities change, since it may have multiple uses.

The "existing uses" method accommodated state regulatory settlements, the peculiarities of each system, the historic facts relating to the unique design of each utility's integrated transmission system. Consequently, different results were reached for each utility's system.

The delineation between transmission and distribution is important, not just for determining state or Federal jurisdiction, but also, to ensure each company's appropriate recovery of stranded costs from retail customers, for allocation of administrative and general and operation and maintenance expenses, as well as for development of any access charges (and associated cost support) for use of a utility's ISO grid facilities.

COMMENT

None.

PART 7

FEDERAL ISSUES

7.1 Two-County Rule.

7.1.1 What is it, how does it affect a utility in a competitive environment, and what resolution is possible?

ANALYSIS

While one commenter noted "there is no reason to segregate this particular element for separate consideration and treatment," others who have raised it believe it important to discuss because it may, like other Federal issues presented herein, be an impediment

to a utility's participation in the competitive environment contemplated by the Rules. Certainly, FERC, in Rule 888 recognized the threat of open access requirements to continued use of two-county financing and provided some solutions.

Two-County financing or "local furnishing" bonds provide financing in the form of tax-exempt bonds for "facilities for the local furnishing of electric energy or gas" if such facilities are part of a system "providing service to the general populous not exceeding the larger of two contiguous counties or one city and a contiguous county." Internal Revenue Code §142(a)(8). The Internal Revenue Service has added two additional conditions for such tax exempt bond status: (I) generally, the total amount of electricity generated by facilities connected directly to the local grid together with the amount generated by that utility's remote generating facilities, cannot exceed in any year the total amount of electricity consumed in the local service area; or (ii) actual metered flows of electricity at each interconnection point are at all times inbound to the local system. A utility with such financing that ceases to meet these conditions loses the favorable interest rate on such financing. The utility's bondholders lose the tax-exempt status of the bonds which have been sold to them and must be made whole by the utility according to the terms of the bonds.

Competitive generation may impact this financing. FERC's solution in Order 888 was to exempt a utility from reciprocal service if providing such service would jeopardize the tax-exempt status of the bonds. Order 888, mimeo at 376-377. The IRS also amended its rules to accommodate a mandatory FERC wheeling order issued under §211 of the Federal Power Act and retain the tax exempt status. I.R.C. §142(f)(2).

The ACC rules do not disturb two county financing as long as no changes are made which specify an obligation for such a financed entity to serve outside of the two-county area. Parties have argued earlier in this Docket that this could happen if the utility became obligated to serve a customer outside of its existing two-county service territory under the proposed retail wheeling provisions. The solution is for the rules to clearly limit the obligation to serve outside of a local furnishing utility's existing service area. Another solution is for the Commission to include in its definition of recoverable stranded costs, any increase in financing costs or the stranded cost of any assets because of local furnishing requirements.

In 888 A, FERC clarified that all costs associated with a loss of tax-exempt status, including the costs of defeasing, redeeming and refinancing tax-exempt bonds are properly considered costs of providing transmission services. FERC explained that "a customer that takes service, understanding that such service will result in the loss of tax-exempt status, shall be responsible for such costs to the extent consistent with Commission policy and a transmission provider may include in its tariff a provision permitting it to seek recovery of such costs...If the transmission customer is not willing to pay the costs associated with the transmission provider's loss of tax-exempt status, the transmission provider will not be required to provide the requested service." (Order 888-A; 78 F.E.R.C. P61,220; 1997 FERC LEXIS 463).

An alternative solution is to provide local furnishing utilities with a mechanism to modify the schedules described in A.A.C. R14-2-1604(A-D) until such time as a Federal solution can be found. FERC has told Congress it needs to find a solution. (Statement by

Elizabeth A. Moler, Chair, FERC, before the Energy and Natural Resources Committee, United States Senate, March 30, 1997.)

Some commenters state that the Rules should not be amended to encourage use of two-county financing for the benefit of some, but not all, utilities. These participants suggest that consumers should not pay costs of financing that have been increased due to a corporation's decision to extend its service territory.

COMMENT

None. See the above discussion.

7.2 Federal Rural Electrification Act (and resulting mortgages, interlocking all-requirements contracts, and related issues).

7.2.1 What is it, how does it affect a cooperative in a competitive environment, and what resolution is possible?

The U.S. Congress in 1936 through the Rural Electrification Act (RE Act), 7 U.S.C. 901 *et seq.*, and again in 1993, through the Rural Electrification Loan Restructuring Act, determined that the national interest would be served by support of rural electric service through low cost loans to rural electric cooperatives to enable them to provide affordable and dependable electric service in sparsely populated areas with loads, which although vital to a rural economy, cost more to serve. Delivering energy costs more in rural areas and the capital investment on a per customer basis is substantially higher. Including areas with more dense population (the small towns) in such systems helps to spread those costs and keeps rates lower.

The Rural Utilities Service (RUS), an agency of the U.S. Department of Agriculture, makes or guarantees and administers RE Act loans and regulates certain cooperative activities. Further, most cooperatives are member owned non-profit entities

which use a tax exemption, embodied in §501(c)(12) of the Internal Revenue Code (26 U.S.C. §501(c)(12)) to further reduce the higher than normal rural costs.

RUS requires as a condition to making or guaranteeing any loans to power supply borrowers (G&T cooperatives), that the borrower enter into RUS all-requirements wholesale power contracts with its distribution members and assign and pledge such contracts as security for the repayment of those loans or any other loans which RUS has permitted to be secured pursuant to the RUS mortgage. The RUS wholesale power contract requires that the rates charged for power and energy produce sufficient revenues to enable the power supply borrower (the G&T) to timely pay the principal and interest on all its debt. RUS relies on the wholesale power contracts and its oversight of cooperatives to certify to the Federal government that "the security for the loan is reasonably adequate and the loan will be repaid within the time agreed." 7 C.F.R. §1717.301.

Most of these loans are amortized over a 35 year period (currently a period that extends about 20 years beyond the target date for full retail choice) and most RUS financed systems obtain a new loan or loan guarantee every three or four years in order to maintain and improve service quality and reliability. In Arizona, five of the affected utility distribution cooperatives and AEPCO are bound together by an all-requirements wholesale power contract that does not expire until December 31, 2020. A sixth affected utility, Navopache Electric Cooperative, is bound until December 31, 2025 by a similar contract to a New Mexico G&T.

RUS finances, at least in part, eight electric systems in Arizona; six are affected utilities and two are tribal utility authorities. RUS financed systems make sales to about 6.6 percent of all electric consumers in Arizona. Federal taxpayers through RUS

hold more than $382 million in outstanding debt to electric utilities in Arizona. The Federal agency has said that a sudden loss of load from these Arizona systems would not only have disastrous effects on the ability of the cooperatives to serve residential consumers in sparsely populated or less profitable areas, it would also compromise RUS efforts to improve the quality of life in rural Arizona. Letter by Blaine D. Stockton, Jr., Assistant Administrator, RUS, September 12, 1996 to the ACC.

The competitive generation supply and resulting termination of exclusive Certificates of Convenience and Necessity inherent to the ACC rules creates a tension with the federal regulatory scheme outlined above and intrudes on the all-requirements contract, the security for the Federal debt, and the mortgages held on that debt. The mandated use of RUS financed delivery facilities by non-RE Act beneficiaries is also problematic. Such use may cause the cooperatives: (I) to lose their tax-exempt status since revenues flowing to the cooperatives from non-members may well exceed 15 percent of a cooperative's total revenues; (ii) to have problems with either current or future financing under the RE Act; and (iii) due to the retail rate cap under the Order, create tension between the distribution cooperative and its G&T, which is obligated to increase rates to the distribution cooperative as load is lost to competition.

RUS has recommended establishment of a customer specific pricing mechanism: (I) that considers the distribution-G&T structure of non-profits; (ii) that imputes a rate of return on rate base for sales to nonmembers; (iii) that includes in rates charged to non-members any tax liability imposed by ACC ordered retail choice[11]; and, (iv) that

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[11] This pricing mechanism was specifically adopted by FERC in Order 888 for non-jurisdictional transmitting utilities providing open access pursuant to reciprocity or §211 requests. As well, FERC exempted such utilities from the reciprocity

does not divert the RUS subsidy away from its intended beneficiaries in Arizona. *Stockton Letter*, p.9.

RUS also asks the Commission to consider through the process the impact of partial stranded cost recovery on the ability of the utility to repay RUS loan and the results of that on RUS ability to continue low cost financing in Arizona in the future. *Stockton Letter*, p.10.

No solution is yet apparent to the Rule's conflict with the RUS system of interlocking all-requirements wholesale power contracts/mortgage security other than the schedule modification offered by the Rules themselves or a total exemption from the Rules.

One commenter raised these issues and noted that while the G&T could probably sell and has sold excess power (at wholesale) to other entities, the "anti-competitive feature is at the distribution level" because of the all-requirements contracts. The commenter adds that G&T financing has been based on those contracts. Another comment noted only that these are "level playing field issues related to competition among PSC's and non-PSC's". The cooperatives, however, are subject to ACC jurisdiction even though they are not investor owned utilities.

Some participants maintain that solutions to the cooperatives' problems include (1) not selling power to non-members or (2) making membership in the cooperative a condition of service; or (3) match the FERC mechanism that is used to handle this financing tool. These participants are concerned that REA financing does not benefit

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requirement if it would threaten their tax exempt status. Order 888, FN499. RUS has proposed the other pricing mechanisms to FERC; no Orders or decisions have yet been made by FERC as to that proposal. Some cooperatives have open access tariffs which incorporate these pricing principles, but they have not been tested at FERC.

competitors on an equal basis. They maintain that the Rules should not encourage this type of financing to the detriment of other competitors.

COMMENT

None. See the above discussion.

7.3 Western Area Power Administration.

7.3.1 What affect will its presence, system, contracts, policies and Federal constraints have on the adoption of retail competition in electric supply?

ANALYSIS

Western Area Power Administration (Western), a Federal agency and transmission provider, is a member of the Southwest Regional Transmission Association, a FERC approved Regional Transmission Group. Additionally, it is voluntarily complying with FERC's open access concepts through a modified open access tariff. Consequently, its presence should not impede implementation of competition in Arizona.

COMMENT

None.

7.4 Interstate Reciprocity.

7.4.1 In view of the Commerce Clause of the U.S. Constitution, what can Arizona require of out-of-state entities to compete in Arizona markets?

ANALYSIS

The sale and delivery of electricity affects interstate commerce. However, historically, it has been subject to local regulation, in large part due to the necessity of such regulation to protect the public health and safety of local citizens and the administrative burden of economic regulation of largely in-state monopolies. As well, this local character

has been preserved in federal legislation which has specifically left certain regulation to the states, *see* Order 888 and the Federal Power Act.

State regulation of interstate commerce is subject to certain limitations: (I) it may not discriminate against interstate commerce; (ii) it may not regulate subject matter which inherently requires uniform national regulation; and, (iii) the state intent underlying the regulation may be of more importance than is the burden on interstate commerce, i.e, the balance of interests must favor state as opposed to national interests. *Southern Pacific Co, v. Arizona,* 325 U.S. 761 (1945).

Concerns have been raised in this docket that an early mandate of competitive generation supply, before other states have acted, will unnecessarily subject Arizona's utilities to cutthroat competition from market entrants located nationwide who would not have entered the Arizona market if other markets were available. Sensing a threat to Arizona's economic and tax base, certain participants asked whether Arizona could limit participation here to foreign entities from states which also have retail competition -- a true reciprocity requirement. That may be unlikely, given the three-prong test of *Southern Pacific*, but the Working Group has not achieved a consensus on this point.

A state may not create economic barriers to out of state products in order to protect local interests. *Dean Milk Co. V. City of Madison*, 340 U.S. 349 (1951). Instead, the purpose or benefits of the law, e.g., public health or welfare must outweigh the burdens on interstate commerce. Reciprocity agreements between states for the sale of products are not *per se* a violation of the Commerce Clause of the U.S. Constitution. However, mandatory reciprocity requirements prohibiting the sale of products from another state unless that state reciprocates is such a violation unless there is a substantial state interest

which can not be achieved by other means. *Great Atlantic & Pacific Tea Co. V. Cottrell,* 424 U.S. 366 (1976).

Arizona may exert regulatory jurisdiction over entities that: (I) meet the definition of jurisdictional entities in the Arizona Constitution, Arizona statutes and the rules; (ii) are doing business within the State of Arizona; and, (iii) have sufficient minimum contacts within the state to support the exercise of jurisdiction. Such entities may also be amenable to jurisdiction by Arizona courts.

In *General Motors Corporation v. Tracy,* 197 U.S. Lexis 692; 65 USLA 4068 (Feb. 18, 1997), the U.S. Supreme Court left in place an Ohio two-tiered tax system, saying Ohio may tax interstate sellers of natural gas at a different and higher rate than it taxes local distribution companies. The Court did not arrive at this result as a legal proposition. Instead, court employed a balancing test to determine the economic harm that the system posed for interstate commerce. After describing the developing natural gas industry and making a distinction between bundled and unbundled service, the Court found that it was unsuited to gathering facts upon which economic decisions could be made. "The most we can say is that modification of Ohio's tax scheme could subject LDC's to economic pressure that in turn could threaten the preservation of an adequate customer base to support continued provision of unbundled services to the captive market." 197 U.S. Lexis at ___.

General Motors notwithstanding, the Commerce Clause generally prohibits state policies that amount to economic protectionism for in-state utilities. Nevertheless, the Commission can and should avoid policies and rules which put in-state jurisdictional utilities at a competitive disadvantage to electric service providers located out-of-state or

out of ACC's jurisdiction. Examples include grafting an additional renewables mandate from previous integrated resource planning orders onto the solar portfolio for affected utilities and continuing an Affected Utility's obligation to serve into the competitive phase-in and beyond.

COMMENT

None.

PART 8

ANTI-TRUST ISSUES

8.1 State Action Immunity Doctrine.

Some participants were concerned about the State-Action Immunity Doctrine ("State Action"). State Action, generally provides an exemption from antitrust laws providing that actions that are taken: I) pursuant to a clearly articulated state policy to displace competition in favor or regulation; and ii) actively supervised by the state, do not violate that antitrust statutes. The Arizona legislature as codified this principle in A.R.S. § 40-286 which provides:

> The provisions of title 44, chapter 10, article 1, shall not apply to any conduct or activity of a public service corporation holding a certificate of public convenience and necessity granted pursuant to this article, which conduct or activity is approved by a statute or this state or of the United States or by the corporation commission or an administrative agency of this state or of the United States having jurisdiction of the subject matter.

Affected Utilities will not have a State Action exemption to the extent they are engaging in competitive, as opposed to monopoly, services.

COMMENT

See discussion above.

8.2 Application of Traditional Antitrust Principles.

COMMENT

The working group reviewed antitrust issues and decided that the ACC does not have jurisdiction to enforce violations of the antitrust laws. Antitrust principles may need to be considered to the extent the Commission is concerned about market power and monopolistic pricing.

PART 9

SUGGESTED CODE CHANGES

9.1 Federal Statutes.

Work Group participants generally agreed that federal statutes may need to be changed, among other things, to harmonize FERC and ACC jurisdiction, address potential antitrust issues and recognize generally the increasingly interstate nature of electricity sales and deliveries. Certain of these issues have been addressed in other portions of this report. No specific federal statutory changes were recommended in relation to this section of the report.

Work Group participants disagreed whether changes to federal statutes are necessary to implement the Rules. Some participants maintained that no amendments were required to implement the Rules. These participants also maintain that amendments should not be undertaken, if at all, until the impact of competition has been reviewed and assessed.

Some participants maintain that federal statutes should be changed to, among other things, harmonize FERC and ACC jurisdiction, address potential antitrust issues and recognize generally the increasingly interstate nature of electricity sales and deliveries. Certain of these issues have been addressed in other portions of this report. No specific federal statutory changes were recommended in relation to this section of the report.

9.2 The Arizona Constitution.

9.2.1 Whether Constitutional amendments are required either to allow or facilitate competition in generation supply and other electric services.

ANALYSIS

The Working Group did not achieve a consensus whether constitutional amendments are required to implement competition. The Working Group debated three principal issues on this subject:

(1) the ACC's authority to require municipal utilities to open their territories to competition and regulate their sales to others and their implementation of retail access (Ariz. Const. art. 15, § 2);

(2) the ACC's power to exercise varying degrees of control over non-PSCs given the provisions of art. 15, § 2; and

(3) the ACC's power to determine just and reasonable rates in the competitive market rather than through traditional rate-of-return, fair value rate cases. See art.15, §§ 3 and 14).

THE ACC'S POWER OVER MUNICIPAL UTILITIES

Affected Utilities maintain that if municipal utilities are to be permitted to serve in the service areas of Affected utilities, the ACC must have constitutional authority to compel

municipalities to open their own service territories to competition and to regulate the terms and conditions for opening those territories. The Affected Utilities maintain that even if the ACC and a municipal utility have authority to open the municipality's service territory pursuant to an IGA, the ACC will not have the power to regulate the municipality's conduct. The Affected Utilities maintain that the ACC will be powerless to enforce the IGA, respond to consumer complaints or enforce complaints by competitive providers regarding unbundled rates or other terms and conditions of service that may be unfair or not cost-justified. The Affected Utilities argue that the governing body of the municipal utility will be the final arbiter of such complaints (subject to an uncertain standard of judicial review), not an independent regulator.

Other participants maintain that municipalities are "regulated" via the ballot box. The municipalities are governed by elected representatives who are responsive to voters. Municipalities do not have an incentive to increase investor returns at the expense of ratepayers. The lack of a profit motive is a disincentive for predatory or anti-competitive practices.

Affected Utilities maintain that the ACC may not enforce its rate setting powers or rules upon municipalities' sales of electricity in other utilities' service territories. According to the Affected Utilities, these differences in regulatory supervision will create significant variations in costs and flexibility for regulated and non-regulated market participants. Some Work Group participants raised several alleged advantages which municipal utilities enjoy over investor-owned PSCs, such as freedom from various taxes and the ability to issue tax-exempt debt.

Other participants point out that California looked at comparative advantages among municipalities and investor-owned utilities and determined that the issue was a non-starter. These participants also maintain that no competitive advantage can be established between the tax advantages enjoyed by investor-owned utilities and the governmental exemptions that are available to municipal utilities.

One municipal utility proposed to form public service subsidiaries or affiliates that would be regulated by the ACC control. Formation of regulated subsidiaries may partially address the Affected Utilities' concerns about the ACC's lack of jurisdiction over sales by municipal utilities in the Affected Utilities' territories. The Affected Utilities maintain that the Rules do not require formation of a subsidiary and do not, in any event, address ACC's lack of jurisdiction over their sales in and access to municipal utilities' service territories.

RATE REGULATION OF PSCs

Affected utilities maintain that the Constitution establishes a single definition of PSC as any corporation engaged in furnishing electricity for light, fuel, or power. Article 15, Section 3 then requires the ACC to prescribe rates for all PSCs. Article 15, Section 14 requires the ACC to ascertain the fair value of all PSCs and use that as the basis for determining rates. Some Affected Utilities maintain that Arizona courts have consistently ruled that these duties are mandatory, and the ACC must exercise this level of supervision over PSCs. See the discussion in Section 1.1.

Affected Utilities maintain that the Competition Rules essentially envision two kinds of PSCs and two systems of rate setting - ACC prescribed, fair value cost based rates for distribution-monopoly "wires service" and market determined rates for competitive electricity supply and, in some cases, other distribution related services.

Other participants maintain that the ACC already has the power to regulate distribution monopolies differently from competitive generation supply. These participants maintain the ACC is empowered by the Constitution to make such distinctions based upon its power to prescribe "just and reasonable classifications to be used" by PSCs pursuant to Article 15, Section 3. Distribution monopolies are "natural monopolies" that continue to be rate-regulated to protect the public from monopolistic pricing. Technology exists to separate distribution monopolies from generation. Generation supply therefore is eligible for competitive pricing without the risk of monopolistic pricing that exists for distribution monopolies. The United States Supreme Court has recognized a market distinction between local gas distributors and competitive gas suppliers in *General Motors v. Tracy*, ___ U.S. ___ (1997).

Affected Utilities maintain that state constitutional mandates prohibit the transition to a competitive market as envisioned by the Competition Rules. Additionally, these requirements impose needless or burdensome regulatory restraints on the desired goal - a fully flexible, free market. For example, these participants maintain that the ACC still must require the filing of tariffs and the Constitution requires rates that are prescribed by the ACC and that are based upon fair value. To the extent that the tariff rates are prescribed by or based upon the market, all tariffs will be suspect. As the market determines rates either below or above a "fair value" premised rate, consumers or competitors may raise these constitutional requirements to invalidate the market based price and to demand refunds of collected monies.

Other participants maintain that the Commission's power to prescribe just and reasonable rates is exclusive and may not be abridged by any other branch of government.

Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n, 178 Ariz. 478, 875 P.2d 137 (Ct. App. 1993). These participants maintain that article XV, section 14 of the Arizona Constitution authorizes the ACC to use the fair value of a utility's assets to artificially determine just and reasonable rates as if they were set in a competitive market. The same goal is achieved, albeit more accurately, through pricing in a competitive market. They maintain that tariffs are not a barrier to competition. For example, the ACC uses competitive tariffs for services in the telecommunications industry. These participants maintain that traditional rate regulation may be required for the transition to competition, and will continue for the foreseeable future for transmission and distribution of electricity.

COMMENT

None.

9.3 Arizona Statutes.

This portion of the report will focus principally on the Working Group's debate regarding possible changes to the Public Utilities statutes (Title 40).

9.3.1 A.R.S. § 40-281

This statute and A.R.S. § 40-282 require utilities to obtain certificates of convenience and necessity ("Certificates") prior to constructing facilities and providing electric service to the public.

ANALYSIS

The debate regarding certificates of convenience and necessity is found in Part 1.1 of this Report.

COMMENT

See the Comment to Part 1.1.

9.3.2 A.R.S. §§ 40-201 and 40-202

ANALYSIS

Affected Utilities maintain that these statutes must be amended to draw distinctions between the level of regulation to be applied to the "wires" distribution function and all other competitive generation and distribution related services. The Affected Utilities maintain that more definitions should be added to A.R.S. § 40-201 to distinguish between competitive generation and distribution services, including definitions for "affected utilities," "electric service providers," "aggregators" and "brokers."

Other participants maintain that the ACC already has the power to classify additional entities as competition is observed. These participants maintain that legislative classifications are unconstitutional to the extent the classifications interfere with the ACC's rates and classification functions.

Affected Utilities and some other participants maintain that, at a minimum, the Legislature should amend A.R.S. § 40-202 to state the public policy of this state as to competition and to mandate or allow different regulation for competitive providers, similar to the statute's provisions relating to telecommunications services.

Other participants agreed that a statement of policy, consistent with article XIV, §15 of the Arizona Constitution, would be desirable. Other participants maintain that the state constitution does not allow statutory mandates for "different regulation" of competitive rates or competitive services.

9.3.3 Rate Statutes

Affected Utilities maintain that A.R.S. §40-203, A.R.S. §§ 40-246 to 40-251 and A.R.S. §§ 40-365 and 40-367 assume a fully regulated monopoly. According to the

Affected Utilities, the statutes give the ACC full power and obligation to establish rates, follow certain procedures in allowing changes to rates and require the posting or publication of all rates. The Affected Utilities maintain that these statutes must be reevaluated, amended and possibly repealed before implementing competition. The Affected Utilities maintain that although the ACC should retain a certain level of jurisdiction over monopoly services, reduced regulation is appropriate for competitive services. If not, they maintain that deregulation will not be achieved and the market will not be allowed to operate.

Other participants maintain that reduced statutory regulation should not be enacted until the effectiveness of existing and potential competition become known. In the case of natural monopoly, regulation will continue to assume the role of a substitute for competition. Markets that are not fully competitive (e.g., oligopolies) require the ACC to balance its rate control function with a role as a facilitator of competition. In effectively competitive markets, they argue that the ACC must secure the prerequisites to competition, such as open access to distribution systems, subsidy-free pricing of services, non-discriminatory pricing, and efficient market entry. These are ratemaking functions that the ACC must exercise before one can understand the implications of a proposed statutory change. This may explain, to some degree, why Working Group participants have not come forward with specific statutory changes to Title 40.

9.3.4 A.R.S. § 40-204

Affected Utilities maintain that this statute should distinguish between monopoly and competitive service providers and relieve competitive providers from the statute's extensive information and regulation requirements. Affected Utilities maintain that

proprietary information for competitive PSCs should be protected to a greater extent than fully regulated, monopoly PSCs. Affected Utilities maintain that similar confidentiality amendments should be added to A.R.S. § 40-360, the state's public records law and Open Meeting statutes (Titles 38 and 39).

Other participants suggest that restricted or closed access to information may discourage or even prevent competition. Lack of competition will continue the current monopolistic pricing and prevent the ACC from reducing the level of regulation for utilities. These participants maintain that such statutory changes should be scrutinized carefully and only after competition has commenced.

9.3.5 A.R.S. §§ 40-221 and 40-222

These statutes authorize the ACC to establish accounting systems and depreciation standards for PSCs. Affected Utilities maintain that this level of regulation will be inconsistent with and unnecessarily burdensome on a competitive marketplace.

Other participants oppose immediate changes for the reasons stated in Sections 12.3.2 to 12.3.4.

9.3.6 A.R.S. § 40-284

Some Affected Utilities maintain that this statute may prohibit or restrict the transaction of utility business within Arizona by a foreign corporation and may need needs to be reexamined in the context of the competitive market. These Affected Utilities maintain that this statute might be the appropriate forum to address concerns about interstate reciprocity. These arguments maintain that, with the exception of California, no other western state has opened its electric market like Arizona and Arizona utilities may

need to seek replacement markets and mitigate stranded costs in other states' markets that will be closed to them.

Other participants maintain that foreign corporations already conduct utility business in Arizona. These participants refer to annual reports of the large Affected Utilities as proof that Arizona utilities have found replacement wholesale markets in other states, including California. These participants maintain that closing or restricting Arizona markets to out-of-state entrants may violate the U.S. Constitution's Commerce Clause ("Commerce Clause"). The state may not discriminate against interstate commerce nor may it unduly burden interstate transactions. *Arkansas Electric Cooperative v. Arkansas PSC*, 461 U.S. 375 (1983). Discriminatory state laws and regulations are "per se" invalid under the Commerce Clause. *Philadelphia v. New Jersey*, 437 U.S. 617 (1978).

9.3.7 A.R.S. § 40-285

This statute provides that ACC approval must be obtained before any PSC may sell, lease, assign, mortgage or otherwise dispose of or encumber its system. Transfers or other dispositions without an order of the ACC are void. Affected Utilities maintain that in a competitive marketplace such a statute is antiquated and inconsistent with the flexibility that utilities need to respond to the demands of the marketplace.

Other participants maintain that these arguments presume the existence of meaningful competition. Meaningful competition will not be realized until after the Rules take effect and the competitive market has been assessed. In any event, protections must be in place to address merger and acquisition activities that may result in monopolistic activities.

Some participants point out that the Rules affect generation, not the state's extensive distribution and transmission systems. These participants further maintain that A.R.S. § 40-285 applies only to systems that are "necessary" to provide a public service. These participants maintain that in a competitive setting facilities would not be "necessary" when alternative providers are available to provide a public service.

9.3.8 A.R.S. § 40-301 et. seq.

These statutes give the ACC power to supervise the utilities' authority to issue stocks, bonds, notes and other evidences of indebtedness and to create liens on their property. The statutes void any loan or stock issuance that was not approved by the ACC. Affected Utilities maintain that these statutes assume that a sole-source provider of a basic utility service should be subject to public interest regulatory jurisdiction. For example, issuance of too much debt may endanger the utility's ability to provide service. Affected Utilities question the need for these statutes if consumers have the right to choose competitive generation supply and other distribution related services. Affected Utilities maintain that these statutes restrict their ability to function effectively in a competitive marketplace and, unless amended, would call into question the validity of all stock and financing issues for competitive service providers.

Other participants maintain that the Commerce Clause prevents these statutes from applying to out-of-state entrants. These participants oppose changes for the reasons set forth in Sections 12.3.2 to 12.3.4 and 12.3.8.

9.3.9 A.R.S. §§ 40-321, 40-322, 40-331, 40-332 and 40-334

These statutes pertain generally to regulation of services and facilities provided by electric utilities. Affected Utilities maintain that these statutes assume a "one

size fits all" standard as to these subjects and assume continued regulation is required. These arguments maintain that the statutes are inappropriate in a competitive market that determines adequate rates, allocates resources and dictates differing levels of service.

Other participants oppose changes for the reasons set forth in Sections 12.3.2 to 12.3.4 and 12.3.8.

9.3.10 A.R.S. § 40-341 et. seq.

This Article establishes a system for conversion of overhead electric facilities. Affected Utilities maintain that, although the need for such statutes may continue, their purpose and function should be reexamined in light of the separation of regulated distribution "wires" services from competitive generation and other distribution related services.

Other participants maintain that the state should retain jurisdiction over overhead electric facilities. These involve legitimate state property and environmental concerns.

9.3.11 A.R.S. § 40-360 et. seq.

This Article establishes the Power Plant and Transmission Line Siting Committee. In general, it requires any person contemplating construction of electric power plant and transmission facilities within the state to file a ten-year plan with the ACC and vests authority over siting and environmental compatibility issues in the Committee and ACC. Affected Utilities question the need for or desirability of a ten-year generation plan that is subject to regulatory review. Other Affected Utilities suggest that the size of facilities covered by the statutes should be reevaluated.

Other participants oppose these changes for the reasons set forth in Sections 12.3.2 to 12.3.4.

9.3.12 A.R.S. § 40-401 et. seq.

These statutes assess charges on PSCs to finance the regulatory expense associated with the operation of the ACC and the Residential Utility Consumer Office. Affected Utilities maintain that the annual assessment provisions may require adjustment since, for example, the assessment is levied upon revenues from intrastate operations of entities holding certificates. Affected Utilities maintain that significantly higher or lower revenues will result from changes in the number of entities holding certificates and in the total of revenues derived from intrastate operations.

Other participants oppose these changes for the reasons set forth in Sections 12.3.2 to 12.3.4.

9.3.13 Title 10

The Rules require most Arizona cooperatives to open their service territories to competition. A.R.S. §§ 10-2072 and 10-2138 prohibit competition by cooperatives. Thus, the cooperatives maintain that they are required to open their territories to competition but under current law are unable to seek replacement customers. Most participants agree these statutes should be repealed. Also, most of Arizona's cooperatives are formed pursuant to A.R.S. § 10-2021 *et seq.* (Non-profit Generation and Transmission Cooperatives) or A.R.S. § 10-2051 (Non-profit Distribution Cooperatives). In general, cooperatives maintain that these are limited purpose statutory structures adequate for the regulated monopoly system for which they were crafted but too restrictive for the increased and varied demands of a competitive market. Affected Utilities and Staff

maintain the statutes should be amended to facilitate the cooperatives' participation in a competitive marketplace.

9.3.14 Non-Regulated Activity by Utilities

Certain Working Group participants suggested either additional legislation or regulations controlling the ability of utilities to compete in non-regulated activities. These participants expressed concern about the utility's ability to participate at all in these businesses or to cross-subsidize such non-regulated activities with revenues from regulated activities. A majority of Work Group participants felt that the ACC has sufficient jurisdiction currently to prohibit any unfair cross-subsidization and/or that prohibition of non-regulated activities would be inconsistent with the move generally to competition.

9.3.15 A.R.S. § 48-1515

One Working Group participant suggested possible repeal or amendment of this statute to remove its arguable limitation on expansion of an existing special district.

COMMENT

None.

EXHIBIT A

MARICOPA COUNTY SUPERIOR COURT CASES
INVOLVING ELECTRIC RESTRUCTURING

Tucson Electric Power Company, an Arizona corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03748

Citizens Utilities Company, a Delaware corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-04176

Arizona Public Service Company, an Arizona corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03753

Arizona Electric Power Cooperative, Inc., a nonprofit Arizona generation and transmission cooperative, v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03920

Graham County Electric Cooperative, Inc., a nonprofit Arizona distribution cooperative v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03921 [Consolidated with Case No. CV97-03920]

Duncan Valley Electric Cooperative, Inc., a nonprofit Arizona distribution cooperative v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03922 [Consolidated with Case No. CV97-03920]

Trico Electric Cooperative, Inc., an Arizona nonprofit corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03928 [Consolidated with Case No. CV97-03920]

Sulphur Springs Valley Electric Cooperative, Inc., an Arizona cooperative, non-profit membership corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03942 [Consolidated with Case No. CV97-03920]

A

LEGAL ISSUES WORKING GROUP
PARTICIPANTS

PARTICIPANT	REPRESENTING
Michael M. Grant, Esq.	Arizona Electric Power Cooperative, Inc., Duncan Valley Electric Cooperative, Inc., Graham County Electric Cooperative, Inc.
Carol S. Hull	Able Refrigeration
Desiree Zinger Karen Krause	Air Conditioning Contractors of Arizona
Suzanne M. Dallimore, Esq. Enrique Lopezlira	Office of the Attorney General
Barbara Kimball Sherman	Arizona Consumers Council
Patricia E. Cooper, Esq,	Arizona Electric Power Cooperative, Inc.
Representative Jeffrey S. Groscost	Arizona House of Representatives
Douglas Nelson, Esq.	Arizona Multi-Family Housing Association
Michael A. Curtis, Esq.	Arizona Municipal Power Users' Association
James P. Bartlett, Esq.	Arizona Power Authority
Steven M. Wheeler, Esq. Thomas L. Mumaw, Esq.	Arizona Public Service
Senator John Wettaw Richard A. Bark, Esq. Deborah S. Johnston	Arizona Senate
Bill Meek	Arizona Utility Investors Association

LEGAL ISSUES WORKING GROUP
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Beth Ann Burns, Esq.	Citizens Utilities Company
C. Webb Crockett, Esq.	Cyprus Climax Metal Company, ASARCO, Inc. Enron Capital & Trade Resources
Toni Tyrone	Deluge, Inc.
Tim Goodluck Lisa V. Wayne Ted Raymond	Dine Power Authority
David Caplow	Economic Energy Alternatives
Douglas C. Nelson, Esq.	Electric Competition Coalition
William D. Baker, Esq.	Electrical District No. 6
Sheryl A. Taylor, Esq.	Electrical District No. 7 and Roosevelt Irrigation District
James K. Tarpey	Enron Capital & Trade Resources
Robert Franciosi	Goldwater Institute
Gerald J. Porter, Esq.	Office of Governor
David K. Johnson	Honeywell, Inc.
Roy W. Jones	Industrial Energy Applications, Inc. and Mohave County Economic Development Authority
Tim Bowden	International Brotherhood of Electrical Workers

LEGAL ISSUES WORKING GROUP
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Robert S. Lynch, Esq.	Irrigation and Electrical Districts' Association
Carl R. Aron	Itron, Inc.
Jeff Woner	K. R. Saline & Association
Mary L. Rosenzweig	League of Arizona Cities and Towns
Michael W. Margrave, Esq.	Margrave Clemins & Verburg
Bobbi Kiese	Motorola
Susan N. Kelly, Esq.	National Rural Electric Cooperative, Association
Dennis W. Hughes	Navopache Electric Co-operative, Inc.
Sam DeFrawi	Department of the Navy
Wm. Kent Romney	Page Electric Utility
Lawrence V. Robertson, Jr., Esq. Michael M. Racy	PG&E Energy Services
Lex J. Smith, Esq. Michael W. Patten, Esq.	Phelps Dodge
Jesse W. Sears, Esq.	City of Phoenix
Andrew A. Brodkey, Esq. Scott A. Gutting	Public Interest Coalition on Energy
Bill Calloway Ted Bobkowski	Ralston Purina Company
Deborah R. Scott, Esq.	Residential Utility Consumer Office
Alan Propper	Resource Management International, Inc.
Robert F. Roos, Esq.	Lewis & Roca L.L.P.

LEGAL ISSUES WORKING GROUP
PARTICIPANTS

Jay I. Moyes, Esq.	City of Safford, Tonopah Irrigation District, Aguila Irrigation District, McMullen Valley Water Conservation & Water District, Harquahila Power District, Electric District No. 8
Jessica Youle, Esq. Kenneth C. Sundlof, Jr., Esq.	Salt River Project
Mike Tarro	SAPHCC
Julie Watson	Southern Energy Trading and Marketing, Inc.
Al Jones Darren M. Lehrfeld, Esq. Steven M. Banzhaf, Esq.	Southern Arizona Mechanical Contractors Association
Andrew W. Bettwy, Esq. Debra S. Jacobson	Southwest Gas Corporation
Creden W. Huber	Sulphur Springs Valley Electric Cooperative, Inc.
Richard F. Brown	SWRTA
Harvey Friedson Cliff Mattice, Esq.	City of Tempe
Loretta Humphrey, Esq. Vinnie Hunt	City of Tucson
Bradley S. Carroll, Esq.	Tucson Electric Power Company
Jimmy Jayne	U. S. Senate - Senator Jon Kyle
Ray Umashandar	University of Arizona
Douglas A. Oglesby	Vantus Energy Corporation
Cory Prochaska	Wellton-Mohawk Irrigation and Drainage District

B

LEGAL ISSUES WORKING GROUP
CHRONOLOGY OF GROUP PROCESS

January 8, 1997
Legal Division sends letters of invitation to participate to a service list prepared by Chief Economist.

January 10-February 3, 1997
Fifty-one companies, municipalities, public interest groups or their attorneys accept 1-8-97 invitation to participate in Working Group.

February 27, 1997
Public Notice and Agenda for first meeting of the Group are posted and mailed.

March 5, 1997
First meeting of Working Group; 42 persons excluding staff attend.

March 13, 1997
Public Notice and Agenda for second meeting of the Group are posted and mailed.

March 19, 1997
Second meeting of Working Group; 30 persons excluding staff attend. Ken Sundlof of the Public Power/Governmental Entities Subgroup and Steve Wheeler of the Stranded Cost Subgroup distribute to the Group lists of issues to consider. Participants discuss issues. Legal Division requests participants' written comments on both lists of issues by March 25, 1997 and promises staff's written responses at the next meeting, April 1, 1997.

March 13-April 1, 1997
Comments received from participants.

March 28, 1997
Public Notice and Agenda for third meeting of the Group are posted and faxed to participants.

April 1, 1997
Third meeting of the Working Group; 35 persons excluding staff attend. Legal Division distributes staff's responses to issues raised at March 19, 1997 meeting by the Public Power/Governmental Entities and Stranded Cost Subgroups. Participants discuss responses.

April 4, 1997
Comments received to date on legislative issues are faxed to participants.

April 4-April 17, 1997
Comments received from participants. Additional individuals and entities join Working Group.

April 16, 1997
Public Notice and Agenda for fourth meeting of the Group are posted and faxed to participants.

April 17, 1997
Fourth meeting of the Working Group; approximately 30 persons excluding staff attend. Utilities Director Carl Dabelstein makes a presentation on stranded costs and distributes its outline to participants. The Stranded Cost, Public Power/Governmental Entities and Federal Issues Subgroups report to the other members of the working group. Participants discuss the issues raised by the Legislative Issues Subgroup.

April 18-May 21, 1997
Comments received from participants and distributed to Working Group. Additional individuals and entities join Group.

May 7,1997
Public Notice and Agenda for fifth meeting of the Working Group are posted andmailed to participants.

May 16, 1997
Complete set of staff and participant comments received to date are mailed to all members of Working Group.

May 21, 1997
Fifth meeting of the Working Group; approximately 40 persons excluding staff attend. Legal Division distributes its outline of the draft report to the Commission and discusses it with participants. Individual participants are selected to act as" reporters" for outline topics. The Group also establishes a tentative timetable for filling out the outline using participant comments.

May 22, 1997
Comments received from participants and mailed to all members of Working Group. Additional individuals and entities join Working Group, which now has 92 persons on its service list.

May 29, 1997
List of reporters for each outline topic and revised timetable are mailed to participants.

May 30-June 29, 1997
Participant comments on outline topics are submitted to reporters and Chief Counsel. Legal Division disseminates copies of comments to all participants.

June 30, 1997
First draft of report is mailed to participants; deadline for comments is July 17, 1997.

July 17, 1997
Notice and agenda for July 24, 1997 meeting are posted and mailed to participants, together with copies of comments received since the July 7 comments mailing.

July 18, 1997
Additional participant comments are mailed to Group members.

July 24, 1997
Sixth meeting of the Working Group; 30 persons excluding staff attend. Participants review first draft of the report, discuss possible edits, Table of Contents and Executive Summary.

July 25, 1997
Reporters meet to edit second draft of report. Revised timetable and new comments received are mailed to participants.

July 28, 1997
Second draft of the report is mailed to participants; deadline for comments is August 18, 1997.

July 29, 1997, August 21, 1997
Comments on second draft of the report are mailed to participants. The August 21, 1997 mailing includes announcement of next meeting date for Working Group.

August 25, 1997
Notice and agenda for August 28, 1997 meeting are posted and mailed to participants.

August 28, 1997
Seventh meeting of the Working Group. Twenty persons excluding staff attend. Participants discuss the comments received to date and the format, Executive Summary and presentation of the final report.

August 29, 1997
Revised timetable is mailed to participants.

September 5, 1997
Proposed final draft of report is mailed to participants; comments are due by September 12, 1997. Mailing includes announcement of final meeting of Working Group on September 26, 1997.

September 8-September 29, 1997
Participants submit editorial comments on the proposed final draft of the report and overviews of their individual substantive comments to be appended to the report submitted to the Commission.

September 19, 1997
Notice and agenda for September 26, 1997 meeting are posted and mailed to participants.

September 26, 1997
Eighth meeting of the working group; 15 persons excluding staff attend. Legal Division distributes Executive Summary which is discussed by the participants. Deadline for submission of final individual comments is the morning of September 30, 1997. Participants are requested to provide disk of their comments for posting to the Commission's web page.

September 30, 1997
Report to the Arizona Corporation Commission by the Legal Issues Working Group is filed with ACC's Docket Control.

C

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: March 5, 1997

TIME: 9:00 a.m.

PLACE: Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona

ATTENDANCE:
Chairman Carl Kunasek
Commission Renz Jennings
Members of Commission Staff

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

Commission Chief Counsel Lindy Funkhouser opened the meeting. Representatives from staff, electric utilities, consumer groups, potential market entrants, and other groups discussed how to identify and address legal issues affecting the Commission's rules on electric competition. Several issues were identified as requiring additional investigation at this time: political subdivisions and intergovernmental agreements; stranded cost legal issues; legislative issues; and federal issues. Subgroups were organized to investigate these issues.

ASSIGNMENTS FOR NEXT MEETING:

With the exception of the Legislative Issues Subgroup, these subgroups are to meet to discuss these issues and report back to the Working Group at the next meeting of the group.

The Legislative Issues Subgroup is to identify and provide to staff by Friday, March 21, the legislative issues they believe need to be addressed to implement the electric competition rules.

These issues will be disseminated among the members of the Working Group, who will have the opportunity to respond to them by April 4.

The Working Group will meet again sometime in early April, at a time and place to be determined.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: March 19, 1997

TIME: 1:00 p.m.

PLACE: Arizona Industrial Commission Auditorium
800 West Washington Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Public Power/Governmental Entities Subgroup
Members of Stranded Cost Issues Subgroup

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP
PUBLIC POWER/GOVERNMENTAL ENTITIES SUBGROUP
STRANDED COST ISSUES SUBGROUP

MATTERS DISCUSSED:

Kenneth C. Sundloff opened the meeting of the Public Power/Governmental Entities Subgroup. Mr. Sundloff reviewed a list of issues for the subgroup to consider. Representatives from interested parties discussed the issues. Commission Chief Counsel Lindy Funkhouser requested participants' written comments on the list of issues by March 25, 1997 and agreed to prepare responses to the issues, through the Commission's staff, at the next meeting scheduled for April 1, 1997.

Steven M. Wheeler opened the meeting of the Stranded Cost Issues Subgroup. Mr. Wheeler reviewed a list of issues for the subgroup to consider. Representatives from interested parties discussed the issues. Commission Chief Counsel Lindy Funkhouser requested participants' written comments on the list of issues by March 25, 1997 and agreed to prepare responses to the issues, through the Commission's staff, at the next meeting scheduled for April 1, 1997.

Participants discussed a timetable for participants to submit legislative comments.

ASSIGNMENTS FOR NEXT MEETING:

Participants will send their comments on the lists of both issues to the Commission's Legal Division by March 25, 1997.

The Commission's Legal Division will prepare responses to the issues for the next meeting scheduled for April 1, 1997.

The next meeting of the Public Power/Governmental Entities and Stranded Cost Issues Subgroups was set for April 1, 1997.

Legislative comments will be submitted for review by mid-April, 1997. Staff will advise participants of a due date for the comments.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: April 1, 1997

TIME: 1:00 p.m.

PLACE: Arizona Corporation Commission, Administration Offices
1300 West Washington Street
Third Floor Conference Rooms A & B
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Public Power/Governmental Entities Subgroup
Members of Stranded Cost Issues Subgroup

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP
PUBLIC POWER/GOVERNMENTAL ENTITIES SUBGROUP
STRANDED COST ISSUES SUBGROUP

MATTERS DISCUSSED:

The Commission's Chief Counsel, Lindy Funkhouser, opened the joint meeting of the Public Power/Governmental Entities and Stranded Cost Issues Subgroups. Mr. Funkhouser reviewed the Legal Division Staff's comments on the list of issues for the subgroups to consider. Representatives from interested parties discussed the issues. Commission Chief Counsel Lindy Funkhouser advised participants that the Commission's Utilities Director, Carl Dabelstein, will be invited to the meeting of the Legislative Subgroup in mid-April, 1997.

ASSIGNMENTS FOR NEXT MEETING:

Participants will meet to discuss legislative issues in mid-April, 1997.

The Commission's Legal Division will advise participants of the date and location of the meeting of the Legislative Issues Subgroup.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: April 17, 1997

TIME: 1:00 p.m.

PLACE: Arizona Industrial Commission Auditorium
800 West Washington Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

Commission Director Carl Dabelstein presented an overview of stranded cost recovery for electric utilities. Director Dabelstein distributed an outline of his presentation.

The participants discussed member comments on legislative issues that may apply to electric restructuring. The group also discussed the future role of the Stranded Cost Issues and Public Power/Governmental Entities subgroups.

ASSIGNMENTS FOR NEXT MEETING:

The Legal Division will prepare an outline of the issues raised by participants to date, and will advise the group of the date and place of the next meeting.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: May 21, 1997

TIME: 1:00 p.m.

PLACE: Arizona Hall of Fame Museum
1101 West Washington Street
Basement Conference Room
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

The chairman distributed an outline of the draft report and discussed it with participants. Individual participants were appointed to act as "reporters" for selected outline topics. The group established a tentative timetable for filling out the outline using participant comments.

The following participants agreed to serve as Reporters on the following topics:

Steven M. Wheeler	*Nature of Restructuring in General and Stranded Cost Recovery.*
Bradley S. Carroll	*Rights and Duties of Public Service Corporations and Antitrust Issues*
Lawrence V. Robertson, Jr.	*Scope of Restructuring*
Beth Ann Burns	*Rates and Ratemaking*
C. Webb Crockett	*ACC Powers/Procedures*
Jessica J. Youle	*Non-PSC Issues*

Patricia E. Cooper	*FERC Issues and Federal Issues*
Douglas C. Nelson	*Taxation Issues*
Michael M. Grant	*Legislative Issues*

ASSIGNMENTS FOR NEXT MEETING:

Participants will submit comments to reporters regarding the topics and reporters will incorporate the comments in separate summaries for their assigned topics.

The Legal Division will prepare a first draft of the report based upon Reporters' summaries by June 30, 1997.

Participants will deliver comments on the draft report by mid-July, 1997 and the group will meet in late July, 1997 to discuss edits to the first report.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: July 24, 1997

TIME: 1:00 p.m.

PLACE: Arizona Industrial Commission Auditorium
800 West Washington Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

The participants discussed the first draft of the Legal Issues Working Group Report. Reporters were instructed to edit the first draft and assist in preparation of a second draft of the report.

ASSIGNMENTS FOR NEXT MEETING:

A second draft of the report will be mailed to participants and a second round of comments will be submitted in August, 1997. Participants will meet in late August, 1997 to discuss edits to the second report.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: August 28, 1997

TIME: 9:30 a.m.

PLACE: Arizona Department of Revenue
Room B-1
1600 West Monroe Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

The participants discuss the second draft of the Legal Issues Working Group Report. Participants will submit comments to the proposed final report, together with a position statement not exceeding 5 pages prior to issuance of the final report. The position statements will be attached to the final report as appendices.

ASSIGNMENTS FOR NEXT MEETING:

A final meeting will be scheduled for late September, 1997 to finalize the report.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: September 26, 1997

TIME: 2:00 p.m.

PLACE: Arizona Department of Revenue
Room B-1
1600 West Monroe Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

The participants discussed the Executive Summary and the presentation of the final report. Commission Chief Counsel Lindy Funkhouser reminded the Working Group that final comments on the report must be submitted no later than the morning of September 30, 1997. He requested that the comments also be presented on a disk for posting on the Commission's webpage. He thanked the participants, especially the Reporters, for their cooperation in the process and for their valuable contributions to the report.

ASSIGNMENTS FOR NEXT MEETING:

No future meetings have been scheduled.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

D

LEGAL ISSUES WORKING GROUP

PARTICIPANT COMMENTS

- Aguila Irrigation District
  The City of Safford
  Electrical District No. 8
  Harquahala Valley Power District
  McMullen Valley Water Conservation & Drainage District
  Tonopah Irrigation District

- Arizona Consumers Council

- Arizona Electric Power Cooperative, Inc.
  Duncan Valley Electric Cooperative, Inc.
  Graham County Electric Cooperative, Inc.

- Arizona Public Service Company

- Arizona Utility Investors Association

- ASARCO, Inc.
  Cyprus Climax Metals
  ENRON Corp.
  Arizona Association of Industries

- Irrigation and Electrical Districts' Association

- PG&E Energy Services

- Residential Utility Consumer Office

- Salt River Project Agricultural Improvement and Power District

- Southern Arizona Mechanical Contractors Association

- City of Tucson

- Tucson Electric Power Company

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Jay I. Moyes
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September 16, 1997

By Facsimile (542-4870) and U.S. Mail

Lindy P. Funkhouser, Esq.
Chief Counsel
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85004

Re: Comments to Proposed Final Draft Report of Legal Issues Working Group

Dear Mr. Funkhouser:

On behalf of the following "non-Affected Utility" municipal corporation electric providers, we are submitting these additional comments on the Proposed Final Draft Report to the Commission:

Aguila Irrigation District
The City of Safford
Electrical District No. 8
Harquahala Valley Power District
McMullen Valley Water Conservation & Drainage District
Tonopah Irrigation District

We express our commendation for the tremendous amount of work that has obviously been devoted to this final draft. Much improvement has been made since the earlier versions, and we congratulate you on the balanced, thorough, and enlightening presentation of the significant issues with which the working group has grappled.

Our first comment is that the very absence of a consensus among the various stakeholders on these legal issues, to which numerous lawyers have contributed their expertise, evidences the state of uncertainty (or, at best, flexibility) of the law regarding certain aspects of the Rules. That may suggest that many of the important legal issues may ultimately need to be resolved by the courts, and that the Commission should proceed very cautiously before concluding that any major changes to the constitution or the relevant statutes are needed at this juncture.

We note the particular choice of words for defining "Consumer" in the introduction section of the report, *viz.*, "*high volume purchasers* of electric generation services." (emphasis added) This definition evidences what we think is an unfortunate, subtle (but real) bias in this entire process. The interests of the small, individual residential and agricultural users of electricity throughout Arizona, and particularly the rural regions, are being subordinated to the interests of the major utilities already here, the out-of-state utilities who want to be here, and the major industrial customers --the *high volume purchasers*--who want to see a price war between the other two. The economic impacts

upon the small, individual consumers of electricity, and especially those served by remote transmission facilities in sparsely populated service areas, are too easily being ignored. Those *low volume* consumers are expected to buy into the magic words "competition will save money for everyone," which are being repeated constantly by the proponents of competition, who often act as if simply saying the mantra often enough will make the assertion a reality. From the vantage point of the rural interests I represent, I remain concerned that there may, indeed, be some economic losers among the consumers in this game, not just "big winners and little winners" as we are being told.

Until more experience is gained, in other states as well as Arizona, with the real economic fallout of competition, the Commission should keep its focus limited to deregulation of the retail sales within those entities over which it clearly has jurisdiction under existing law. If the results of that are as wonderful for *all consumers* as we are being promised they will be, no time will be wasted by the not-for-profit municipal and district utilities joining into the full competition game, because their own governing bodies -- their taxpayers and customers -- will insist upon it without the need of any mandate from the State.

We offer one editorial suggestion, with respect to the very last item of the report. It was our understanding that, even though it was once mentioned in a list of possible statutes for which the Rules could have some implications, the repeal or amendment of A.R.S. 48-1515 was not being suggested or argued by any participant. We would ask you to consider deletion of the last section, 9.4.15, from the report.

Finally, we refer again to my comment letter of June 11, 1997, and the fundamental positions asserted therein. Only minimal changes in Arizona statutes, and no constitutional amendments, are necessary or advisable in order to implement the Rules. Changes, if any, must be motivated by protection of Arizona's *citizen* consumers, not national economic interests. Ongoing debates by investor owned utilities aimed at the demise of public power should not be allowed to obfuscate the basic issues and processes necessary for the Commission to go about its business of implementing competition for electric generation within its jurisdiction.

Your report is very well done, and will advance the appropriate progress of this process; and we appreciate the hard work that has made it possible.

Respectfully,

Jay I. Moyes

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June 12, 1997

By Facsimile (542-4870) and U.S. Mail

Lindy P. Funkhouser, Esq.
Chief Counsel
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85004

Re: Comments to Legal Issues Working Group

Dear Mr. Funkhouser:

I represent the following non-PSC municipal corporation electric providers with regard to the ACC electric competition rules proceedings and resulting working group processes:

The City of Safford
Aguila Irrigation District
Electrical District No. 8
Harquahala Valley Power District
McMullen Valley Water Conservation & Drainage District
Tonopah Irrigation District

I have participated in certain meetings of, and reviewed comments of other participants in, the legal issues working group. On behalf of the above-named entities, these general comments are submitted to emphasize three fundamental positions, without reiterating in detail supporting points presented by other commentators or citing the supporting legal authority. We anticipate providing more detailed comments after review of the forthcoming summary reports of the "recorders" and your draft report to the Commissioners.

1. Changes in Arizona law should be minimal, motivated only by legal necessity in order to benefit Arizona citizens, not national economic powers.

All of our comments are founded upon the following principle: *Changes in Arizona law in order to implement electric competition are acceptable only if absolutely necessary for the benefit and protection of the electricity consuming citizenry of Arizona.*

Economic and institutional dislocation will inevitably follow full competition in the electric industry, just as it has in every other "so-called de-regulation" process and jurisdiction. That dislocation is a defensible price for Arizona to pay only if the electric consumer citizens of Arizona are truly benefitted thereby. Simply because major, national financial and industrial powers seek private economic advantage and *increased profits* for their worldwide shareholders is *not* adequate justification for dismantling the current reliable and broadly affordable (though not fully competitive) integrated electric generation, transmission and distribution system serving Arizona's citizens.

Not just coincidentally, almost all of the district/municipal electric utilities are small, and serve primarily the sparsely populated regions of rural Arizona, heavily dependent upon agricultural economies. These are not the markets sought by the national and regional giants currently hovering over Arizona and pressing the ACC at every turn to hastily impose full competition regardless of the unresolved issues and unknown costs. The major PSCs, in and out of Arizona, are lining up only the fattest and ripest cherries to be picked among the large industrial users and densely populated, easily aggregated load centers. Rural Arizona and the logistically expensive-to-serve agricultural and residential customers must not be left alone to hold the bag of reallocated and dislocated facilities and costs, "stranded" or otherwise, that will no longer be shouldered by the major industrial customers who will enjoy prime economic bargaining leverage in an open marketplace. For the protection of the rural Arizona citizens and economies, the small, publicly owned district/municipal utilities will need every possible protection from unnecessary regulatory costs, and every possible advantage from preference resources once the free marketplace is at work statewide.

2. **Constitutional amendment is ill-advised and unnecessary.**

Municipal/district electric utilities exist *solely* to benefit their constituent Arizona citizenry, and they have always been adequately governed by that same citizenry. Their every act must be conducted under the broad light of open public scrutiny. They enjoy no guaranteed return on their investments, and must answer directly to their constituency if they do not operate in the best economic interests of that *local* constituency. Most are able to serve power at substantially lower rates, compared to PSCs, largely *because* they are governed by the people who pay the rates (avoiding the enormous costs, proportionate to their small size, that ACC regulatory compliance would impose,) and because they are not required to deliver profits to non-customer investors. There is no need for an additional layer of costly bureaucratic oversight of these publicly owned, governed and operated, *not-for-profit* entities.

In contrast, the framers of the Arizona Constitution wisely distinguished the need for careful oversight of the activities of the *private investor*-owned utilities, whose policies are devised behind closed doors and whose goals must necessarily make the economic interests of

their *international shareholder and creditor constituency* paramount over the interests of their Arizona customers.

None of my district clients enjoys an exclusive monopoly service territory. Both APS and those districts serve accounts (some for the same customer) on the same distribution wires. Customers in those districts have always been able to exercise the choice to take service from APS instead, and they base that choice solely upon comparative rates and related economic considerations. Predictably, if open competition does what its proponents say it will, customer-driven market forces will, in due course, politically force open the territories of those few municipals that presently have monopoly service territories. That process will occur *without the aid of, or need for, constitutionally mandated ACC jurisdiction, if there are real economic benefits from allowing those citizens access to competing generation markets.* Current contractual wheeling and supply arrangements between the municipals and the PSC transmission and generation utilities can be augmented by intergovernmental agreements. They can provide appropriate treatment of stranded costs, if any, and the practical enforcement of fair, reciprocal competitive practices as a condition of allowing municipals competitive access to customers outside their current service areas.

Implementation of competition does not require amendment to the well-reasoned constitutional distinction between PSCs and non-PSCs; and any such tinkering by the legislature and the voters could have many unintended consequences for historical utility regulatory alignments.

3. **The "level playing field" argument is a red herring.**

The recently increased volume level of clamor by the large investor-owned PSCs for a state and federal regulatory "level playing field" is simply another chorus of their perennial whining for help to escape the inescapable -- their economic dilemma of trying to sell affordable power to Arizona customers while lining their investors' pockets with profits. In contrast, public power is able to "pay its shareholders" -- its local customer citizenry -- by keeping costs and *rates* as low as possible consistent with sound management for longevity and reliability. It has no other master to serve. Public power cannot be blamed and should not be penalized because of that fundamental difference.

Recent independent studies, of which you are aware, demonstrate that there are as many, if not more, "tilts" of the playing field in favor of the investor-owned utilities as for the publicly-owned. APS, as the lead singer in this chorus, only points out those items which support their aim of depriving the municipals of "preferences" to federal power resources, tax-exempt financing, and other historical benefits. But their complaints are only diversionary tactics, hiding the equally broad array of special tax, economic and political benefits enjoyed by PSCs. *The real objective of their complaint is not a level field; it is the total demise of public power as a*

competitor, leaving them the only player on the field.

Federal preference power is a product of federal legislation, not state. And its allocations are based upon long-standing public policy, *historical* load and need (not future competitive market opportunities.) Debates about federal power preferences have no place in this process of opening Arizona to competition, and we refer to the comments of Sheryl Taylor on this issue. (It must be noted, however, that if the more radical environmental groups, purporting to protect endangered species with no regard for human costs, have their way, then the costs of federal preference power will continue its rate escalation spiral such that the PSCs will soon celebrate their exemption from the burdens of take-or-pay federal power contracts, and all power consumers will be the losers.)

In summary, we reiterate our basic principle that changes in law are acceptable only if they provide benefit to all the citizens of Arizona, not just the major, national industrial and financial institutions who are politically and economically driving this competitive process. And any such changes should be and can be minimal. We will vigorously contend against efforts to constitutionally impose new ACC jurisdiction upon district and municipal electric providers, or to legislatively destroy the vital ability of rural public power consumers to rely upon federal preference resources. Neither of these objectives of the PSCs is necessary to effectively implement electric competition in a manner that will broadly benefit the citizens of Arizona.

Thank you for the opportunity to comment on behalf of the above-named public entities.

Respectfully,

Jay I. Moyes

JIM/dmn
205772

To: Lindy Funkhouser, Legal Issues Working Group, Draft RP3
From: Barbara Sherman, for the Arizona Consumers Council
Date: 7/22/97

- The purpose of the Arizona Corporation Commission regulation and oversight of electric industry has been to protect the interests of the residential. low income and small business customers. The federal and state move toward electric competition will not eliminate the need for protection of these customers. Changes in electricity regulation must take this into account. After the changes, a revised legal and regulatory framework must ensure that electricity is reliable, safe, and available at affordable prices to the majority of the customers -- the small residential, the low income, and business consumers.

- We note with significant concern that the definition of "consumer" in the report only refers to one type of consumer, namely, the "high-volume purchasers of electric generation services." See position above about the role of the Arizona Corporation Commission.

- With relation to the changes in the Arizona Constitution and Arizona State statutes or FERC, the Arizona Consumers Council concurs with those who would keep a close eye on potential problems and minimize changes until they are necessary. Again, the constitution and statutes offer many tools for protecting consumers. In particular, it is critical that the Arizona Corporation Commission always has the ability to oversee electric utility operations to prevent price gouging and fraud as well as to oversee minimum standards for safety and reliability. For example, the needs for business confidentiality must not overshadow the residential and small business consumers need for protection, i.e., for Arizona Corporation Commission oversight of financial business information.

- The question has been posed as to whether or not the staff at the Arizona Corporation Commission should express its own opinion in the working reports. Perhaps the working reports are not the right vehicle for staff opinions, since they are intended as a compilation of the opinions, needs and positions of the many differing stakeholders in the process. However, it would be a disservice to the public if the staff did not specify its recommendations. The ACC staff is knowledgeable, experienced, and has done a good job of protecting the interests of the low income, the residential and the small business consumers in Arizona, overall. Most of the staff have many years of expertise that should not be lost in the critical change in electric regulation. The Arizona Consumers Council recommends that a separate staff report be prepared with staff recommendations re electric restructuring for the Arizona Corporation Commission and made public so that informed decisions are made in the rules.

The staff has a duty to represent the public's interest and not just to tell the commissioners what they want to hear.

* One of the most important issues regarding the restructuring of electricity is the stranded costs/benefits issue. The price tag for generation plants loom large for the industry and all the consumers, but especially the residential and small business consumers. Electric consumers should not have to pay for "stranded costs" except as they receive the benefits of competition. Regulated electricity rates and bundled rates already include the costs of the generation plants. "Stranded benefits" should be distributed among all customers.

- Prior to decisions on rules changes, it would be wise to quantify the rules change impacts on the electricity rates of low income, residential and other small consumers. It is important to retain customer classes and classes of service insofar as they are necessary to evaluate whether small consumers are getting their fair share of the benefits of competition. Tax impacts also need to be quantified. We should be moving into competition with our eyes open, knowing the probable impacts, so that we can prevent problems.

- Provisions need to made --even with competition--for social programs re hardship cases whether low income or health.

- Also, integrated resource planning has consumer protection and national defense implications that must be taken into account even though electricity is moving into competition.

- The obligation to serve will change with competition, however; small consumers will need a reliable electricity source.

* Consumer interests demand some continuation of legal constraints against cross-subsidization of other business ventures with electricity.

- All electric service providers need to meet minimum standards of service. New and foreign providers should meet similar requirements to those of Arizona's long term service providers.

- As for the "fairness" issues and "level playing field" issues, it must be remembered that there have been and will continue to be a need for rural areas of Arizona to receive adequate, safe and reliable electricity at affordable rates. Much of the tax and loan infrastructure that create differences between investor owned utilities and municipals or cooperatives arose from the need to provide electricity in areas where population density is low.

Thank you for the opportunity to share our views. Barbara Sherman

AEPCO, Duncan and Graham's (the "Cooperatives")

Minority Report

Legal Issues Working Group

The most significant failing of the Report of the Arizona Corporation Commission's Legal Issues Working Group (the "Report") is its political rather than legal nature. This is driven by two major factors: (1) the currently pending litigation concerning the Rules and (2) the upcoming Legislative session. Both elements have transformed what should be a thoughtful analytical road map on legal obstacles to competition and how to address them into a mismash of policy pronouncement and legal obfuscation that, at best, confuses and, at worst, actively misleads the reader.

For example, because the Rules are being challenged in court, notably absent from the Report are meaningful recommendations as to who has what jurisdiction and how should it be exercised to achieve the desired goal of a competitive electric marketplace. Understandably, the Commission's attorneys can't concede that the Courts long ago decided the Legislature controls the competition issue because that would damage the ACC's litigation defense.

The SRP and other municipals are so concerned about any opening of the Constitution which might lead to an examination of their non-regulated status that they oppose necessary Article 15 amendments. Similarly, prospective providers and large industrial consumers are so fearful of any legislative debate which might delay the January 1, 1999 start date that they oppose any examination of Title 40 - even change which would produce a more flexible market for competitors and a more competitive market for consumers.

The Report, therefore, finesses these issues by offering pro and con and avoiding conclusions on settled matters. For example, a Report reader does not know that:

- More than 50 years ago, the Supreme Court decided the Legislature's control of the Certification process does not conflict with the ACC's rate-making power.

- Since that time, Arizona's courts have ruled repeatedly that a regulatory compact exists and the Commission may administer but may not change the policy of regulated monopoly.

- More than 40 years ago, the Supreme Court ruled that the Commission can only use "fair value" as the basis for prescribing just and reasonable rates.

- Since that time, Arizona's courts have ruled repeatedly that ACC rate orders and tariffs not based on "fair value" are void and the rates collected are subject to refund.

Instead, the best the Report can muster on these critical, settled legal issues is the following tepid statement:

> The Working Group's consensus is that the Courts or perhaps the Legislature ultimately will determine whether the Commission must have legislative or constitutional authority to promulgate the Rules . . . (Report, p. 3).

Report readers should first view Rod Serling's televised admonition many years ago: "There's a signpost up ahead. You just crossed over into the Twilight Zone."

The Cooperatives disagree in many areas with the Report's analyses, conclusions and, most importantly, its lack of recommendations on key subjects. In the interests of brevity, we will highlight five major Constitutional and Legislative subjects most in need of better focus:

<u>The Constitution</u>.

Several constitutional hurdles stand between today's regulated market and competition. The two most critical are:

- **Article 15, Sections 3 and 14.** No one disagrees that the Constitution gives the Commission exclusive ratemaking authority. However, like most power offered by that document, it is not unfettered. As to rates, (1) the Commission, not the provider nor consumer, must set them and (2) they must be based on "fair value", not some other standard including the market. Since statehood, every time the ACC has tried to ignore either mandate the courts have ruled the rate invalid. As importantly, in at least one case, they also ordered a refund of all dollars collected under it. If these Constitutional requirements aren't changed, no supplier and no consumer will have a market based rate on which they can rely. This issue must be resolved by the Legislature and the people.

- **Article 15, Section 2.** The ACC Rules seek to regulate non-electric supply services, i.e. metering, billing and collection, etc. However, since these functions are not included in the definition of activities ascribed to a public

service corporation, several cases dictate the ACC can't exercise this power and can't be given it by the Legislature. If regulation of these services is desired, a Constitutional change is required.

Title 40.

The Cooperatives feel that many revisions to Title 40 are necessary to allow competition to work. We refer to this subject as "De-regulate, don't re-regulate." The three most important areas are:

- **A.R.S. § 40-281.** Placing the debate about what the Certificate statute currently requires to one side, no one can seriously argue that the Legislature shouldn't take action to clarify what the State's public policy on competition should be in the future. This is a critical issue because failure to act will leave, unnecessarily, the entire foundation of competition in jeopardy.

- **A.R.S. §§ 40-285 and 40-301 et seq.** These statutes require a utility to seek ACC approval before selling assets or issuing stock or notes. Violations render the sales, stock or notes void. They burden a competitive market, slow decisions and cause providers, potential or current, to wonder if Arizona's market is worth the peril. They were created by the Legislature for another time and must be re-examined by the Legislature to see if they still fit.

- **Rate Statutes.** The statutes in Title 40 - A.R.S. §§ 40-250 and 40-367 among them - assume a highly regulated monopoly market where tariffs, standard terms and conditions, rate hearings and regulatory filings are required to assure customer satisfaction, not consumer choice. Thus, the Legislature, pursuant to its Constitutional power, has imposed on the Commission a variety of filing, hearing and process requirements. They are paternalistic and antithetical to the goal of a competitive marketplace. The ACC can't de-regulate and its Rules don't purport to. Only the Legislature can deal with this issue.

The nature of a minority report is to poke at the core product. This memorandum is no exception to that general rule. However, we do not by these comments minimize nor denigrate the considerable effort devoted to the Report by all participants.

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Steven M. Wheeler (602) 382-6327

September 19, 1997
HAND DELIVERED

Lindy Funkhouser
Chief Counsel
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, AZ 85004

RE: Final Report of the Legal Issues Working Group

Dear Mr. Funkhouser:

Thank you very much for the opportunity to participate in the Legal Issues Working Group. You are to be congratulated for your management of this exceedingly difficult process. Although I am disappointed that the Final Report utilized a standard of "unanimous consensus" for determining whether recommendations would be presented to the Commission (a process which allows one participant to "blackball" a recommendation otherwise supported by a clear majority of those present), I nonetheless commend you for the "inclusiveness" of your workshops and the opportunity for all to present their views, comments and concerns.

The purpose of this letter is to present an overview of the substantive comments of Arizona Public Service Company to the Final Report, as your September 5, 1997 memo invites. These comments are designed to promote, not retard, the movement toward responsible retail access as quickly as possible. And, as in the past, Tom Mumaw and I stand ready to work with you and the other parties to revise the Competition Rules to cure their many obvious deficiencies.

The summary comments set forth below will concentrate solely on legal issues associated with the Competition Rules.[1] The many policy issues raised by the Competition Rules [2] will be

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[1] This summary is not intended to be a complete presentation of all of APS's views on the Competition Rules. Those views have been expressed in previous pleadings and written comments to the Commission and in part are the subject of an APS legal challenge to the rules. Nothing in these comments shall serve as a waiver of any argument APS has or may have with respect to the Competition Rules.

[2] Such issues include the calculation and recovery mechanisms for stranded cost, failure of the rules to address reliability concerns or industry structure, the impact of competition on local and state tax revenues and the plethora of technical and administrative implementation issues.

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left to APS comments made in other forums and working groups. With that introduction, and without repeating the extensive legal analysis and argument we have provided during the workshop process, the following represent the significant legal issues APS believes must be addressed by the Commission in connection with the Competition Rules:

1. Lack of Commission Authority.

The Commission simply has no jurisdiction, even if adequate compensation is paid, to (a) grant CC&N's to competitive generation service providers or (b) force incumbent Affected Utilities to make their distribution facilities available to competitors. The fact that APS, and virtually all other parties, favor retail access in one form or another cannot cure this obvious lack of Commission authority. The cases cited by APS make it perfectly clear, and no party has cited any direct precedent to the contrary, that it is the legislature, not the Commission, that must establish the foundational authority for retail access in the electric utility industry. Only then can the Commission begin the implementation task. We urge the Commission to work with APS to remedy this defect as soon as possible.

2. Mitigation Standard Related to Recovery of Stranded Costs.

The mitigation standard in R14-2-1607 is clearly unlawful, unreasonable and overly vague. The Commission cannot legally require utilities to expend potentially unlimited amounts of private capital and other resources to pursue ill-defined business ventures not subject to ACC jurisdiction solely to qualify for compensation to which the utility is otherwise lawfully entitled as a result of the Commission's actions. Therefore, Section A of R14-2-1607 should delete the phrase "every feasible" and add "reasonable" and add "that are directly related to its regulated business" so that the subsection would now read:

> The Affected Utility shall take reasonable, cost effective measures 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, that are directly related to its regulated business.

3. Regulation of Non-Public Service Corporations.

R14-2-1611(A) states ". . . nor shall Arizona electric utilities which are not Affected Utilities be able to compete for sales in the service territories of the Affected Utilities."

Notwithstanding this unambiguous pronouncement, numerous working group participants continue to argue about the extent to which non-PSCs are able to compete in investor owned utility service areas, either directly under the Competition Rules or through some as yet unproduced intergovernmental agreement. Given the confusion this debate has engendered, the Commission should clarify and further reconfirm that R14-2-1611 does not permit non-PSCs to compete within the service territories of Affected Utilities. If such competition is sought by a non-PSC, then appropriate legislative changes must be implemented to insure that such competition is authorized, fair, conducted on a reciprocal basis, and provides for such compensation as may be required for any "takings" of utility property (*e.g.*, under A.R.S. § 9-516).

4. **Obligation to Serve.**

Affected Utilities are required to provide a bundled "standard offer" service to end-users that are under no reciprocal obligation to take such service. The Final Report acknowledges the lack of legal support for this unilateral burden on Affected Utilities but, although proposing some minor changes to the Competition Rules, it does nothing to either lift that burden or to equalize it by imposing such an obligation to serve on other ESPs.

5. **Recovery of Stranded Costs in Rates for Non-Competitive Services.**

A.A.C. R14-2-1607(J) is, at best, ambiguous and arguably in direct conflict with Subsection H of the same regulation. The Final Report is needlessly "soft" in its recommendation for an amendment to this part of the Competition Rules to clarify from whom stranded costs can be recovered. At a minimum, the first sentence of Subsection J should be deleted.

6. **"Streamlined" Regulation of Competitive Services and Competitive Service Providers.**

The Final Report seemingly accepts the notion that the Commission has the authority to excuse compliance by certain ESPs with specific statutory provisions. There is absolutely no authority cited for such a proposition. Moreover, several of the statutes in question (*e.g.*, A.R.S. §§ 40-285; 40-301, *et seq.*; and 40-360.02) require or at least authorize severe penalties for non-compliance. Thus, it is unlikely that any ESP could reasonably rely on the Commission's unilateral waiver or modification of these statutes.

The only prudent course of action to recommend to the Commission would be to seek legislative modification of those statutes that are no longer necessary or which would restrict competition. APS has already proposed such modifications to the Joint Legislative Study Committee currently evaluating electric industry competition issues.

Thank you for the opportunity to present these additional comments. I hope the Commission Staff will carefully consider these views and support these changes to the Competition Rules that are so clearly required to provide meaningful customer choice in an efficiently and lawfully restructured industry.

Sincerely,

Steven M. Wheeler
for SNELL & WILMER L.L.P.
Attorneys for Arizona Public Service Company

SMW:DN

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September 29, 1997

Lindy Funkhouser, Esq.
Chief Counsel
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

DELIVERED BY U.S. MAIL, E-MAIL & FAX

Dear Lindy:

As you are aware, the Arizona Utility Investors Association believes that the Corporation Commission's rule establishing electric competition leaves a gaping hole in the regulatory oversight of the transition to competition with regard to municipal aggregation.

The final draft of the report of the Legal Issues Working Group in Sections Four and Five purports to address issues involving non-public service corporations. However, those sections deal only with municipal electric utilities and are silent about other municipalities which may choose to offer the same services as those reserved for Electric Service Providers under the provisions of R14-2-1601, 1605 and 1606.

The rule itself ignores municipal corporations unless they are operating electric utilities, but the Commission's Legal Division has asserted that municipalities may offer services that have been defined as competitive by the Commission, i.e., electric generation, ancillary services, metering, meter reading and billing and collection.

This creates a serious dichotomy which should be expressed as an unresolved legal issue. The dichotomy is as follows:

1. The foundation of the Commission rule is that the transition to competition will be regulated by the Commission and that market entrants which choose to compete as Electric Service Providers must submit to Commission jurisdiction.

Indeed, all of the pertinent language in the rule anticipates that electric competitors will be regulated, as in R14-2-1605 which says, "A *properly certificated* Electric Service Provider may offer any of the following services under bilateral or multilateral contracts with retail consumers:" (Emphasis added)

2. However, the Commission is barred by the Arizona Constitution from regulating municipal corporations and has no apparent authority to compel a municipality to obtain a Certificate of Convenience & Necessity or submit in any other way to Commission rules and regulations.

3. As a result, cities and towns throughout Arizona will be able to aggregate thousands of retail electric customers without following the same rules imposed on other Electric Service Providers. They will be able to set prices, aggregate electric loads, install and read meters, bill customers and establish their own protocols without regulatory oversight from anyone who knows anything about the electric industry.

4. While it's not possible to predict precisely the effect of creating a potentially large unregulated segment of the industry, the consequences could be severe for system reliability, consumer understanding and the conduct of a competitive marketplace.

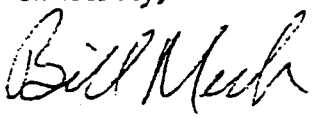
5. Members of the staff of the Utilities Division who were instrumental in drafting the competitive rule say it was always their intention to require regulation of Electric Service Providers and not to create an unregulated segment of the industry during the transition to full competition.

In our view, municipal corporations should either a) be excluded from competing in the service territories of Affected Utilities until the Commission has relinquished its regulation of competitive services or b) be required by legislation to follow Commission rules and regulations governing the transition to competition.

In R14-2-1611, the Commission purports to exclude Arizona electric utilities which are not public service corporations from competing for sales in the service territories of Affected Utilities. Therefore, it may be possible to amend the rule to apply a similar prohibition to municipalities which do not succumb to Commission jurisdiction. The other option is a statutory enactment described previously.

In any case, the report of the Legal Issues Working Group should at least recognize the prospect of unregulated municipal aggregation as a significant unresolved legal issue.

Sincerely,



Bill Meek
President

MEMORANDUM

TO: Lindy Funkhouser, Chief Counsel, Legal Division
ARIZONA CORPORATION COMMISSION

FROM: Webb Crockett, Lou Stahl

DATE: September 15, 1997

RE: Final Comments on the Report to the Arizona Corporation Commission Regarding Electric Industry Competition

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The following represents final comments on the Report to the Arizona Corporation Commission ("Report").

It should be noted that many of the comments previously made by the Consumers represented herein, ASARCO, Incorporated, Cyprus Climax Metals, ENRON Corp. and the Arizona Association of Industries, with respect to the various Drafts of the Report were not included in the Final Draft of the Report. The Consumers are again providing their position on issues, as the representatives of a major segment of the interested parties, as well as specific citations to relevant authority which should have been included in the Report in order for the Commission to have a more complete understanding of the constitutional, statutory and legal basis for any decisions the Commission makes regarding electric industry competition.

It is respectfully submitted that the following comments be considered by the Commission in connection with its review of the Report:

Introduction:

The Introduction does not reflect that there was often not a consensus on whether any action should be taken at all, as well as many areas where a consensus could simply not be reached on any particular action. For example, with respect to the proposed Constitutional and statutory amendments requested by the Affected Utilities, some participants believe that no amendments are necessary, and, therefore, believe no action is necessary.

The term "Consumer" should be construed more broadly than to "refer primarily to high-volume purchasers of electric generation services." Other consumers who would not be considered high-volume purchasers are also involved in the deregulation process.

Scope of the Commission's Authority:

The Affected Utilities argue that the incumbent utilities have the right to a monopoly position due to an alleged regulatory compact with the State of Arizona. The position of many of the consumers of electricity, as well as other parties, is that mere acquisition of a certificate of convenience and necessity in a given area does not give a public service corporation the exclusive right to provide electric service, and

no property right to a monopoly may be claimed. Absent from the discussions in the Report, however, is any citation to the approval of the consumers' viewpoint by the Superior Court of Arizona as set forth in the recent decision of the Honorable Steven D. Sheldon in *U.S. West Communications, Inc. v. The Arizona Corporation Commission, et al.*, CV 95-14284 (May 6, 1997). This is an important decision in this area of which the Commission should be aware and which should be followed as it progresses through the appellate system. The disposition of the *U.S. West* case on the regulatory compact and takings arguments will undoubtedly have a significant impact on the Affected Utilities' arguments. Thus, the citation to the *U.S. West* case should be noted at each juncture where the regulatory compact is discussed or referenced, as well as in the sections where the Affected Utilities raise the takings arguments. (Sections 1.1, 1.2, 1.3, 1.4, 1.5, 2.1, 2.2.)

It should have been made clear in the Report that A.R.S. § 40-281 does <u>not</u> provide for an exclusive and indefinite monopoly. There are no perpetual rights under Arizona law. The Arizona Constitution makes it very clear that monopolies are disfavored, stating "<u>monopolies</u> and trusts <u>shall never be allowed</u> in this State..." (Ariz. Const. Art. 14, § 15) (emphasis added). This cornerstone Constitutional principle is set forth in footnote 4 on page 7 of the Report, but should be stated in the text rather than relegated to a footnote. This principle should be reiterated in Sections 1.1, 1.2, 1.3, 1.4, 1.5, 2.1, 2.2.

Section 1.1:

Page 3, bottom paragraph – There was not a consensus of the Working Group that (1) the Commission must have additional legislative or constitutional authority to promulgate the Rules; (2) the Commission should clarify that the Rules do not affect the exclusivity of distribution services; or (3) the Rules need to distinguish between certificates for distribution and certificates for other services.

Page 6 – Footnote number 3 should not be relegated to a footnote but should be included in the text of the Report.

Section 1.2: It is incorrectly stated on Page 10 that "The Working Group consensus is that the Commission should consider addressing this possibility in amendments to the Rules." The consumers who have been actively participating in the Working Group do not agree that the Rules need to be amended. Thus, it should be noted that **"no consensus"** was reached on this section. Comments A and C should be eliminated to the extent they state or imply that the Rules need to be amended or augmented. The goals of Comment B, and even A and C, may be reached without amendments to the Rules. Further, with respect to Comment B, the consumers take the position that the obligation to serve should and does continue so long as Affected Utilities are recovering stranded costs because until such costs are fully recovered, Affected Utilities are being paid for their investment and for the costs of implementing competition. Affected Utilities should not be allowed to pass on additional costs to consumers.

Section 1.3: The text of Article 15, Section 10 of the Arizona Constitution should also be included in this section. Section 10 provides: "All electric, transmission, . . . corporations, for the transportation of electricity, . . . for profit, are declared to be common carriers and subject to control by law." Further, under the provisions of A.R.S. § 40-332, the Commission has the power to order joint use of facilities.

Section 1.5: In the final paragraph of this section on page 14, the words "and consumers" should be inserted after the word "Staff" in order to alert the Commission that others share Staff's views on this issue.

Section 2.1: On page 14, first paragraph, it should be noted that more than a single participant agrees that the Affected Utilities should be precluded from cross-subsidizing their unregulated activities with funds received from ratepayers, that accounting methods and procedures to prevent cross-subsidization should be implemented, and that they should be required to pay fair market value for the use of utility personnel, services, and equipment used, as well as royalties for any intangible benefit gained, through affiliation with the regulated utility. These directives should be extended to encompass any use of the personnel, assets or credit of the utility to benefit the unregulated activities.

Section 3.1: In response to the statements in this section that utilities should be required to expend resources in mitigation of stranded costs, some parties believe there should be no limitations on such mitigation requirements. Rather than limit mitigation efforts to only the use of funds generated by "traditional utility service" the Affected Utilities should be required to use any revenues that are generated by or from the use of personnel, assets or the credit of the utility to mitigate stranded costs. Consumers should receive the benefit of all revenues generated by the assets, personnel or credit of the utility. Those assets, personnel and credit of the utility were traditionally devoted to serving the public, with the ratepayers returning the investments to the corporation through rates, and any continuing revenues from such assets, personnel and credit should be utilized to complete the return of that portion of the investment rendered stranded by competition.

Footnote number 6 on page 17 should have the word "duties" stricken and replaced with the words "legal obligations".

Sections 3.2 and 3.3: It should be noted that there is a disagreement as to whether there is a conflict between R14-2-1607(J) and R14-2-1607(H). Also, the Commission should be aware that the Consumers take the position that stranded costs should be recovered from all who benefit from competition. Under the "comment" on page 20, the words "see the discussion above" should be stricken and replaced with "no consensus".

Section 7.1: It should be noted in this section that some participants take the position that the availability of two county financing is a benefit which will not be available to all participants in a

competitive market. Recognizing this fact, the Commission should not draft specific rules or make changes to the Rules which will affirmatively foster the use of this benefit by some participants to the detriment of other participants. More particularly, if a corporation chooses to extend its service territory in such a manner as to increase its costs of financing, these costs should not be passed through to consumers as costs. The last sentence in the second full paragraph on page 43 ("Another solution is for the Commission to include in its definition of recoverable stranded costs, any increase in financing costs or the stranded cost of any assets because of local furnishing requirements.") should be deleted. If corporations wish to take advantage of beneficial financing, they should also recognize that they must live within the parameters of that financing in order to accept it. Corporations should be required to weigh the benefits of the financing against its possible burdens prior to accepting it, even if some of those burdens mean foregoing some market share.

Section 7.2: Here again, the Consumers' viewpoint was never incorporated into the Final Draft of the Report. To accurately reflect the participants' positions, it should be noted that some participants believe that solutions to the issues raised in this section are possible without amendments to the Rules. Possible solutions may include that co-operatives simply not sell to non-members, or make membership in the co-operative a condition of service. Still another possibility is to match the FERC mechanism put in place to handle this financing tool. Companies should not be able to utilize this type of favorable financing without being required to recognize that benefits and burdens must be weighed, even if some of those burdens require a lesser market share or more limited service areas in the competitive market. As discussed with respect to the two county financing, REA financing is beneficial financing which is not available to all participants in a competitive market. That fact should be noted in reviewing the Report, as well as the position that no Rules should be adopted which will foster the use of this financing by some, to the detriment of others in a competitive environment.

Section 9.3: Further comment on this section relates to the ability of the Commission to permit the market to determine fair and reasonable rates for services. The Commission's power to prescribe rates is exclusive and cannot be interfered with by the legislature, the courts or the executive branch of the state government. *Pueblo Del Sol Water Co. v. Arizona Corp. Comm'n*, 160 Ariz. 285, 772 P.2d 1138 (Ct. App. 1988); *Southwest Gas Corp. v. Arizona Corp. Comm'n*, 169 Ariz. 279, 818 P.2d 714 (Ct. App. 1991); *Consolidated Water Utils., Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 875 P.2d 137 (Ct. App. 1993). The Commission, in operating in the regulated monopoly arena, sets rates as a surrogate for the market because, in the case of natural monopolies or regulated monopolies, there is no market. Regulation is an attempt to artificially duplicate the market and market rates. The Commission is permitted wide latitude in setting rates and, by allowing the market to set reasonable rates, those rates, by all estimations, will be lower than regulated monopoly rates. Regulation in the

traditional form may still be required, and may continue under the present statutory and constitutional scheme, for the operations of, and the setting of rates, charges, fees, etc. for the transmission and distribution of electricity.

Section 9.4: The Commission should note at the outset of this section that there is substantial disagreement over whether statutes and/or the Constitution need to be amended, and if so, what those amendments should be, as well as the scope of the amendments, if any. Specifically, it is the position of many interested parties that statutory and Constitutional amendments are not necessary.

Section 9.4.1 A.R.S. §§ 40-281 and 282: Since distribution and transmission services have not been deregulated, these statutes are required to remain in force and effect for those services. The Rules draw a sufficient distinction between distribution, transmission and generation.

Section 9.4.6 Foreign corporations already do business in Arizona. This fact contradicts the arguments and hypothetical issues raised by the Affected Utilities with respect to this statute and necessary amendments thereto.

Sections 9.4.7 and 9.4.8 A.R.S. §§ 40-285 and 40-301 et seq.: The Report should have made it clear that it is only generation which is being deregulated and that distribution and transmission will remain subject to regulation and control by the Commission. Additionally, reference should be made back to the recommended statement of policy noted in Section 9.4.2, which could be designed to adequately address the applicability and the scope of these statutes in the generation area. In addition, A.R.S. § 40-285 would not apply to competitors since facilities would not be "necessary" in the performance of duties to the public when there are alternative providers available to the public. It is, however, necessary to retain the limitations set forth in A.R.S. § 40-285 when "necessary" facilities are involved.

Section 9.4.10 It should be reiterated that it is only generation which is being deregulated, not distribution or transmission. Thus, it is still necessary to retain the provisions set forth in A.R.S. § 40-341, et seq. in order to allow consumers to convert overhead facilities to underground.

Section 9.4.11 It should be reiterated in this section that it is only generation which is being deregulated, not distribution or transmission. Thus, it is still necessary to retain the limitations set forth in A.R.S. § 40-360, et seq. with reference to siting generating plants and high voltage lines.

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HAND DELIVERED

September 12, 1997

Lindy Funkhouser, Chief Counsel
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007-2996

Re: Comments on the Proposed Final Draft of the Report of the Legal Issues Working Group to the Arizona Corporation Commission

Dear Mr. Funkhouser:

By memorandum of September 5, 1997, you submitted the proposed final draft report of the Legal Issues Working Group to its participants. You asked for individual final comments to be returned to you no later than September 12, 1997.

I want to congratulate you on pulling together a report that gives a clear picture of the major issues that the Legal Issues Working Group confronted during its deliberations. I think the Commission should be greatly aided by your editing effort. I have only two observations.

First, the discussion in Section 1.1 of the "monopoly" status of Certificates of Convenience and Necessity issued under A.R.S. Section 40-281 can easily be remedied by a clarification to that statute similar to that done for the telecommunications industry. Of the various possible statutes in Title 40 discussed in the report, this is, in my view, the one statute that clearly deserves consideration for legislative change. Other problems that have been raised probably can be more effectively addressed after Arizona benefits from watching California implement its program beginning in January.

Second, the unresolved discussions mentioned in several parts of the report concerning utilities that are regulated by the

Commission and those that are not can also be left for another time. It is important to note the lack of agreement on whether a problem exists and what actions may or may not be necessary. Effective implementation of this program will require all of the Commission's resources. Being sidetracked by entering into this area will not help. California saw no reason to change its current scheme and Arizona need not either. When the Commission is finished deregulating retail electric sales, it will by then have evidence of whether that portion of the distribution business that remains within its jurisdiction has problems or not. There will be plenty of time then to consider cures to any real problems that can be demonstrated through experience rather than speculation.

Again, congratulations on the excellent effort that has gone into this report.

Sincerely,

Robert S. Lynch

RSL:psr
cc: IEDA Members

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September 11, 1997

Mr. Lindy Funkhouser
Chief Counsel, Legal Division
1200 West Washington
Phoenix, Arizona 85007

Re: Report of the Arizona Corporation Commission's Legal Issues Working Group ("Report")

Dear Mr. Funkhouser:

Pursuant to the agreement reached at the August 28, 1997 meeting of the Legal Issues Working Group, as reflected in Constance J. Fitzsimmons September 5, 1997 transmittal memorandum, PG&E Energy Services ("Energy Services") hereby submits its individual "final comments."

THE REPORT

As you are aware, a representative of Energy Services has participated as both a member of the Legal Issues Working Group and a "reporter" during the period of time when the Report was being developed. At various times that individual has made substantive observations, suggested editorial changes and offered written text where believed appropriate in support of the collaborative effort contemplated by R14-2-1616. Recognizing that a consensual process by its very nature cannot fully accommodate the views of all concerned, Energy Services nevertheless believes that the form of Report transmitted on September 5, 1997, on balance, represents an inclusive and fair presentation of the issues addressed and arguments advanced by the participants. Accordingly, it has nothing to suggest by way of addition or modification as of this juncture.

THE REOPENED PROCEEDING

As you are also aware from its active participation as an Intervenor in the Maricopa County Superior Court litigation resulting from the Commission's issuance of Decision No. 59943 and

its adoption of R14-2-1601 et seq., Energy Services believes that the Commission's actions in that regard were within its constitutional and statutory powers and jurisdiction.[1] In addition, Energy Services believes such actions were consistent with and in furtherance of the public interest of the State of Arizona and its residents. What is crucial for all concerned is for the Commission to continue to act in this manner during the transition to a competitive environment in the provision of electric services.

Through its issuance of Decision No. 60351 on August 29, 1997, the Commission has determined to reopen the electric competition proceeding (Docket No. U-000-94-165) in order to (i) receive presentations and recommendations from representatives of each working group established by R14-2-1601 et seq., and (ii) consider proposed additions and/or modifications to the previously adopted electric competition rules. Energy Services will continue to be an active participant in the reopened proceeding; and actively supports the Commission's indicated intention to conduct that proceeding in an expeditious manner. Significant in this regard is the following statement of the Commission:

> "Because the Rules phase in competition according to an <u>established schedule</u>, the Commission believes that the rule making process should commence as early as possible <u>to meet that schedule</u>." (Decision No. 60351 at page 2, lines 1-3) (emphasis added)

By its issuance of Decision No. 59943 and its adoption of R14-2-1601 et seq., the Commission established a framework by which Arizona's retail electric markets could transition to competition. That transition is now under way. Through the reopened proceeding provided for by Decision No. 60351, the Commission will be in a position to adopt such additional measures, if any, as may be necessary to assure that such transition is fair, equitable and orderly. But, as the Commission has correctly concluded, such "fine tuning" does not require that the previously adopted schedule for implementing competition be disturbed or delayed. To the contrary, the public interest requires that it not.

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[1] Energy Services also believes that no constitutional or statutory changes are necessary to support or rationalize the Commission's actions. Certain parties have suggested certain "clarifying" amendments to various provisions of Title 40 of the Arizona Revised Statutes. Energy Services believes such changes are unnecessary, and would oppose any proposals of that nature if they entail a risk of undercutting or restricting the Commission's authority to provide for competition in the retail electric industry.

CONCLUSION

Thank you for the opportunity to submit these "final comments" in connection with the September 5, 1997, version of the Report.

Very truly yours,

Lawrence V. Robertson, Jr.

Lawrence V. Robertson, Jr.
Attorney for PG&E Energy Services

LVR: mbd

Residential Utility Consumer's Office

Comments on Draft of Legal Issues Working Group

September 15, 1997

The following are the preliminary comments of the Residential Utility Consumer Office (RUCO) to the Report of the Arizona Corporation Commission's Legal Issues Working Group ("Report"). RUCO will have additional comments as to legal matters as more specific proposals are made and the reports of the various other working groups are published.

A. Purpose of Comments

The legislature established the RUCO for the following purpose:

> "The purpose of the residential utility consumer office is to represent the interests of residential utility consumers, critically analyze proposals made by public service corporations to the corporation commission, develop its own recommendations and present them to the commission."

Laws 1987, Ch. 222, Sec. 1.

The statute expands on the purpose of RUCO by giving its Director the power to participate in utility rate cases and other proceedings of the Arizona Corporation Commission ("ACC") affecting residential consumers. The statute states:

> "A. The director may:
>
> 1. Research, study and analyze residential utility consumer interests.
>
> 2. Prepare and present briefs, arguments, proposed rates or orders and intervene or appear on behalf of residential utility consumers before hearing officers and the corporation commission as a party in interest and also participate as a party in interest pursuant to Secs. 40-254 and 40-254.01 in proceedings relating to rate making or rate design and involving public service corporations . . ."

A.R.S. § 40-464.

The following comments are tendered as a result of the determination of the Director that the prospect of a major change in the regulation of electric utilities may have a tremendous impact on residential consumers.

B. General Comments

The Report continually discusses issues and concerns of the "Consumer." On page 1 of the Report, "Consumer" is defined as referring "primarily to high-volume purchasers of electric generation services." While RUCO is concerned with this "Consumer," RUCO's primary concern is on behalf of residential utility consumers.

The Report does not directly address issues of primary importance to the residential consumer of electricity. The major issue to residential consumers is the provision of uninterrupted, universal electric power at the lowest possible rates.

The introduction of the salutary concept of competition in the provision and sale of generation of electricity cannot be allowed to leave even a moments gap in the assurance of uninterrupted, universal electric power at the lowest possible rates.

The Report has not addressed the legal aspects of providing uninterrupted, universal electric power at the lowest possible rates, or the legal mechanisms which might allow residential consumers to participate in the market for lower cost generation, billing and collection, metering and meter-reading services. These issues remain to be resolved. RUCO is advocating evidentiary hearings prior to any additional rule making so all parties may present their positions on a "level playing field." It is clear from the Report that little consensus was reached by the legal working group; a similar situation exists with the other working groups. An evidentiary record will provide the commission with a solid basis for any modifications, additions or corrections that may need to be made to the Electric Retail Competition Rules. Such evidentiary hearings are compelled by the omission of any meaningful legal analysis in the Report related to the assurance of uninterrupted, universal electric power at the lowest possible rates.

C. Sections 1.2, 1.4 and 6.5

Sections 1.2 and 1.4 address legal issues related to the ACC's ability to require utilities to be the "provider of last resort" and the ability to regulate providers of generation services who are not currently regulated.

For residential consumers, there must be a provider of last resort. Certain areas of the State, by virtue of an area's rural character, topography, low densities or other reasons, may not be attractive to providers of generation services. Again, there can be no doubt that each residential consumer in Arizona shall be served in an efficient and low cost manner with electricity at that consumer's home.

Section 6.5 addresses resource planning issues. The availability of low cost, uninterrupted, universal service applies to any discussion of future planning to ensure that the generation resources are available to handle the future needs of the residents of Arizona. While the natural equilibrium of the marketplace will likely satisfy the availability of generation resources in the long term, it is necessary that continual review be undertaken in the short term to insure that residential consumers have resources available.

Various mechanisms should be examined to encourage competition among providers for the residential consumers as customers. These mechanisms are the province of other working groups. The ACC will be required to make a final determination on these mechanisms following recommendations from working groups. Presentation of evidence may also be necessary for the ACC to make a reasoned determination as to the mechanisms that will be available to the residential consumer.

D. Sections 5.1 and 6.1, Stranded Costs

A broad examination of the existence and quantification of stranded costs must be undertaken. The parties to such an inquiry must be required to examine and quantify any such costs which might be attributable to the residential consumer. No levy of stranded costs on the residential consumer can be allowed without a process that allows residential consumers to meaningfully participate. The residential consumer must have the opportunity to advocate for its position in an evidentiary proceeding.

RUCO agrees with Staff that concepts such as "mitigation" are well defined in bodies of law such as commercial lease law and such bodies of law should be examined to determine precise analogies to the anticipated proceedings when stranded costs are alleged. Two examples point out availability of such other bodies of law. In *Corrigan v. City of Scottsdale*, 149 Ariz. 538, 720 P.2d 513 (1986), certiorari denied 107 S.Ct. 577, 479 U.S. 986, 93 L.Ed.2d 580, the Arizona Supreme Court set out a standard for measuring damages which may have accrued as a result of a temporary taking, a concept quite similar to a stranded cost. Such a test, which looks to the overall economic consequences of the action in question, is an analogous situation which assists in understanding a stranded cost issue or claim.

> "Recognizing this problem, we feel the best approach is not to require the application of any particular damage rule to all temporary taking cases. Instead we hold that the proper measure of damages in a particular case is an issue to be decided on the facts of each individual case. It is our intent to compensate a person for the losses he has actually suffered by virtue of the taking. . . . The damages awarded and the way to measure those damages thus may be adapted to compensate the party . . . for his actual losses.

> We emphasize, however, that no matter what measure of damages is appropriate in a given case, the award must only be for actual damages. Such actual damages must be provable to a reasonable certainty similar to common law tort damages. (Citation omitted) This approach will compensate for losses actually suffered while avoiding the threat of windfalls . . . .

149 Ariz. at 543-4.

The concept of mitigation is likewise well documented in Arizona law:

> "The party injured by a breach of contract has a duty to take reasonable steps to avoid the consequences of known injuries. *Coury Bros. Ranches, Inc. v. Ellsworth*, 103 Ariz. 515, 518, 446 P.2d 458, 461 (1968); *Fairway Builders, Inc. v. Malouf Towers Rental Co., Inc.*, 124 Ariz. 242, 255, 603 P.2d 513, 526 (App. 1979); *Barnes v. Lopez*, 25 Ariz.App. 477, 481, 544 P.2d 694, 698 (1976). The party in breach has the burden of showing that mitigation was reasonably possible, but was not reasonably attempted. *Fairway Builders*, supra, 124 Ariz. at 255, 603 P.2d at 526. Whether the duty is violated is a question of fact. 124 Ariz. at 256, 603 P.2d at 526.

Northern Arizona Gas Service, Inc. v. Petrolane Transport, Inc., 145 Ariz. 467, 477, 702 P.2d 696 (App. 1984).

Other applicable concepts and law will apply to the stranded cost analysis.

E. Conclusion

RUCO is hopeful that the advent of competition in generation, billing and collection, metering and meter-reading services will be a benefit to the residential consumers of Arizona. RUCO, however, is concerned that the competition to provide electricity to large users may harm the residential consumer. All legal analysis should commence with the premise that the provision of uninterrupted, universal electric power at the lowest possible rates is the cornerstone of the new competitive market and the regulations of that market.

The lack of a consensus shown in the Report and the indefinite nature of many of the proposals coming from the various working groups, points to the need to be ever mindful of the interests of the residential consumer. It is RUCO's position that evidentiary hearings are essential for the ACC to resolve the numerous issues for which no consensus can be reached. The protection of universal, low cost electric service for the residential customers will best be effectuated through a process that

allows all parties, including the consumer advocates, to provide the complete record upon which the ACC can base the difficult decisions it must make.

SRP

Supplement to

Report of the Arizona Corporation Commission's

Legal Issues Working Group

The Salt River Project Agricultural Improvement and Power District ("SRP") submits this supplement to the Legal Issues Working Group report for the purpose of addressing specific legal issues which may apply to the participation of public power entities such as SRP in a competitive market.

Introduction

SRP is a governmental entity (an Arizona agricultural improvement district) which provides electric power to its customers and, through the Salt River Valley Water Users Association, water delivery services to shareholders. As a public body, SRP represents the interest of its constituents and makes its various comments in this regard. SRP and its customers support the transition to competition and are committed to bringing competition to Arizona quickly and effectively.

As a governmental entity, SRP is not regulated by the Corporation Commission and is not subject to the competition rules. However, SRP has actively participated in these proceedings in order to lend its expertise in a positive manner and to coordinate SRP's transition to a competitive market with the efforts of the Corporation Commission.

In the spirit of promoting a fast and effective transition to a competitive market SRP makes these specific comments to the sections of the report:

1.1 No comment.

1.2 No comment.

1.3 Under the Rules distribution systems will remain regulated. Under the Rules the distribution utility will receive a just and reasonable return on distribution system investment, probably using traditional rate making principles. There is no issue of a taking where prices are properly set. The Commission has always had the authority to order a regulated utility to wheel the power of another provider. *See e.g. Arizona Constitution, Art. 15, § 10; A.R.S. § 40-332.*

1.4 No comment.

1.5 SRP supports any reasonable step to "streamline" or eliminate unnecessary elements of regulation.

2.1 This point addresses utility and non-utility activities by the same Affected Utility, and deals with the argument the utility status somehow gives the utility an advantage in competing in other markets (e.g. heating and air conditioning). SRP opposes any new regulation which would limit competition.

2.2 SRP agrees that in a competitive market place there may be certain proprietary information which should be kept confidential, as long as the public has full access to that information which remains relevant to those aspects of the industry which remain regulated.

3.1 A number of methodologies have been suggested to recover stranded costs. SRP continues to work with other participants to explore the various methodologies.

3.2 No comment.

3.3 SRP supports a future charge, per kWh or per kW, levied on all customers. SRP does not support an exit fee. SRP believes that this is a fair way to assess the costs of a transition to competition to those customers who will benefit from competition. SRP also advocates a rate cap so that prices should be no higher than they are now, with no "dampening" of demand and reliability.

3.4 - 3.7 No Comment

4.1 No Comment

4.2 SRP supports the elimination of unnecessary regulation, including aspects of the affiliate interest rules which do not directly relate to unregulated parts of a business.

4.3 In general terms this section deals with the irrational fear of the investor-owned utilities that public power entities such as SRP will be more effective competitors. Called the "level playing field" argument, this is a non-issue.

Historically customers have always had the choice of public power. In other words, customers could always have chosen (either through local governments or with legislative authority) to "municipalize" the provision of electricity. This "competition" has always acted as a "market" control on the businesses of the investor owned utilities[1].

[1] As has the option of private power served as a competitive force on public power.

As we move toward greater customer choice, it would be counter-intuitive to limit the choice of public power. As before, public power will be a market force in pushing the market toward greater efficiencies and innovation.

In making their arguments the investor-owned utilities fall into the trap of assuming that public power has their same motivations. Public power is owned and controlled by its customers. It has no stockholders demanding greater profits. Thus, public power is not motivated to expand its profits by taking the business of the investor owned utilities. Its motivation is to serve its customers by operating its business rationally and efficiently.

Under competition, prices will be set by the market. The historic cost structure of any competitor, and there are many differences, will have no relevance to market price. Instead, the market will set prices based on marginal cost, as in any other industry.

4.3.1 No comment

4.3.2 Public power, and SRP in particular, does not need an intergovernmental agreement to participate in competition. The purpose of the IGA is to provide a coordinating mechanism between deregulation by the Corporation Commission and the voluntary transition to market competition in the service territories of public power entities. The IGA will not subject SRP to Corporation Commission regulation, nor will it subject the Corporation Commission to SRP regulation. The entities will simply agree to coordinate their respective activities, basically to promote consumer understanding and acceptance, statewide, during the transition process.

4.4 No comment.

5.1 No comment

5.2 The relationship between pubic power and investor owned utilities is addressed under paragraph 4.3 above.

6.1 - 6.4 No comment

7.1 The "two county rule" provides advantages to certain investor owned utilities. As with the other "level playing field" arguments, it is irrelevant to the issues at hand.

7.2 - 7.4 No comment

8.1 - 8.2 No comment

9.1 No comment

9.2 No comment

9.3.1 There is no need to amend the Arizona Constitution. Those advocating amendment are simply promoting delay in the transition to competition.

The suggestion that the customers of governmental, public power, entities should be subjected to additional regulation through the Corporation Commission is silly. We are in the process of deregulation, not more regulation. The sole reason for Corporation Commission regulation of investor owned utilities is to keep the investors (shareholders) from abusing the monopoly position granted to them. This concept is recognized in the constitution of Arizona, as it is in almost every other state.

The real motivation for this suggestion is that the investor owned utilities wish to protect themselves against competition by subjecting other utilities to their same regulatory burdens. The answer is not to increase regulation of others, but to reduce unnecessary regulation by the Commission.

9.4 SRP strongly advocates a minimalist approach on legislative change. The goal should be to implement competition quickly and effectively. Any activity which might slow down the process should be avoided. For this reason SRP advocates only two legislative items at this time. These are to solidify the Commission's general authority to implement its rules, and to deal with the changes in state tax revenues which might happen in competition. SRP is also receptive to changes that would, in general, streamline or eliminate unnecessary elements of regulation. Any other change should await the implementation of competition, where the need and details of the change will be better known and understood.

FINAL COMMENTS OF
SOUTHERN ARIZONA MECHANICAL CONTRACTORS ASSOCIATION TO
PROPOSED FINAL DRAFT OF LEGAL ISSUES WORKING GROUP REPORT

This document constitutes the Southern Arizona Mechanical Contractors Association's ("SAMCA") final comments to the proposed final draft of the Legal Issues Working Group report to the Arizona Corporation Commission, and is presented by SAMCA's legal counsel undersigned. SAMCA's final comments are specifically addressed to Section 9.4.14 of the Working Group Report.

I. WHAT IS SAMCA

SAMCA was formed in 1987 to provide representation and mutual assistance to air conditioning, heating and refrigeration contractors in Tucson in identifying and preventing unfair competition from utilities. SAMCA currently is 86 members strong and its members derive from every facet of the mechanical contracting industry. The majority of SAMCA members are Arizona-licensed contractors. Those contractors compose 68% of SAMCA's total membership. An additional 18% of SAMCA members are suppliers of air conditioning, heating and refrigeration equipment. The remaining members are various service companies who provide support to the mechanical contracting industry.

2. THE PROBLEM OF CROSS-SUBSIDIZATION

Even though the electric utility industry in Arizona may be "deregulating," the distribution of electricity to retail customers will remain a monopoly created and protected by state law and regulated by the Arizona Corporation Commission ("Commission"). The Commission will continue to determine both the rates the utitities are to charge for distribution and the profits to be derived from such distribution.

There has been much discussion within the Working Group about recovery of the "stranded costs" of the utilities which will result from deregulation. While the utilities must make reasonable efforts to mitigate those stranded costs, some stranded costs will necessarily exist. Some members of the Working Group have expressed their belief that one of the preferred methods of stranded cost recovery is to allow the utilities to compete freely in nonregulated markets, such as appliance retailing and servicing. When the utilities enter such businesses, they find themselves in head-to-head competition with small and locally-owned independent businesses.

The entry of utilities into markets traditionally dominated by

locally-owned, small, independent proprietors has the distinct possibility of creating unfair competition in which such businesses are unable to effectively compete against the larger, better-financed utility or utility-affiliated competitor. This situation is compounded further if utilities are allowed to subsidize and aid their nonregulated activities with profits, services and advantages obtained and acquired through their regulated activities. Such "cross-subsidization" enables the utility affiliates to offer products and services below their real market value. Unchecked cross-subsidization will eventually force the locally-owned, independent businesses out of the market.

Cross-subsidization can take many forms. Several examples are as follows:

(1) A utility's nonregulated affiliate can at no little or no cost enclose promotional materials in the monthly utility bill. By so doing, the nonregulated business has immedately and substantially reduced its operating costs and received an enormous competitive advantage in the market.

(2) A utility maintains a wealth of information on consumer needs, requests and other market characteristics which may be readily available to its nonregulated affiliate to be used as a valuable marketing tool. Small, independent businesses do not have access to such important marketing information.

(3) A utility may offer its nonregulated affiliate or the customers thereof below-market interest rates and extended payment plans on products and services. Such financing arrangements are usually cost prohibitive to small businesses, thereby placing them at a competitive disadvantage.

(4) A utility may provide loans, loan guarantees or other financial subsidies to assist the business venture of its nonregulated affiliate in getting off the ground. Small businesses do not have such a ready source of financing.

(5) Because of economies of scale, a nonregulated utility affiliate may be able to bypass the normal distribution channels and buy direct from manufacturers at favorable prices, placing the independent businesses at a competitive disadvantage.

(6) By using the utility's name and logo, the nonregulated utility affiliate has instant recognition in the marketplace, which is something competitors must work for many years to achieve. Moreover, such name recognition may lead to unjustified consumer confidence.

(7) A utility's nonregulated affiliate may use fully-trained employees transferred from the regulated utility. However, the competitors of the utility affiliate may spend a great deal of time, effort and money to provide comparable training for its employees.

(8) Nonregulated affiliates may share office space with the utility either rent free or at a discount to the fair market rental rate. Rent or ownership payments constitute a substantial overhead expense for small businesses.

(9) An array of utility-developed computer and office technology may be available to subsidize the efforts of the nonregulated utility affiliate.

(10) The nonregulated affiliate may have the use of utility vehicles, tools, equipment, accounting and legal departments, and managerial talent at no cost, while such services are very costly to independent businesses.

Thus, small, independent service providers in the competitive market stand to be severely prejudiced and ultimately harmed if nothing is done to prohibit or control cross-subsidization. If utilities are to be permitted to engage in nonregulated activities, they should be required to do so on a level playing field, without the many competitive advantages which may be gained through their utility affiliations.

3. PREVENTION OF CROSS-SUBSIDIZATION

Arizona has no existing legislation which prevents unfair cross-subsidization. The Commission's affiliated interest rules are inadequate to prevent cross-subsidization and its devastating effects on small businesses. Those rules merely prohibit utilities from entering into transactions with their affiliates unless they open up their books to the Commission for review. There is nothing contained within said rules which actually prevents cross-subsidization by utilities. Under the current rules, utilities and their nonregulated affiliates may share costs, marketing information, employees and equipment; and the affiliates may enjoy the benefits of the utilities' financing capabilities, economies of scale and name recognition.

The easiest and most effective way of preventing cross-subsidization is to enact a new rules to replace the affiliated interest rules which would completely separate utility and nonutility business activities. SAMCA submitted a draft of its proposed rules to the Working Group. This separation of activities

would avoid the problems of identifying and properly allocating costs which are associated with different and unrelated activities. A complete separation also prevents utility affiliates from receiving unfair competitive advantages, such as name recognition, logo use, customer base and a readily-available technical expertise. Separating activities is the simplest and surest way to avoid these problems. A complete separation would ensure that utilities pursue competitive ventures on a stand-alone basis. Utilities should only be permitted to provide utility service, and all nonutility activities should be conducted by affiliates without the advantages of cross-subsidization.

4. THE WORKING GROUP'S REPORT

Section 9.4.14 of the report states, in part, that a majority of the Working Group believes that the Commission has "sufficient jurisdiction currently to prohibit any unfair cross-subsidization and/or that prohibition of non-regulated activities would be inconsistent with the move generally to competition." As SAMCA has repeatedly brought to the attention of the Working Group, such a statement about the beliefs of a "majority" of the working group contradicts the written record in this matter. Therefore, in SAMCA's view, the proposed final draft of Section 9.4.14 of the report does not accurately reflect the views expressed by concerned members of the Working Group.

5. CONCLUSION

The restructuring of the Arizona electric utility industry involves issues of vital importance to SAMCA. SAMCA believes the Working Group's report fails to address important issues which will seriously affect the competitive market. New Commission rules or legislation, or both, will be necessary to adequately protect third party victims, such as SAMCA and its members, from harmful fallout eminating from the deregulation process.

I respectfully submit these comments on behalf of SAMCA this 10th day of September, 1997.

Sincerely,

Steven M. Banzhaf
BANZHAF & WATKINS
Attorneys for Southern Arizona
Mechanical Contractors Association

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September 11, 1997

Lindy P. Funkhouser, Esq.
Arizona Corporation Commission
Legal Division
1200 W. Washington, Room 230
Phoenix, AZ 85007-2927

Re: Legal Issues Working Group -- Final Draft Report

Dear Lindy:

Again, I want to thank you very much for the opportunity to participate in the Legal Issues Working Group and to review the Final Draft Report. The City of Tucson offers the following comments to the report.

The report seems balanced in that it presents the points of view that the various participants expressed without making judgments regarding the correctness or incorrectness of such points. Several of the issues will undoubtedly be affected by the determinations of the pending lawsuits and we do not believe comments on these issues would be helpful at this time.

The City agrees with those participants who oppose any amendment to the Constitution that would impact or compromise the municipalities' rights to regulate their own municipally owned utilities. All avenues to implement the spirit of the rules should be explored before any such constitutional amendment is suggested.

The sections relating to FERC and federal issues illustrate the complexity of this area and although the City has no specific recommendations, it is felt that many of these issues will be sorted out as the rules become implemented.

The City looks forward to working with the Commission, the Commission staff, and other participants in the implementation of these rules and any consequent changes and modifications.

Sincerely,

Loretta Humphrey
Principal Assistant City Attorney

LH:lr

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Tucson Electric Power Company

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September 23, 1997

Mr. Lindy Funkhouser
Chief Counsel
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85004

Re: Legal Issues Working Group Final Report

Dear Mr. Funkhouser:

At your invitation, Tucson Electric Power Company ("TEP"), by this letter, provides an overview of its comments to the Final Report of the Legal Issues Working Group that has met regarding issues related to competition in the retail electric industry in Arizona. TEP recognizes that the Final Report is the product of many hours of coordination and correlation by you, your staff, the Reporters and other members of the Working Group. During the Working Group sessions many viewpoints were expressed and debated, and as the Final Report reflects, little agreement was reached. You and your staff are to be commended for providing the environment where these discussions could occur and for developing the Final Report document.

TEP's substantive legal concerns with the Competition Rules are well documented. TEP has stated its position on these matters in the record of the Competition Rules' docket and during the workshop sessions. Without repeating each of those concerns in detail, TEP notes that none of them are resolved by the Final Report. TEP believes that given the time and effort that has been devoted to the legal workshops, the Final Report should set forth recommendations to amend the Competition Rules.

Specifically, there were no recommendations proposed on such matters of legal significance as: (a) the Commission's authority to enact the Competition Rules and redefine certificates of convenience and necessity; (b) an Affected Utility's obligation to serve customers in a competitive environment; (c) legal standards for the mitigation and recovery of stranded costs; (d) rewrites of the sections of Title 40 that are necessary in a competitive environment; and (e) the regulation of non-public service corporations (such as SRP and the tribal utilities) that indicate an intent to compete with public service corporations. Without a resolution of these important issues, the Competition Rules will continue to deny Affected Utilities the due process that they are entitled to.

Now that reports from other working groups will be filed in the near future, TEP would recommend that the Legal Issues Working Group be continued to study the legal ramifications of such reports and the recommendations therein. Perhaps in this context, specific legal recommendations could be made as the Competition Rules are interpreted and/or amended.

As always, TEP is willing to work with the Commission and Staff to address and implement positive changes to the Competition Rules. TEP continues in its support of competition and in its commitment that any such competition must be equitable and fair. TEP believes that by including sound recommendations for appropriate changes to the Competition Rules in subsequent reports, all of the parties will be aiding in the implementation of competition in Arizona.

Sincerely,

Bradley S. Carroll
Counsel, Regulatory Affairs

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REPORT TO THE

ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE COMPETITION

IN THE PROVISION OF ELECTRIC SERVICE

THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. U-0000-94-165

Submitted By

The Stranded Cost Working Group

September 30, 1997

CARL J. KUNASEK
CHAIRMAN

JAMES M. IRVIN
COMMISSIONER

RENZ D. JENNINGS
COMMISSIONER

ARIZONA CORPORATION COMMISSION

JACK ROSE
EXECUTIVE SECRETARY

September 29, 1997

To the Commissioners:

Decision No. 59943, issued by the Commission on December 26, 1996, contained rules ("Rules") providing for a phased-in transition to retail electric competition in Arizona, beginning on January 1, 1999. Such Rules required the creation of special Working Groups to address several key issues related to the introduction of competitive power markets in this State. One such group was the Stranded Cost Working Group.

Rule R14-2-1607.C required the Stranded Cost Working Group to be comprised of representatives of all stakeholders and coordinated by the Director of Utilities. Its charge was to develop recommendations for the analysis and recovery of standard costs, and to deliver a report thereon to the Commission within ninety days of the end of 1997.

While consensus was achieved on some issues, it is disappointing to report that many issues remain unresolved. This reflects both the complexity of the issues and diversity of competing stakeholder interests. For those issues where consensus was not established, Staff included in the report its analysis of the issues and related recommendations. This is consistent with our traditional responsibility for developing and advancing recommendations to the Commission for consideration in setting regulatory policy.

Respectfully submitted,

Carl W. Dabelstein
Director-Utilities Division
Arizona Corporation Commission

CWD:rkt

STRANDED COST WORKING GROUP

REPORT TO THE COMMISSION

TABLE OF CONTENTS

		Page
Executive Summary		ii
I.	Introduction	1
II.	Definition of Stranded Costs	5
III.	Components of Stranded Costs	10
IV.	Mitigation of Stranded Costs	14
V.	Calculation Methodology	19
VI.	Calculation Period	28
VII.	Market Clearing Price	30
VIII.	True-Up Mechanism	33
IX.	Cost Allocations	36
X.	Recovery Mechanism	37
XI	Accounting, Tax & Finance Issues	53
Appendix A	List of Working Group Participants	70
Appendix B	Summary of Meetings Held	72
Appendix C	Voting Roster	73
Appendix D	Dissenting Comments	75

Report of the Stranded Cost Working Group

Executive Summary

The purpose of this report is to present to the Arizona Corporation Commission ("Commission") the findings and recommendations of a special working group assembled to address the issue of stranded costs in the context of introducing retail competition in the electric utility industry in the State of Arizona. In general terms, stranded costs are costs that utilities have incurred or will incur in connection with the provision of regulated monopoly service that will likely not be recoverable in a competitive market.

In December 1996 the Commission issued Decision No. 59943 approving rules (the "Rules") for a phased-in transition to a competitive retail electric power market beginning January 1, 1999. In connection therewith, the Rules require the creation of a special working group (the "Working Group") to develop recommendations for the analysis and recovery of stranded costs for inclusion in a special report to the Commission. Such a group was created at a meeting of interested parties held in the Commission's Phoenix Hearing Room on March 4, 1997. This is the report required of that Group.

At the initial meeting of the Working Group it was generally agreed by the attendees that the most efficient way to proceed would be through subcommittees established to examine specific issue areas. Three such groups were established: a Calculation Methodology Subcommittee, a Recovery Mechanism Subcommittee, and an Accounting Tax and Finance Subcommittee. Each subcommittee met on several occasions to analyze issues and develop recommendations for the Working Group.

Another matter addressed at the kickoff meeting of the Working Group was the manner by which it would be determined whether a consensus exists among the participants with respect to any issue brought before them. For that purpose, twenty parties, representing a balanced, cross-section of participating stakeholders were given voting authority. Ten votes represented the interests of parties involved in the generation, transmission, or distribution of electricity. Five votes were reserved for parties representing consumer interests, and five for public interest groups and governmental agencies. It was further agreed by the participants that consensus would be said to exist when a two-thirds super majority, based on the number of votes cast, was received.

While consensus on some issues was achieved, it is disappointing to report that many issues remain unresolved. This reflects the overall complexity of the stranded cost issue, the substantial dollar amounts involved, and the diversity of participating stakeholder interests. The following is a summary of the issues upon which consensus was achieved using the agreed upon voting procedure:

- The definition of stranded costs contained in Section R14-2-1601 of the Rules should not be changed.

- Stranded costs may include the following categories of costs:

  - generation assets
  - power purchase agreements
  - fuel contracts
  - regulatory assets
  - employment transition costs
  - environmental mandates

  With respect to the above, the parties reserve the right to oppose or challenge the inclusion of any particular cost or component when a request to recover stranded costs is made.

- The Rules should be changed to allow stranded cost recovery from customers who are not taking competitive power. The second sentence of Section R14-2-1607(J) of the Rules should remain in effect, but this Section should be amended to allow all customers to pay stranded costs, including customers who remain on standard offer rates. However, the charge to standard offer customers should account for contributions that are already being made toward stranded costs and should not cause customers' prices to increase.

- Stranded costs should be recovered from ratepayers using a a charge with both an energy and/or demand component.

- Customers should have the option to pay a lump sum amount in lieu of a stranded cost charge.

- The Commission should consider some type of rate cap as part of the development of a stranded cost recovery program.

- Stranded Costs should be allocated to jurisdictions and customer classes in a manner consistent with the specific company's current rate treatment of the stranded asset, in order to affect a recovery of stranded costs that is in substantially the same proportion as the recovery of similar costs from customers or customer classes under current rates. Updated rate design to correct flaws in current rate design would be acceptable.

Historically, utility regulatory policy in Arizona has been created through the rate case decisions and other orders issued by the Commission, based on recommendations developed and advanced by the Utility Division Staff ("Staff"). In keeping with its traditional responsibility, Staff coordinated the efforts of the Working Group and its subcommittees in addressing the multitude of issues relating to the definition, quantification and recovery of stranded costs, and in developing the recommendations being conveyed herein. Although not a voting party for purposes of establishing the extent to which consensus on issues exists, Staff was an active participant in this process and performed extensive analyses of the issues. In connection therewith, Staff has developed its position on a number of the issues, many of which have not achieved

consensus within the Working Group or its subcommittees. The following recommendations of the Staff are submitted for the Commission's consideration:

- Due to uncertainty which exists with respect to whether the Commission intended that the costs of nuclear fuel disposal be included with the costs of nuclear decommissioning for purposes of computing the System Benefits Charge, R14-2-1608.A should be clarified to eliminate any ambiguity.

- Because the circumstances of what constitutes reasonable and prudent mitigation efforts can vary widely between companies, a generic approach should be avoided, and such efforts be evaluated on a case-by-case basis, as part of the Affected Utilities stranded cost filings anticipated under R14-2-1607.G.

- Amounts prudently spent in connection with Affected Utilities' stranded cost mitigation efforts should be considered as a recoverable stranded cost.

- The preferred method for computing stranded costs is a "Net Revenues Lost" approach, which compares future revenue streams under a continuation of regulation with those that are estimated to be received in a competitive power market.

- Calculations of stranded costs should reflect the expected remaining cost recovery periods associated with the respective assets. That includes estimated service lives implicit in current book depreciation rates, the remaining contract periods under existing fuel and purchased power agreements, and remaining scheduled recovery periods for applicable regulatory assets and liabilities.

- In developing any estimates of the market clearing price for power for use in calculating stranded costs, caution should be exercised in emphasizing today's wholesale market prices, which may be unsustainable in the long run. The issue of market clearing price should be further studied, with the utilities bearing a strong burden of proof with respect to the reasonableness of any estimation method they choose.

- Estimates of stranded costs should be periodically trued-up to assure electric restructuring in Arizona is carried out in the public interest such that affected parties are neither unjustly benefited or penalized.

- The period for recovering stranded costs should be ten years.

- All power users, including new customers, self-generators, interruptible customers, and special contract customers, should be allocated an appropriate share of the stranded costs, but a distinction may be made between parties taking competitive power and those not, insofar as such difference reflects the fact that parties continuing to take standard offer service are paying for stranded costs in rates.

- The stranded cost charge should properly reflect the demand and energy characteristics of the underlying stranded costs.

- The Rules should contain some requirement that the proceeds from the stranded cost charges be used by the utilities to extinguish existing obligations, whether financial, such as debt or equity securities, or operating, such a long-term fuel and purchased power contracts.

- Parties advocating the imposition of price caps on the utilities, or the absorption of stranded costs by utility investors should provide specific details and/or justification with such recommendations.

- The Commission's Rules should be sufficiently clear with respect to stranded cost identification, quantification, and recovery such that the potential for mandatory accounting or tax write-offs is minimized.

- The Affected Utilities' stranded cost filings required under R14-2-1607.G should include detailed descriptions of the companies' proposed accounting for stranded costs and related revenues.

- Significant issues remain with respect to tax exempt securities and entities exempt from income taxation. Further analysis of these issues is necessary.

For purposes of preparing and distributing this report, it was agreed in the Working Group that, when the Utilities Division had completed drafting the report, copies would be distributed to all participants for comments about any significant omissions, misstatement of facts, typographical errors, or spelling mistakes. The parties providing

responses to the draft were: APS, TEP, AEPCO, and Energy Strategies, Inc. It was further agreed that when the report was in final form, it would be sent to all participants who would then be given an opportunity to file dissenting comments for inclusion in the report. Such comments appear as Appendix D to the report. The comments contained therein are an integral part of the report.

I. INTRODUCTION

The purpose of this report is to present the findings and recommendations of a special working group assembled to address the stranded costs that will occur with the introduction of retail competition in the electric utility industry in the State of Arizona.

On December 26, 1996, the Arizona Corporation Commission (the "Commission") issued Decision No. 59943 which approves rules (the "Rules") that specifically provide for a phased transition to a competitive retail power market. In connection therewith, the affected utilities are required to make at least 20% of their 1995 system retail peak demand available for competitive generation supply to all customer classes on January 1, 1999. The required eligibility will increase to 50% on January 1, 2001. Full competitive generation is scheduled to occur no later than January 1, 2003.

As will be more fully explained elsewhere in this report, stranded costs represent amounts previously spent in connection with the provision of traditional regulated utility service that are not likely be recoverable in a competitive power industry with prices set by the market, not elected or appointed regulators. Almost without exception this has been the most contentious issue in every state addressing retail electric competition. The Commission recognized the likelihood of the occurrence of stranded costs by including in the Rules a definition of this phenomenon associated with public utility deregulation (R14-2-1601.8), and also by including a specific section (R14-2-1607) addressing the recovery of stranded costs of affected utilities.

Rule R14-2-1607.C requires the creation of a working group comprised of representatives of all stakeholders and coordinated by the Director of Utilities, to develop recommendations for the analysis and recovery of stranded costs. Such a working group was created on March 4, 1997 at a meeting of interested parties in the Commission's Phoenix Hearing Room. As summarized in Appendix A attached hereto, more than fifty parties were represented in the Working Group and its subcommittees.

Rule R14-2-1607.D lists the key items that the Commission felt should be included within the scope of analyzing the stranded cost issue. These are:

- The impact of stranded cost recovery on the effectiveness of competition.
- The impact of stranded cost recovery on customers of the affected utility who do not participate in the competitive market.
- The impact, if any, on the affected utility's ability to meet its debt obligations.
- The impact of stranded cost recovery on prices paid by consumers who participate in the competitive market.
- The degree to which the affected utility has mitigated or offset stranded costs.
- The degree to which some assets have values in excess of their book values.
- The appropriate treatment of negative stranded costs.
- The time period over which stranded cost charges may be recovered.
- The ease of determining the amount of stranded costs.
- The applicability of stranded costs to interruptible customers.

- The amount of electricity generated by renewable generating resources owned by the affected utility.

When considering the above and other key issues surrounding stranded costs and their recovery at the first meeting of the Working Group, it was generally agreed that a more efficient approach would be obtained by establishing subcommittees to examine specific issue areas. Three such groups were created: a Calculation Methodology Subcommittee, a Recovery Mechanism Subcommittee, and an Accounting, Tax and Finance Issues Subcommittee. The latter was given responsibility for assessing the accounting, tax and financial implications of findings and recommendations of the other two subcommittees. A list of the meetings conducted by the Working Group and the subcommittees appears in Appendix B.

It should be noted that the scope of the investigation undertaken by the Stranded Cost Working Group and its subcommittees did not include any consideration of the legal issues (i.e. the "regulatory taking" issue or whether a legal contract actually existed with respect to the traditional "regulatory compact") relating to stranded costs. Such matters were addressed by the Legal Issues Working Group. The issue discussions and recommendations contained herein reflect solely the analyses performed by members of the Working Group and Staff's knowledge of traditional public utility regulation and ratemaking in Arizona, and electric restructuring activities currently underway throughout the nation.

Each of the subcommittees was required to submit a report to the Working Group at the conclusion of their analyses. The reports reflect the results of analyses and discussion of various issues papers presented by subcommittee participants. Such reports were the basis for discussion of the issues and subsequent votes taken by the Working Group.

Rule R14-2-1607.B states that the Commission shall allow recovery of unmitigated stranded costs by affected utilities. Although there was a clear recognition by working Group participants of the need for and propriety of stranded cost recovery in order to achieve an equitable and efficient transition to retail competition, there was considerable diversity of opinion with respect to the manner in which it should be quantified, the extent to which it should be recoverable, and the recovery mechanism to be used.

Rule R14-2-1607.E requires the Stranded Cost Working Group to file a report on its activities and recommendations by September 30, 1997. This report includes such findings and recommendations. To determine the extent to which a consensus exists with respect to any issue, a voting procedure was agreed upon by the Working Group. For that purpose, twenty parties representing a balanced cross-section of participating stakeholders were given voting authority. A voting roster is attached hereto as Appendix C. As indicated thereon, ten votes were to be from parties involved in the generation, transmission or distribution of electricity, five votes from parties representing consumer interests, and five votes from public interest groups and governmental agencies. It is noted that, pursuant to direction from the Chairman, the Utilities Division ("Staff") was not a voting party. It was further agreed by the participants that consensus would be said to exist when a two-thirds super majority, based on the number of votes cast, was received.

Throughout the remainder of this report are summaries explaining in detail the various issues analyzed by the Working Group and related subcommittees, along with findings and recommendations. While consensus on some issues has been achieved, it is disappointing to report that many issues are yet unresolved. Incorporated as Appendix D

to this report are the comments of parties not agreeing with the information contained herein. Such dissenting comments are intended to speak for themselves. This reflects the overall complexity of the stranded cost issue, the substantial dollar amounts involved, and the diversity of participating stakeholder interests. As in most of the other states considering retail competition, the Commission will likely have to decide among competing interests on many key issues.

II. DEFINITION OF STRANDED COSTS

Traditionally, public utilities have operated under licenses and franchises granting them the exclusive right to operate in specific geographic areas. This monopoly status was desirable because utilities are typically highly capital intensive, requiring a comparatively large plant investment relative to annual revenues. By eliminating the element of competition, it was believed that costs to the consumer were minimized, by avoiding the unnecessary duplication of services. To guarantee that such monopoly power was not abused, regulation was substituted for competition to bring about fulfillment of the objective of having an adequate supply of utility service at a reasonable price.

One of the primary tools of regulators was the ability to set prices for utility service through the determination of revenue requirements in public hearings. A utility has traditionally been permitted an opportunity to collect revenues equal to its prudently incurred costs of providing safe, reliable service to all that request it under the obligation to serve. In setting rates, utility regulators are not required or obligated to guarantee that

the companies will achieve their authorized returns, but only to be given a fair opportunity to do so.

Under their traditional obligation to serve, utilities have incurred certain long-term costs, which may not now be fully recoverable in a competitive generation market, with prices based on marginal costs. In the transition to retail competition, the utilities that undertook such investments must have an opportunity to recover the prudent cost of uneconomic assets and obligations which were made under a different set of circumstances.

Stranded costs typically arise when a customer leaves his host utility to buy power from another supplier and the cost savings the utility realizes by not having to meet the demand and energy needs of the departing customer cannot compensate for the revenue it loses because the customer is no longer paying regulated rates for power. They may also occur if the host utility must discount tariffed rates to a customer to retain that customer's business. The recovery of legitimate stranded costs is necessary to prevent cost shifting between customer classes, to treat utility investors fairly, and to promote efficient competition. Stranded cost recovery is mandated by the FERC in its wholesale competition rules, was affirmed in the 1996 Economic Report of the President, and has been endorsed by all the states moving toward retail competition.

This Commission properly recognized the potential for significant stranded costs to occur, and the need for the establishment of a mechanism for their recovery that is fair and workable to assure the development of efficient competition beneficial to all customers, by including consideration thereof in the Rules covering retail electric competition.

Rule R14-2-1601 contains ten key definitions relevant to electric industry restructuring. Included therein is the following:

> "Stranded Cost" means the verifiable net difference between:
>
> a. The value of all prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchased power contracts, fuel contracts, and regulatory assets), acquired or entered into prior to adoption of this Article, under traditional regulation of Affected Utilities; and
>
> b. The market value of those assets and obligations directly attributable to the introduction of competition under this Article.

One issue visited by the Calculation Methodology Subcommittee of the Stranded Cost Working Group was whether the current definition in the Rules was adequate. A number of parties' position papers indicated a preference for a definition that considers stranded costs as an aggregation of uneconomic costs incurred under the obligation to serve, rather than focusing on specific assets and liabilities of the affected utilities that may be recorded at amounts other than their current fair market values as is indicated in the existing definition. The proposed substitute definition tends to reflect expected reductions in future revenue streams when market-based revenues replace the traditional cost-based regulated revenues.

Staff also had difficulty in accepting the existing definition as written. As may be seen in the examples below, there are significant unrecorded assets and liabilities that may become stranded during the transition to retail competition. Staff views the existing Rule as ambiguous and possibly too limiting in that respect.

Over the years, this Commission has made certain "promises" in ratemaking, both explicit and implicit, to utilities under its jurisdiction that some current expenditures

would be recoverable through future rates. Generally, current expenditures deferred for future rate recovery are reflected as some type of "regulatory asset" on the respective utility's balance sheet. There are, however, instances where such amounts are not allowed under Generally Accepted Accounting Principles to be deferred for financial accounting and reporting purposes; thus, they are required to be charged to expense as incurred, regardless of the regulatory promise.

As an example, in Decision Nos. 57586 and 58497, this Commission required Tucson Electric Power Company to defer for future rate recovery certain portions of the non-fuel operations and maintenance expenses, depreciation and property taxes incurred at Unit No. 2 at the Springerville Generating Station. Such amounts represented what the Commission believed to be "excess capacity" costs, and were not recoverable in rates until after a later date when the unit became fully used and useful. Due to the uncertainty surrounding the date upon which recovery of these deferred costs would commence and over what period such recovery would occur, current accounting rules denied the recognition of a regulatory asset and required the Company to charge the respective amounts to expense in their entirety, notwithstanding the Commission's previous orders for deferral. As a result, that Company has a significant unrecorded regulatory asset that will likely become stranded during the transition to competition.

Another example of an unrecorded regulatory asset on the books of utilities in this State is that associated with postemployment benefits other than pensions. Until very recently, the Commission denied utilities' requests to adopt for ratemaking purposes the accrual method of accounting for such costs as has been required since 1993 under Statement of Financial Accounting Standards No. 106. Instead, it only allowed in rates

the recovery of current amounts paid for retirees' benefits, with the implicit promise that, as current accrued liabilities under SFAS No. 106 are ultimately paid in the future, they will be allowed in rates at that time. As a result, since the utilities in this State adopted SFAS No. 106 in 1993, they have had to charge to expense all related amounts not allowed in current rates, including both the difference between current accruals and cash payments, and the amortization of a transitional obligation as required under the Standard. For the affected utilities this has created another significant unrecorded regulatory asset.

In addition to unrecorded regulatory assets, there may also be unrecorded and potentially strandable contingent liabilities. These contingent liabilities can become recognizable liabilities under certain conditions, which thereby become a strandable cost to be allowed recovery. These could include take-or-pay obligations under existing fuel contracts and future demand charges under purchased power agreements that become uneconomic in a competitive environment, as well as the remaining, yet unrecognized portions of the obligations that will be incurred in connection with the closure of existing generating units at the end of their useful service lives.

Based on the foregoing, and in order to remove a potentially significant controversial ambiguity from the definition, Staff recommended to the Calculation Methodology Subcommittee that the phrase "both recorded and unrecorded" be included parenthetically immediately following the words "jurisdictional assets and liabilities" in the definition. The parties in attendance supporting retention of the definition in its existing form prevailed. When the issue was placed before the Stranded Cost Working Group, the current definition received support from fifteen of the eighteen voting

members present. There appears to be a clear consensus to leave the definition of Stranded Costs in the Rules unchanged.

III. COMPONENTS OF STRANDED COSTS

Rule R14-2-1607.G requires affected utilities to file estimates of unmitigated stranded costs. Such estimates are to be fully supported by analyses and by records of market transactions undertaken by willing buyers and willing sellers. A key consideration in the quantification of stranded costs is the categories of expenditures that should be included. This topic was thoroughly addressed by the Calculation Methodology Subcommittee.

Stranded costs resulting from the transition to a competitive electric industry may take many forms. There was general agreement among the Subcommittee members with respect to the types of costs that may be considered as strandable. These include:

- Generation Assets
- Purchased Power Agreements
- Fuel Contracts
- Regulatory Assets
- Employment Transition Costs
- Environmental Mandates

Clearly the most significant stranded costs are those incurred in connection with the generation of electricity, since that is the business sector which is being opened to competition. That includes utility-owned generation assets which may be comprised of net plant in service, construction work in progress, common plant associated with

generation-related activities, fuel inventories and handling facilities, and applicable materials and supplies. Such amounts may be offset by related accumulated deferred income taxes, unamortized investment tax credits or other related balance sheet reserves. Some utilities may also have leased generating assets that will become stranded. The calculation of stranded costs should reflect all generating units and other sources of power supply, whether above or below market. Fairness and equity demand that the benefits from units that may have bus bar costs lower than the market be used to offset the stranded costs of uneconomic units.

Potential stranded costs associated with generating facilities include not only the current capital costs of the facilities, but also the cost of their physical removal at the end of their respective service lives. Such amounts for the decommissioning of nuclear plants and disposing of nuclear waste are very significant. While clearly not as great, the costs of properly removing and disposing of fossil plants at their retirement from service may nevertheless be substantial. It is noted that, under the existing Rules, nuclear decommissioning costs are recoverable as part of the Systems Benefit Charge, rather than a stranded cost charge.

Purchased Power Agreements (including contracts with Qualified Facilities) under which utilities procure a portion of their capacity and energy supply requirements are another category of potential stranded costs. When the previously approved costs incurred under these contracts exceed market-based rates, otherwise unrecoverable costs will be incurred. It is appropriate to also consider within the context of stranded costs all obligations and commitments under existing fuel and transportation contracts.

Regulatory Assets are another type of potentially stranded costs. They represent current expenditures that have been deferred on the utilities' balance sheets for future expense recognition for accounting and ratemaking purposes. Such treatment is consistent with the long-standing principle followed by this Commission and other regulatory bodies in attempting to effectively synchronize ratepayer benefit with cost recovery. Regulatory assets may also be created for moderating the rate impact of uncontrollable or non-annually recurring events, or for promoting utility involvement in public policy initiatives. Examples of Regulatory Assets having stranded cost implications include:

- Previously flowed-through deferred income taxes
- Deferred Fuel Costs
- Deferred Demand Side Management Costs
- Deferred Pensions and SFAS No.106 Costs
- Unrecovered Plant and Regulatory Studies Costs
- Environmental and Storm Damage Costs
- Extraordinary Property Losses
- Deferred Contract Buyout Costs
- Unamortized Debt Losses
- Unamortized Phase-in or Rate Synchronization Costs

Another type of stranded costs is employee-related restructuring costs. Commissioner Irvin specifically requested that the Working Group consider the propriety of including such costs in stranded cost calculations. Included in this category may be the cost of retraining employees to perform their present tasks more efficiently or to

perform new tasks to properly transition the workforce for competition. This category may also include costs incurred to retrain or otherwise effectively and fairly prepare for separation of those employees that may not be retained as a result of company reengineering or downsizing to accommodate retail competition. Clearly a burden of proof would exist for the respective utilities to demonstrate that such costs would not be incurred absent the industry restructuring. Thus far, the regulators in the States of California, Michigan, New Jersey, Maine and Pennsylvania have provided for the inclusion of such expenditures in stranded cost recovery.

The final category of stranded costs identified by the Calculation Methodology Subcommittee is that associated with environmental mandates. This would include capital expenditures made to accommodate environmental regulations such as those occurring as a result of compliance with the Clean Air Act.

In identifying the types of costs to consider as being potentially strandable, it is noteworthy that several members of the Calculation Methodology Subcommittee were of the opinion that no capital costs added after December 26, 1996, the date of the Commission's Decision creating the Electric Restructuring Rules, should be allowed for inclusion in stranded cost calculations. The parties believe that the Commission's Decision effectively put the utilities on notice that such subsequent investments should be considered to be at risk in the marketplace. This is not unlike the position of the FERC in Order No. 888 whereby utilities will be allowed to recover wholesale stranded costs associated with contracts executed after July 11, 1994 (the date of the initial FERC stranded costs rulemaking notice) only if specific stranded cost provisions are contained in the contract.

Although the focus of this analysis was directed toward potentially strandable generation costs, Staff believes that it is appropriate to recognize that, to the extent any portion of the affected utilities' distribution business (i.e. customer metering and billing) is similarly removed from the scope of regulation, additional stranded costs may result.

At the voting meeting of the Stranded Cost Working Group, a very strong consensus (16 for, none against, with 2 abstentions) was achieved with respect to the list of possible components of stranded costs previously identified above, and with the Calculation Subcommittee's recommendation that a burden of proof is on the affected utility to justify all requests for stranded cost recovery. It was also clear that a strong consensus exists with respect to the position that any interested party may oppose or challenge the inclusion of any particular element of an affected utility's stranded cost calculations. Staff recommends that the Rules be modified to more clearly reflect these positions. As an additional clarification of the Rules, Staff also recommends that the Commission state its intent of whether nuclear fuel disposal costs are to be part of the nuclear decommissioning costs recovered in the System Benefits Charge as provided in R14-2-1608.A, or whether they should be considered as stranded costs. There were differing interpretations among Working Group participants.

IV. MITIGATION OF STRANDED COSTS

Rule R14-2-1607.A requires affected utilities to "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." As part of its analyses, the Calculation Methodology Subcommittee considered the issue of

mitigation and the ways that mitigation could occur. Although no specific recommendation by the Subcommittee was made to the Working Group, there was general agreement among the parties that utilities should aggressively pursue ways to mitigate or otherwise reduce stranded costs. The participants had various views on the different mitigation techniques available.

In considering the development and adoption of mitigation strategies, it is important to consider that a significant portion of stranded investment represents sunk costs or obligations which, by definition, cannot be mitigated. They can only be reallocated or offset by additional revenues. Accordingly, many mitigation proposals are merely targeted to shift the obligations between utility investors, consumers, taxpayers, wheeling customers or independent power producers. As a result, not all mitigation strategies being advanced are necessarily based on considerations of fairness or equity when the ultimate bearer of this financial responsibility is identified.

Mitigation can be achieved in two primary ways: cost reduction and containment efforts and revenue enhancement strategies. Mitigation can occur when affected utilities reduce and bring generation and operating costs in line with those of the market. This may be accomplished by reducing operating costs (both labor and non-labor) through productivity and efficiency gains, and by repowering or retrofitting plants and replacing inefficient generating units and equipment as well as improvements that facilitate fuel switching. Another mitigation tool available with significant cost reduction potential is the renegotiation or buy-out of above market, or otherwise uneconomic, fuel, transportation, or purchased power contracts.

Stranded cost mitigation may also occur when affected utilities are able to generate additional sources of revenue. Such efforts may include the development of new energy sales opportunities at prices above the respective utility's actual variable fuel and O&M costs, the sale of existing excess utility-owned capacity and purchased capacity rights, and the sale of emission (SO2 and NOx) credits. It is believed by Staff that utilities with substantial transmission capacity will find marketing to be a more effective strategy than will utilities without sufficient interconnection possibilities. It should be noted that there exists substantial disagreement between the utilities and other members of the Subcommittee with respect to the extent to which revenues from non-utility activities of the companies or their affiliates may be considered as sources of funds for mitigating stranded costs. The utilities do not believe non-utility revenues should be considered as available for mitigating stranded costs, while other parties believe such was intended by the language appearing in R14-2-1607.A. For example, TEP believes that profits from activities that are unrelated to the provision of electricity in Arizona, that do not require the use of assets that were required to serve electric customers in the State, and that are at risk to the utility's shareholders (but not ratepayers) should not be considered as a source of funds to offset stranded costs. Energy Strategies, on the other hand, feels that mitigation measures may include any activity that can reasonably be expected to reduce stranded costs. If the retail access environment provides an Affected Utility with the opportunity to provide new or expanded services, such as home security services, they believe that any net revenues derived therefrom should be an offset to stranded costs.

A third way that stranded costs may be mitigated is through the accelerated depreciation of generation assets or the accelerated amortization of regulatory assets.

Unless, however, the accelerated expense recognition is accompanied by commensurate cost recovery, this mitigation is merely a transfer of wealth from utility investors to consumers. One way for this technique to achieve true mitigation is for it to be accomplished via some type of existing rate freeze or negotiated earnings sharing agreement between the respective utility and its regulators.

Another hybrid approach intended to "mitigate" stranded generation costs can be seen in accounting gimmickry proposed by several large utilities attempting to offset "overvalued" net generation assets with existing investments in transmission assets. Implicit in such proposals is an assertion that the companies' transmission assets are grossly undervalued relative to their current replacement costs. Such under-valuation arguably may be attributed to difficulties in replacing transmission facilities because of: growing environmental and health concerns, problems associated with acquiring new rights-of-way, and decreased availability of land. By offsetting over-valued generation with undervalued transmission, a mitigating effect was said to occur. In its proposal to the Michigan Public Service Commission, Consumers Power requested approval for the simultaneous creation of an additional $635 million of transmission assets (based on a study of reconstruction costs), and reduction of a like amount of the Company's embedded investment in generation assets. Somewhat similar proposals were also submitted by Southern Cal Edison and South Carolina Gas & Electric to their respective state regulators. Although the Michigan PSC did permit Consumers to do some recasting of book depreciation provisions between generation and transmission assets, this offsetting technique has not been widely accepted by regulators, either Federal or state, as a mitigation strategy.

Among the positions taken by Subcommittee participants with respect to the mitigation of stranded costs was that of Salt River Project who believes any such consideration must recognize efforts already taken by affected utilities. Representatives of the large industrial consumers opined that utilities seeking to recover stranded costs should be required to file a mitigation plan outlining their program. AEPCO expressed concerns that because Arizona cooperatives are also regulated by the Rural Utilities Service and operate under extensive Federal rules, their flexibility is limited.

Staff believes that it is not unreasonable to require an affected utility to take appropriate and prudent measures to mitigate stranded costs. However, because the circumstances of what constitutes reasonable and prudent mitigation efforts can be expected to vary widely between companies, a generic approach for analysis should be avoided. Mitigation efforts should be evaluated on a case-by-case basis. Moreover, it is important to note that mitigation efforts themselves may generate additional strandable costs. Accordingly, Staff recommends that the Rules be modified with respect to stranded cost mitigation only to the extent that they will permit each Affected Utility to independently demonstrate that their mitigation efforts were reasonable and cost-beneficial, based on all relevant facts and circumstances. Moreover, Staff recommends that amounts prudently spent in connection with mitigation be properly considered as a recoverable stranded cost.

V. CALCULATION METHODOLOGY

The principal objective of the Calculation Methodology Subcommittee of the Stranded Cost Working Group was to evaluate and respond to the Retail Electric Competition Rules as they presently exist, relative to possible stranded cost calculation methodologies. In their present form, the Rules contain no specific guidance with respect to the manner in which stranded costs should be quantified; however, included among the factors for the Working Group to consider in developing our recommendations is the ease of the calculation (R14-2-1607.D.9).

It was agreed by the participants that an acceptable calculation methodology had to have the following characteristics:

- It should be reasonable, fair, and equitable.
- It should be nondiscriminatory.
- It should promote economic efficiency.
- It should provide a reasonable opportunity for the affected utility to recover stranded costs.

Stranded costs will vary significantly between both utilities and those parties attempting to quantify stranded costs. This is attributable not only to actual or perceived differing facts and circumstances existing between the companies, but also to the assumptions made with respect to critical variables in the process. Assumptions having a significant effect on stranded cost quantifications include categories of includible costs, retail market share, the market clearing price for power, and the number of years implicit in the calculation process.

Two predominant approaches exist for quantifying stranded costs. *Administrative approaches* essentially represent negotiations between utilities and their regulators. They

are an attempt to quantify stranded costs on the basis of estimates and other expectations of the future market prices and asset values. *Market valuation methods* use observed valuation of assets in a current market context, such as through auctions, asset sales or the divestiture of assets. In both cases, the market value (administratively determined or actual) is compared with regulated value to determine the level of stranded costs. Thus far, it is clear that no one broadly accepted and recognized methodology has emerged in the industry.

The Subcommittee participants advanced two administrative methodologies for quantifying stranded costs and two market-based approaches. The administrative methods are the *Net Revenues Lost* approach and *Replacement Cost Valuation* approach. The market valuation methods include *Auction and Divestiture* and *Stock Market Valuation.*

Net Revenues Lost

The "Net Revenues Lost" approach is a top-down quantification method that compares the expected future annual revenue requirements for the affected utility's generation business under traditional cost-based regulation with the annual revenues expected to be recovered in a competitive generation market with prices based on marginal cost. It recognizes that utilities that made multiple investment decisions under the traditional regulatory paradigm expected a revenue stream from customers to cover the cost of such investments over their useful lives. Under this scenario, stranded cost is measured as the net present value of the annual differences between the expected revenues under a continuation of regulation and those likely to be received after the introduction of retail competition. It is the manner by which the FERC in its Order No.

888 has directed companies subject to its jurisdiction to quantify wholesale stranded costs.

Within the Calculation Methodology Subcommittee the principal advocates of this approach were the investor-owned utilities, SRP, and AEPCO. The chief opponents were the independent power producers and consumer representatives.

Among the principal advantages cited supporting the use of this approach are:

- It considers all of an affected utility's generation costs under traditional techniques understood by regulators, utilities, and other usual participants in the ratemaking process.
- It allows the calculation to reflect both above-market and below-market assets and costs.
- It properly reflects a declining rate base investment in generation plant and regulatory assets as such sunk costs are recovered through periodic depreciation and amortization.
- It is a relatively simple mathematical calculation once relevant assumptions are known.
- It can accommodate periodic true-up to reflect the effect of changes in market prices or other market conditions.
- It allows the analysis of impacts on specific customer classes.

Some Subcommittee participants cited disadvantages of this methodology, including:

- The calculation may reflect certain costs (i.e. fuel costs, administrative costs, etc.) that some parties feel are more appropriately characterized as business risks rather than stranded costs.
- Due to the long lives of generation plants and purchased power agreements, there is a great deal of uncertainty associated with the calculation period.

- Due to such a high level of uncertainty, it will require public hearings that may become very contentious, time-consuming, and costly.

- It will prolong the involvement of regulators in the competitive segment of the electric business.

- It may create disincentives to reduce costs.

The major difficulty in applying the revenues-lost approach is that it is highly dependent on current estimates of the future market clearing price of power, market share, and assumptions about off-system sales over the calculation period. As more fully explained later in this report, the market clearing price is influenced by a number of difficult-to-predict factors.

Replacement Cost Valuation

A second administrative methodology that may be used to quantify stranded costs is that which intends to compare an estimate of the market value of generation assets with their actual recorded net book value. The key is to arrive at a fair and reasonable estimate or appraisal of the fair market value. Among those parties advocating this calculation method were industrial consumers, the Public Interest Coalition on Energy, and the Land and Water Fund of the Rockies.

One such approach advanced in the Subcommittee was "Replacement Cost Valuation." Under this methodology, stranded cost is computed on a bottom-up, asset-by-asset basis, as the difference between the reported net book value of generation assets and their current replacement value (a proxy for market value) based on the most cost-effective technology available in the market, a gas-fired combined cycle combustion turbine. The current market value of regulatory assets would be presumed to be zero.

This approach produces a direct measurement of asset values at a single point in time, as compared with the annual calculations required under the revenues-lost method. This was the approach used by the California utilities in their filings for estimated 1998 transition costs. As with any of the four methods discussed herein, there are both advantages and disadvantages to cite. The perceived advantages include:

- The accounting treatment is relatively straightforward.
- The need to forecast future electricity prices is avoided.
- It provides specific asset values in a competitive market.
- Using the replacement cost as a proxy for long-run marginal cost, stranded costs are computed based on long-term values rather than temporary price phenomena.
- The need for periodic, lengthy regulatory proceedings is obviated.

Among the disadvantages cited are:

- Many stranded costs would not be covered by this approach.
- What constitutes the most cost-effective technology available and how that may be translated into an asset value may be very contentious.
- The replacement cost may not accurately reflect the composition of factors (i.e. level of available excess capacity in the market) underlying the market clearing price for power in the region.
- The method involves much uncertainty, and with no opportunity for subsequent true-up, there is strong potential for significant under or over recovery of stranded costs.

Auction and Divestiture

One of two market valuation methods is the "Auction and Divestiture" approach advanced by Citizens Utilities. The basic procedure would have the utilities actually submit their assets for bidding and sale in an independent auction. Stranded costs would then be measured as the difference between sales proceeds and reported net book values. A key result will be that successful bidders bear all risks of forecast errors. This method has been used in other states such as Massachusetts, Vermont and at least to a certain extent in California. Recently, the New England Electric System reached an agreement to sell 18 power plants while Pacific Gas & Electric announced an upcoming auction of three of its fossil generating plants. It must be noted, however, that such action was not only to address stranded costs, but in some instances to also mitigate market power in generation. Under the California restructuring plan, PG&E and Southern Cal Edison are required to sell enough of their fossil-based power plants to ensure they compete fairly with other power suppliers in the State without having an edge in the generation market.

The advantages cited by those advocating this forced sale of assets include:

- Stranded cost calculations are based on actual market values, thereby avoiding the estimation process.
- It does not require contested hearings or periodic true-ups.
- Market power can be reduced or eliminated.
- Utilities desiring to maintain ownership of certain of their assets may participate in the bidding process.
- In recent years, auctions have been replacing regulatory administrative procedures in a number of areas, such as with the FCC auctions of various segments of radio spectrum.

The reasons given by parties for opposing auctions and divestitures are many, including:

- Costs for preparing the assets for sale and administering the auctions are difficult to predict, but will certainly add to the stranded cost totals.

- A forced sale of all assets within a very short time frame may lead to "fire sale" prices.

- Uncertainty exists with respect to how many parties might participate in an auction of generating assets in Arizona.

- Tremendous administrative hurdles such as unwinding current power supply contracts, soliciting stockholder approvals, and obtaining the releases of mortgaged property from bond trustees will be very complicated, costly, and time consuming.

- The Commission lacks the authority to order such asset sales and divestitures.

- Given the great uncertainty that presently exists with respect to the future competitive retail electric market, such action may not produce more accurate estimates of stranded costs.

- There are substantial restrictions under the Atomic Energy Act and Nuclear Regulatory Commission regulations on the transfer of the ownership and operating licenses of nuclear generating facilities that will severely limit the field of potential bidders.

- The new open-access transmission rules sufficiently mitigate the potential for exercising market power in generation, thereby rendering moot a perceived key benefit of auctions.

Stock Market Valuation

The other market-based valuation method considered by the Calculation Methodology Subcommittee was offered by the Goldwater Institute. Using the "Stock Market Valuation" approach to quantify stranded costs, utilities would be required to split

their common stock into two new classes. Each existing common share would be exchanged for one share of Class A Stock and one share of Class B stock. The traditional stockholder benefits and rights would continue for the Class A shares. The Class B shares would give holders sole claim against any stranded costs to be recovered by the respective utility. After some appropriate predetermined stabilization period (i.e. six months), stranded costs for the company would be computed as follows:

Net Book Value of the Company

\- Average Market Value of Class A Stock

= Measured Stranded Costs

The party advocating this methodology suggested that, prior to the stock split, it be established that the actual stranded cost payments to be made to Class B shareholders would be something less than a full 100% of the above amount in order to encourage the mitigation of stranded costs, and to remove any incentives for the possible "exaggeration of stranded costs through lowering the value of the stock prior to the stranded settlement determined under this formula."

The advantages of this market-based mechanism include:

- It establishes a more objective measure of stranded costs and is easier to apply than the administrative approaches.
- It is an up-front method that does not require periodic revisiting.
- It is fair to both shareholders and consumers since it accounts for all of a utility's assets, both those above and below market.

The perceived disadvantages of this method include:

- Obtaining the necessary administrative, corporate, and regulatory approvals may be quite complicated, time-consuming and costly.

- Stranded cost recoveries paid to Class B stockholders would not be available to service some of the debt of the organization.

- Several of the entities (i.e. the cooperatives) incurring stranded costs do not have common stock.

- There is no assurance that this type of proxy valuation will produce measurements of stranded costs that are more accurate than the administrative methods cited.

At the voting meeting of the Working Group, the four methods were presented to the participants to ascertain the extent to which any consensus may exist. The eighteen voting parties present cast their ballots in the following manner:

Net Revenues Lost	-	9 votes
Replacement Cost Valuation	-	7 votes
Auction and Divestiture	-	1 vote
Stock Market Valuation	-	1 vote

Based on the foregoing, according to the agreed upon criteria previously described, there is no clear consensus among the members of the Working Group as to the recommended method for Affected Utilities to use in computing their stranded costs. It is clear, however, there is a strong preference (i.e. sixteen of the eighteen votes cast supported one of the two administrative methods) by the participants for use of an administrative approach.

It is Staff's belief that, notwithstanding the lack of a clear consensus, the preferred method for computing stranded costs, and that which we recommend for the Commission

to incorporate into the Rules, is the Net Revenues Lost method. While it did not receive a super majority, it was the method receiving the greatest support of those voting members present. No method is without disadvantages or probable significant controversy. It is, however, a method that has been adopted by the FERC and other states, and is one which most closely mirrors the ratemaking process with which all parties involved in traditional utility regulation in this State are familiar.

VI. CALCULATION PERIOD

There are two time periods warranting consideration in connection with stranded costs. The first is the period over which stranded costs are computed when using administrative approaches. The second is that over which stranded costs may be recovered. The former will be addressed here, while the latter is considered later herein.

The time period over which stranded costs are computed will affect their overall quantification. With respect to wholesale stranded costs, the FERC applied a reasonable expectation standard in determining whether a utility reasonably incurred costs on behalf of departing customers. In arriving at the exit fee to be charged to departing customers, the difference between average annual revenues over the three years prior to the customer's departure and either the utility's estimate of revenues it can receive by selling the released capacity and energy, or the average annual cost to the customer of replacement capacity and energy under commitments with new suppliers, is multiplied by the number of years the utility could have reasonably expected to continue to serve the departing generation customer. Such provision is applicable to wholesale power contracts executed before July 11, 1994, that do not contain specific exit fees or other stranded cost

provisions. For contracts executed after that date, stranded costs are recoverable only if they are provided for explicitly. This reflects the FERC position that, under the former, there was a reasonable expectation of the utility continuing to serve the customer beyond the current contract term, while the latter reflects the position that FERC effectively put companies on notice of fundamental changes in the industry with its initial stranded cost rulemaking proposal in 1994.

Reasonable expectation, in Staff's opinion, is also relevant in quantifying retail stranded costs. The focus, however, should not be on individual customers, but the entire retail load. In determining the appropriate time period over which such computations should be made, a principal consideration is the fact that, under the traditional obligation to serve, utilities incurred significant obligations on behalf of their customers. Using very long planning horizons, companies undertook construction programs to assure there was sufficient and reliable capacity over the long term. These costs were incurred by the respective utilities to fulfill their retail franchise obligations to serve customers directly under the promises that competing entities would not provide direct retail service, and that there would be a fair opportunity to recover the prudent investments that had been made. Under traditional ratemaking, the costs of long-term investments were spread over their estimated useful service lives, with the intent of properly synchronizing cost recovery with ratepayer benefit. Under this traditional paradigm, there was a reasonable expectation that utilities would be given a fair opportunity to recover such costs over the periods the assets would be used in connection with the provision of retail service. The accurate quantification of stranded costs must appropriately consider the expected remaining cost recovery periods associated with such assets that were anticipated and

reflected in the traditional ratemaking process. Imposing some limit on the period for quantifying stranded costs would not only deny the Affected Utilities a reasonable opportunity for full cost recovery, but would also deprive ratepayers of the potential benefits from recognizing the declining net rate base investments occurring over time. If ratepayers are required to pay these costs, they should receive the benefit of lower costs as the asset becomes more fully depreciated and its fixed costs are lower. For the same reasons that stranded cost recovery is deemed appropriate, Staff believes that recognizing the full expected cost recovery period is also appropriate when quantifying stranded costs. That would mean reflecting the remaining estimated service lives implicit in currently approved book depreciation rates for generation assets, the remaining contract periods under existing purchased power agreements, and the remaining scheduled amortization periods for all regulatory assets.

The period over which stranded costs should be computed was not discussed in any great detail in the Calculation Methodology Subcommittee, nor was it voted upon by the Working Group. Accordingly, no consensus with respect to this issue has been established. Staff recommends that the Rules be expanded to clarify that, in connection with the use of administrative methods to quantify stranded costs, the expected remaining cost recovery periods implicit in current service rates, be considered.

VII. MARKET CLEARING PRICE

The most critical variable in attempting to quantify stranded costs is that of the expected market clearing price of power over the calculation horizon. It is implicit in most stranded cost calculation methodologies. Estimates of the market price are

necessary for projecting future annual revenues under the Net Revenues Lost approach. Moreover, if one may assume that a prudent investor factors future revenue streams into the process of deciding upon the extent to which funds are to be committed, then estimates of the market clearing price for power may reasonably be assumed as being implicit in the bids that would be offered in connection with the Auction and Divestiture approach.

There are significant risks in estimating the market price for power. If the estimates are too high, the quantification of stranded costs will be understated. Conversely, if the estimates are too low, then the quantification will be overstated. The party ultimately bearing the risk of such estimates will largely be dependent upon the calculation method selected and whether there will be opportunities for subsequent revisions to the estimates.

Conceptually, in a deregulated electric industry, the market clearing price will approach long-run marginal cost. Attempting to forecast such prices is a most difficult undertaking. Among the factors affecting the market price are: customer demand, market structure, generation and transmission capacity availability, generation fuel mix and costs, business decisions made by competing independent generators, interest rates and inflation, developments in technology, and new laws and regulations. Moreover, a clear definition of what constitutes the relevant market has yet to be decided. Any current estimate will be speculative at best.

Other states considering retail competition have considered a variety of ways to establish the market price for power for purposes of quantifying stranded costs. In California, for example, the utilities will use a market rate of 2.4 cents/kilowatt-hour to estimate transition costs in 1998. It represents estimated short-run avoided costs for the

year, and will be trued-up at a later date. Ultimately, the California Power Exchange price will be used once that market is established.

In Michigan, the stranded cost recovery plan to be used by Detroit Edison is based on a 2.5 cents/kilowatt-hour market clearing price for 1997, based on a regional cost analysis using data from the Michigan Electric Coordinated System. The Michigan PSC requires such estimates to be trued-up annually.

Several members of the Calculation Methodology Subcommittee had opinions as to how the market clearing price for power should be determined for purposes of quantifying stranded costs. Energy Strategies believes that, for the short term, market price should be established by use of an index of retail electricity prices in markets (including California) open to the Affected Utility. For the long term, it should be based on the long-term replacement cost of generating capacity and forecasts of future fuel and operating costs. The Land and Water fund urges caution in using any single price at a given time as representing the "market." AEPCO mentioned the possibility of using a published index (i.e. Dow Jones Palo Verde electricity index) to define a market clearing price. However, they caution against use of such an index since during the transition to competition, as some present indices may reflect unreasonably low current prices of new participants trying to establish a foothold in the market. As a starting point, they suggest using an average base, computed by summing all electric revenues for capacity and energy annually for the State of Arizona and dividing that number by kilowatt-hours sold during the same time frame. Fort Huachuca opines that the market clearing price should reflect actual market transactions. If feasible, an Arizona power flow/price model should be developed to assist in the forecasting process. Staff would urge caution in the use of

today's wholesale power market prices as being reflective of future prices. Distortions in the market have created pricing trends that are likely unsustainable in the long run.

There was no consensus established within the Calculation Methodology Subcommittee as to the most appropriate way to measure or project the market price for power, nor was any vote on this issue taken by the Working Group. Staff is of the opinion that the parties should continue to study this matter. For purposes of the required stranded cost filings to be made by the Affected Utilities, they should bear a strong burden of proof as to the reasonableness of whatever estimation method they may incorporate into their respective applications. Such burden of proof should be tempered by the extent to which there will be an opportunity for subsequent, periodic true-up. As retail competition becomes firmly established in Arizona, a standard measure of market price that can be used by all Affected Utilities in quantifying stranded costs may be adopted.

VIII. TRUE-UP MECHANISM

As noted previously, there is considerable uncertainty in attempting to quantify stranded costs. Not only is the estimated market price of power critical to the process, but other factors may affect the outcome as well. These include output supplied, success of mitigation efforts undertaken, and length of the calculation period. As a result of such uncertainty, the quantification of stranded costs is subject to a wide range of outcomes. This is particularly true with respect to the use of administrative calculation approaches where the Affected Utility retains ownership of the stranded assets. A key question is whether it is reasonable to lock utility customers or investors into a single up front forecast of stranded costs.

The obvious solution to such concerns is the use of some type of periodic revisiting of the stranded cost calculations. An ongoing approach reduces the risks of estimation. Moreover, where such factors as market price indices, production profiles, and avoidable benchmark values are reconsidered, the result is a fairer, more accurate stranded cost recovery process. To the extent that the use of some type of true-up mechanism is agreed upon, the next questions to ponder are the frequency of the revisiting and the components of the calculation subject to updating.

The positions of the Calculation Methodology Subcommittee were varied. AEPCO, APS, Fort Huachuca, TEP, and SRP supported a true-up in one form or another, while the Arizona Consumers Council felt a true-up could "skew the numbers," and that it was important for all parties to know in advance what their obligation would be so they could adequately plan for retail competition. For those parties recommending auctioning or divesting stranded generation assets, this inquiry was moot.

As for the frequency of such an undertaking, AEPCO felt biennial revisits would suffice, while SRP believed annual true-ups would be more appropriate.

The opinions on the factors to be considered in a periodic update were also varied. AEPCO believes that, in addition to changes in the market price of power, other adjustments might include depreciation lives or amortization periods, the effect of changes in maintenance practices, and other cost savings. They also believe that over- or under-recoveries should be subject to prospective inclusion in recomputed stranded cost charges. APS recommends that adjustments to stranded cost estimates be prospective and only reflect material changes in assumptions. It is their opinion that dollar-for-dollar true-ups would take away the incentive to improve. This is counter to the position of Fort

Huachuca who recommends that all valuation factors, regardless of method used, should be subject to change at the time of true-ups. SRP feels that true-ups should focus on three areas: 1) adjusting forecasted sales to actual, 2) adjusting forecasted market price to actual, and 3) adjusting costs downward only.

The subject of periodic true-ups to the stranded cost calculations was presented to the Working Group for consideration and voting to establish whether any consensus of position exists among the participants. Specifically, two issues were put to a vote. First, the voting members were asked: "Should there be a periodic true-up of quantified stranded costs?" The response included seven in favor, five opposed, with six abstentions. While there was a simple majority, under the agreed upon threshold, there was no consensus. The second issue placed before the voting members was "If there is to be a periodic true-up, at what interval shall that occur?" The response was quite mixed:

One year	1 vote
Two Years	2 votes
Other	6 votes
Abstain	9 votes

Clearly there exists no widespread agreement within the Working Group as to whether there should be any revisiting of the stranded cost calculations once made and accepted by the Commission.

Staff strongly supports the concept of a periodic true-up as being necessary to assure that electric restructuring in Arizona is carried out in a manner that protects the public interest. Such a revisiting does not have to guarantee a dollar-for-dollar recovery, but at a minimum, should enable prospective adjustments of the stranded cost charge to reflect

major uncontrollable variables, particularly the market clearing price for power. We believe that a true-up mechanism will guarantee that any unanticipated variances are corrected on a timely basis and that the stranded cost charge to be paid by consumers is equitable. Rule R14-2-1607.L, which states that the Commission may order regular revisions to stranded cost estimates, should be clarified to provide for annual revisiting of the stranded cost calculations.

IX. COST ALLOCATIONS

Once stranded costs have been properly computed, the next step before developing a recovery mechanism and charge is to establish the manner by which such costs are to be allocated jurisdictionally and between customer classes. The jurisdictional allocation is necessary to properly segregate the Affected Utility's stranded costs between its wholesale business activities subject to FERC regulation, and its retail business subject to jurisdiction by the Arizona Corporation Commission and regulators in any other state in which the company operates. Once the Arizona retail portion is known, it is then necessary to properly and equitably distribute the costs between the various customer classes such as residential, commercial, and industrial.

The principal concern with respect to the cost allocation issue is that there be no inappropriate cost shifting between jurisdictions or customer groups. The method used must be fair and reasonable. It is noted, however, that over time allocation ratios will change as the underlying embedded costs and customer composition and usage patterns change. Such changes may be included within the scope of any true-up mechanism that

might be adopted by the Commission in connection with stranded cost calculation and recovery.

Of the various matters addressed by the Working Group and its subcommittees, there was greater unity on this issue than any other. The Recovery Mechanism Subcommittee made the following recommendation to the Working Group:

> Stranded costs should be allocated to jurisdictions and classes in a manner consistent with the specific company's current rate treatment of the stranded asset in order to effect a recovery of stranded costs that is in substantially the same proportion as the recovery of similar costs from customers or customer classes under current rates. (For example, stranded generation assets should be allocated using the demand allocation method used for production plant.) Updated rate design to correct flaws in current design would be acceptable.

At its voting meeting the Working Group specifically considered the above recommendation as written. It received an overwhelming majority of nineteen of the twenty voting members present. Accordingly, Staff recommends that the Commission incorporate into the Rules a requirement that stranded costs be allocated jurisdictionally and between customer classes in the manner described above.

X. RECOVERY MECHANISM

In establishing an appropriate mechanism for the recovery of stranded costs, there are a number of key considerations. These include the type of charge to be made, the parties to whom it will be assessed, and the time period over which it will be levied.

In addressing this issue, the participants in the Recovery Mechanism Subcommittee of the Working Group agreed that the stranded cost recovery mechanism should:

- Be reasonable and timely;
- Be fair, equitable and nondiscriminatory;
- Promote economic efficiency; and
- Provide reasonable opportunity for Affected Utilities to recover stranded costs.

Stranded cost recovery mechanisms fall into two principal categories: direct customer assignment and global. The direct customer assignment approach calculates the level of stranded costs directly assignable to each customer leaving the system. This is based on the principle of cost causation and is the method adopted by the FERC for recovery of wholesale stranded costs. At the wholesale level it is feasible to effectively administer this method because of the relatively small number of contracts involved. A global approach involves some type of across-the-board charge or a general tax, based on the concept that electric restructuring will bring overall benefits to society in general. In other words, all consumers will ultimately benefit. This theory is consistent with the manner in which stranded costs were spread in the deregulation of the gas pipeline industry, and the way in which the interstate portion of the costs of non-traffic sensitive plant was assigned when the interexchange business segment of the telephone industry was deregulated. It is also implicit in the current property tax mechanisms in most states whereby some portion of all citizens' tax payments support the public schools, whether or not the taxpayers actually have children attending school.

The Rules are silent with respect to any specific recovery mechanism. Rule R14-2-1607.H permits an Affected Utility to request Commission approval of "distribution charges or other means of recovering unmitigated stranded costs from customers who reduce or terminate service from the Affected Utility as a direct result of competition.."

Rule R14-2-1607.I provides that "The Commission shall...determine for each Affected Utility....appropriate Stranded Cost recovery mechanisms..." Finally, Rule R14-2-1607.J states "Stranded Cost may only be recovered from customer purchases made in the competitive market using the provisions of this Article".

The Subcommittee considered three mechanisms for recovering stranded costs: a variable charge based on kW/kWh usage, a fixed fee (including but not limited to, an exit fee) independent of consumption, and an access fee levied on competitive suppliers.

Many of the participants preferred the first alternative. TEP believes a wires charge applied to all customers on a per kWh basis, based on the last three years of consumption for a particular customer class, is consistent with the objectives. APS feels the charge should be spread over as wide a base as possible and should be based on a $/kW or cents/kWh, or a combination thereof, depending on the customer class. SRP also stated a preference for a non-bypassable kW/kWh usage charge, but with no exit fees. Fort Huachuca took a similar position, but recommends an exit fee option for customers with demands exceeding one MW.

Several of the consumer groups also stated a preference for a wires charge, but consistent with the Rules, they believe it should only apply to those parties choosing to enter the competitive market. They also recommend that some of the stranded costs be borne by the utilities' investors and new entrants into the power generation market.

PG&E Energy Services stated their opposition to stranded costs being assessed to new competitive power providers by asserting it would create barriers to market entry. That position was echoed by Energy Strategies who also stated that such assessment is inappropriate because there is no cost causation justifying such treatment. Staff notes

that there is some historical basis for such far-reaching assignment of costs between customers and new market participants as competition is introduced to a portion of a traditionally regulated industry. As the long distance segment of the telephone business was deregulated, the interstate portion of the costs of the non-traffic sensitive local loop was assigned to both the end users (as a subscriber line charge) and competing long distance carriers (as a carrier access line charge). It is noted, however, over time, the obligation of the competing carriers has been reduced with a larger share being assumed by the end user customers.

To summarize the parties' positions, the principal advantages cited for a non-bypassable across-the-board kW/kWh charge to all consumers were:

- Costs are apportioned by demand and energy usage levels resulting in all customers appropriately paying their fair share of stranded costs.
- It is easily understood and mirrors existing electric rate and pricing practices.
- It allows for a clear delineation of the impact of stranded costs on rates.
- It is supported by existing metering technology and is relatively easy to bill and administer.
- It properly recognizes the overall societal benefits of electric restructuring in the long run.

The principal disadvantages are:

- Basing stranded cost recovery on future usage may impact future purchasing decisions.
- Consumption based charges could affect decisions about business expansion or location for energy-intensive industries.

- The Rules only permit recovery from parties taking competitive power.

- Imposing stranded costs on new market participants is anti-competitive.

Support for a non-usage based, fixed fee for stranded cost recovery was provided by Citizens Utilities and the Goldwater Institute. Both believe that a usage based recovery mechanism does not comport with sound economic principles and may result in future adverse effects on consumption, thereby exacerbating the stranded cost problem. Notwithstanding its stated preference, TEP indicated it would not oppose a fixed charge recovery mechanism, such as a meters charge, as long as it was established consistent with customer class cost characteristics and usage patterns. The major factors supporting a fixed fee cited by the parties include:

- It has minimal impacts on consumption.

- It reflects the fact that most stranded costs are fixed.

- It can minimize the potential for over-/under-recoveries.

The principal disadvantages cited include:

- A fixed charge may be unfair to lower use consumers and may not give sufficient consideration to the customer's ability to pay.

- It may encourage uneconomic consumption based on short-run marginal cost.

Any determination of an appropriate stranded cost recovery mechanism should also consider the effect of and on new customers, departing customers, self-generating customers, interruptible customers, special contract customers, and municipalization.

With respect to new customers, there was general agreement within the Subcommittee that they should pick up their fair share of stranded costs in the same

manner as if they had been served all along. Otherwise, a gross inequity may occur, or there may be an incentive created for customers to attempt to bypass stranded cost obligations by trying to appear as though they are "new" customers.

The key consideration with respect to departing customers is whether they are truly leaving the system. Consumers discontinuing service from their host utility should not be subject to paying an exit fee if they are truly relocating from the service territory. Not only may attempting to levy an exit fee be impractical in such circumstances, it may be of questionable legality. Moreover, to a certain extent, the departures will be offset by the addition of new customers of the utility who will assume their respective stranded cost burdens, thus adding some degree of balance or symmetry to the process.

As for those customers that depart their host utility to self-generate, several Subcommittee participants believe there should be a continuation of the stranded cost obligation. TEP believes that new self-generators should not be immune from bearing stranded costs, particularly those that have historically been customers of the host utility and for whom the facilities were built. AEPCO takes a similar position, as do the representatives of the various residential and low-income consumer groups. Several parties commented that stranded costs should be a part of the charge for stand-by or back-up service requested by self-generators. Calpine Energy is of the opinion that, while new self-generators may be subject to the stranded cost obligation, those self-generating before the issuance of the Commission's Rules should be exempt.

Interruptible customers create an interesting stranded cost implication. By definition, interruptible service applies to energy made available (i.e. freed-up) at times of high system demand under agreements (typically with large industrial customers) which

permit the curtailment of service by a supplier in return for lower service rates. The interruptible rates are usually developed to reflect the full cost of service, less some credit representing the higher peaking capacity costs avoided when service to the respective customer is suspended. Clearly, the stranded cost implications for such customers are different from those of full service, firm customers. APS feels that interruptible customers should not bear any capacity-related stranded costs, but should be allocated energy-related stranded costs. SRP recognized a distinction between varying types of interruptible service customers. They believe a review of the Affected Utility's planning process is critical to a determination of the extent to which interruptible customers should be charged for stranded costs.

Whether to charge special contract customers for any stranded costs was also discussed by the Subcommittee. The Fort Huachuca representative opined that special contract customers, as a class, should be assigned a portion of the overall stranded cost estimate, but whether they are actually recoverable should be an item for negotiation between the customer and the utility. According to the Fort, the general body of ratepayers should not bear the stranded cost obligation of special contract customers.

Municipalization, where a current retail customer becomes a wholesale customer, also received some consideration by the Recovery Method Subcommittee. Sham municipalizations to avoid wholesale stranded costs were a major concern of the FERC and specific provisions with respect thereto were incorporated in Order No. 888. There is some feeling that this Commission should take similar precautions to minimize the possibility of such tactics being undertaken to evade responsibility for stranded costs. Staff believes that whatever recovery mechanism may ultimately be decided upon by this

Commission, it should not create incentives for self-generation or municipalization by creating a loophole through which customers can avoid their fair share of stranded costs.

After considering the various issues surrounding recovery methods and the parties that should ultimately pay stranded cost charges, the Subcommittee was unable to establish a clear preference. In its report to the Working Group, it recommended three options concerning stranded cost payment responsibilities:

> Option A: The second sentence of Section R14-2-1607(J) of the Competition Rules should remain in effect, but this Section should be amended to allow all customers to pay stranded costs, including customers who remain on standard offer rates. However, the charge to standard offer customers should account for contributions that are already being made toward stranded costs.
>
> Option B: The second sentence of Section R14-2-1607(J) of the Competition Rules should remain in effect, but this Section should be amended to allow all customers to pay stranded costs, including customers who remain on standard offer rates. However, the charge to standard offer customers should account for contributions that are already being made toward stranded costs and should not cause customers' prices to increase.
>
> Option C: No change should be made to the rules regarding who should pay for stranded costs.

In addition, the Subcommittee recommended that the recovery mechanism should be either a non-bypassable kW/kWh surcharge with the option of an exit fee, or a fixed fee, to be determined on a utility by utility basis.

The length of the recovery period is primarily a function of the size of the stranded investment to be recovered and the extent to which the parties are interested in concluding the transition period as rapidly as possible. The shorter the recovery period, the greater the stranded cost charge and likelihood it will be recovered. The longer the

recovery period, the smaller the periodic charge, but the greater the uncertainty and delay until retail competition is fully achieved. Most of the Subcommittee members recommended relatively short recovery periods. Citizens Utilities calls for a recovery period as short as possible. TEP initially recommended a period of 4 or 5 years to the extent feasible, but later expressed concern that this may put too much pressure on total prices to consumers. AEPCO believes the period should be company-specific, based on relevant circumstances. APS suggests a period of 4 to7 years, with the former mirroring the current competition phase-in schedule and the latter providing a smaller surcharge burden on consumers. A similar recommendation was made by the representative of Fort Huachuca. SRP suggested a period of 5 to 7 years, but said that extended recovery may be warranted for certain costs such as nuclear decommissioning. The residential and low-income consumer representatives felt the recovery period should be as long as possible, while the major industrial customers opined that the recovery period for stranded cost recovery should be as short as practical in order to expedite the transition and to minimize market distortions. Calpine Energy recommended a period of five years to coincide with programs in other states.

None of the above recommended recovery periods are out of line with what has been decided in other states. For example, California has established a five-year recovery period for all stranded costs, except nuclear decommissioning. Michigan has established a ten-year recovery period, while stranded costs in Oklahoma are to be recovered over a 3 to 7 year period.

In deciding upon an appropriate recovery period, it must be recognized that the recovery of stranded costs relating to very long-lived assets over a shorter period

produces a greater annual cost. This may be seen in a comparison of the monthly payments on an 8%, $100,000 home mortgage over different loan periods. For a thirty-year loan, the monthly payment is $734, but for a fifteen-year loan, the payment is $956. This creates a particular problem with the current restriction in the Rules denying stranded cost recovery from parties not taking competitive sources of power. It is mathematically impossible to not increase rates in the aggregate and have full stranded cost recovery, when the recovery period is shorter than the average remaining service lives/amortization terms of the underlying assets, and no opportunity exists to assign stranded costs to parties other than those taking competitive power. Staff believes there needs to be a change in the Rules in this respect.

Another factor to consider in connection with the determination of a proper recovery period is the fact that nuclear decommissioning costs have been removed from stranded costs and will be included as a component of the System Benefits charge. Given the magnitude of projected decommissioning costs, combined with the fact that the Palo Verde Units have nearly twenty-eight years remaining of their projected forty-year lives, it is likely that the period for recovering system benefits will necessarily have to be quite long.

The Subcommittee's recommendation to the Working Group included two options with respect to the recovery period. Under Option A, the time period would depend on the level of stranded costs and be as short as possible, perhaps 3 to 7 years. The period would be fixed prior to the implementation of retail competition, and no stranded cost recovery would be allowed after the expiration of that period. Under Option B, the time period for recovery would balance the goals of minimizing the impact on rates, the

shortest recovery period practicable, and a reasonable opportunity for utilities to recover unmitigated stranded costs.

At the Working Group voting meeting, several matters relating to stranded cost recovery were brought before the attendees. One dealt with selecting an actual recovery period, with alternatives of three years, five years, seven years, ten years, or some other more appropriate period being available. The Group declined to vote on this issue, stating their desire to know the magnitude of stranded costs before stating a recovery period preference. By a vote of 12 ayes, 4 nays and 2 abstentions, the Group established a consensus that the Commission's Rule limiting stranded cost recovery to just those parties taking competitive power should be changed. Another matter voted upon was "If stranded costs are to be recovered from standard offer customers, should they be recovered at the same rate as that being charged to customers taking competitive power. The result was 10 ayes, 0 nays, and 8 abstentions. According to the agreed upon voting procedure, this did not constitute consensus on the issue.

The voting members were also asked to consider "How should stranded costs be recovered from ratepayers?". None preferred solely an energy charge, four voted for a fixed charge, none supported an exit fee, and fifteen supported a charge with both an energy and/or demand component. There was one abstention.

With respect to ratepayer payment options, the participants of the Working Group were asked whether customers should have the opportunity to make a lump sum payment in lieu of an on-going stranded cost charge. Nineteen voted for the proposal, while only one party voted against it. There is a clear consensus supporting this ratepayer option.

Finally, the voters were specifically asked to consider Option B of the three stranded cost payment responsibility proposals advanced by the Subcommittee that were previously described in this section of the report. The proposal received support from fourteen of the twenty voting members present, thereby establishing consensus under the voting procedures agreed upon.

With respect to all of the various matters voted upon, notwithstanding the decision to table the vote on a recovery period, Staff strongly believes that there must be some specificity in this regard incorporated into the Rules. We prefer a period of ten years, as reflecting a proper balance of all relevant factors. We do note that, given the magnitude of nuclear decommissioning liabilities, it is highly likely the Systems Benefits Charge will be assessed to consumers for at least that length of time. Staff further supports an amendment of the Rules to place some obligation on all power users (including new customers, self-generators, interruptible customers, and special contract customers) for the stranded costs of the Affected Utilities, but we would not oppose a distinction in charges between parties taking competitive power and those not, insofar as such difference reflects the fact that the parties not taking alternative source power are paying for stranded costs in rates, and differences reflecting the costs of serving interruptible customers. With respect to a recovery mechanism, Staff supports a charge that properly reflects the demand and energy characteristics of the underlying stranded costs, and would not oppose granting the ratepayers an option to settle their stranded costs obligation on a lump-sum basis.

Finally, the Rules are silent with respect to any constraints placed upon the Affected Utilities' use of the proceeds from stranded cost charges. This topic received little

attention in the deliberations of the Working Group or its subcommittees. Staff believes that the Rules should contain some specific requirement that such proceeds be used to extinguish the utilities' existing obligations, whether financial, such as debt or equity securities, or operating, such as long-term fuel and purchased power contracts.

In addition to the foregoing, four other matters should be addressed herein. First, several of the parties recommended that utility investors should bear some responsibility for stranded costs through some type of sharing mechanism. The position paper filed by the Arizona Community Action Association, the Arizona Consumers Council, and Arizona Citizens Action states their desire that some portion of the stranded costs should be borne by utility investors. Energy Strategies, representing major industrial consumers, also recommend that stranded costs be split between customers and investors. None of the parties' position papers contained any substantive explanation or justification for requiring utility investors to assume any of the stranded costs.

While some absorption by the Affected Utilities' investors would undoubtedly reduce the stranded cost burden for consumers to ultimately bear, the Staff is unaware of any legal or regulatory basis for doing so. Presumably, the prudence of expenditures underlying existing service rates has already been established, and no justification for a revisiting of prudence or any other basis for assigning some or all of the stranded cost responsibility to investors was provided by any party. Moreover, nothing has been advanced by any party indicating that the introduction of retail competition has relieved the Commission of its traditional responsibility to provide the utilities under its jurisdiction a reasonable opportunity to recover its costs of providing service plus a fair return on prudently invested capital.

A second issue warranting some discussion herein is that of "asset securitization" as a tool to address stranded costs. Although there was only token discussion about this topic in the Working Group and subcommittees, it is something that is gaining national prominence and should, therefore, at least be acknowledged in this report to the Commission. In states such as California, Pennsylvania, Michigan, New Jersey, and Rhode Island a concept has been introduced whereby the state would create a new entity for the purpose of issuing tax exempt debt backed by a pledge of the expected revenues to be received by the electric utilities under their respective stranded cost recovery plans. In theory, the up front lump-sum proceeds from the bonds would be used by the utilities to reduce stranded costs and related obligations, with the debt service to be paid from stranded cost recovery revenues. In California, a portion of the proceeds will also be used to fund an immediate 10% rate reduction for residential and small business customers at the commencement of retail competition.

Those advocating this approach assert that it balances the interests of all stakeholders, is consistent with the traditional regulatory compact, and will facilitate the transition to competition. Since the bonds are likely to be favorably received by the rating agencies, the interest rates are expected to be less than the rates on the utilities' other borrowings, and by paying off some of the higher cost capital, the companies' overall cost of capital will be reduced. Parties opposing this concept argue that, since this is done on a one-time up front basis, there is substantial risk that stranded costs may be over recovered. They further allege that such a policy could have significant anti-competitive effects and, therefore, may violate anti-trust laws and undermine the competitive process by providing incumbent utilities an unfair advantage over their competitors. The method

is also not without significant accounting and tax hurdles to overcome. Implicit in the plan is the assumption that the utilities will not be required to recognize the securitization bonds as liabilities on their balance sheets. Under new accounting standards recently issued by the Financial Accounting Standards Board, however, the companies may likely have to recognize the new bonds as their own. Moreover, there are key assumptions about the IRS treatment of the interest payments on the securitization bonds and the utilities' use of the proceeds. Although at the time of this writing the California utilities anticipate a favorable IRS response, any unfavorable rulings could derail the process. At this point, Staff is taking no position on the concept of securitization as a tool to address stranded costs, other than to inform the Commission that, to the extent they desire to investigate the matter further, we believe that such an inquiry should be jointly conducted with members of the legislature and other affected State agencies.

An additional matter warranting discussion in this section of the report is the request by some parties that, as part of this Working Group's activities, the Affected Utilities should be required to perform, and make available to their fellow participants, estimates of their retail stranded costs. For several reasons, Staff has not supported this request. First, the overriding objective of this Working Group is to develop recommendations for Rules covering the procedures to be used in connection with the quantification and recovery of stranded costs, not an actual quantification of stranded costs. As they presently exist, the Rules contemplate the Affected Utilities filing formal estimates of their stranded costs prior to the commencement of retail competition. Given the present schedule for that to occur on January 1, 1999, it is most obvious that such filings will likely be made in the near future. The actual estimates will be available at that time.

Second, as may be obvious from reading this report, such an undertaking is highly complicated and based on a wide range of assumptions and methodologies for which no universal acceptance among the parties has yet been achieved. Changes in assumptions can affect the results by orders of magnitude. Given such uncertainty, it is highly likely that estimates prepared now will change significantly by the time the Companies' formal estimates are filed with the Commission. Substantial public confusion will most certainly occur if two sets of significantly different estimates for a given Affected Utility were published within a very short period of time. Third, much of the information upon which such calculations are based has become of competitive value. The utilities should not be forced to disclose such information publicly, any more than requiring the independent power producers to provide estimates of their market prices for the next ten years. Fourth, some parties allege that estimates of stranded costs must be known, in order to fairly assess the reasonableness of the stranded cost recovery plan. While Staff agrees that the magnitude of stranded costs can affect the amount of the customer charge, if the process for quantifying and recovering stranded costs is sound, then we believe the result of that process, by definition is sound. Finally, for those parties who believe they have a strong need to have some indication of the utilities' stranded costs, it should be noted that such entities as Fitch Investors' Services, Moody's, and Resource Data International, have published estimates for most investor-owned utilities.

A final issue is that of imposing a price cap. Several parties recommend that the Commission establish a Rule requiring some form of price cap. Although no one supplied any significant details of such a plan, the concept received overwhelming support from nineteen of the twenty parties voting on this issue at the last meeting of the

Working Group. Price caps are an issue that has been addressed in other states. Some states, such as California, have been able to accomplish this by the use of the asset securitization bonds as previously described herein. No such undertaking has yet been planned by this Commission. Given the Commission's existing responsibility to permit the utilities a fair opportunity to recover their costs of providing regulated service, and lack of authority to set prices for services that are no longer regulated, it is unclear how any unilateral action could take place whereby price caps are imposed on the Affected Utilities. Staff believes this may only occur through some mutual agreement to which the companies are a party, such as the existing rate agreements with APS and TEP.

XI. ACCOUNTING, TAX AND FINANCE ISSUES

Although stranded costs have very significant accounting, tax and finance implications, the Rules are relatively silent in this area. R14-2-1607.I.3 requires that the Commission shall consider the impact of stranded costs on the Affected Utilities' ability to meet debt obligations. Beyond that, there are no specific requirements. As a result, a special subcommittee to the Working Group was established to address such implications insofar as they relate to the issues and recommendations being developed by the Calculation Methodology and Recovery Mechanism Subcommittees. The Subcommittee identified several key issues in each of the three areas for consideration. Although the following recommendations were submitted by the Subcommittee to the Working Group, no specific consensus was established thereon.

- Accounting issues should be linked to the quantification of stranded costs so that the target level of quantified stranded costs have the opportunity of actually being recovered.

- Accounting requirements and their implications for utilities should be analyzed and an effort be made to minimize negative impacts.

- Useful lives which were set for utility assets in past rate proceedings may be different than economic lives in the competitive environment, and this should be taken into consideration in the calculation of stranded costs.

- The Working Group should consider treatment of project or lease financed assets comparable to assets owned by the utility and develop a mechanism that ensures that stranded cost recovery captures the above market portion of the costs of power generated from these financed facilities.

- Local authorities and other interested parties should be made aware of the tax revenue impacts that could follow from stranded cost recovery and the move to competitive power generation and be encouraged to participate in the appropriate forums designated to deal with these issues.

The following is a discussion of the key topics addressed in the various issue areas.

Accounting

The accounting issues identified and addressed by the Subcommittee included:

- The implications of stranded cost calculations and recovery on existing accounting standards.

- The implications of proposed accounting standards on stranded investment quantification and recovery.

- Accounting for stranded costs under the FERC/RUS Uniform Systems of Accounts.

- Accounting implications of accelerated and/or decelerated depreciation.

The Federal Power Act of 1935 provided the Federal Power Commission (predecessor to the FERC) authority over rates, service, and security issuances by entities providing interstate electric service. As part of its rate authority, the FPC issued its

Uniform System of Accounts ("USOA") for use by electric utilities under its jurisdiction in maintaining their accounting and in their published financial statements. The accounting principles embedded in the USOA are generally comparable with Generally Accepted Accounting Principles.

The key accounting standard that must be addressed is Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation*, ("SFAS No. 71"), which defines a regulated entity and contains standards that must be complied with in preparing financial statements issued by pubic utilities. SFAS No. 71 applies to an enterprise that has regulated operations that meet all the following criteria:

- The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.

- The regulated rates are designed to recover the specific costs of providing the regulated services or products.

- In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

Under SFAS No. 71, the most important difference between the accounting used by regulated entities and unregulated businesses is the ability of regulators to create assets ("Regulatory Assets") by deferring to future periods (and therefore recoverable in future rates) certain current costs which would otherwise be charged to expense under Generally Accepted Accounting Principles. With their legal authority to identify the types and amounts of costs to be recoverable in rates, regulators have traditionally been able to

provide the necessary level of assurance through rate orders that such amounts deferred meet the criteria to properly be reflected as assets in published financial statements. The parties responsible for setting accounting standards have long recognized and accepted the distinction between accounting and reporting by utilities and other entities. Many of the stranded costs of the Affected Utilities are a direct result of the application of the FERC USOA and SFAS No. 71.

With the emergence of competition and deregulation in the utility industry, many of the utilities previously subject to SFAS No. 71 discovered that they no longer met the criteria stated for categorization as a "regulated enterprise". In response thereto, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 101, *Accounting for Discontinuation of Application of SFAS No. 71*. The thrust of the new standard is that, when an enterprise ceases to meet the criteria of SFAS No. 71, it must discontinue its application, and eliminate from its books of account and financial statements the effects of the actions by regulators that would not have been recorded by enterprises in general. Generally, that means writing off all regulatory assets and liabilities. For the Affected Utilities of Arizona that would mean having to immediately write-off (and charge to retained earnings) all generation-related regulatory assets, which currently represent a significant portion of stranded costs.

In 1995, an additional accounting standard having significant negative implications on stranded costs was issued. Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, addressed concerns that arose within the accounting profession and in the financial community, particularly with respect to reported assets of utilities, given the

extent to which restructuring and deregulation was occurring in the industry. SFAS No. 121 lists certain events, (including a significant change in the regulatory climate in which a company operates), the occurrence of which requires the respective company to consider whether any of its assets may have become impaired. For this purpose, the carrying amount of the affected asset must be compared to the expected future undiscounted value of related net cash flows. If the recorded amount exceeds the projected cash flows, an impairment must be recognized and book value of the asset reduced to its fair market value (i.e. discounted net cash flows).

Any analysis of the accounting implications of stranded costs and their recovery must consider the requirements and potential implications of SFAS Nos. 71, 101, and 121.

Earlier this year, the Securities and Exchange Commission sent a letter to the three major investor-owned electric utilities in California: Pacific Gas & Electric, Southern California Edison, and San Diego Gas & Electric, containing a message informing them that, with the establishment of deregulated generation scheduled for a date certain (January 1, 1998), the three companies may no longer meet the criteria for SFAS No.71 for the generation segment of their businesses. Specifically, the SEC Staff raised two concerns. First, the service rates to be used after the introduction of competition do not appear to be consistent with the traditional ratemaking process envisioned under SFAS No. 71. Second, there may not exist the degree of reasonable assurance of cost recovery required under SFAS No. 71.

The major impact on the three utilities of being forced to go off of SFAS No. 71 would be the requirement that they immediately write-off all generation-related

regulatory assets, notwithstanding the legislated provisions for stranded cost recovery in that State. Then, to the extent that the generating assets are impaired, further write-offs would be required under SFAS No. 121. Essentially, all stranded costs would have to be charged to retained earnings.

The letters to the California companies initiated intensive discussions between the utilities, the SEC Staff, the Emerging Issues Task Force of the FASB, the AICPA Public Utility Subcommittee, and the Accounting Subcommittee of the NARUC. Among the critical issues discussed were:

- When should the companies actually go off of SFAS No. 71?
  - When a date certain for deregulation is firmly set?
  - As of the date certain?
- Can the financial character of a stranded cost change as a result of a change in the manner by which its underlying cost will be recovered?

Within the past couple of months, some resolution of these issues has been achieved. The Emerging Issues Task Force of the FASB has determined that the appropriate date to go off of SFAS No. 71 would be when a date certain for deregulation is firmly established. Moreover, with respect to whether the nature of an asset may change due to the characteristics of its ultimate cost recovery, it was tentatively agreed that could occur. This is a very significant point in connection with stranded cost recovery. Where stranded costs are to be fully recoverable and collected through a distribution charge, an existing stranded generation asset or generation-related regulatory asset that would otherwise have to be written off due to the discontinuance of SFAS No. 71, may continue to be carried on the books of the utility as a distribution-based regulatory asset.

Specific accounting guidance from the FERC with respect to the proper accounting for stranded costs or related revenues has been relatively sparse. The FERC requires utilities to recognize stranded cost revenues in the period in which the related costs are charged to expense. This is consistent with the traditional matching principle of accounting, and will prevent double recovery, cost shifting, and inappropriate financial reporting. The FERC also requires utilities to submit their proposed accounting for stranded costs and related revenues as part of their stranded cost rate filings.

Specifically addressing some of the parties' concerns, TEP feels that, because of its recent financial history and current equity position, the effect of any adverse accounting consequences could result in negative equity, which would be financially devastating for the Company. Other parties raised similar concerns about being required to discontinue using SFAS No. 71.

Staff strongly recommends that the Commission's Rules be completely clear with respect to stranded cost identification, quantification, and recovery, such that the potential for required write-offs is minimized. Moreover, the Affected Utilities' stranded cost filings anticipated under R14-2-1607.G should be required to include detailed descriptions of the companies' proposed accounting for stranded costs and related revenues.

Taxes

The introduction of retail competition creates significant tax issues. These include not only the tax effects on the Affected Utilities, but also the effect on state and local governments. The Subcommittee identified seven potentially critical tax issues:

- The effect of stranded investment quantification and recovery mechanisms on existing tax normalization rules in the Internal Revenue Code and IRS Regulations.

- The effect of deregulating generation on the existing definition of "Public Utility Property" in the Internal Revenue Code.

- Implications of stranded cost recovery on future corporate taxes.

- Potential for recapture of accelerated tax depreciation and investment tax credits.

- Implications of existing tax attributes (i.e. operating loss carry-forwards).

- Differences in tax status of participating entities.

- The need to create awareness for potentially significant reductions in tax collections by State and Local governments.

Of the seven issues identified above, the first two relate to the effect of income taxes in traditional public utility ratemaking. The next four relate primarily to the potential effect of retail competition on corporate income taxes, both Federal and State, that the Affected Utilities will have to pay. The final issue is one, the resolution of which is largely beyond the Commission's scope of authority. Nevertheless, the level of awareness of the public and affected governmental authorities can be raised. Only the latter received any significant attention in the meetings of the Subcommittee.

1. Income Taxes in Ratemaking. To address the first two issues, it is first necessary to consider the effect of income taxes in traditional public utility ratemaking and financial reporting. As a major operating expense, income taxes are a significant component of the cost of providing service. They affect revenue requirements in two principal ways. First, they are an allowed operating expense comprised of three elements: current income taxes, deferred income taxes, and net investment tax credits. Second, the net accumulated

benefits of accelerated tax depreciation and investment credits appear in utilities' financial statements as balance sheet reserves and may be used to reduce the net rate base to which the rate of return is applied in computing required operating income in ratemaking. It should be noted that alternative ratemaking options do exist with respect to the investment tax credits.

Current income taxes represent the computed liability for a given rate case test year as though actual tax returns are prepared based on computed revenues and expenses. Deferred income taxes represent the computed tax effect of book-tax differences that balance out over time. The use of accelerated depreciation for tax purposes and straight-line depreciation for ratemaking and book purposes is the largest such difference experienced by utilities. The Investment Tax Credit permitted taxpayers a reduction in their income tax liabilities based on a percentage of amounts spent currently for certain classes of plant and equipment. Utilities account for such credits by deferring them on their balance sheets, and amortizing them as a reduction of income taxes over the lives of the assets that gave rise to the credits. Traditionally, the income tax category "net investment tax credit" represented the difference between the tax credits deferred in the current period and the current period amortization of credits deferred in prior years. Since the Tax Reform Act of 1986 terminated the Investment Tax Credit, this income tax expense category today generally reflects only the amortization of prior years' credits.

Both accelerated depreciation and investment credits were intended by the Congress to enable corporate taxpayers to reduce their current federal tax liabilities and invest the tax savings in new plant and equipment, thereby creating new jobs and expanding the economy. Initially, there were no restrictions placed on utility regulators with respect to

the treatment of accelerated depreciation or tax credits in ratemaking. As a result, most regulators "flowed through" these benefits directly to ratepayers in the form of lower service rates. Eventually, the Congress became alarmed that such ratemaking treatment not only defeated the purpose for which the benefits were initially created, but that it also significantly reduced the Federal tax receipts due to the reductions in utilities' gross revenues and taxable incomes. Accordingly, legislation was enacted which is now incorporated into the Internal Revenue Code and IRS regulations that severely restrict the options available to regulators.

The concept of reflecting deferred income taxes and investment credits in ratemaking is labeled "normalization". One of the key directives governing the normalization of accelerated depreciation is the "consistency requirement" in Code Section 168 (i)(9)(B). This requires that a ratemaking authority use an estimate or projection of a regulated company's tax expense, depreciation expense, and balances of accumulated deferred income taxes that are all consistently determined with respect to each other and with respect to rate base. A similar consistency requirement exists for the Investment Tax Credit in Code Section 46 (f)(10). Basically, these serve to limit regulators' ability to consider in ratemaking the deferred tax and investment tax benefits associated with a particular asset or group of assets. To the extent all or a portion of the cost of an asset is temporarily or permanently excluded from ratemaking, an equivalent portion of the related tax benefits similarly may not be considered in developing revenue requirements under the consistency rules. During the past few years there have been numerous IRS Private Letter Rulings addressing utility phase-in plans, cost disallowances, and assets removed from the scope of regulation. In all instances, the IRS found that when any such

capital adjustment is made to regulated rate base, a similar adjustment must be made to the related tax benefits. Although technically, Private Letter Rulings may not be cited as precedents, they are useful in showing the IRS position on certain issues. With respect to this matter, the IRS position has been totally consistent. Such information is relevant to this report in that, it is clear that the consistency standard must be properly considered in connection with the quantification and recovery of stranded costs. For example, to the extent that any portion of the cost of stranded generation assets for which an Affected Utility has taken accelerated depreciation and/or investment tax credit is not allowed to be recovered, there must be a corresponding adjustment to the related tax benefits.

Staff recommends that the Rules be expanded to clearly indicate that all requirements of the Internal Revenue Code and IRS Regulations should be considered and properly complied with in connection with the quantification and recovery of stranded costs of the Affected Utilities.

2. Corporate Taxes. The introduction of retail competition will affect the corporate income taxes of the Affected Utilities in several ways. First, any write-off of generating plant assets will have no immediate tax consequences unless it is accompanied by a physical abandonment of the asset. Under Section 165(a) of the Internal Revenue Code, an Affected Utility will be permitted a Federal tax deduction based on the unrecovered tax basis of the asset disposed of.

Second, to the extent utilities actually sell generation assets (i.e. under the Auction and Divestiture Approach) any gains or losses will have income tax consequences. Gains typically will be taxed as ordinary income to the extent of accelerated depreciation taken,

with the excess subject to capital gains treatment. This is known as "depreciation recapture". Losses generally will be available to offset other taxable income.

Third, amending or severing fuel, transportation, or purchased power agreements (one of the stranded cost mitigation strategies previously identified) will create tax benefits. Costs incurred with canceling contractual arrangements are generally currently deductible. Costs of modifying existing contracts are generally ratably deductible over the term of the new arrangement.

Fourth, if Affected Utilities experience reduced revenues and taxable income after the introduction of competition, their Federal and state tax liabilities will correspondingly decrease. To the extent they have available tax attributes, their value may be diminished.

Finally, in addition to the income tax effects above, taxes other than income taxes will undoubtedly feel the impact of retail competition. Property taxes based on net book costs may decline if stranded costs have to be written off. Sales and gross receipts may decline where the price of electricity is reduced due to the effects of competition and the level of consumption is not increased by at least a corresponding percentage.

When considering corporate taxation issues, it must be noted that several of the entities that will be participating in competitive power markets are not subject to income taxes. In its filed comments, AEPCO described its current exemption from income taxes under Section 512(c)(3) of the Internal Revenue Code, limiting revenue from non-members sources to 15% of total revenue. To the extent that limit is exceeded, the tax exemption could be in jeopardy. Resolution of tax issues associated with the introduction of retail competition must appropriately consider the effect on those entities currently not subject to income taxes.

As stated, the Rules are silent with respect to income and other types of taxes. Staff recommends that the Commission consider incorporating additional language that assures changes in tax liabilities are properly treated in the quantification, mitigation and recovery of stranded costs of the Affected Utilities, such that no parties are unjustly enriched or unfairly detrimented.

3. Effect of Retail Competition on State and Local Taxes. Of the various tax issues, this received the greatest scrutiny by the Subcommittee. State regulators and taxing authorities around the nation are beginning to realize that the introduction of retail electric competition has the potential to significantly adversely impact tax collections. Without changes, there will be potential tax revenue reductions and an unlevel playing field between utilities and non-utility competitors. Significant tax-related policy questions will have to be answered prior to the current January 1, 1999 date established by this Commission for the transition to full competition to begin.

State and local governments have historically taxed utilities heavily and disproportinately. Utilities, on average, pay twice the amount of taxes as other businesses. This chiefly occurred over the years for political expedience. It is unlikely this can continue in a deregulated generation market. A competitive market cannot bear an inequitable assignment of the tax burden. Competition increases the incentive to reduce costs and customers will migrate to companies that don't have heavy tax burdens to recover in the price for their service. Tax authorities need to begin considering what changes are required to assure there is an equitable redistribution of the tax burden and what will enhance the chances for effective competition.

Retail competition will affect taxpayers and tax authorities in several ways. Revenue based taxes will decrease due to lower prices and revenues lost when customers depart their host utility. Property taxes may decrease due to reductions in market value of generation assets, any write-offs associated with stranded costs, or premature plant abandonments. State income taxes will decrease due to profit declines, reflecting price reductions and sales lost to tax exempt or out-of-state producers.

There are a number of responses available to State and local taxing authorities. One solution is to impose a tax on all energy consumption in the State, regardless of where produced or the entity source. Another is to change the manner in which utilities are taxed comparable to other businesses. Additional options include the imposition of a revenue tax on power marketers to level the playing field between in-state and out-of-state suppliers, or repealing tax exemptions enjoyed by only certain market participants.

In addressing this issue, the Subcommittee was aware that any resolution was beyond the scope of the Commission's authority. The intent was to explore the issue and obtain information that could be disseminated for purposes of raising the level of awareness of potentially affected parties. Subsequent to the creation of this Subcommittee a special investigative committee has been created by the State Legislature to analyze the effect of retail competition on State and local taxes. Our concerns are now being addressed. Accordingly, no recommendations in connection with this matter are being made.

Finance

The subcommittee identified several key Finance issues that warrant consideration in connection with Electric Industry Restructuring:

- The effects of bond indenture requirements on stranded cost recovery proposals.

- The effects of restrictions on private use and tax exempt bonds on stranded cost recovery proposals and the use of underlying assets in competitive markets.

- The effect of stranded cost quantifications and recovery periods on existing security ratings and rating agency criteria.

- The proper consideration of project financed assets in quantifying stranded costs.

- The proper treatment of assets which have been sold and leased back (i.e. operating and capital leases and related obligations).

- Use of stranded cost recovery proceeds to reduce/adjust capitalization.

- The effects of competitive generation risks on capital structure and dividend payout ratios.

Several financial issues raised by Staff received little discussion, including whether there was any evidence that investors had previously been compensated for stranded costs, what should be the applicable discount rate (i.e. authorized rate of return) to use for any financial studies prepared in connection with stranded cost quantification or recovery, and if the existence of asset specific financing (i.e. pollution control bonds) should be considered in stranded cost calculations.

The major concerns identified by the Affected Utilities in this area include the implications of forced asset sales and the ability to maintain the tax exempt status of debt securities. With respect to the former, to the extent the Affected Utilities are required to sell or otherwise divest their current stranded assets, it will necessitate their securing from the respective bond trustees releases of the assets from the liens of the mortgage indentures. This may be difficult and costly.

Utilities issuing mortgage bonds pledge their investments in utility assets as the underlying collateral. Typically, mortgage indentures include plant-to-bond ratios in

excess of one. That means, for every $1 in bonds issued, something in excess of $1 dollar in plant assets is required as security. For some utilities, the ratio is as high as 1.6 or 1.7 to one. Utilities must have additional, unbonded assets available anytime they plan to issue new bonds or dispose of existing bonded assets. To issue new bonds, additional bonded property must be placed under the lien of the mortgage. To obtain a release of assets in connection with their sale, a utility generally must substitute other bondable property as replacement collateral or, in the alternative, place the net proceeds with the bond trustee. These may be used either to retire outstanding debt or be held in escrow until sufficient replacement property is available for bonding. Forcing utilities to sell or auction off assets may not automatically provide cash to reduce stranded costs, and it may significantly reduce their ability to issue new debt. This must be considered in deciding upon an appropriate method for recovering stranded costs.

Another significant Finance issue addressed by the Subcommittee is the effect that retail competition may have on those companies with tax exempt debt. TEP and SRP raised concerns about the potential to lose their bonds' tax exempt status if restructuring is not conducted properly. TEP has significant "two-county" bonds outstanding. The interest on such bonds is tax exempt to the recipients as long as the facilities acquired with the proceeds therefrom are used solely for the "local furnishing of electric energy or gas." That has been defined as service limited to two contiguous counties or one city and a contiguous county. To serve beyond such limits may disqualify the interest payment of such bonds from their exempt status. In consideration of its concerns about possibly losing tax exemptions, TEP suggests the Commission might consider including in the Rules a provision similar to that applicable to cooperatives that would authorize utilities

to request Commission approval to modify the phase-in schedule described in R14-2-1604 (A-D) as may be necessary in these circumstances. SRP raised similar concerns about its debt and the effects of mandatory exit fees and forced asset sales on its continuing tax exempt status.

AEPCO stated concerns about its debt that is subject to mortgage arrangements with the Rural Utilities Services. To the extent that the introduction of retail competition adversely affects the applicable coverage rations (i.e. Times-Interest-Earned and Debt Service Coverage) significantly, the Company may experience increases in the interest rates on its variable interest debt or face mandatory bond redemptions.

Based on the foregoing and its independent analysis of the financial issues, Staff believes that many of the concerns cannot be fully addressed until additional clarity and specificity is incorporated into the Rules. This includes, in particular, some resolution as to whether asset divestiture is going to be mandated, and the manner by which, as well as the period during which, stranded cost recovery shall occur. Accordingly, Staff recommends further study of these issues with appropriate revisions to the Rules at a later date when more information is known.

STRANDED COST WORKING GROUP

LIST OF PARTICIPANTS

Name	Representing
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A. B. Baarsdon (1)	Nordic Power
Ronald Ballard (1) (2)	City of Tucson
Michael Block (1) (2) (3)	Goldwater Institute
Jana Brandt (1)	RUCO and Salt River Project
Sean Breen (2)	Citizens Utilities
Tom Broderick (1) (2) (3)	PG&E Energy Services
Richard Brown	SWRTA
Maureen Bureson	MLB Consulting
David Caplow	Economic Energy Alternatives
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Ellen Corkhill	American Association of Retired Persons
George Courteny (3)	Arizona Dept. of Revenue
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Sandra Dunphy (1)	BHP Copper
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Rick Gilliam (1) (3)	Land & Water Fund
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Larry Graber	Swiss Energy Association
Janet Guerrero	Enron Corporation
Scott Gutting	Arizona Association of Industries, Intel Corporation, and Allied Signal
Stephanie Hamilton	Cinergy Corporation
Kevin Higgins (1) (2) (3)	Energy Strategies, Inc., Cyprus Climax Metals Co., and BHP Copper
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Jimmy Jayne	Office of Senator Kyle
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Name	Representing
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David Mills (2)	Allied Signal
Dan Neidlinger (1) (2) (3)	Fort Huachuca
Doug Nelson (1) (2) (3)	Electric Competition Coalition
Paul O'Dair	Navopache/Mohave Electric Cooperatives
Darrel Pichoff (2)	City of Mesa Electric Utility, Irrigation & Electric Districts Assn., and Arizona Municipal Power Users Assn.
Jerry Porter	Office of the Governor
Betty Pruitt	Arizona Community Action Assn.
Michael Raci	Munger & Munger
Dwayne Richard	Arizona Food Marketing Alliance
Donald Robinson (1) (2) (3)	Arizona Public Service Company
Mike Rowley (1) (2)	Calpine Corporation and Enserco
Monsinor Edward Ryle (3)	Arizona Catholic Conference
Jeff Schlegel (1) (2)	Arizona Community Action Assn. and Arizona Catholic Conference
Deborah Scott	Residential Utility Consumer Office
Marty Sedler (1) (2)	Intel Corporation
Barbara Sherman	Arizona Consumers Council
Louis Stahl	Streich Lang
Albert Sterman (2)	Arizona Consumes Council
Josie Stukes (1) (2) (3)	Arizona Electric Power Cooperatives
Hon. John Wettaw	Arizona State Senator
Tim White (2) (3)	Office of State Treasurer
Jeff Woner (1) (2)	K. R. Saline & Associates
Hon. Barry Wong	Arizona State Representative

(1) Participant in Calculation Methodology Subcommittee
(2) Participant in Recovery Mechanism Subcommittee
(3) Participant in Accounting, Tax and Finance Subcommittee

Note: The above summary was prepared from the mailing lists used in connection with the Stranded Cost Working Group Mailings. It does not necessarily reflect actual attendance at Group and subcommittee meetings.

STRANDED COST WORKING GROUP

SUMMARY OF MEETINGS HELD

Working Group:

March 4, 1997

April 4, 1997

July 25, 1997

Subcommittees:

Calculation Methodologies	Recovery Mechanism	Accounting, Tax & Finance
March 13, 1997	March 10, 1997	March 12, 1997
April 1, 1997	April 1, 1997	April 8, 1997
May 2, 1997	May 2, 1997	May 1, 1997
June 26, 1997	June 26, 1997	June 26, 1997

STRANDED COST WORKING GROUP

VOTING ROSTER

Group	Organization	Principal
Incumbent and New Energy Suppliers:		
1. Investor-Owned Utility	Arizona Public Service	Don Robinson
2. Investor-Owned Utility	Tucson Electric Power	Joe King
3. Investor-Owned Utility	Citizens Utilities	Sean Breen
4. Municipal Utility	Salt River Project	Deborah Kimberly
5. Municipal Utility	City of Mesa, Arizona Municipal Power Users	Darrel Pichoff
6. Generation & Transmission	AEPCO	Josie Stukes
7. Transmission & Distribution	Navapache & Mohave Electric Co-ops	Paul O'Dair
8. Competitor	Electric Competition Coalition	Doug Nelson
9. Competitor	Calpine Corp. & Enserco	Mike Rowley
10. Competitor	Nordic Power	Andy Baardson
Consumers:		
1. Consumer	RUCO	Greg Patterson
2. Consumer	Arizona Community Action	Jeff Schlegel
3. Consumer	Arizona Assn. of Industries	Scott Gutting

Group	Organization	Principal
Consumers – Cont.:		
4. Consumer	Energy Strategies, BHP Copper, Cyprus Climax	Kevin Higgins
5. Consumer	Arizona Food Marketing	Dwayne Richard
Public Interest & Other:		
1. Public Interest	Goldwater Institute	Michael Block
2. Public Interest	Department of Commerce	Stephen Ahern
3. Public Interest	Land & Water Fund	Rick Gillam
4. Other	IBEW Local #1116	Elizabeth Firkins
5. Other	Arizona Utility Investors	Bill Meek

Note: For purposes of establishing whether consensus with respect to a particular issue exists among the participants, a two-thirds super majority, based on votes cast, was agreed upon as the accepted threshold.

STRANDED COST WORKING GROUP

DISSENTING COMMENTS

- Arizona Community Action Association
- Arizona Consumers Council and Arizona Citizen's Association
- Arizona Electric Power Cooperative
- Arizona Public Service Company
- City of Tucson
- Electric Competition Coalition
- Energy Strategies (ASARCO, BHP Copper, et al)
- Goldwater Institute
- Land & Water Fund of the Rockies
- Nordic Electric Arizona
- PG&E Energy Services
- Residential Utility Consumers Office
- Tucson Electric Power Company

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Arizona Community Action Association
Final Summary of Positions on Stranded Costs
September 26, 1997

Introduction
Stranded costs must be borne fairly by the utilities, by new market entrants, and by consumers for whose needs the stranded assets and obligations were designed to meet. As Commissioner Kunasek said, "there is plenty of pain to go around, and the burden should be shared."

The stranded cost calculation methodology and recovery mechanism should ensure that residential and low income utility customers do not pay for any stranded costs resulting from competition in which they do not participate. In addition, stranded costs associated with one customer class should not be recovered from or shifted to any other class.

The allocation and recovery of stranded costs should not cause increased costs for any small consumer. We continue to advocate for a residential consumer price cap for standard offer service, and a price ceiling inclusive of stranded costs for residential consumers in the competitive market to ensure that stranded cost recovery does not increase costs for residential consumers.

Definition of Stranded Cost
The definition of stranded cost in the Rules (R14-2-1601) is reasonable and should not be changed. In summary, this definition states that stranded cost is the verifiable net difference between the value of prudent jurisdictional assets and obligations under traditional regulation, and the market value of those assets directly attributable to the introduction of retail electric competition.

Recovery Mechanisms
Stranded costs should be recovered from utilities and their shareholders, new entrants to the Arizona market, and consumers who participate in (and expect to benefit from) the competitive market.

Regarding recovery of a portion of stranded costs from customers, we support the rules that state that stranded costs may only be recovered from customers served competitively. Residential and low income utility customers should not have to pay for any stranded costs resulting from competition in which they do not participate.

The stranded costs to be recovered from consumers receiving competitive services should be collected using a non-bypassable distribution access charge applied on a per kWh basis to the volume of energy sales to these consumers.

Regarding recovery of a portion of stranded costs from new market entrants, these funds should be collected using a market access charge (or entrance or license fee) applied on a per kWh basis to the volume of in-state energy sales.

The Commission should create a fund which the utilities could draw upon to pay for stranded costs. The non-bypassable distribution access charges and the new market entrant access charges (or license fees) collected for stranded costs should be deposited in this fund.

The amount of stranded costs to be recovered from consumers and new market entrants (determined using the calculation method) should be set as a maximum, which could be adjusted downward if conditions change but could never exceed the maximum. Setting the amount of stranded costs to be recovered as a maximum will avoid surprises and eliminate any additional risk for consumers in the future. Commission staff and interested parties should be able to petition the Commission to reduce the amount of stranded costs to be recovered if conditions change (rather than having a regularly-scheduled reassessment).

Securitization should be explored as a mechanism to reduce the total amount of stranded cost.

Some assets should be sold in the market (i.e., divestiture should be encouraged) and the resulting funds used to offset stranded costs, where feasible.

Time Period For Recovery
The amount of stranded costs should be fixed as a maximum. The time period for recovery should be fixed at first, but may need to be shortened (e.g., if load growth at the distribution level increases faster than assumed, or if the amount of stranded costs to be recovered is adjusted downward).

Allocation of Stranded Costs Between Jurisdictions and Classes

The determination and allocation of stranded costs should be company specific.

New customers who participate in the competitive market should pay stranded cost charges.

Stranded costs associated with one customer class should not be recovered from or shifted to any other customer class.

The allocation methods should be the same as the Commission-approved approaches used by the utilities currently to allocate costs.

The allocation methods should not cause increased costs for any consumer.

Mitigation of Stranded Costs
We continue to be concerned that accelerated depreciation of assets as a mechanism for mitigating stranded costs places a burden on captive smaller customers (including low income and residential customers), while larger customers should

shoulder either smaller parts of the burden (under the recent rate settlements) or none of the burden (under some special contracts). Customers are paying now for investments that will soon be "stranded," and accelerated depreciation just increases near-term costs, resulting in either price increases or smaller reductions in existing rates for captive customers.

Methods for Calculating Stranded Costs

Bottom-up, asset-by-asset calculation methods should be used to calculate stranded costs. The burden of proof should be on the utilities to provide evidence of stranded cost due to the introduction of retail electric competition for each and every asset or obligation that the utilities believe is stranded. In addition, the calculation method should account for any and all assets whose market values are greater than their book values.

Top-down, revenue lost methods should not be used. While top-down methods can be less complex to implement, their use could result in inaccurate estimates of stranded cost. As Hirst, Hadley, and Baxter (1996) noted, top-down methods do poorly in estimating the amount of stranded costs if utilities lose sales, which is likely for at least some sales under retail electric competition. (See Methods to Estimate Stranded Commitments for a Restructuring U.S. Electricity Industry, ORNL/CON-424, Oak Ridge National Laboratory, January 1996.)

Although it may not be practical or effective, the stock market valuation method should also be investigated.

Determining Market Values and Market Clearing Prices

Market values and market clearing prices should be determined by using a combination of market and administrative methods. Some assets should be sold in the market (divested) and the resulting prices used as the market values in the analysis of stranded costs. Market values of other assets and obligations can be determined by using administrative methods. One such method would use the sale prices of similar assets sold by other utilities to estimate the market value of a given asset (i.e., a comparable value approach similar to real estate appraisals). Another approach would be to use independent appraisals of market value when prices of comparable assets sold in the market are not available.

Determining market clearing price is important only for those assets that continue to be held by the generation affiliate of an affected utility. For these assets, independent forecasts and evidentiary proceedings can be used to estimate market clearing prices.

To: Carl Dabelstein
From: Barbara Sherman, Arizona Consumers Council
RE: Stranded Cost Report

I wish, to compliment the report drafters. I find the report very thorough and appreciate the efforts in the report to be fair.

Please accept my apologies for being so late, I was just able to read the report because of my travels.

p.11. Thank you for the sentence. "Fairness and equity..."

p.14. I appreciate the Staff's recommendation re nuclear decommissioning costs.

p.16. I concur with the last sentence of the first (incomplete) paragraph.
How do the issues of cross subsidization affect it, however?

p.18. I concur that migration efforts should be evaluated on a case-by-case basis.

p.35. I concur with your Staff position that a periodic true-up is necessary to protect the public interest.

p.42. end of second complete paragraph. If self-generators expand their generation capacity, they should not be exempt.

p.43. last sentence of first complete paragraph. I wholeheartedly concur that the general body of ratepayers should not bear the stranded cost obligations of special contract customers.

p.50. Personally, I have difficulty with the concept of securitization because of our Arizona Constitutional provision against public monies going to the benefit of private interests.

p.64. I support your recommendation re taxes at the end of the third (complete) paragraph.

Everyone involved deserves credit for a good report.

COST WORKING GROUP FINAL COMMENTS

The following constitute my comments to the final report of the Stranded Cost Working Group. These comments are in response to the request of Carl W. Dabelstein, Director Utilities Division.

First I must decent in the manner in which the 20 assigned voting members was defined as to consensus. It was my understanding that a consensus would be reached when a super-majority 2/3 of the entire group would vote in the affirmative, not two thirds of those voting. If a member of the voting group could not attend, then that member was to send another person from the stakeholder group to represent the missing voting member so as to assure all groups and/or stakeholders would be represented in all votes.

With respect to the manner in which the voting was done to achieve any consensus on any issue. It was supr-ising that a consensus of 14 voting members was achieved on any issue. The system was set up to practically insure that a consensus would not be achieved. By not allowing the give and take of real discussion with each stakeholder group having to relinquish all or part of a position taken so that others could modify their positions on the range of issues before the voting members, no consensus could possibly be achieved.

By voting on each question and issue as an individual

item there was no reason for any participant to change the last stated position in the individual sub-groups. No one could be assured that any voting member could or would modify their stated position if they could not be assured that others would modify any other position.

Members also were at a disadvantage in not having any figures as to the magnitude of stranded costs and therefore could not realistically vote on a series of issues as to time frame and methodology of quantifying stranded costs etc. Complexity of the issues comes into play especially if there is no opportunity to collectively and creatively bargain over all issues that were on the table.

It was my understanding that in the final phase of the process this type of negotiation would take place in order to come to a resolution of the issues by all parties involved.

I certainly can not agree with the position that the rules should be amended to allow all customers including those who are on the standard offer to pay stranded costs. Those who remain on the standard offer are not paying and will continue to pay a share of stranded costs through the Commission's rate structure. How can you have a rate cap or not cause customers rates to increase if stranded costs are determined by the Commission to be far in excess of what is now paid by captive ratepayers.

By allowing some customers to pay a lump sum amount in lieu of a stranded cost charge how to we account for

any true-up in stranded costs? Is the Commission going to tack on an additional charge if a true-up is dreamed to require a higher charge? What happens if the customer who pays the exit fee comes back on the system? Does the customer get a free ride if they sign up with a company which has a wires charge? Does that same customer avoid the those stranded cost charges? It appears that there are many questions which need answering before this issue can be resolved.

The recommendations of staff while important to the final deliberations of the commission should not become more important than the positions of the other parties in the working group. As stated before, there really was no opportunity for the working group to really come to consensus because of the way the voting group was asked to consider the issues individually.

The first three bullets on pages v and vi appear to be self explanatory and conform to present rules. Bullet four, "Net Revenues Lost" approach while the preferred method of the embedded utilities leaves many questions unanswered. To our preferred methodology would be asset by asset or "Replacement Cost Valuation" (pages 22-23 of the report). Under this methodology a true-up would not be required or necessary and all parties would know going in what the stranded cost would be. Other market decisions could be taken by all parties without being afraid that the numbers would change in the future.

Bullet 5 should be expanded to include likely revenues generated by assets built under regulation and paid for by captive ratepayers or described as stranded costs because they are not fully paid for. If these assets are available to enhance revenues of the utilities they should only be considered as stranded costs if those assets or the part utilized for existing customers under regulation is not recovered.

Bullet 6 is good but bullet 7 is not necessary if the bottom up approach is used as the stranded cost would be known and accepted before competition takes place.

Bullet 8 should be changed to the period not exceeding the time when full competition is in place for no more than two years.

Bullet 8 is unacceptable as it requires that consumers on standard offer who are now paying for stranded costs in rates will be assessed an even higher rate, perhaps raising rates to unacceptable levels. Competition we were told will lower rates not raise them.

Other bullets are acceptable.

When mitigating stranded costs care must be taken to make sure that the affected utilities do not write off assets which will show that higher rates to captive ratepayers are necessary to or to recover those assets as stranded costs. The Commission should take into consideration other uses of assets which will bring revenues to the affected utilities, thereby mitigating stranded costs.

Some of these assets were built under regulation as part of the rate base but can be expanded by the utilities to bring in other revenue.

Should investors assume some of the liability for stranded costs? It seems to me that under regulation, utilities and the investors benefited as rates of return regulation almost always assured investors a return that was usually above market for investments. Investors lost only when the affected utilities went outside their area of expertise and into investments unrelated to energy generation, transmission or distribution and lost money in the general market. Investors have had the benefit of almost uninterrupted profits while captive ratepayers were in many cases charged higher than needed rates. It is only fair that all parties should bear the costs of deregulation so all can benefit -- consumers with lower rates and utilities with higher profits.

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Arizona Electric Power Cooperative, Inc.

AEPCO

Comments

on the

Stranded Cost Working Group Report

September 25, 1997

The Arizona Electric Cooperative, Inc. ("AEPCO") submits these comments on the Report of the Stranded Cost Working Group (the "Report").

AEPCO congratulates the members of the Working Group, Utilities Division Director Carl Dabelstein, and his staff for their comprehensive analysis. Although AEPCO disagrees with several of the Report's statements, conclusions and recommendations, the process and the resulting Report are valuable.

By re-opening the Rules docket, the Commission has indicated it will hold hearings on and consider amendments to the Rules on a variety of issues including stranded costs. For this reason, AEPCO will abbreviate these comments and will not critique the Report line by line or matter by matter. Instead, these comments will focus on major subject areas of most concern to AEPCO, its member owners and their member customers.

II. Definition of Stranded Costs

AEPCO proposes the following definition of "Stranded Cost" to replace the existing definition found in Rule R14-2-1601. The proposed definition includes updated language and concepts as discussed in the Working Group sessions.

"Stranded cost" means the verifiable net difference between:

a. The aggregation of prudent jurisdictional assets and obligations, recorded and unrecorded on a utilities books of record (such as generation assets, purchased power agreements, fuel contracts, regulatory assets and environmental mandates), incurred for, or in anticipation of, the obligation

to provide electric service under a regulatory framework;

and

b. The market value of those assets and obligations directly attributable to the introduction of competition under this Article.

III. Components of Stranded Costs

Although no companion conclusion or recommendation is offered, AEPCO is concerned about the following statement at pages 13-14 of the Report:

> [I]t is noteworthy that several members of the Calculation Methodology Subcommittee were of the opinion that no capital costs added after December 26, 1996 ... should be allowed for inclusion in stranded cost calculations.

The statement ignores the fact that Affected Utilities, AEPCO among them, are subject to a series of ongoing regulatory and statutory mandates requiring capital expenditures which did not cease on Rules' adoption. For example, as a result of the last Resource Planning Order, AEPCO remains subject to a one MW renewable capacity goal by the end of the year 2000 (Decision No. 58643, pp. 78-79). This is in addition to the Rules' Solar Resource Portfolio requirements.

Both legally and as a matter of equity and fairness, the Commission should recognize certain post 1996 capital costs as stranded if they are incurred because of continuing regulatory, environmental or other legal requirements.

IV.Mitigation of Stranded Costs

AEPCO strongly supports the discussion attributed to TEP at the bottom of page 16 of the Report that "non-utility revenues should (not) be considered as available for mitigating

stranded costs..." Reduced to its essence, the stranded cost inquiry should be: "How has the change to a competitive regulatory model affected the value of your utility assets?" If those assets are diminished in value, that figure is stranded cost. It may be offset only by revenues gained using the same assets because competition may have opened a new electric market.

Prior to Rules' adoption, utilities could enter the home security business, offer Internet services or open a pizza stand. After Rules' adoption, the situation has not changed. These are non-jurisdictional activities which should count neither for nor against jurisdictional customers. The income or losses from these activities similarly should count neither for nor against stranded costs.

AEPCO would recommend the Rules be amended to make it clear that non-utility revenues are not available to mitigate stranded costs and effort or lack thereof in non-jurisdictional areas is irrelevant as an issue in stranded cost proceedings.

V. Calculation Methodology

AEPCO strongly supports use of the "Net Revenues Lost" methodology for determining Stranded Costs as discussed at pages 20-22 and pages 27-28 of the Report. Particularly in light of AEPCO's all-requirements contractual relationships with its member distribution cooperatives, this methodology is well-suited to assess costs stranded by the transition. As to the primary perceived disadvantage - its dependence on future price and other projections - this may be overcome by a periodic true-up procedure.

VII. Market Clearing Price

AEPCO believes that the appropriate price by which to define stranded costs is the long term marginal price which represents investment in an electrical system that was built under the concept of "obligation to serve" and reflects energy that will be provided over a long period, not just for one hour or one day. This long term price will not be subject to wide or "wild" market fluctuations. The market clearing prices attributed to California and Michigan's rules reflect the cost of power on a short term basis. Even a futures commodity price is also based on short term requirements. Obviously, all future power can not and will not be sold at the short term marginal cost. That price will not be a sufficient economic incentive to support the additional capacity that will be needed to serve Arizona in the not too distant future.

The danger of setting too low a price by which to define stranded costs is the very real potential of overstating stranded costs. The second consequence of overstating stranded costs is that Affected Utilities may be forced to write down their assets and incur very significant financial losses. Few, if any, utilities could withstand such a blow.

AEPCO believes that further study is needed on this subject to ascertain the correct calculation of this long term marginal price.

X. Recovery Mechanism

AEPCO disagrees with the Staff position that a period of ten years should be incorporated into the Rules as an outside limit to the recovery period (Report, pages 48-49 and Recommendation at page vi). The recovery period will be impacted by a wide range of factors and any arbitrary limit may carry the unintended consequence of actually raising barriers to competition.

In AEPCO's case, its all-requirements contracts currently expire in the year 2020. Most of its major assets have useful lives extending well beyond a presumptive ten-year recovery period. An artificially compressed recovery period may unnecessarily accelerate recovery and, of necessity, raise the stranded cost recovery charge.

AEPCO is not certain what the correct answer ultimately will be as to an appropriate recovery period. But, it does feel strongly that maximum flexibility as to available options will benefit its member owners.

COMMENTS OF ARIZONA PUBLIC SERVICE COMPANY ON STRANDED COST WORKING GROUP REPORT

I. INTRODUCTION

Arizona Public Service Company ("APS" or "Company") must first acknowledge the tremendous effort that obviously went into the final report of the Stranded Cost Working Group ("Final Report"). Although somewhat sketchy on some important details, the Final Report was relatively comprehensive in its scope and represents a thoughtful analysis of many of the fundamentals of the stranded cost issue. Furthermore, it makes a number of significant recommendations to the Arizona Corporation Commission ("Commission") - recommendations that will no doubt improve the Commission's self-described "framework" for electric competition in the form of A.A.C. R14-2-1601, *et seq.* ("Competition Rules").

This being said, the Company found the Final Report to be incomplete or deficient in a number of areas. APS would therefore make the following recommendations to the Commission:

1) the Competition Rules should explicitly link "stranded cost" recovery to the introduction of retail electric generation competition;

2) the Competition Rules should allow inclusion of post-1996 obligations in the definition of "stranded costs;"

3) the Competition Rules should authorize inclusion as "stranded costs" the "going concern" or CC&N value for "Affected Utilities;"

4) Nuclear fuel disposal costs should be included as part of any "systems benefits" charge;

5) the Competition Rules should adequately define and limit the scope of required "stranded cost" mitigation;

6) the length of time over which "stranded costs" are to be calculated and recovered should be greatly reduced from the periods recommended in the Final Report;

7) the proposed frequency and manner of "stranded cost" recovery true-ups suggested in the Final Report should be modified to provide incentives, hasten the adoption of market-based prices, and avoid adding unnecessary complexity and uncertainty to the "stranded cost" recovery process; and,

8) the Commission should clarify the meaning of the various factors listed in A.A.C. R14-2-1607(D) and delete therefrom of irrelevant factors.

In addition to these substantive areas of dispute, the Commission should adopt two further procedural recommendations. The first is that the Commission immediately schedule evidentiary hearings to resolve the many substantive "stranded cost" issues. The second is that the Commission establish a firm schedule for "Affected Utilities" to make a "stranded cost" filing **after** the resolution of these same substantive issues.

II. LINKAGE BETWEEN STRANDED COST RECOVERY AND COMPETITION

The Final Report correctly describes "stranded cost" recovery as an essential issue in every jurisdiction's consideration of retail restructuring but then fails to recommend similar linkage in this instance. Resolution of how "stranded costs" are to be calculated and how their recovery is to be implemented are critical to "Affected Utilities," their customers, and even to their potential competitors. The Competition Rules should therefore be amended to make the initial phase of competitive electric generation, as described in Competition Rule 1604(A) dependent upon the Commission's ascertainment of a "stranded cost" estimate and approval of a "stranded cost" recovery mechanism for each of the "Affected Utilities."

III. THE DEFINITION AND SCOPE OF "UNMITIGATED STRANDED COST"

Several of the specific criticisms APS has to the Final Report fall under this general category. These are the treatment of post-1996 obligations, the value of the Company's heretofore exclusive CC&N, the treatment of nuclear fuel disposal costs, and "stranded cost" mitigation.

A. Post - 1996 Obligations:

The definition of "stranded cost" in Competition Rule 1601(8) only includes obligations entered into prior to 1997 "under traditional regulation." As such, it ignores the fact that "traditional regulation" and the legal service obligations of "Affected Utilities" continue unchanged until at least 1999. Moreover, each "Affected Utility" retains at least some aspects of traditional regulation and the obligation to serve until it no longer is required to provide "standard offer" service, which will be 2003 at the earliest[1]. The "Affected Utilities" also are under an obligation to mitigate their otherwise strandable costs. Clearly "stranded cost" should encompass prudently incurred costs to meet all of these post-1996 service obligations to the extent such costs are not recoverable through competitive rates.

Interestingly, the Final Report of the Commission's Legal Issues Working Group partially recognized this deficiency in the competition Rules, as did the Final Report of this Working Group. Yet neither proposes to simply eliminate the arbitrary 1996 cut-off date by deleting the words "prior to the adoption of this Article" from Competition Rule 1601(8). The Commission should adopt this change to the Competition Rules.

[1] Even these dates are relevant only to the provision of competitive generation. The obligation of "Affected Utilities" to provide competitive metering, billing, etc., services under Competition Rule 1606(c) is indefinite in duration, and thus the possibility of incurring additional "stranded costs" in the provision of such services is equally open-ended.

B. CC&N Value:

Several Arizona judicial decisions recognize that a public service corporation's exclusive service area rights are a part of the firm's "going concern" value and thus are properly compensable if taken by government. This is precisely what the Competition Rules have done, and yet the definition of "stranded cost" makes no mention of this additional value.

C. Nuclear Fuel Disposal:

The Final Report recommends that the Commission determine whether nuclear fuel disposal costs are an element of "stranded costs" or part of the "systems benefits" charge under Competition Rule 1608. Such a recommendation is surprisingly non-committal on what ought to be a simple and non-controversial clarification of Competition Rule 1608(A). This Subsection already classifies nuclear decommissioning costs as "systems benefits." There is no logical reason to distinguish the cost of disposing of spent nuclear fuel from the other costs of nuclear plant disposal. Thus, APS urges the Commission to amend and clarify Subsection A of the above regulation by adding the parenthetical "including nuclear fuel disposal costs" after the word "programs" at the end of such Subsection.

D. Mitigation:

The Final Report of the Legal Issues Working Group contains an excellent discussion of the majority view of that body relative to the need to narrow the scope of required mitigation measures. If it were clear that required "stranded cost" mitigation is limited to the reduction of costs and the remarketing of power or the expansion of other traditional electric utility services, there will be less need to worry about whether the costs of failed mitigation efforts should themselves be treated as yet additional "stranded costs." Therefore, consistent with the above discussion, Competition Rule 1607(A) should be amended by substituting of the word "reasonable" for the words "every feasible" in line 1

thereof, and by adding the words "that relate to regulated utility service" after the word "measure" in line 2.

IV. STRANDED COST MEASUREMENT AND RECOVERY PERIODS AND FREQUENCY AND SCOPE OF "STRANDED COST" TRUE-UPS

The discussion in the Final Report on the period used for determining "stranded costs" is a good example of how one ill-conceived idea begets another, which then begets yet a third. "Stranded costs" should be viewed as a transitional phenomenon -existing largely due to the present imbalance of generation supply and demand. Yet the Final Report drags this measurement of "stranded costs" out over the next 20-30 years. Because the Final Report apparently contemplates this overly long period for measurement of "stranded costs", it then concludes that the recovery period for such costs must be extended to 10 years. Such a long recovery period coupled with the even longer measurement period then appears to lead to the suggestion that repeated and comprehensive true-ups of both the calculation and recovery of "stranded costs" are appropriate.

A. Measurement Period:

Ideally, the measurement of "stranded costs" should match the period of market imbalance that is largely responsible for creating them in the first place.[2] APS expects that period to be much shorter than the remaining life of existing generating assets. Thereafter, market prices can be expected to track long run marginal costs, and the need for explicit "stranded cost" recovery would end.[3]

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[2] In the context of this discussion, the term "stranded costs" refers primarily to the above market costs of generating facilities and/or purchased power rather than so called "regulatory assets".

[3] Interestingly enough, the replacement cost method of estimating "stranded costs" would, if corrected to reflect the temporary imbalance between market price and long run marginal cost, represent a useful proxy for "stranded costs" during this transition period.

Carrying out the calculation of "stranded costs" over the then remaining life of the assets (power contracts) in question creates a multitude of avoidable problems:

1) It effectively keeps the present stock of generating assets on traditional cost of service regulation for decades, thus postponing the transition to market-based generation pricing;

2) It exacerbates the already significant problem of prognosticating future market prices for generation and the operating performance of individual generating plants; and,

3) It makes the calculation of "stranded costs" more sensitive to assumptions about the proper discount rate to be applied to future costs and revenues.

Keeping generation priced on a cost-of-service basis for the remaining life of existing generating assets (rather than transitioning to market-based pricing) is inconsistent with the whole intent of the Competition Rules. The Final Report also minimizes the tremendous complexity added to the quantification process by stretching out the calculation period. Moreover, as is discussed below, having too long a period for the calculation of "stranded costs" also leads to the need for extended recovery periods, as well as controversial and time consuming efforts to fine tune the process through repeated true-up proceedings.

B. Recovery Period:

To put it bluntly, ten years is too long. APS sees little justification to extend the recovery period to such a length that it may be longer than the entire projected market imbalance period. APS would think a five to seven year period for "stranded cost" recovery to be sufficient. Although APS has argued loud and long for the recovery of "stranded costs," it has always viewed this as a transitional step that ought to be concluded as quickly as possible.

C. True-Ups:

APS believes that any true-ups should be both infrequent (no more often than every two to three years) and limited to: 1) correcting for errors in assumed market prices; and 2) the inclusion of post-1996 "stranded costs" (as has been previously addressed in the Company's Comments). Varying the recovery of "stranded costs" because of changes in the projected generating costs of "Affected Utilities" or changes in the assumed operating performance of their generating units would remove all incentive to control such costs and performance. Similarly, if the allocation factors used for "stranded cost" recovery are subsequently adjusted, "Affected Utilities" have no incentive, and fact, will have a powerful disincentive to mitigate "stranded costs" through wholesale or off-system retail sales. This is because the profits from such sales will first be used to offset the total amount of recoverable "stranded costs" while the very existence of these substitute sales would mean that a greater percentage of this reduced sum of "stranded costs" would be allocated to the Company's remaining retail customers -thus effectively "double-counting" the benefit of any mitigation.

V. AMENDMENT OF COMPETITION RULE 1607(D)

Some parties have incorrectly interpreted Subsection D of Competition Rule 1607 as qualifying the language in Subsection B. Although some of the factors listed in Subsection D will impact the **calculation** of "unmitigated stranded costs," and others will be relevant considerations in the **method** and/or **timing** of "stranded cost" recovery, none can reasonably be read as qualifying the right of "Affected Utilities" to **recover**

"unmitigated stranded costs." This is made clear by the Commission's repetition of these same 11 factors in Subsection I of the same Competition Rule, which discusses the specific issues of recovery mechanisms and charges used to recovery "stranded costs."

The Commission can and should clarify the intent of Subsection D. Moreover, Paragraph 11 of both Subsection D and Subsection I should be eliminated. The issue of renewables is relevant to neither the quantification of nor the recovery mechanism for "stranded costs" and is more than adequately dealt with in Competition Rule 1609.

VI. PROCEDURAL ISSUES

The need for evidentiary hearings to resolve "stranded cost" issues (not to mention the issues of reliability, metering, etc.) should now be evident to even the most ardent and headstrong supporter of the Competition Rules. The workshop process has run its course, and yet the Commission lacks the fundamental evidentiary basis to further its goal of competition by 1999. Further rulemaking at this time, except in selected areas, risks making a bad situation worse and is no substitution for evidentiary hearings.

Although considerable time has been lost, there is still a chance to complete the critical tasks before 1999 if the Commission starts immediately. The Final Report could serve as the catalyst for this effort by calling on the Commission for prompt evidentiary hearings on at least the issues of "stranded cost."

Second, the "Affected Utilities" will soon be preparing their "stranded cost" filings. Given the present uncertainties and lack of resolution surrounding the whole plethora of "stranded cost" issues identified in the Final Report, it makes little sense to

address them in the context of these individual tariff filings. Assuming that the Company's first procedural suggestion is adopted, the Commission should then set a realistic timetable for the "Affected Utilities" to make their initial "stranded cost" filings.

IX. CONCLUSION

APS does not wish its Comments to obscure the many positive aspects of the Final Report. The strong endorsement therein of the Competition Rules' assurance of "stranded cost" recovery and the recognition that Competition Rule 1607(J) must be amended are certainly welcome. The rejection of involuntary divestiture and the recommended use of the "lost revenues" method of computing "stranded costs" (albeit a recommendation marred by the overly long period suggested for their computation and recovery) are likewise consistent with past comments by the "Affected Utilities." Yet the Final Report is, like the Competition Rules themselves, incomplete and flawed. Thus, APS asks the Commission to consider its Comments and the recommendations contained therein.

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CITY OF TUCSON

The Sunshine City

DEPARTMENT OF OPERATIONS
P.O. BOX 27210
TUCSON, ARIZONA 85726-7210

September 25, 1997

Mr. Carl W. Dabelstein
Director, Utilities Division
Arizona Corporation Commission
1200 West Street
Phoenix, Arizona 85007-2996

Dear Mr. Dabelstein:

As Director of the Department of Operations, I have been appointed by the City Manager to direct the City of Tucson's efforts on electrical deregulation in the State of Arizona. Also signatory to this letter are Ron Ballard, Operations Administrator for Facilities and Design Management who, as you are aware, was a participant on the Stranded Cost Working Group. Finally, you also will find the name of Jim Perry, Operations Administrator for Technical Planning and Resources.

The following letter outlines comments of the City of Tucson with the Stranded Cost Workin Group report. As you are aware, the Stranded Cost issue presents some of the most far-reaching problems in the task of restructuring the electric utility industry. It poses direct impacts on consumers, investors, and the potential effectiveness of competition. Beyond these impacts it also poses possible shifts in costs from electric rates to taxes, possible loss of existing jobs and industry, and erosion of future economic development potential, as well as impacts on the environment and renewable energy production. Careful examination and deliberation of the policies to be used for calculation, mitigation, and recovery of Stranded Cost is clearly required.

As time was of the essence, and the September 19th draft version did not reach the City until the 22nd, the comments reflect primarily the September 5, 1997 draft version. A quick comparison of the drafts, however, indicate only a small number of changes, although several are very important. Of some consequence, however, is the statement on page iii of the Executive summary relating to consensus: "For that purpose, twenty parties, representing a balanced, cross-section of participating stakeholders were given voting authority" (emphasis added). While I cannot comment on the correctness of this statement statewide, I am not certain if it holds true for municipal customers and particularly those classes served by TEP. Specifically, I am concerned whether commercial, small industrial and municipal customers were adequately represented; these classes account for over 40% of the revenues by TEP. While I am uncertain of what can be done at this late date, serious consideration should be given to cities, as a voting member, when determining the membership for the Super Working Group.

The City supports the Commission's efforts to establish viable retail competition for electric service. The City also appreciates the considerable effort and thought that members of the Stranded Cost Working Group contributed to this process. However, as evident in the report, there is still much to be done. As noted, "it is disappointing to report that many issues are yet unresolved."

It is the City's belief that certain language and provisions could prove detrimental to consumers and serve to undermine the effectiveness of competition. We therefore urge the Commission to undertake formal investigative proceedings on the issue of Stranded Cost at their earliest convenience to resolve fundamental matters on Stranded Cost policy. Such proceedings could include the formation of panels and the calling of expert witnesses.

The following pages outline the primary concerns of the City of Tucson and the recommendations it supports. The City appreciates your initiative to make the City's comments a part of the report.

Respectfully submitted,

Ronald L. Meyerson, Director
Department of Operations

Ron Ballard, Operations Administrator
Facilities Design and Management Division

Jim Perry, Operations Administrator
Technical Planning & Resources Division

Attachment

CITY OF TUCSON'S RESPONSE TO THE STRANDED COST WORKING GROUP REPORT

Public policy, just as traditional regulatory policy, is outcome-oriented. The success of a specific policy is measured in terms of its results. Sound public policy on Stranded Cost matters needs to be guided by two primary elements: 1) the issue of fairness to consumers and investors, and; 2) what will help a competitive market to function effectively.

In order to provide perspective and constructive recommendations, the City's response to the Stranded Cost Working Group report examines several key components: I. Threshold Issues; II. The Task and Recommendations; III. Additional Issues Addressed and Recommendations and Findings; IV. Commentary on Recommendations and Findings; V. Recommendations of the City Tucson Based on this Critique.

I. Threshold Issues

Under Rule R14-2-1607.C The Commission required that "A working group to develop recommendations for the analysis and recovery of Stranded Cost shall be established." Rule R14-2-1607.C.2 outlined the representatives of various groups to be included in the group. Rule R14-2-1607.C.3 stated: "The working group shall be coordinated by the Director of the Utilities Division of the Commission or by his or her designee." Under Rule R14-2-1607.D the Commission instructed the Working Group "to consider at least the following factors" and specified 11 issues to be examined. The Working Group did not provide guidance or recommendations on 8 of those 11 issues.

Before addressing this evident problem, and the Staff's "disappointment," it is important to discuss two threshold issues that affected the report and could continue to have a dramatic effect on the discussion of Stranded Cost in Arizona.

A. Outcome-Oriented Regulation and State Authority to Determine Sharing of the Stranded Cost Burden

The problem of apportioning shares of stranded costs between consumers and investors is fundamental to both the issues of impact on individuals and the viability of a competitive retail market. Several members of the Working Group requested that the threshold issue of sharing stranded cost burdens between consumers and investors be examined. The Staff responded by stating: "While some absorption by the Affected Utilities' investors would undoubtedly reduce the stranded cost burden for consumers to ultimately bear, the Staff is unaware of any legal or regulatory basis for doing so. Presumably, the prudence of expenditures underlying existing service rates has been established and there is no legal opportunity for a revisiting."

It has come to the City's recent attention, however, that several states have found in their investigations that utilities <u>do not</u> have a legal right to full recovery of stranded costs.

The Maine Public Utilities Commission, for example, determined in their 1996 deregulation plan that:

"A commission may decline to allow the recovery of costs, even if prudently incurred costs, without exceeding constitutional limits unless the result is confiscation of the utility's property, taken as a whole. Such confiscation will be found only where the utility's financial integrity is seriously jeopardized. Duquesne Light v. Barasch, 448 U.S. 299 (1989)." [Maine Public Utilities Commission, Electric Utility Industry Restructuring: Report and Recommended Plan, Docket No. 95-462 (December 31, 1996)]

In the Duquesne Light case cited by the Maine Commission, the United States Supreme Court upheld the right of state legislatures to disallow utility investments previously found prudent and approved by state regulators. The Supreme Court stated:

"a state scheme of utility regulation does not 'take' property simply because it disallows recovery of capital investments that are not 'used and useful' in service to the public."

The Supreme Court also stated that changing standards from original "prudence" tests that may have been applied to investments was not unconstitutional:

"The adoption of a single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since Hope Natural Gas, supra. As demonstrated in Wisconsin v. FPC, circumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors."

Accordingly, the Court found:

"The Constitution within broad limits leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public."

Similar to the reasoning of the Maine Public Utilities Commission, the Massachusetts Department of Public Utilities found no legal right to full recovery of stranded costs:

"The Department concludes that we are not required to ensure that electric companies continue to receive from ratepayers the same level of recovery of investments and return on those investments that they receive as regulated monopolies, or to insure the companies against possible losses in a competitive market. Rather, the Department's duty under this line of takings cases is to balance the interests of ratepayers and shareholders in the new circumstances of a restructured electric industry, in order to achieve a fair result and set just and reasonable rates." [Massachusetts Department of Public Utilities, Electric Industry Restructuring Plan: Model Rules and Legislative Proposal, Docket 96-100 (December 30, 1996)]

The Vermont Public Service Board was even more direct in its finding:

'The Supreme Court decisions on the limits that the Takings Clause imposes on utility regulation reveal several clear principles upon which the Court's decisions are consistently anchored. The overarching principle is that under the Takings Clause, it is the end result of regulation that matters rather than the specific methodology by which the result is obtained; the end result must represent a balancing of ratepayer and shareholder interests, and fall within a range of reasonableness. Subsumed under this overarching principle are several subsidiary principles: the Constitution does not require full recovery of prudently incurred utility costs; the Constitution does not require states to protect utilities from the effects of competition; and the Constitution does not require rates that guarantee the financial viability of the utility." [Vermont Public Service Board, The Power To Choose: A Plan To Provide Customer Choice of Electricity Suppliers, Docket No. 5854 (December 31, 1996)]

The Report's position on this issue should be reexamined. Any subsequent discussion of stranded costs should include a full discussion of the presumed rights of the Affected Utilities to recovery. Coincident with that discussion should be a discussion of the quantified stranded costs under consideration, even if in the form a preliminary estimate, or range of estimates. There is no ability to gauge the fairness, or end result that is the purpose of the regulatory process without such quantification to guide policy-making.

This leads to a second threshold topic requiring comment.

B. Stranded Cost Estimates and Public Policy Making

Members of the Working Group also requested that, as part of the Working Group's activities, the Affected Utilities should perform and make available estimates of their retail stranded costs. Given that the function of regulation is to provide a fair outcome, and that policy recommendations by the Working Group need to be based on a clear understanding of the possible impacts of certain policy choices, this request was eminently reasonable. However, the Staff did not support this request and provided five reasons to support its decision.

1) The "overriding objective of this Working Group is to develop recommendations for Rules covering the procedures to be used in connection with the quantification and recovery of stranded costs, not an actual quantification of stranded costs."

As noted above, the purpose of regulation is to provide a fair outcome. It is not reasonable to expect that methods determined in isolation from an understanding of relative impacts will produce a reasonable and fair outcome. In fact, not addressing quantification of outcome for policy-making jeopardizes the opportunity to produce policies that will result in a fair outcome. Indeed, if utilities have differing assumptions, or coincident assumptions within their preliminary estimates, it would help to clarify and advance discussion. It is reasonable to expect that the quantifications discussed in the Working Group would not be final numbers. It is also reasonable to expect that

development of final numbers will only come through specific discussion of preliminary estimates and specific policies that may be determined based in part on those estimates. Setting policy on calculation methodology and preferred assumptions prior to submission of the formal estimates due by January 1, 1999 seriously jeopardizes sound policy-making and the resulting impact on the effectiveness or viability of a competitive retail market.

2) "Second, as may be obvious from reading this report, such an undertaking is highly complicated and based on a wide range of assumptions and methodologies for which no universal acceptance among parties has yet been achieved."

It can be safely assumed that the Affected Utilities have already developed a range of estimates on stranded cost, based on varying assumptions. Thus, there would be no additional effort to produce these numbers. Further, the fact that differing methodologies and assumptions may have been used can prove vitally useful in assessing the relative impacts of differing policies. In addition, a neutral party could produce estimates using Oak Ridge National Laboratory's ORFIN model, or any other standard economic planning model available.

3) "Third, much of the information upon which such calculations are based has become of competitive value. The utilities should not be forced to disclose such information publicly, any more than requiring independent power producers to provide estimates of their market prices for the next ten years."

The City is uncertain as to the basis of this reason. First, much of the information used to calculate stranded costs is available in public documents and industry sources. Both financial analysts and major competitors have already done competitive assessments, including stranded cost assessments of most utilities. Second, the calculations are required to be filed formally by January 1, 1999 anyhow. Delay in making preliminary estimates available to the Working Group has interfered only with policy-making, it has not functioned to assure market protection.

4) "Fourth, some parties allege that estimates of stranded costs must be known, in order to fairly assess the reasonableness of the stranded cost recovery plan." The Report asserted however: "if the process for quantifying and recovering stranded costs is sound, then we believe the result of that process, by definition is sound."

Unfortunately this could indicate that the Staff has lost sight of the purpose of regulation which is based on producing a fair outcome. The standard measure is one in which the outcome determines if the process is fair, not one in which the process determines if the outcome is fair. The judgment on the abstract "soundness" of methodology and process is therefore, considered to be subjective.

5) "Finally, for those parties who believe they have a strong need to have some identification of the utilities' stranded costs, it should be noted that such entities as

Fitch Investors' Services, Moody's, and Resource Data International, have published estimates for most investor-owned utilities."

This is contrary to the third reason cited by the Report and demonstrates that the argument concerning the private nature of stranded cost estimates cannot be supported. The estimates should have been provided by other means and discussed with the members of the Working Group, if the Affected Utilities proved unwilling to provide their own estimates.

II. The Task and Recommendations

It is the City's feeling that the need to resolve or discuss in an informed manner, both the issue of authority to determine sharing of stranded costs, and any initial quantification of stranded cost, severely limited the ability of Working Group members to fully discuss or assess any given method or assumption for calculation or recovery. Clearly this limited meaningful discussion on the impacts of alternative policies and left members of the Working Group in the dark on the relative merits of methods or assumptions. This problem certainly contributed to the inability to provide findings or recommendations on fundamental issues.

As noted above, the Working Group did not provide guidance or recommendations on 8 of the 11 specific issues outlined by the Commission.

The impact of stranded cost recovery on the effectiveness of competition.

Result: The Working Group did not make any meaningful assessment of this issue, and made no recommendation or finding.

The impact, if any, on the affected utility's ability to meet its debt obligation.

Result: While the report includes a brief discussion of this issue, there were no recommendations voted upon and the Report concluded; "Based on the foregoing and its independent analysis of the financial issues, Staff believes that many of the concerns cannot be fully addressed until additional clarity and specificity is incorporated into the Rules. This includes, in particular, some resolution as to whether asset divestiture is going to be mandated, and the manner by which, as well as the period during which, stranded cost recovery shall occur. Accordingly, Staff recommends further study of these issues with appropriate revisions to the Rules at a later date when more information is known."

The impact of stranded cost recovery on prices paid by consumers who participate in the competitive market.

Result: The Working Group did not make any recommendations, and due to the lack of clarity on methodology and other terms provided no meaningful guidance on this question. However, one indirect reference does indicate a possible increase in rates: "It is mathematically impossible to not increase rates in the aggregate and have full stranded cost recovery, when the recovery period is shorter than the

average remaining service lives/amortization terms of the underlying assets, and no opportunity exists to assign stranded costs to parties other than those taking competitive power. Staff believes there needs to be a change in the Rules in this respect."

The degree to which some assets have values in excess of their book values.

Result: The Working Group offered no recommendations or meaningful guidance on this issue.

The appropriate treatment of negative stranded costs.

Result: The Working Group offered no recommendations or meaningful guidance on this issue.

The time period over which stranded cost charges may be recovered.

Result: "The Group declined to vote on this issue stating their desire to know the magnitude of stranded costs before stating a recovery period preference." (at 46) After considering various issues surrounding recovery methods, the Subcommittee was unable to establish a clear preference."

The applicability of Stranded Costs to interruptible customers.

Result: A range of views were offered on this issue, however no meaningful guidance or recommendation was provided.

The amount of electricity generated by renewable generating resources owned by the affected utility.

The Working Group offered no guidance or recommendations on this issue.

Of those issues specified by the Commission, the Working Group could only be deemed to have addressed three in any meaningful manner.

The degree to which the affected utility has mitigated or offset stranded costs.

Result: "Although no specific recommendation by the Subcommittee was made to the Working Group, there was general agreement that utilities should aggressively pursue ways to mitigate or otherwise reduce stranded costs. The participants have various views on the different mitigation techniques available." "Staff recommends that the Rules be modified with respect to stranded cost mitigation only to the extent that they will allow each Affected Utility to independently demonstrate that their mitigation efforts were reasonable and cost-beneficial, based on all relevant facts and circumstances. Moreover, Staff recommends that amounts prudently spent in connection with mitigation be properly considered as a recoverable cost."

The impact of stranded cost recovery on customers of the Affected Utility who do not participate in the competitive market.

Result: "By a vote of 12 ayes, 4 nays, and 2 abstentions, the Group established a consensus that the Commission's Rule limiting stranded cost recovery to just those

parties taking competitive power should be changed. Another matter voted upon was 'if stranded costs are to be recovered from standard offer customers, should they be recovered at the same rate as that being charged to customers taking competitive power?' The result was 10 ayes, 0 nays, and 8 abstentions. According to the agreed upon voting procedure, this did not constitute consensus on the issue."

The ease of determining the amount of Stranded Costs.

Result: The Working Group acknowledged many of the variables, however, it offered no findings or recommendations on this issue.

As indicated earlier, the Stranded Cost Working Group did not provide guidance or recommendations on 8 of the 11 specific issues outlined by the Commission. As noted by the Staff's stated "disappointment," a number of vital issues remain unaddressed. However, the City views this situation not as an unresolvable problem, but rather an an opportunity to discuss matters further.

III. Additional Issues Addressed and Recommendations and Findings

Despite the failure of the Working Group to address or provide guidance and recommendations on the issues outlined by the Commission, a number of other issues were addressed. Working Group consensus was largely confined to very general matters, such as nonexclusive categories costs to be included in calculations. However, because of the disparity of opinion and the failure to reach consensus, or to put forward alternative recommendations, on many issues the Staff provided its own analysis and recomendations. Unfortunately, some from the outside may view the substance of the recommendations contained in the report as largely Staff-driven. This impression needs to be corrected, but examples which may contribute to it are provided as follows:

A. As noted in the report, "there was no clear consensus among the members of the Working Group as to the recommended method for Affected Utilities to use in computing their stranded costs. It is, however, the Staff's belief that, notwithstanding the lack of a clear consensus, the preferred method for computing stranded costs, and that which we recommend for the Commission to incorporate into the Rules, is the Net Revenues Lost method." It is significant to note that only the utilities favored this method and that the Staff support determined much of the following discussion and deliberation on issues related to the Net Revenues Lost approach. The Net Revenues Lost methodology is discussed further in Section IV.

B. Although the Working Group declined to vote on the term for recovery of stranded costs due to lack of information, the Staff noted that it "strongly believes there must be some specificity in this regard incorporated into the Rules. We prefer a period of ten years, as reflecting a proper balance of all relevant factors."

C. As noted by the Staff, "There was no consensus established as to the most appropriate way to measure or project market price for power, nor was any vote taken by the Working group. Staff is of the opinion that the parties should continue to study this matter." Market price is one of the critical issues related to the Net Revenues Lost methodology and the relative success is dependent on the market price method chosen.

D. The subject of "true-ups" which are also essential to the Net Revenues Lost approach was presented as a question to the members of the Working Group, although there was no agreement "as to whether there should be any revisiting of the stranded cost calculations one made and accepted by the Commission." The Staff noted that it "strongly supports the concept of a periodic true-up as being necessary to assure that electric restructuring in Arizona is carried out in a manner that protects the public interests." The use of "true-ups" is discussed in Section IV.

E. In addition to the "true-up" the Staff also supported the concept of a "lump sum payment" being made to cover an individual consumer's stranded cost bill. However, this recommendation is inconsistent with the concept of a true-up. Once a "lump sum" payment is made, the presumption is that there are no additional payments.

F. Although there were no questions identified or issues voted upon in relation to municipalization, the Report's noted that the Commission "should not create incentives for self-generation or municipalization by creating a loophole through which customers can avoid their fair share of stranded costs." Municipalization, of course, falls under FERC jurisdiction and not that of the Commission. The Report's statements made in regard to "sham" municipalization and fear of "loopholes" are, in the City's mind, over generalizations/simplifications and require further discussion. This issue is discussed further in Section IV. In regard to self-generation, the Report's recommendation appears inconsistent with state policy to encourage renewable energy development and in direct conflict with Rule R14-2-1607.J which states: "Stranded Costs may only be recovered from customer purchases made in the competitive market using the provisions of this Article. Any reduction resulting from self-generation, demand side management, other demand reduction attributable to any cause other than the retail access provisions of this Article shall not be used to calculate or recover any Stranded Cost from a consumer."

G. On the issue of taxes, there were no questions identified or votes taken on recommendations. The staff noted that this issue "is largely beyond the Commission's scope of authority." Despite this acknowledgment, the staff assumed there would be some redistribution of the tax burden onto general taxpayers and advised: "Tax authorities need to begin considering what changes are required to assure there is an equitable redistribution of the tax burden and what

will enhance the chances for effective competition." The Staff also recommended that "the Commission consider incorporating additional language that assures changes in tax liabilities are properly treated in the quantification, mitigation, and recovery of stranded costs of the Affected Utilities, such that no parties are unjustly enriched or unfairly detrimented [sic]." This issue is discussed at greater length in Section IV.

H. The Staff noted that "although there was only token discussion" concerning securitization that it should be acknowledged in the report. Following a full page discussion of the pros and cons of the issue the Staff recommended that to the extent the Commission desired to investigate this issue, an inquiry should be jointly conducted with members of the legislature and other affected State agencies.

I. The Staff also wanted to alter the definition of the types of assets to be included in stranded cost recovery to include unrecorded assets and other liabilities. Staff offered the rationale that, "Over the years, this Commission has made certain 'promises' in ratemaking, both explicit and implicit, to utilities under its jurisdiction that some current expenditures would be recoverable through future rates." Expansion of the definition in this manner would have created problems in proving or disproving valid costs. The Staff recommendation to change this definition was put to a vote and the Working Group wisely rejected it by consensus.

Section IV. Commentary on Recommendations and Findings

A. Recommendation of the Net Revenues Lost Approach

On this issue, the Working Group divided in a vote with 9 members (utilities) supporting this method, 7 members supporting Replacement Cost Valuation, 1 supporting Auction and Divestiture and 1 supporting Stock Market Valuation. The Staff recommended Net Revenues Lost methodology be used.

Part of the Staff's justification is that, "It recognizes that utilities that made multiple investment decisions under the traditional regulatory paradigm expected a revenue stream from customers to cover the cost of such investments over their useful lives."

The Report may take the role of regulation beyond its legal base in this interpretation of the "traditional regulatory paradigm." As noted above, regulators in other states have found that utilities have no legal right to a guaranteed cost recovery. It is not the role of regulators to protect utilities or the usefulness of their plants from the effects of competition and changing circumstances. Further, this position appears to contradict the following statement: "In setting rates, utility regulators are not required or obligated to guarantee that the companies will achieve their authorized returns, but only be given a fair opportunity to do so."

The Staff also justified its recommendation based on the adoption of Net Revenues Lost methodology by the Federal Energy Regulatory Commission and the judgment that it "most closely mirrors the ratemaking process with which all parties involved in traditional utility regulation in this State are familiar."

It must be noted that FERC deals with wholesale contracts and not retail ratemaking. Alterations in the market that affect wholesale contracts may be more effectively addressed through revenue differentials. Retail ratemaking at the state level, however, is based on invested capital and value of assets. What mirrors this process is not estimates of revenue differentials but some form of asset valuation—as most closely reflected in Replacement Cost Valuation which is a bottom-up asset-by-asset approach, rather than the top-down method of Net Revenues Lost.

One of the primary problems of a Net Revenues Lost approach is that it buries the treatment of various assets and costs that should not be included, and places the burden on intervenors to identify and disprove doubtful assumptions. This conflicts with the consensus that was reached that the burden of proof should be on the utility. Without a rate cap and with on-going "true-ups" discussed below, there is no way to fix a ceiling figure for what stranded costs will be. Thus, there would be no way to assess at the outset, ultimate impacts on consumers or impacts on the effectiveness of competition of this method of calculation.

The report does acknowledge the difficulty of estimating future market clearing prices and associated difficult-to-predict factors, but it does not recognize the shift of the burden in the regulatory process from the Affected Utilities to intervenors and the larger impacts of associated recommendations made by the Staff.

The issue of cost methodology needs to be closely examined in terms of the quantification of impacts on consumers and investors and the effectiveness of a competitive market. It must also be assessed in terms of who will carry the burden of proof for cost justifications. These examinations still remain to be undertaken.

B. True-ups

While there was no consensus on whether there should be a true-up mechanism, the Report strongly supported the concept as associated with a Net Revenues Lost approach. An inability to utilize a true-up may have been incorrectly attributed to the Replacement Cost Valuation approach. It can be utilized under Replacement Cost Valuation by allowing a true-up if the asset is sold subsequent to the valuation. The term of this true-up period could be flexible and range from the full period during which recovery is allowed to the useful life of the asset (which is preferable). It should also be noted that under the Net Revenues Lost approach, to the extent that the burden of proof is shifted to intervenors, the true-up could repeatedly create this problem each time a periodic true-up is held, thus increasing the dimension of that burden. This might be avoided by only allowing downward adjustment of the amount to be recovered in the true-up process, and not upward adjustment.

This leads to a larger discussion of mitigation.

C. Mitigation and Inclusion of Assets

Rule R14-2-1607.A requires every affected utility to "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." Consistent with this Rule, there was general agreement on the Working Group that utilities "should aggressively pursue ways to mitigate or otherwise reduce stranded costs." However, there was substantial disagreement with respect to the extent to which revenues from non-utility activities of the companies and their affiliates may be considered as sources of funds for mitigating stranded costs.

Staff recommended that "the Rules be modified with respect to stranded cost mitigation only to the extent that they will permit each Affected Utility to independently demonstrate that their mitigation efforts were reasonable and cost beneficial, based on all relevant facts and circumstances. Moreover, Staff recommends that amounts prudently spent in connection with mitigation be properly considered as a strandable asset."

It is clear that the mitigation process will function most effectively if investors also have some burden of stranded costs at stake. It is the City's position that relying solely on regulatory investigative measures to determine what has been "reasonable" may not suffice. Having investors share some portion of stranded cost could also be a guard against minimal mitigation if the true-up process only allows a downward adjustment of the amount to be recovered. The effect of the Report's recommendations, however unintended, may encourage minimal mitigation and act against efficiency incentives.

Also, as recommended by the Report, inclusion of amounts spent in connection with mitigation as stranded costs, may be small amounts in proportion, but if the cost of testimony, counsel and witnesses to justify the mitigation process is included, it will place consumers and other intervenors in an ironic and disadvantaged position of paying for the opposition's case. This does not meet a standard of fairness and such amounts should not be included as strandable assets.

What should be included, consistent with the Rules and as suggested by several members of the Working Group, are those assets of affiliates or other businesses owned by the Affected Utility. Measures already undertaken should also be included in the assessment. It is only with a global perspective on inclusion of investor's share of the burden, total assets, and total efforts that a fair and thorough process of mitigation can be undertaken.

The change in Rule 14-2-1607.A as recommended by the Report would only serve to weaken the mitigation process and should be rejected. Further examination and discussion of this issue is required to develop the thorough process outlined by the Commission.

D. Tax Issues

There are four primary elements related to tax issues: 1) calculation, mitigation, and recovery treatment; 2) level playing field concerns; 3) assurance that burdens are not shifted from the electricity consumer to the taxpayer for no net savings; 4) the need to protect existing revenue streams so that larger shifts are not needed in the tax base.

Although state and local taxes received substantial discussion by the subcommittee, there was no recommendation offered. The Staff deferred on one hand to the proper jurisdiction of state and local government, but contrary to that deferral offered cursory analysis and opinions that display a remarkable lack of balance and understanding.
The Staff advised, "Tax authorities need to begin considering what changes are required to assure there is an equitable redistribution of the tax burden and what will enhance the chances for effective competition."

There exists a clear danger that without proper tax policy, efforts might be made to achieve savings on consumer electric bills by shifting costs to consumers as taxpayers. This is an issue with far-reaching implications for consumers, existing jobs and industry and future economic development.

Although there were no Working Group votes or recommendations in regard to tax issues the Report stated: "State and local governments have historically taxed utilities heavily and disproportionately. Utilities, on average pay twice the amount of taxes as other businesses. This chiefly occurred over the years for political expedience."

On the otherhand, it should be recognized that the utility industry enjoys as quasi-governmental status, complete with the ability to invoke powers of eminent domain. Utilities have been inextricably tied to economic development, safety and security, environmental conditions, and social welfare beyond the measure of any other industry of their size and concentration. At the local level, utilities occupy public streets and ways in a manner unlike any other business and this is the basis of their commerce. Local franchises and sales taxes paid in return for the privilege of utilizing public streets and ways and the infrastructure that supports those streets and ways totals four (4) percent of gross revenues in the City of Tucson. This can hardly qualify as "heavy and disproportionate" and based on "political expedience."

Despite the Staff's advice to tax authorities to "assure there is an equitable redistribution of the tax burden" it is essential that there be no shifting of electricity costs from consumer bills to tax bills, and that there be no displacement of the existing revenue stream to cause greater burdens on taxpayers. Equitable options to tax all users of the distribution system, or on all local sales of kilowatt hours may be considered, but not provisions that would shift greater tax burdens to consumers and local businesses. In addition to this "revenue neutral" position, it is also important to the stability of the tax base that revenue streams remain local.

E. Franchise Contracts

The Report notes in the first sentence in the body of the report, "Traditionally, public utilities have operated under licenses and franchises granting them the exclusive right to operate in specific geographic areas." This statement, needs to be tempered somewhat.

Franchises arise from an earlier form of competition in the industry when local governments commonly placed electric services out to bid. Like most local government service contracts, franchise agreements are term limited and contain varying provisions. The exclusive monopoly, if it is granted in the contract (and the standard form of franchise does not guarantee exclusivity), is usually limited in duration. Under a monopoly system, while other competitors have not been available, competitive pressure existed primarily through the standard option of municipalization upon expiration or some other triggering mechanism during the term of the agreement. Some franchises also include the specific ability to access competitive suppliers. The City of Tucson's franchise is both term limited and contains terms that allow access to competitive supply.

At the time the Commission was formed in 1913, there was a nationwide debate going on over the most efficient form of utility service: franchises, municipal systems, or state regulation. State legislators at the time wisely allowed a pluralistic system to operate in Arizona. The question of whether state regulation can substitute for competition is now being answered in the negative. However, the pre-existing forms of competition whose powers and authorities remain in place, may play an important role on behalf of consumers.

The City feels that it is important to recognize that there are significant and long standing jurisdictional issues at stake. Despite the formation of state regulatory agencies and their ratesetting powers, franchises have remained as an alternative form of service that are well suited for aggregation and a competitive environment. They provide consumers with a form of publicly accountable, non-profit, non-discriminatory leverage they would not have otherwise in a competitive marketplace. This could help in a significant manner to advance the effectiveness of a competitive market. It is important that the Staff recognize that franchise contracts held by local governments offer a pre-existing form of competition and new opportunities for consumers, and that stranded cost proposals may face both statutory and constitutional obstacles.

Section V. Recommendations Supported by the City of Tucson Based on this Critique

The City of Tucson continues to support the consensus developed on a few specific issues by the Working Group. But the City also believes that there is a clear need to advance the discussion on stranded cost through a more balanced consideration of the issues. There are eleven recommendations the City offers based on its previous participation in the Stranded Cost Working Group and this subsequent critique:

1) That the ACC should undertake investigative proceedings on Stranded Cost issues at its earliest convenience. Given that the Staff is disappointed in the report and has recommended further study, there is clearly a need for further public process. In view of the fact that the Staff has also recommended changes in the Rules, it would be appropriate for this process to take the form of a formal investigative proceeding that can require filing of essential information.

2) That development of policies to identify, calculate and recover stranded costs include preliminary estimates of stranded cost provided by the utilities or calculated from publicly available information. As noted in this critique, it is essential that selection of methodologies and policy be developed with consideration of the relative proportion and impacts posed by different methods and mechanisms.

3) That Replacement Cost Valuation be included in the recommendations to the Commission. This is in view of the fact that nearly half the voting members of the Working Group supported this methodology and that it provides an opportunity for greater accountability in both calculation and mitigation.

4) That all assets should be included in stranded cost evaluation and no capital costs after12/26/96.

5) That the Commission investigate an approach to mitigation that will incorporate investor sharing of stranded cost burdens, true-up periods, downward adjustment only, inclusion of all utility and utility affiliate assets, inclusion of efforts that may have already been undertaken, and vigorous mitigation measures generally as outlined in R14-2-1607.A.

6) That decisions concerning true-ups and recovery periods be based on a thorough understanding of the relative impacts for each methodology, and that true-up consideration include subsequent sale of assets valued under a Replacement Cost Valuation methodology.

7) That there be a clear allocation of stranded costs between jurisdictions and classes as recommended by the Recovery Mechanism Subcommittee.

8) That some portion of stranded costs be borne by investors as advocated by several members of the Working Group.

9) That a rate cap be put in place.

10) That economic savings on electric rates not be shifted to increase burdens on tax accounts and that local governments be allowed to work out mechanisms to maintain revenue streams in a manner that will support a level playing field for all competitors.

11) That the Commission recognize that the franchise contracts held by local governments offer a pre-existing form of competition, and that the proposals on stranded costs being considered may face both statutory and constitutional obstacles.

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September 26, 1997

I. INTRODUCTION

The Electric Competition Coalition (ECC) presents its formal comments on the Report of the Stranded Cost Working Group, dated September 30, 1997 ("the report"). ECC does not believe that the report reflects the work or positions of the Stranded Cost Working Group. ECC vigorously disputes many of the findings, conclusions and recommendations contained in the report. The staff's recommendation will seriously discourage and delay competition in Arizona.

In summarizing the staff's recommendation, it is proposing a 100 percent recovery of all stranded costs, using the net revenues lost approach and applying the "full expected cost recovery period" for quantifying all stranded assets, with all present and future customers repaying these stranded costs over 10 years. The staff's recommendation merely perpetuates regulated utility monopolies without granting Arizona consumers the ability to lower their electric costs in the near term.

The position of ECC was presented earlier in its letter dated May 5, 1997 and in its memorandum and "stranded cost prinicples" dated June 25, 1997, both of which are attached to these comments. ECC presents these additional general and specific comments to the report.

II. ECC'S COMMENTS

A. General Comments

ECC recognizes that the recovery of verifiable stranded costs is a necessary step in moving towards full competition. ECC supports the recovery of verified stranded costs, subject to the following conditions and propositions:

1. There never was a regulatory compact between the Commission and the affected utilities.

2. The affected utilities should only be able to seek recovery of verifiable, non-mitigated costs for which there was a reasonable expectation of recovery but for the advent of retail electric competition.

3. Customers should be protected by the Commission in the quantification and recovery of stranded costs so that they may benefit from retail competition.

4. Investors have long been aware that restructuring in the electric industry is occurring and that their utility investments are not immune from technological or regulatory change.

5. Electric utility investors have for many years been compensated at levels sufficient to cover the risk of some loss of their strandable investments.

6. Not all strandable investments may have been prudently incurred; however, this determination may need to be revisited if a lost revenue approach is adopted.

7. Stranded cost recovery should be neutral irrespective as to whether a customer accepts competitive services or the standard offer tariff.

8. No exit fee should be assessed against customers because it creates a barrier to entry by new market entrants and it is contrary to the objectives of moving towards open competition.

9. Stranded costs should be recovered within a reasonable time period of not more than 5 years.

10. The stranded cost recovery program should promote economic efficiency and the prompt transition to competitive markets.

The Staff inserted numerous and unsubstantiated legal conclusions throughout the Report. These legal issues were assigned to another working group, under Rule R14-2-1616, for its consideration and recommendation to the Commission. Furthermore, many stakeholders, including ECC, are contesting these unfounded conclusions in the pending appeals of these Rules by the utilities.[1] The final report acknowledges that these matters were to be addressed by the Legal Issues Working Group. However, that same paragraph on page 3 of the report gives the misimpression that these legal issues were discussed and addressed by the Stranded Cost Working Group.[2] The Stranded Cost Working Group did not analyze any legally related consequence of stranded cost recovery.

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[1] Tucson Electric Power Co. v. Arizona Corporation Com'n, Maricopa County Superior Court CV-97-03748; Arizona Public Service Co. v. Arizona Corporation Com'n, Maricopa County Superior Court CV-97-03753; AEPCO *et al.* v. Arizona Corporation Com'n, Maricopa County Superior Court CV-97-03920, CV-97-03921, CV-97-03922, CV-97-03928, & CV-97-03942 (consolidated); and Citizens Utilities v. Arizona Corporation Com'n, Maricopa County Superior Court CV-97-97-04176.

[2] "It should be noted that the scope of the investigation undertaken by the Stranded Cost Working Group and its subcommittees did not include any consideration of the legal issues (i.e. the 'regulatory taking' issue or whether a legal contract actually existed with respect to the traditional 'regulatory compact') relating to stranded costs. Such matters were addressed by the Legal Working Group. The issue discussions and recommendations contained herein reflect solely the analyses performed by members of the Working Group and Staff's knowledge of traditional public utility regulation and ratemaking in Arizona, and electric restructuring activities currently underway throughout the nation." Report at 3.

Given the brief time in which to provide the misstatements of facts and omissions in the report, ECC is including those corrections along with its overall perspective regarding stranded costs in these comments.

B. Specific Comments

These particular comments relate to specific points and sections as were presented in the report.

I. INTRODUCTION

1. Purpose of the Working Group. In analyzing the stranded costs issue, the Commission ordered the Working Group under Rule R14-2-1607.D to examine (a) the impact of stranded cost recovery on the effectiveness of competition; (b) the impact of stranded cost recovery on consumers of the affected utility who do not participate in the competitive market; (c) the impact, if any, on the affected utilities ability to meet its debt obligations; and (d) the impact of stranded cost recovery on prices paid by customers who participate in the competitive market. Unfortunately, no stranded cost figures were provided by the affected utilities as requested by ECC and others. Therefore, these impacts were not evaluated by the Working Group. Instead, the focus of this report is on the maximum recovery of potential stranded costs by the affected utilities.

A federal study titled *Electricity Prices in a Competitive Environment* concluded that retail competition will lower electricity prices between $15 billion and $60 billion a year. This unbiased study by the Energy Information Agency, an arm of the U.S. Department of Energy, confirms the benefits of a prompt transition to competitive electric markets. Although stranded costs will initially limit the cost savings derived from competition, the Working Group failed to address the magnitude of the consumer benefits that will be derived from electric competition.

2. Mitigation and Book Value Analyses. The Commission further requested the Working Group to examine the degree to which the affected utility has mitigated or offset stranded costs and the degree to which some assets have values in excess of the book values. Again these mitigation programs and the numbers associated with the mitigation effort and the book values relative to market were not made available to the Working Group. Rule R14-2-1607.D. As a consequence, the Working Group was precluded from performing its functions.

3. Negative Stranded Costs. The appropriate treatment of negative stranded costs was to be addressed by the Working Group, under Rule R14-2-1607.D. This issue was not addressed, except in a general sense, by the Working Group.

4. Role of the Working Group. The report on page 4 says that "Rule R14-2-1607.B states that the Commission shall allow recovery of unmitigated stranded costs by affected utilities." As a precondition of this recovery, the two subsections following this Subsection B required the formation of the Working Group and the development of the recommendations by the Working Group to the Commission based upon the impacts of potential stranded cost recovery on competition, all customers, prices paid by consumers in the competitive market,

mitigation efforts by the affected utilities, and the other considerations under Rule R14-2-1607.C & D. For reasons mentioned previously, these analyses were not conducted. Instead, this report focuses primarily on the impacts on utility investors.

II. DEFINITION OF STRANDED COSTS

5. Affected Utilities Do Not Have a Monopoly Over Generation. An incorrect legal conclusion is presented in the first full paragraph on page 5 under the section covering the definition of stranded costs. It says:

> Traditionally, public utilities have operated under licenses and franchises granting them the exclusive right to operate in specific geographic areas. This monopoly status was desirable because utilities are typically highly capital intensive, requiring a comparatively large plant investment relative to annual revenues. By eliminating the element of competition, it was believed that costs to the consumer were minimized, by avoiding the unnecessary duplication of services. To guarantee that such monopoly power was not abused, regulation was substituted for competition to bring about fulfillment of the objective of having an adequate supply of utility service at a reasonable price.

This paragraph incorrectly implies that public utilities were granted exclusive rights to operate all services. In fact, public utilities were only granted a nonexclusive franchise by cities to install certain local distribution systems. Nothing in the franchise nor in a certificate of convenience and necessity issued by the Commission implies that public utilities were granted a monopoly to generate electricity by the affected utilities. Furthermore, any efforts to avoid duplication of services applies only to the local distribution system and not the generation of electricity.

6. Occurrence of Stranded Cost. The report, on page 6, incorrectly states that stranded costs are only incurred when a customer leaves the host utility or if the customer receives a discounted tariff:

> Stranded costs typically arise when a customer leaves his host utility to buy power from another supplier and the costs savings the utility realizes by not having to meet the demand and energy needs of the departing customer cannot compensate for the revenue it loses because the customer is no longer paying regulated rates for power. They may also occur if the host utility must discount tariffed rates to a customer to retain that customer's business. The recovery of legitimate stranded costs is necessary to prevent cost shifting between customer classes, to treat utility investors fairly, and to promote efficient competition. Stranded cost recovery is mandated by the FERC in its wholesale competition rules, was affirmed in the 1996 Economic Report of the President, and has been endorsed by the all the states moving toward retail competition.

Stranded costs have and may occur irrespective of retail competition. Some stranded costs result from wholesale competition, technological changes in the industry, energy

conservation, changes in load or load growth expectations, the use of alternative power sources, and other causes. Stranded costs may be due to several other factors: overbuilding of plant capacity; inaccurate predictions of future resources, such as the extinction of natural gas for power generation during the 1970's; long-term power contracts with unfavorable prices and conditions that were negotiated between willing buyers and willing sellers; and interests in generating facilities that were built during times when power was thought to be scarce and inflation and interest rates were high.

The Rules properly define stranded costs, in R14-2-1601(8), as the difference between the traditional values of the utilities' assets and obligations as compared to their market values which are "directly attributable to the introduction of competition" under the Electric Competition Rules. The purpose of this definition is to distinguish those stranded costs attributable solely to competition from those caused by other factors described previously.

7. Unrecorded Assets and Liabilities. The report states that the staff has difficulty in accepting the existing regulatory definition of stranded costs, on page 7. Staff concludes there are "significant unrecorded assets and liabilities that may become stranded during the transition to retail competition." The report does not explain how the public interest might be protected if the affected utility has a wide discretion in declaring "unrecorded assets and liabilities" as being subject to stranded costs recovery. Furthermore, the Working Group was denied the opportunity to address the nature and magnitude of these "unrecorded assets and liabilities" (including those described in the report) and how the recovery of those stranded costs may impact competition and consumers.

8. Ratemaking Process. The report contains an incorrect and inappropriate statement regarding the ratemaking process. Its says on pages 7 & 8:

> Over the years, this Commission has made certain "promises" in ratemaking, both explicit and implicit, to utilities under its jurisdiction that some current expenditures would be recoverable through future rates. Generally, current expenditures deferred for future rate recovery are reflected as some type of "regulatory asset" on the respective utility's balance sheet. There are, however, instances where such amounts are not allowed under Generally Accepted Accounting Principles to be deferred for financial accounting and reporting purposes; thus, they are required to be charged to expense as incurred, regardless of the regulatory promise.

This statement inaccurately concludes, without citing any facts or legal authority, that the Commission has made "promises" to the affected utilities. There is no legal precedent for the creation of a "regulatory promise" between the Commission and the affected utilities.

III. COMPONENTS OF STRANDED COSTS

9. Activities of the Working Group. The emphasis of the Working Group was on requiring the verification of the potential stranded cost component. The Working Group did not examine in detail the various examples of regulatory assets as contained on page 12.

Reservations have been expressed by several regarding the legitimacy of some items, including regulatory assets, employment transition cost, and environmental mandates. Many of these items are normally absorbed as investment risks in both the regulated and non-regulated industries. A higher level of proof may therefore be required in order to show that these unique costs are at risk and potentially strandable solely as a result of the transition to a competitive electric market.

IV. MITIGATION OF STRANDED COSTS

10. Mitigation Should be Mandated, Not Discouraged. Efforts by utility management to mitigate the potential stranded costs were emphasized in the Electric Competition Rules. "The Affected Utilities shall take every feasible, cost-effective measure to mitigate or offset Stranded Cost . . ." R14-2-1607.A. "The Commission shall allow recovery of unmitigated Stranded Cost by Affected Utilities. R14-2-1607.B (emphasis added). Moreover the Working Group, if it had received stranded cost estimates, were to examine "the degree to which the Affected Utility has mitigated or offset Stranded Cost." R14-2-1607.D(5). The Working Group stressed that the utilities should use all prudent management efforts in mitigating potentially strandable costs. Staff however suggests that mitigation will likely be fruitless. Report at 15.

The degree of mitigation will directly affect the amount of stranded cost and the price and timeline in moving towards full open competition. Unfortunately, the staff's position seems to be one of apologizing for the mitigation requirement in the Rules, and instead the staff warns that these efforts will merely result in additional strandable costs. Report at 18. By the very definition of "mitigation," meaning cost reductions or revenue enhancement, there logically can not be any additional stranded costs associated with mitigation efforts.

ECC has discussed with the Commission the need for affiliate rules and standards of conduct between the utilities and their marketing activities. Utilities may mitigate potential stranded costs by selling their generation and other services competitively. Arizona's utilities are actively marketing in other states, including California, and in other service areas in Arizona. However, the costs associated with these marketing efforts should be segregated and appropriate standards of conduct should be in place to assure all utility customers that they are not incurring these costs.

V. CALCULATION METHODOLOGY

11. Vote on the Methodology. ECC supported the market evaluation approach to stranded costs, and as a second option the replacement cost valuation method of calculating stranded costs. The report misapplies the voting rules adopted by the Working Group. Despite the fact that there was no consensus as to a calculation methodology, the report says the vote shows a simple majority "preference" for the lost revenue approach. Report at 27. The Working Group did not adopt any method for coming to a decision except by super majority which would constitute a consensus.

12. Net Revenues Lost Method. Staff supports the Net Revenues Lost method, because it was adopted by the Federal Energy Regulatory Commission (FERC) and other states,

and because it closely mirrors the ratemaking process with which staff is familiar. Report at 28. The purpose of the Working Group was to examine the approach which would be most compatible with moving the electric industry towards full competition, not which method has been applied by others or may be most consist with the monopolistic ratemaking framework. Staff also relies extensively on the FERC approach to stranded costs. In announcing Order 888, Chair Elizabeth A. Moler of FERC declared on April 24, 1996, "Today's actions by the Commission will benefit the industry and consumers to the tune of billion of dollars every year. They will give us an electric industry ready to enter the 21st Century. These rules will accelerate competition and bring lower prices and more choices to energy customers."[3] Similarly, Arizona's Electric Competition Rules, including the framework for stranded costs, should be applied so as to "accelerate competition and bring lower prices and more choices to energy customers" in Arizona.

A serious shortcoming of the Net Revenues Lost method is that it treats all generation costs, both the fixed investments and the variable operational costs, as being potentially strandable and subject to reimbursement by departing customers. Clearly these more flexible operational costs (including administrative charges) could be mitigated and those customers who decide to seek other generation should not be saddled with the variable costs of their previous supplier. Overcollection of stranded costs is likely, and any true-up mechanism will not likely return the overcharged dollars to the same customers who paid the overage.

VI. CALCULATION PERIOD

13. Assumption of Reasonable Expectations. In addressing the calculation period, the staff believes "reasonable expectations" of the utilities is relevant in quantifying stranded costs. Report at 29. However, the "reasonable expectations" of consumers and electric service providers were disregarded. The Arizona Constitution and statutes create the reasonable expectation that consumers could be their own self-generator or wholesale supplier (such as through special districts or municipalization). Alternative power sources (such as natural gas) and the competitive wholesale electric environment create the reasonable expectation that stranded costs would be mitigated and electric prices would be lowered for retail consumers. In 1978 Congress passed the Public Utility Regulatory Policies Act which created the reasonable expectation that consumers could self-direct their electric services. Since 1989 independent power producers have produced over half of new generating capacity in the United States[4] which created the reasonable expectation that this power would be sold competitively and at lower prices for the benefit of all consumers. The Federal Energy Policy Act of 1992, which mandates transmission access, codified what was already happening in the marketplace, with the reasonable expectation that generation would be sold both to wholesale customers and end-users. Since 1992 many states, including California and Nevada, have embraced open retail competition which creates the reasonable expectation that retail access would occur in Arizona. These

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[3] FERC Docket Nos. RM 95-8-000, RM 94-7-001, RM 95-9-000 and RM 96-11-000 (Press Release, Apr. 24, 1996).

[4] David W. Penn, *Change: The Old and New World of Competition* (Am. Public Power Ass'n, August 1994) at 8.

expectations of consumers and electric service providers should be of equal importance when addressing the expectation of utilities and their investors.

The report also says on page 29: "These [stranded] costs were incurred by the respective utilities to fulfill their retail franchise obligations to serve customers directly under the promises that competing entities would not provide direct retail service, and that there would be a fair opportunity to recover the prudent investments that had been made." Staff mistakenly assumes there is an immutable "regulatory compact" which guarantees a recovery of strandable costs and a return on such investments. As stated previously, this is an incorrect legal conclusion unsupported by fact or law.

14. Computation Period for Stranded Costs. The report notes that the period over which stranded costs should be computed had not been raised and discussed by the Working Group. Report at 30. With good reason, because within a vacuum without any particular asset or figures in mind, the Working Group was unable to address the merits or demerits on any period of time. Since this issue was not discussed by the Working Group, it is inappropriate for the report to say there was no consensus and therefore the staff has the liberty to make a recommendation on behalf of the Working Group.

VII. MARKET CLEARING PRICE

15. Use of Synthetic Prices. A serious shortcoming of the Net Revenues Lost approach is the necessity of accurately forecasting future market prices of competitive power, as pointed out by the staff. Report at 30-33. Obviously, there will not be one price at any given point in time for all customers, not to mention over the next 10 years. An artificial "market" price will have to be resolved. As a consequence, this approach will require a costly bureaucratic process in which to model, debate, administrate and litigate a "synthetic" price.

Staff suggests that "as retail competition becomes firmly established in Arizona, a standard measure of market price that can be used by all Affected Utilities in quantifying stranded costs may be adopted." Report at 33. However, the staff's proposal for stranded cost will impede and seriously block retail competition from occurring during this proposed 10-year recovery period. Moreover, the one price concept is a carryover of the monopolistic paradigm which ignores price differentiations resulting from the creativity and variety of services and products in the competitive electric industry. As a consequence, it is misleading to assume one "standard measure of market price" will evolve from retail competition.

VIII. TRUE-UP MECHANISM

16. Annual Adjustments to Stranded Costs Inhibit Competitive Markets. The Net Revenues Lost approach brings with it the burden and costs of an ongoing "true-up" mechanism. Staff suggests an annual reexamination of stranded cost calculations. Report at 36. Annual changes in stranded costs impair the ability of consumers and marketers to negotiate competitive prices. Before market transactions may occur, the full cost of electricity, transmission, local distribution services, and stranded costs must be known. In a competitive environment, certainty of stranded costs must be known in order to make comparisons and to close transactions. The

utilities and consumers will constantly be engaged in a regulatory review process over stranded costs, which will be time-consuming and costly. Moreover, the Commission personnel and administrative costs associated with this frequent true-up process, and how those costs will be recovered, have not been addressed.

IX. COST ALLOCATIONS

17. Annual Allocation Updates. Staff suggests that the allocation of stranded costs be adjusted annually or whenever there is a true-up. Report at 37. Again, this process over the next 10 years, as proposed by staff, would require additional costs in administering a "regulated" market.

X. RECOVERY MECHANISM

18. Self-Generators and Municipalities. Self-generators and municipalization should be discouraged or prohibited, according to the staff, so that these power users will be obligated to pay stranded costs. Report at 43-44. The possibility of self-generation and municipalization were pre-existing conditions when the utilities made their investments. In essence, the Commission are being asked to reverse the trend towards consumer choice by denying consumes the privileges and rights they were entitled to enjoy prior to the adoption of the Rules and the advent of electric competition.

19. Palo Verde. The Palo Verde Nuclear Plant units have nearly 28 years remaining on their projected 45-year lives, according to the Report (at 46). The Palo Verde cost deferrals were previously being amortized over a 35-year period, and the recent "Rate Reduction Agreement" of Arizona Public Service Company provides for their recovery over an 8 year period, for these "regulatory assets." ACC Docket No. U-1345-95-491 (Pre-filed Direct Testimony of APS). This settlement agreement should be taken into consideration when addressing the magnitude of stranded costs and their mitigation.

20. Staff's Recovery Period. The staff suggests a 10-year recovery period. Report at 48. This is longer than any proposed by any of the participants in the Working Group. In addition to perpetuating the regulatory process (and the related administrative costs), this extended recovery period would clearly place Arizona at a competitive disadvantage in lowering consumers' overall power costs.

21. Investor Risk. Staff has concluded that investors cannot incur any loss in stranded cost. Report at 49. Staff suggests that departing customers should pay their incumbent utility "expectation damages" so that utility investors are no worse off than they would have been without retail competition. It infers that regulators have the duty to protect investors from the consequences of decisions by utility management who served at the sufferance of those investors. Investors have the freedom to protect themselves such as by owning low-cost utilities or other investments. Staff incorrectly implies that the Commission guaranteed the returns of utility investors, because they had forsaken the high risks and high rewards of ordinary stocks for the low risks and low returns of a regulated industry. This is a false implication. A recent analysis by the National Association of Regulatory Utility Commissioners concluded that common stockholders of 72 percent of all major electric and telecommunication utility companies earned

a higher internal rate of return than did the average stockholders of the major non-regulated U.S. industrial corporations over the 21-year period of 1972-92. Michael Foley and Ann Thompson, *Electric and Telephone Utility Stockholder Returns: 1972-1992* (Wash. D.C.: NARUC, 1993), p. 1.

The staff's report also says "nothing has been advanced by any party indicating that the introduction of retail competition has relieved the Commission of its traditional responsibility to provide the utilities under its jurisdiction a reasonable opportunity to recover its costs of providing service plus a fair return on prudently invested capital." Report at 49. This statement misses the mark. These utilities are entitled to recover their cost of service and a fair return on assets that continue to be regulated, such as non-stranded local distribution systems, but not generation which may be sold competitively. The Commission has the responsibility to protect the public interest of Arizona's consumers under the Arizona Constitution.

22. Neutral Recovery Mechanism. ECC has urged neutrality in the recovery of stranded costs. Any verifiable stranded cost was obviously incurred because of the "reasonable expectation" of servicing all customers, both those that leave and those that stay with the incumbent utility. Therefore, the proration of any stranded cost should be as a component of the standard offer incurred by customers who stay with the incumbent utility and as a charge to those who may seek other supplies. The Working Group addressed whether the Rules should be changed to allow stranded cost recovery from customers who are taking competitive power, with 12 voting in favor, 4 opposed, and 2 abstentions. The Working Group next voted on the proposition "that if stranded costs are to be recovered from standard offer customers, should they be recovered at the same rate as that being charged to customers taking competitive power?" Ten members voted in favor, none voted against, and eight abstained. Nevertheless, the report deemphasis this result by saying there was no consensus even though a clear simple majority had approved these concepts.

23. Estimates of Stranded Costs to the Working Group. Estimates of "retail" stranded costs, as requested by ECC and others, were rejected by staff as being unnecessary, premature, and prejudicial to the utilities. Report at 51-52. The directive to the Working Group required the evaluation of stranded cost impacts on the transition to competition. A.A.C. R14-2-1607.D. Rule R14-2-1607.G states that "[t]he Affected Utilities shall file estimates of unmitigated Stranded Costs" in order that the Working Group may have completed its tasks. That Rule further states that "[s]uch estimates shall be fully supported by analyses and by records of market transactions undertaken by willing buyers and willing sellers." This Working Group process was to occur prior to the hearings on stranded costs, as set forth in Rule R14-2-1607.I.

The Working Group was, in essence, denied the tools in which to perform its work. Without these estimates, it was not possible to determine whether or not the "wide range of assumptions and methodologies" referred to by staff actually do result in complications and disagreement as assumed by staff. Report at 52. As to the notion that disclosure of these stranded cost estimates will create a competitive advantage to others, it is unclear how the source or size of these figures will affect market conditions, except to discourage new entrants from marketing in Arizona because of the uncertainty of stranded costs. Staff makes an inappropriate comparison by suggesting that disclosure of stranded cost estimates is the same as requesting

independent power producers to provide estimated market prices for the next 10 years. The affected utilities are asking the Commission for compensation to be paid by customers who are to be protected by the Commission. The independent power producers have and are willing to bear the financial risks of their decisions without any Commission "guarantee." The purpose of competition is the use of market forces instead of relying on regulated forecasting. Finally, staff says these estimates are already available from investment firms. Gross estimates as contained in these publications are not relevant to these issues, or their solutions.

X. ACCOUNTING, TAX AND FINANCE ISSUES

24. Income Taxes in Ratemaking. Staff recommends that the Electric Competition Rules be driven by the Internal Revenue Code and IRS Regulations. Report at 63. Staff contends that the utilities have a "regulatory guarantee" of recovery on uneconomic investments. However, an equally valid argument exits that the tax code is the ultimate regulatory compact between government and all industries, governing all investment cost recoveries (economic or not). Despite the fact that this "compact" has been changed almost every year for the past 15 years, staff suggests that the utilities "regulatory compact" include decisions of Congress and the Internal Revenue Service. All industries and consumers shoulder the risk of change in the tax laws, and there is no equitable reason why utilities should be treated preferentially.

25. Corporate Taxes. Staff suggests that the Rules be amended so that tax liabilities may be properly treated in the quantification, mitigation and recovery of stranded costs. Report at 65. Although it is unclear in the report, it appears that staff is recommending that any reduction in tax liability of the utilities should be addressed as a stranded cost.

26. State and Local Taxes. Staff says that "significant tax-related policy questions will have to be answered prior to the current January 1, 1999 date established by this Commission for the transition to full competition to begin." Report at 65. Staff acknowledges, however, that no study was performed by the Working Group on these tax consequences (if any) and the resolution of tax policy issues is beyond the scope of the Commission. Report at 66. ECC asserts that electric competition should not be delayed or driven by tax policies. These matters will be addressed, in needed, by the Arizona Legislature.

Staff concludes, without supporting study or data, that retail competition will cause revenue-based taxes to decrease because of lower electric prices and revenues lost when customers depart their host utility. Report at 66. This conclusion ignores the dynamics of the Arizona economy, in which an expanded economy will generate more sales (of both electricity and other goods and services) and the related revenue-based taxes paid by others. Moreover, taxes may still be recovered from third-party suppliers in addition to the host utility that provides the local distribution services.

As to property taxes, staff presumes that they will decrease due to reductions in market value of generation assets, any write-offs associated with stranded costs, or premature plant abandonment. Report at 66. Staff seems to be saying that electric prices should remain artificially high so that ratepayers will pay more property taxes through their utility. This is an inefficient method of public finance. More importantly, there is no evidence that any property

tax revenues will be diminished as a result of electric competition. These issues are presently under study by the Arizona Tax Research Association and were not addressed by the Stranded Costs Working Group.

III. CONCLUSION

The Electric Competition Coalition appreciates this opportunity to include its comments as part of the final report. Some of ECC's members are presenting their individual comments under separate cover, and the Comments of Enron are attached hereto.

Respectfully submitted,

Douglas C. Nelson
Executive Vice President

DCN/vyg

Attachments: -ECC Letter to Commissioners dated May 5, 1997
-ECC Memorandum to Corporation Commission (Kim Clark) and Stranded Cost Principles dated June 27, 1997
-Comments of Enron Capital & Trade Resources on Staff's Report from Stranded Cost Working Group dated September 26, 1997

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ECC ELECTRIC COMPETITION COALITION, INC.

For the Pursuit of Open Markets and Consumer Choice

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Members:

The Ascendix Group
Calpine Corp.
Enron Corp.
Nordic Electric Arizona, L.L.C.
PG&E Energy Services

May 5, 1997

Chairman Carl Kunasek
Arizona Corporation Commission

Commissioner Jim Irvin
Arizona Corporation Commission

Commissioner Renz Jennings
Arizona Corporation Commission

Re: Retail Electric Competition in Arizona

Dear Chairman & Commissioners:

On behalf of the Electric Competition Coalition, we wish to assure you that we are actively participating in your working group process. As you may know, ECC is comprised of new market entrants who eagerly seek to serve all classes of customers in Arizona. We are referred to as "electric service providers" in your Rules. The purpose of our letter is to respond to the Chairman and Commissioner Irvin's memorandum of April 4 and to suggest recommendations for expediting this process.

ECC and its members are providing to the working groups what we believe to be constructive ideas. ECC and its members also have informally discussed solutions with Commission staff, consumer groups, the affected utilities, and other interest groups. We believe a prompt approach towards retail access, with the least amount of contention, will be beneficial for all. We are making the following suggestions to help expedite and smooth out this transition.

- **Voluntary Customer Sign Up with Service Commencing on January 1, 1999.**

We urge the Commission to retain the January 1, 1999 implementation date. As that day approaches and there is greater publicity about the competitive electric markets, more and more consumers will likely explore market rates and the opportunities of electric choice. As a consequence, we suggest that the Commission allow consumers to voluntarily sign-up for an open access rate now, with service effective January 1, 1999.

During the next 19 months, the Commission, the affected utilities, ECC and the consumer groups will continue to educate the public on this transition to open competition. Some consumers will be more cautious about change and others may wish to sit back and take a wait-and-see attitude. Many have and many more will explore how they may participate in open access.

Any selection process will create a perception of "winners" and "losers" among communities, businesses and other consumers. Instead of waiting for another two years in which additional consumers might sign up, consumers should be able to voluntarily move into the open market on a quarterly basis after January 1, 1999. With this quarterly sign up, an orderly transition will occur without giving some customers a 2-year competitive advantage. During each 90-day period the utilities will have time in which to complete the paperwork. The notion of "winners" or "losers" by a geographical or other selection process will be avoided.

- **Numbers Are Needed to Resolve Stranded Costs**

On stranded costs, we need the numbers. The magnitude and source of strandable investments and regulatory assets need to be known before significant movement might be made by the participants. Discussion of general principles and concepts are of limited value until the working group has some idea as to how much is claimed to be recovered and who might pay. Stakeholders in these stranded cost meetings are unlikely to reach consensus on the core issues of stranded cost calculations and recovery mechanisms until there are assurances the framework will not impede competition or adversely affect customers. We have requested these numbers in the past and again we ask the Commission to assist us in moving this process forward by urging the affected utilities to furnish these figures as soon as possible.

- **Customers Need Unbundled Rates In Order to Plan Their Futures**

In reference to the unbundling of rates, customers should be entitled to receive now the unbundled rate from their utility so that they may plan for this transition to open access. This information gives all customers the same opportunity as the utilities in seeking out their most efficient cost of services. This information is readily available today, and customers should not be "in the dark" when planning their economic future, while the utilities are positioning themselves for competition.

We appreciate your commitment to consumer choice and the marketplace. We welcome the opportunity to continue to work with you and we stand ready to assist you and the Commission staff in meeting your objectives.

Sincerely,

Doug C. Nelson

Douglas C. Nelson
Executive Vice President

DCN/vyg

cc: Mr. Carl Dabelstein
Director, Utilities Division
Members of Stranded Cost Working Group
Members of Customers Selection Issues Working Group
Members of Unbundling Services and Standard Offer Working Group
Members of Legal Issues Working Group
Mr. Jerry Porter
Governor's Office

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ECC ELECTRIC COMPETITION COALITION

For the Pursuit of Open Markets and Consumer Choice

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MEMORANDUM

TO: KIM CLARK

FROM: DOUGLAS C. NELSON

DATE: JUNE 27, 1997

SUBJECT: STRANDED COST

The stranded costs principles supported by ECC are attached. The Electric Competition Coalition submits these additional comments on stranded cost.

1. The key objectives of the recovery program should include these principles:

   - Any stranded cost recovery program shall promote economic efficiency and the prompt evolution of competition.
   - Any stranded investment recovery mechanism must be fair to investors and equitable towards all for whom the underlying investments were intended to benefit, including those that leave the system or who come into the system.
   - Stranded Costs shall be verified.
   - Any stranded cost recovery program must consider all reasonable mitigation measures so as to lower the amount of any Stranded Costs.
   - Stranded Costs should be recovered within a reasonable time period.
   - The recovery mechanism should be sufficiently certain so that comparisons may be made in evaluating the relative costs of competitive services.
   - Any charge, if deemed appropriate, should be simple and understandable to ratepayers and competitors and not impede consumer choice for power supply or other competitive services.

2. The definition of stranded cost should only included the recorded assets as of December 26, 1996. If the market value of the accumulative assets of a utility

equals or exceeds its net book value, by definition there cannot be any stranded cost.

3. The net lost revenue recovery approach has the disadvantage of recovering greater or less than the payments that would fulfill investor expectations. Another disadvantage is the revenue requirements becomes ambiguous and loses economic significance if the utility has fewer obligations to serve and more opportunities to resource itself in the competitive market.

4. Environmental mandates as a potential component of stranded cost should be disallowed if non-regulated firms must comply with the same environmental requirements.

5. New market entrants should not be singled out and required to pay "a market access charge" to repay stranded costs. It would create a financial barrier around service territories of monopolistic utilities who do not pay this access charge. Utilities would have a major competitive advantage and prices would remain comparatively higher for electric consumers.

6. New customers under the standard offer tariff should be obligated to pay their proportional share of the stranded cost.

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ECC Stranded Cost Principles

1. Principles of Neutrality

- Neutral as to whether a customer accepts competitive services or the Standard Offer tariff (from the incumbent utility).
- Neutral as to geographical area (i.e. same class and size customer in Tucson would pay same as customer in Phoenix).
- Neutral as to amount of future power consumption (i.e. a fixed charge per month based on historic demand, not future energy use).

2. Principle of a Ceiling on Stranded Costs Charges

Any stranded cost charges should not be greater than the customer's current rate, when any future stranded cost charge is combined with the future cost of the competitive power supply and delivery.

3. Principle of FERC and ACC Apportionment

Based on the utilities' past rate case allocations, stranded cost will be apportioned based on the FERC and ACC for wholesale stranded investment (i.e. 10% of generation for wholesale).

4. Principle of Equitable Allocation between Stranded Cost Charges and the Standard Offer Tariff.

Customers who remain on the system or purchase generation from others should bear equally any stranded costs. Stranded costs may only be recovered from customers who make purchases in the competitive market under the Rules (R14-2-1607). Customers who do not make purchases from the competitive market and purchase power under the Standard Offer tariff should, in essence, be repaying their portion of "stranded cost" in the Standard Offer tariff.

Demand associated with self-generation, demand side management, and "other demand reduction attributable to any cause other than the retail access provisions" of the Rule should not be used in calculating or recovering stranded costs from a customer. R14-2-1607.J. Excess generation resulting from overestimating demand should be recovered proportionately through the Standard Offer tariff.

5. Principle of Verified Stranded Costs

Cost of any stranded investment should be verified and the "lost revenue" approach should not be adopted. Market valuation of stranded investments is the preferred approach, such as through a separate stock class designated for stranded investments as proposed by the Goldwater Institute.

6. Principle of Fixed Monthly Meter Charge

All customers should incur equally a one-time determination of their proportionate share of stranded costs, to be collected over time through a meter charge. These sunk costs would be recovered through meter charges collected in a statewide pool for disbursement to repay stranded costs of all Arizona utilities. Instead of a "wire charges" which would be based on future power consumption, the certainty of the meter charge will provide fixed information in analyzing market conditions.

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COMMENTS OF ENRON CAPITAL & TRADE RESOURCES ON STAFF'S REPORT FROM THE STRANDED COST WORKING GROUP

Enron Capital & Trade Resources, Inc. ("Enron") offers the following comments on the Report of the Stranded Cost Working Group. Enron has not participated directly in the stranded cost working group, but has participated through its membership in the Electric Competition Coalition (ECC). As a new market entrant in Arizona, Enron has an interest in the outcome of the rulemaking proceeding and in the determination of stranded cost methodologies and recoveries. Both the stranded cost methodology and recovery mechanisms will directly affect Enron's ability to compete and the customers' ability to participate in the restructured environment.

I. Failure of the Report to Reflect the Efforts of the Working Group

In several sections of the Report, Staff substitutes its preference over the preference of the Working Group. This is unacceptable. Such action undermines the Working Group process and the efforts of those who participated.

A. Definition of Stranded Cost

Staff indicates a "difficulty in accepting" the Commission's definition of Stranded Costs. Report at 7. The Working Group voted 15-3, a two-thirds consensus, that the definition of stranded costs should remain as presently stated in the Rules. However, Staff goes on to say that "unrecorded" regulatory assets need to be factored into the stranded cost calculation. If the asset is unrecorded from a regulatory perspective, in other words the utility is not currently granted authority to recover the asset in rates, how does transition into a competitive market make that asset recoverable as a stranded cost? In fact, the example which Staff uses to illustrate this concept, excess capacity costs, could be equated to a determination of the Commission that the cost was not a prudently incurred cost. The Commission had determined that the asset was not used and useful and therefore should not be recovered in rates. That determination pre-dated competition in Arizona and therefore is unrelated to a transition into a competitive market.

In addition, the Report points to FAS 106 Post-Retirement costs as an unrecorded cost. The threshold question that has to be asked is: How are these costs stranded as the result of competition? Why could these costs not be recovered as they are incurred through the distribution charges of the utility as they are incurred?

B. Calculation Methodology

No consensus was reached in terms of the Calculation Methodology. However, the Report at 27 states that Staff believes that Net Revenues Lost approach is the preferred method because it "closely mirrors the ratemaking process with which all parties involved in traditional utility regulation in this State are familiar." Clearly, this statement represents a bias toward a more familiar regulatory process as opposed to an embracing of competition. In addition, the Net Revenues Lost approach does not provide a market valuation of the relevant assets, but provides

a guaranteed revenue stream to the utilities over the period of time that the utilities would have expected to retain over the remaining useful lives. This is wholly unacceptable. This methodology provides no incentives to improve efficiencies, reduce costs, etc. In fact, this method may actually increase stranded cost recovery.

Enron believes the only way to truly determine stranded costs is to have a market valuation. There are several ways of determining market value:

1. For divested assets, or divestiture of the merchant function, the net stranded costs shall be the difference between the divested asset's market price and its book value net of depreciation. Enron is not advocating mandatory divestiture, but rather voluntary divestiture as a means to remedy stranded costs. In addition to providing a means of determining stranded costs, divestiture is a means of mitigating vertical market power concerns, absent functional or structural separation. (See Mitigation of Stranded Costs section below).

2. As to the stranded costs related to facilities that the utility still owns, the net stranded costs shall be based upon the capital costs of all facilities owned by the utility in light of current and expected market prices; however, in no event shall estimates of revenues that would have been earned in a regulated environment be used in determining net stranded costs.

    - Appraisal of the assets would be another way of determining the market value of the assets without auctioning the assets.

    - Output contracts is another means by which to determine the value of generation assets. It provides a value for the power generated as opposed to the physical generating asset.

3. Stranded costs shall be prudently incurred costs for which the utility was not compensated in its return for regulatory risks incurred due to the transition to a competitive environment for which the utility attempted to mitigate in a prudent and cost-effective manner.

C. Components of Stranded Costs

A list of Regulatory Assets are included in the report. Report at 12. However, the report fails to mention how these items represent stranded costs as a result of a transition into a competitive market.

In addition, the Report at 12 states that retraining employees to perform their present tasks more efficiently should be considered as a stranded costs for employee-related restructuring. While Enron agrees that the issue of employee displacement should be addressed as a stranded cost, Enron believes that any funds or benefits associated with labor transition issues must directly benefit employees. Unfortunately, the report fails to address the need for an independent, third-

party entity to administer the recovery of such funds. A clear separation is necessary if employees are to be fully compensated and cross-subsidization is to be avoided. Lastly, there needs to be a recognition that regulated "utility" employees will now have new employment opportunities in a competitive market as opposed to a regulated one.

D. Mitigation of Stranded Costs

The Report at 15 indicates that two primary ways of mitigation are cost reduction and revenue enhancement strategies. We agree that utilities can continue to make efforts to reduce their labor and non-labor operating costs through improving efficiencies and through the renegotiation, buy-out or buy-down of above market transportation or purchased power contracts.

We also agree that there is an opportunity for additional revenues to be generated through the participation in the competitive market to the utility's affiliates. We would strongly object to the utilities participating in the competitive market themselves due to the access to utility information and assets to which other market entrants would not have. Enron strongly supports, at a minimum, functional separation of the vertically integrated monopoly between generation, transmission and distribution. In addition, Enron believes it is important to have structural separation between a utility and its unregulated affiliates with standards of conduct adopted by this Commission which govern the relationship between the affiliated entities. As such, Enron and other members of ECC will be proposing that the Commission begin an investigation into standards of conduct for Arizona utilities.

The Report at 16 states that a rate freeze must accompany an accelerated depreciation of generation assets. Enron is opposed to a rate freeze. Rate freezes prevent the customer from realizing the benefits that can accrue to them from competitive offerings by freezing rates at a particular level. Enron and the California public advocate group (TURN) have recently announced their displeasure for the California model, which incorporates a rate freeze, because it keeps the benefits of competition away from the consumers. The Working Group supported a rate cap, this was not reflected in the Report.

In addition to the problems identified in the Report at 16 and 17 in offsetting the "undervalued" transmission assets with the "overvalued" generation assets, Enron submits that transmission assets may increase in value as a result of competition. Companies will be willing to pay more for capacity rights. In addition, the reason why transmission capacity may be "undervalued" in relation to its replacement value is that it is probably nearly fully depreciated. The utility has already collected its value and return through rates.

E. Recovery Mechanism

Enron is in agreement with the voting parties that stranded cost recovery should be recovered from all customers, including those who will be receiving standard offer service. Enron agrees with the voting parties who indicated a preference (10-yes, 0-no and 8-abstentions) that the rate charged to standard offer and competitive customers should be the same. While the report indicated this was not a point of consensus, it does represent a majority of the voting members,

which the report has adopted in other areas. However, the Report at 47 indicates "Staff's" preference for a distinction between parties taking competitive power and those who do not. Application of stranded cost recovery to only the participants in the market, differentiation in stranded cost recovery rates between those who choose another supplier and those who do not, and the assessment of an "exit fee" are all examples of competitive barriers to entry. Stranded costs are the result of assets being valued in the market at less than their book value less depreciation--not because customers are exercising their right to choose.

In regard to securitization, Enron wishes to add some arguments that have not been identified in the Report. Securitization, implemented properly, is one viable means for recovering stranded costs. However, until the market is competitive the level of stranded costs is unknown. Utilities should be required to submit their stranded cost to a market valuation, which better values the utilities' true stranded costs, and helps mitigate those costs and otherwise protects against overrecovery. Without a valuation of assets, the anti-competitive aspects of securitization are so profound that they virtually eliminate any benefit to consumers.

The Report at 50 also states that it is unfair to require the Affected Utilities to estimate their stranded costs liability because such calculations are of a competitive nature unless the independent power producers are willing to provide their estimates of market prices for the next ten years. The difference is that the utilities are seeking recovery of stranded costs to which the independent power producers are not laying claim.

II. Failure to Follow the Direction of the Rulemaking

In Enron's opinion, the report fails to contain the determinations that the Working Group had been charged with making in the rulemaking. In R14-2-1607.D., several factors were to have been considered in developing recommendations. Many of the factors were to have been considered in developing recommendations. Many of the factors were not considered due to a lack of information provided by the utilities in terms of their estimate of stranded costs. Therefore, the impact of stranded cost recovery on competition, non-participants, the utility, and on prices paid by consumers have not been addressed in the report.

In fact, the Net Revenues Lost approach does not even comport with the Commission's definition of Stranded Cost (R14-2-1601.8.):

> "Stranded Cost" means the verifiable net difference between:
>
> a. The value of all prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchased power contracts, fuel contracts, and regulatory assets), acquired or entered into prior to adoption of this Article, under traditional regulation of Affected Utilities; and
>
> b. The market value of those assets and obligations directly attributable to the introduction of competition under this Article.

The Net Revenues Lost approach does not compare the value of jurisdictional assets and obligations to a market value of those assets to determine stranded costs, as Enron supports. Instead, the Net Revenues Lost method provides the utilities with a guaranteed revenue stream. This approach does not try to differentiate between cost which may be reduced due to efficiency gains, reduction in administrative costs, etc. which have nothing to do with the valuation of the assets directly affected by competition.

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Dissenting Comments of Asarco, BHP Copper, Cyprus Climax Metals, Phelps-Dodge, and the Public Interest Coalition on Energy

Introduction

Asarco, BHP Copper, Cyprus Climax Metals, Phelps-Dodge (collectively, the "Mines"), and the Public Interest Coalition on Energy ("Coalition")[1] have participated in every meeting of the Stranded Cost Working Group and its three subcommittees. This involvement has included participation by individual companies, as well as representation by Energy Strategies, Inc. on behalf of the entire group. In addition, the Mines and the Coalition have submitted joint comments on stranded cost issues to each of the Subcommittees.

We believe it is important at the outset to clarify the nature of the Report of the Stranded Cost Working Group: foremost, it is not really a report *from* the Working Group. Rather, it is a report from the utilities staff director expressing primarily his own views and recommendations on stranded cost. In most cases, the staff director's recommendations do not flow logically from the efforts of the Working Group; in a number of important instances, his views are in direct conflict with the Working Group's consensus recommendations. In addition, much of the background discussion in the report is the work of the author, not of the group, and as such it reflects the author's orientation rather than a generally-accepted view. While the views of the Working Group participants have been available in written form for several months, the staff director's recommendations which dominate the Report were revealed at the last moment, and have not been subject to the discussion and scrutiny of the Working Group process.

As a result, our dissenting comments are not aimed at the consensus recommendations of the Working Group, but at the staff director's recommendations and analysis which color the Report. In addition, we find it necessary to present the reasoning behind several key consensus recommendations of the Working Group, because the Report itself, in emphasizing the staff

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[1] The Public Interest Coalition on Energy is a consortium of energy consumer interests which includes Arizona Association of Industries, Allied Signal, Arizona Retailers Association, Arizona Small Business Association, Arizona Hotel/Motel Association, Arizona Multihousing Association, Arizona Mobile Home Parks Association, Arizona Food Marketing Association, National Federation of Independent Businesses, Arizona Mining Industry Gets Our Support, and Lake Havasu Manufacturing Group.

director's positions, fails to explain adequately the rationale behind the consensus views to which the he is opposed. Finally, we must comment on certain important items upon which no consensus exists, so that the interests of electric consumers are fairly considered in the debate. In no uncertain terms, we find the staff director's analysis and recommendations on stranded cost recovery to be entirely inadequate when it comes to considering the impact on consumers.

Comments

1. A fundamental error in the staff director's recommendations is his failure to recognize that stranded cost recovery requires using judgment to balance the interests of both utility shareholders *and* electric power consumers.

The Commission requires the Working Group to consider eleven factors in developing recommendations for the analysis and recovery of stranded costs. Included in the Commission's requirements are: (1) the impact of Stranded Cost recovery on the effectiveness of competition, (2) the impact of Stranded Cost recovery on customers of the Affected Utility who do not participate in the competitive market, and (3) the impact of Stranded Cost recovery on prices paid by consumers who participate in the competitive market. [R14-2-1607.D]

Ignoring these requirements, the staff director advances the argument that changing electric generation service from a monopolistic to a competitive model requires that consumers compensate shareholders through a stranded cost recovery mechanism in which consumers essentially pay Affected Utilities exactly what the consumers would have paid over the next twenty-five years[2] had regulation continued and competition never occurred. Any and all utility generation costs which, when combined, are (predicted to be) above the market price during this twenty-five year period -- including fuel, O&M, fixed plant costs, return on equity, and administrative and general costs -- are to be borne by the consumer in the form of stranded cost charges which are paid over a ten year period [pp. 20-22, 27-28, 30, 48].

In advancing this position, the staff director recommends extending stranded cost obligations to customers who do not (or cannot) participate in the competitive market [p.46], and then ultimately concludes that he does not see how stranded cost recovery can be unilaterally determined by the Commission in a manner which does not increase the final price to consumers over what is paid today. [p. 53]

In construing stranded cost recovery to mean that consumers must pre-pay all above-market costs which would have occurred over the next twenty-five years under regulation, the staff director is clearly ignoring the impact of stranded cost recovery on the effectiveness on

[2] The staff director recommends that the computation period for stranded cost recovery extend over the remaining useful life of the stranded assets, which we infer to be around twenty-five years.

competition. In disavowing the important public policy objective of incorporating a price cap into the recovery mechanism, the staff director is ignoring the impact of stranded cost recovery on customers who participate in the competitive market; and in recommending the extension of stranded cost recovery to all customers -- without a price cap -- the staff director is ignoring the impact on those customers who do not participate in the competitive market.

Customers are adamantly opposed to the staff director's approach.

2. The consensus view of the Working Group is to balance utility and customer interests by incorporating a price cap into the design of the stranded cost recovery mechanism.

The Working Group addresses the impacts of stranded cost recovery on competition and consumers by recommending that the stranded cost recovery mechanism include a price cap. This consensus recommendation is made twice:

> The Commission should consider some type of rate cap as part of the development of a stranded cost recovery program. [Passed, 19-1]
>
> The Rules should be changed to allow stranded cost recovery from customers who are not taking competitive power. The second sentence of Section R14-2-1607(J) of the Rules should remain in effect, but this Section should be amended to allow all customers to pay stranded costs, including customers who remain on standard offer rates. However, *the charge to standard offer customers should account for contributions that are already being made toward stranded costs and should not cause customers' prices to increase.* [Emphasis added; passed 14-6]

The price cap concept is articulated in the Report of the Recovery Mechanism Subcommittee. The intent is that the stranded cost charge be set in a way that the final cost of power to consumers -- generation plus delivery plus stranded cost -- does not exceed current rates. [Subcommittee report, p. 4] Thus, for example, if a customer's current regulated price is 8 cents per kWh, and market-priced generation costs 3.5 cents per kWh and delivery costs 2.5 cents per kWh, then stranded costs for this customer would be capped at 2 cents per kWh.[3]

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[3] Note that the price cap is achieved by restricting the size of the stranded cost payment such that the final price does not increase. The staff director incorrectly infers that a price cap would require control over the competitive price of generation, which, of course, is not viable, since this price is set by the market. Instead, the stranded cost charge should be set within a price cap at the start of retail access. The generation price used to set the cap should be the same one used in setting (or implicit in) the stranded cost charge. If a particular retail access customer's market generation price deviates from the market price used to set the price cap, it should be considered merely an outcome of the market, and it would not be necessary to further adjust the price cap.

Taken together, the consensus recommendations suggest that there be a reasonable upper boundary on the stranded cost charge both to protect consumers and to allow meaningful competition to take place. This upper boundary is modest in comparison to the approach taken in California, New York, and Pennsylvania, where stranded cost recovery is being structured in combination with a price *decrease* for consumers.
It is important to note that the second recommendation above reflects a compromise offered by consumers as part of the Working Group process. Both the Affected Utilities and the staff director pressed hard for a change in the Rules to include standard offer customers in stranded cost recovery. Consumers preferred the Rule as written, which limits stranded cost recovery to those customers taking competitive power on the grounds that standard offer customers already pay for strandable cost in their rates [Decision No. 59943, Order and Order, p. 48]. In the spirit of compromise, consumers offered to join in the recommendation to extend the stranded cost recovery to standard offer customers *if a price cap were also included in the recommendation.* This compromise language was later adopted in a consensus vote during the Working Group's final meeting. The staff director's recommendation, however, would undo the compromise by extending stranded cost recovery to all customers while omitting the price cap.

We recommend that the Commission adopt the two consensus recommendations of the Working Group identified above because the recommendations provide important consideration for consumers and for the effectiveness of competition in the design of the stranded cost recovery charge. Without a price cap on the stranded cost charge, the implementation of retail competition would be effectively nullified.

3. Despite a disclaimer indicating that the Working Group did not undertake a legal analysis to examine the legal basis for stranded cost recovery [p.3], the staff director relies upon an informal and questionable legal argument to justify his recommendations to exempt utility shareholders from any risk associated with strandable costs [pp. 6, 29-30, 49, 53].

The staff director relies on informal legal argument throughout the Report, primarily to justify arguments in favor of extending the impact of regulatory pricing (through the stranded cost charge) for the foreseeable future in order to protect utility shareholders from "absorbing" any stranded costs. This informal legal argument is inappropriate for a number of reasons:

(1) Drawing informal conclusions of law is hazardous and inappropriate in general.

(2) The informal legal argument which is presented is that of only one perspective in a national legal debate in which there are strong counter arguments.

(3) The informal legal argument which is presented may differ substantially from the Staff's and the Commission's actual legal conclusions.

(4) The informal legal argument is used by the staff director to justify the extensiveness of the stranded cost burden assigned to consumers, even though, from the outset of the Working Group process, the staff director expressly forbade the participants from considering or discussing this issue under the auspices of the Stranded Cost Working Group. Participants were told that the issue of appropriate sharing of stranded cost burden between customers and the utilities was the purview of the Legal Issues Working Group; for its part, the Stranded Cost Working Group was to proceed "as if" the portion assigned to customers was 100 percent. Consumers made it clear that we disagreed with such an approach, but continued to participate in good faith. It is inappropriate then, for the Report of the Stranded Cost Working Group to contain extensive treatment of a subject it was not permitted to discuss in its work. The informal legal argument used to support the staff director's recommendations is not the consensus view of the Working Group -- nor could it have been, since the subject was not permitted to be considered.

Based on the informal legal argument tied to the "reasonable expectations" of utility investors, the staff director recommends that consumers be obligated to provide utilities a revenue stream equivalent to what would have occurred under continued regulation for the remaining life of the generation assets (presumably twenty-five years or so) [pp. 29-30]. He then responds to consumers' calls for investors to share some of the strandable cost responsibility by indicating that he is unaware of any legal or regulatory basis for investors to share such responsibility [p. 49].

The staff director seems to equate investor responsibility with "absorption" of stranded costs, as if the future costs which are under debate here are truly known. However, such is not the case. The use of the term "stranded" cost gives the impression that such "stranding" has already occurred, when in fact the very exercise of quantifying such costs inherently involves guessing about *what might happen* under future market conditions. Hence we are really talking about *potentially* stranded, or "strandable" cost.

Yet, the staff director expresses the view that if the stranded cost obligation on customers falls short of full pre-payment of the amount necessary to achieve regulatory pricing, then "absorption" by shareholders will have occurred. This view demonstrates that the staff director has not adopted a realistic vision for transitioning to competition.

The staff director seems unwilling to view the movement to competition as a genuine transition for the utilities involved -- a transition in which investors' capital will face increased opportunity and increased risk -- a world in which the bottom line is not known in advance. Instead, he seeks to impose a continued state of regulatory pricing -- one in which consumers receive no cost savings from competition and regulatory-style "true-ups" create disincentives for utilities to improve efficiencies. The staff director does not recognize -- nor has he allowed any discussion about -- a transition strategy in which only a portion of the utilities' *potentially* stranded cost is guaranteed through special charges on customers, and the remainder is at risk -- mitigated for better or for worse by the utilities -- without a true-up.

The Commission should reject the staff director's informal legal analysis concerning the basis for stranded cost recovery as well as his extreme view that consumers are obligated to provide utilities a revenue stream equivalent to what would have occurred under continued regulation for the foreseeable future. We recommend that the Commission remain open to approaches to stranded cost recovery in which the utilities remain at risk for some portion of the *potentially* stranded cost.

4. The staff director's recommendation that the Commission incorporate the "Net Revenues Lost" calculation method into the Rules should be rejected. Such an action would arbitrarily restrict the measurement approaches which could be presented to the Commission and would needlessly tie the Commission's hands in determining the magnitude of stranded cost.

The Net Revenues Lost approach to calculating stranded cost is one of four approaches presented and reviewed within the Working Group. It was unanimously opposed by consumers. The object of this approach is to calculate over, say, a ten to thirty year period, the amount customers would have had to pay for electric power if regulation continued and competition never occurred. The present value of this amount less the market-based revenues the utility receives is deemed to be stranded cost. The version of this approach endorsed by the staff director also includes a periodic "true-up," in which deviations from expected revenues and costs result in a recalculation of the stranded cost charge, and in which the effects of mitigation can be incorporated. Unfortunately, mitigation in this model is virtually identical to the treatment of utility cost reductions under traditional regulation, both in regard to regulatory pricing and the (dis)incentive to cut costs.

One of the chief flaws of the Net Revenues Lost approach is that it saddles consumers with the *operating costs* of the utility that would have been expected if regulation were to continue into the foreseeable future; thus, a customer *who is no longer taking generation service* from a utility nonetheless pays a stranded cost charge which is derived by subtracting the market price of power from the sum of that utility's *future cost of fuel, purchased power, operations and maintenance, and even a share of its administrative and general costs*. Added to these operating costs are the fixed costs of the generation assets, which also may include a return on equity on the stranded resources. This approach is virtually guaranteed to balloon the stranded cost calculation to where it approaches (or even exceeds) the net book value of the utility's generation assets. In other words, stranded cost calculated this way is likely to yield results which imply that the market value of the utility's generation is close to zero -- a highly implausible claim -- yet one which customers may be stuck paying for if the Commission incorporates the Net Revenues Lost approach into the Rule as recommended by the staff director.

The Report says quite plainly that it is "clear that no one broadly accepted and recognized methodology [for calculating stranded cost] has emerged in the industry." [p. 20] We agree; indeed, a diversity of approaches is presented in the Report. Each of the alternatives to the Net Revenues Lost approach provides a direct measurement of asset values at a single point in time,

in contrast with the annual calculations required under the Net Revenues Lost approach. In this regard, we believe the alternative approaches are more consistent with the change to a new pricing paradigm.

Consumers who participated in the Working Group were unanimous in their preference for the Replacement Cost approach [pp. 22-23]. The Report indicates that at the final meeting of the Working Group, 9 votes were cast for the Net Revenues Lost approach and 7 for the Replacement Cost approach (plus one each for two other methods). We note that two votes from consumer and public interest representatives in favor of the Replacement Cost approach were not accepted by the staff director because they were submitted late (although they were submitted while the meeting was still in session). This observation is important because the staff director draws on the voting tally to support his recommendation endorsing the Net Revenues Lost approach [p.28]. Conversely, we believe the voting tally confirms the lack of consensus of the group on this issue and the unanimity of consumers in their opposition to the Net Revenues Lost approach.

The lack of consensus on the calculation methodology is hardly surprising, nor is such an outcome necessarily unhealthy. It is disappointing, though, that the staff director would advise the Commission to incorporate just one of the approaches into the Rule -- the approach unanimously opposed by consumers [pp. 27-28]. Given the diversity of approaches, it would make more sense for the Commission to remain open to a number of ways of evaluating the magnitude of stranded cost. Clearly, as the burden of proof to make a case for stranded cost is on the Affected Utility, and as the utilities prefer the Net Revenues Lost approach, the Commission will certainly have the opportunity to review stranded cost calculated according to that approach -- whether or not its use is required in the Rules. However, *requiring* its use in the Rules will only serve to tie the Commission's hands in considering alternative approaches which may be presented by others. Such a situation would not serve the public interest. The staff director's recommendation should be rejected.

5. The staff director's recommendation that the Commission allow recovery of stranded costs which are somehow incurred as part of stranded cost mitigation is difficult to comprehend and is in direct conflict with Staff's and the Commission's previous reasoning on this question and should be rejected.

The staff director recommends that "amounts prudently spent in connection with mitigation be properly considered as a recoverable stranded cost." [p. 18] As mitigation, by definition, refers to revenue enhancement and cost reductions, the concept of mitigation-related stranded costs would appear to be a contradiction-in-terms -- that is, unless the staff director is making the unlikely recommendation that consumers be responsible for utility mitigation efforts which end up as failures.

This issue has been previously addressed by the Commission. We agree with the Commission's

analysis, made in response to Tucson Electric Power, "that there are no recoverable Stranded Costs associated with mitigation, since those costs cannot be both necessary to furnish electricity to consumers in its service territory and be incurred prior to the adoption of theses Rules." [Decision No. 59943, Opinion and Order, p. 46]. The staff director's recommendation is simply a repetition of the earlier request from Tucson Electric Power that the Commission correctly rejected. It should be rejected again.

6. The staff director's recommendation to assign stranded costs to self-generation is in direct conflict with the Rule and with the consensus recommendation of the Working Group and should be rejected.

The staff director recommends that self-generators should be required to pay stranded cost. This recommendation is in direct conflict with the consensus recommendation of the Working Group which states that "the second sentence of Section R14-2-1607(J) of the Rules should remain in effect..." The second sentence in R14-2-1607(J) states:

> Any reduction in electricity purchases from an Affected Utility resulting from self-generation, demand side management, or other demand reduction attributable to any cause other than the retail access provisions of this Article shall not be used to calculate or recover any Stranded Cost from a consumer.

Thus, the Working Group supports the Commission's decision not to assign stranded cost charges to a customer's *reduction* in energy purchased from the grid. In adopting this provision, the Commission rejected a request from Tucson Electric Power to assign stranded cost to self-generators, stating that "there is no compelling reason to impose Stranded Cost responsibility on self-generators under these Rules, when none has been imposed in the past." [Decision No. 59943, Opinion and Order, pp. 48-49]

We agree with the Commission's reasoning and the consensus of the Working Group. Self-generation has been a customer option for many years under traditional regulation. Stranded cost recovery brought about by retail access should not now be used as a pretext to start insulating utilities from this existing business risk.

The staff director's recommendation is simply a repetition of the earlier request from Tucson Electric Power which has already been rejected by the Commission. It should be rejected again.

7. The staff director's recommendation regarding special contract customers and the allocation of stranded costs is confusing; unless the recommendation is clarified to indicate that any assignment of stranded cost charges to special contract customers is to be accompanied by a price cap, it should be rejected.

In Executive Summary of the Report, the staff director recommends:

> All power users, including new customers, self-generators, interruptible customers, and special contract customers, should be allocated an appropriate share of the stranded costs, but a distinction may be made between parties taking competitive power and those not, insofar as such difference reflects the fact that parties continuing to take standard offer service are paying for stranded cost in rates. [p. vi]

If this statement were made by a party which supported a price cap, the portion applying to special contract customers would be comprehensible. It would be taken to mean that a portion of the special contract customer's existing rate would be labeled "stranded cost charge." No net price increase would be realized. In fact, this is what would occur for all standard offer customers under the Working Group's consensus recommendation for a price cap, discussed above (see Section 2).

However, the staff director has not agreed to support a price cap. We have already stated our objections to his position as it pertains to all customers. In the case of special contract customers, assigning stranded cost without a price cap (set at the contract price) would be particularly onerous and of questionable legality. Such customers have a binding contract approved by the Commission. Under the Rule, they are restricted from pursuing competitive options until their contract expires or is successfully renegotiated. In the Rule, special contract customers are not assigned stranded cost charges because they do not take competitive power. If this feature is changed, it should be changed in accordance with the consensus recommendation of the Working Group; that is, a price cap should be included.

8. The staff director suggests that, under a regime in which all customers are charged stranded cost, a "distinction" can be made between parties taking competitive power and those who are not. This statement is confusing.

This reference to a "distinction" occurs in the passage just quoted above in the previous section. It is not clear what is meant here by "distinction". If it means that standard offer customers would pay for strandable cost within their existing rates, and retail access customers would pay the *same costs,* except as a separate charge, then we have no objection to noting such a "distinction." However, if the statement implies that retail access customers could be charged a *different* stranded cost charge than a similarly-situated standard offer customer, then we would register serious objections. Such a practice would be discriminatory and would violate one of the principles the Working Group accepted as axiomatic: the stranded cost recovery mechanism would be equitable and *non-discriminatory* [pp. 37-38].

Discriminatory treatment of retail access customers was never considered by the Working Group. Such a practice would be an obvious impediment to competition. If the staff director's recommendation implies such discriminatory treatment, then it should be rejected.

Conclusion

We support the consensus recommendations of the Stranded Cost Working Group presented on pp. iii-iv of the Executive Summary of the Report. These recommendations provide useful guidance to the Commission on the subjects of price cap, cost allocation, and recovery mechanism.

Further, the Working Group process has provided a meaningful dialogue on calculation methodologies. The Report provides a synopsis of four such approaches. Among the members of the Working Group, there is no consensus on a preferred methodology; however, among consumers there *is* a consensus *against* the methodology proposed by the staff director. We wish to stress that it is absolutely unnecessary for the Commission to incorporate one particular methodology into the Rule. In fact, to do so would be a great mistake. Requiring the use of one particular method in the Rules will only serve to tie the Commission's hands in considering alternative approaches which may be presented in evidentiary hearings.

Finally, we wish to register our serious objections to the direction and tactics taken by the staff director. He has used his position of Working Group facilitator to prohibit discussion of utility responsibility for strandable cost and to torpedo consumer requests that stranded cost information be made available to the Working Group. In authoring the Report, he has heavy-handedly superimposed his own views on the work product of the group, leaving consensus recommendations to which he is opposed virtually unexplained.

More importantly, we believe the staff director is committing a fundamental error in failing to recognize that stranded cost recovery requires using judgment to consider not just the interests of utility shareholders, but electric power consumers as well. His recommendations clearly ignore the impact of stranded cost recovery on the effectiveness on competition; and in disavowing the important public policy objective of incorporating a price cap into the recovery mechanism, he is failing to consider the impact of stranded cost recovery on all consumers of electric power in the state. In short, his recommendations on stranded cost would stymie competition by overburdening consumers, and are not in the public's interest.

In committing to a public policy of retail electric competition, the Commission has taken a bold step. But in order to accomplish this objective, the Commission must firmly reject the recommendations of the staff director on stranded cost. Instead, the Commission should accept the consensus recommendations of the Working Group and proceed to implement retail competition, serving notice to the Affected Utilities that the burden of proof is on them to demonstrate that they should receive any stranded cost recovery.

If stranded costs are to be recovered, detailed cost information must be made available to the stakeholders immediately, because if consumers are to accept the burden of paying for any strandable cost, there must be ample opportunity to review the numbers and the justification. As consumers, we will continue to work in good faith toward the implementation of retail competition in Arizona, and we will look to the Commission to provide the judgment necessary to balance the

interests of the stakeholders equitably.

Kevin Higgins and Scott Gutting
Energy Strategies, Inc.

GOLDWATER INSTITUTE

LIMITED GOVERNMENT · ECONOMIC FREEDOM · INDIVIDUAL RESPONSIBILITY

Comments on the Final Report of the Stranded Cost Working Group

submitted by the Goldwater Institute

The Goldwater Institute is in the small minority of participants who have no self-interest in the outcome of the process and whose recommendations are made in the spirit of helping the vast majority of electricity users. We believe, and the evidence indicates, that unregulated markets are the best way to improve consumers' standard of living. Consequently, we have strong misgivings about policy recommendations in the report that continue to rely on the old regulatory way of doing things.

When thinking about calculating and recovering stranded costs it is important to remember why we are undertaking this exercise in the first place. The move toward competition has been driven by the inability of the current, administratively-oriented system of setting prices and allocating costs to cope with a rapidly changing energy market. Although regulators were supposed to induce economically efficient behavior, utilities are now burdened with billions of dollars of investment that are worthless under competition. This waste of capital, and the high prices consumers have paid and will continue to pay to cover the cost of these assets, are significant damage. Relying on the methods that got us into this problem to solve it is paradoxical, and only promises continued punishment for Arizona's electricity consumers.

Specifically with regard to the recommendations made in the report:

1. Net revenues lost is the preferred method for computing stranded costs. (p. v)

The net revenues lost method of calculating stranded costs uses the discredited rate hearing approach to calculating stranded costs. We concur with all of the disadvantages listed, although the report does not give them their proper weight when compared with the advantages cited. While the uncertainty and cost in terms of both time and money are serious flaws, the advantages listed are either shared with other methods, trivial or irrelevant.

- Although the math may be simple, it is in the assumptions where the traditional method stumbles.

- The stock market valuation approach offered by the Goldwater Institute also reflects both above and below market value of assets and depreciation and amortization of sunk costs.
- The value of a true-up is doubtful. The net revenue approach relies on multiyear forecasts of a host of variables that affect electricity supply and demand. The additional information gained by the passage of one or two years is not going to make the cost of revising the forecasts worthwhile.
- The claim the net lost revenue approach allows the analysis of impacts on specific customer classes perpetuates a myth of the current system that costs can be scientifically allocated among customer classes. Cost allocations are essentially politically guided price discrimination. Allocation of stranded costs will also be more political than scientific. Thus, the allocation formula can and will be independent of the way stranded costs are calculated.

Finally, the net revenues lost approach takes a one-sided view of competition. It freezes into place the assumption that all that competition does is reduce revenues. Although it may (very imperfectly) predict cost savings due to lowered input prices or projected workforce reductions, the lost revenues approach will completely miss fundamental changes in the way of doing business, such as those seen with airline deregulation. The result of airline deregulation was not only a decline in air fares. Airlines became more efficient and changed their product mix. The same will occur in the electric market. Competition will change the way utilities operate in ways that cannot be forecast. Consequently, the lost revenues approach is biased toward overstating stranded costs.

2. The period for recovering stranded costs should be ten years. (p. vi)

Although it is not surprising that staff would make a recommendation of their own (and they may be within their rights to do so), what is surprising is the time period they suggest. Recommendations from all participants in the working group fall within the range of four to seven years. No participant suggested a period longer than seven. Staff's recommendation is also longer than the average recovery period implemented by other states.

Although we recognize that extending the recovery period lessens the magnitude of any stranded cost charge, that advantage is outweighed by a ten year twilight-period of regulation. Having a long recovery period is a problem waiting to happen. The longer that stranded charges are in place, the more time there is for people to find ways to avoid them and the more distortion and inefficiency they will induce. As currently envisioned in staff recommendations, the recovery period would be ten years of hearings for true-ups, hearings for rules for new customers and suppliers and hearings for rules for those who wish to exit; all the while innovation promises to radically change the market. Again, this is placing reliance on a system whose faults are leading us to deregulate in the first place.

3. The stranded cost charge should properly reflect the demand and energy characteristics of the underlying stranded costs.

This recommendation rests on the belief that there is some scientific, normative system that properly allocates costs when in fact cost allocation methods are little better than politically directed witchcraft. The current two-part schedule of demand and energy charges is an artifact of the current system and cannot survive in a truly competitive market. Hotels and airlines do not have two-part charges, even though like utilities they have large capital costs.

The basic objective in designing a stranded cost recovery system should be to avoid visiting the "sins of the past," on the future. Specifically, whatever caused (or generated) stranded costs under the previous regulatory regime, recovery of these costs should not unduly influence the future energy consumption decisions of residential and business users. As the Council of Economic Advisors noted in the 1996 *Economic Report of the President* (p 188):

Because stranded costs are sunk, economic reasoning suggests that they should be recovered through mechanisms that do not artificially reduce power consumption.

In order to keep stranded cost recovery as neutral with respect to consumption and location decisions as possible, we suggest that regardless of how stranded cost is measured, it be recovered by using a "meter charge." This unavoidable charge would be an obligation of whomever owned the property or business. This would be a fixed fee, payable, perhaps monthly, over the recovery period, and would not vary with future energy use. (Customers could also be given the option of prepaying the present discounted value of the meter charges in a single up-front payment.)

The reason for using a fixed monthly charge (or the option of paying a single up-front fee) is that such charges have a minimal impact on electricity consumption. This is best shown with an example. We calculate that the average household would have to pay about $150 per year for five years in stranded cost recovery. Paid as a monthly charge on the bill it would represent a modest 0.47% decrease in purchasing power. A consumer could spread this decrease over all her purchases, causing a minimal impact on her living standard.

However, if stranded costs were recovered through a charge per kilowatt-hour, the average household would have to pay over 20% more per kilowatt-hour compared to a fixed charge. Consequently, a per kWh charge diminishes the benefit of competition visible to consumers by lowering the break in prices they will receive. We calculate that with a meter charge consumption would increase nearly twice as much than with a kilowatt-hour charge. Since a higher price means less consumption, with a kilowatt-hour consumers pay for stranded costs by buying significantly less electricity instead of having a choice in how to change their buying decisions. A kilowatt-hour charge forces consumers to pay for stranded costs with a lot of sweat during the summer rather than a tiny decrease

in how much they spend on renting videos. This can represent a significant change in that standard of living for the poor and the elderly.

In order to fairly apportion the stranded costs by these meter fees, the stranded costs could be allocated to customer classes based on relative past consumption and then allocated to individual customers on the basis of past consumption (new customers would be assessed a typical meter fee based on their specific attributes). For example, if the allocation of stranded cost to residential ratepayers resulted in an average stranded cost charge of say $12 per month (per household) this might actually be collected by assessing a monthly fee over the transition period equal to 1.4 cents per kWh of consumption during the year before the introduction of competition.

LAND AND WATER FUND OF THE ROCKIES
ENERGY PROJECT

COMMENTS ON THE STRANDED COST WORKING GROUP REPORT
SEPTEMBER 26, 1997

The stranded cost issue is key to the interests of the Land and Water Fund (LAW Fund) primarily because of the parallels between and relationships among cost and benefits potentially "stranded" by the competitive environment. Similar to the programs encompassed by the System Benefits Charge (SBC), the Stranded Cost Working Group is struggling with issues related to recovery of costs of obligations incurred under a regulated monopoly regime, in a competitive environment.

Moreover, the impact of stranded cost recovery in Arizona is potentially so large as to overwhelm other utility obligations and the benefits of a competitive energy market itself. The importance of fair determination and treatment of stranded costs in the forthcoming competitive energy supply market cannot be overstated. Our comments address the following conceptual areas: calculation of stranded costs, competitive market value, and recovery mechanisms.

Stranded Cost Calculation

The magnitude of stranded costs for the major utilities in Arizona is very large. Assuming that Staff's recommended 10 year amortization period is adopted and represents about half of the weighted average remaining book life, the amount of uneconomic costs presently being recovered through rates will increase by 100%. This rate impact for APS and TEP will be large indeed. As a result, the importance of accuracy and fairness in stranded cost determination is enormous. In a practical sense, this impact along with the considerably smaller effects of the System Benefits Charge and the Solar Portfolio Standard, must not exceed the anticipated cost reduction related to competitive energy supplies. To do otherwise would result in a rate increase related to the advent of competition. Launching competition to provide cost savings to consumers and immediately following with an increase in electricity prices challenges common sense, or what we term the "front page test."

We support netting all negative and positive stranded costs (assets and obligations such as purchased power contracts) in the determination of recoverable amounts. In the inevitable rate proceeding to accompany the filing of unbundled tariffs, attempts to update costs through new depreciation and other studies should be analyzed very closely. For example, the discussion of the costs of "decommissioning" fossil-fuel plants on page 11 of the report implies that such costs are not presently being recovered. The fact is that these costs are recovered over the useful life of the asset through a higher depreciation rate. In addition, regulatory assets are included in current rates, and being recovered through 2004 and in some cases beyond. To help relieve upward pressure on rates, expanding the amortization period for the remaining regulatory asset recovery to be consistent with stranded cost recovery should be considered. These and other issues must be closely examined in the formal proceeding to follow filing of unbundled tariffs.

Competitive Market Value

As pointed out in the report, the competitive market value is a critical element of the calculation of stranded costs. The theory presumes that costs of competitive energy supply that exceed this level will not be recoverable in a competitive environment. However, true market value can really only be determined by the market. It is instructive to note the results of divestiture of generation facilities in other parts of the country. For example, the non-nuclear generation assets of the New England Electric System yielded a 45% premium above net book value at auction.

We don't understand the basis for the rather emphatic position of Staff in favor of the administrative Net Revenues Lost method of calculating stranded cost. The Staff has not been able to identify a reasonable method for determining the "market value" of strandable assets, an essential ingredient of this method. The weak support for this approach is reflected in the voting: only seven of nineteen votes cast in favor. While we acknowledge there is little support for the market base approaches, we urge the Commission to carefully scrutinize the relative practicality of each option. We believe such examination may find the market-based divestiture method more attractive. Other states have found that market-based divestiture, in conjunction with administrative approaches for the near-term, have provided an effective balance for calculation of stranded costs.

The importance of market value requires close examination of the underlying assumptions implicit in the theoretical premise. The assumption that all customers, given a choice of suppliers, will choose the supplier with the lowest rates is suspect. We believe that this assumption is not valid. Many energy consumers have already demonstrated that energy characteristics other than price are of value to them. For example, APS' solar green pricing program in Flagstaff attracted considerably more customers willing to pay a premium for a small renewable supply than expected. Moreover, reliability is more important to some customers than others given the popularity of interruptible rate options. Perhaps a better real-world example is in the telecommunications area. Despite having prices higher than most long distance competitors, AT&T still controls the majority of the market. Whether the specific reasons for this situation relate to name recognition, reliability concerns, or consumer laziness is not important. What is important is to recognize that empirical evidence supports Arizona's Affected Utilities' ability to charge premium rates for their "name brand" energy services. Thus, we believe that using marginal cost (page 20) or a gas-fired combined cycle unit (page 22) as an across the board market value is likely to overstate the stranded costs of incumbent utilities. Under these circumstances, we recommend that market-based approaches be used to determine fair market values.

Stranded Cost Recovery

Page iv of the Executive Summary (and page 47 of the report) discuss the treatment of customers who remain on Standard Offer rates, i.e. choose not to participate in the competitive environment. While the intent is unclear, we believe that a change to the Restructuring Rule yielding a stranded cost policy that increases rates is not in the public interest. As previously stated, a rate increase related to the advent of competition simply does not pass the "front page test."

Should the Commission decide that periodic true-ups to stranded cost recovery prices should occur, we recommend that the public participation resource reviews contemplated by other

working groups would be an appropriate forum. Use of such a forum would help minimize the number of proceedings, and would allow efficiency in access to relevant information.

NORDIC ELECTRIC ARIZONA, L.L.C.

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September 25, 1997

Mr. Carl W. Dabelstein
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: Comments on Report of the Stranded Costs Working Group

Dear Mr. Dabelstein:

Following are Nordic's comments on your developed report to the Arizona Corporation Commission for the Stranded Cost Working Group.

1. The staff's recommendations are not consistent with the wishes and desires of the Stranded Cost Working Group. The report appears to have been drafted by your staff, favoring the affected utilities without concern for the Arizona consumers that desire a fair entry into retail competition. Nordic objects to the contents of the report.

2. In order for the Stranded Cost Working Group to develop recommendations on all issues, it was necessary to have available proposed costs that might be stranded. Staff felt that this would be unfair to the utilities. The Working Group could have made recommendations that may have been favorable to the utilities, and then both the consumers and the utilities would then have be able to plan for the future. The rules require that the affected utilities file the cost information with the Commission, and this has not been done.

3. Staff believes that the utilities had a monopoly to generate power, however Arizona Statures expressly state that no monopolies shall exist in the State of Arizona. The affected utilities were granted a nonexclusive franchise by either cities or counties which allowed the construction of transmission and/or distribution lines. The franchise is not related to the installation of generation. Nordic could apply for the same franchise in most counties of the State, and the franchise would be granted.

4. At least two of the commission members have addressed the stranded cost issue to the working group, and implied that the amount of stranded cost to be recovered by affected utilities would be somewhere between zero and 100%. Staff in this report proposes a 100 percent recovery of stranded costs using the lost revenue approach. However, the

Working Group also felt that the affected utilities and their stockholders should bear a fair share of the burden. Investors should not expect a windfall from the collection of stranded costs at the expense of the consumers.

5. Even if deregulation did not occur, some of the costs that affected utilities may try to recover would have been written off the books for a number of business reasons. One reason may be the inefficiency of operation of existing plants. A second reason may be that long term electrical energy would be available to the utility by competitive electric providers at a price below the production costs for the effected utilities. Marketing low cost electrical energy would make good business sense, and benefit the consumers without lowering the profit margin for the utility.

6. Consumers should have the right to select their own electric provider without having to pay a penalty for leaving an affected utility. No exit fee should be approved by the commission.

7. The right of consumers to have self generation has been a reality in Arizona since the beginning of time. This right must be protected by the commission. The Working Group did not agree that self generation customers be involved in the recovery of stranded costs.

8. Stranded costs, if any, should be recovered from all classes of customers receiving electric service including those receiving electrical energy from the competitive market place, as well as those that remain in the utility system.

9. Page 45 of the report acknowledges that most of the Working Group members recommended a relatively short recovery period. What is wrong with the 4 to 5 year recovery period mandate of the Working Group? Nordic favors 4 to 5 years so that consumers may better plan for future expansion and electrical needs.

10. Retail sales taxes collected throughout the State will not change materially (if at all) due to deregulation. New energy providers will also collect taxes on energy sold at retail. The economy will continue to grow, existing customers will seek additional opportunities due to deregulation, and new consumers of electrical energy will start paying sales taxes.

Please accept these comments (including objections) to the Report of the Stranded Costs Working Group.

Sincerely submitted,

Nordic Electric Arizona, L.L.C.

A. B. Baardson, consultant to Nordic

PG&E Energy Services

September 24, 1997

Carl W. Dabelstein
Director-Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007-2996

Re: Dissenting Comments on the "Stranded Cost Working Group" Report

PG&E Energy Services offers the following brief dissenting comments on the final Stranded Cost Working Group Report (cover letter dated September 19, 1997).

We were **not** eligible to vote in the elections cited in the report, even though we were a very active participant in each of the three stranded cost subcommittee working groups. Voter eligibility had been determined a few weeks prior to our initial involvement and was not reconsidered although we requested voter eligibility. This was unfortunate from our perspective.

Summary of Dissent

Our dissent is with the overall impact, if adopted, of Staff's recommendations.

Our major disagreement is the absence of suggestions by Staff that Arizona's affected utilities should take significant responsibility for and fully cooperate in creating a competitive electricity market ***in return for*** the opportunity to recover their stranded costs. Stranded cost recovery should not be a goal in and of itself. It should be linked to an irreversible and timely outcome of competition in electricity services.

Electricity competition in Arizona cannot occur without the on-going cooperation of Arizona's existing utilities. In our opinion, Arizona presently does not enjoy cooperation from its major utilities in creating competition. Stranded cost recovery can be a useful carrot to achieve timely competition in electric services. Arizona must find a way to make it in the self interest of the Arizona utilities to cooperate.

Some states are using stranded cost recovery in clever ways to achieve their policy goals. In order to get reasonable stranded cost recovery provisions in California, the utilities had to agree to do a great many things they preferred **not** to do. Now, they must not only do them, but do them in a very short time frame. These include opening the market 100% on an aggressive (1998) timetable, requiring "voluntary divestiture", forcing bidding of all generation into a power exchange and leaving an enormous number of details up to the incumbent utilities with instructions simply to figure things out. As a result, Arizona's utilities are today enjoying real marketing opportunities and successes in California.

In our opinion, not only are Staff's recovery provisions more favorable to the utilities than California's provisions, but they also do **not** require any genuine cooperation. A ten year recovery period, inclusion of unrecorded assets, and a net revenues lost recovery mechanism are only a few of Staff's recommendations which are overly favorable to the utilities and hostile to competition.

In return for granting stranded cost recovery, we suggest Arizona obtain genuine commitments from Arizona's utilities to do such tasks as quickly create billing and metering computer system interfaces with multiple competitors, commitments to appropriately separate merchant from regulated functions, commitments to submit workable open access distribution tariffs (on the first pass,12-31-97) that truly

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exclude the costs of competitive services, commitments for a timely Desert Star ISO, commitments for safe and reliable system operations until Desert Star is fully operational, commitments to achieve competition in billing and metering, commitments to quickly address and eliminate abuses of market power and, of course, commitments to start competition on January 1, 1999.

Our concerns are heightened because the current accelerated stranded cost recovery programs in place for some of Arizona's utilities do not require utility cooperation in creating competition and, thus, are a dangerous precedent. For instance, APS is recovering $1.3 billion in regulatory assets on an accelerated basis. However, we have seen no behaviors of cooperation from APS to indicate that they intend to support competition on any timetable. We have seen behaviors quite the opposite.

We also submit the following specific dissenting comments:

1. Our positions regarding stranded cost recovery were set forth earlier in comments submitted April 25, 1997, and are repeated below. From our working group experiences, we believed a variant of position C below enjoyed consensus. However, on page 44 all three options are presented and the report states, "...the Subcommittee was unable to establish a clear preference." We believe customers selecting competitive supply should **not** be greeted into the market with a price increase merely as a result of exercising choice.

Our basic positions are:

a. **During stranded cost recovery, retail customers eligible for choice must have the opportunity of purchasing competitive services at prices lower than those of the affected utilities.** Even if Arizona's affected utilities have the opportunity to recover 100% of stranded cost, efficient new entrants **may** be able to offer lower prices for competitive services **if** the stranded cost recovery mechanism is structured to encourage competition.

b. **Affected utilities must NOT have the opportunity to recover more than 100% stranded costs.** If overly inclusive of costs, a net lost revenues recovery mechanism can easily provide the opportunity to recover much more than 100% stranded cost.

c. **Stranded cost recovery must be a neutral consideration in an eligible customer's decision to select either "standard offer" or competitive supply.**

2. **Unrecorded Assets**: We disagree with Staff's recommendation on page 9 to insert the phrase "both recorded and unrecorded." Any assets **unrecorded** as of 12-26-96 should **not** be afforded stranded cost recovery.

3. **Net Revenues Lost**: On page 20, FERC Order 888 is cited in support of the "net revenues lost" approach. In our opinion, there are very significant differences between what FERC has ordered and what the Arizona Commission Staff is proposing. The Arizona Commission Staff proposal relies much more heavily on forecasts than FERC's method.

4. **Net Revenues Lost**: The net revenues lost approach is inconsistent with the Arizona rule's definition of Stranded Cost. The definition clearly focuses on *market value*. Also, the working group reached a consensus **not** to change this definition.

PG&E Energy Services

Thank you for including our comments in the final report.

Sincerely,

Tom Broderick

Tom Broderick
Regulatory Consultant, PG&E Energy Services

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Jane Dee Hull
Governor

Greg Patterson
Director

September 26, 1997

Carl Dabelstein, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: Stranded Cost Working Group Report

Dear Carl:

Enclosed please find RUCO's Comments to the Stranded Cost Working Group Report. Please append these comments to the working group's final report.

If you have any questions, please contact me at 279-5659 ext. 352.

Sincerely,

Greg Patterson
Director

RUCO'S RESPONSE TO THE STRANDED COST WORKING GROUP REPORT

September 25, 1997

PROCEDURAL COMMENTS

The Arizona Corporation Commission has taken great steps in fostering competition in the electric industry in Arizona. In December 1996, the Commission adopted rules, which provided a framework for moving the electric industry from a monopoly to a competitive marketplace. At the time of adopting those rules, the Commission acknowledged that there were several complex issues where further guidance was needed, including but not limited to, the recoverability of stranded investment, intra-state and inter-state reciprocity, and the status of new Certificates of Convenience and Necessity (CC&N's). The Commission concluded:

> [T]hat these gaps, to the extent that they exist, can be filled in later with workshops, ***working groups***, ***subsequent evidentiary hearings***, and perhaps subsequent ***rulemaking proceedings***; while competition is approaching rapidly, the transition to competition will allow time to address these issues and resolve them in a timely fashion. (Emphasis added.)[1]

Commission Decision No. 59943 at p. 3.

For the past six months, interested parties and Staff have been engaged in a rigorous schedule of working group meetings and preparation of written comments on a myriad of issues facing both the Commission and industry in this inevitable transition from a noncompetitive to a competitive electric industry. Despite the participants' extensive efforts, the Working Groups have not proven to be as productive as they were originally envisioned to be. The time-intensive nature of the working groups has precluded many interested parties with limited resources from full participation in all the groups. It is evident from the Stranded Cost Working Group Report ("Report") that the various parties with their diverse interests were unable to reach consensus on the majority of the issues.

Due in part to this lack of consensus within the Working Groups, the Stranded Cost Report unfortunately gives short shrift to many parties' positions, and ultimately emphasizes Staff's position on the issues. The reports of the three subcommittees, the Recovery Mechanism Subcommittee, the Calculation Methodologies Subcommittee, and the Accounting, Finance and Tax Subcommittee were not even appended to the Report. This results in a negation of the effort and time that many parties have expended within the Working Groups. Furthermore, this omission is inappropriate and a disservice to the Commission, who may wish to review the efforts of the subcommittees.

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[1] The Commission has anticipated evidentiary hearings as part of the rulemaking process as noted above in Decision No. 59943 and again in Commission Decision No. 60351, issued August 25, 1997, where the Commission authorized evidentiary hearings regarding any aspect of electric competition.

Therefore, RUCO has attached the subcommittee reports as Appendix A to these comments. In addition, many issues not previously contemplated by the Utilities Staff have arisen in the Working Groups, and these issues require a fact-finding process which is beyond the working groups' power.

Examination of the Stranded Cost Working Group Report reveals that a more formal fact-finding process must take place before the Commission can properly determine the best method to follow in the electric restructuring process. RUCO contends that an informed policy-making decision process dictates that the interested parties should have the opportunity to formally present evidence in support of their positions and interests. This is a critical step. All concerned parties should also be afforded an opportunity to cross-examine witnesses and provide rebuttal evidence.

In the Electric Restructuring process, the Commission has before it the weighty task of assessing the conflicting interests of many parties regarding the provision of electric power, an essential resource. With such a panoply of viewpoints to assess, the Commission must have access to a proper evidentiary record that identifies all the diverse parties' interests and priorities. In turn, the parties are entitled to present facts in support of their positions, and the Commission deserves to be exposed to a critical analysis of those facts.

GENERAL COMMENTS ON STRANDED COST

The following highlights RUCO's position regarding stranded cost recovery. As indicated above, RUCO asserts that an evidentiary hearing is the appropriate forum for addressing the details of its position.

(1) Stricter Standards for Stranded Cost Recovery.

In contrast to Staff's proposals, RUCO's position with respect to stranded cost recovery is based on the requirement that utilities meet more stringent standards for proving that they will incur stranded costs when retail competition is introduced and for claiming that customers should be held responsible for such costs.

(a) The utilities should be charged with a high burden of proof with respect to any claimed stranded costs.

(b) Utility investors, whose financial returns have included a risk premium, must assume some responsibility for stranded costs. Considerations of fairness demand that customers should not have to bear the total burden of stranded costs. By definition, stranded costs derive from investments that are not used and useful.

(c) Utilities should be required to absorb some share of stranded costs claimed by the utilities, in order to introduce a more effective financial incentive to mitigate such costs.

(2) Rate Unbundling to Identify the Stranded Cost Component in Existing Rates

The stranded cost issue would be more readily understandable by all concerned if the stranded cost component of current and prospective utility rates were identified. The "unbundling" of customer rates would identify the stranded cost component and would make it clear that those customers who continue to receive full utility (standard offer) service will have the same responsibility for stranded costs as those customers who switch to alternative suppliers. The difference, of course, is that in the case of standard offer customers, the costs are not actually stranded by competition – they are only potentially strandable – while in the case of a customer who switches to an alternative supplier, the costs would be stranded absent the stranded cost charge.

A hypothetical example, using a simple cents/kWh tariff, makes this clear:

Rate Component	Current Rate	Standard Offer Rate	Competitive Rate
Transmission, Distribution & Other Utility Services	2.0 cents	2.0 cents	2.0 cents
Generation Component			
-- Economic	3.0	3.0	n.a.
-- Uneconomic (Strandable Cost)	1.5	1.5	1.5
Total Paid to Utility	6.5	6.5	3.5
Paid to Competitive Supplier	-	-	3.0
Total Cost of Power	6.5	6.5	6.5

(3) Revenue-Neutral Unbundling

An additional source of confusion, also related to rates, is the potential effect of rate unbundling on rate design. RUCO proposes simply that unbundling should be effected in a revenue-neutral manner, both as between customer classes and within customer classes. Each cost element would be functionalized, classified and allocated as it is now. This would mean that the total of each utility tariff component would remain unchanged – unbundling in and of itself would not affect the total customer charge, demand charge or energy charge for any customer.

To clarify this point, and the previous one, rates will of course tend to change over time, but unbundling in and of itself should not lead to different charges, except to the extent that customers switch to lower-cost generation suppliers.

RUCO RESPONSES TO THE SPECIFIC POINTS RAISED BY THE STRANDED COST WORKING GROUP REPORT.

In this section, RUCO has responded to specific recommendations addressed in the Report (including Executive Summary). The language from the Report is italicized; RUCO's response follows.

- *The definition of stranded costs contained in Section R14-2-1601 of the Rules should not be changed.* Executive Summary at p. iii.

  RUCO agrees with this position.

- *Stranded costs may include the following categories of costs:*

  - *generation assets*
  - *power purchase agreements*
  - *fuel contracts*
  - *regulatory assets*
  - *employment transition costs*
  - *environmental mandates*

  With respect to the above, the parties reserve the right to oppose or challenge the inclusion of any particular cost or component when a request to recover stranded costs is made. Executive Summary at p. iii

  RUCO agrees with this position, however, RUCO believes that retailing expenses for generation should also be included.

- *The Rules should be changed to allow stranded cost recovery from customers who are not taking competitive power. The second sentence of Section R14-2-1607(J) of the Rules should remain in effect, but this Section should be amended to allow all customers to pay stranded costs, including customers who remain on standard offer rates. However, the charge to standard offer customers should account for contributions that are already being made toward stranded costs and should not cause customers' prices to increase.* Executive Summary at iv.

  RUCO agrees. It should be made clear that the confusion arises because of the failure to identify the uneconomic or potentially strandable generation cost component in existing rates and standard offer rates. This is discussed in RUCO's General Comments, above.

- *Stranded costs should be recovered from ratepayers using a charge with both an energy and/or demand component.* Executive Summary at iv.

RUCO agrees. Furthermore, tariffs for each rate class should continue to have the same billing determinants as they do now. For example, most residential customers would continue to have a two-part customer and energy tariff. Of course, time-differentiated tariffs and three-part (customer, energy and demand) residential tariffs could be introduced in the future. General Comment (3) above deals with revenue neutral unbundling, which is the underlying issue here.

- *Customers should have the option to pay a lump sum amount in lieu of a stranded cost charge.* Executive Summary at v.

  RUCO disagrees. The lump sum option, which would in practice be restricted to large business customers, gives an opportunity for stranded cost evasion and special deals. For example, customers thinking of expanding their business, and thereby increasing their consumption, would find it particularly attractive to pay a lump sum based on their historical level of consumption. Furthermore, a lump sum payment eliminates an opportunity for true-up of stranded costs.

- *The Commission should consider some type of rate cap as part of the development of a stranded cost recovery program.* Executive Summary at iv.

  RUCO believes that a rate cap could be considered <u>during the transition period</u>, but not during the competitive period. A rate cap could be an element of the transition plan for a particular utility, provided it is recognized that Arizona's utilities should, during the next several years, be in a <u>declining cost situation</u>. A rate reduction, i.e., a rate cap at a level below the level of current rates, coupled with allowing a utility some flexibility with regard to stranded cost recovery (e.g., accelerated depreciation), could be considered. The impact of a rate cap on stranded cost recovery needs to be taken into account when stranded costs are trued-up.

- *Stranded costs should be allocated to jurisdictions and customer classes in a manner consistent with the specific company's current rate treatment of the stranded asset, in order to affect a recovery of stranded costs that is in substantially the same proportion as the recovery of similar costs from customers or customer classes under current rates. Updated rate design to correct flaws in current rate design would be acceptable.* Executive Summary at iv.

  RUCO agrees with first statement. See RUCO General Comment (3) above. However, RUCO disagrees that updated rate designs would be acceptable. Instead, RUCO advocates a revenue-neutral unbundling approach, where rate design remains constant.

RUCO RESPONSES TO STAFF'S RECOMMENDATIONS

Because Staff has utilized the Executive Summary as a vehicle to articulate its position, RUCO has taken this opportunity to respond on a point-by-point basis. Again, the language from the report is italicized, and RUCO's response follows.

- *Due to uncertainty which exists with respect to whether the Commission intended that the costs of nuclear fuel disposal be included with the costs of nuclear decomissioning for purposes of computing the System Benefits Executive Charge, R14-2-1608. A should be clarified to eliminate any ambiguity.* Executive Summary at v.

  RUCO has no position on this issue.

- *Because the circumstances of what constitutes reasonable and prudent mitigation efforts can vary widely between companies, a generic approach should be avoided, and such efforts be evaluated on a case-by-case basis, as part of the Affected Utilities stranded cost filings anticipated under R14-2-1607.G.* Executive Summary at v.

  RUCO agrees. An evidentiary hearing is essential to identify utility-specific mitigation potential. However, RUCO does not believe that it is possible in such a hearing to identify each and every possible opportunity for mitigation. Consider how long the list of possible mitigation categories is, let alone the specific opportunities within each category:

  - the utility can be restructured;
  - overhead costs can be reduced;
  - financial costs can be reduced through securitization if authorized;
  - financial costs can be reduced through other types of refinancing or financial restructuring or risk mitigation strategies;
  - overhead costs can be spread over a wider range of sales or services;
  - assets that are of less value to the Company than to potential buyers can be sold (potential buyers may pay a premium for generation assets in order to get a foothold in the market);
  - favorable sales contracts can be entered into;
  - new markets can be found for power;
  - new markets can be found for services provided by generation-related staff;

- O & M costs can be cut;

- uneconomic plants can be closed down;

- high-cost purchased power agreements can be restructured or bought out;

- high-cost purchased fuel agreements can be restructured or bought out;

- the performance of generating assets (plant heat rates and availability factors) can be improved;

- generating plant capacity can be upgraded;

- generating plant life extension can add value; and

- generation asset values can be enhanced in the case of return-to-service units.

If they can economically returned to service when power market conditions change;

- generation asset values can be enhanced in the case of generation sites owned by the utility adjacent to existing transmission rights of way, if generating units can be upgraded or new generating units can be more easily sited there; and/or

- generally, the use of land and facilities for new purposes can enhance their values[2].

It is impossible for the Commission or for parties to this proceeding to identify all the possible sources of cost mitigation. The utility itself cannot identify in advance all the sources that it will only identify over time in response to financial and competitive pressures. At this time, the best it can probably do is to take such steps as hiring management and strategic consultants to bring new ideas. Steps of this kind could be the subject of the evidentiary hearing.

In these circumstances, however, an evidentiary hearing is not enough. RUCO believes strongly that the Commission should introduce a financial incentive to mitigate by allowing utilities something less than full recovery of the face value of their stranded cost claims.

- *Amounts prudently spent in connection with Affected Utilities' stranded cost mitigation efforts should be considered as a recoverable stranded cost.* Executive Summary at v.

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[2] Mitigation strategies are discussed in *Strategies to Address Transition Costs in the Electricity Industry*, Oak Ridge National Laboratory, July 1996 (ORNL/CON-431).

RUCO agrees, provided new costs, such as legal fees, are not recoverable. However, funds spent to mitigate prior stranded costs, such as buying out uneconomic coal contracts, could be recovered.

- *The preferred method for computing stranded costs is a "Net Revenues Lost" approach, which compares future revenue streams under a continuation of regulation with those that are estimated to be received in a competitive power market.* Executive Summary at v.

  RUCO disagrees. While interim stranded cost recovery could be based on less-than-full recovery of amounts determined administratively by the Commission, it is essential, in RUCO's opinion, to have true-up(s) based upon market valuation of a utility's generation assets. Stranded cost is equal to the excess (if any) of book value over market value of generating assets, adjusted retailing costs of the utility versus alternative suppliers, on a net system-wide basis for each utility. (Certain items such as regulatory assets are, prima facie, strandable at their full book value because they have no market value.)

  Valuations for purposes such as property tax assessment have typically been based upon one or more of three methods: (1) discounted future income from the asset (which is comparable to the approach proposed by Staff above); (2) replacement cost new (which can also be included indirectly in the proposed Staff method, by means of setting the future market prices equal to the full cost of power from the most economical new generating facilities such as gas-fired combined cycle plants); and (3) comparable sales.

  Method (3) is the preferred method because it relies upon actual market data – prices that are paid in the market place for similar assets in transactions between willing sellers and willing buyers – rather than upon opinions about future prices of electricity, costs and performance characteristics of the utility's facilities, etc., which are required in the method proposed by Staff.

  Errors in forecasting led to today's stranded cost problem of nuclear generating units. Equally great errors are possible in forecasting how large those stranded costs will turn out to be. Depending on the forecasts of electricity prices, stranded costs can vary dramatically. In recent testimony in Arkansas, for example, an Entergy Arkansas, Inc. consultant testified that according to the assumptions used, the company's stranded costs could be equal to $2,050 million or negative $784 million, depending primarily on the range of forecasted market prices of electricity.[3] Those estimates were based on running the Excess Cost Over Market (ECOM) model developed in Texas, which uses a methodology of the kind proposed by Staff.

[3] Larry Brockman, Rebuttal Testimony, page 27, in Arkansas PSC Docket No. 96-360-U, September 2, 1997.

- *Calculations of stranded costs should reflect the expected remaining cost recovery periods associated with the respective assets. That includes estimated service lives implicit in current book depreciation rates, the remaining contract periods under existing fuel and purchased power agreements, and remaining scheduled recovery periods for applicable regulatory assets and liabilities.* Executive Summary at v.

  RUCO agrees. However, as noted above, the best way to take into account market expectations about the length of life of facilities is to find out how much they would yield in the market itself.

- *In developing any estimates of the market clearing price for power for use in calculating stranded costs, caution should be exercised in emphasizing today's wholesale market prices, which may be unsustainable in the long run. The issue of market clearing price should be further studied, with the utilities bearing a strong burden of proof with respect to the reasonableness of any estimation method they choose.* Executive Summary at v.

  RUCO agrees with this statement, with one important exception. Staff refers to wholesale market prices. The correct valuation would be based on retail prices, which are equal to wholesale prices plus a retail adder. In order to provide retail generation services to end-use customers, alternative suppliers will have to incur many costs that are clearly not embedded in the market prices of bulk power. Such costs will include administrative and general expenses, billing service costs, customer service costs, marketing and other transaction costs. Absent a retail adder to reflect these and other similar cost items, retail market prices will be significantly under-estimated. Utility "generation" costs – which the utilities are comparing with "market prices" - include overhead or similar costs. Stranded costs are not being estimated on an apples-to-apples basis.

- *Estimates of stranded costs should be periodically trued-up to assure electric restructuring in Arizona is carried out in the public interest such that affected parties are neither unjustly benefited or penalized.* Executive Summary at v.

  RUCO agrees. Indeed, for the reasons stated above, RUCO does not believe that it will prove possible to make reasonably accurate estimates of stranded costs until there is reliable market price information available – in the market for generating assets, not only the market for electricity.

- *The period for recovering stranded costs should be ten years.* Executive Summary at vi.

  RUCO disagrees. This is too long a period. A period of four to six years, depending on the utility, should be set. Otherwise, the advent of unfettered competition would be too long delayed.

- *All power users, including new customers, self-generators, interruptible customers, and special contract customers, should be allocated an appropriate share of the stranded costs, but a distinction may be made between parties taking competitive power and those not, insofar as such difference reflects the fact that parties continuing to take standard offer service are paying for stranded costs in rates.* Executive Summary at vi.

  RUCO agrees with the intention of the Staff's point. However, the point is expressed in a confusing manner. The problem is that the strandable cost component of current and prospective full-service or standard offer tariffs is not identified – see RUCO General Comment (2) above.

- *The stranded cost charge should properly reflect the demand and energy characteristics of the underlying stranded costs.* Executive Summary at vi.

  RUCO agrees. See RUCO General Comments (2) and (3) above which address the identification of the stranded cost component in current rates and, in setting unbundled rates, adhering to revenue-neutrality.

- *The Rules should contain some requirement that the proceeds from the stranded cost charges be used by the utilities to extinguish existing obligations, whether financial, such as debt or equity securities, or operating, such a long-term fuel and purchased power contracts.* Executive Summary at vi.

  RUCO agrees.

- *Parties advocating the imposition of price caps on the utilities, or the absorption of stranded costs by utility investors should provide specific details and/or justification with such recommendations.* Executive Summary at vi.

  RUCO strongly disagrees. The burden of proving the level of stranded costs, the adequacy of the utility's cost mitigation strategies, and the argument for full recovery of stranded costs from customers, should remain with the utility. As noted in RUCO General Comment (1) above and in connection with stranded cost mitigation potential, considerations of fairness and financial incentives support the absorption of some part of the face value of stranded cost claims by utility investors.

- *The Commission's Rules should be sufficiently clear with respect to stranded cost identification, quantification, and recovery such that the potential for mandatory accounting or tax write-offs is minimized.* Executive Summary at vi.

  No comment.

- *The Affected Utilities' stranded cost filings required under R14-2-1607.G should include detailed descriptions of the companies' proposed accounting for stranded costs and related revenues.* Executive Summary at vi.

RUCO agrees.

- *Significant issues remain with respect to tax exempt securities and entities exempt from income taxation. Further analysis of these issues is necessary.* Executive Summary at vi.

  RUCO agrees.

CONCLUSIONS

It is evident from the discussion above that numerous crucial issues regarding stranded cost recovery remain undecided. RUCO contends that evidentiary hearings are the essential "next step" that the Commission must take in its rulemaking process. This is the only procedure that will ensure that the Commission has a reasoned basis for modifying the existing Electric Competition Rules. RUCO strongly urges that such evidentiary hearings be scheduled immediately, so that electric industry competition in Arizona can become reality in a timely manner.

APPENDIX A

REPORT OF THE STRANDED COST WORKING GROUP
RECOVERY MECHANISM SUBCOMMITTEE
June 30, 1997

The Recovery Mechanism Subcommittee was formed by the Stranded Cost Working Group on March 4, 1997, to address issues related to the recovery of stranded costs. The Subcommittee's goals are to develop recommendations regarding stranded cost recovery mechanisms; to evaluate and respond to the Retail Electric Competition Rules as they presently exist and as they relate to cost recovery mechanisms; and to submit a written report to the Stranded Cost Recovery Working Group by June 30, 1997.

Members of the Subcommittee included representatives from:

Energy Strategies Inc. for Asarco, BHP Copper, Cyprus Climax Metals, Phelps Dodge (Mines) and the Public Interest Coalition on Energy[1] (Coalition);
City of Tucson;
City of Mesa;
Arizona Public Service Company (APS);
Phelps Dodge;
International Brotherhood of Electrical Workers;
Land Water Fund of the Rockies;
PG&E Energy Services;
Arizona Electric Power Cooperative, Inc. (AEPCO);
Tucson Electric Power Company (TEP);
Salt River Project (SRP);
Citizens Utilities Company (Citizens);
Arizona Community Action Association;
Arizona Consumers Council;
Arizona Citizen Action;
Fort Huachuca;
Goldwater Institute;
Arizona Utility Investors Association; and
Electric Competition Coalition for The Ascendix Group, Calpine Corporation, Enron Corporation, Nordic Electric Arizona, and PG&E Energy Services.

The Subcommittee agreed that in developing recommendations regarding recovery mechanisms, the stranded cost recovery mechanisms should:

a. be reasonable and timely;

[1] The Public Interest Coalition on Energy is a consortium of energy consumer interests which includes Arizona Association of Industries, Allied Signal, Arizona Retailers Association, Arizona Small Business Association, Arizona Hotel/Motel Association, Arizona Multihousing Association, Arizona Mobile Home Parks Association, Arizona Food Marketing Association, National Federation of Independent Businesses, Arizona Mining Industry Gets Our Support, and Lake Havasu Manufacturing Group.

than currently known and quantified costs (plant assets, power purchase contracts, etc.).

- The period also could be adjusted to a shorter time period if, for example, load growth at the distribution level increases faster than assumed, or the amount of stranded costs to be recovered is adjusted downward.

The Subcommittee had different views on the guidelines that should be used to establish the time period. Generally, consumer groups and new electric service providers preferred Option A below, and the utilities preferred Option B.

Option A: (1) a. The time period should depend on the magnitude of stranded costs and should be as short as possible, for example from 3 to 7 years.

b. The time period should be fixed and known prior to the implementation of competition.

c. At the end of that fixed time period stranded cost recovery ends.

(2) The possibility of establishing a time period that would allow recovery of stranded costs without consequent price increases should be considered.

Option B: The time period for recovery needs to balance the goals of achieving minimum rate impacts, the shortest possible time for recovery, and a reasonable opportunity for utilities to recover net unmitigated stranded costs.

Allocation of Stranded Costs

The Competition Rules, as they presently exist, allow stranded costs to be recovered only from those who participate in the competitive market. The group discussed the feasibility of collecting stranded costs in a short time period, when recovery is restricted to a percentage of consumers participating during the phase-in. Recognizing that problems may arise due to this restriction, the group discussed the possibility that all customers, including standard offer customers, pay stranded cost. Some parties (consumer groups and new electric service providers) prefer how the existing rules treat this issue, but agree that this alternative would be acceptable given certain restrictions. While other parties (Affected Utilities) believe that all customers should pay stranded costs unconditionally.

The Mines and Coalition would not oppose the inclusion of standard offer customers in stranded cost recovery if the following conditions are met: prices are capped, stranded costs are allocated according to current treatment of assets, and the

Regarding R14-2-1607(J), the Arizona Utility Investors Association is concerned that the Competition Rule does not define self-generation and that this provision potentially allows groups of customers to evade stranded cost. The Investors Association also pointed out that this section of the Rule conflicts with the FERC which allows stranded cost recovery caused by self-generation.

The Arizona Community Action Association, Arizona Consumers Council, and Arizona Citizen Action agree with the language proposed by the Mines and Coalition above, with the conditions that (1) the allocation and recovery of stranded costs should not cause increased costs for any consumer, and (2) the allocation should only be limited to that portion of the stranded costs to be recovered from consumers, if any.

City of Tucson believes that stranded costs should not be shifted from one class to another and suggests capping rates at current levels to avoid unfairly disadvantaging small consumers.

Fort Huachuca points out that "The rates currently in effect for both APS and TEP are not based on specific customer cost allocation methods explicitly approved in rate orders of the Commission; recent rate adjustments for both companies have generally been "across-the board" in nature due to rate settlements agreed to by the various parties and the Commission. Accordingly, little weight has been given to cost of service in the recent past in the setting of rates." Fort Huachuca believes that the Commission should apply the same allocation method for utilities with similar load profiles.

PG&E Energy Services believes that existing utility's cost of service methodologies require additional supporting detail and Commission review if they are to be used in stranded cost recovery and economic separation of competitive and re-regulated services.

AEPCO suggests that for the purposes applying recovery mechanisms, it may be necessary to treat AEPCO and its members as a single system. They believe that the complexity of implementing stranded cost recovery through the two levels of existing rate design will take significant additional efforts.

The Goldwater Institute advocates fixed meter charges that are independent of the stranded costs to be recovered from former providers. The meter charges may depend upon a customer's past or expected consumption levels. TEP commented that this approach has the disadvantage of ignoring cost causality and would thus yield inequitable results with respect to specific energy providers and their customers.

SRP and others offered the following advantages and disadvantages of using existing allocation methodologies:

Advantages:

c. The Arizona Utility Investors Association believes that the recovery of stranded cost through a usage charge could be defeated in cases where municipalities take over distribution systems, thereby shifting that obligation to other energy consumers.

The Arizona Community Action Association, Arizona Consumers Council, and Arizona Citizen Action support the use of a non-bypassable distribution access charge applied on a per kWh basis to the volume of energy sales to consumers. Additionally, they suggest that a portion of stranded costs could be collected from new market entrants using a market access charge (or entrance or license fee) applied on a per kWh basis to the volume of in-state energy sales.

PG&E Energy Services is opposed to paying any stranded cost access fees that apply only to new market entrants. They believe that such fees would create a barrier to entry for new market entrants because incumbent utilities could market to the same customers and not incur this cost.

The Goldwater Institute believes that stranded costs should be recovered through a "meter charge." It would be an obligation of whomever owned the property or business. The meter charge is a fixed fee, payable over the recovery period or in a lump sum, and would not vary with future energy use.

TEP supports a kWh charge, but would not object to the application of a fixed charge such as a meter charge. TEP believes that it should be done within the context of customer class allocation where a particular class is assigned a fixed charge consistent with proportional usage patterns and costs that have been imposed by that class on the system.

Citizens' position is that the recovery mechanism for stranded costs should be a fixed (or largely fixed), non-bypassable fee levied by regulated distribution entities on all customers eligible to select competitive suppliers. Customers should have an option of paying a one-time fee to buy out their stranded cost liability.

Advantages and disadvantages of a *fixed fee* are:

Advantages:

a. It has a minimal impact on electricity consumption.
b. It minimizes economic impacts, for example, on consumption decisions and economic development. From the standpoint of economic development, SRP suggests that given the relatively short period envisioned for collecting the majority of stranded costs, such impact on major purchasing decisions may be minor.
c. Assuming the time period for recovery is tied to the magnitude of stranded costs, a fixed charge also can help shorten the transition period to full competition.

allow all customers to pay stranded costs, including customers who remain on standard offer rates. However, the charge to standard offer customers should account for contributions that are already being made toward stranded costs.

Option B: The second sentence of Section R14-2-1607(J) of the Competition Rules should remain in effect, but this Section should be amended to allow all customers to pay stranded costs, including customers who remain on standard offer rates. However, the charge to standard offer customers should account for contributions that are already being made toward stranded costs and should not cause customers' prices to increase.

Option C: No change should be made to the Rules regarding who should pay for stranded costs.

3. Stranded costs should be allocated to jurisdictions and classes in a manner consistent with the specific company's current rate treatment of the stranded asset in order to effect a recovery of stranded costs that is in substantially the same proportion as the recovery of similar costs from customers or customer classes under current rates. (For example, stranded generation assets should be allocated using the demand allocation method used for production plant.) Updated rate design to correct flaws in current rate design would be acceptable.

4. The recovery mechanism should be either (1) a non-bypassable kW or kWh surcharge with the option of an exit fee when mutually agreed upon by the utility and consumer; (2) a fixed fee; or (3) determined on a utility by utility basis whether the charge should be variable or fixed.

REPORT OF THE STRANDED COST WORKING GROUP
CALCULATION METHODOLOGIES SUBCOMMITTEE
June 30, 1997

The Calculation Methodologies Subcommittee was formed by the Stranded Cost Working Group on March 4, 1997, to address issues related to calculating stranded costs. The Subcommittee's goals are to develop recommendations regarding stranded cost calculation methodologies; to evaluate and respond to the Retail Electric Competition Rules as they presently exist and as they relate to calculation methodologies (particularly the definition of stranded cost); and to submit a written report to the Stranded Cost Recovery Working Group by June 30, 1997.

Members of the Subcommittee included representatives from:

Energy Strategies Inc. for Asarco, BHP Copper, Cyprus Climax Metals, Phelps Dodge (Mines) and Public Interest Coalition on Energy[1] (Coalition);
City of Tucson;
City of Mesa;
Arizona Public Service Company (APS);
Phelps Dodge;
International Brotherhood of Electrical Workers;
Land Water Fund of the Rockies;
PG&E Energy Services;
Arizona Electric Power Cooperative, Inc. (AEPCO);
Tucson Electric Power Company (TEP);
Salt River Project (SRP);
Citizens Utilities Company (Citizens);
Arizona Community Action Association;
Arizona Consumers Council;
Arizona Citizen Action;
Fort Huachuca;
Goldwater Institute;
Arizona Utility Investors Association; and
Electric Competition Coalition for The Ascendix Group, Calpine Corporation, Enron Corporation, Nordic Electric Arizona, and PG&E Energy Services.

The Subcommittee agreed that in developing recommendations regarding calculation methodologies, the methodologies should:

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[1] The Public Interest Coalition on Energy is a consortium of energy consumer interests which includes Arizona Association of Industries, Allied Signal, Arizona Retailers Association, Arizona Small Business Association, Arizona Hotel Motel Association, Arizona Multihousing Association, Arizona Mobile Home Parks Association, Arizona Food Marketing Association, National Federation of Independent Businesses, Arizona Mining Industry Gets Our Support, and Lake Havasu Manufacturing Group.

The Subcommittee agreed that the burden of proof is on the Affected Utility to demonstrate stranded costs. The Subcommittee also agreed on several possible components of stranded costs, including but not limited to:

a. generation assets.
b. power purchase agreements.
c. fuel contracts.
d. regulatory assets.
e. employment transition costs.
f. and environmental mandates.

The Subcommittee recognizes that an Affected Utility might make a case to include as a stranded cost any of the particular components identified, but each of the other parties retains its right to oppose or challenge the inclusion of any particular cost or component when a request to recover stranded cost is made.

Calculation Methods

Two predominant approaches to calculating stranded costs are Administrative Approaches and Market Valuation Methods. Both approaches essentially calculate stranded cost by taking the difference between the market value of an asset and its net book value. Under both approaches the net book value of an asset is similarly derived, but the approaches have different ways of measuring the market value of an asset. Administrative approaches measure market value based upon estimates of market values, whereas market valuation approaches allow the market to directly determine the value of the asset (such as though the sale of an asset).

Administrative Approaches

Two different administrative approaches have been proposed: the Net Lost Revenues Approach, which is primarily recommended by the utilities; and Replacement Cost Valuation, which has been advocated by the Mines and Coalition.

The Net Lost Revenues Approach calculates future annual net revenues that would have occurred under continued regulation and translates them into cents per kWh. This cents per kWh is then compared to an estimate of the market price per kWh, and the present value of the difference is stranded costs.

Advantages and disadvantages of the *Net Lost Revenues Approach* identified by members of the Subcommittee are presented below.

Advantages:

offer customers, whether or not these customers are assigned an explicit stranded cost charge.

If, instead of a direct measurement at a point in time, an annualized approach to calculating stranded cost is adopted, the Mines and Coalition recommend that a "pay-as-you go" approach with a pre-determined cut-off date be adopted. Such an approach would base stranded costs on the above-market portion of *current-year* fixed generation costs only.

Advantages and disadvantages of *Replacement Cost Valuation* include:

Advantages:

a. The accounting treatment of stranded assets and obligations is relatively straightforward.
b. Replacement cost estimates serve as a proxy for sale prices, so this approach could be an alternative to divestiture.
c. Avoids the need to base stranded cost on forecasts of future electricity prices.
d. By using replacement cost as a proxy for long-run marginal cost (and thus long-run price) stranded cost is based on long-term values and not temporary price phenomena.

Disadvantages:

a. Because utilities identify the assets for which recovery is desired, this approach may not include all offsets to stranded costs.
b. It could become a political process and involve time consuming hearings.
c. The adoption of what is effectively an estimate of long run marginal cost (LRMC) as an administrative proxy for market price ignores both the current imbalance of supply and demand in the Southwest and the current regional generation mix.

Market Valuation Methods

Two alternatives were proposed to obtain asset values through the market: through Auction and Divestiture and through Stock Market Valuation.

The Auction and Divestiture Approach was suggested by Citizens but also has some support from other members. Auction and divestiture has been adopted in Massachusetts and California. The process described by Citizens is similar to that which has been proposed in Vermont, where the utility turns over all assets for auction for which they will recover the net book value. The difference between the auction proceeds and the net book value is the stranded costs. Stranded costs could then be financed through the sale of state bonds.

Advantages and disadvantages of *Auction and Divestiture* discussed by the Subcommittee include:

Advantages and disadvantages of the *Stock Market Valuation Approach*:

Advantages:

a. It establishes market value in the market, thereby avoiding the estimation process and regulatory involvement.
b. Proponents believe that it is more likely to produce accurate results than an administrative process.
c. It is a relatively simple concept and straightforward to implement.
d. Valuing stock A is routine for stock analysts, who value stocks after major divestitures. Securities analysts could also estimate Stock A prior to the split.
e. The value of stock A will reflect both the costs and opportunities of competition. It measures the overall net effect on equity value of instituting competition and does not simply estimate the impact of competition on revenues (through administrative approaches).
f. Proponents of this approach believe that it honors the regulatory promise to provide a fair return to utility shareholders.

Disadvantages:

a. Stranded costs recovered go to stock B shareholders, so utilities are not able to use costs recovered to pay off debt.
b. Obtaining approval from stockholders, creditors, and pertinent regulatory authorities may be lengthy, difficult, and entail significant transaction costs.
c. It may not be practical for some utilities, due to their debt and equity structures.
d. Opponents believe there is no assurance that this kind of proxy valuation would necessarily yield accurate results.
e. Arizona power customers are obligated up-front to paying stranded cost charges that are calculated by Wall Street and not by Arizona regulators.
f. It is impractical for the cooperatives, which have no stock issues.
g. The sale of the income stream attributable to stranded cost recovery may not produce a more accurate or objective estimate of stranded costs than the lost revenues approach.
h. Market participants have a strong incentive to keep the price of "A" shares as low as possible during the valuation period, both to assure full recovery of stranded costs and to assure future capital appreciation in their share value.

Rating of Calculation Methodologies

To get a better idea of how well each of the methods meets the objectives set out by the Subcommittee (the objectives are listed on page 2), members were asked to rate the different methodologies. The utilities almost overwhelmingly rated the Net Lost Revenues approach optimal in meeting all of the objectives, with the exception of Citizens. Citizens advocates Auction and Divestiture. Replacement Cost Valuation was generally rated poor to satisfactory in meeting the objectives, and Auction and Divestiture

REPORT OF THE STRANDED COST WORKING GROUP
ACCOUNTING, FINANCE, AND TAX SUBCOMMITTEE
July 15, 1997

The Accounting, Finance, and Tax Subcommittee was formed by the Stranded Cost Working Group on March 4, 1997. The Subcommittee's goals are to develop recommendations on accounting, finance, and taxation issues associated with opening competition for retail generation supply and stranded cost recovery.

Participating members of the Subcommittee included representatives from:

Energy Strategies Inc. for Asarco, BHP Copper, Cyprus Climax Metals, Phelps Dodge (Mines) and Public Interest Coalition on Energy[1] (Coalition);
Arizona Public Service Company (APS);
PG&E Energy Services;
Arizona Electric Power Cooperative, Inc. (AEPCO);
Tucson Electric Power Company (TEP);
Salt River Project (SRP);
Goldwater Institute;
City of Tucson;
Arizona Utility Investors Association; and
Electric Competition Coalition for The Ascendix Group, Calpine Corporation, Enron Corporation, Nordic Electric Arizona, and PG&E Energy Services.

Accounting Issues

The group identified several accounting matters to be addressed:

1. The implications of stranded costs calculations and recovery on existing accounting standards.
    a. SFAS No. 71
    b. SFAS No. 90
    c. SFAS No. 92
    d. SFAS No. 101
    e. SFAS No. 121

2. The implications of proposed accounting standards on stranded investment quantification and recovery.

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[1] The Public Interest Coalition on Energy is a consortium of energy consumer interests which includes Arizona Association of Industries, Allied Signal, Arizona Retailers Association, Arizona Small Business Association, Arizona Hotel/Motel Association, Arizona Multihousing Association, Arizona Mobile Home Parks Association, Arizona Food Marketing Association, National Federation of Independent Businesses, Arizona Mining Industry Gets Our Support, and Lake Havasu Manufacturing Group.

3. Accounting for stranded costs and their recovery under the FERC Uniform System of Accounts.

4. Accounting implications of accelerated and/or decelerated depreciation.

Accounting Standard No. 71

Statement of Financial Accounting Standard (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation*, defines what constitutes a regulated entity and contains standards of accounting for the effects of regulation. The premise for SFAS 71 is that regulated enterprises should account for the economic effects that result from the cause-and-effect relationship of costs and revenues in the rate-regulated environment.

One of the standards addressed by SFAS 71 is the method by which a regulator can create an asset by deferring for future recovery a current cost that would otherwise be charged to expense. To create such an asset, both of the following criteria must be met:

1. It is probable that future revenue in an amount at least equal to the capital cost will result from inclusion of that cost in rates; and

2. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

If either of the above is not met, the corresponding asset must be written off. Utilities following SFAS 71 must continually assess whether they remain regulated entities under definition criteria contained in the Standard.

Accounting Standard Nos. 90 and 92

SFAS 90, *Regulated Enterprises – Accounting for Abandonments and Disallowances of Plant Costs*, and SFAS 92, *Regulated Enterprises – Accounting for Phase-In Plans*, contain criteria for permitting certain plant-related costs to be deferred for future rate recovery. Costs not meeting such criteria may not be deferred and must be written off.

Accounting Standard No. 101

SFAS 101, *Accounting for Discontinuation of Application of SFAS 71*, includes the following examples of situations that may warrant discontinuation of SFAS 71:

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

3. Increasing competition that limits the enterprise's ability to sell utility services or products at rates that will recover costs; and
4. Regulatory actions resulting from resistance to rate increases that limit the enterprise's ability to sell services or products at rates that will recover costs if the enterprise is unable to obtain relief from prior regulatory actions through appeals or the courts.

The thrust of SFAS 101 is that when an enterprise ceases to meet the criteria of SFAS 71, either in part (i.e. an operating division or product line) or in total, it must discontinue its application and eliminate the assets on its books that were created by regulators.

Accounting Standard No. 121

SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, amends SFAS 71 to clarify that existing regulatory assets should be written off if they are no longer considered probable of recovery. Under SFAS 121, a utility would have to determine whether or not its remaining plant assets would be recoverable through expected future market prices. If market pricing is not expected to be fully compensatory, the utility will be subject to additional write-downs (beyond those required by SFAS 101) of the relevant assets to reflect the expected revenue levels.

Positions on Accounting Issues

TEP believes that the consequences of accounting issues to TEP relative to other investor-owned utilities may be significantly greater. If TEP is required to write off its regulatory assets or write down substantial portions of its plant assets as a result of the loss of SFAS 71 treatment or the application of other SEC rules, TEP could find itself with negative equity. They believe that application of these accounting standards as well as unfavorable stranded cost recovery could cripple their financial prospects.

AEPCO also believes that with changes in the competitive environment, the electric utilities in the State will face possible discontinuances of regulatory accounting. If this happens, previously approved regulatory assets, which were on the utilities balance sheets under SFAS 71 will no longer be allowed for book purposes and will immediately be written off to the utilities equity. AEPCO could face significant write-offs of regulatory assets if they are required to discontinue regulatory accounting.

Also, AEPCO believes that previously approved useful lives which were set for utility assets in past rate proceedings may be different than economic lives in the competitive environment. The Commission should take this into consideration in the calculation formula for stranded cost.

SRP believes existing regulatory assets should be allowed as part of recoverable stranded costs. SRP does have regulatory assets on its balance sheet consisting primarily of bond defeasance losses and the cost of buyouts of uneconomic fuel contracts. SRP's Board has determined that these costs should be collected in rates over time to reflect the long-lived benefit of the actions. Non-recovery of these regulatory assets would create an immediate write-off of accumulated net revenues (SRP's equity equivalent) leading to a deterioration of SRP's financial measures.

A more technical expression of the above comment is that stranded costs should be allowed recovery and requirement of SFAS 101 should be avoided (discontinuation of application of SFAS 71). As the situation in California demonstrated, poorly crafted or not well understood rules could create the need for a write-off, even if the principle of recovery of regulatory assets is agreed upon. In general, as long as the appropriate regulatory body establishes a period over which stranded costs can be recovered and this mechanism is applied, SFAS 71 should continue to apply.

APS adds that it is necessary to link accounting issues to the quantification of stranded costs so that the target level of quantified stranded costs have the opportunity of actually being recovered.

The Mines and Coalition and the Calpine Corporation suggest that accounting requirements and its implications for utilities should be analyzed and an effort should be made to minimize negative impacts. But accounting considerations should not drive the underlying policy to implement retail access.

Finance Issues

In the finance area, issues identified by the group were:

1. The effects of bond indenture requirements on stranded cost recovery proposals.
2. The effects of restrictions on private use and tax exempt bonds on stranded cost recovery proposals and the use of underlying assets in competitive markets.
3. Effect of stranded cost quantification and recovery proposals on existing security ratings and rating agency criteria.
4. The proper consideration of project financed assets in quantifying stranded costs.
5. The proper treatment of assets which have been sold and leased back (i.e., operating and capital leases and related obligations).
6. Use of stranded cost recovery proceeds to reduce/adjust capitalization.
7. Effects of competitive generation risks on capital structure and dividend payout ratios.

<u>Tucson Electric Power's Position on Finance Issues</u>

Two-County Bonds:

The Pima and Apache County Industrial Development Authorities have issued approximately $673 million of outstanding tax-exempt "local furnishing" bonds which benefit TEP's retail customers by reducing significantly the capital costs of serving such customers. TEP believes the Competition Rules could potentially imperil the tax-exempt status of these bonds and the related customer savings of at least $11 million annually. TEP and other Arizona utilities issue tax-exempt bonds on the basis of local furnishing bonds, referred to as "two-county bonds."

Interest on conduit revenue bonds issued after 1968 by, or on behalf of, state or local governments to finance facilities for privately-owned businesses may be excluded from gross income for federal income tax purposes only if substantially all bond proceeds are used to provide one or more of the types of exempt facilities listed in section 142 (a) of the Internal Revenue Code of 1986 (the "1986 Code"). Section 142 (a)(8) provides an exemption for "facilities for the local furnishing of electric energy or gas."

Section 142 (f) states that this local furnishing exemption applies only to facilities which are part of a system providing service to the general populace in an area not exceeding the larger of (i) two contiguous counties; or (ii) one city and a contiguous county (i.e., Consolidated Edison Company of New York which provides electric service to New York City and one contiguous county). Treasury Regulations clarify that an otherwise qualifying local furnishing system will not be disqualified by reason of its interconnections with other utilities for the emergency transfer of electricity, or because the system includes facilities located outside the area which they serve.

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

(1) Except possibly during emergencies, the *total amount* of electricity generated by facilities connected directly to the utility's local grid, together with the amount of electricity generated by the local utility's interest in remote generating facilities (whether or not directly connected to the utility's local distribution grid) *during each year* (or, in one case, each six months) does not exceed the *total amount* of electricity consumed in the qualifying local service area;

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

Implementation of the Rules could endanger the tax-exempt status of interest on local furnishing bonds issued (and to be issued) if the Rules cause utilities to violate the local furnishing requirements specified in IRS rulings.

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

In either case, if the Rules fail to properly address these or related issues, TEP believes utilities and its customers could be adversely affected by the loss of low cost financing or the stranding of assets financed with tax-exempt local furnishing bonds.

FERC has expressed concern about jeopardizing the tax-exempt status of utilities' bonds and expressed intent that their status not be disturbed. There are several ways the Arizona Corporation Commission could address these local furnishing issues. One option would be to include a provision, similar to that provided for electric cooperatives, that would authorize utilities to request the Commission to modify the schedule described in R14-2-1604 (A-D) so as to preserve the tax-exempt status of interest on such bonds issued and to be issued for these utilities. Another option would be to research the issues further and to include specific language in the Rules which support the preservation of local furnishing debt in a retail wheeling environment. Finally, the Commission could allow stranded cost recovery for any increase in financing costs or the cost of any assets stranded because of local furnishing requirements.

Project and Lease Financing:

Adequate stranded cost recovery is also critical to maintaining a utility's ability to meet its financial obligations under special arrangements involving the financing of utility plant and equipment. In some cases, utilities have entered into complex project financing and lease financing transactions as a way to finance plant and equipment.

Under a customary leveraged lease financing, the owner of a facility sells the facility to an institution (or a consortium of institutions) usually referred to as an owner participant. The owner participant finances the purchase price with a combination of equity furnished by it and debt supplied by a group of lenders, or debt participants. The facility is then leased back to the seller who will operate it as lessee under the terms of a

lease which has a specific long-term rent payment schedule. While the debt is secured by the assets, lenders look heavily to the credit of the lessee in deciding whether and on what terms to lend money to finance the lease transaction. Unlike limited or non-recourse project financing, the lessee operator is not usually immune from personal liability for repayment of the lease obligations.

To the extent that stranded cost recovery does not fully account for the difference in the costs of these leased assets, as evidenced by the lease obligations, and the market value of the assets, TEP could risk default under the leases, triggering serious financial consequences. Accordingly, the Commission should consider the existence of any project or lease financed assets that utility may currently own or operate and develop a mechanism that ensures that stranded cost recovery captures the above market portion of the costs of power generated from these financed facilities.

AEPCO's Position on Finance Issues

The debt instruments of AEPCO are predicated on a consolidated mortgage arrangement (as supplemented or amended) with the Rural Utilities Service (RUS). Whereas, stranded cost recovery methodology is not specially addressed, the RUS mandates that AEPCO as a mortgagor "...subject to applicable laws and rules and regulatory orders of regulatory bodies, will design its rates for electric energy and other services furnished by it with a view to paying and discharging all taxes, maintenance expenses, cost of electric energy and other operating expenses of its electric transmission and distribution system and electric generating facilities, if any, and also to making all payments in respect of principal and interest on the Notes when and as the same shall become due, to providing and maintaining reasonable working capital for the mortgagor..." and of maintaining a minimum Times Interest Earned Ratio and a Debt Service Coverage Ratio; respectively.

To the extent that credit rating of the National Rural Utilities Cooperative Finance Corp. (CFC), AEPCO's guarantor on tax-exempt debt, is adversely affected, the interest rate payable by AEPCO on existing variable-rate debt will be higher than normal. This statement may also be made for any new, subsequent debt AEPCO acquires in the future. AEPCO's tax-exempt debt represents some of the Cooperatives' lowest sources of long-term financing. This debt typically is tied to specific units of property. If any of these units were ever deemed "stranded without recovery" there would be pooled indenture considerations, applicable debt redemption considerations, material adverse change reviews, and other factors to analyze.

In the event that CFC, for example, saw the recovery proposals of stranded costs on AEPCO as detrimental to their credit exposure, they may demand enhanced security interests from the Cooperative, such as debt service reserve requirements, more onerous subordinated term certificate conditions, or more expensive guaranty fees.

Also, AEPCO typically has fairly onerous debt redemption clauses, in relation to investor-owned utilities, and has as many utilities do in the Arizona, strict call provisions on most of its debt obligations. Write-offs of stranded investment would not necessarily result in a commensurate redemption of the associated debt, in the sense, it is precluded by various contractual provisions, further eroding AEPCO's equity position.

The primary risk on AEPCO's capital structure, as a result of significant stranded cost, recoverable and non-recoverable, would be in the acquisition of additional debt. To the extent that debt was deemed as prudent by the mortgagees, the interest rate would be a function of the ultimate determination of stranded cost.

Salt River Project's Position on Finance Issues

Each debt agreement is a complex document with a series of covenants, restrictions, and financial tests that the issuer must comply with. For example, most of SRP's debt is issued as revenue bonds; the bondholders have first claim on the revenues from SRP's electric system after operating expenses have been paid. However, the indenture contains an explicit commitment to comply with all provisions of the Internal Revenue Code relating to tax-exempt bonds.

SRP believes that private use problems should not be created for tax-exempt financed assets. Federal legislation and regulation by the IRS create the ground rules for preserving the tax-exempt status of any existing and future tax-exempt bonds for municipalities. The concept that tax-exempt bond financed assets should not be used to benefit private parties rather than the general public is straightforward, but as with most tax issues the details and the regulation are complex.

In one particular example, divestiture of generating assets would create a "change in use" issue where the proceeds of the divestiture would have to be used immediately for IRS proscribed remedial action on tax-exempt bonds used to finance the assets. It is not a given that the sale proceeds plus stranded cost recovery over time to net plant value would be sufficient to accomplish the remedial action.

In particular, SRP believes that the use of exit fees should be avoided. These would create a contractual relationship with customers that the IRS currently deems a private use rather than use by the general public.

SRP further adds that stranded cost recovery should not impact bond ratings. This implies that the stranded cost recovery system should not have a material adverse change on the overall financial condition of the bond issuer and should not impose specific conditions that impact the credit of particular types of bonds. For example, a stranded cost mechanism that forced sale of assets, such as nuclear power plants, at market prices well below book value would create significant financial pressure on the owner utility.

Finally, SRP believes that maximum flexibility should be allowed in how stranded cost proceeds are utilized. Each utility may have different existing constraints on how revenues and other proceeds can be used. Constraining use of stranded cost proceeds may conflict with some of these constraints, and would not appear to have any other benefit.

Tax Issues

The key tax issues are expected to be:

1. Effect of stranded investment quantification and recovery mechanisms on existing tax normalization rules in the Internal Revenue Code and IRS Regulations.
2. Effect of deregulating generation on existing definition of "Public Utility Property" in the Internal Revenue Code.
3. Implication of stranded cost recovery method on future corporate tax liabilities.
4. Potential for recapture of accelerated tax depreciation and investment tax credits.
5. The implications of existing tax attributes (i.e., net operating loss carry forwards).
6. The need to create awareness for potentially significant reductions in tax collections by State and Local governmental entities.
7. Differences in tax status of participating entities.

Effects on State and Local Taxes

The Department of Revenue (Centrally Valued Properties Unit) determines the full cash value of gas and electric utilities operating within the state for purposes of property taxation, per A.R.S. § 48-242. Together, the gas and electric utilities and Salt River Project, comprise approximately 16% of the total property tax base in the state and pay an estimated $400 million in property taxes to counties, cities, towns, school districts and other taxing jurisdictions.

All gas and electric utilities (except rural electric cooperative) are valued by the "historical cost less depreciation" method, pursuant to A.R.S. § 42-144.02, as follows:

Full Cash Value =

1. Net book value of Plant in Service, plus
2. CWIP x 50%, plus
3. Net book value of Environmental Protection Facilities x 50%, plus
4. Material and supplies.

All of the above information is based on information reported to the Arizona Corporation Commission and FERC as of December 31 of the year preceding the tax year.

The Department of Revenue indicated that the potential property tax impact results from the use of plant in service as the basis for the property tax valuation. As currently defined by statute, plant in service includes all used and useful plant, and depreciation means straight line depreciation over the useful life of the item of property. However, rapid erosion of the tax base would be created by allowing the utilities to accelerate depreciation in order to avoid stranded costs. Also, since total plant in service is the basis for the valuation, similar erosion would take place if a lower cost basis for the facilities is established, or if plant is taken out of service because of external or functional obsolescence. Clearly, the way in which stranded costs are handled will impact Arizona property taxes for gas and electric utilities.

City of Tucson believes that Arizona municipalities' general fund revenue received from energy utility franchise fees, sales tax revenue, and property taxes should be preserved. Competition may allow for the bypass of franchise fees and other revenues from energy providers. Also, the accounting treatment allowed in certain areas may effect property tax assessments. The City of Tucson recommends that strategies for preserving the revenue stream for governmental entities should be considered in formulating deregulation policy.

TEP indicated that utilities are among the most heavily taxed industries in any state. The various taxes include sales taxes, gross receipts taxes, franchise taxes, revenue taxes, property taxes and income taxes. All such taxes are driven by either the value of the utilities' assets or revenues. To the extent that significant stranded costs are written off as unrecoverable, there will likely follow an erosion of the property tax base.

As utility service rates are lowered due to the effects of competition and reductions in rate base, there will be a corresponding reduction in tax collection. If the introduction of retail competition causes tax receipts from utilities to decrease, the state, counties and municipalities will have to develop alternative revenue collection strategies in a relatively short time period. This situation may include increases in tax rates. TEP recommended that local authorities and other interested parties should be made aware of the tax revenue impacts that could follow from stranded cost recovery and the move to competitive power generation and be encouraged to participate in the appropriate forums designated to deal with these issues.

AEPCO also feels that state and local authorities should be kept up with the progress of the Commission and the working group on stranded costs. AEPCO believes the areas in the state that will be hardest hit by the stranded cost issue will probably be the smaller school districts around the state in which utility property is currently a significant portion of the assessed valuation. For example, Chochise County (#02), school district #2600 in which AEPCO's facilities represent 95 percent of this school district's total valuation.

In addition, AEPCO suggests that Arizona's electric competition rules should not give states, other than Arizona, and their electric service providers an unfair advantage and thus move jobs and the tax revenue generated by those jobs to other states.

The Mines and Coalition do not agree that there *will* be a corresponding reduction in tax collections if utility service rates are lowered. Consumers are likely to spend as much as 90 percent of their utility savings on other goods and services – and thus contribute to offsetting tax collections. Perhaps more importantly, the economic stimulus of lower electric power rates and the increased tax collections associated with economic growth may more than offset reductions in utility-related tax revenues.

Also, the Mines and Coalition believe the statement that alternative revenue collection strategies may include increases in tax rates is overly prescriptive and is made in the absence of any discussion or analysis of mitigating factors. Other mitigating factors include: (1) the gradual nature of the phase-in under the Rule, which will provide time for taxing authorities to respond to any *net* changes in tax collections, and which allow the tax-generating economic activity induced by competition an opportunity to develop, and (2) the role of any stranded cost recovery in propping up utility tax collections.

The Mines and Coalition suggest that the tax implications of retail electric competition should be anticipated and addressed (when necessary), but the achieving of lower electricity prices should not be delayed in order to maintain sales and property tax collections which can no longer be supported by underlying economic values. The tax implications of retail electric competition fall into at least three categories:

1. *The impact of differential treatment for utility property and transactions under current tax law.* The taxing of utility assets and transactions at rates which differ from those of potential competitors should be addressed to eliminate the potential for tax-induced price distortions. Other states have already implemented such tax law changes in anticipation of retail competition.

2. *The impact of electricity price reductions.* Electricity price reductions would represent an increase in the purchasing power of Arizona consumers and in the economic health of Arizona companies. Much of the savings would be expended on other goods and services transactions which would be subject, in most cases, to sales tax. As indicated above, the benefits of price reductions should not be delayed in order to maintain tax revenues which can no longer be supported by underlying economic values from electricity sales and property.

3. *Potential revenue impact on local governments highly dependent on electric generation property taxes.* If electric generation property taxes are reduced, the impact will be felt primarily in a small number of taxing jurisdictions which may be relatively dependent on such facilities for tax revenues. Any potential impact on

property tax revenues would not justify delaying the benefits of retail competition to the rest of society, but it may warrant consideration for special mitigation in the form of state revenue transfers to bridge a transition period for affected jurisdictions.

SRP suggests that the appropriate recommendation is for extensive communication to legislators and local politicians on the recommendations of the Working Group and their implications. Stranded cost recovery solutions and the impact of market forces should be considered in tandem with associated tax implications, with the objective of maintaining state tax revenues needed to support education and government services in the state.

A summary of current legislative tax issues being discussed was provided by the Electric Competition Coalition and is attached to this report. The attachment includes: (1) the Electric Competition – Taxation Work Group Work Plan; and (2) the June 11, 1997, Agenda of the Electric Industry Competition Taxation – Work Group.

Recommendations

Recommendations to the Stranded Cost Working Group by the Accounting, Finance, and Tax Subcommittee are presented below. They represent a summary of recommendations made by Subcommittee members in this report. The recommendations were not agreed to by all members and may not represent a consensus of the Subcommittee.

1. Accounting issues should be linked to the quantification of stranded costs so that the target level of quantified stranded costs have the opportunity of actually being recovered.

2. Accounting requirements and its implications for utilities should be analyzed and an effort should be made to minimize negative impacts.

3. Useful lives which were set for utility assets in past rate proceedings may be different than economic lives in the competitive environment, and this should be taken into consideration in the calculation of stranded costs.

4. The Working Group should consider the desirability of including the following provisions in the Competition Rules:

   A. The Affected Utility will include in its application a description of the proposed transaction, a statement of the reasons why such transaction threatens the tax-exempt status of the financing, and possible alternatives, if any, that might be available to accommodate the objectives of the transaction without threatening the tax-exempt status of the Affected Utility's financing. Upon a showing by the Affected Utility that the

transaction as proposed could be violative of the "private use" restrictions or the "local furnishing" rules promulgated by the Internal Revenue Service for tax-exempt debt financing, the Commission shall issue a decision exempting the Affected Utility from the requirements of this Article with respect to that particular transaction and permitting the transaction to be structured in an alternative way, if available, that is not violative of such restrictions or rules.

B. The Affected Utility will have the burden of proof to demonstrate the extent to which any such losses exist as a result of "private use" restrictions or "local furnishing" rules applicable to its facilities. The Commission will conduct a public hearing on any request made by an Affected Utility pursuant to this section. If the Commission finds that the Affected Utility has made a reasonable showing as to the existence and extent of unmitigable losses attributable to the "private use" restrictions or "local furnishing" rules, the Commission will issue a decision permitting the Affected Utility to modify its Stranded Cost charges to include such additional losses, [subject to any limitations previously imposed by the Commission on the recovery period associated with such Stranded Costs.]

5. The Working Group should consider treatment of project or lease financed assets comparable to assets owned by the utility and develop a mechanism that ensures that stranded cost recovery captures the above market portion of the costs of power generated from these financed facilities.

6. Local authorities and other interested parties should be made aware of the tax revenue impacts that could follow from stranded cost recovery and the move to competitive power generation and be encouraged to participate in the appropriate forums designated to deal with these issues.

ATTACHMENT

Accounting, Finance, and Tax Subcommittee Report

Electric Competition – Taxation Work Group
Work Plan

Work Group Members

Martin Shultz, Designated Chair	–	APS
Ron Ballard	–	City of Tucson
Carl Kunasek or designee	–	ACC Commissioner
Kevin McCarthy or designee	–	ATRA
Greg Patterson or designee	–	RUCO
Jerry Porter or designee	–	Governor's Office
Jeff Schlegel or designee	–	Schlegel & Associates
Chuck Shipley or designee	–	Arizona Mining Association
Russell Smoldon or designee	–	SRP

Work Group's Goal/Charge

Goal: To provide the Joint Legislative Study Committee on Electric Competition (JLSC-EC) with tax alternatives that are revenue neutral and provide a tax system that fosters a level playing field for electric competition.

Charge: To develop recommendations involving potential changes to Arizona's tax and fee structure as currently charged to Arizona-based utility companies, potential market entrants into Arizona's electricity markets, and customers that will produce an equitable tax system. This process will include considering a new kilowatt hour taxes in lieu of the current property taxes.

Deliverable: A written report containing the work group's recommendations and supporting analysis and documentation.

Time line:

June 17, 1997	Draft Work Plan & Scoping Document
June 19, 1997	JLSC-EC Meeting in Flagstaff
Sept. 25, 1997	Draft Report
Oct 1, 1997	Report presented to the JLSC-EC

Establish Work Group Rules

1. The chair will preside at each meeting and will facilitate the discussion.
2. Meetings will be informal – parliamentary procedure is not necessary.
3. Meetings will be noticed and open to the public.
4. Stakeholders and other interested party may submit written documents expressing their view point on issues and may be allotted speaking time at the discretion of the work group.

5. Legislative staff will provide assistance with recording meetings, research (within resources), and drafting reports.
6. Draft reports will be faxed/sent to work group members well in advance of decision making meetings for their input and their comments will be incorporated in the reports. The chair will be responsible for approving the final content of the reports.
7. Comments on reports will be due to the chair within 3 days of the due date for the report.
8. The work group will work toward consensus recommendations. If a consensus can not be reached on an issue the different opinions/alternatives will be presented in the reports.
9. Meetings will start and end on time.

Work Plan/Scoping Document

Following is an outline of the issues that the work group will research and develop to provide the JLSC-EC with taxation recommendations. The work plan is to provide a framework for the work group's activities. Issues and tasks may be deleted, added, or amended during the research period depending on time frames, difficulty in obtaining information, and the importance of the issue.

Topic	Description	Research Activity	Completion Date
A. Overview of Utility Taxes	To provide the JLSC-EC with a comprehensive list of all current taxes, fees, and charges paid by utilities and to what jurisdictions.	1) Identify state & local taxes, fees, & charges paid by the utilities. 2) Identify jurisdiction dependence on utility revenues a) State -- utility % of revenue b) City Survey -- League of Cities c) School District -- DOR run d) Special Districts -- DOR run e) Other	1) completed (see attached) 2a) 6/30/97 b) 7/15/97 c) 7/31/97 d) 7/31/97 e) 7/31/97
B. Review of Other State Taxes	To provide the JLSC-EC with information regarding other state tax legislation.	1) Compare other state taxation legislation on utilities. (APS & SRP study) 2) Identify possible NEXUS issues	1) completed (see attached) 2) 9/15/97

Joint Legislative Study Committee — Electric Competition

Item	Description	Research Activity	Report Date
C. Property Tax Issues	To provide the JLSC-EC with an analysis of Arizona's property tax on utilities and whether it places Arizona in a competitive disadvantage and to provide JLSC-EC with an analysis of a kilowatt hour tax in lieu of property taxes.	1) Comparison of Arizona's property tax with the property taxes of other Western Grid States. a) Survey other states' revenue departments with hypothetical utility sample (Minnesota survey) b) analysis of Arizona's competitive situation (national/regional) 2) Analysis of kilowatt hour tax in lieu of property tax a) calculation of tax rate necessary for revenue neutrality. b) identify distribution issues (distributing revenue back to taxing jurisdictions) c) identify other implementation issues (such as nexus issues)	1a) 8/8/97 b) 9/15/97 2a) 9/15/97 b) 9/15/97 c) 9/15/97
D. TPT & Use Tax Issues	To provide the JLSC-EC with an analysis of any legislative changes necessary to the TPT & Use tax when utility services are unbundled.	1) Review of existing statutes to determine if collections from the TPT and Use tax will be affected with the unbundling of services.	1) 8/30/97
E. State Revenue Impact	To provide the JLSC-EC with an analysis of potential state revenue impacts due to electric competition.	1) Identify possible economic benefits and/or losses due to electric competition (e.g. including possible impacts from closure of existing plants, write-down in plant values, and tax base increases from new entrants)	1) 8/30/97
F. City Taxes & Franchise Fees	To provide the JLSC-EC with an analysis of potential revenue impacts that may impact cities with electric competition.	1) City Survey -- League of Cities 2) Identify tax/fees/charges issues that will impact cities with electric competition	1) 7/15/97 2) 8/30/97
G. School Finance Issues	To provide the JLSC-EC with an analysis of potential impacts to education finance due to electric competition	1) analysis identifying potential education fiscal impacts (e.g. including possible impacts from closure of existing plants, write-down in plant values, and tax base increases from new entrants)	1) 8/30/97
H. Equity Issues	To provide the JLSC-EC with an analysis of equity issues	1) analysis of current tax policy that may create barriers to competition 2) reciprocity issues 3) level playing field issues (current state tax policy for municipalities, IOUs, co-ops, etc.).	1) 8/30/97 2) 8/30/97 3) 8/10/97

Joint Legislative Study Committee -- Electric Competition

Topic	Description	Responsible Entity	Target Date
I Tax Incentives	To provide the JLSC-EC with an analysis of the current tax incentives and possible future incentives	1) identify current and potential tax incentives for new technology 2) identify current tax incentives and issues related to residential low income providers	1) 8/30/97 2) 8/30/97
J. Timing Issues	To provide the JLSC-EC with recommendations as to the timing of taxation issues needed as part of electric industry re-structuring.	1) Analysis of how long it would take to adopted any of these changes proposed and the opportune time for enactment	1) 9/15/97

Notes:

Electric Industry Competition
Taxation – Work Group
Agenda – June 11, 1997

I. Introduction of Members

Martin Shultz, Designated Chair	–	APS
Carl Kunasek or designee	–	ACC Commissioner
Kevin McCarthy or designee	–	ATRA
Greg Patterson or designee	–	RUCO
Jerry Porter or designee	–	Governor's Office
Jeff Schlegel or designee	–	Schlegel & Associates
Chuck Shipley or designee	–	Arizona Mining Association
Russell Smoldon	–	SRP

II. Work Group's Goal/Charge

Goal: To provide the Joint Legislative Study Committee on Electric Competition (JLSC-EC) with tax alternatives that are revenue neutral and provide a tax system that fosters a level playing field for electric competition.

Charge: To develop recommendations involving potential changes to the taxes and fees currently charged to Arizona utility companies, potential market entrants, and customers that will provide an equitable tax system including the consideration of a kilowatt hour tax in lieu of current property taxes.

Deliverable: A written report containing the work group's recommendations and supporting analysis and documentation.

Time line:

June 17, 1997	Draft Work Plan & Scoping Document
June 19, 1997	JLSC-EC Meeting in Flagstaff
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Oct 1, 1997	Report presented to the JLSC-EC

III. Establish Work Group Rules

(Below are some suggestions on how the work groups should proceed)

1. The chair will preside at each meeting and will facilitate the discussion.
2. Meetings will be informal – parliamentary procedure is not necessary.
3. Meetings will be noticed and open to the public.
4. Stakeholders and other interested party may submit written documents expressing their view point on issues and may be allotted speaking time at the discretion of the work group.

5. Legislative staff will provide assistance with minutes, research (within resources), and drafting the reports.
6. Draft reports will be faxed/sent to work group members well in advance of decision making meetings for their input and their comments will be incorporated in the reports. The chair will be responsible for approving the final content of the reports.
7. Comments on reports will be due to the chair within 3 days of the due date for the report.
8. The work group will work toward consensus recommendations. If a consensus can not be reached on an issue the different opinions/alternatives will be presented in the reports.
9. Meetings will start and end on time.

IV. Development of Work Plan/Scoping Document

A. List of Issues

1) Overview of Utility Taxes and Issues -- tax list
2) What Other States Are Doing -- APS/SRP paper
3) Property Tax Issues -- competitive issues
4) TPT & Use Tax Issues -- unbundling issues
5) City Taxes/Franchise Fees -- potential loss of revenue
6) Nexus Issues
7) Equity Issues
8) Potential Loss to State Revenues
9) Education Finance Issues
10) Timing Issues

B. Tasks

1) Develop Any Other Issues
2) Analysis of Current Taxes/Fees Paid and to What Jurisdictions
3) Analysis of Taxing Alternatives
   a) Kilowatt Hour
   b) Unbundling Issues
   c) Nexus
   d) Equity Issues
4) Analysis of Recommended Legislation

V. Schedule Next Meetings

TAXES

Arizona State Taxes

- Income Tax
- Transaction Privilege Tax
- Use Tax
- Property Tax
- Vehicle License Tax
- Diesel Fuel Tax
- Gasoline Tax
- Motor Carrier Tax
- Unemployment Tax
- Underground Storage Tank Tax

Arizona City Taxes

- Sales Tax
- Use Tax
- Franchise Fee

Federal Taxes

- Income Tax
- Environmental Tax
- Heavy Vehicle Use Tax
- FICA
- Unemployment Tax
- Diesel Fuel Tax

Other Miscellaneous Fees/Taxes

- Regulatory Assessment Fees - including FERC, ACC, and RUCO
- Department of Energy Decommissioning and Decontamination Fee

TUCSON ELECTRIC POWER COMPANY

COMMENTS ON STRANDED COST REPORT
SUBMITTED BY COMMISSION STAFF

Tucson Electric Power Company ("TEP") has been an active participant in the Stranded Cost workgroup and its sub-committees formed for the purpose of exploring the range of issues that surround the stranded cost debate. TEP believes that the Report of Commission Staff on Stranded Costs tendered in this Docket accurately describes the various positions and issues that were elicited from the efforts of the Stranded Cost workgroup over the past several months. There are, however, a few issues on which TEP would like to amplify its views and respectfully submit those views to the Commission for its consideration.

Mitigation of Stranded Costs

On page 16 of the Report, Staff indicates that some participants believe that mitigation measures may or should include *any* activity that can reasonably be expected to reduce Stranded Costs. TEP firmly believes that this standard is misdirected and, if adopted, would go too far and result in an imputation of income-earning activities to Stranded Cost mitigation that lacks a sufficient economic nexus to justify being so treated. Income-earning activities that yield profits from assets that have no relationship to provision of electric service in Arizona and are not paid for in any way by customers should not be applied in reduction of Stranded Costs for an Affected Utility. For example, if an Affected Utility set up a subsidiary company (capitalized with shareholder money) that develops renewable energy projects in lesser developed countries, any profits derived from those efforts should not be applied to Stranded Cost mitigation. Because jurisdictional customers take no risk under this scenario and because no jurisdictionally related assets were used, there is no logical basis on which to conclude that any profits should be applied in mitigation of the parent company's Stranded Costs. To apply such profits, if any, to mitigation would create a disincentive on the part of Affected Utilties to

explore other energy opportunities outside of traditionally related electric service--opportunities that may be highly desirable in the new environment of competition as companies seek ways to survive and prosper under a dramatically more uncertain world.

On the other hand, if assets paid for in whole or in part by such customers are used in connection with the new business opportunities; or if the new business is otherwise related to the provision of electric service in Arizona; then, in each of these instances, some of the profits derived from the business should be applied against the mitigation of Stranded Costs. For example, if an Affected Utility set up a subsidiary to engage in the provision of competitive metering services in Arizona and metering equipment were contributed to that business by the former utility, TEP believes that it would be appropriate for some reasonable percent of profits to be applied in mitigation of Stranded Costs.

Tax-Exempt Financing

On pages 68-69 of the Report, Staff touches on the concern that TEP has expressed in Sub-committee meetings that restructuring may have adverse impacts on those Affected Utilities that have tax-exempt debt financing, including TEP. Staff indicates that TEP has suggested the Commission might consider including in the Rules a provision similar to that applicable to cooperatives contained in R14-2-1604(A-D).[1] While TEP believes that the larger resolution of the tax-exempt issue may lie in Congress, TEP believes that the Commission could help with at least some part of the potential problem. To that end, TEP has prepared specific language that it would like the Commission to consider which would offer some partial relief from the possible adverse impacts of retail access on tax-exempt financing. The proposed language, which could be adopted in the form of an amendment to the Rules, is as follows:

[1] TEP believes that cooperatives should not be permitted to compete for retail customers of other Affected Utilities until the tax-exempt issue is more fully resolved.

"R14-2-___. Savings Provision for Tax-Exempt Financed Facilities

A. If an Affected Utility would be required under this Article to engage in a transaction that would threaten the tax-exempt status of certain financing obtained by the Affected Utility prior to the date of adoption of this Article in compliance with provisions of the Internal Revenue Code, the Affected Utility may suspend its obligation to engage in such transaction and file with the Commission a request for exemption from the application of this Article. The Affected Utility will include in its application a description of the proposed transaction, a statement of the reasons why such transaction threatens the tax-exempt status of the financing, and possible alternatives, if any, that might be available to accomodate the objectives of the transaction without threatening the tax-exempt status of the Affected Utility's financing. Upon a showing by the Affected Utility that the transaction as proposed could be violative of the "private use" restrictions or the "local furnishing" rules promulgated by the Internal Revenue Service for tax-exempt debt financing, the Commission shall issue a decision exempting the Affected Utility from the requirements of this Article with respect to that particular transaction and permitting the transaction to be structured in an alternative way, if available, that is not violative of such restrictions or rules.

B. If, as a result of the implementation of the provisions of this Article, an Affected Utility experiences a reduction in the use of tax-exempt financed facilities and a corresponding loss of revenues which cannot be offset or mitigated by alternative uses or other revenue-producing transactions associated with those facilities without violating the "private use" restrictions or "local furnishing" rules promulgated by the Internal Revenue Service, the Affected Utility may file with the Commission an application requesting to have such unmitigable losses treated as Stranded Costs. The Affected Utility will have the burden of proof to demonstrate the extent to which any such losses exist as a result of "private use" restrictions or "local furnishing" rules applicable to its facilities. The Commission will conduct a public hearing on any request made by an Affected Utility pursuant to this section R14-2-____.B. If the Commission finds that the Affected Utility has made a reasonable showing as to the existence and extent of unmitigable losses attributable to the "private use" restrictions or "local furnishing" rules, the Commission will issue a decision permitting the Affected Utility to modify its Stranded Cost charges to include such additional losses, subject to any limitations previously imposed by the Commission on the recovery period associated with such Stranded Costs."

Paragraph A is designed to address transactions, such as retail wheeling requests, that an Affected Utility with tax-exempt debt financing may be called upon to perform under the Rules but which, if effected as requested, could cause the Affected Utility to

fall out of compliance with applicable rules and regulations of the I.R.S. for tax-exempt financed facilities. For example, under the "two-county" rules, TEP is required by existing I.R.S. regulations to monitor certain power flows from and over certain two-county bond financed facilities (Springerville generating station and the "express" transmission line from that location down to Tucson). It is also required to ensure that a certain level of power flows from the financed generating facilities flow into the Tucson service area. If, as a result of a retail wheeling request, TEP were to be unable to maintain those power flows in compliance with the I.R.S. regulations, it may trigger a violation of those rules that could inevitably force some form of adverse action, including a possible bond defeasance.

Paragraph B addresses the possibility of creating a stranded asset by virtue of its tax-exempt financing status. For instance, if a generating station were financed with tax-exempt bonds and retail competition caused the Affected Utility owner to lose load previously served from that facility, existing I.R.S. regulations may effectively limit its ability to sell some of the new excess capacity associated with that generating unit even though it might otherwise be in the utility's interest to try to sell the power to compensate for the lost load. The Affected Utility may find itself confronted with a real Hobson's choice: live with the excess capacity and lose profitable sales opportunities or make the sales and live with the risk of I.R.S. action that might ultimately require a bond defeasance.

The above proposed Rule will at least allow Affected Utilities with some short-term options that could help them avoid significant adverse consequences associated with the loss of tax-exempt status attributable to the competitive changes currently underway.

Securitization

On pages 50-51 of the Report, Staff provides an outline of the asset securitization issue that is receiving growing prominence across the country in the stranded cost debate.

TEP believes that the Commission should give full consideration to the possibility of supporting Affected Utilities' ability to arrange for the issuance of securitized transition bonds to help finance Stranded Costs. TEP further believes that a more in-depth exploration of this financing technique should be undertaken under the auspices of the Commission and its Staff in an effort to separate fact from fiction.

There is persuasive evidence available that significant benefits to customers can be derived from asset-based securitization of Stranded Costs. Many who have undertaken an extensive study of the potential advantages and disadvantages of securitization have concluded that, because of the financial structure employed, significant savings can be achieved in the carrying cost of stranded asset recovery that can be directly transferred to customers. Certainly the technique is not without its critics. But simply to accept the existence of criticism as incontrovertible evidence of the financing technique's lack of merit is short-sighted. Since there is clear evidence that others have thought the technique worthwhile by adopting it as one of the principal elements of their restucturing plans, TEP believes that participants in Arizona should at a minimum devote a sufficient amount of time to studying the financing vehicle to determine whether or not it has merit as a possible tool for lowering Stranded Costs to Arizona customers.

Clarification of Regulatory Assets in Stranded Cost Definition

On pages 7-9 of the Report, Staff points out that the definition of Stranded Costs includes regulatory assets but offers a suggestion that the definition be clarified to explicitly recognize both recorded and unrecorded regulatory assets in order to avoid any ambiguity. When this suggestion was initially raised in the Stranded Cost Calculation Sub-committee, TEP supported the clarification. However, there appeared to be little enthusiasm held by the non-utility participants for modifying in any way the definition of Stranded Costs. While TEP believed that a clarifying modification would improve the definition, TEP also believed that sufficient precedent existed to recognize both recorded

and unrecorded regulatory assets and that accordingly, the definition generally was acceptable as it currently stands in the Rules. In the spirit of trying to find some common ground for accomodation in the Stranded Cost debates, TEP consequently acceded to the majority view that no change to the definition was required.

Nonetheless, TEP continues to believe that the suggested clarification of the term "regulatory assets" proffered by Staff would represent an improvement in the definition of Stranded Costs by explicitly recognizing the special accounting treatment of certain types of regulatory assets of utilities. Thus, while TEP is generally supportive of the existing definition of Stranded Costs, TEP would also strongly endorse a clarifying change that removes any ambiguity on the subject of whether unrecorded regulatory assets are includible in Stranded Costs.

Calculation of Stranded Costs

On pages 19 and 22 of the Report, Staff indicates that there are a number of critical variables that can have an impact on the calculation of Stranded Costs, including retail market share. While a recommended method of determining an Affected Utility's retail market share is not made clear from Staff's Report, to the extent that an inference may be drawn from the Report that retail market share should be estimated at the outset of an Affected Utility's Stranded Cost calculation, TEP would object to that construction.

It is true that a Stranded Cost calculation will have to be based upon estimates of certain variables. One of the most elusive of these is market price because there are so many ways that this number could be calculated. But at least there is significant data available with which to arrive at an estimate for market price once you decide on the fundamental basis (e.g., cost of combined cycle unit, index of prices based on sales, or other possible bases) for deriving it. TEP believes that retail market share would be a more attenuated estimate than market price in some respects because noone will be able

to tell how all the competitive suppliers, including the Affected Utilities, will fare once the doors to competition are open.

Therefore, TEP suggests that retail market share should not be a part of the initial calculation tendered by Affected Utilities but should instead be factored into the calculation in subsequent true-up proceedings once actual data are available.

Prudence Determinations

The Report sets forth a number of different approaches to calculating Stranded Costs. Some participants in the stranded cost debate across the country have suggested that regulators should revisit prudence reviews made in the past with respect to the incurrence of costs by utilities currently being recovered in rates. TEP has consistently maintained that no valid legal basis exists for a regulatory authority to revisit and potentially disallow costs that have already been determined by such authority to have been prudently incurred, and reaffirms that position here.

While certain parties to the Stranded Cost proceedings may find it tempting to encourage re-consideration of previous prudence decisions in an effort to reduce the Stranded Cost calculation, such an action would seriously hinder the move to competitive choice by embroiling affected parties in a divisive legal dispute that will serve only to delay the process further. TEP believes that in calculating Stranded Costs, past decisions over prudently incurred costs should be preserved and such costs should form the basis for determining the historical, regulatorily incurred costs of Affected Utilities.

Use of Stranded Cost Proceeds

On page vi of the Executive Summary section of the Report, Staff recommends that "[t]he Rules should contain some requirement that the proceeds from the stranded cost charges be used by the utilities to extinguish existing obligations, whether financial,

such as debt or equity securities, or operating, such as long-term fuel and purchased power contracts." TEP respectfully disagrees with this recommendation.

In Arizona, affiliated interest rules and holding company provisions promulgated by the Commission already impose significant restrictions on utility operations and the manner in which financial decisions are made. Furthermore, a use of proceeds requirement would encroach too heavily on the domain of utility management who will be faced with the challenges of operating in different ways in order to survive and prosper in a new competitive environment. In order to properly discharge their duties, managers must be given sufficient flexibility to make the decisions they deem to be in the company's best interests when it comes to use of financial resources, including Stranded Cost proceeds. It is a foregone conclusion that each Affected Utility's circumstances and needs will differ; prescribing a formula for use of proceeds to be applied to all of the Affected Utilities would simply fail to take that into account.

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REPORT OF THE PARTICIPANTS IN WORKSHOPS ON CUSTOMER SELECTION ISSUES

Docket No. U-0000-94-165

In Compliance with R14-2-1604.E.4.

September 30, 1997

Arizona Corporation Commission
Utilities Division
1200 West Washington
Phoenix, Arizona 85007

TABLE OF CONTENTS

1. Introduction 1

2. Rule Requirements 3

3. Customer Selection Issues 5

3.1. Phase-in of Competition 5

3.2. Customer Selection Methods 7
3.2.1. First-come, First-served 7
3.2.2. Random Selection of Volunteers 8
3.2.3. Open Subscription with Pro Rata Reduction 8
3.2.4. Random Selection of Customers 9
3.2.5. Bidding 10

3.3. Customer Selection by Class 10
3.3.1. Large Commercial and Industrial Customers (3 MW or Greater) 10
3.3.2. Small and Medium Commercial Customers 11
3.3.3. Residential Customers 12

3.4. Low Income Customers 12
3.4.1. Reserve Part of Residential Allocation 13
3.4.2. Target Low Income Customers 13
3.4.3. Selection Preference for Customers on Low Income Rates 14
3.4.4. Aggregate Low Income Load 14

3.5. Geographic Selection 14

3.6. Renewable Resources 15

3.7. Other Special Selection Criteria 15

3.8. 3 MW Limitation 16

3.9. Special Contracts 17

3.10. Aggregation 18
3.10.1. Customer Class of Aggregated Customers 18
3.10.2. Aggregation Before or After the Selection Process 18
3.10.3. Self-aggregation 18

3.10.4. Certification of Aggregators 19

3.11. Customer Selection Time Period 20
3.11.1. Start of Time Period 20
3.11.2. Length of Time Period 21

3.12. Determination of Required Percentages Being Met 22

3.13. Estimating Peak Load 23

3.14. Administration of Selection Process 23
3.14.1. Who Should Administer the Process? 23
3.14.2. Other Administrative Issues 25

3.15. Consumer Education 26

4. Staff Recommendations 27

5. Workshop Participants 29

1. INTRODUCTION

On December 26, 1996, the Arizona Corporation Commission adopted rules for retail electric competition (Decision No. 59943). The rules provide for a phase-in of competition. In the first phase, to begin in 1999, Affected Utilities[1] are required to open up 20 percent of their base year markets (as measured by kW demand in 1995) to competition. In the second phase, to begin in 2001, the competitive market is enlarged to at least 50 percent of base year markets. Full competition begins in 2003.

The Affected Utilities are required to file plans with the Commission on how they will select customers for participation in the competitive market prior to 2003. Those plans are due by the end of 1997. To assist the utilities and the Commission in understanding selection issues, R14-2-1604.E.4. of the Retail Electric Competition rules required the Commission Staff to "commence a series of workshops on selection issues within 45 days of the adoption of this Article and staff shall submit a report to the Commission discussing the activities and recommendations of participants in the workshops. The report shall be due not later than 90 days prior to the date indicated in R14-2-1602." The due date is October 2, 1997.

In February 1997, Staff invited organizations and individuals to participate in workshops on customer selection issues related to retail electric competition. Participants included representatives from utilities, customers, state and local government agencies, environmental and consumer advocates, and potential electric service providers.

Workshops were held on March 25, 1997, and April 30, 1997. Participants were also invited to provide written comments in May 1997 and August 1997. This report summarizes the discussion and recommendations of the participants. Section 4. of the report contains Staff recommendations that were not reviewed by the other participants.

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1 Affected Utilities are: Ajo Improvement Company, Arizona Electric Power Cooperative, Arizona Public Service Company, Citizens Utilities Company, Duncan Valley Electric Cooperative, Graham County Electric Cooperative, Mohave Electric Cooperative, Morenci Water and Electric Company, Navopache Electric Cooperative, Sulphur Springs Valley Electric Cooperative, Trico Electric Cooperative, and Tucson Electric Power Company.

2. RULE REQUIREMENTS

The retail competition rules contain some requirements concerning who can participate in the competitive market (R14-2-1604.). For the first phase, at least 20 percent of an Affected Utility's 1995 system retail peak is to be made available for competition by January 1, 1999. The following provisions apply to the first phase:

- all customer classes are to be included;
- at least 15 percent of eligible demand will be reserved for residential consumers;
- consumers with demands greater than 3 MW will account for no more than half of the eligible demand;
- loads of consumers can be aggregated;
- all customers producing or purchasing at least 10 percent of their annual electricity consumption from photovoltaic or solar thermal resources installed in Arizona after January 1, 1997, will be eligible; and
- no single consumer can have more than 20 percent of the eligible demand in a given year.

For the second phase, at least 50 percent of an affected utility's 1995 system retail peak is to be made available for competition by January 1, 2001. The following provisions apply to the second phase:

- all customer classes are to be included;
- at least 30 percent of eligible demand will be reserved for residential consumers;
- consumers with demands greater than 3 MW will account for no more than half of the eligible demand;
- loads of consumers can be aggregated; and
- all customers producing or purchasing at least 10 percent of their annual electricity consumption from photovoltaic or solar thermal resources installed in Arizona after January 1, 1997, will be eligible.

The rules also require that the "method for selecting customers to participate in the competitive market must fairly allow participation by a wide variety of customers of all sizes of loads."

3. CUSTOMER SELECTION ISSUES

3.1. Phase-in of Competition

Sections A., B., and D. of R14-2-1604 set forth the three phases through which Arizona consumers achieve retail electric competition. Many participants oppose a phase-in approach to competition. They prefer a flash-cut to competition (i.e., 100 percent competition starting at one time instead of a phase-in); however, there is disagreement as to when that flash-cut should occur.

One potential market entrant suggested a date of January 1999 for all customers who have applied earlier through an established process and for first-time service connections, and that eligibility for all consumers be established in January 2000. One Affected Utility wants to "wait until we are ready and then implement 100% across the board." Another Affected Utility wants to push back the date for full competition until after pilot programs are conducted. Some commercial and industrial consumers do not want a flash-cut if it means delaying the start of competition beyond January 1, 1999. One Affected Utility, two consumer groups, and two other group members support a phase-in approach. But one of those members would support a modified flash-cut, as an alternative to a phase-in, where 20 percent of customers could participate first and the rest about 6 months later. That member declines to specify a starting date, but does not want full competition delayed beyond January 2003.

Of those group members who do favor a flash-cut, their preferred dates are as follows:

GROUP MEMBER	*PREFERRED DATE*
1 potential market entrant	October 1998
industrial and commercial customers	January 1999
other potential market entrants	January 1999
1 consumer group	January 2000
1 Affected Utility	2000 or 2001
3 Affected Utilities	January 2001
1 Affected Utility	2002

Group members have identified the following advantages and disadvantages of a phase-in approach to competition:

Advantages

+ Checkpoint dates would be provided to determine if the process is on schedule and allow adjustments to be made.

+ A phase-in would allow retail access to go forward without delay.

Disadvantages

- True competition could be delayed.
- Arbitrary criteria would be used to select customers.
- The marketplace could be distorted.
- Administrative burden could increase.
- Customer dissatisfaction could occur.
- An unlevel playing field for competing business customers could be created.
- Part of the Affected Utility's business would be managed in competition and part in monopoly.

Although the retail competition rules specify a phase-in approach with milestone dates, they do not preclude adding customer participation between the milestone dates. If a phase-in approach is used, most group members prefer either a continuous phase-in, allowing for steady increases in participation each month (such as 1 percent per month in 1999 and 2000 and 2 percent per month in 2001 and 2002), or a stair-step approach, with steps of either three months or six months.

The group's preferences on type of phase-in are as follows:

GROUP MEMBER	*PREFERRED TYPE OF PHASE-IN*
3 potential market entrants	continuous
large industrial and commercial customers	continuous
1 Affected Utility	continuous
1 consumer group	continuous
1 Affected Utility	stair-step (6 months)
1 large customer	stair-step (6 months)
1 other group member	stair-step (6 months)
other potential market entrants	stair-step (3 months)
1 consumer group	stair-step
1 government agency	stair-step
3 Affected Utilities	no additions between milestone dates
1 consumer group	no additions between milestone dates
1 Affected Utility	customers > 3 MW on 1/1/99; rest on 1/1/01

Group members have identified the following advantages and disadvantages of a continuous phase-in or stair-steps within a phase:

Advantages

+ Unfairness concerns associated with restricting customer participation could be mitigated.
+ New residents and businesses would be allowed to participate.
+ There would be shorter consumer waiting periods.

Disadvantages

– Administration could become too complicated.

3.2. Customer Selection Methods

Assuming there will be a phase-in of competition, possible methods for customer selection include first-come, first-served; random selection among volunteers; open subscription with pro rata reduction; random selection among all customers; and bidding. "First-come, first-served" means that volunteers are selected in the order that they volunteer to participate in the competitive market. "Random selection of volunteers" means that customers would be randomly selected from a pool of volunteers. "Open subscription with pro rata reduction" would allow part of every volunteer's load to participate in the competitive market instead of selecting some customers and excluding others. This approach is intended for large customers when requested participation exceeds phase-in limits. "Random selection of customers" means that customers would be selected randomly from an Affected Utility's customer base. "Bidding" means that customers would bid on the opportunity to participate; those with the highest bids would be selected. One participant has suggested that customers receive coupons that could be resold to other customers.

There is no support among group members for the bidding method of selection, but there is strong support for each of the other methods. However, most group members prefer the method used to vary by customer class.

3.2.1. First-come, First-served

Group members have identified the following advantages and disadvantages of a first-come, first-served selection method:

Advantages

+ Consumers would have freedom to choose or not to choose participation in competition.
+ Consumers most interested in retail access would participate.

+ Motivated customers and suppliers would develop the marketplace more rapidly.

Disadvantages

- Self-selection during a phase could distort information about how electric retail competition might work.
- Too many customers may volunteer.
- A flood of applications could cause a processing delay.
- A volunteer method is less likely to include consumers who are unaware of their opportunities, lack information, are slower moving, or are conservative.

3.2.2. Random Selection of Volunteers

Group members have identified the following advantages and disadvantages of a random selection of volunteers method:

Advantages

+ Consumers would have freedom to choose or not to choose to participate in competition.
+ Consumers most interested in retail access would apply to participate.
+ Motivated customers and suppliers would develop the marketplace more rapidly.

Disadvantages

- A fair and equitable deselection process would be required.
- Self-selection during a phase could distort information about how electric competition might work.
- A volunteer method is less likely to include consumers who are unaware of their opportunities, lack information, are slower moving, or are conservative.
- Exclusion from participation through random selection could distort the competitive positions of business customers in markets for their own products.

3.2.3. Open Subscription with Pro Rata Reduction

Group members have identified the following advantages and disadvantages of an open subscription with pro rata reduction method for large customers:

Advantages

+ A greater number of large consumers could participate in the competitive market.
+ Open subscription with pro rata reduction would be more equitable than random selection for larger business customers.
+ Open subscription with pro rata reduction would allow for broad participation among business customers.
+ Certainty would be added to the competitive process.
+ No consumer would be left out.

Disadvantages

– Cost shifting to nonparticipating customers could occur unless a certain load factor were required.
– Extra administration could be required because the percentage of eligible load must be calculated as each customer signs up.
– The market structure may not be in place to handle the increased number of customers participating in direct access.

3.2.4. Random Selection of Customers

Group members have identified the following advantages and disadvantages of a random selection of customers method:

Advantages

+ Consumers would have equal opportunities to participate in the competitive market.
+ There would be a representative sample of all customer classes, including low income customers.
+ Random selection could offer a better view of the actual mechanics and benefits of competition.
+ Many consumers would be selected who are not aware of the competitive market, which would offer an opportunity for educating them.

Disadvantages

– Many consumers would be selected who are not interested in participating in the competitive market.
– A perception of unfairness may be created.
– Businesses may get a competitive advantage over other businesses.

- Random selection could distort the competitive positions of business customers in markets for their own products.

3.2.5. Bidding

Group members have identified the following disadvantages of a bidding method:

Disadvantages

- Significant educational and administrative issues could be caused.
- Large, informed customers would be favored.
- Customers may perceive bias.

3.3. Customer Selection by Class

The group agrees that there are three major classes of customers: residential, commercial, and industrial. Master-metered customers would be included in the commercial class. There is also general consensus that different approaches should be used for different size customers. Also, there should be a distinction between residential and commercial/industrial customers.

3.3.1. Large Commercial and Industrial Customers (3 MW or Greater)

Although most large industrial and commercial customers prefer eliminating the rule provision that limits the participation of customers with loads over 3 MW to 50 percent of eligible demand, they and some of the other participants prefer that large customers be selected via open subscription with pro rata reduction if requested participation exceeds phase-in limits. Pro rata reduction would allow part of every volunteer's load to participate in the competitive market instead of selecting some customers and excluding others.

To avoid cost-shifting to nonparticipating customers, an Affected Utility has suggested that partial loads be structured at the customer's average annual load factor for the entire load. However, large industrial and commercial customers do not believe that cost-shifting would occur because the portion of the load remaining with the utility would be charged cost-based rates and because of payments for stranded costs.

The breakdown of selection methods preferred for large customers is as follows:

GROUP MEMBER	PREFERRED SELECTION METHOD
large industrial and commercial customers	pro rata reduction
2 Affected Utilities	pro rata reduction
2 consumer groups	pro rata reduction
1 government agency	pro rata reduction
other potential market entrants	pro rata reduction
2 potential market entrants	first-come, first-served
2 Affected Utilities	random selection of volunteers
1 Affected Utility	random selection of customers
1 consumer group	random selection of customers
1 other group member	random selection of customers
1 large customer	pro rata reduction for customers > 10 MW, random selection of volunteers for others

3.3.2. Small and Medium Commercial Customers

Several of the parties recommend that random selection of customers be used for small and medium commercial customers. Account names could be drawn until the allotted percent of the coincident peak load for the group is accounted for. Selections would be made for the customer's total load, not just for a portion of the load. The small commercial class could be over-sampled to account for an assumed amount of consumers who will not want to participate. Two group members have suggested that a combination of geographic targeting and random selection could be used to select these customers. However, potential market entrants and some large industrial and commercial customers believe that a first-come, first-served method could be used for this customer class.

The breakdown of selection methods preferred for small and medium commercial customers is as follows:

GROUP MEMBER	PREFERRED SELECTION METHOD
potential market entrants	first-come, first-served
large industrial and commercial customers	first-come, first-served
1 Affected Utility	random selection of volunteers
4 Affected Utilities	random selection of customers
1 large industrial customer	random selection of customers
2 consumer groups	random selection of customers
1 government agency	random selection of customers
1 other group member	random selection of customers
1 consumer group	random selection of customers and geographic targeting
1 large customer	random selection of customers and geographic targeting

3.3.3. Residential Customers

Most of the group interprets the rule requirement that at least 15 percent of competitive contract demand is to be reserved for residential customers (R14-2-1604.A.2.) as not meaning that 85 percent is reserved for others. If more residential customers want to participate than are represented by the 15 percent, they can be part of the 85 percent. However, one Affected Utility prefers that residential customers be restricted to 15 percent so that consumer complaints can be limited and kinks in the process can be ironed out. One other Affected Utility believes that the 15 percent could be expanded if there are insufficient volunteers among commercial and industrial customers. On the other hand, if fewer residential customers sign up than allowed by the 15 percent requirement, some potential market entrants have suggested that the remaining portion of the 15 percent be made available to other customers.

Several group members recommend that random selection of customers be used for residential customers. Account names could be drawn until the allotted percent of the coincident peak load for the group is accounted for. Selections would be made for the total metered account. The residential class could be over-sampled to account for an assumed amount of nonparticipants. However, other group members recommend that residential customers be selected on a first-come, first-served basis. One consumer group has suggested that residential customers be selected through random selection of customers for large geographic areas, but use geographic targeting to select non-urban and rural customers as well as low-income consumers in urban areas.

The breakdown of selection methods preferred for residential customers is as follows:

GROUP MEMBER	*PREFERRED SELECTION METHOD*
2 consumer groups	random selection of customers
4 Affected Utilities	random selection of customers
1 other group member	random selection of customers
1 government agency	random selection of customers
potential market entrants	first-come, first served
2 large industrial customers	first-come, first-served
1 Affected Utility	random selection of volunteers
other large industrial and commercial customers	random selection of volunteers
1 consumer group	random selection of customers and geographic targeting

3.4. Low Income Customers

There is general consensus that low income customers should have the opportunity to participate in the competitive market. The selection plans should

incorporate design features that equitably include low income customers. However, the group disagrees on how to accomplish that. The following four subsections describe suggestions that have been made.

3.4.1. Reserve Part of Residential Allocation

Low income consumer advocates recommend that part of the residential allocation be reserved for low income consumers, based on the portions of low income customers in each of the service territories. Some industrial and commercial customers are either in favor of this or have indicated that they would not object to the recommendation. One Affected Utility prefers a combination of reserving part of the residential allocation for low income and a selection preference for customers currently on low income rates.

One potential problem with reserving part of the residential allocation for low income consumers is that if there is low participation by low income consumers, there would be lower participation for the residential class overall than would otherwise occur. However, this situation may be minimized with appropriate education directed to all customers. Another idea is to project participation rates for low-income consumers based on actual participation midway through each competitive phase and reserve that portion for low income. The remainder would default to the residential class.

3.4.2. Outreach Efforts

A good faith attempt could be made to reach low income customers. They could be reached through bulk mailings by zip code and through neighborhood associations. Customers on current low income programs could be targeted, but not all low income customers apply for these programs, especially elderly customers.

Low income customers will need to be educated to ensure that they understand their options and can make informed choices. However, one consumer group believes that low income customers should be targeted the same way as all other customers because potential sellers will have to work with low income customers the same way as other customers. All customers will need to be educated as to how to participate in the new competitive market.

Many of the group members support targeting low income consumers through special outreach efforts, although the group did not determine how the outreach efforts could be funded. These members include four Affected Utilities, a potential market entrant, a large industrial customer, a government agency, and another member. However, one Affected Utility has suggested that information to low income consumers should be provided by the Commission or by the electric service providers rather than by the Affected Utilities. Information might also be provided to low income consumers by social service organizations.

3.4.3. Selection Preference for Customers on Low Income Rates

An Affected Utility and a consumer group have proposed that all customers currently participating in low income discounted rates be eligible to shop competitively. The discounts would not be available to those who leave the standard offer. The list of low income customers could be made available free of charge to all registered suppliers and aggregators, but the customers could request that their names be kept confidential. A potential market entrant also believed that low income consumers should be selected before others if that would support Arizona's public policy objectives.

3.4.4. Aggregate Low Income Load

Some potential market entrants have suggested that the Commission act as an aggregator to pool the low income segment of residential load and solicit competitive bids to serve the load. The aggregated load could include customers in more than one service area.

3.5. Geographic Selection

Most of the group agrees that customers should not be selected by geographic area. Geographic selection would be more applicable to a limited pilot program. Only two group members have expressed support for geographic targeting along with other methods. One potential market entrant encourages utilities to open specific geographic areas to competition in addition to the rule-required phase-in percentages of load selected through other methods. The following advantages and disadvantages of geographic selection have been identified:

Advantages

+ Aggregation of customers might be encouraged.
+ Marketing costs might be reduced.
+ There may be operational efficiencies for distribution utilities.
+ There may be an opportunity to gain information about potentially less desirable markets.

Disadvantages

– Geographic selection might be viewed by customers as showing favoritism.
– Geographic selection would not fairly represent competition.
– Selected areas might be unfairly advantaged and have an edge in economic development.

- Industrial customers who must compete in global markets might be disadvantaged if they are not selected.
- It may be difficult to incorporate rural and other non-urban areas with geographic selection.

3.6. Renewable Resources

The retail competition rules provide that those customers willing to purchase 10 percent of their load from solar resources installed after January 1, 1997, will be selected for participation (R14-2-1604.E.3.). The group agrees that it is not necessary to go beyond the rule requirement in regard to renewable resources. The group also agrees to interpret the rule requirement regarding solar resources installed after January 1, 1997, to mean that the resource would be available on January 1, 1999, or contracted for delivery on January 1, 1999. The customer must continue to receive 10 percent of their electric consumption from the solar resource.

One potential market entrant has suggested that the provision will have little or no impact until after customers know whether they will have retail access in January 1999. Possible solutions, offered by the potential market entrant, are to accelerate customer notification or to offer retail access now to anyone willing to meet the solar requirement. One Affected Utility discounts the potential market entrant's claim that the rule provision will have little or no impact because it is anticipated that consumer education (including education on the eligibility of consumers who purchase 10 percent of their load from solar resources) will take place prior to January 1999 and prior to the selection of consumers. Another Affected Utility has suggested that the Commission could begin a public relations effort towards education. There is no support from other group members to provide earlier preference for these customers.

3.7. Other Special Selection Criteria

There is group consensus to the following:

- Credit worthiness should not matter more in the selection process than usual.
- No preference should be based on rural or urban area because it could be considered discriminatory and because the major difference in providing service to the two areas is in distribution system costs, which will continue to be regulated. However, effort should be made to be sure consumer education goes to rural areas.
- The need for emergency services should not be a criterion for selection because customers in this situation should make their own decisions about participation in the competitive market.

- There should be no preference based on load size beyond what is in the rules.
- There should be no preference for customers whose facilities are more energy-efficient than those of other customers.

Most of the group want no special selection criteria beyond what is already in the retail competition rules. Special provisions do not replicate the market, make the process more complicated, and are unfair to other customers.

Although most group members prefer that there be no special preference for new load because it could be discriminatory against existing customers and because new load is not included in the 20 percent of 1995 peak load (base year market), one potential market entrant wants preference for new service connections. In addition, one group member has suggested that economic efficiency should be considered because customers selected should be those who value competition the most and who could benefit the most, but there is no support from other members for this idea.

3.8. 3 MW Limitation

The retail competition rules limit the number of customers with demands greater than 3 MW from participating in each phase (R14-2-1604.A.1.). Half of the group members would consider a customer's load to be per meter (or per meter charge); the other half would consider it to be per utility bill. One utility would look at the "essence" of each customer.

The group agrees that if a customer's expansion causes the customer's load to go over 3 MW, additional load should not be penalized. "Once you're in, you're in." Eligibility could be determined by existing load as of a certain date. A customer could buy more electricity at other times.

Would an aggregated load be subject to the 3 MW limitation? The group is split on this issue. Seven group members recommend that an aggregated group with a combined load greater than 3 MW should not be subject to the limitation. The 3 MW limitation should apply to a customer's load before being aggregated. On the other hand, five group members recommend that an aggregated load should be subject to the 3 MW limitation. One member feels that a self-aggregator's load should count toward the limitation. Another member believes that load should not be considered as a selection criterion.

3.9. Special Contracts

Most of the group support the rule provision that customers on special contracts can participate in the competitive market prior to expiration of the contract only if both parties agree to it (R14-2-1604.F.). One viewpoint is that special contract customers should not be selected for participation in the competitive market because they already get lower cost power; however, one group member has suggested that contract customers should be allowed in the second phase. Another viewpoint is that a customer on a special contract could use a financial instrument to trade power on the open market (contract for differences). It has also been suggested by some potential market entrants and a consumer group that a customer has a choice to break a contract, pay associated penalties, and then participate in competition.

There is disagreement over when a special contract customer would be eligible for participation in the competitive market if its contract expires after the selection cutoff date but before the date of full competition. The following viewpoints have been expressed:

- It matters whether the customer entered into the contract before or after the Commission's adoption of the rules.
- If the contract expires during the first year of a phase, the customer should be eligible to participate in the selection process for that year and begin taking delivery of power upon expiration or termination of the contract.
- Eligibility should be based on a date certain.
- Special contract customers should be eligible for selection on the expiration date of the contract.
- Special contract customers should be eligible in the month their contract expires.
- Special contract customers should be eligible at the next selection opportunity after expiration of the contract.
- Special contract customers should be eligible at the next phase after the contract expires.
- Special contract customers should be eligible when full competition occurs.

One potential market entrant recommends that the Commission refuse to approve any new special contracts because they impede the advent of competition. Although discounts are essential in a competitive market, they tilt the playing field in favor of existing monopolies. Some large industrial and commercial customers object to this position on the grounds that it is an unwarranted infringement on a customer's freedom to choose.

3.10. Aggregation

The retail competition rules permit the loads of multiple consumers to be aggregated (R14-2-1605.A.3). It is assumed that aggregated customers would have greater buying power than individual customers. However, the group has identified issues regarding how aggregation would affect the selection process and about the certification of aggregators.

3.10.1. Customer Class of Aggregated Customers

The group agrees that aggregated customers would be considered to be in the class they were in before being aggregated ("what was, is"). Therefore, if residential and commercial customers were aggregated together, the customers would continue to be considered to be in the same class as before being aggregated.

3.10.2. Aggregation Before or After the Selection Process

Most of the group agrees that aggregation of customers should be allowed both before and after the selection process. Before selection, an aggregated group would replace the individual account names on the list within a service area and have one entry. Some parties prefer to divide an aggregated group into smaller groups for application purposes. Application for selection could be by class. After selection, an aggregator could obtain a list of selected customers and combine them into a larger buying group. A potential market entrant recommends that all residential and small industrial customers be encouraged to aggregate their loads in each service area. There might also be "super aggregators" who would serve as administrators of aggregated groups.

Two Affected Utilities recommend that customers not be allowed to aggregate before selection because they may complain if the aggregator does not get chosen or customers could sign up with multiple aggregators to hedge their bets.

3.10.3. Self-aggregation

Many group members agree that customers could aggregate their own metered accounts into one entry for selection. Some potential market entrants have pointed out that customers, depending on the type of business, will vary as to the number of locations and meters. They feel that preferential treatment should not be granted to those customers who may have a large load at one meter. They do not want configuration of meters to be the basis for distinguishing between potential customers who may qualify within customer classes.

On the other hand, two Affected Utilities, a large customer, and a consumer group recommend that aggregation not occur until after selection. One of those Affected Utilities has suggested that premises be selected so that customers with multiple sites could not aggregate before selection and be treated as part of the 3 MW limitation.

The group agrees that multiple sites could be aggregated across service territories after selection, but selection should occur by service area. It has also been suggested that a self-aggregator should be treated no differently from an outside aggregator.

3.10.4. Certification of Aggregators

The retail competition rules provide for the Commission to issue Certificates of Convenience and Necessity (CC&Ns) to electric service providers (R14-2-1603.). The rules are not clear on whether aggregators are electric service providers and would need CC&Ns. There is general agreement in the group that a self-aggregator should not need a CC&N.

Several group members feel that all aggregators should be required to obtain certification from the Commission. One Affected Utility has suggested that certification of aggregators may be needed to protect consumers against fraud until consumers are fully educated in the complexities of purchasing electricity. On the other hand, other group members feel that only registration is necessary. One group member wants registration with the Commission to be required of all aggregators, power marketers, brokers or other entities seeking to sell generation to customers in Arizona. That group member recommends that the Commission regulate those entities to ensure that customers are protected and competitors work cooperatively to ensure reliable, efficient system operation.

There is disagreement on whether an "agent aggregator," such as a nonprofit neighborhood association, who is not a supplier and does not take possession of power should need a CC&N. Some group members want a CC&N to be required for an agent aggregator as protection for consumers. Other group members have suggested that only registration be required for an agent aggregator because transaction costs for certification would reduce the number of aggregators and that it is not necessary for consumer protection because there are laws providing protection from fraud.

The breakdown of group preferences for certification of aggregators is as follows:

	AGENT AGGREGATORS	*OTHER AGGREGATORS*
2 Affected Utilities	certification	certification
large industrial and commercial customers	certification	certification
1 potential market entrant	certification	certification
1 consumer group	certification	certification
2 consumer groups	registration	certification
1 Affected Utility	nothing	certification
1 large customer	nothing	certification
1 Affected Utility	registration	registration
other potential market entrants	registration	registration
1 government agency	registration	registration
1 other group member	registration	registration

3.11. Customer Selection Time Period

The retail competition rules require the Affected Utilities to file their customer selection plans by the end of 1997 (R14-2-1604.E.). The rules are silent on when the plans are to be implemented.

3.11.1. Start of Time Period

Most potential market entrants want the selection process to start as soon as possible, generally as soon as the method of selection is determined. Fall 1997, October 1, 1997, and January 1, 1998, have been mentioned as possible starting dates. This would allow more time for educating consumers and marketing to consumers. Having the names of selected consumers before beginning education and marketing activities could help to reduce costs because advertising materials could be targeted. Early selection could make full subscription on the competition start date more likely, but two or three stages could be needed to get full subscription. One recommendation is to start the selection process at least six months before the starting date of competition to account for operational considerations, such as signing contracts.

Most industrial and commercial customers want the process to begin as soon as the Commission has approved stranded cost charges, system benefit charges, and unbundled tariffs. Some Affected Utilities and consumer groups have suggested that, before selection can begin, customers must be educated. Other Affected Utilities feel that the selection process should begin closer to the competition start date.

The breakdown of group preferences as to when the selection process should start is as follows:

GROUP MEMBER	WHEN SELECTION PROCESS SHOULD BEGIN
potential market entrants	right away
1 large customer	as soon as selection plans are approved
1 potential market entrant	as soon as selection plans, stranded cost charges, unbundled tariffs, and system benefit charges are approved
large industrial and commercial customers	as soon as selection plans, stranded cost charges, unbundled tariffs, and system benefit charges are approved
1 consumer group	as soon as selection plans, stranded cost charges, unbundled tariffs, and system benefit charges are approved
1 government agency	as soon as selection plans, stranded cost charges, unbundled tariffs, and system benefit charges are approved
2 consumer groups	as soon as selection plans, stranded cost charges, unbundled tariffs, and system benefit charges are approved and consumer education has occurred
2 Affected Utilities	as soon as selection plans, stranded cost charges, unbundled tariffs, and system benefit charges are approved and consumer education has occurred
1 other group member	as soon as selection plans, stranded cost charges, unbundled tariffs, and system benefit charges are approved; consumer education has occurred; an ISO is in place; and public policy issues resolved
3 Affected Utilities	closer to competition start date

3.11.2. Length of Time Period

Most of the group members agree that customers should have at least several months to decide whether or not to participate in the competitive market One group member has stated that residential consumers, especially, do not have enough information about competition and will need a long window of time to decide. The length of time needed to make a choice could be dependent on the success of customer education. An Affected Utility believes that, with a volunteer method, sufficient time for an educational period must be allowed prior to actual selection so that as many customers as possible participate rather than just the more active and educated consumers. One potential market entrant feels that, in order to volunteer, customers and new suppliers should first reach an agreement for service, specify all parameters of service, and indicate a requested start date. Therefore, all customers could begin shopping at the same time and volunteer upon completion of these criteria.

A few group members have suggested that the selection process continue until the full 20 percent allocation is filled. One Affected Utility has suggested that, if a customer is randomly selected, there should be no time limitation on the customer to make a

choice. That Affected Utility feels that a customer should be deemed part of the competitive market when the customer has been offered a choice. On the other hand, some potential market entrants believe that one or two months would be enough time for customers to choose; some customers are ready today.

3.12. Determination of Required Percentages Being Met

The group has discussed interpretation of the part of the retail competition rules that says, "Each Affected Utility shall make available at least 20% of its 1995 system retail peak demand for competitive generation supply..." (R14-2-1604.A.). Does it mean that customers associated with 20 percent of demand *are eligible to choose* a competitive supplier or that customers associated with 20 percent of demand *choose* a competitive supplier? Affected Utilities and one consumer group prefer the first interpretation, but large customers and potential market entrants prefer the latter. Affected Utilities believe that a customer should be deemed part of the competitive market when that customer has been offered a choice and has made that choice. Customers who choose to continue receiving service from their current utility, either under a standard offer or under a special rate, should be considered as participating in the competitive market. On the other hand, consumers and potential market entrants in the group feel that 100 percent of consumers should have the opportunity to choose a competitive supplier and that the first round of selection should continue until at least 20 percent of eligible registrants have been selected and are willing to take part in the competitive market.

Another issue is what happens if a consumer chooses to go into the competitive market but later chooses to take the utility's standard offer and then wants to return to the competitive market at a later time. One suggestion is that the utility could allow the customer to go back to the competitive market. A second suggestion is that consumers must stay in the competitive market and that the standard offer is a competitive rate. An opposing view is that the standard offer is not a competitive rate, although a competitive rate from a utility's unregulated subsidiary would count. One Affected Utility has suggested that residential customers should be able to return to the competitive market throughout the phase-in periods; however, the utility should decide whether to allow a load greater than 1 MW to return to the standard offer from the competitive market.

One potential market entrant mentioned that actual percentages will be lower than the minimum percentages (20 percent and 50 percent) contained in the rules. This is because of significant load growth between 1995 and the future years and because of frequently large differences between coincident and noncoincident peak loads. The Affected Utilities could calculate what the actual percentages are likely to be to determine whether the phase-in percentages are adequate. Utilities and one large customer do not want the phase-in percentages to be reviewed, but the other group members who responded to this issue are in favor of reviewing the percentages, mostly to have them increased.

3.13. Estimating Peak Load

The retail competition rules define "eligible demand" as the total consumer kilowatts of demand which an Affected Utility must make available to competitive generation or the consumer kilowatts of demand provided competitively in an Affected Utility's distribution territory, whichever is greater (R14-2-1601.6.). The rules prefer the use of coincident annual peak demand data, instead of noncoincident peak data, where data permit (R14-2-1604.A.).

The group has discussed how to determine coincident peak demands (customer's usage at the time of the utility's peak). Firm load, not non-firm load, would be considered in these determinations. Coincident demand data may have to be estimated for customers without adequate metering equipment. Although one group member believes that this level of sophistication is not necessary for implementing a phase-in schedule, most of the group agrees with an Affected Utility's recommendation to use the following methods for estimating coincident demand:

1. For medium-size customers with demand meters, use the billing demand for the utility's peak month in the year prior to the competitive start date and a class average coincidence factor.

2. For small commercial customers without demand meters, use the energy from the utility's peak month and a class average monthly load factor.

3. For residential customers, use a historic class average coincident peak.

One group member agrees with the above methods for determining aggregate eligible demand, but does not want these calculations to be used to limit the eligible load for any individual customer. Another Affected Utility wants to modify no. 1 above to use the class average coincidence factor for the month of the system peak, to modify no. 2 to use a class average system coincident load factor for the month of the system peak, and to use no. 2 for residential customers instead of using no. 3.

3.14. Administration of Selection Process

3.14.1. Who Should Administer the Process?

Some group members have suggested that either the distribution utility or the "wires" function of a vertically integrated utility should administer the customer selection process. Each utility's marketing or sales personnel would be excluded from any involvement in the process. One Affected Utility has pointed out that this is a short-term phase-in; the process should be kept simple and should not add more costs. Some

potential market entrants feel that the distribution utility should be allowed to administer the selection process as long as the utility has adopted standards of conduct, enforceable by the Commission, which assure that all competitors have equal information and access to the customers who are selected to participate. Some large industrial and commercial customers are concerned that Affected Utilities could be in a position to discriminate against particular customers.

Other group members recommend that an independent party handle the administration for a perception of fairness. The utility should not be involved in the process. The utility would be notified of customers who have been selected afterwards. One Affected Utility has proposed that the costs for an independent, self-funded third party be paid for through either supplier and aggregator registration fees or by selling the list of selected customers. Anyone, including the utility, would have to pay for the list of names. Another Affected Utility has suggested that the distribution utility should administer the process, but that an independent party should be hired for any random selection.

One potential market entrant feels that the selection process should be a community effort, open to all interested parties and supervised by the Commission. Another potential market entrant believes that there should be no selection process. Customers would reach agreements with suppliers and then notify the distribution utility which simply keeps a running total of load switching and customer class.

The breakdown of preference about who should administer the customer selection process is as follows:

GROUP MEMBER	*PREFERRED SELECTION ADMINISTRATOR*
3 Affected Utilities	distribution utility or "wires" function
large industrial and commercial customers	distribution utility or "wires" function
some potential market entrants	distribution utility or "wires" function
1 government agency	distribution utility or "wires" function
1 other group member	distribution utility or "wires" function
1 Affected Utility	distribution utility or "wires" function; independent party for random selection
consumer groups	independent party
1 Affected Utility	independent party
1 large customer	independent party
1 potential market entrant	independent party
1 potential market entrant	community effort
1 potential market entrant	no selection process

3.14.2. Other Administrative Issues

One potential market entrant has suggested that customers choosing an alternative provider may need protection against retaliation by the Affected Utility. In the United Kingdom, regulators addressed this concern by adopting performance standards and consumer safeguards. The Affected Utilities could conduct education programs for their wires employees concerning the impropriety of any discrimination or retaliation for loss of customers to competitors. All of the group members, except three Affected Utilities, agree with this suggestion. The three Affected Utilities feel that such a program is unnecessary because they do not think retaliation will be a problem, they already have employee standards of conduct in place, or they intend to conduct their wires business independently.

A potential market entrant also recommends that utilities move competitive commodity sales into a fully separated affiliate subject to strong marketing affiliate rules to avoid anti-competitive behavior. The utility would be prohibited from providing the affiliate with preferential treatment, confidential customer information, or any utility information that would provide a competitive advantage to the affiliate.

The group has discussed the issue of dissemination of customer information. The retail competition rules (R-14-2-1606.F.) require an electric service provider to provide 12 months of customer electric consumption data to another electric service provider, upon authorization by the customer. The rules do not mention release of names and addresses of customers selected to participate in the competitive market or costs of disseminating customer information.

The majority of the group feels that names and addresses of selected customers should be released, but many group members want the customer to approve it first. Otherwise, there could be an issue of invasion of privacy. Two group members have suggested that a noncontact list be established for those selected customers who do not want to receive direct marketing. The selected customers would be provided with names and phone numbers of all eligible entities from whom they can receive service.

Some potential market entrants believe that names should be released because, otherwise, the process would have the effect of preferential treatment for Affected Utilities and their affiliates. Another group member has suggested that the names of selected consumers be kept confidential from the Affected Utilities to prevent unfair marketing and that lists of selected customers should be distributed to all providers at the same time.

Some large industrial and commercial customers feel that a balance must be struck between protection of privacy for individual customers and the need for a level playing field for sellers. Whether names are to be released depends on the program design. Those group members feel that any program which includes random selection of customers should include a provision that the names will be released.

A potential market entrant recommends that clear procedures be established to timely disseminate information on phase-in participants to suppliers. That group member recommends that Affected Utilities be required to provide customer information to marketers upon request. The information should include for each identified customer: name, address, load profile data for at least two years, and other pertinent data that would permit the marketer to develop products to meet the customer's needs. The data belong to the customer, not to the utility.

3.15. Consumer Education

There is general consensus that consumer education will be very important. Most of the group want education to occur before the customer selection process begins. Customers need to understand the selection process, the phase-in schedule, and details regarding the opportunity for choice. Informed customers are necessary for customer satisfaction, limited customer complaints, and a successful process. Although larger customers may be knowledgeable, the majority of customers will require ongoing information through a variety of means.

Low income advocates and a potential market entrant recommend that the Commission take an active role in developing standards for educational materials, in reviewing materials, or in providing unbiased consumer education.

Only one potential market entrant has suggested that consumer education be concurrent with choice. Most residential and small commercial customers will not be receptive to learning until faced with a decision because they are too busy. One way to provide some education now could be to informationally unbundle current bills. Bills could be broken out by power production, transmission, distribution, customer service, marketing, and other. This would educate customers on what they are currently paying for major service components and enable comparison to competitors. However, an Affected Utility has stated that it does not currently have the capability to provide this information on customer bills.

4. STAFF RECOMMENDATIONS

The following recommendations are from Staff and have not been reviewed by the other group members.

1. The customer selection plans filed by the Affected Utilities should be reviewed by Staff. Staff's recommended approvals or modifications of the plans would be considered by the Commission at Open Meetings.

2. The phase-in schedule should be modified as follows:

January 1, 1999	20 % of 1995 system retail peak
January 1, 2000	35 % of 1995 system retail peak
January 1, 2001	50 % of 1995 system retail peak
January 1, 2002	75 % of 1995 system retail peak
January 1, 2003	100 % retail competition

3. Customer selection plans should contain discussion on including low income customers in retail competition.

4. The retail competition rules should be revised to clarify whether a customer's load should be considered to be by utility bill or by meter.

5. Aggregators who are power suppliers or who take possession of power should be required to obtain certification from the Commission. The Commission should clarify in its rules whether aggregators who are not power suppliers or who do not take possession of power (agent aggregators) need to obtain certification. Self-aggregators should not be required to obtain certification from or register with the Commission.

6. The retail competition rules should be revised to clarify the meaning of "Each Affected Utility shall make available..." as to whether selected customers must choose a competitive supplier to be counted toward the minimum percentage of 1995 system retail peak demand.

7. Each distribution utility or "wires" function of a vertically integrated utility may administer the selection process as long as the utility has adopted standards of conduct which assure that all competitors have equal information and access to selected customers.

8. The Affected Utilities should instruct their employees about the impropriety of any discrimination or retaliation for loss of customers to competitors.

9. Selected customer names and addresses should be distributed to competitive providers, only with the customer's approval and adequate compensation to the utility.

10. Commission Staff should start a working group on consumer information.

5. WORKSHOP PARTICIPANTS AND PROVIDERS OF WRITTEN COMMENTS

ORGANIZATION	INDIVIDUALS
AARP	Ellen Corkhill
Abbott Laboratories	David Salyers
Arizona Community Action Agency	Betty Pruitt
Arizona Consumers Council	Barbara Sherman, Dr. Albert Sterman
Arizona Corporation Commission Staff	Caroline Butler, Kim Clark, Mark DiNunzio, Bob Gray, Barbara Keene
Arizona Electric Power Cooperative	Dennis Criswell
Arizona Energy Office	Stephen Ahearn
Arizona Multihousing Association	Suzanne B. Gilstrap, James P. Grady
Arizona Public Service Company	Barbara Klemstine, Pat Vincent
Asarco	Jerry Turner
Ascendix Group	Pat Osorio
BHP Copper	Sandra B. Dunphy
Brown & Bain for Phelps Dodge, Morenci Water and Electric, and Ajo Improvement Co.	Michael Patten
Calpine Corp.	Mike Rowley
Chemical Lime	Mike Pinnau
Citizens Utilities Company	Sean R. Breen, Tom Ferry
City of Tucson	Karen Thoreson
Cyprus Climax Metals	Mike McElrath
Diné Power Authority	Gabriel Freeland, Lisa V. Wayne
Economic Energy Alternatives	David Caplow
Electric Competition Coalition	Doug C. Nelson
Energy Strategies for ASARCO, BHP Copper, Cyprus Climax Metals, Phelps-Dodge, and Public Interest Coalition on Energy	Scott Gutting, Kevin Higgins
Enron Capital and Trade Resources Corp.	Janel Guerrero, Lyndon Taylor, Jim Tarpey
Enserco Energy	Allen Dennis
Goldwater Institute	Michael Block
Honeywell	Jeff Sutherland
Intel Corp.	Marty Sedler
Navopache Electric Cooperative	Mike Evans, Paul O'Dair
Neidlinger & Associates for Fort Huachuca	Dan Neidlinger
Nordic Electric Arizona	Andy Baardson
PG&E Energy Services	Tom Broderick
Ralston Purina Co.	Ted Bobkowski, Bill Calloway
Residential Utility Consumer Office	Steve Cibelli, Greg Patterson
Salt River Project	Jana Brandt, Mike McGinnis
Southwest Gas	Keith Brown
Sulphur Springs Valley Electric Coop.	Jack G. Crask, Creden Huber
Trico Electric Cooperative	Charlie Emerson
Tucson Electric Power Company	Bentley Erdwurm, Chuck Miessner
K.R. Saline & Assoc.	Jeff Woner

REPORT OF THE PARTICIPANTS IN WORKSHOPS ON CUSTOMER SELECTION ISSUES

Docket No. U-0000-94-165

In Compliance with R14-2-1604.E.4.

September 30, 1997

Arizona Corporation Commission
Utilities Division
1200 West Washington
Phoenix, Arizona 85007

SOLAR PORTFOLIO STANDARD SUBCOMMITTEE REPORT

Presented to

UNBUNDLED SERVICES AND STANDARD OFFER WORKING GROUP

For Review and Inclusion in

The Working Group Final Report

September 26, 1997

Retail Electric Competition
Working Group Process

Docket No. U-0000-94-165

REPORT TO THE

ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE COMPETITION

IN THE PROVISION OF ELECTRIC SERVICE

THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. U-0000-94-165

Submitted By

The Legal Issues Working Group

September 30, 1997

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Submitted By

The Stranded Cost Working Group

September 30, 1997

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IN THE MATTER OF THE COMPETITION

IN THE PROVISION OF ELECTRIC SERVICE

THOUGHOUT THE STATE OF ARIZONA

DOCKET NO. U-0000-94-165

Submitted By

The Legal Issues Working Group

September 30, 1997

REPORT OF THE ARIZONA CORPORATION COMMISSION'S LEGAL ISSUES WORKING GROUP

INTRODUCTION

The Arizona Corporation Commission ("Commission") established the Legal Issues Working Group (the "Working Group") pursuant to A.A.C. R14-2-1616 to identify, analyze and provide recommendations to the Commission on legal issues relevant to Title 14, Chapter 2, Article 16 of the Arizona Administrative Code (the "Rules"). *See* A.A.C. R14-2-1601 to -1616, "Retail Electric Competition." This report ("Report") identifies and analyzes legal issues which the Commission should consider in evaluating modifications or additions to the Rules and relevant Arizona statutes.

This Report discusses regulatory policy regarding industry restructuring only to the extent policy explains or defines a legal issue that is relevant to the Rules. This Report does not recommend any policy over other policy choices that are available to the Commission.

The working group considered a number of amendments to the existing Rules, additional rulemaking as well as legislative and constitutional changes. Some participants believed that any amendments to the Rules were unnecessary. The working group did not reach unanimity for recommending any particular action. The working group's observations regarding legal issues in the Report are contained in sections entitled "Comment."

PART 6: FERC ISSUES

This part identifies the exclusive powers of the Federal Energy Regulatory Commission ("FERC") and the Arizona Corporation Commission. It identifies initiatives involving competition that may require FERC approval, such as establishment of an independent service organization ("ISO"). This part discusses the factors that may determine the jurisdictional separation of distribution and transmission.

PART 7: FEDERAL ISSUES

This part explains tax-exempt financing under the "Two-County" rule. This part explains how FERC has addressed this rule with respect to open access for transmission services. This part discuss the potential effect of the Rural Electrification Act's upon electric cooperatives in a competitive environment. This part discusses what Arizona may require of out-of-state entities under the Commerce Clause of the U.S. Constitution.

PART 8: ANTI-TRUST ISSUES

This part explains why utilities will not have state-action immunity from anti-trust laws to the extent the utilities provide competitive services.

PART 9: SUGGESTED CODE CHANGES

This part identifies the arguments for and against the need for legislative changes to facilitate competition. It identifies the state statutes that the group discussed.

The Legal Division excised incorrect or redundant material from the draft and further summarized the Reporters' comments. Participants were given opportunity to comment on a second and third draft of the report. A chronology of the group's activities is attached to the Report as Appendix B. The minutes of the group's meetings are collected in Appendix C.

The report consists of Nine Parts, representing issues that the Working Group identified. The Working Group did not identify legal issues that may affect the matters discussed in the reports of other working groups involved in electric restructuring.

The attached Appendix D contains participants' separate comments regarding the Report.

PART 1: SCOPE OF THE COMMISSION'S AUTHORITY

This part summarizes the legal arguments for and against the Commission's power to adopt the Rules. Part 1.2 contains comments for the Commission to consider in addressing electric utilities' obligations to serve customers in a competitive environment.

PART 2: RATES AND RATEMAKING

This part identifies legal issues relating to cost allocation and confidentiality of information under competition.

PART 3: STRANDED COST RECOVERY

This part identifies the issues to be decided in a stranded cost proceeding. It also identifies standards in the Rules that certain Affected Utilities have challenged as unreasonably vague. This part identifies legal arguments that may affect stranded cost recovery mechanisms and stranded cost "true up" proceedings.

PART 4: ACC POWERS/PROCEDURES

This part identifies procedural issues that the Commission may face with respect to stranded costs, affiliated interests, non-public service corporations, antitrust, intergovernmental agreements, in-state reciprocity, and resource planning.

PART 5: NON-PSCs

This part discusses the various entities that operate as public service corporations outside the Commission's jurisdiction. The part discusses the laws that affect the relationships between these entities and public service corporations.

ARIZONA CORPORATION COMMISSION'S
ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP
EXECUTIVE SUMMARY

INTRODUCTION

The following summarizes the attached final report of the Commission's Legal Issues Working Group (the "Working Group" or "group"). Appendix A is a list of the members of the Working Group.

Working Group participants prepared the report through a series of drafts compiled from oral comments at public meetings and from written comments from the participants. These participants are largely responsible for the focus and content of the final report.

The Working Group designated participants ("Reporters") to collect written comments and contributions from participants. The Working Group assigned Reporters by subject-matter and the Reporters incorporated material into a report format. The Reporters' work was collected into a single draft report and participants were given an opportunity to suggest changes and additional material for the final report. The Reporters are responsible for the balance and comprehensive nature of the work in the final report.

The Working Group's Reporters are as follows:

Steven M. Wheeler	***Nature of Restructuring in General and Stranded Cost Recovery.***
Bradley S. Carroll	***Rights and Duties of Public Service Corporations and Antitrust Issues***
Lawrence V. Robertson, Jr.	***Scope of Restructuring***
Beth Ann Burns	***Rates and Ratemaking***
C. Webb Crockett	***ACC Powers/Procedures***
Jessica J. Youle	***Non-PSC Issues***
Patricia E. Cooper	***FERC Issues and Federal Issues***
Douglas C. Nelson	***Taxation Issues***
Michael M. Grant	***Legislative Issues***

9.3.5 A.R.S. §§ 40-221 and 40-222 63

9.3.6 A.R.S. § 40-284 63

9.3.7 A.R.S. § 40-285 64

9.3.8 A.R.S. § 40-301 et. seq. 65

9.3.9 A.R.S. §§ 40-321, 40-322, 40-331, 40-332 and 40-334 65

9.3.10 A.R.S. § 40-341 et. seq. 66

9.3.11 A.R.S. § 40-360 et. seq. 66

9.3.12 A.R.S. § 40-401 et. seq. 67

9.3.13 Title 10 67

9.3.14 Non-Regulated Activity by Utilities 68

9.3.15 A.R.S. § 48-1515 68

Exhibit A Maricopa County Superior Court Cases Involving Electric Restructuring

Appendix A List of Working Group Participants

Appendix B Chronology of Group Process

Appendix C Special Open Meeting Minutes

Appendix D Comments of Participants

7.2 Federal Rural Electrification Act (and resulting mortgages, interlocking all-requirements contracts, and related issues). 47

7.2.1 What is it, how does it affect a cooperative in a competitive environment, and what resolution is possible? 47

7.3 Western Area Power Administration. 51

7.3.1 What affect will its presence, system, contracts, policies and Federal constraints have on the adoption of retail competition in electric supply? 51

7.4 Interstate Reciprocity. 51

7.4.1 In view of the Commerce Clause of the U.S. Constitution, what can Arizona require of out-of-state entities to compete in Arizona markets? 51

PART 8 - ANTI-TRUST ISSUES 54

8.1 State Action Immunity Doctrine. 54

8.2 Application of Traditional Antitrust Principles. 55

PART 9 - SUGGESTED CODE CHANGES 55

9.1 Federal Statutes. 55

9.2 The Arizona Constitution. 56

9.2.1 Whether Constitutional amendments are required either to allow or facilitate competition in generation supply and other electric services. 56

9.3 Arizona Statutes. 60

9.3.1 A.R.S. § 40-281 60

9.3.2 A.R.S. §§ 40-201 and 40-202 61

9.3.3 Rate Statutes 61

9.3.4 A.R.S. § 40-204 62

6.1 ACC's Exclusive Jurisdiction. 33

6.1.1 In view of FERC Orders 888, 888-A, 889, 889-A, FERC decisions, case law, the U.S. Constitution and the various Federal acts, what exclusive (or concurrent) jurisdiction may the ACC exercise in the context of competitive electric energy services, whether in wholesale and/or retail transactions considering the interstate nature of the transmission lines? . 33

6.2 FERC's Exclusive Jurisdiction. 36

6.2.1 In view of Rules 888, 888-A, 889, 889-A FERC decisions, case law, the U.S. Constitution and the various Federal acts, what exclusive (or concurrent) jurisdiction may FERC exercise in the context of competitive electric energy services, whether in wholesale and/or retail transactions within Arizona considering the interstate nature of the transmission lines? 36

6.3 FERC Approvals. 39

6.3.1 What actions taken in Arizona or involving Arizona public utilities to move to retail competition in the electric industry (including any formation of an ISO) will require FERC approvals and what criteria will FERC apply? 39

6.4 Jurisdictional Separation of Distribution-Transmission Lines. 42

6.4.1 The FERC has issued criteria and decisions to assist in determining what is a distribution line and what is a transmission line so as to assert appropriate FERC jurisdiction over transmission lines. What are the criteria, how should they be applied, and what FERC actions are required to confirm that determination? 42

PART 7 - FEDERAL ISSUES 44

7.1 Two-County Rule. 44

7.1.1 What is it, how does it affect a utility in a competitive environment, and what resolution is possible? 44

the mechanism by which stranded costs are recovered. 18

3.2 The legal standards relevant to stranded cost recovery mechanisms. 21

3.3 The legal standards governing stranded cost recovery mechanisms (*e.g.*, non-by passable CTC or exit fee). 22

3.4 The ACC's powers to "true-up" any initial stranded cost estimates to eliminate possible over/under recovery of stranded cost amounts. 22

3.5 Legal standards for "securitizing" or using public funding mechanisms for the recovery of stranded costs. 23

3.6 Whether Arizona recognizes a "regulatory compact" as a binding contract that affects the recovery of stranded costs or limits the ACC's power to amend regulations affecting public service corporations. 23

3.7 Whether the ACC has awarded stranded cost recovery for telecommunications providers or for gas LDC's in Arizona. 23

PART 4 - ACC POWERS/PROCEDURES 24

4.1 Stranded Cost Proceedings. 24

4.2 Affiliated Interest Rules. 24

4.3 Non-PSC's. 25

4.3.1 Antitrust Principles. 26

4.3.2 In-State Reciprocity. 27

4.4 Resource Planning Issues. 30

PART 5 - NON-PSC'S 31

5.1 Municipal Corporations, Non-PSCs with Federal Interests. 31

5.2 Relations Between Non-PSC's and PSC's. 32

PART 6 - FERC ISSUES 33

TABLE OF CONTENTS

EXECUTIVE SUMMARY ES-1

INTRODUCTION 1

PART 1 - SCOPE OF THE COMMISSION'S AUTHORITY 2

1.1 Whether the Commission may authorize "electric service providers" (as defined in the Rules) to offer generation, billing and collection, metering and meter-reading services and other information services on a competitive basis in areas where such services were previously exclusively provided by "Affected Utilities." 2

1.2 Whether the Rules may require Affected Utilities to serve all customers as the "provider of last resort" if Affected Utilities no longer have the exclusive right to serve such customers? 9

1.3 Whether the Commission may lawfully compel Affected Utilities to make their distribution and other facilities available to competitors on demand 12

1.4 Whether the Commission may regulate entities as "Electric Service Providers" under the Rules that are not defined as "public service corporations" under the Arizona Constitution. 14

1.5 Whether the Commission may streamline procedures for complying with statutes that regulate public service corporations. 14

PART 2 - RATES AND RATE MAKING 16

2.1 Cost Allocation and Separation Issues. 16

2.2 Confidentiality. 17

PART 3 - STRANDED COST RECOVERY 18

3.1 The legal procedures (hearing and/or utility filings) necessary to determine Affected Utilities stranded costs; legal procedures necessary to vary the annual level of stranded cost recovery, change the total amount of stranded cost recovery or change

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The Report refers to the Commission's Legal Division as "Staff." References to "Affected Utilities" are intended to encompass the utilities defined in A.A.C. R14-2-1601(1).[1] "Consumer" refers primarily to potential high-volume purchasers of electric generation services.

PART 1

SCOPE OF THE COMMISSION'S AUTHORITY

1.1 Whether the Commission may authorize "electric service providers" (as defined in the Rules) to offer generation, billing and collection, metering and meter-reading services and other information services on a competitive basis in areas where such services were previously exclusively provided by "Affected Utilities."

ANALYSIS

SUMMARY OF ARGUMENTS REGARDING AUTHORITY AND "REGULATORY COMPACT"

Certain Affected Utilities have filed actions in the Maricopa County Superior Court, alleging that the Commission does not have constitutional or statutory authority to adopt the Rules.[2] These Affected Utilities maintain that the Arizona Constitution and the Legislature, pursuant to its power under article XV, section 6, created a policy of "regulated monopoly" for electric utilities. These arguments also rely on judicial decisions that refer to Arizona's policy of "regulated monopoly" as being Legislative in origin or, alternatively, the result of a regulatory contract.

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[1] Two affected utilities, Morenci Water and Electric and Ajo Improvement Company, serve Morenci and Ajo. References to Affected Utilities throughout the report may not reflect these utilities' positions.

[2] Those cases are listed in the attached Exhibit "A" to the Report. The Residential Utility Consumer Office filed an action to challenge the Rules and has voluntarily dismissed the action.

Some Affected Utilities maintain that regulated monopoly for distribution and generation results in a "regulatory compact" between utilities and the state. These Affected Utilities maintain that their certificates of convenience and necessity, authorized pursuant to A.R.S. § 40-281, grant the Affected Utilities exclusive rights to deliver electric service, including generation and retail transmission, within their service territories.

Some participants maintain that competitive pricing unlawfully delegates to the market the Commission's duty to determine just and fair rates based upon the "fair value" of a public service corporation's assets. These utilities also maintain that the Rules violate the Arizona Constitution, article XV, § 14, which requires the Commission to determine "fair value" of a utility's assets. Other participants maintain that competitive pricing is within the Commission's constitutional powers to "prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected..." by public service corporations. Ariz. Const. art. XV, § 3.

Arguments in support of the Rules maintain that the State of Arizona has not entered into a regulatory compact favoring perpetual monopolies. These participants cite a decision of the Maricopa County Superior Court as denying a regulatory compact with respect to a telecommunications PSC, *U.S. West Communications, Inc. v. Arizona Corporation Commission, et al.*, Mar. Co. Sup. Ct. Cause No. CV95-14284 (May 6, 1997). These participants maintain that no Arizona case expressly uses the term "regulatory compact." These arguments maintain that Section 40-281 is intended to prevent unnecessary duplication of lines and facilities within distribution areas; it does not address competitive pricing of services, like generation, that are separable from distribution monopolies.

Participants in support of the Rules maintain that, in a monopoly setting, fair value is used to determine rates artificially, as if the rates were set in a competitive market. If rates are based upon a competitive market, then the Commission's fair value determination has been accomplished more directly and accurately than in the non-competitive setting.

The Working Group's consensus is that the Courts or perhaps the Legislature ultimately will determine whether the Commission must have legislative or constitutional authority to promulgate the Rules, although some participants recommended that the Commission should work with the Legislature to obtain authority to adopt and implement the Rules. In the meantime, the Commission should clarify that the Rules do not affect the exclusivity of distribution services under existing certificates of convenience and necessity. The Rules should also distinguish between certificates for distribution monopolies and certificates for other services that are unbundled or separated from distribution services.

ARGUMENTS BY AFFECTED UTILITIES

Affected Utilities maintain that the Arizona Supreme Court expressly recognized the existence of a regulatory compact in *Application of Trico Electric Cooperative, Inc.*, 92 Ariz. 373, 377 P.2d 309, wherein the court stated:

> By the issuance of a certificate of convenience and necessity to a public service corporation the State in effect <u>contracts</u> that if the certificate holder will make adequate investment and render competent and adequate service, he may have the privilege of a monopoly as against any other private utility.

92 Ariz. at 380-381 (emphasis added). *See also City of Tucson v. Polar Water Co.*, 76 Ariz. 404, 265 P.2d 773 (1954) (CC&N recognized as a "contract" between the state and utility); *New England Coalition on Nuclear Pollution v. Nuclear Regulatory Comm'n*, 727 F.2d 1127, 1130 (D.C. Cir. 1984) ("the very nature of government rate regulation" is "a

compact whereby the utility surrenders its freedom to charge what the market will bear in exchange for the state's assurance of adequate profits.").

These utilities maintain that "regulated monopoly" is Arizona's legislative policy for regulating electric utilities. They maintain that this policy was created by, and therefore may only be modified by, the Arizona Legislature, not the Commission. In support of this position, the utilities cite cases such as *Tonto Creek Estates v. Arizona Corporation Commission*, 177 Ariz. 49, 56, 864 Ariz. 1081, 1088 (Ct. App. 1993), which states that "[t]he concept of regulated monopoly arose from the Legislature in granting the Commission authority to issue certificates of public convenience and necessity to public service corporations."

The Utilities argue that Arizona courts have determined that the "contract" is one creating a constitutionally protected "vested property right" (*Trico,* 92 Ariz. at 381) and that the Corporation Commission is under a duty to protect the exclusive right to serve electricity in the region where the utility renders service, under its certificate (*Trico,* 92 Ariz. at 387). The court in *Trico* held as follows:

> We hold that the Corporation Commission was under a <u>duty</u> to Trico to protect it in the exclusive right to serve electricity in the region where it rendered service, under its certificate.

92 Ariz. at 387 (emphasis added). Twenty years later, the Arizona Supreme Court strengthened and reiterated this view in *James P. Paul Water Company v. Arizona Corporation Commission*, 137 Ariz. 426, 671 P.2d 404 (1983). In that decision, the Supreme Court reaffirmed the exclusive right to provide service under a CC&N, 137 Ariz. at 429, and branded as clearly unlawful the Commission's attempt to certificate a competitor promising lower rates:

> . . . the Commission lost sight of its obligation to respect *Paul*'s expectation, as a certificate holder, of an opportunity to provide service as needed.

137 Ariz. at 431.

Affected Utilities maintain that the elements of this regulatory compact are long-standing, clear and obvious. A public service corporation is required to serve those within its territory, to make extensions and improvements to meet future demands, to subject many of its business transactions to prior Commission approval and to limit its revenues and income to those established by the Commission.[3] In return, the utility is granted a monopoly for exclusive service rights therein and the constitutional guarantee of just and reasonable rates that allow it to recover its cost of service and earn a fair return on the fair value of its properties. Electric public service corporations in this state have committed billions of dollars of private capital to meet their collective obligations in reliance on this compact. *Cf. United States v. Winstar Corp.*, 116 S.Ct. 2432 (1996) (government financially responsible to regulated business for economic injury suffered by change in regulatory policy).

The Affected Utilities maintain that the history of the regulatory compact in America has been well chronicled. *See, e.g.,* Sidak and Spulber, "Deregulatory Takings and Breach of the Regulatory Contract," 71 *N.Y.U. Law Review* 851 (1996); George L. Priest, "The

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[3] Pursuant to A.R.S. § 40-321, *et seq.*, the Legislature purports to give the Commission the authority to order a public service corporation to provide specified services in an approved manner to customers within the utility's service area. Moreover, A.A.C. R14-2-202(C) forbids a public service corporation from abandoning service within its territory without express Commission approval. Thus, once a utility becomes a regulated public service corporation, it apparently cannot "get out of the business" without Commission approval.

Origins of Utility Regulation and the 'Theories of Regulation' Debate," 36 *J.L.& Econ.* 289 (1993).

ARGUMENTS BY CONSUMERS AND STAFF

Potential consumers maintain that a certificate of convenience and necessity does not provide, in effect, that a public service corporation may "corner the market" on electric service. Arizona court decisions refer to regulated monopoly as a public policy, rather than as a contractual obligation. *See Ariz. Corp. Comm'n v. Superior Court*, 105 Ariz. 56, 59, 459 P.2d 489 (1969); *Winslow Gas Co. v. Southern Union Gas Co.*, 76 Ariz. 383, 385, 265 P.2d 442, 443 (1954); *Pacific Greyhound Lines v. Sun Valley Bus Lines, Inc.*, 70 Ariz. 65, 71, 216 P.2d 404, 408 (1950); *Corp Comm'n v. Pacific Greyhound Lines*, 54 Ariz. 159, 177, 94 P.2d 443 (1939).[4] The law does not recognize monopolistic pricing as a vested property right. *See Columbia Steel Casting v. Portland General Electric*, 103 F.3d 1446 (9th Cir. 1996); *F.T.C. v. Ticor*, 504 U.S. 621 (1992).

The Affected Utilities' interpretation of Section 40-281 also frustrates the Commission's authority, which is derived from the Arizona Constitution rather than from a legislative delegation. "Where the Constitution has said that public service corporations shall be governed by the Corporation Commission in a given respect, it is the last, the highest, and controlling fundamental law as to that matter." *State v. Tucson Gas, Electric Light and Power Co.*, 15 Ariz. 294, 301, 138 P.781, 784 (1914). In the event of a conflict between the Commission's constitutional authority and a state statute, the Constitution will

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[4] The Legislature recently added Section 40-281(D) to provide that Section 40-281 should not be construed as "granting <u>or having granted</u>" an exclusive franchise or monopoly to any telecommunications corporation. If Section 40-281 never granted exclusive rights to telecommunications companies, then it follows that the statute never granted the rights to other public service corporations.

prevail. *Ethington v. Wright*, 66 Ariz. 382, 394, 189 P.2d 209, 217 (1948); *Tucson Gas*, 15 Ariz. at 301, 138 P. at 784; *State ex rel. Corbin v. Ariz. Corp. Comm'n*, 174 Ariz. 216, 219, 848 P.2d 301, 304 (App. 1992).

The Commission's rate making power includes adoption of rules that prescribe the classifications and methods that will be used to determine rates and charges. *See Consolidated Water Util. Ltd. v. Ariz. Corp. Comm'n*, 178 Ariz. 478, 483-85, 875 P.2d at 137, 142-44 (App. 1994); *Woods,* 171 Ariz. at 294, 830 P.2d at 815; *Ethington*, 66 Ariz. at 392, 189 P.2d at 216 (Commission's "full and exclusive power" extends to "*making rules, regulations, and orders concerning such classifications, rates and charges by which public service corporations are to be governed....*" (emphasis added)).

Some participants maintain that Arizona's Constitution prefers competition and disfavors monopolies.[5] These participants cite a decision of the Maricopa County Superior Court as denying a regulatory compact with respect to a telecommunications PSC, *U.S. West Communications, Inc. v. Arizona Corporation Commission, et al.*, Mar. Co. Sup. Ct. Cause No. CV95-14284 (May 6, 1997). The Rules follow this principle and apply traditional rate regulation only to natural monopolies, such as companies that erect electric distribution lines, to prevent harm to the public from monopolistic pricing. Services that become separable from the natural monopoly, like electric generation, are eligible for pricing in the competitive market. The Commission's rate making function may change as a particular service becomes less essential or integral to the public service performed by

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[5] Article XV, § 15 provides, in pertinent part, that "[m]onopolies and trusts shall never be allowed in this State...."

the company. *See Mountain States Tel. and Tel. Co. v. Ariz. Corp. Comm'n*, 132 Ariz. 109, 116, 644 P.2d 263, 270 (App. 1982).

The changing nature of the electric industry has led one court to conclude that, while vertically-integrated electric monopolies may have been tolerated in the past, future generations should not be bound to a policy based upon the technological limitations of another time. *See Appeal of Public Service of New Hampshire*, 141 N.H. 13, 676 A.2d 101, 104 (1996). The same court, applying a state constitutional prohibition against monopolies similar to Arizona's, held that competition in electricity should be affirmed "with all doubt resolved against the perpetuation of monopolies." *Id.*, 676 A.2d at 105. The *New Hampshire* court upheld retail electric competition despite utilities' arguments that 80 years of statutes and court decisions granted them exclusive franchises.

COMMENT

None.

1.2 Whether the Rules may require Affected Utilities to serve all customers as the "provider of last resort" if Affected Utilities no longer have the exclusive right to serve such customers?

ANALYSIS

A.A.C. R14-2-1606 provides that Affected Utilities will provide electric service ("Standard Offer Tariffs") to all customers within a class in their utility service areas until the Commission has determined that (1) all consumers in the class have the opportunity to purchase power on a competitive basis and (2) all stranded costs pertaining to that class have been recovered. The Affected Utilities' obligation to supply electric generation will cease when stranded costs are fully recovered and competitive pricing is fully available to customers.

Affected Utilities maintain that A.A.C. R14-2-1606 requires incumbent utilities to continue providing electric services to all customers within their utility service areas even though they no longer possess the exclusive right to provide such services (*e.g.*, generation, billing and collection, meter-reading, etc.). This obligation to serve will not terminate until some indefinite time in the future. The Affected Utilities maintain that no other "electric service provider" has a similar obligation. Several utilities have claimed that the traditional utility obligation to serve is legally dependent upon the concomitant *exclusive* right to serve. *See, e.g., James P. Paul Water Company* and *Tonto Creek Estates*, supra. Affected Utilities claim that the burden to plan for and serve (at regulated rates that do not explicitly provide for the recovery of associated costs) these customers is inconsistent with the free market regime envisioned by the Commission and unlawfully harms the Affected Utility's competitive position.

Affected Utilities maintain that the Rules should not impose an obligation to serve in situations where the exclusive right to serve no longer exists, or at least should establish more definite criteria for terminating an affected distribution utility's obligation to supply electric generation.[6] The Affected Utilities maintain that the Rules should explicitly provide for full recovery of all costs incurred in meeting this obligation.

For example, the Commission could classify customers by the size of their load. Customers purchasing 1MW or greater could be classified so that the obligation to serve

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[6] The "opportunity" to participate in competitive pricing does not mean that customers have actually availed themselves of the opportunity. The Rules probably require that the opportunity be available in a meaningful way. The FCC dealt with a similar issue in *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, Inter LATA Services in Michigan*, CC Docket No. 97-137, Memorandum Opinion and Order (Released August 19, 1997).

would cease when that customer is able to purchase generation from another supplier. If that customer returns to the affected distribution utility, the customer remains in the competitive marketplace notwithstanding the customer's decision not to choose another supplier. The obligation to provide competitive services may continue for customers purchasing lesser amounts during the transition until all customers in each class have the opportunity to receive competitive services such as generation.

The Commission could define the point at which all customers of a class have the opportunity to participate in the competitive market by using some presumptive time provisions. For example, customers of a class will presumptively have the opportunity to participate at least by a certain date, such as January 1, 2003, as provided in A.A.C. R14-2-1604(D). The Commission could extend the date upon a finding of extraordinary circumstances, including the Affected Utility's failure or inability to make all its customers available for competitive generation. The Working Group consensus is that clarification would be appropriate.

At least one Affected Utility suggests that linking the obligation to serve to "full" recovery of stranded costs might be too inflexible. This objection suggests that stranded cost recovery might extend beyond the time that all customers have the opportunity to purchase competitive power. Many participants maintain that the Commission should consider addressing this possibility in amendments to the Rules. *See* R14-2-1606(A).

The working group found that the Commission may not regulate entities that are not "public service corporations" as defined in article XV, § 2 of the Arizona Constitution. *See Rural/Metro Corp. v. Arizona Corporation Commission*, 129 Ariz. 116, 117, 629 P.2d 83, 84 (1981).

COMMENT

A. **The Commission may consider clarifying the point at which all customers of a class have the opportunity to participate in the competitive market.**

B. **The Commission may address whether the obligation to serve should be linked to stranded cost recovery that extends well beyond the point at which all customers of a class have the opportunity to participate in the competitive market.**

C. **The Commission may explicitly state in the Rules that the reasonable costs of meeting the obligation to serve will be recoverable in rates.**

D. **The Commission may not regulate corporations that do not conduct activities described in article XV, § 2, Arizona Constitution.**

1.3 **Whether the Commission may lawfully compel Affected Utilities to make their distribution and other facilities available to competitors on demand.**

See the analysis and comments contained in Section 1.1.

The Rules contemplate that electric service providers (particularly generators) who desire to sell to customers within the existing certificated areas of electric utilities will have access to the distribution facilities of the Affected Utilities subject to terms and conditions and rates to be established by the Commission. Several of the utilities have argued that this provision represents an unlawful "taking" of a private utility's property (*see Loretto v. Teleprompter Manhattan CATV Corp.,* 450 U.S. 419, 102 S.Ct. 3164, 73 L.Ed. 2d 868 (1982); *GTE Northwest, Inc. v. Public Utility Commission of Oregon,* 321 Or. 458, 900 P.2d 495 (1995)) that is not authorized by any specific Arizona constitutional or statutory provision.

The Commission Staff maintains (1) the Affected Utilities will be compensated for access to their distribution lines and for the power produced through their generation plants; (2) a regulatory taking has not occurred since the Affected Utilities will continue to

use of their property, albeit under competition; and (3) a monopoly is not a property interest under the Takings Clause of the state or federal constitutions, see *Tennessee Electric Power Co. v. Tennessee Valley Authority*, 306 U.S. 118, 141 (1939); *Law Motor Freight, Inc. v. Civil Aeronautics B'd*, 364 F.2d 139, 144 (1st Cir. 1966) ("[F]reedom from competition is not constitutionally protected.").

Some participants maintain that A.R.S. § 40-331 and/or A.R.S. § 40-332 authorize the Commission to compel Affected Utilities to "wheel" power from other sellers of generation to customers capable of being served from existing distribution facilities, upon a determination that the "public convenience and necessity." These participants cite to article XV, § 10, which provides that "[a]ll electric, transmission...corporations, for the transportation of electricity,...for profit, are declared to be common carriers and subject to control by law."

Working Group members disagree as to whether A.R.S. § 40-331 and/or A.R.S. § 40-332 apply only to circumstances in which an Electric Service Provider ("ESP A") seeks to use the facilities of an Affected Utility ("Affected Utility B") in order to serve ESP A's own customers outside of Affected Utility B's traditional service area. The Affected Utilities maintain that the statutes do not permit ESP A to use Affected Utility B's facilities to directly compete for Affected Utility B's customers. The participants also disagree as to whether these statutory provisions authorize the use of an Affected Utility's facilities by non-public service corporations that are not and can not be regulated by the Commission.

COMMENT

None.

1.4 Whether the Commission may regulate entities as "Electric Service Providers" under the Rules that are not defined as "public service corporations" under the Arizona Constitution.

ANALYSIS

The Rules regulate as an "electric service provider," any "company supplying, marketing, or brokering at retail any of the services described in R14-2-1605 or R14-2-1606." A.A.C. R14-2-1601(V). The Arizona Constitution allows the Commission to regulate "public service corporations" which are defined, in relevant part, as "[a]ll corporations other than municipal engaged in furnishing... electricity for light, fuel, or power...." Ariz. Const. article 15, § 2. As the Commission moves toward competitive pricing, it may classify certain services as less essential to a public service. The Commission may eventually classify services or "electric service providers" as being outside the Commission's regulatory authority. See analysis in Part 1.1. *See also, Rural/Metro Corp. v. Arizona Corporation Commission*, 129 Ariz. 116, 117, 629 P.2d 83, 84 (1981) (ACC may not regulate entities that are not "public service corporations" under article XV, § 2 of the Arizona Constitution.)

COMMENT

None.

1.5 Whether the Commission may streamline procedures for complying with statutes that regulate public service corporations.

ANALYSIS

The Rules provide that "electric service providers" may offer competitive generation and other services under less stringent rate procedures than for Affected Utilities that provide exclusive services in their existing territories. For example, rates for competitive generation service are deemed to be just and reasonable to the extent they are "market

determined." *See, e.g.,* R14-2-1612(A). Electric service providers file a tariff for each service that sets the maximum rate and terms and conditions that will apply. A.A.C. R14-2-1603(B).

Certain Affected Utilities maintain that the Rules should require an electric service provider for competitive generation to follow the established Commission procedures for rate filings and rate changes, including the extensive cost of service, financial and other information required by A.A.C. R14-2-103. These arguments maintain that the Constitution's fair value provisions mandate such procedures for all services, including competitively priced services. Section 1.1 summarizes the "pro" and "con" arguments on this position.

Some Affected Utilities maintain that legislative changes should be made to streamline procedures in at least the following areas: confidentiality of utility information on file with the Commission (*e.g.,* A.R.S. §§ 40-204 and 40-367), existing provisions regarding rate filings and tariffs (*e.g.,* A.R.S. §§ 40-248, 40-250, 40-361, 40-365, 40-367), standards relating to rate discrimination and preferences (*e.g.,* A.R.S. §§ 40-334, 40-374), requirements for Commission approval for financings and sale of assets (*e.g.,* A.R.S. §§ 40-285, 40-301, *et seq.*), annual reports, etc.

Certain participants also maintain that the Commission should modify existing rules, particularly to the affiliated interest rules (A.A.C. R14-2-801, *et seq.*), the resource planning rules (A.A.C. R14-2-701, *et seq.*), the depreciation and rate filing rules (A.A.C. R14-2-102 and 103), and the customer service rules for electric utilities (A.A.C. R14-2-201, *et seq.*).

Staff and consumers maintain that the Commission may exercise its ratemaking powers and streamline procedures to facilitate competitive pricing. This includes

streamlining procedures for utilities to comply with statutes governing public service corporations.

COMMENT

None.

PART 2

RATES AND RATE MAKING

2.1 Cost Allocation and Separation Issues.

ANALYSIS

In the interest of leveling the playing field between non-regulated utility activities and small businesses, some participants suggested that the rules should (1) preclude utilities from cross-subsidizing their unregulated activities with funds received from ratepayers under Commission authorized rates; (2) establish accounting procedures and standards to prevent cross-subsidization by requiring the utilities to assign direct and indirect costs to the unregulated activities; and (3) require the unregulated activities to pay fair market value for the use of utility personnel, services, and equipment and to pay royalties for any intangible benefit gained through affiliation with the utility.

Some participants maintain that the existence of cross-subsidization would suggest that regulated rates are too high. The Commission could address cross-subsidization through orders to show cause. The consensus of the group is that the Commission has sufficient power to deal with cross-subsidization through rate making orders. These participants did not see a need to change the Rules at this time.

COMMENT

None.

2.2 Confidentiality.

ANALYSIS

A participant suggests that A.R.S. § 38-431.02, *Notice of meetings*, be amended to provide that documents and other information related to a public body's discussions or consultations on negotiations, bids, or proposals for power and energy transactions, for the purchase or sale of fuel, or for the construction, ownership, or operation of generation or transmission facilities would not be public records, except that any contracts executed by the public body would be public records unless otherwise exempted by law.

The commenter also suggests amending A.R.S. § 40-204 to provide that information related to negotiations, bids, or proposals for power and energy transactions, for the purchase or sale of fuel, or for the construction, ownership, or operation of generation or transmission facilities would not be open to public inspection, unless ordered by the Commission for good cause shown.

The Working Group generally agreed that confidentiality procedures will have to be scrutinized at some time. The Working Group sharply disagreed over whether such a review should take place before or after competition commences.

COMMENT

The working group did not reach a consensus regarding what information should be confidential, although the group agreed that some confidentiality should be given to information that the Commission requires to be filed for regulatory purposes. In that regard, the Commission may provide by rule that commercially sensitive/proprietary information would be kept confidential unless, upon notice to the utility that would be affected by disclosure, extraordinary circumstances justify disclosure.

PART 3

STRANDED COST RECOVERY

3.1 The legal procedures (hearing and/or utility filings) necessary to determine Affected Utilities stranded costs; legal procedures necessary to vary the annual level of stranded cost recovery, change the total amount of stranded cost recovery or change the mechanism by which stranded costs are recovered.

ANALYSIS

If a utility claims stranded cost recovery in conjunction with a rate case, the issue would be subject to the same general filing and/or hearing requirements attending other claimed costs. Similarly, the legal procedures associated with changes to total amounts of stranded costs, annual levels of recovery or mechanisms by which stranded costs are recovered may be subject to the same limitations as recovery of other costs in a rate case. If the Commission establishes a stranded cost recovery mechanism, subsequent *changes* to the recovery balance or other details of the plan may be resolved in an abbreviated proceeding similar to fuel or other adjustment clause mechanisms. *See, e.g., Scates v. ACC,* 118 Ariz. 531, 578 P.2d 612, *appeal after remand,* 124 Ariz. 73, 601 P.2d 1357 (1978). *See also,* A.A.C. R 14-2-1607(L).

The elements of proof for stranded cost recovery under the Rules would be generally as follows:

A. Prove the value of jurisdictional asset or obligation which was:

I. prudent,

ii. acquired or entered into[7] prior to adoption of the Rules under the traditional regulation of Affected Utilities.

B. Prove that the market value of the asset or obligation

I. decreased,

ii. as a direct consequence of competition.

C. Prove that the utility mitigated the stranded cost by every reasonable measure related to the provision of regulated electric service which was

I. feasible, and

ii. cost-effective.

The burden of proof with respect to "prudence" may, in many cases, already have been addressed in prior Commission proceedings. Moreover, many of the costs that would fit within the stranded cost category for Affected Utilities have been (a) explicitly approved by the Commission, in some cases after expensive prudence reviews[8], (b) subject to review and not challenged by parties in previous rate cases, or (c) required by federal law or Commission order. Most Working Group participants agreed it would be unnecessary and unduly expensive and time-consuming to require a utility to "re-litigate" issues previously reviewed and/or resolved by the Commission. In addition to the presumption of prudence, the Commission may employ traditional principles of *res judicata*, *stare decisis*, and regulatory estoppel to prevent unwarranted re-litigation of previously decided matters. The Working Group's consensus is that the Commission may review prior

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[7] "Acquired" includes duties existing under law as of the date the Rules were adopted.

[8] One participant noted, as an example, that the prudence review of the planning and construction of the Palo Verde Nuclear Generating Station cost approximately $40 million. The result of that review was reflected in a rate settlement agreement approved by the Commission in Decision No. 57649 (December 6, 1991).

prudence determinations that were materially influenced by extraordinary circumstances, such as fraud or concealment.

The Commission's regulations provide that "all investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made." *See* A.A.C. R14-2-103(A)(3)(l).

Certain Affected Utilities believe the standard for utility "mitigation" measures in the Rules is unlawful, unreasonable, and overly vague. The utilities maintain that the Rules may be interpreted as allowing the Commission to require utilities to expend potentially unlimited amounts of private capital and other resources to pursue ill-defined business ventures outside ACC jurisdiction. Other participants comment that Affected Utilities should be required to use any revenues that are generated by or from the use of personnel, assets or the credit of the utility to mitigate stranded costs. These participants maintain that ratepayers should receive the benefit of revenues generated by the regulatory assets, personnel or credit of the utility.

The consensus of the Working Group is that the Commission may inquire as to the efforts that utilities have undertaken to reasonably mitigate stranded costs through cost reductions, efficiency improvements, market expansion and/or the development of new products and services related to the provision of traditional utility service. Staff suggests that the Commission may clarify the level of mitigation that is "reasonable" by borrowing mitigation concepts from another body of law, like commercial lease law or public condemnation law.

COMMENT

A. **The Commission may accept prior prudence determinations as binding for stranded cost proceedings absent extraordinary circumstances, such as fraud or concealment.**

B. **Although some participants believe no change to the stranded cost recovery provisions is required, most participants agree that the Commission should clarify the mitigation standard in the Rules to define "reasonable" mitigation efforts that relate to the provision of regulated utility service.**

3.2 The legal standards relevant to stranded cost recovery mechanisms.

ANALYSIS

A.A.C. R14-2-1607(J) provides that stranded costs may only be recovered from "customer purchases made in the competitive market." Participants disagreed whether this provision means that stranded costs can only be recovered in the price for competitive services. These arguments maintain that such a construction is inconsistent with A.A.C. R14-2-1607(H). They maintain that "stranded costs" are, by definition, are costs that can not be recovered in the competitive generation market. Participants disagree whether A.A.C. R14-2-1607(J) conflicts with A.A.C. R14-2-1607(H).

The Working Group's consensus, with the exception of Consumers (who maintain that the Rules are sufficient to determine stranded costs), is that the Commission should more precisely define stranded cost recovery mechanisms. The Rules should be amended to the extent the first sentence in R14-2-1607(J) may be read as limiting the classes of customers or services that the Commission may designate for stranded cost recovery.

COMMENT

See the discussion above.

3.3 The legal standards governing stranded cost recovery mechanisms (*e.g.*, non-by passable CTC or exit fee).

ANALYSIS

The Rules provide that customers who are not eligible to receive competitive generation services do not, by definition, create "stranded costs" and therefore will not pay a stranded cost fee. Further, the Rules do not allow stranded cost recovery from purchases in non-competitive or monopolistic markets. These restrictions may require stranded costs to be recovered through an exit fee or some other non-usage-sensitive mechanism. The preferred mechanism for stranded cost recovery is outside the scope of the Working Group's review. Depending upon the Commission's interpretation of R14-2-1607(J), certain mechanisms may require amendment or waiver of the Rules.

COMMENT

See the discussion in Section 3.2 above.

3.4 The ACC's powers to "true-up" any initial stranded cost estimates to eliminate possible over/under recovery of stranded cost amounts.

ANALYSIS

The consensus of the Working Group is that the ACC is not legally required to "true-up" any reasonable initial stranded cost estimates any more than it is legally required to true-up reasonable estimates of other costs used in setting rates. However, the Commission may "true-up" stranded costs.

COMMENT

None.

3.5 Legal standards for "securitizing" or using public funding mechanisms for the recovery of stranded costs.

ANALYSIS

The participants did not study the legal issues associated with "securitizing" or public funding mechanisms for the recovery of stranded costs.

COMMENT

None.

3.6 Whether Arizona recognizes a "regulatory compact" as a binding contract that affects the recovery of stranded costs or limits the ACC's power to amend regulations affecting public service corporations.

ANALYSIS

This issue engendered considerable disagreement among the Working Group participants. The arguments regarding a "regulatory compact" are discussed in Part 1.1.

COMMENT

None.

3.7 Whether the ACC has awarded stranded cost recovery for telecommunications providers or for gas LDC's in Arizona.

ANALYSIS

The Commission traditionally prescribes rates to *avoid* stranded costs for any public service corporation, through rates charged to the utility's remaining customers (telephone) or recoupment of lost sales margins in rates (gas) or by a combination of both. With respect to gas LDCs, FERC Order No. 888-A, issued March 3, 1997 (starting at page 488, *et seq.*), and the Commission's 1990 Decision No. 50575 contain stranded cost recovery principles. FERC did not require a showing of prudence or mitigation and the ACC's decision did not interfere with this pattern.

COMMENT

None.

PART 4

ACC POWERS/PROCEDURES

4.1 Stranded Cost Proceedings.

See the analysis in Part 3.1.

The nature of a stranded cost proceeding will depend, in part, on (1) the methodology for determining the amount of recoverable stranded costs; (2) who will pay the stranded cost; and (3) the recovery mechanism (i.e., a surcharge on all ratepayers to be paid into a common fund, a meter charge, a rate surcharge, etc.).

Also, the Working Group's consensus is the Commission may implement automatic adjustment clauses in appropriate contexts to allow stranded costs to be adjusted based upon changed circumstances. Adjustment clauses have been approved in other contexts in the past and would obviate the need for utilities to make supplemental applications to the Commission to recoup their stranded costs. *See, e.g., Scates v. ACC*, 118 Ariz. 531, 578 P.2d 612, *appeal after remand*, 124 Ariz. 73, 601 P.2d 1357 (App. 1978).

COMMENT

None. See comment to Part 3.1.

4.2 Affiliated Interest Rules.

The Commission's rules relating to public utility holding companies and "affiliated interests" (*See* A.A.C. R14-2-801 through R14-2-806), apply to Class A investor-owned utilities under the jurisdiction of the Commission. A.A.C. R14-2-802(A). Although most utilities entering the competitive market will likely meet the definition of a "Class A investor-

owned" utility, some entities seeking to enter the competitive market in Arizona may not be Class A utilities. The Commission may revise the Rules to address the issues relating to the affiliated interests of companies not falling within the scope of the Commission's existing affiliated interest rules. The Commission's regulatory powers may be limited for entities that are not public service corporations.

COMMENT

None.

4.3 Non-PSC's.

The Commission may regulate only a "public service corporation" ("PSC") as defined in article 15, § 2 of the Arizona Constitution. The same provision expressly excludes municipal entities from the Commission's jurisdiction. Some participants maintain that intergovernmental agreements may be used to coordinate, but not regulate, competitive pricing for non-public service corporations. Certain participants maintain that the agreements may not allow the Commission to assert regulatory powers over such entities.

Alternatively, other participants maintain that existing rules, statutes and the Constitution must be amended to bring non-public service corporations, namely municipal corporations, under the jurisdiction of the Commission, or some other independent agency.

For-profit subsidiaries of non-PSCs may be subject to the Commission's jurisdiction. Some question exists whether the Commission may, in such instances, use its affiliated interest rules to regulate the for-profit affiliate's transactions with the non-PSC. The Commission regulates affiliated interest transactions of PSCs in A.A.C. R14-2-801 through -806. The Commission's power to regulate affiliate transactions of a non-public service

corporation may be found in article 15, § 3 of the Arizona Constitution, which provides that the Commission may require a public service corporation to report information about, and obtain permission for transactions with, its parent, subsidiary, and other affiliated corporations. *See Arizona Corp. Comm'n v. State*, 171 Ariz. 286, 830 P.2d 807 (1992).

COMMENT

None.

4.3.1 Antitrust Principles.

Non-PSCs and PSCs will be subject to the traditional oversight of the Federal Trade Commission ("FTC") and other federal and state agencies in the area of anti-competitive actions. The FTC is a law enforcement agency with statutory authority over a variety of industries, including the electric power industry. The FTC enforces the FTC Act (15 U.S.C. §§ 41-58) and the Clayton Act (15 U.S.C. §§ 12-27) which prohibit, among other things, "unfair methods of competition," "unfair or deceptive acts or practices," and mergers or acquisitions that may "substantially lessen competition or tend to create a monopoly."

In some instances the federal antitrust law's definition of "person" or "parties" embrace cities and municipalities, so that they will be subject to antitrust enforcement actions. 17 McQuillin *Municipal Corporations* (3rd Ed. 1990) 534, citing *Lafayette v. Louisiana Power & Light Co.*, 431 U.S. 963, 98 S. Ct. 1123. Generally, whether actions of a municipality violate the antitrust laws is a question of the extent to which the actions taken are authorized or directed by the state pursuant to state policy. *Id.* Thus, the Commission and the Courts may have jurisdiction over anti-competitive behavior affecting

PSCs, depending upon the activities undertaken and the nature of the entity which is the perpetrator of the anti-competitive behavior.

COMMENT

None.

4.3.2 In-State Reciprocity.

The Rules address in-state reciprocity between non-PSCs and PSCs for purposes of competition. A.A.C. § 14-2-1611. Further, A.R.S. §§ 11-951 through 954 authorize the Commission and municipal subdivisions of this State to enter into intergovernmental agreements ("IGAs") to jointly exercise any powers common to the contracting powers. A.R.S. § 11-952(A). Some interested parties maintain that such IGAs could be used to facilitate competition between PSCs and non-PSCs by controlling some of the practices of the non-PSCs through contractual rather than regulatory means.

Some participants maintain that IGAs may not be used to limit the exercise of an entity's regulatory power. Some participants believe that IGAs could permit municipalities, or other "public agencies" as defined in A.R.S. § 11-951 to enter into agreements with the Commission so that the separate governmental agencies would agree to exercise their individual powers in a parallel and consistent manner. However, none of the participants addressed whether an Affected Utility, electric service provider, customer or other person may enforce such an agreement. The proposed form of such an IGA was not available for comment.

A.A.C. R14-2-1611(E) provides as follows:

> If an electric utility making a filing under R14-2-1611(D) is an Arizona political subdivision or municipal corporation, then the existing service territory of such electric utility shall be deemed

> open to competition if the political subdivision or municipality has entered into an intergovernmental agreement with the Commission that establishes nondiscriminatory terms and conditions for Distribution Services and other Unbundled Services, provides a procedure for complaints arising therefrom, and provides for reciprocity with Affected Utilities.

An IGA would generally address the respective operations of the Commission and the political subdivision or municipality, so that their efforts to establish competition in electric generation are coordinated. An IGA would be based on the general authority of A.R.S. § 11-952, and deal with the joint exercise of the parties or their respective authorities to regulate electric operations within their respective jurisdictions. Specifically, A.R.S. § 11-952(A) provides:

> If authorized by their legislative or other governing bodies, two or more public agencies by direct contract or agreement may contract for services or jointly exercise any powers common the contracting parties and may enter into agreements with one another for joint or cooperative action . . . .

Staff maintains that an IGA between two governmental entities to agree to jointly exercise their respective authorities is authorized by A.R.S. §§ 11-951 through 11-954. An IGA will not be used to limit the exercise of an entity's regulatory power in the public interest. The IGA may "confirm that separate governmental entities will exercise their powers in a parallel and consistent manner." Some participants cite, as an example, the IGA entered into by the Commission with the Federal Power Commission that was approved by the Arizona Supreme Court in *Garvey v. Trew*, 64 Ariz. 342, 170 P.2d 845 (1946).

Staff maintains that the general provisions of an IGA "will consist of the powers of the respective state political subdivisions and will explain how the political

subdivisions will coordinate the exercise of their respective political powers." One party agrees with the general scope of the agreement as described by the Commission. Another believes that the IGA should address whether there is "equal protection of the law for PSCs and non-PSCs."

Another participant points out that an IGA will not create an independent regulatory entity with jurisdiction to assure fair and equitable treatment of PSC's and consumers' purchases in municipal corporations' territories.

Other participants maintain that the IGA statutes only permit public agencies to exercise jointly held powers. Therefore, so the argument goes, the Commission may only enter into IGAs with entities which have the same type of regulatory powers as the Commission. This group of interested parties take the position that non-PSCs do not have "joint power and authority" with the Commission; thus, no IGAs may be entered into with such governmental non-PSCs. There appears to be no dispositive case law in Arizona on the issue, although *Garvey v. Trew*, 64 Ariz. 342, 170 P.2d 845 (1946) and Op. Atty. Gen I84-135 shed some limited light on both sides of the issue. These participants also maintain that the IGA may not be used to give the Commission power over municipal corporations since it is specifically denied such power under article XV, section 2 of the Arizona Constitution.

Some participants claim that the Commission has used IGAs in the past when it agreed with the public utility commissions on some Indian reservations that the Commission should set the rates for telephone service on the reservation, even though the utility commission on the reservation had power to do so. In short, as with many of the issues facing the Commission, there is no bright-line answer to the issue of how to deal

with the in-state reciprocity issues, but the IGAs may be a viable mechanism to facilitate reciprocity, at least in part.

COMMENT

None.

4.4 Resource Planning Issues.

The Commission provides for resource planning and oversight. See A.C.C. R14-2-701, *et seq.* The need for full, formal generation resource planning will likely decrease once competition is implemented and fully underway. As with any competitive market, supply and demand factors may provide optimum market efficiency, and an equilibrium will be reached at some point in the future.

Resource planning ensures that the public is not left without adequate supply, even for a short period of time. Historically, construction of generation and distribution facilities required far-reaching resource planning. Advances in technology has progressively reduced lead-time, thereby permitting quicker response to changes or shifts in demand. Competitors want an adequate supply, as well as facilities, to meet the anticipated demand. Competitors want their resource planning information to be confidential.

Resource planning is monitored by federal (such as FERC) and state (such as the Commission) authorities. As competition commences, the Commission may consider additional rulemaking to deal with confidentiality concerns or to protect Arizona's public from periodic shortages. Oversight may be provided by an independent system operator as well as consumer organizations.

COMMENT

None.

PART 5

NON-PSC'S

5.1 Municipal Corporations, Non-PSCs with Federal Interests.

ANALYSIS

Within Arizona, many different kinds of "non-PSCs" operate as electric utilities. These include municipal utilities (owned/operated by a city or town), electrical districts, irrigation districts, agricultural improvement districts and power districts. General governing authority for the municipalities and the districts is found in Article 13 of the Arizona Constitution, A.R.S. Title 48 (districts) and A.R.S. Title 9 (municipalities). Tribal utilities are non-PSCs that are not generally regarded as municipal corporations. Some non-PSCs provide electric service within a defined and exclusive service territory; others provide electric service within the service territories of existing PSCs and other non-PSCs.

A variety of federal interests affect PSCs and non-PSCs. For example, cooperatives' (PSCs) and municipal corporations' (non-PSCs) contract for federal preference power; the federal government has a considerable interest in Tribal activities; federal proprietary interests exist for facilities used by certain districts under federal reclamation law; and the federal government guarantees, funds or otherwise authorizes financing obligations of certain PSCs, cooperatives and municipal corporations.

Two parties commented that federal interests might complicate Commission jurisdictional issues and should be researched. The ACC Staff believes a federal interest in a non-PSC does not preclude the non-PSC's ability to offer a competitive generation supply.

COMMENT

None.

5.2 Relations Between Non-PSC's and PSC's.

ANALYSIS

Some participants maintain that the new Rules allow both non-PSCs and PSCs to provide competitive generation (but not distribution) service to customers within each other's service territories, subject to certain conditions. One commenter believes the Rules do not allow such competition. In the context of non-PSC, certain statutes were identified by parties as potentially restricting the authority of PSCs and non-PSCs to compete with each other. No participant identified any Arizona law that would preclude non-PSCs from providing access to their distribution systems and service area customers. (One commenter cited A.R.S. § 9-516 as preventing the Commission from granting CC&Ns over a municipality's service area under certain circumstances.) Another participant maintained that the Commission can authorize PSCs to provide competitive generation to customers in non-PSC territories. Four parties pointed out that Arizona law does not require non-PSCs to provide access to their distribution facilities.

Three parties raised issues relating to the impact of Title 9 on the ability of the Commission to authorize competition among PSCs and non-PSCs. One of these parties asserts that A.R.S. § 9-516 prohibits the Commission from authorizing a PSC to compete with "municipal corporations." However, by its express terms, A.R.S. § 9-516 is applicable only to cities and towns, not the full panoply of municipal corporations or other non-PSCs. A second commenter believes Title 9 gives cities and towns the exclusive right to provide electricity within their boundaries. Several commenting parties believe A.R.S. § 9-516

imposes a condemnation requirement on cities and towns in order for them to compete with PSCs. Commission Staff believes this statute does not require such condemnation to offer "competitive generation supply."

One party identified A.R.S. § 48-1515 and "similar statutes" as possibly having an anti-competitive effect on certain special taxing districts (non-PSCs) if improperly construed as restricting expansion of an existing district, rather than limiting creation of new districts. A.R.S. § 48-1751 also may limit an electric district to selling only surplus energy outside its service area.

Title 40 (relating to PSCs generally), Title 10 (relating to PSC cooperatives) and franchising statutes were raised by various parties as limitations on the general ability of PSCs to compete with each other, as well as with non-PSCs. The impact of these statutes is more fully addressed in Section 12 of this report.

COMMENT

None.

PART 6

FERC ISSUES

6.1 ACC's Exclusive Jurisdiction.

6.1.1 In view of FERC Orders 888, 888-A, 889, 889-A, FERC decisions, case law, the U.S. Constitution and the various Federal acts, what exclusive (or concurrent) jurisdiction may the ACC exercise in the context of competitive electric energy services, whether in wholesale and/or retail transactions considering the interstate nature of the transmission lines?

ANALYSIS

FERC's jurisdiction is limited by its enabling law and only includes public utilities. It has indirect jurisdiction over transmitting utilities through complaints which may be brought pursuant to §211 of the Federal Power Act. It has no jurisdiction over municipals, PMA's or RUS borrowers who were brought into open access only through reciprocity concepts.

The Energy Policy Act of 1992 forbids FERC from ordering "retail wheeling" or direct access to power supply by retail customers, leaving such orders to the states' discretion. *See* 16 U.S.C. § 824k(h). FERC has affirmed that it is a state decision to permit or require retail wheeling and has left it to state regulatory authorities to deal with any stranded costs or stranded benefits occasioned by retail wheeling on facilities or services used in local distribution. (62 FR 12274, 12409). Further, in 888-A FERC clarified that "states have the authority to determine the retail marketing areas of the electric utilities within their respective jurisdictions" along with the authority to determine the end user services those utilities provide. (62 FR 12274, 12279).

Additionally, exclusive jurisdiction has been reserved to the states (and therefore the ACC) over the following matters: the provision and pricing of retail sales of electric energy (as opposed to unbundled transmission) and the siting of transmission and distribution lines. While states retain jurisdiction over local distribution lines, FERC claims to be the final arbiter of their definition (see discussion in §8.4 below).

FERC and state commissions each have jurisdiction over separate aspects of a retail wheeling transaction: FERC has jurisdiction over rates, terms and conditions of unbundled retail transmission in interstate commerce by public utilities while state

commissions have jurisdiction over local distribution facilities, the rates for services using those facilities to make a retail sale, and the service of delivering electric energy to end users (62 FR 12274, 12279,12372) even if there are no identifiable local distribution facilities. Thus, in all cases, states have the means to ensure that customers do not avoid their responsibility for stranded costs or benefits.

Nevertheless, FERC has further indicated in 888-A (and the Federal Power Act supports such interpretation) that FERC and a state have concurrent jurisdiction to order stranded cost recovery when retail customers obtain retail wheeling in interstate commerce from public utilities in order to reach a different generation supplier.

If the state regulatory authority is not authorized to order stranded cost recovery for direct retail access, FERC may permit a utility to seek a customer-specific surcharge to be added to an unbundled transmission rate. (Order 888, FERC Stats. & Regs. at 31,824-26; and 18 C.F.R. 35.26). FERC will not interfere if the state agency has such authority and has, in fact, addressed such costs, regardless of whether it has allowed full, partial or no recovery.

FERC will be the primary forum for recovery of stranded costs caused by "retail-turned-wholesale" customers, such as the creation of a municipal utility system to purchase wholesale power on behalf of retail customers who were formerly bundled customers of the historical utility power supplier (e.g., by annexing retail customers of another service territory). 18 C.F.R. 35.26. FERC will not intercede in every instance of municipalization, but only in cases where the new wholesale entity uses FERC-mandated transmission access to obtain a new power supply on behalf of retail customers that were formerly supplied power by the utility.

Additionally, FERC in 888-A deems transmission line siting as a state-exclusive function and will not interfere in a state's decision and jurisdiction over such issues. FERC will not encroach on the following areas: state authority over local service issues including reliability of local service; administration of integrated-resource planning and utility buy-side and demand-side decisions, including DSM; authority over utility generation and resource portfolios; generation siting; and authority to impose non-by passable distribution or retail stranded cost charges along with charges for social or environmental programs. (Order 888 and 18 C.F.R. 35.27)

COMMENT

None.

6.2 FERC's Exclusive Jurisdiction.

6.2.1 In view of Rules 888, 888-A, 889, 889-A FERC decisions, case law, the U.S. Constitution and the various Federal acts, what exclusive (or concurrent) jurisdiction may FERC exercise in the context of competitive electric energy services, whether in wholesale and/or retail transactions within Arizona considering the interstate nature of the transmission lines?

ANALYSIS

FERC appears to have staked out exclusive jurisdiction in unbundled state retail transactions and requires utilities to implement any state retail access experiments under the Order 888 pro forma wholesale tariffs. Where specific provisions are inapplicable for service to unbundled retail customers, e.g, filing of individual service agreements and requirements for customer deposits, public utilities must seek a waiver of those tariff provisions. (New England Power Company, et al., 75 F.E.R.C. P61,008 (1996).

FERC rejected retail transmission tariffs filed by Portland General Electric ("PGE") and Washington Water Power ("WPP") to implement retail competition experiments in Washington, Idaho and Oregon. WPP's tariffs had been approved by the Washington and Idaho state regulatory commissions and PGE's were submitted to Oregon's. However, FERC noted that no state authority had requested FERC approval of any of the separate retail tariffs or variations from the 888 pro forma tariff (to accommodate any special needs of a state retail access program) and so rejected the tariffs without prejudice. FERC left the door open to the state commissions for such requests, instructing that the separate retail tariff or variations from the pro forma tariff sought should still be consistent with FERC's open access and comparability principles.

WPP argued that the retail experiments did not constitute unbundling within the meaning of Order 888, because WPP had simply removed the energy component from its current bundled retail tariff and included non production costs for transmission, distribution and general expenses. FERC disagreed and found instead that the tariff included the "separation of products that we have determined creates unbundled retail transmission of power that is within our exclusive jurisdiction." Citing Order 888, FERC noted. "When a retail transaction is broken into two products that are sold separately,...we believe the jurisdictional lines change.....When a bundled retail sale is unbundled and becomes separate transmission and power sales transactions, the resulting transmission transaction falls within the Federal sphere of influence." *The Washington Water Power Company*, Docket No. ER97-960-000 (Issued Feb. 25, 1997); 78 F.E.R.C. P61,178; 1997 FERC LEXIS 306.

In its proposed retail tariff, PGE had used the pro forma tariff adding stranded cost recovery charges, service agreements and local distribution provisions to it. Nevertheless, it was rejected since the Oregon Commission had not made a specific request that PGE be allowed such variance from the open access compliance tariff.

FERC uses *PGE* to explain that absent FERC approval of a specific state commission request, the open access tariff must be used for all unbundled retail transmission, including pilot or experimental programs. In such programs, state commissions may "determine the rates jurisdictional to them by establishing a bundled delivery price (including stranded costs) and then subtracting the utility's open access tariff rates for transmission and ancillary services." *Portland General Electric Company*, Docket No. ER97-1112-000 (Issued March 3, 1997); 78 F.E.R.C. P61,219; 1997 FERC LEXIS 579.

FERC casts "buy-sell" transactions in a similar jurisdictional model. Where "an end user arranges for the purchase of generation from a third party supplier and a public utility transmits that energy in interstate commerce and resells it as part of a 'nominal' bundled retail sale to the end user," FERC says the retail sale is actually the functional equivalent of two unbundled sales (one transmission, and the other the sale of power) and that FERC has exclusive jurisdiction over the transmission component. FERC has acknowledged that in such a transaction there would also be an element of local distribution which would be subject to local jurisdiction. (Fed. Reg. Vol. 61, No. 92, p. 21,620).

FERC will also assert exclusive jurisdiction in a holding company or other multi-state situation where a state regulatory agency decision, e.g. on stranded cost recovery, could

result in an inappropriate shift of disallowed costs to affiliated operating companies in other states. (62 FR 12,274, P12,409)

In short, FERC claims that "matters of interstate commerce, including the vast integrated electric system that supply the nation's industrial, commercial and residential customers are the responsibility of the Federal government." (Statement by Elizabeth A. Moler, Chair, FERC, before the Energy and Natural Resources Committee, United States Senate, March 30, 1997.) As made clear by FERC Orders 888 and 888-A, 889 and 889-A, this includes all transmission transactions, coordination services and agreements, independent system operators, regional power pools, and power exchanges.

COMMENT

None.

6.3 FERC Approvals.

6.3.1 What actions taken in Arizona or involving Arizona public utilities to move to retail competition in the electric industry (including any formation of an ISO) will require FERC approvals and what criteria will FERC apply?

ANALYSIS

The majority of the current rules will not require FERC approval. A commenter indicated that FERC cooperation would only be needed in delineation of transmission and distribution lines and perhaps for stranded costs imposition. However, FERC's very recent decisions in *PGE* and *WPP*, as discussed in §8.2.1 above, provide that the ACC and public utilities must, in conformance with those decisions, detail and seek FERC pre-approval of all unbundled retail tariffs that deviate in any way from the Order 888 open access compliance tariffs filed, including those which add stranded cost recovery charges,

distribution charges, service agreements, etc. Further, the ACC and public utilities must propose and seek approval of the delineation of transmission and distribution lines as discussed below.

Additionally, any proposal for ISO creation (whether state or regional), relevant ISO procedures (including transfer of operational control of FERC jurisdictional facilities), transmission pricing, access fees, tariffs, expansion, or enforcement will also require FERC pre-approval. *Pacific Gas and Electric Company, et al.,* Docket Nos. EC96-19-000 and ER96-1663-000 (Issued November 26, 1996).

In Orders 888 and 888-A, FERC has issued specific guidance for formation of an ISO which apply *only if the ISO is also a control area operator.* These FERC principles include:

1. The ISO's governance should be structured in a fair and non-discriminatory manner.

2. An ISO and its employees should have no financial interest in the economic performance of any power market participant. An ISO should adopt and enforce strict conflict of interest standards.

3. An ISO should provide open access to the transmission system and all services under its control at non-pancaked rates pursuant to a single, unbundled, grid-wide tariff that applies to all eligible users in a non-discriminatory manner.

4. An ISO should have the primary responsibility in ensuring short-term reliability of grid operations. Its role in this responsibility should be well-defined and comply with applicable standards set by NERC and the regional reliability council.

5. An ISO should have control over the operation of interconnected transmission facilities within its region.

6. An ISO should identify constraints on the system and be able to take operational actions to relieve those constraints within the trading rules

established by the governing body. These rules should promote efficient trading.

7. The ISO should have appropriate incentives for efficient management and administration and should procure that services needed for such management and administration in an open competitive market.

8. An ISO's transmission and ancillary services pricing policies should promote the efficient use of and investment in generation, transmission, and consumption. An ISO or an RTG of which the ISO is a member should conduct such studies as may be necessary to identify operational problems or appropriate expansions.

9. An ISO should make transmission system information publicly available on a timely basis via an electronic information network consistent with the Commission's requirements.

10. An ISO should develop mechanisms to coordinate with neighboring control areas.

11. An ISO should establish an ADR process to resolve disputes in the first instance.

FERC has not issued specific guidance for non-control area operator ISO's. Presumably, their hallmark would be independence with respect to governance and financial interests to ensure that the ISO is independent and would not favor any class of transmission users.[9]

FERC does not require ISO's. In Rule 888-A, FERC said it does not believe it "appropriate to require public utilities or power pool to establish ISO's, preferring instead to allow time for functional unbundling to remedy undue discrimination."

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[9] In an order on the proposed PJM ISO FERC stated: "The principle of independence is the bedrock upon which the ISO must be built if stakeholders are to have confidence that it will function in a manner consistent with this Commission's pro-competitive goals." Order 888-A, FN219, citing *Atlantic City Electric Company, et al.*, 77 F.E.R.C. P61,148 (1996).

COMMENT

None.

6.4 Jurisdictional Separation of Distribution-Transmission Lines.

6.4.1 The FERC has issued criteria and decisions to assist in determining what is a distribution line and what is a transmission line so as to assert appropriate FERC jurisdiction over transmission lines. What are the criteria, how should they be applied, and what FERC actions are required to confirm that determination?

The answer is unclear. FERC recognized in Order No. 888 that once retail service was unbundled, there would be a need to draw a distinction between facilities used for transmission and those used for local distribution[10] so as to leave states with authority over the service of delivering electric energy to end users. Toward that end, FERC has adopted a case-by-case methodology in delineating between "transmission" and "distribution" facilities regulated by FERC and those left to the States. FERC has not established a "bright line" test. Guidance will develop as FERC issues decisions.

Order 888 requires public utilities to consult with state regulatory agencies before filing any transmission distribution classifications and/or cost allocations (for such facilities to be included in rates) with FERC. If those classifications and/or cost allocations have state regulatory support, if the state regulators have specifically evaluated the seven indicators and any other relevant facts, and if the state's recommendations are consistent with the principles of Order 888, the Commission will defer to them. FERC has said it hopes to use this mechanism to take advantage of state regulatory authorities' knowledge and expertise concerning the facilities of the utilities they regulate. (Order 888 Introduction/Summary, Fed. Reg. Vol. 61, No. 92, P21541).

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[10] *Washington Water Power Company,* FN8.

In Order 888, FERC provided seven local distribution indicators for states to use in the evaluation process:

1. Local distribution facilities are normally in close proximity to retail customers.

2. Local distribution facilities are primarily radial in character.

3. Power flows into local distribution systems; it rarely, if ever, flows out.

4. When power enters a local distribution system, it is not reconsigned or transported on to some other market.

5. Power entering a local distribution system is consumed in a comparatively restricted geographical area.

6. Meters are based at the transmission/local distribution interface to measure flows into the local distribution system.

7. Local distribution systems will be reduced voltage.

FERC added that it would consider jurisdictional recommendations by states that take into account other technical factors that the state believes are appropriate in light of historical uses of particular facilities. Order 888-A reaffirmed that approach and the tests to distinguish between state and Federal jurisdiction (Fed. Reg. Vol. 62, No. 50, P12,372). The order also recognized that the test does not resolve all possible issues, but is designed for flexibility to include unique local characteristics and usage. (Rule 888-A, 62 Fed. Reg. 12,274, P12279).

FERC approved such a specific state recommendation in *Pacific Gas and Electric Co., et al.,* Docket No. EL96-48-000 (Issued October 30, 1996); 77 F.E.R.C. P61,077; 1996 FERC LEXIS 1975. *Pacific Gas* accepted a delineation of certain lines of three major California utilities as part of that state's electric industry restructuring. The

utilities reserved the ability to change the initial delineation as uses of the facilities change, since it may have multiple uses.

The "existing uses" method accommodated state regulatory settlements, the peculiarities of each system, the historic facts relating to the unique design of each utility's integrated transmission system. Consequently, different results were reached for each utility's system.

The delineation between transmission and distribution is important, not just for determining state or Federal jurisdiction, but also, to ensure each company's appropriate recovery of stranded costs from retail customers, for allocation of administrative and general and operation and maintenance expenses, as well as for development of any access charges (and associated cost support) for use of a utility's ISO grid facilities.

COMMENT

None.

PART 7

FEDERAL ISSUES

7.1 Two-County Rule.

7.1.1 What is it, how does it affect a utility in a competitive environment, and what resolution is possible?

ANALYSIS

While one commenter noted "there is no reason to segregate this particular element for separate consideration and treatment," others who have raised it believe it important to discuss because it may, like other Federal issues presented herein, be an impediment

to a utility's participation in the competitive environment contemplated by the Rules. Certainly, FERC, in Rule 888 recognized the threat of open access requirements to continued use of two-county financing and provided some solutions.

Two-County financing or "local furnishing" bonds provide financing in the form of tax-exempt bonds for "facilities for the local furnishing of electric energy or gas" if such facilities are part of a system "providing service to the general populous not exceeding the larger of two contiguous counties or one city and a contiguous county." Internal Revenue Code §142(a)(8). The Internal Revenue Service has added two additional conditions for such tax exempt bond status: (I) generally, the total amount of electricity generated by facilities connected directly to the local grid together with the amount generated by that utility's remote generating facilities, cannot exceed in any year the total amount of electricity consumed in the local service area; or (ii) actual metered flows of electricity at each interconnection point are at all times inbound to the local system. A utility with such financing that ceases to meet these conditions loses the favorable interest rate on such financing. The utility's bondholders lose the tax-exempt status of the bonds which have been sold to them and must be made whole by the utility according to the terms of the bonds.

Competitive generation may impact this financing. FERC's solution in Order 888 was to exempt a utility from reciprocal service if providing such service would jeopardize the tax-exempt status of the bonds. Order 888, mimeo at 376-377. The IRS also amended its rules to accommodate a mandatory FERC wheeling order issued under §211 of the Federal Power Act and retain the tax exempt status. I.R.C. §142(f)(2).

The ACC rules do not disturb two county financing as long as no changes are made which specify an obligation for such a financed entity to serve outside of the two-county area. Parties have argued earlier in this Docket that this could happen if the utility became obligated to serve a customer outside of its existing two-county service territory under the proposed retail wheeling provisions. The solution is for the rules to clearly limit the obligation to serve outside of a local furnishing utility's existing service area. Another solution is for the Commission to include in its definition of recoverable stranded costs, any increase in financing costs or the stranded cost of any assets because of local furnishing requirements.

In 888 A, FERC clarified that all costs associated with a loss of tax-exempt status, including the costs of defeasing, redeeming and refinancing tax-exempt bonds are properly considered costs of providing transmission services. FERC explained that "a customer that takes service, understanding that such service will result in the loss of tax-exempt status, shall be responsible for such costs to the extent consistent with Commission policy and a transmission provider may include in its tariff a provision permitting it to seek recovery of such costs...If the transmission customer is not willing to pay the costs associated with the transmission provider's loss of tax-exempt status, the transmission provider will not be required to provide the requested service." (Order 888-A; 78 F.E.R.C. P61,220; 1997 FERC LEXIS 463).

An alternative solution is to provide local furnishing utilities with a mechanism to modify the schedules described in A.A.C. R14-2-1604(A-D) until such time as a Federal solution can be found. FERC has told Congress it needs to find a solution. (Statement by

Elizabeth A. Moler, Chair, FERC, before the Energy and Natural Resources Committee, United States Senate, March 30, 1997.)

Some commenters state that the Rules should not be amended to encourage use of two-county financing for the benefit of some, but not all, utilities. These participants suggest that consumers should not pay costs of financing that have been increased due to a corporation's decision to extend its service territory.

COMMENT

None. See the above discussion.

7.2 Federal Rural Electrification Act (and resulting mortgages, interlocking all-requirements contracts, and related issues).

7.2.1 What is it, how does it affect a cooperative in a competitive environment, and what resolution is possible?

The U.S. Congress in 1936 through the Rural Electrification Act (RE Act), 7 U.S.C. 901 *et seq.*, and again in 1993, through the Rural Electrification Loan Restructuring Act, determined that the national interest would be served by support of rural electric service through low cost loans to rural electric cooperatives to enable them to provide affordable and dependable electric service in sparsely populated areas with loads, which although vital to a rural economy, cost more to serve. Delivering energy costs more in rural areas and the capital investment on a per customer basis is substantially higher. Including areas with more dense population (the small towns) in such systems helps to spread those costs and keeps rates lower.

The Rural Utilities Service (RUS), an agency of the U.S. Department of Agriculture, makes or guarantees and administers RE Act loans and regulates certain cooperative activities. Further, most cooperatives are member owned non-profit entities

which use a tax exemption, embodied in §501(c)(12) of the Internal Revenue Code (26 U.S.C. §501(c)(12)) to further reduce the higher than normal rural costs.

RUS requires as a condition to making or guaranteeing any loans to power supply borrowers (G&T cooperatives), that the borrower enter into RUS all-requirements wholesale power contracts with its distribution members and assign and pledge such contracts as security for the repayment of those loans or any other loans which RUS has permitted to be secured pursuant to the RUS mortgage. The RUS wholesale power contract requires that the rates charged for power and energy produce sufficient revenues to enable the power supply borrower (the G&T) to timely pay the principal and interest on all its debt. RUS relies on the wholesale power contracts and its oversight of cooperatives to certify to the Federal government that "the security for the loan is reasonably adequate and the loan will be repaid within the time agreed." 7 C.F.R. §1717.301.

Most of these loans are amortized over a 35 year period (currently a period that extends about 20 years beyond the target date for full retail choice) and most RUS financed systems obtain a new loan or loan guarantee every three or four years in order to maintain and improve service quality and reliability. In Arizona, five of the affected utility distribution cooperatives and AEPCO are bound together by an all-requirements wholesale power contract that does not expire until December 31, 2020. A sixth affected utility, Navopache Electric Cooperative, is bound until December 31, 2025 by a similar contract to a New Mexico G&T.

RUS finances, at least in part, eight electric systems in Arizona; six are affected utilities and two are tribal utility authorities. RUS financed systems make sales to about 6.6 percent of all electric consumers in Arizona. Federal taxpayers through RUS

hold more than $382 million in outstanding debt to electric utilities in Arizona. The Federal agency has said that a sudden loss of load from these Arizona systems would not only have disastrous effects on the ability of the cooperatives to serve residential consumers in sparsely populated or less profitable areas, it would also compromise RUS efforts to improve the quality of life in rural Arizona. Letter by Blaine D. Stockton, Jr., Assistant Administrator, RUS, September 12, 1996 to the ACC.

The competitive generation supply and resulting termination of exclusive Certificates of Convenience and Necessity inherent to the ACC rules creates a tension with the federal regulatory scheme outlined above and intrudes on the all-requirements contract, the security for the Federal debt, and the mortgages held on that debt. The mandated use of RUS financed delivery facilities by non-RE Act beneficiaries is also problematic. Such use may cause the cooperatives: (I) to lose their tax-exempt status since revenues flowing to the cooperatives from non-members may well exceed 15 percent of a cooperative's total revenues; (ii) to have problems with either current or future financing under the RE Act; and (iii) due to the retail rate cap under the Order, create tension between the distribution cooperative and its G&T, which is obligated to increase rates to the distribution cooperative as load is lost to competition.

RUS has recommended establishment of a customer specific pricing mechanism: (I) that considers the distribution-G&T structure of non-profits; (ii) that imputes a rate of return on rate base for sales to nonmembers; (iii) that includes in rates charged to non-members any tax liability imposed by ACC ordered retail choice[11]; and, (iv) that

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[11] This pricing mechanism was specifically adopted by FERC in Order 888 for non-jurisdictional transmitting utilities providing open access pursuant to reciprocity or §211 requests. As well, FERC exempted such utilities from the reciprocity

does not divert the RUS subsidy away from its intended beneficiaries in Arizona. *Stockton Letter*, p.9.

RUS also asks the Commission to consider through the process the impact of partial stranded cost recovery on the ability of the utility to repay RUS loan and the results of that on RUS ability to continue low cost financing in Arizona in the future. *Stockton Letter*, p.10.

No solution is yet apparent to the Rule's conflict with the RUS system of interlocking all-requirements wholesale power contracts/mortgage security other than the schedule modification offered by the Rules themselves or a total exemption from the Rules.

One commenter raised these issues and noted that while the G&T could probably sell and has sold excess power (at wholesale) to other entities, the "anti-competitive feature is at the distribution level" because of the all-requirements contracts. The commenter adds that G&T financing has been based on those contracts. Another comment noted only that these are "level playing field issues related to competition among PSC's and non-PSC's". The cooperatives, however, are subject to ACC jurisdiction even though they are not investor owned utilities.

Some participants maintain that solutions to the cooperatives' problems include (1) not selling power to non-members or (2) making membership in the cooperative a condition of service; or (3) match the FERC mechanism that is used to handle this financing tool. These participants are concerned that REA financing does not benefit

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requirement if it would threaten their tax exempt status. Order 888, FN499. RUS has proposed the other pricing mechanisms to FERC; no Orders or decisions have yet been made by FERC as to that proposal. Some cooperatives have open access tariffs which incorporate these pricing principles, but they have not been tested at FERC.

competitors on an equal basis. They maintain that the Rules should not encourage this type of financing to the detriment of other competitors.

COMMENT

None. See the above discussion.

7.3 Western Area Power Administration.

7.3.1 What affect will its presence, system, contracts, policies and Federal constraints have on the adoption of retail competition in electric supply?

ANALYSIS

Western Area Power Administration (Western), a Federal agency and transmission provider, is a member of the Southwest Regional Transmission Association, a FERC approved Regional Transmission Group. Additionally, it is voluntarily complying with FERC's open access concepts through a modified open access tariff. Consequently, its presence should not impede implementation of competition in Arizona.

COMMENT

None.

7.4 Interstate Reciprocity.

7.4.1 In view of the Commerce Clause of the U.S. Constitution, what can Arizona require of out-of-state entities to compete in Arizona markets?

ANALYSIS

The sale and delivery of electricity affects interstate commerce. However, historically, it has been subject to local regulation, in large part due to the necessity of such regulation to protect the public health and safety of local citizens and the administrative burden of economic regulation of largely in-state monopolies. As well, this local character

has been preserved in federal legislation which has specifically left certain regulation to the states, *see* Order 888 and the Federal Power Act.

State regulation of interstate commerce is subject to certain limitations: (I) it may not discriminate against interstate commerce; (ii) it may not regulate subject matter which inherently requires uniform national regulation; and, (iii) the state intent underlying the regulation may be of more importance than is the burden on interstate commerce, i.e, the balance of interests must favor state as opposed to national interests. *Southern Pacific Co, v. Arizona,* 325 U.S. 761 (1945).

Concerns have been raised in this docket that an early mandate of competitive generation supply, before other states have acted, will unnecessarily subject Arizona's utilities to cutthroat competition from market entrants located nationwide who would not have entered the Arizona market if other markets were available. Sensing a threat to Arizona's economic and tax base, certain participants asked whether Arizona could limit participation here to foreign entities from states which also have retail competition -- a true reciprocity requirement. That may be unlikely, given the three-prong test of *Southern Pacific*, but the Working Group has not achieved a consensus on this point.

A state may not create economic barriers to out of state products in order to protect local interests. *Dean Milk Co. V. City of Madison*, 340 U.S. 349 (1951). Instead, the purpose or benefits of the law, e.g., public health or welfare must outweigh the burdens on interstate commerce. Reciprocity agreements between states for the sale of products are not *per se* a violation of the Commerce Clause of the U.S. Constitution. However, mandatory reciprocity requirements prohibiting the sale of products from another state unless that state reciprocates is such a violation unless there is a substantial state interest

which can not be achieved by other means. *Great Atlantic & Pacific Tea Co. V. Cottrell,* 424 U.S. 366 (1976).

Arizona may exert regulatory jurisdiction over entities that: (I) meet the definition of jurisdictional entities in the Arizona Constitution, Arizona statutes and the rules; (ii) are doing business within the State of Arizona; and, (iii) have sufficient minimum contacts within the state to support the exercise of jurisdiction. Such entities may also be amenable to jurisdiction by Arizona courts.

In *General Motors Corporation v. Tracy,* 197 U.S. Lexis 692; 65 USLA 4068 (Feb. 18, 1997), the U.S. Supreme Court left in place an Ohio two-tiered tax system, saying Ohio may tax interstate sellers of natural gas at a different and higher rate than it taxes local distribution companies. The Court did not arrive at this result as a legal proposition. Instead, court employed a balancing test to determine the economic harm that the system posed for interstate commerce. After describing the developing natural gas industry and making a distinction between bundled and unbundled service, the Court found that it was unsuited to gathering facts upon which economic decisions could be made. "The most we can say is that modification of Ohio's tax scheme could subject LDC's to economic pressure that in turn could threaten the preservation of an adequate customer base to support continued provision of unbundled services to the captive market." 197 U.S. Lexis at ___.

General Motors notwithstanding, the Commerce Clause generally prohibits state policies that amount to economic protectionism for in-state utilities. Nevertheless, the Commission can and should avoid policies and rules which put in-state jurisdictional utilities at a competitive disadvantage to electric service providers located out-of-state or

out of ACC's jurisdiction. Examples include grafting an additional renewables mandate from previous integrated resource planning orders onto the solar portfolio for affected utilities and continuing an Affected Utility's obligation to serve into the competitive phase-in and beyond.

COMMENT

None.

PART 8

ANTI-TRUST ISSUES

8.1 State Action Immunity Doctrine.

Some participants were concerned about the State-Action Immunity Doctrine ("State Action"). State Action, generally provides an exemption from antitrust laws providing that actions that are taken: I) pursuant to a clearly articulated state policy to displace competition in favor or regulation; and ii) actively supervised by the state, do not violate that antitrust statutes. The Arizona legislature as codified this principle in A.R.S. § 40-286 which provides:

> The provisions of title 44, chapter 10, article 1, shall not apply to any conduct or activity of a public service corporation holding a certificate of public convenience and necessity granted pursuant to this article, which conduct or activity is approved by a statute or this state or of the United States or by the corporation commission or an administrative agency of this state or of the United States having jurisdiction of the subject matter.

Affected Utilities will not have a State Action exemption to the extent they are engaging in competitive, as opposed to monopoly, services.

COMMENT

See discussion above.

8.2 Application of Traditional Antitrust Principles.

COMMENT

The working group reviewed antitrust issues and decided that the ACC does not have jurisdiction to enforce violations of the antitrust laws. Antitrust principles may need to be considered to the extent the Commission is concerned about market power and monopolistic pricing.

PART 9

SUGGESTED CODE CHANGES

9.1 Federal Statutes.

Work Group participants generally agreed that federal statutes may need to be changed, among other things, to harmonize FERC and ACC jurisdiction, address potential antitrust issues and recognize generally the increasingly interstate nature of electricity sales and deliveries. Certain of these issues have been addressed in other portions of this report. No specific federal statutory changes were recommended in relation to this section of the report.

Work Group participants disagreed whether changes to federal statutes are necessary to implement the Rules. Some participants maintained that no amendments were required to implement the Rules. These participants also maintain that amendments should not be undertaken, if at all, until the impact of competition has been reviewed and assessed.

Some participants maintain that federal statutes should be changed to, among other things, harmonize FERC and ACC jurisdiction, address potential antitrust issues and recognize generally the increasingly interstate nature of electricity sales and deliveries. Certain of these issues have been addressed in other portions of this report. No specific federal statutory changes were recommended in relation to this section of the report.

9.2 The Arizona Constitution.

9.2.1 Whether Constitutional amendments are required either to allow or facilitate competition in generation supply and other electric services.

ANALYSIS

The Working Group did not achieve a consensus whether constitutional amendments are required to implement competition. The Working Group debated three principal issues on this subject:

(1) the ACC's authority to require municipal utilities to open their territories to competition and regulate their sales to others and their implementation of retail access (Ariz. Const. art. 15, § 2);

(2) the ACC's power to exercise varying degrees of control over non-PSCs given the provisions of art. 15, § 2; and

(3) the ACC's power to determine just and reasonable rates in the competitive market rather than through traditional rate-of-return, fair value rate cases. See art.15, §§ 3 and 14).

THE ACC'S POWER OVER MUNICIPAL UTILITIES

Affected Utilities maintain that if municipal utilities are to be permitted to serve in the service areas of Affected utilities, the ACC must have constitutional authority to compel

municipalities to open their own service territories to competition and to regulate the terms and conditions for opening those territories. The Affected Utilities maintain that even if the ACC and a municipal utility have authority to open the municipality's service territory pursuant to an IGA, the ACC will not have the power to regulate the municipality's conduct. The Affected Utilities maintain that the ACC will be powerless to enforce the IGA, respond to consumer complaints or enforce complaints by competitive providers regarding unbundled rates or other terms and conditions of service that may be unfair or not cost-justified. The Affected Utilities argue that the governing body of the municipal utility will be the final arbiter of such complaints (subject to an uncertain standard of judicial review), not an independent regulator.

Other participants maintain that municipalities are "regulated" via the ballot box. The municipalities are governed by elected representatives who are responsive to voters. Municipalities do not have an incentive to increase investor returns at the expense of ratepayers. The lack of a profit motive is a disincentive for predatory or anti-competitive practices.

Affected Utilities maintain that the ACC may not enforce its rate setting powers or rules upon municipalities' sales of electricity in other utilities' service territories. According to the Affected Utilities, these differences in regulatory supervision will create significant variations in costs and flexibility for regulated and non-regulated market participants. Some Work Group participants raised several alleged advantages which municipal utilities enjoy over investor-owned PSCs, such as freedom from various taxes and the ability to issue tax-exempt debt.

Other participants point out that California looked at comparative advantages among municipalities and investor-owned utilities and determined that the issue was a non-starter. These participants also maintain that no competitive advantage can be established between the tax advantages enjoyed by investor-owned utilities and the governmental exemptions that are available to municipal utilities.

One municipal utility proposed to form public service subsidiaries or affiliates that would be regulated by the ACC control. Formation of regulated subsidiaries may partially address the Affected Utilities' concerns about the ACC's lack of jurisdiction over sales by municipal utilities in the Affected Utilities' territories. The Affected Utilities maintain that the Rules do not require formation of a subsidiary and do not, in any event, address ACC's lack of jurisdiction over their sales in and access to municipal utilities' service territories.

RATE REGULATION OF PSCs

Affected utilities maintain that the Constitution establishes a single definition of PSC as any corporation engaged in furnishing electricity for light, fuel, or power. Article 15, Section 3 then requires the ACC to prescribe rates for all PSCs. Article 15, Section 14 requires the ACC to ascertain the fair value of all PSCs and use that as the basis for determining rates. Some Affected Utilities maintain that Arizona courts have consistently ruled that these duties are mandatory, and the ACC must exercise this level of supervision over PSCs. See the discussion in Section 1.1.

Affected Utilities maintain that the Competition Rules essentially envision two kinds of PSCs and two systems of rate setting - ACC prescribed, fair value cost based rates for distribution-monopoly "wires service" and market determined rates for competitive electricity supply and, in some cases, other distribution related services.

Other participants maintain that the ACC already has the power to regulate distribution monopolies differently from competitive generation supply. These participants maintain the ACC is empowered by the Constitution to make such distinctions based upon its power to prescribe "just and reasonable classifications to be used" by PSCs pursuant to Article 15, Section 3. Distribution monopolies are "natural monopolies" that continue to be rate-regulated to protect the public from monopolistic pricing. Technology exists to separate distribution monopolies from generation. Generation supply therefore is eligible for competitive pricing without the risk of monopolistic pricing that exists for distribution monopolies. The United States Supreme Court has recognized a market distinction between local gas distributors and competitive gas suppliers in *General Motors v. Tracy*, ___ U.S. ___ (1997).

Affected Utilities maintain that state constitutional mandates prohibit the transition to a competitive market as envisioned by the Competition Rules. Additionally, these requirements impose needless or burdensome regulatory restraints on the desired goal - a fully flexible, free market. For example, these participants maintain that the ACC still must require the filing of tariffs and the Constitution requires rates that are prescribed by the ACC and that are based upon fair value. To the extent that the tariff rates are prescribed by or based upon the market, all tariffs will be suspect. As the market determines rates either below or above a "fair value" premised rate, consumers or competitors may raise these constitutional requirements to invalidate the market based price and to demand refunds of collected monies.

Other participants maintain that the Commission's power to prescribe just and reasonable rates is exclusive and may not be abridged by any other branch of government.

Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n, 178 Ariz. 478, 875 P.2d 137 (Ct. App. 1993). These participants maintain that article XV, section 14 of the Arizona Constitution authorizes the ACC to use the fair value of a utility's assets to artificially determine just and reasonable rates as if they were set in a competitive market. The same goal is achieved, albeit more accurately, through pricing in a competitive market. They maintain that tariffs are not a barrier to competition. For example, the ACC uses competitive tariffs for services in the telecommunications industry. These participants maintain that traditional rate regulation may be required for the transition to competition, and will continue for the foreseeable future for transmission and distribution of electricity.

COMMENT

None.

9.3 Arizona Statutes.

This portion of the report will focus principally on the Working Group's debate regarding possible changes to the Public Utilities statutes (Title 40).

9.3.1 A.R.S. § 40-281

This statute and A.R.S. § 40-282 require utilities to obtain certificates of convenience and necessity ("Certificates") prior to constructing facilities and providing electric service to the public.

ANALYSIS

The debate regarding certificates of convenience and necessity is found in Part 1.1 of this Report.

COMMENT

See the Comment to Part 1.1.

9.3.2 A.R.S. §§ 40-201 and 40-202

ANALYSIS

Affected Utilities maintain that these statutes must be amended to draw distinctions between the level of regulation to be applied to the "wires" distribution function and all other competitive generation and distribution related services. The Affected Utilities maintain that more definitions should be added to A.R.S. § 40-201 to distinguish between competitive generation and distribution services, including definitions for "affected utilities," "electric service providers," "aggregators" and "brokers."

Other participants maintain that the ACC already has the power to classify additional entities as competition is observed. These participants maintain that legislative classifications are unconstitutional to the extent the classifications interfere with the ACC's rates and classification functions.

Affected Utilities and some other participants maintain that, at a minimum, the Legislature should amend A.R.S. § 40-202 to state the public policy of this state as to competition and to mandate or allow different regulation for competitive providers, similar to the statute's provisions relating to telecommunications services.

Other participants agreed that a statement of policy, consistent with article XIV, §15 of the Arizona Constitution, would be desirable. Other participants maintain that the state constitution does not allow statutory mandates for "different regulation" of competitive rates or competitive services.

9.3.3 Rate Statutes

Affected Utilities maintain that A.R.S. §40-203, A.R.S. §§ 40-246 to 40-251 and A.R.S. §§ 40-365 and 40-367 assume a fully regulated monopoly. According to the

Affected Utilities, the statutes give the ACC full power and obligation to establish rates, follow certain procedures in allowing changes to rates and require the posting or publication of all rates. The Affected Utilities maintain that these statutes must be reevaluated. amended and possibly repealed before implementing competition. The Affected Utilities maintain that although the ACC should retain a certain level of jurisdiction over monopoly services, reduced regulation is appropriate for competitive services. If not, they maintain that deregulation will not be achieved and the market will not be allowed to operate.

Other participants maintain that reduced statutory regulation should not be enacted until the effectiveness of existing and potential competition become known. In the case of natural monopoly, regulation will continue to assume the role of a substitute for competition. Markets that are not fully competitive (e.g., oligopolies) require the ACC to balance its rate control function with a role as a facilitator of competition. In effectively competitive markets, they argue that the ACC must secure the prerequisites to competition, such as open access to distribution systems, subsidy-free pricing of services, non-discriminatory pricing, and efficient market entry. These are ratemaking functions that the ACC must exercise before one can understand the implications of a proposed statutory change. This may explain, to some degree, why Working Group participants have not come forward with specific statutory changes to Title 40.

9.3.4 A.R.S. § 40-204

Affected Utilities maintain that this statute should distinguish between monopoly and competitive service providers and relieve competitive providers from the statute's extensive information and regulation requirements. Affected Utilities maintain that

proprietary information for competitive PSCs should be protected to a greater extent than fully regulated, monopoly PSCs. Affected Utilities maintain that similar confidentiality amendments should be added to A.R.S. § 40-360, the state's public records law and Open Meeting statutes (Titles 38 and 39).

Other participants suggest that restricted or closed access to information may discourage or even prevent competition. Lack of competition will continue the current monopolistic pricing and prevent the ACC from reducing the level of regulation for utilities. These participants maintain that such statutory changes should be scrutinized carefully and only after competition has commenced.

9.3.5 A.R.S. §§ 40-221 and 40-222

These statutes authorize the ACC to establish accounting systems and depreciation standards for PSCs. Affected Utilities maintain that this level of regulation will be inconsistent with and unnecessarily burdensome on a competitive marketplace.

Other participants oppose immediate changes for the reasons stated in Sections 12.3.2 to 12.3.4.

9.3.6 A.R.S. § 40-284

Some Affected Utilities maintain that this statute may prohibit or restrict the transaction of utility business within Arizona by a foreign corporation and may need needs to be reexamined in the context of the competitive market. These Affected Utilities maintain that this statute might be the appropriate forum to address concerns about interstate reciprocity. These arguments maintain that, with the exception of California, no other western state has opened its electric market like Arizona and Arizona utilities may

need to seek replacement markets and mitigate stranded costs in other states' markets that will be closed to them.

Other participants maintain that foreign corporations already conduct utility business in Arizona. These participants refer to annual reports of the large Affected Utilities as proof that Arizona utilities have found replacement wholesale markets in other states, including California. These participants maintain that closing or restricting Arizona markets to out-of-state entrants may violate the U.S. Constitution's Commerce Clause ("Commerce Clause"). The state may not discriminate against interstate commerce nor may it unduly burden interstate transactions. *Arkansas Electric Cooperative v. Arkansas PSC*, 461 U.S. 375 (1983). Discriminatory state laws and regulations are "per se" invalid under the Commerce Clause. *Philadelphia v. New Jersey*, 437 U.S. 617 (1978).

9.3.7 A.R.S. § 40-285

This statute provides that ACC approval must be obtained before any PSC may sell, lease, assign, mortgage or otherwise dispose of or encumber its system. Transfers or other dispositions without an order of the ACC are void. Affected Utilities maintain that in a competitive marketplace such a statute is antiquated and inconsistent with the flexibility that utilities need to respond to the demands of the marketplace.

Other participants maintain that these arguments presume the existence of meaningful competition. Meaningful competition will not be realized until after the Rules take effect and the competitive market has been assessed. In any event, protections must be in place to address merger and acquisition activities that may result in monopolistic activities.

Some participants point out that the Rules affect generation, not the state's extensive distribution and transmission systems. These participants further maintain that A.R.S. § 40-285 applies only to systems that are "necessary" to provide a public service. These participants maintain that in a competitive setting facilities would not be "necessary" when alternative providers are available to provide a public service.

9.3.8 A.R.S. § 40-301 et. seq.

These statutes give the ACC power to supervise the utilities' authority to issue stocks, bonds, notes and other evidences of indebtedness and to create liens on their property. The statutes void any loan or stock issuance that was not approved by the ACC. Affected Utilities maintain that these statutes assume that a sole-source provider of a basic utility service should be subject to public interest regulatory jurisdiction. For example, issuance of too much debt may endanger the utility's ability to provide service. Affected Utilities question the need for these statutes if consumers have the right to choose competitive generation supply and other distribution related services. Affected Utilities maintain that these statutes restrict their ability to function effectively in a competitive marketplace and, unless amended, would call into question the validity of all stock and financing issues for competitive service providers.

Other participants maintain that the Commerce Clause prevents these statutes from applying to out-of-state entrants. These participants oppose changes for the reasons set forth in Sections 12.3.2 to 12.3.4 and 12.3.8.

9.3.9 A.R.S. §§ 40-321, 40-322, 40-331, 40-332 and 40-334

These statutes pertain generally to regulation of services and facilities provided by electric utilities. Affected Utilities maintain that these statutes assume a "one

size fits all" standard as to these subjects and assume continued regulation is required. These arguments maintain that the statutes are inappropriate in a competitive market that determines adequate rates, allocates resources and dictates differing levels of service.

Other participants oppose changes for the reasons set forth in Sections 12.3.2 to 12.3.4 and 12.3.8.

9.3.10 A.R.S. § 40-341 et. seq.

This Article establishes a system for conversion of overhead electric facilities. Affected Utilities maintain that, although the need for such statutes may continue, their purpose and function should be reexamined in light of the separation of regulated distribution "wires" services from competitive generation and other distribution related services.

Other participants maintain that the state should retain jurisdiction over overhead electric facilities. These involve legitimate state property and environmental concerns.

9.3.11 A.R.S. § 40-360 et. seq.

This Article establishes the Power Plant and Transmission Line Siting Committee. In general, it requires any person contemplating construction of electric power plant and transmission facilities within the state to file a ten-year plan with the ACC and vests authority over siting and environmental compatibility issues in the Committee and ACC. Affected Utilities question the need for or desirability of a ten-year generation plan that is subject to regulatory review. Other Affected Utilities suggest that the size of facilities covered by the statutes should be reevaluated.

Other participants oppose these changes for the reasons set forth in Sections 12.3.2 to 12.3.4.

9.3.12 A.R.S. § 40-401 et. seq.

These statutes assess charges on PSCs to finance the regulatory expense associated with the operation of the ACC and the Residential Utility Consumer Office. Affected Utilities maintain that the annual assessment provisions may require adjustment since, for example, the assessment is levied upon revenues from intrastate operations of entities holding certificates. Affected Utilities maintain that significantly higher or lower revenues will result from changes in the number of entities holding certificates and in the total of revenues derived from intrastate operations.

Other participants oppose these changes for the reasons set forth in Sections 12.3.2 to 12.3.4.

9.3.13 Title 10

The Rules require most Arizona cooperatives to open their service territories to competition. A.R.S. §§ 10-2072 and 10-2138 prohibit competition by cooperatives. Thus, the cooperatives maintain that they are required to open their territories to competition but under current law are unable to seek replacement customers. Most participants agree these statutes should be repealed. Also, most of Arizona's cooperatives are formed pursuant to A.R.S. § 10-2021 *et seq.* (Non-profit Generation and Transmission Cooperatives) or A.R.S. § 10-2051 (Non-profit Distribution Cooperatives). In general, cooperatives maintain that these are limited purpose statutory structures adequate for the regulated monopoly system for which they were crafted but too restrictive for the increased and varied demands of a competitive market. Affected Utilities and Staff

maintain the statutes should be amended to facilitate the cooperatives' participation in a competitive marketplace.

9.3.14 Non-Regulated Activity by Utilities

Certain Working Group participants suggested either additional legislation or regulations controlling the ability of utilities to compete in non-regulated activities. These participants expressed concern about the utility's ability to participate at all in these businesses or to cross-subsidize such non-regulated activities with revenues from regulated activities. A majority of Work Group participants felt that the ACC has sufficient jurisdiction currently to prohibit any unfair cross-subsidization and/or that prohibition of non-regulated activities would be inconsistent with the move generally to competition.

9.3.15 A.R.S. § 48-1515

One Working Group participant suggested possible repeal or amendment of this statute to remove its arguable limitation on expansion of an existing special district.

COMMENT

None.

EXHIBIT A

MARICOPA COUNTY SUPERIOR COURT CASES INVOLVING ELECTRIC RESTRUCTURING

Tucson Electric Power Company, an Arizona corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03748

Citizens Utilities Company, a Delaware corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-04176

Arizona Public Service Company, an Arizona corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03753

Arizona Electric Power Cooperative, Inc., a nonprofit Arizona generation and transmission cooperative, v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03920

Graham County Electric Cooperative, Inc., a nonprofit Arizona distribution cooperative v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03921 [Consolidated with Case No. CV97-03920]

Duncan Valley Electric Cooperative, Inc., a nonprofit Arizona distribution cooperative v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03922 [Consolidated with Case No. CV97-03920]

Trico Electric Cooperative, Inc., an Arizona nonprofit corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03928 [Consolidated with Case No. CV97-03920]

Sulphur Springs Valley Electric Cooperative, Inc., an Arizona cooperative, non-profit membership corporation v. The Arizona Corporation Commission, an agency of the State of Arizona, Case No. CV97-03942 [Consolidated with Case No. CV97-03920]

A

LEGAL ISSUES WORKING GROUP
PARTICIPANTS

PARTICIPANT	REPRESENTING
Michael M. Grant, Esq.	Arizona Electric Power Cooperative, Inc., Duncan Valley Electric Cooperative, Inc., Graham County Electric Cooperative, Inc.
Carol S. Hull	Able Refrigeration
Desiree Zinger Karen Krause	Air Conditioning Contractors of Arizona
Suzanne M. Dallimore, Esq. Enrique Lopezlira	Office of the Attorney General
Barbara Kimball Sherman	Arizona Consumers Council
Patricia E. Cooper, Esq,	Arizona Electric Power Cooperative, Inc.
Representative Jeffrey S. Groscost	Arizona House of Representatives
Douglas Nelson, Esq.	Arizona Multi-Family Housing Association
Michael A. Curtis, Esq.	Arizona Municipal Power Users' Association
James P. Bartlett, Esq.	Arizona Power Authority
Steven M. Wheeler, Esq. Thomas L. Mumaw, Esq.	Arizona Public Service
Senator John Wettaw Richard A. Bark, Esq. Deborah S. Johnston	Arizona Senate
Bill Meek	Arizona Utility Investors Association

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Beth Ann Burns, Esq.	Citizens Utilities Company
C. Webb Crockett, Esq.	Cyprus Climax Metal Company, ASARCO, Inc. Enron Capital & Trade Resources
Toni Tyrone	Deluge, Inc.
Tim Goodluck Lisa V. Wayne Ted Raymond	Dine Power Authority
David Caplow	Economic Energy Alternatives
Douglas C. Nelson, Esq.	Electric Competition Coalition
William D. Baker, Esq.	Electrical District No. 6
Sheryl A. Taylor, Esq.	Electrical District No. 7 and Roosevelt Irrigation District
James K. Tarpey	Enron Capital & Trade Resources
Robert Franciosi	Goldwater Institute
Gerald J. Porter, Esq.	Office of Governor
David K. Johnson	Honeywell, Inc.
Roy W. Jones	Industrial Energy Applications, Inc. and Mohave County Economic Development Authority
Tim Bowden	International Brotherhood of Electrical Workers

LEGAL ISSUES WORKING GROUP
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Mary L. Rosenzweig	League of Arizona Cities and Towns
Michael W. Margrave, Esq.	Margrave Clemins & Verburg
Bobbi Kiese	Motorola
Susan N. Kelly, Esq.	National Rural Electric Cooperative, Association
Dennis W. Hughes	Navopache Electric Co-operative, Inc.
Sam DeFrawi	Department of the Navy
Wm. Kent Romney	Page Electric Utility
Lawrence V. Robertson, Jr., Esq. Michael M. Racy	PG&E Energy Services
Lex J. Smith, Esq. Michael W. Patten, Esq.	Phelps Dodge
Jesse W. Sears, Esq.	City of Phoenix
Andrew A. Brodkey, Esq. Scott A. Gutting	Public Interest Coalition on Energy
Bill Calloway Ted Bobkowski	Ralston Purina Company
Deborah R. Scott, Esq.	Residential Utility Consumer Office
Alan Propper	Resource Management International, Inc.
Robert F. Roos, Esq.	Lewis & Roca L.L.P.

LEGAL ISSUES WORKING GROUP
PARTICIPANTS

Jay I. Moyes, Esq.	City of Safford, Tonopah Irrigation District, Aguila Irrigation District, McMullen Valley Water Conservation & Water District, Harquahila Power District, Electric District No. 8
Jessica Youle, Esq. Kenneth C. Sundlof, Jr., Esq.	Salt River Project
Mike Tarro	SAPHCC
Julie Watson	Southern Energy Trading and Marketing, Inc.
Al Jones Darren M. Lehrfeld, Esq. Steven M. Banzhaf, Esq.	Southern Arizona Mechanical Contractors Association
Andrew W. Bettwy, Esq. Debra S. Jacobson	Southwest Gas Corporation
Creden W. Huber	Sulphur Springs Valley Electric Cooperative, Inc.
Richard F. Brown	SWRTA
Harvey Friedson Cliff Mattice, Esq.	City of Tempe
Loretta Humphrey, Esq. Vinnie Hunt	City of Tucson
Bradley S. Carroll, Esq.	Tucson Electric Power Company
Jimmy Jayne	U. S. Senate - Senator Jon Kyle
Ray Umashandar	University of Arizona
Douglas A. Oglesby	Vantus Energy Corporation
Cory Prochaska	Wellton-Mohawk Irrigation and Drainage District

B

LEGAL ISSUES WORKING GROUP
CHRONOLOGY OF GROUP PROCESS

January 8, 1997
Legal Division sends letters of invitation to participate to a service list prepared by Chief Economist.

January 10-February 3, 1997
Fifty-one companies, municipalities, public interest groups or their attorneys accept 1-8-97 invitation to participate in Working Group.

February 27, 1997
Public Notice and Agenda for first meeting of the Group are posted and mailed.

March 5, 1997
First meeting of Working Group; 42 persons excluding staff attend.

March 13, 1997
Public Notice and Agenda for second meeting of the Group are posted and mailed.

March 19, 1997
Second meeting of Working Group; 30 persons excluding staff attend. Ken Sundlof of the Public Power/Governmental Entities Subgroup and Steve Wheeler of the Stranded Cost Subgroup distribute to the Group lists of issues to consider. Participants discuss issues. Legal Division requests participants' written comments on both lists of issues by March 25, 1997 and promises staff's written responses at the next meeting, April 1, 1997.

March 13-April 1, 1997
Comments received from participants.

March 28, 1997
Public Notice and Agenda for third meeting of the Group are posted and faxed to participants.

April 1, 1997
Third meeting of the Working Group; 35 persons excluding staff attend. Legal Division distributes staff's responses to issues raised at March 19, 1997 meeting by the Public Power/Governmental Entities and Stranded Cost Subgroups. Participants discuss responses.

April 4, 1997
Comments received to date on legislative issues are faxed to participants.

April 4-April 17, 1997
Comments received from participants. Additional individuals and entities join Working Group.

April 16, 1997
Public Notice and Agenda for fourth meeting of the Group are posted and faxed to participants.

April 17, 1997
Fourth meeting of the Working Group; approximately 30 persons excluding staff attend. Utilities Director Carl Dabelstein makes a presentation on stranded costs and distributes its outline to participants. The Stranded Cost, Public Power/Governmental Entities and Federal Issues Subgroups report to the other members of the working group. Participants discuss the issues raised by the Legislative Issues Subgroup.

April 18-May 21, 1997
Comments received from participants and distributed to Working Group. Additional individuals and entities join Group.

May 7,1997
Public Notice and Agenda for fifth meeting of the Working Group are posted andmailed to participants.

May 16, 1997
Complete set of staff and participant comments received to date are mailed to all members of Working Group.

May 21, 1997
Fifth meeting of the Working Group; approximately 40 persons excluding staff attend. Legal Division distributes its outline of the draft report to the Commission and discusses it with participants. Individual participants are selected to act as" reporters" for outline topics. The Group also establishes a tentative timetable for filling out the outline using participant comments.

May 22, 1997
Comments received from participants and mailed to all members of Working Group. Additional individuals and entities join Working Group, which now has 92 persons on its service list.

May 29, 1997
List of reporters for each outline topic and revised timetable are mailed to participants.

May 30-June 29, 1997
Participant comments on outline topics are submitted to reporters and Chief Counsel. Legal Division disseminates copies of comments to all participants.

June 30, 1997
First draft of report is mailed to participants; deadline for comments is July 17, 1997.

July 17, 1997
Notice and agenda for July 24, 1997 meeting are posted and mailed to participants, together with copies of comments received since the July 7 comments mailing.

July 18, 1997
Additional participant comments are mailed to Group members.

July 24, 1997
Sixth meeting of the Working Group; 30 persons excluding staff attend. Participants review first draft of the report, discuss possible edits, Table of Contents and Executive Summary.

July 25, 1997
Reporters meet to edit second draft of report. Revised timetable and new comments received are mailed to participants.

July 28, 1997
Second draft of the report is mailed to participants; deadline for comments is August 18, 1997.

July 29, 1997, August 21, 1997
Comments on second draft of the report are mailed to participants. The August 21, 1997 mailing includes announcement of next meeting date for Working Group.

August 25, 1997
Notice and agenda for August 28, 1997 meeting are posted and mailed to participants.

August 28, 1997
Seventh meeting of the Working Group. Twenty persons excluding staff attend. Participants discuss the comments received to date and the format, Executive Summary and presentation of the final report.

August 29, 1997
Revised timetable is mailed to participants.

September 5, 1997
Proposed final draft of report is mailed to participants; comments are due by September 12, 1997. Mailing includes announcement of final meeting of Working Group on September 26, 1997.

September 8-September 29, 1997
Participants submit editorial comments on the proposed final draft of the report and overviews of their individual substantive comments to be appended to the report submitted to the Commission.

September 19, 1997
Notice and agenda for September 26, 1997 meeting are posted and mailed to participants.

September 26, 1997
Eighth meeting of the working group; 15 persons excluding staff attend. Legal Division distributes Executive Summary which is discussed by the participants. Deadline for submission of final individual comments is the morning of September 30, 1997. Participants are requested to provide disk of their comments for posting to the Commission's web page.

September 30, 1997
Report to the Arizona Corporation Commission by the Legal Issues Working Group is filed with ACC's Docket Control.

C

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: March 5, 1997

TIME: 9:00 a.m.

PLACE: Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona

ATTENDANCE:
Chairman Carl Kunasek
Commission Renz Jennings
Members of Commission Staff

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

Commission Chief Counsel Lindy Funkhouser opened the meeting. Representatives from staff, electric utilities, consumer groups, potential market entrants, and other groups discussed how to identify and address legal issues affecting the Commission's rules on electric competition. Several issues were identified as requiring additional investigation at this time: political subdivisions and intergovernmental agreements; stranded cost legal issues; legislative issues; and federal issues. Subgroups were organized to investigate these issues.

ASSIGNMENTS FOR NEXT MEETING:

With the exception of the Legislative Issues Subgroup, these subgroups are to meet to discuss these issues and report back to the Working Group at the next meeting of the group.

The Legislative Issues Subgroup is to identify and provide to staff by Friday, March 21, the legislative issues they believe need to be addressed to implement the electric competition rules.

These issues will be disseminated among the members of the Working Group, who will have the opportunity to respond to them by April 4.

The Working Group will meet again sometime in early April, at a time and place to be determined.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: March 19, 1997

TIME: 1:00 p.m.

PLACE: Arizona Industrial Commission Auditorium
800 West Washington Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Public Power/Governmental Entities Subgroup
Members of Stranded Cost Issues Subgroup

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP
PUBLIC POWER/GOVERNMENTAL ENTITIES SUBGROUP
STRANDED COST ISSUES SUBGROUP

MATTERS DISCUSSED:

Kenneth C. Sundloff opened the meeting of the Public Power/Governmental Entities Subgroup. Mr. Sundloff reviewed a list of issues for the subgroup to consider. Representatives from interested parties discussed the issues. Commission Chief Counsel Lindy Funkhouser requested participants' written comments on the list of issues by March 25, 1997 and agreed to prepare responses to the issues, through the Commission's staff, at the next meeting scheduled for April 1, 1997.

Steven M. Wheeler opened the meeting of the Stranded Cost Issues Subgroup. Mr. Wheeler reviewed a list of issues for the subgroup to consider. Representatives from interested parties discussed the issues. Commission Chief Counsel Lindy Funkhouser requested participants' written comments on the list of issues by March 25, 1997 and agreed to prepare responses to the issues, through the Commission's staff, at the next meeting scheduled for April 1, 1997.

Participants discussed a timetable for participants to submit legislative comments.

ASSIGNMENTS FOR NEXT MEETING:

Participants will send their comments on the lists of both issues to the Commission's Legal Division by March 25, 1997.

The Commission's Legal Division will prepare responses to the issues for the next meeting scheduled for April 1, 1997.

The next meeting of the Public Power/Governmental Entities and Stranded Cost Issues Subgroups was set for April 1, 1997.

Legislative comments will be submitted for review by mid-April, 1997. Staff will advise participants of a due date for the comments.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: April 1, 1997

TIME: 1:00 p.m.

PLACE: Arizona Corporation Commission, Administration Offices
1300 West Washington Street
Third Floor Conference Rooms A & B
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Public Power/Governmental Entities Subgroup
Members of Stranded Cost Issues Subgroup

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP
PUBLIC POWER/GOVERNMENTAL ENTITIES SUBGROUP
STRANDED COST ISSUES SUBGROUP

MATTERS DISCUSSED:

The Commission's Chief Counsel, Lindy Funkhouser, opened the joint meeting of the Public Power/Governmental Entities and Stranded Cost Issues Subgroups. Mr. Funkhouser reviewed the Legal Division Staff's comments on the list of issues for the subgroups to consider. Representatives from interested parties discussed the issues. Commission Chief Counsel Lindy Funkhouser advised participants that the Commission's Utilities Director, Carl Dabelstein, will be invited to the meeting of the Legislative Subgroup in mid-April, 1997.

ASSIGNMENTS FOR NEXT MEETING:

Participants will meet to discuss legislative issues in mid-April, 1997.

The Commission's Legal Division will advise participants of the date and location of the meeting of the Legislative Issues Subgroup.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: April 17, 1997

TIME: 1:00 p.m.

PLACE: Arizona Industrial Commission Auditorium
800 West Washington Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

Commission Director Carl Dabelstein presented an overview of stranded cost recovery for electric utilities. Director Dabelstein distributed an outline of his presentation.

The participants discussed member comments on legislative issues that may apply to electric restructuring. The group also discussed the future role of the Stranded Cost Issues and Public Power/Governmental Entities subgroups.

ASSIGNMENTS FOR NEXT MEETING:

The Legal Division will prepare an outline of the issues raised by participants to date, and will advise the group of the date and place of the next meeting.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: May 21, 1997

TIME: 1:00 p.m.

PLACE: Arizona Hall of Fame Museum
1101 West Washington Street
Basement Conference Room
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

The chairman distributed an outline of the draft report and discussed it with participants. Individual participants were appointed to act as "reporters" for selected outline topics. The group established a tentative timetable for filling out the outline using participant comments.

The following participants agreed to serve as Reporters on the following topics:

Steven M. Wheeler	*Nature of Restructuring in General and Stranded Cost Recovery.*
Bradley S. Carroll	*Rights and Duties of Public Service Corporations and Antitrust Issues*
Lawrence V. Robertson, Jr.	*Scope of Restructuring*
Beth Ann Burns	*Rates and Ratemaking*
C. Webb Crockett	*ACC Powers/Procedures*
Jessica J. Youle	*Non-PSC Issues*

Patricia E. Cooper	*FERC Issues and Federal Issues*
Douglas C. Nelson	*Taxation Issues*
Michael M. Grant	*Legislative Issues*

ASSIGNMENTS FOR NEXT MEETING:

Participants will submit comments to reporters regarding the topics and reporters will incorporate the comments in separate summaries for their assigned topics.

The Legal Division will prepare a first draft of the report based upon Reporters' summaries by June 30, 1997.

Participants will deliver comments on the draft report by mid-July, 1997 and the group will meet in late July, 1997 to discuss edits to the first report.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: July 24, 1997

TIME: 1:00 p.m.

PLACE: Arizona Industrial Commission Auditorium
800 West Washington Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

The participants discussed the first draft of the Legal Issues Working Group Report. Reporters were instructed to edit the first draft and assist in preparation of a second draft of the report.

ASSIGNMENTS FOR NEXT MEETING:

A second draft of the report will be mailed to participants and a second round of comments will be submitted in August, 1997. Participants will meet in late August, 1997 to discuss edits to the second report.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: August 28, 1997

TIME: 9:30 a.m.

PLACE: Arizona Department of Revenue
Room B-1
1600 West Monroe Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

The participants discuss the second draft of the Legal Issues Working Group Report. Participants will submit comments to the proposed final report, together with a position statement not exceeding 5 pages prior to issuance of the final report. The position statements will be attached to the final report as appendices.

ASSIGNMENTS FOR NEXT MEETING:

A final meeting will be scheduled for late September, 1997 to finalize the report.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

ARIZONA CORPORATION COMMISSION
SPECIAL OPEN MEETING MINUTES

DATE: September 26, 1997

TIME: 2:00 p.m.

PLACE: Arizona Department of Revenue
Room B-1
1600 West Monroe Street
Phoenix, Arizona 85007

ATTENDANCE:
No Quorum
Members of Commission Staff
Members of Legal Issues Working Group

TOPIC: ELECTRIC RESTRUCTURING LEGAL ISSUES WORKING GROUP

MATTERS DISCUSSED:

The participants discussed the Executive Summary and the presentation of the final report. Commission Chief Counsel Lindy Funkhouser reminded the Working Group that final comments on the report must be submitted no later than the morning of September 30, 1997. He requested that the comments also be presented on a disk for posting on the Commission's webpage. He thanked the participants, especially the Reporters, for their cooperation in the process and for their valuable contributions to the report.

ASSIGNMENTS FOR NEXT MEETING:

No future meetings have been scheduled.

The meeting adjourned.

Lindy Funkhouser
Chairman, Legal Issues Working Group
Chief Counsel, Arizona Corporation Commission

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LEGAL ISSUES WORKING GROUP

PARTICIPANT COMMENTS

- Aguila Irrigation District
  The City of Safford
  Electrical District No. 8
  Harquahala Valley Power District
  McMullen Valley Water Conservation & Drainage District
  Tonopah Irrigation District

- Arizona Consumers Council

- Arizona Electric Power Cooperative, Inc.
  Duncan Valley Electric Cooperative, Inc.
  Graham County Electric Cooperative, Inc.

- Arizona Public Service Company

- Arizona Utility Investors Association

- ASARCO, Inc.
  Cyprus Climax Metals
  ENRON Corp.
  Arizona Association of Industries

- Irrigation and Electrical Districts' Association

- PG&E Energy Services

- Residential Utility Consumer Office

- Salt River Project Agricultural Improvement and Power District

- Southern Arizona Mechanical Contractors Association

- City of Tucson

- Tucson Electric Power Company

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September 16, 1997

By Facsimile (542-4870) and U.S. Mail

Lindy P. Funkhouser, Esq.
Chief Counsel
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85004

Re: Comments to Proposed Final Draft Report of Legal Issues Working Group

Dear Mr. Funkhouser:

On behalf of the following "non-Affected Utility" municipal corporation electric providers, we are submitting these additional comments on the Proposed Final Draft Report to the Commission:

Aguila Irrigation District
The City of Safford
Electrical District No. 8
Harquahala Valley Power District
McMullen Valley Water Conservation & Drainage District
Tonopah Irrigation District

We express our commendation for the tremendous amount of work that has obviously been devoted to this final draft. Much improvement has been made since the earlier versions, and we congratulate you on the balanced, thorough, and enlightening presentation of the significant issues with which the working group has grappled.

Our first comment is that the very absence of a consensus among the various stakeholders on these legal issues, to which numerous lawyers have contributed their expertise, evidences the state of uncertainty (or, at best, flexibility) of the law regarding certain aspects of the Rules. That may suggest that many of the important legal issues may ultimately need to be resolved by the courts, and that the Commission should proceed very cautiously before concluding that any major changes to the constitution or the relevant statutes are needed at this juncture.

We note the particular choice of words for defining "Consumer" in the introduction section of the report, *viz.*, "*high volume purchasers* of electric generation services." (emphasis added) This definition evidences what we think is an unfortunate, subtle (but real) bias in this entire process. The interests of the small, individual residential and agricultural users of electricity throughout Arizona, and particularly the rural regions, are being subordinated to the interests of the major utilities already here, the out-of-state utilities who want to be here, and the major industrial customers --the *high volume purchasers*--who want to see a price war between the other two. The economic impacts

upon the small, individual consumers of electricity, and especially those served by remote transmission facilities in sparsely populated service areas, are too easily being ignored. Those *low volume* consumers are expected to buy into the magic words "competition will save money for everyone," which are being repeated constantly by the proponents of competition, who often act as if simply saying the mantra often enough will make the assertion a reality. From the vantage point of the rural interests I represent, I remain concerned that there may, indeed, be some economic losers among the consumers in this game, not just "big winners and little winners" as we are being told.

Until more experience is gained, in other states as well as Arizona, with the real economic fallout of competition, the Commission should keep its focus limited to deregulation of the retail sales within those entities over which it clearly has jurisdiction under existing law. If the results of that are as wonderful for *all consumers* as we are being promised they will be, no time will be wasted by the not-for-profit municipal and district utilities joining into the full competition game, because their own governing bodies -- their taxpayers and customers -- will insist upon it without the need of any mandate from the State.

We offer one editorial suggestion, with respect to the very last item of the report. It was our understanding that, even though it was once mentioned in a list of possible statutes for which the Rules could have some implications, the repeal or amendment of A.R.S. 48-1515 was not being suggested or argued by any participant. We would ask you to consider deletion of the last section, 9.4.15, from the report.

Finally, we refer again to my comment letter of June 11, 1997, and the fundamental positions asserted therein. Only minimal changes in Arizona statutes, and no constitutional amendments, are necessary or advisable in order to implement the Rules. Changes, if any, must be motivated by protection of Arizona's *citizen* consumers, not national economic interests. Ongoing debates by investor owned utilities aimed at the demise of public power should not be allowed to obfuscate the basic issues and processes necessary for the Commission to go about its business of implementing competition for electric generation within its jurisdiction.

Your report is very well done, and will advance the appropriate progress of this process; and we appreciate the hard work that has made it possible.

Respectfully,

Jay I. Moyes

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June 12, 1997

By Facsimile (542-4870) and U.S. Mail

Lindy P. Funkhouser, Esq.
Chief Counsel
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1200 West Washington
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Re: Comments to Legal Issues Working Group

Dear Mr. Funkhouser:

I represent the following non-PSC municipal corporation electric providers with regard to the ACC electric competition rules proceedings and resulting working group processes:

The City of Safford
Aguila Irrigation District
Electrical District No. 8
Harquahala Valley Power District
McMullen Valley Water Conservation & Drainage District
Tonopah Irrigation District

I have participated in certain meetings of, and reviewed comments of other participants in, the legal issues working group. On behalf of the above-named entities, these general comments are submitted to emphasize three fundamental positions, without reiterating in detail supporting points presented by other commentators or citing the supporting legal authority. We anticipate providing more detailed comments after review of the forthcoming summary reports of the "recorders" and your draft report to the Commissioners.

1. Changes in Arizona law should be minimal, motivated only by legal necessity in order to benefit Arizona citizens, not national economic powers.

All of our comments are founded upon the following principle: *Changes in Arizona law in order to implement electric competition are acceptable only if absolutely necessary for the benefit and protection of the electricity consuming citizenry of Arizona.*

Economic and institutional dislocation will inevitably follow full competition in the electric industry, just as it has in every other "so-called de-regulation" process and jurisdiction. That dislocation is a defensible price for Arizona to pay only if the electric consumer citizens of Arizona are truly benefitted thereby. Simply because major, national financial and industrial powers seek private economic advantage and *increased profits* for their worldwide shareholders is *not* adequate justification for dismantling the current reliable and broadly affordable (though not fully competitive) integrated electric generation, transmission and distribution system serving Arizona's citizens.

Not just coincidentally, almost all of the district/municipal electric utilities are small, and serve primarily the sparsely populated regions of rural Arizona, heavily dependent upon agricultural economies. These are not the markets sought by the national and regional giants currently hovering over Arizona and pressing the ACC at every turn to hastily impose full competition regardless of the unresolved issues and unknown costs. The major PSCs, in and out of Arizona, are lining up only the fattest and ripest cherries to be picked among the large industrial users and densely populated, easily aggregated load centers. Rural Arizona and the logistically expensive-to-serve agricultural and residential customers must not be left alone to hold the bag of reallocated and dislocated facilities and costs, "stranded" or otherwise, that will no longer be shouldered by the major industrial customers who will enjoy prime economic bargaining leverage in an open marketplace. For the protection of the rural Arizona citizens and economies, the small, publicly owned district/municipal utilities will need every possible protection from unnecessary regulatory costs, and every possible advantage from preference resources once the free marketplace is at work statewide.

2. **Constitutional amendment is ill-advised and unnecessary.**

Municipal/district electric utilities exist *solely* to benefit their constituent Arizona citizenry, and they have always been adequately governed by that same citizenry. Their every act must be conducted under the broad light of open public scrutiny. They enjoy no guaranteed return on their investments, and must answer directly to their constituency if they do not operate in the best economic interests of that *local* constituency. Most are able to serve power at substantially lower rates, compared to PSCs, largely *because* they are governed by the people who pay the rates (avoiding the enormous costs, proportionate to their small size, that ACC regulatory compliance would impose,) and because they are not required to deliver profits to non-customer investors. There is no need for an additional layer of costly bureaucratic oversight of these publicly owned, governed and operated, *not-for-profit* entities.

In contrast, the framers of the Arizona Constitution wisely distinguished the need for careful oversight of the activities of the *private investor*-owned utilities, whose policies are devised behind closed doors and whose goals must necessarily make the economic interests of

their *international shareholder and creditor constituency* paramount over the interests of their Arizona customers.

None of my district clients enjoys an exclusive monopoly service territory. Both APS and those districts serve accounts (some for the same customer) on the same distribution wires. Customers in those districts have always been able to exercise the choice to take service from APS instead, and they base that choice solely upon comparative rates and related economic considerations. Predictably, if open competition does what its proponents say it will, customer-driven market forces will, in due course, politically force open the territories of those few municipals that presently have monopoly service territories. That process will occur *without the aid of, or need for, constitutionally mandated ACC jurisdiction, if there are real economic benefits from allowing those citizens access to competing generation markets.* Current contractual wheeling and supply arrangements between the municipals and the PSC transmission and generation utilities can be augmented by intergovernmental agreements. They can provide appropriate treatment of stranded costs, if any, and the practical enforcement of fair, reciprocal competitive practices as a condition of allowing municipals competitive access to customers outside their current service areas.

Implementation of competition does not require amendment to the well-reasoned constitutional distinction between PSCs and non-PSCs; and any such tinkering by the legislature and the voters could have many unintended consequences for historical utility regulatory alignments.

3. **The "level playing field" argument is a red herring.**

The recently increased volume level of clamor by the large investor-owned PSCs for a state and federal regulatory "level playing field" is simply another chorus of their perennial whining for help to escape the inescapable -- their economic dilemma of trying to sell affordable power to Arizona customers while lining their investors' pockets with profits. In contrast, public power is able to "pay its shareholders" -- its local customer citizenry -- by keeping costs and *rates* as low as possible consistent with sound management for longevity and reliability. It has no other master to serve. Public power cannot be blamed and should not be penalized because of that fundamental difference.

Recent independent studies, of which you are aware, demonstrate that there are as many, if not more, "tilts" of the playing field in favor of the investor-owned utilities as for the publicly-owned. APS, as the lead singer in this chorus, only points out those items which support their aim of depriving the municipals of "preferences" to federal power resources, tax-exempt financing, and other historical benefits. But their complaints are only diversionary tactics, hiding the equally broad array of special tax, economic and political benefits enjoyed by PSCs. *The real objective of their complaint is not a level field; it is the total demise of public power as a*

competitor, leaving them the only player on the field.

Federal preference power is a product of federal legislation, not state. And its allocations are based upon long-standing public policy, *historical* load and need (not future competitive market opportunities.) Debates about federal power preferences have no place in this process of opening Arizona to competition, and we refer to the comments of Sheryl Taylor on this issue. (It must be noted, however, that if the more radical environmental groups, purporting to protect endangered species with no regard for human costs, have their way, then the costs of federal preference power will continue its rate escalation spiral such that the PSCs will soon celebrate their exemption from the burdens of take-or-pay federal power contracts, and all power consumers will be the losers.)

In summary, we reiterate our basic principle that changes in law are acceptable only if they provide benefit to all the citizens of Arizona, not just the major, national industrial and financial institutions who are politically and economically driving this competitive process. And any such changes should be and can be minimal. We will vigorously contend against efforts to constitutionally impose new ACC jurisdiction upon district and municipal electric providers, or to legislatively destroy the vital ability of rural public power consumers to rely upon federal preference resources. Neither of these objectives of the PSCs is necessary to effectively implement electric competition in a manner that will broadly benefit the citizens of Arizona.

Thank you for the opportunity to comment on behalf of the above-named public entities.

Respectfully,

Jay I. Moyes

JIM/dmn
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AEPCO, Duncan and Graham's (the "Cooperatives")

Minority Report

Legal Issues Working Group

The most significant failing of the Report of the Arizona Corporation Commission's Legal Issues Working Group (the "Report") is its political rather than legal nature. This is driven by two major factors: (1) the currently pending litigation concerning the Rules and (2) the upcoming Legislative session. Both elements have transformed what should be a thoughtful analytical road map on legal obstacles to competition and how to address them into a mismash of policy pronouncement and legal obfuscation that, at best, confuses and, at worst, actively misleads the reader.

For example, because the Rules are being challenged in court, notably absent from the Report are meaningful recommendations as to who has what jurisdiction and how should it be exercised to achieve the desired goal of a competitive electric marketplace. Understandably, the Commission's attorneys can't concede that the Courts long ago decided the Legislature controls the competition issue because that would damage the ACC's litigation defense.

The SRP and other municipals are so concerned about any opening of the Constitution which might lead to an examination of their non-regulated status that they oppose necessary Article 15 amendments. Similarly, prospective providers and large industrial consumers are so fearful of any legislative debate which might delay the January 1, 1999 start date that they oppose any examination of Title 40 - even change which would produce a more flexible market for competitors and a more competitive market for consumers.

The Report, therefore, finesses these issues by offering pro and con and avoiding conclusions on settled matters. For example, a Report reader does not know that:

- More than 50 years ago, the Supreme Court decided the Legislature's control of the Certification process does not conflict with the ACC's rate-making power.

- Since that time, Arizona's courts have ruled repeatedly that a regulatory compact exists and the Commission may administer but may not change the policy of regulated monopoly.

- More than 40 years ago, the Supreme Court ruled that the Commission can only use "fair value" as the basis for prescribing just and reasonable rates.

- Since that time, Arizona's courts have ruled repeatedly that ACC rate orders and tariffs not based on "fair value" are void and the rates collected are subject to refund.

Instead, the best the Report can muster on these critical, settled legal issues is the following tepid statement:

> The Working Group's consensus is that the Courts or perhaps the Legislature ultimately will determine whether the Commission must have legislative or constitutional authority to promulgate the Rules . . . (Report, p. 3).

Report readers should first view Rod Serling's televised admonition many years ago: "There's a signpost up ahead. You just crossed over into the Twilight Zone."

The Cooperatives disagree in many areas with the Report's analyses, conclusions and, most importantly, its lack of recommendations on key subjects. In the interests of brevity, we will highlight five major Constitutional and Legislative subjects most in need of better focus:

<u>The Constitution</u>.

Several constitutional hurdles stand between today's regulated market and competition. The two most critical are:

- **Article 15, Sections 3 and 14.** No one disagrees that the Constitution gives the Commission exclusive ratemaking authority. However, like most power offered by that document, it is not unfettered. As to rates, (1) the Commission, not the provider nor consumer, must set them and (2) they must be based on "fair value", not some other standard including the market. Since statehood, every time the ACC has tried to ignore either mandate the courts have ruled the rate invalid. As importantly, in at least one case, they also ordered a refund of all dollars collected under it. If these Constitutional requirements aren't changed, no supplier and no consumer will have a market based rate on which they can rely. This issue must be resolved by the Legislature and the people.

- **Article 15, Section 2.** The ACC Rules seek to regulate non-electric supply services, i.e. metering, billing and collection, etc. However, since these functions are not included in the definition of activities ascribed to a public

service corporation, several cases dictate the ACC can't exercise this power and can't be given it by the Legislature. If regulation of these services is desired, a Constitutional change is required.

Title 40.

The Cooperatives feel that many revisions to Title 40 are necessary to allow competition to work. We refer to this subject as "De-regulate, don't re-regulate." The three most important areas are:

- **A.R.S. § 40-281.** Placing the debate about what the Certificate statute currently requires to one side, no one can seriously argue that the Legislature shouldn't take action to clarify what the State's public policy on competition should be in the future. This is a critical issue because failure to act will leave, unnecessarily, the entire foundation of competition in jeopardy.

- **A.R.S. §§ 40-285 and 40-301 et seq.** These statutes require a utility to seek ACC approval before selling assets or issuing stock or notes. Violations render the sales, stock or notes void. They burden a competitive market, slow decisions and cause providers, potential or current, to wonder if Arizona's market is worth the peril. They were created by the Legislature for another time and must be re-examined by the Legislature to see if they still fit.

- **Rate Statutes.** The statutes in Title 40 - A.R.S. §§ 40-250 and 40-367 among them - assume a highly regulated monopoly market where tariffs, standard terms and conditions, rate hearings and regulatory filings are required to assure customer satisfaction, not consumer choice. Thus, the Legislature, pursuant to its Constitutional power, has imposed on the Commission a variety of filing, hearing and process requirements. They are paternalistic and antithetical to the goal of a competitive marketplace. The ACC can't de-regulate and its Rules don't purport to. Only the Legislature can deal with this issue.

The nature of a minority report is to poke at the core product. This memorandum is no exception to that general rule. However, we do not by these comments minimize nor denigrate the considerable effort devoted to the Report by all participants.

To: Lindy Funkhouser, Legal Issues Working Group, Draft RP3
From: Barbara Sherman, for the Arizona Consumers Council
Date: 7/22/97

- The purpose of the Arizona Corporation Commission regulation and oversight of electric industry has been to protect the interests of the residential. low income and small business customers. The federal and state move toward electric competition will not eliminate the need for protection of these customers. Changes in electricity regulation must take this into account. After the changes, a revised legal and regulatory framework must ensure that electricity is reliable, safe, and available at affordable prices to the majority of the customers -- the small residential, the low income, and business consumers.

- We note with significant concern that the definition of "consumer" in the report only refers to one type of consumer, namely, the "high-volume purchasers of electric generation services." See position above about the role of the Arizona Corporation Commission.

- With relation to the changes in the Arizona Constitution and Arizona State statutes or FERC, the Arizona Consumers Council concurs with those who would keep a close eye on potential problems and minimize changes until they are necessary. Again, the constitution and statutes offer many tools for protecting consumers. In particular, it is critical that the Arizona Corporation Commission always has the ability to oversee electric utility operations to prevent price gouging and fraud as well as to oversee minimum standards for safety and reliability. For example, the needs for business confidentiality must not overshadow the residential and small business consumers need for protection, i.e., for Arizona Corporation Commission oversight of financial business information.

- The question has been posed as to whether or not the staff at the Arizona Corporation Commission should express its own opinion in the working reports. Perhaps the working reports are not the right vehicle for staff opinions, since they are intended as a compilation of the opinions, needs and positions of the many differing stakeholders in the process. However, it would be a disservice to the public if the staff did not specify its recommendations. The ACC staff is knowledgeable, experienced, and has done a good job of protecting the interests of the low income, the residential and the small business consumers in Arizona, overall. Most of the staff have many years of expertise that should not be lost in the critical change in electric regulation. The Arizona Consumers Council recommends that a separate staff report be prepared with staff recommendations re electric restructuring for the Arizona Corporation Commission and made public so that informed decisions are made in the rules.

The staff has a duty to represent the public's interest and not just to tell the commissioners what they want to hear.

* One of the most important issues regarding the restructuring of electricity is the stranded costs/benefits issue. The price tag for generation plants loom large for the industry and all the consumers, but especially the residential and small business consumers. Electric consumers should not have to pay for "stranded costs" except as they receive the benefits of competition. Regulated electricity rates and bundled rates already include the costs of the generation plants. "Stranded benefits" should be distributed among all customers.

- Prior to decisions on rules changes, it would be wise to quantify the rules change impacts on the electricity rates of low income, residential and other small consumers. It is important to retain customer classes and classes of service insofar as they are necessary to evaluate whether small consumers are getting their fair share of the benefits of competition. Tax impacts also need to be quantified. We should be moving into competition with our eyes open, knowing the probable impacts, so that we can prevent problems.

- Provisions need to made --even with competition--for social programs re hardship cases whether low income or health.

- Also, integrated resource planning has consumer protection and national defense implications that must be taken into account even though electricity is moving into competition.

- The obligation to serve will change with competition, however; small consumers will need a reliable electricity source.

* Consumer interests demand some continuation of legal constraints against cross-subsidization of other business ventures with electricity.

- All electric service providers need to meet minimum standards of service. New and foreign providers should meet similar requirements to those of Arizona's long term service providers.

- As for the "fairness" issues and "level playing field" issues, it must be remembered that there have been and will continue to be a need for rural areas of Arizona to receive adequate, safe and reliable electricity at affordable rates. Much of the tax and loan infrastructure that create differences between investor owned utilities and municipals or cooperatives arose from the need to provide electricity in areas where population density is low.

Thank you for the opportunity to share our views. Barbara Sherman

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September 19, 1997
HAND DELIVERED

Lindy Funkhouser
Chief Counsel
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, AZ 85004

RE: Final Report of the Legal Issues Working Group

Dear Mr. Funkhouser:

Thank you very much for the opportunity to participate in the Legal Issues Working Group. You are to be congratulated for your management of this exceedingly difficult process. Although I am disappointed that the Final Report utilized a standard of "unanimous consensus" for determining whether recommendations would be presented to the Commission (a process which allows one participant to "blackball" a recommendation otherwise supported by a clear majority of those present), I nonetheless commend you for the "inclusiveness" of your workshops and the opportunity for all to present their views, comments and concerns.

The purpose of this letter is to present an overview of the substantive comments of Arizona Public Service Company to the Final Report, as your September 5, 1997 memo invites. These comments are designed to promote, not retard, the movement toward responsible retail access as quickly as possible. And, as in the past, Tom Mumaw and I stand ready to work with you and the other parties to revise the Competition Rules to cure their many obvious deficiencies.

The summary comments set forth below will concentrate solely on legal issues associated with the Competition Rules.[1] The many policy issues raised by the Competition Rules [2] will be

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[1] This summary is not intended to be a complete presentation of all of APS's views on the Competition Rules. Those views have been expressed in previous pleadings and written comments to the Commission and in part are the subject of an APS legal challenge to the rules. Nothing in these comments shall serve as a waiver of any argument APS has or may have with respect to the Competition Rules.

[2] Such issues include the calculation and recovery mechanisms for stranded cost, failure of the rules to address reliability concerns or industry structure, the impact of competition on local and state tax revenues and the plethora of technical and administrative implementation issues.

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left to APS comments made in other forums and working groups. With that introduction, and without repeating the extensive legal analysis and argument we have provided during the workshop process, the following represent the significant legal issues APS believes must be addressed by the Commission in connection with the Competition Rules:

1. Lack of Commission Authority.

The Commission simply has no jurisdiction, even if adequate compensation is paid, to (a) grant CC&N's to competitive generation service providers or (b) force incumbent Affected Utilities to make their distribution facilities available to competitors. The fact that APS, and virtually all other parties, favor retail access in one form or another cannot cure this obvious lack of Commission authority. The cases cited by APS make it perfectly clear, and no party has cited any direct precedent to the contrary, that it is the legislature, not the Commission, that must establish the foundational authority for retail access in the electric utility industry. Only then can the Commission begin the implementation task. We urge the Commission to work with APS to remedy this defect as soon as possible.

2. Mitigation Standard Related to Recovery of Stranded Costs.

The mitigation standard in R14-2-1607 is clearly unlawful, unreasonable and overly vague. The Commission cannot legally require utilities to expend potentially unlimited amounts of private capital and other resources to pursue ill-defined business ventures not subject to ACC jurisdiction solely to qualify for compensation to which the utility is otherwise lawfully entitled as a result of the Commission's actions. Therefore, Section A of R14-2-1607 should delete the phrase "every feasible" and add "reasonable" and add "that are directly related to its regulated business" so that the subsection would now read:

> The Affected Utility shall take reasonable, cost effective measures 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, that are directly related to its regulated business.

3. Regulation of Non-Public Service Corporations.

R14-2-1611(A) states ". . . nor shall Arizona electric utilities which are not Affected Utilities be able to compete for sales in the service territories of the Affected Utilities."

Notwithstanding this unambiguous pronouncement, numerous working group participants continue to argue about the extent to which non-PSCs are able to compete in investor owned utility service areas, either directly under the Competition Rules or through some as yet unproduced intergovernmental agreement. Given the confusion this debate has engendered, the Commission should clarify and further reconfirm that R14-2-1611 does not permit non-PSCs to compete within the service territories of Affected Utilities. If such competition is sought by a non-PSC, then appropriate legislative changes must be implemented to insure that such competition is authorized, fair, conducted on a reciprocal basis, and provides for such compensation as may be required for any "takings" of utility property (*e.g.*, under A.R.S. § 9-516).

4. Obligation to Serve.

Affected Utilities are required to provide a bundled "standard offer" service to end-users that are under no reciprocal obligation to take such service. The Final Report acknowledges the lack of legal support for this unilateral burden on Affected Utilities but, although proposing some minor changes to the Competition Rules, it does nothing to either lift that burden or to equalize it by imposing such an obligation to serve on other ESPs.

5. Recovery of Stranded Costs in Rates for Non-Competitive Services.

A.A.C. R14-2-1607(J) is, at best, ambiguous and arguably in direct conflict with Subsection H of the same regulation. The Final Report is needlessly "soft" in its recommendation for an amendment to this part of the Competition Rules to clarify from whom stranded costs can be recovered. At a minimum, the first sentence of Subsection J should be deleted.

6. "Streamlined" Regulation of Competitive Services and Competitive Service Providers.

The Final Report seemingly accepts the notion that the Commission has the authority to excuse compliance by certain ESPs with specific statutory provisions. There is absolutely no authority cited for such a proposition. Moreover, several of the statutes in question (*e.g.*, A.R.S. §§ 40-285; 40-301, *et seq.*; and 40-360.02) require or at least authorize severe penalties for non-compliance. Thus, it is unlikely that any ESP could reasonably rely on the Commission's unilateral waiver or modification of these statutes.

The only prudent course of action to recommend to the Commission would be to seek legislative modification of those statutes that are no longer necessary or which would restrict competition. APS has already proposed such modifications to the Joint Legislative Study Committee currently evaluating electric industry competition issues.

Thank you for the opportunity to present these additional comments. I hope the Commission Staff will carefully consider these views and support these changes to the Competition Rules that are so clearly required to provide meaningful customer choice in an efficiently and lawfully restructured industry.

Sincerely,

Steven M. Wheeler
for SNELL & WILMER L.L.P.
Attorneys for Arizona Public Service Company

SMW:DN

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September 29, 1997

Lindy Funkhouser, Esq.
Chief Counsel
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1200 W. Washington
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DELIVERED BY U.S. MAIL, E-MAIL & FAX

Dear Lindy:

As you are aware, the Arizona Utility Investors Association believes that the Corporation Commission's rule establishing electric competition leaves a gaping hole in the regulatory oversight of the transition to competition with regard to municipal aggregation.

The final draft of the report of the Legal Issues Working Group in Sections Four and Five purports to address issues involving non-public service corporations. However, those sections deal only with municipal electric utilities and are silent about other municipalities which may choose to offer the same services as those reserved for Electric Service Providers under the provisions of R14-2-1601, 1605 and 1606.

The rule itself ignores municipal corporations unless they are operating electric utilities, but the Commission's Legal Division has asserted that municipalities may offer services that have been defined as competitive by the Commission, i.e., electric generation, ancillary services, metering, meter reading and billing and collection.

This creates a serious dichotomy which should be expressed as an unresolved legal issue. The dichotomy is as follows:

1. The foundation of the Commission rule is that the transition to competition will be regulated by the Commission and that market entrants which choose to compete as Electric Service Providers must submit to Commission jurisdiction.

Indeed, all of the pertinent language in the rule anticipates that electric competitors will be regulated, as in R14-2-1605 which says, "A *properly certificated* Electric Service Provider may offer any of the following services under bilateral or multilateral contracts with retail consumers:" (Emphasis added)

2. However, the Commission is barred by the Arizona Constitution from regulating municipal corporations and has no apparent authority to compel a municipality to obtain a Certificate of Convenience & Necessity or submit in any other way to Commission rules and regulations.

3. As a result, cities and towns throughout Arizona will be able to aggregate thousands of retail electric customers without following the same rules imposed on other Electric Service Providers. They will be able to set prices, aggregate electric loads, install and read meters, bill customers and establish their own protocols without regulatory oversight from anyone who knows anything about the electric industry.

4. While it's not possible to predict precisely the effect of creating a potentially large unregulated segment of the industry, the consequences could be severe for system reliability, consumer understanding and the conduct of a competitive marketplace.

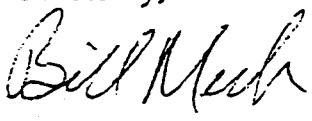
5. Members of the staff of the Utilities Division who were instrumental in drafting the competitive rule say it was always their intention to require regulation of Electric Service Providers and not to create an unregulated segment of the industry during the transition to full competition.

In our view, municipal corporations should either a) be excluded from competing in the service territories of Affected Utilities until the Commission has relinquished its regulation of competitive services or b) be required by legislation to follow Commission rules and regulations governing the transition to competition.

In R14-2-1611, the Commission purports to exclude Arizona electric utilities which are not public service corporations from competing for sales in the service territories of Affected Utilities. Therefore, it may be possible to amend the rule to apply a similar prohibition to municipalities which do not succumb to Commission jurisdiction. The other option is a statutory enactment described previously.

In any case, the report of the Legal Issues Working Group should at least recognize the prospect of unregulated municipal aggregation as a significant unresolved legal issue.

Sincerely,



Bill Meek
President

M E M O R A N D U M

TO: Lindy Funkhouser, Chief Counsel, Legal Division
ARIZONA CORPORATION COMMISSION

FROM: Webb Crockett, Lou Stahl

DATE: September 15, 1997

RE: Final Comments on the Report to the Arizona Corporation Commission Regarding Electric Industry Competition

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The following represents final comments on the Report to the Arizona Corporation Commission ("Report").

It should be noted that many of the comments previously made by the Consumers represented herein, ASARCO, Incorporated, Cyprus Climax Metals, ENRON Corp. and the Arizona Association of Industries, with respect to the various Drafts of the Report were not included in the Final Draft of the Report. The Consumers are again providing their position on issues, as the representatives of a major segment of the interested parties, as well as specific citations to relevant authority which should have been included in the Report in order for the Commission to have a more complete understanding of the constitutional, statutory and legal basis for any decisions the Commission makes regarding electric industry competition.

It is respectfully submitted that the following comments be considered by the Commission in connection with its review of the Report:

Introduction:

The Introduction does not reflect that there was often not a consensus on whether any action should be taken at all, as well as many areas where a consensus could simply not be reached on any particular action. For example, with respect to the proposed Constitutional and statutory amendments requested by the Affected Utilities, some participants believe that no amendments are necessary, and, therefore, believe no action is necessary.

The term "Consumer" should be construed more broadly than to "refer primarily to high-volume purchasers of electric generation services." Other consumers who would not be considered high-volume purchasers are also involved in the deregulation process.

Scope of the Commission's Authority:

The Affected Utilities argue that the incumbent utilities have the right to a monopoly position due to an alleged regulatory compact with the State of Arizona. The position of many of the consumers of electricity, as well as other parties, is that mere acquisition of a certificate of convenience and necessity in a given area does not give a public service corporation the exclusive right to provide electric service, and

no property right to a monopoly may be claimed. Absent from the discussions in the Report, however, is any citation to the approval of the consumers' viewpoint by the Superior Court of Arizona as set forth in the recent decision of the Honorable Steven D. Sheldon in *U.S. West Communications, Inc. v. The Arizona Corporation Commission, et al.*, CV 95-14284 (May 6, 1997). This is an important decision in this area of which the Commission should be aware and which should be followed as it progresses through the appellate system. The disposition of the *U.S. West* case on the regulatory compact and takings arguments will undoubtedly have a significant impact on the Affected Utilities' arguments. Thus, the citation to the *U.S. West* case should be noted at each juncture where the regulatory compact is discussed or referenced, as well as in the sections where the Affected Utilities raise the takings arguments. (Sections 1.1, 1.2, 1.3, 1.4, 1.5, 2.1, 2.2.)

It should have been made clear in the Report that A.R.S. § 40-281 does <u>not</u> provide for an exclusive and indefinite monopoly. There are no perpetual rights under Arizona law. The Arizona Constitution makes it very clear that monopolies are disfavored, stating "<u>monopolies</u> and trusts <u>shall never be allowed</u> in this State..." (Ariz. Const. Art. 14, § 15) (emphasis added). This cornerstone Constitutional principle is set forth in footnote 4 on page 7 of the Report, but should be stated in the text rather than relegated to a footnote. This principle should be reiterated in Sections 1.1, 1.2, 1.3, 1.4, 1.5, 2.1, 2.2.

Section 1.1:

Page 3, bottom paragraph – There was not a consensus of the Working Group that (1) the Commission must have additional legislative or constitutional authority to promulgate the Rules; (2) the Commission should clarify that the Rules do not affect the exclusivity of distribution services; or (3) the Rules need to distinguish between certificates for distribution and certificates for other services.

Page 6 – Footnote number 3 should not be relegated to a footnote but should be included in the text of the Report.

Section 1.2: It is incorrectly stated on Page 10 that "The Working Group consensus is that the Commission should consider addressing this possibility in amendments to the Rules." The consumers who have been actively participating in the Working Group do not agree that the Rules need to be amended. Thus, it should be noted that **"no consensus"** was reached on this section. Comments A and C should be eliminated to the extent they state or imply that the Rules need to be amended or augmented. The goals of Comment B, and even A and C, may be reached without amendments to the Rules. Further, with respect to Comment B, the consumers take the position that the obligation to serve should and does continue so long as Affected Utilities are recovering stranded costs because until such costs are fully recovered, Affected Utilities are being paid for their investment and for the costs of implementing competition. Affected Utilities should not be allowed to pass on additional costs to consumers.

Section 1.3: The text of Article 15, Section 10 of the Arizona Constitution should also be included in this section. Section 10 provides: "All electric, transmission, . . . corporations, for the transportation of electricity, . . . for profit, are declared to be common carriers and subject to control by law." Further, under the provisions of A.R.S. § 40-332, the Commission has the power to order joint use of facilities.

Section 1.5: In the final paragraph of this section on page 14, the words "and consumers" should be inserted after the word "Staff" in order to alert the Commission that others share Staff's views on this issue.

Section 2.1: On page 14, first paragraph, it should be noted that more than a single participant agrees that the Affected Utilities should be precluded from cross-subsidizing their unregulated activities with funds received from ratepayers, that accounting methods and procedures to prevent cross-subsidization should be implemented, and that they should be required to pay fair market value for the use of utility personnel, services, and equipment used, as well as royalties for any intangible benefit gained, through affiliation with the regulated utility. These directives should be extended to encompass any use of the personnel, assets or credit of the utility to benefit the unregulated activities.

Section 3.1: In response to the statements in this section that utilities should be required to expend resources in mitigation of stranded costs, some parties believe there should be no limitations on such mitigation requirements. Rather than limit mitigation efforts to only the use of funds generated by "traditional utility service" the Affected Utilities should be required to use any revenues that are generated by or from the use of personnel, assets or the credit of the utility to mitigate stranded costs. Consumers should receive the benefit of all revenues generated by the assets, personnel or credit of the utility. Those assets, personnel and credit of the utility were traditionally devoted to serving the public, with the ratepayers returning the investments to the corporation through rates, and any continuing revenues from such assets, personnel and credit should be utilized to complete the return of that portion of the investment rendered stranded by competition.

Footnote number 6 on page 17 should have the word "duties" stricken and replaced with the words "legal obligations".

Sections 3.2 and 3.3: It should be noted that there is a disagreement as to whether there is a conflict between R14-2-1607(J) and R14-2-1607(H). Also, the Commission should be aware that the Consumers take the position that stranded costs should be recovered from all who benefit from competition. Under the "comment" on page 20, the words "see the discussion above" should be stricken and replaced with "no consensus".

Section 7.1: It should be noted in this section that some participants take the position that the availability of two county financing is a benefit which will not be available to all participants in a

competitive market. Recognizing this fact, the Commission should not draft specific rules or make changes to the Rules which will affirmatively foster the use of this benefit by some participants to the detriment of other participants. More particularly, if a corporation chooses to extend its service territory in such a manner as to increase its costs of financing, these costs should not be passed through to consumers as costs. The last sentence in the second full paragraph on page 43 ("Another solution is for the Commission to include in its definition of recoverable stranded costs, any increase in financing costs or the stranded cost of any assets because of local furnishing requirements.") should be deleted. If corporations wish to take advantage of beneficial financing, they should also recognize that they must live within the parameters of that financing in order to accept it. Corporations should be required to weigh the benefits of the financing against its possible burdens prior to accepting it, even if some of those burdens mean foregoing some market share.

Section 7.2: Here again, the Consumers' viewpoint was never incorporated into the Final Draft of the Report. To accurately reflect the participants' positions, it should be noted that some participants believe that solutions to the issues raised in this section are possible without amendments to the Rules. Possible solutions may include that co-operatives simply not sell to non-members, or make membership in the co-operative a condition of service. Still another possibility is to match the FERC mechanism put in place to handle this financing tool. Companies should not be able to utilize this type of favorable financing without being required to recognize that benefits and burdens must be weighed, even if some of those burdens require a lesser market share or more limited service areas in the competitive market. As discussed with respect to the two county financing, REA financing is beneficial financing which is not available to all participants in a competitive market. That fact should be noted in reviewing the Report, as well as the position that no Rules should be adopted which will foster the use of this financing by some, to the detriment of others in a competitive environment.

Section 9.3: Further comment on this section relates to the ability of the Commission to permit the market to determine fair and reasonable rates for services. The Commission's power to prescribe rates is exclusive and cannot be interfered with by the legislature, the courts or the executive branch of the state government. *Pueblo Del Sol Water Co. v. Arizona Corp. Comm'n*, 160 Ariz. 285, 772 P.2d 1138 (Ct. App. 1988); *Southwest Gas Corp. v. Arizona Corp. Comm'n*, 169 Ariz. 279, 818 P.2d 714 (Ct. App. 1991); *Consolidated Water Utils., Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 875 P.2d 137 (Ct. App. 1993). The Commission, in operating in the regulated monopoly arena, sets rates as a surrogate for the market because, in the case of natural monopolies or regulated monopolies, there is no market. Regulation is an attempt to artificially duplicate the market and market rates. The Commission is permitted wide latitude in setting rates and, by allowing the market to set reasonable rates, those rates, by all estimations, will be lower than regulated monopoly rates. Regulation in the

traditional form may still be required, and may continue under the present statutory and constitutional scheme, for the operations of, and the setting of rates, charges, fees, etc. for the transmission and distribution of electricity.

Section 9.4: The Commission should note at the outset of this section that there is substantial disagreement over whether statutes and/or the Constitution need to be amended, and if so, what those amendments should be, as well as the scope of the amendments, if any. Specifically, it is the position of many interested parties that statutory and Constitutional amendments are not necessary.

Section 9.4.1 A.R.S. §§ 40-281 and 282: Since distribution and transmission services have not been deregulated, these statutes are required to remain in force and effect for those services. The Rules draw a sufficient distinction between distribution, transmission and generation.

Section 9.4.6 Foreign corporations already do business in Arizona. This fact contradicts the arguments and hypothetical issues raised by the Affected Utilities with respect to this statute and necessary amendments thereto.

Sections 9.4.7 and 9.4.8 A.R.S. §§ 40-285 and 40-301 et seq.: The Report should have made it clear that it is only generation which is being deregulated and that distribution and transmission will remain subject to regulation and control by the Commission. Additionally, reference should be made back to the recommended statement of policy noted in Section 9.4.2, which could be designed to adequately address the applicability and the scope of these statutes in the generation area. In addition, A.R.S. § 40-285 would not apply to competitors since facilities would not be "necessary" in the performance of duties to the public when there are alternative providers available to the public. It is, however, necessary to retain the limitations set forth in A.R.S. § 40-285 when "necessary" facilities are involved.

Section 9.4.10 It should be reiterated that it is only generation which is being deregulated, not distribution or transmission. Thus, it is still necessary to retain the provisions set forth in A.R.S. § 40-341, et seq. in order to allow consumers to convert overhead facilities to underground.

Section 9.4.11 It should be reiterated in this section that it is only generation which is being deregulated, not distribution or transmission. Thus, it is still necessary to retain the limitations set forth in A.R.S. § 40-360, et seq. with reference to siting generating plants and high voltage lines.

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HAND DELIVERED

September 12, 1997

Lindy Funkhouser, Chief Counsel
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007-2996

Re: Comments on the Proposed Final Draft of the Report of the Legal Issues Working Group to the Arizona Corporation Commission

Dear Mr. Funkhouser:

By memorandum of September 5, 1997, you submitted the proposed final draft report of the Legal Issues Working Group to its participants. You asked for individual final comments to be returned to you no later than September 12, 1997.

I want to congratulate you on pulling together a report that gives a clear picture of the major issues that the Legal Issues Working Group confronted during its deliberations. I think the Commission should be greatly aided by your editing effort. I have only two observations.

First, the discussion in Section 1.1 of the "monopoly" status of Certificates of Convenience and Necessity issued under A.R.S. Section 40-281 can easily be remedied by a clarification to that statute similar to that done for the telecommunications industry. Of the various possible statutes in Title 40 discussed in the report, this is, in my view, the one statute that clearly deserves consideration for legislative change. Other problems that have been raised probably can be more effectively addressed after Arizona benefits from watching California implement its program beginning in January.

Second, the unresolved discussions mentioned in several parts of the report concerning utilities that are regulated by the

Commission and those that are not can also be left for another time. It is important to note the lack of agreement on whether a problem exists and what actions may or may not be necessary. Effective implementation of this program will require all of the Commission's resources. Being sidetracked by entering into this area will not help. California saw no reason to change its current scheme and Arizona need not either. When the Commission is finished deregulating retail electric sales, it will by then have evidence of whether that portion of the distribution business that remains within its jurisdiction has problems or not. There will be plenty of time then to consider cures to any real problems that can be demonstrated through experience rather than speculation.

Again, congratulations on the excellent effort that has gone into this report.

Sincerely,

Robert S. Lynch

RSL:psr
cc: IEDA Members

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September 11, 1997

Mr. Lindy Funkhouser
Chief Counsel, Legal Division
1200 West Washington
Phoenix, Arizona 85007

Re: Report of the Arizona Corporation Commission's Legal Issues Working Group ("Report")

Dear Mr. Funkhouser:

Pursuant to the agreement reached at the August 28, 1997 meeting of the Legal Issues Working Group, as reflected in Constance J. Fitzsimmons September 5, 1997 transmittal memorandum, PG&E Energy Services ("Energy Services") hereby submits its individual "final comments."

THE REPORT

As you are aware, a representative of Energy Services has participated as both a member of the Legal Issues Working Group and a "reporter" during the period of time when the Report was being developed. At various times that individual has made substantive observations, suggested editorial changes and offered written text where believed appropriate in support of the collaborative effort contemplated by R14-2-1616. Recognizing that a consensual process by its very nature cannot fully accommodate the views of all concerned, Energy Services nevertheless believes that the form of Report transmitted on September 5, 1997, on balance, represents an inclusive and fair presentation of the issues addressed and arguments advanced by the participants. Accordingly, it has nothing to suggest by way of addition or modification as of this juncture.

THE REOPENED PROCEEDING

As you are also aware from its active participation as an Intervenor in the Maricopa County Superior Court litigation resulting from the Commission's issuance of Decision No. 59943 and

its adoption of R14-2-1601 et seq., Energy Services believes that the Commission's actions in that regard were within its constitutional and statutory powers and jurisdiction.[1] In addition, Energy Services believes such actions were consistent with and in furtherance of the public interest of the State of Arizona and its residents. What is crucial for all concerned is for the Commission to continue to act in this manner during the transition to a competitive environment in the provision of electric services.

Through its issuance of Decision No. 60351 on August 29, 1997, the Commission has determined to reopen the electric competition proceeding (Docket No. U-000-94-165) in order to (i) receive presentations and recommendations from representatives of each working group established by R14-2-1601 et seq., and (ii) consider proposed additions and/or modifications to the previously adopted electric competition rules. Energy Services will continue to be an active participant in the reopened proceeding; and actively supports the Commission's indicated intention to conduct that proceeding in an expeditious manner. Significant in this regard is the following statement of the Commission:

> "Because the Rules phase in competition according to an <u>established schedule</u>, the Commission believes that the rule making process should commence as early as possible <u>to meet that schedule</u>." (Decision No. 60351 at page 2, lines 1-3) (emphasis added)

By its issuance of Decision No. 59943 and its adoption of R14-2-1601 et seq., the Commission established a framework by which Arizona's retail electric markets could transition to competition. That transition is now under way. Through the reopened proceeding provided for by Decision No. 60351, the Commission will be in a position to adopt such additional measures, if any, as may be necessary to assure that such transition is fair, equitable and orderly. But, as the Commission has correctly concluded, such "fine tuning" does not require that the previously adopted schedule for implementing competition be disturbed or delayed. To the contrary, the public interest requires that it not.

---

[1] Energy Services also believes that no constitutional or statutory changes are necessary to support or rationalize the Commission's actions. Certain parties have suggested certain "clarifying" amendments to various provisions of Title 40 of the Arizona Revised Statutes. Energy Services believes such changes are unnecessary, and would oppose any proposals of that nature if they entail a risk of undercutting or restricting the Commission's authority to provide for competition in the retail electric industry.

CONCLUSION

Thank you for the opportunity to submit these "final comments" in connection with the September 5, 1997, version of the Report.

Very truly yours,

Lawrence V. Robertson, Jr.

Lawrence V. Robertson, Jr.
Attorney for PG&E Energy Services

LVR: mbd

Residential Utility Consumer's Office

Comments on Draft of Legal Issues Working Group

September 15, 1997

The following are the preliminary comments of the Residential Utility Consumer Office (RUCO) to the Report of the Arizona Corporation Commission's Legal Issues Working Group ("Report"). RUCO will have additional comments as to legal matters as more specific proposals are made and the reports of the various other working groups are published.

A. Purpose of Comments

The legislature established the RUCO for the following purpose:

> "The purpose of the residential utility consumer office is to represent the interests of residential utility consumers, critically analyze proposals made by public service corporations to the corporation commission, develop its own recommendations and present them to the commission."

Laws 1987, Ch. 222, Sec. 1.

The statute expands on the purpose of RUCO by giving its Director the power to participate in utility rate cases and other proceedings of the Arizona Corporation Commission ("ACC") affecting residential consumers. The statute states:

> "A. The director may:
>
> 1. Research, study and analyze residential utility consumer interests.
>
> 2. Prepare and present briefs, arguments, proposed rates or orders and intervene or appear on behalf of residential utility consumers before hearing officers and the corporation commission as a party in interest and also participate as a party in interest pursuant to Secs. 40-254 and 40-254.01 in proceedings relating to rate making or rate design and involving public service corporations . . ."

A.R.S. § 40-464.

The following comments are tendered as a result of the determination of the Director that the prospect of a major change in the regulation of electric utilities may have a tremendous impact on residential consumers.

B. General Comments

The Report continually discusses issues and concerns of the "Consumer." On page 1 of the Report, "Consumer" is defined as referring "primarily to high-volume purchasers of electric generation services." While RUCO is concerned with this "Consumer," RUCO's primary concern is on behalf of residential utility consumers.

The Report does not directly address issues of primary importance to the residential consumer of electricity. The major issue to residential consumers is the provision of uninterrupted, universal electric power at the lowest possible rates.

The introduction of the salutary concept of competition in the provision and sale of generation of electricity cannot be allowed to leave even a moments gap in the assurance of uninterrupted, universal electric power at the lowest possible rates.

The Report has not addressed the legal aspects of providing uninterrupted, universal electric power at the lowest possible rates, or the legal mechanisms which might allow residential consumers to participate in the market for lower cost generation, billing and collection, metering and meter-reading services. These issues remain to be resolved. RUCO is advocating evidentiary hearings prior to any additional rule making so all parties may present their positions on a "level playing field." It is clear from the Report that little consensus was reached by the legal working group; a similar situation exists with the other working groups. An evidentiary record will provide the commission with a solid basis for any modifications, additions or corrections that may need to be made to the Electric Retail Competition Rules. Such evidentiary hearings are compelled by the omission of any meaningful legal analysis in the Report related to the assurance of uninterrupted, universal electric power at the lowest possible rates.

C. Sections 1.2, 1.4 and 6.5

Sections 1.2 and 1.4 address legal issues related to the ACC's ability to require utilities to be the "provider of last resort" and the ability to regulate providers of generation services who are not currently regulated.

For residential consumers, there must be a provider of last resort. Certain areas of the State, by virtue of an area's rural character, topography, low densities or other reasons, may not be attractive to providers of generation services. Again, there can be no doubt that each residential consumer in Arizona shall be served in an efficient and low cost manner with electricity at that consumer's home.

Section 6.5 addresses resource planning issues. The availability of low cost, uninterrupted, universal service applies to any discussion of future planning to ensure that the generation resources are available to handle the future needs of the residents of Arizona. While the natural equilibrium of the marketplace will likely satisfy the availability of generation resources in the long term, it is necessary that continual review be undertaken in the short term to insure that residential consumers have resources available.

Various mechanisms should be examined to encourage competition among providers for the residential consumers as customers. These mechanisms are the province of other working groups. The ACC will be required to make a final determination on these mechanisms following recommendations from working groups. Presentation of evidence may also be necessary for the ACC to make a reasoned determination as to the mechanisms that will be available to the residential consumer.

D. Sections 5.1 and 6.1, Stranded Costs

A broad examination of the existence and quantification of stranded costs must be undertaken. The parties to such an inquiry must be required to examine and quantify any such costs which might be attributable to the residential consumer. No levy of stranded costs on the residential consumer can be allowed without a process that allows residential consumers to meaningfully participate. The residential consumer must have the opportunity to advocate for its position in an evidentiary proceeding.

RUCO agrees with Staff that concepts such as "mitigation" are well defined in bodies of law such as commercial lease law and such bodies of law should be examined to determine precise analogies to the anticipated proceedings when stranded costs are alleged. Two examples point out availability of such other bodies of law. In *Corrigan v. City of Scottsdale*, 149 Ariz. 538, 720 P.2d 513 (1986), certiorari denied 107 S.Ct. 577, 479 U.S. 986, 93 L.Ed.2d 580, the Arizona Supreme Court set out a standard for measuring damages which may have accrued as a result of a temporary taking, a concept quite similar to a stranded cost. Such a test, which looks to the overall economic consequences of the action in question, is an analogous situation which assists in understanding a stranded cost issue or claim.

> "Recognizing this problem, we feel the best approach is not to require the application of any particular damage rule to all temporary taking cases. Instead we hold that the proper measure of damages in a particular case is an issue to be decided on the facts of each individual case. It is our intent to compensate a person for the losses he has actually suffered by virtue of the taking. . . . The damages awarded and the way to measure those damages thus may be adapted to compensate the party . . . for his actual losses.

> We emphasize, however, that no matter what measure of damages is appropriate in a given case, the award must only be for actual damages. Such actual damages must be provable to a reasonable certainty similar to common law tort damages. (Citation omitted) This approach will compensate for losses actually suffered while avoiding the threat of windfalls . . . .

149 Ariz. at 543-4.

The concept of mitigation is likewise well documented in Arizona law:

> "The party injured by a breach of contract has a duty to take reasonable steps to avoid the consequences of known injuries. *Coury Bros. Ranches, Inc. v. Ellsworth*, 103 Ariz. 515, 518, 446 P.2d 458, 461 (1968); *Fairway Builders, Inc. v. Malouf Towers Rental Co., Inc.*, 124 Ariz. 242, 255, 603 P.2d 513, 526 (App. 1979); *Barnes v. Lopez*, 25 Ariz.App. 477, 481, 544 P.2d 694, 698 (1976). The party in breach has the burden of showing that mitigation was reasonably possible, but was not reasonably attempted. *Fairway Builders*, supra, 124 Ariz. at 255, 603 P.2d at 526. Whether the duty is violated is a question of fact. 124 Ariz. at 256, 603 P.2d at 526.

Northern Arizona Gas Service, Inc. v. Petrolane Transport, Inc., 145 Ariz. 467, 477, 702 P.2d 696 (App. 1984).

Other applicable concepts and law will apply to the stranded cost analysis.

E. Conclusion

RUCO is hopeful that the advent of competition in generation, billing and collection, metering and meter-reading services will be a benefit to the residential consumers of Arizona. RUCO, however, is concerned that the competition to provide electricity to large users may harm the residential consumer. All legal analysis should commence with the premise that the provision of uninterrupted, universal electric power at the lowest possible rates is the cornerstone of the new competitive market and the regulations of that market.

The lack of a consensus shown in the Report and the indefinite nature of many of the proposals coming from the various working groups, points to the need to be ever mindful of the interests of the residential consumer. It is RUCO's position that evidentiary hearings are essential for the ACC to resolve the numerous issues for which no consensus can be reached. The protection of universal, low cost electric service for the residential customers will best be effectuated through a process that

allows all parties, including the consumer advocates, to provide the complete record upon which the ACC can base the difficult decisions it must make.

SRP

Supplement to

Report of the Arizona Corporation Commission's

Legal Issues Working Group

The Salt River Project Agricultural Improvement and Power District ("SRP") submits this supplement to the Legal Issues Working Group report for the purpose of addressing specific legal issues which may apply to the participation of public power entities such as SRP in a competitive market.

Introduction

SRP is a governmental entity (an Arizona agricultural improvement district) which provides electric power to its customers and, through the Salt River Valley Water Users Association, water delivery services to shareholders. As a public body, SRP represents the interest of its constituents and makes its various comments in this regard. SRP and its customers support the transition to competition and are committed to bringing competition to Arizona quickly and effectively.

As a governmental entity, SRP is not regulated by the Corporation Commission and is not subject to the competition rules. However, SRP has actively participated in these proceedings in order to lend its expertise in a positive manner and to coordinate SRP's transition to a competitive market with the efforts of the Corporation Commission.

In the spirit of promoting a fast and effective transition to a competitive market SRP makes these specific comments to the sections of the report:

1.1 No comment.

1.2 No comment.

1.3 Under the Rules distribution systems will remain regulated. Under the Rules the distribution utility will receive a just and reasonable return on distribution system investment, probably using traditional rate making principles. There is no issue of a taking where prices are properly set. The Commission has always had the authority to order a regulated utility to wheel the power of another provider. *See e.g. Arizona Constitution, Art. 15, § 10; A.R.S. § 40-332.*

1.4 No comment.

1.5 SRP supports any reasonable step to "streamline" or eliminate unnecessary elements of regulation.

2.1 This point addresses utility and non-utility activities by the same Affected Utility, and deals with the argument the utility status somehow gives the utility an advantage in competing in other markets (e.g. heating and air conditioning). SRP opposes any new regulation which would limit competition.

2.2 SRP agrees that in a competitive market place there may be certain proprietary information which should be kept confidential, as long as the public has full access to that information which remains relevant to those aspects of the industry which remain regulated.

3.1 A number of methodologies have been suggested to recover stranded costs. SRP continues to work with other participants to explore the various methodologies.

3.2 No comment.

3.3 SRP supports a future charge, per kWh or per kW, levied on all customers. SRP does not support an exit fee. SRP believes that this is a fair way to assess the costs of a transition to competition to those customers who will benefit from competition. SRP also advocates a rate cap so that prices should be no higher than they are now, with no "dampening" of demand and reliability.

3.4 - 3.7 No Comment

4.1 No Comment

4.2 SRP supports the elimination of unnecessary regulation, including aspects of the affiliate interest rules which do not directly relate to unregulated parts of a business.

4.3 In general terms this section deals with the irrational fear of the investor-owned utilities that public power entities such as SRP will be more effective competitors. Called the "level playing field" argument, this is a non-issue.

Historically customers have always had the choice of public power. In other words, customers could always have chosen (either through local governments or with legislative authority) to "municipalize" the provision of electricity. This "competition" has always acted as a "market" control on the businesses of the investor owned utilities[1].

[1] As has the option of private power served as a competitive force on public power.

As we move toward greater customer choice, it would be counter-intuitive to limit the choice of public power. As before, public power will be a market force in pushing the market toward greater efficiencies and innovation.

In making their arguments the investor-owned utilities fall into the trap of assuming that public power has their same motivations. Public power is owned and controlled by its customers. It has no stockholders demanding greater profits. Thus, public power is not motivated to expand its profits by taking the business of the investor owned utilities. Its motivation is to serve its customers by operating its business rationally and efficiently.

Under competition, prices will be set by the market. The historic cost structure of any competitor, and there are many differences, will have no relevance to market price. Instead, the market will set prices based on marginal cost, as in any other industry.

4.3.1 No comment

4.3.2 Public power, and SRP in particular, does not need an intergovernmental agreement to participate in competition. The purpose of the IGA is to provide a coordinating mechanism between deregulation by the Corporation Commission and the voluntary transition to market competition in the service territories of public power entities. The IGA will not subject SRP to Corporation Commission regulation, nor will it subject the Corporation Commission to SRP regulation. The entities will simply agree to coordinate their respective activities, basically to promote consumer understanding and acceptance, statewide, during the transition process.

4.4 No comment.

5.1 No comment

5.2 The relationship between pubic power and investor owned utilities is addressed under paragraph 4.3 above.

6.1 - 6.4 No comment

7.1 The "two county rule" provides advantages to certain investor owned utilities. As with the other "level playing field" arguments, it is irrelevant to the issues at hand.

7.2 - 7.4 No comment

8.1 - 8.2 No comment

9.1 No comment

9.2 No comment

9.3.1 There is no need to amend the Arizona Constitution. Those advocating amendment are simply promoting delay in the transition to competition.

The suggestion that the customers of governmental, public power, entities should be subjected to additional regulation through the Corporation Commission is silly. We are in the process of deregulation, not more regulation. The sole reason for Corporation Commission regulation of investor owned utilities is to keep the investors (shareholders) from abusing the monopoly position granted to them. This concept is recognized in the constitution of Arizona, as it is in almost every other state.

The real motivation for this suggestion is that the investor owned utilities wish to protect themselves against competition by subjecting other utilities to their same regulatory burdens. The answer is not to increase regulation of others, but to reduce unnecessary regulation by the Commission.

9.4 SRP strongly advocates a minimalist approach on legislative change. The goal should be to implement competition quickly and effectively. Any activity which might slow down the process should be avoided. For this reason SRP advocates only two legislative items at this time. These are to solidify the Commission's general authority to implement its rules, and to deal with the changes in state tax revenues which might happen in competition. SRP is also receptive to changes that would, in general, streamline or eliminate unnecessary elements of regulation. Any other change should await the implementation of competition, where the need and details of the change will be better known and understood.

FINAL COMMENTS OF
SOUTHERN ARIZONA MECHANICAL CONTRACTORS ASSOCIATION TO
PROPOSED FINAL DRAFT OF LEGAL ISSUES WORKING GROUP REPORT

This document constitutes the Southern Arizona Mechanical Contractors Association's ("SAMCA") final comments to the proposed final draft of the Legal Issues Working Group report to the Arizona Corporation Commission, and is presented by SAMCA's legal counsel undersigned. SAMCA's final comments are specifically addressed to Section 9.4.14 of the Working Group Report.

I. WHAT IS SAMCA

SAMCA was formed in 1987 to provide representation and mutual assistance to air conditioning, heating and refrigeration contractors in Tucson in identifying and preventing unfair competition from utilities. SAMCA currently is 86 members strong and its members derive from every facet of the mechanical contracting industry. The majority of SAMCA members are Arizona-licensed contractors. Those contractors compose 68% of SAMCA's total membership. An additional 18% of SAMCA members are suppliers of air conditioning, heating and refrigeration equipment. The remaining members are various service companies who provide support to the mechanical contracting industry.

2. THE PROBLEM OF CROSS-SUBSIDIZATION

Even though the electric utility industry in Arizona may be "deregulating," the distribution of electricity to retail customers will remain a monopoly created and protected by state law and regulated by the Arizona Corporation Commission ("Commission"). The Commission will continue to determine both the rates the utitities are to charge for distribution and the profits to be derived from such distribution.

There has been much discussion within the Working Group about recovery of the "stranded costs" of the utilities which will result from deregulation. While the utilities must make reasonable efforts to mitigate those stranded costs, some stranded costs will necessarily exist. Some members of the Working Group have expressed their belief that one of the preferred methods of stranded cost recovery is to allow the utilities to compete freely in nonregulated markets, such as appliance retailing and servicing. When the utilities enter such businesses, they find themselves in head-to-head competition with small and locally-owned independent businesses.

The entry of utilities into markets traditionally dominated by

locally-owned, small, independent proprietors has the distinct possibility of creating unfair competition in which such businesses are unable to effectively compete against the larger, better-financed utility or utility-affiliated competitor. This situation is compounded further if utilities are allowed to subsidize and aid their nonregulated activities with profits, services and advantages obtained and acquired through their regulated activities. Such "cross-subsidization" enables the utility affiliates to offer products and services below their real market value. Unchecked cross-subsidization will eventually force the locally-owned, independent businesses out of the market.

Cross-subsidization can take many forms. Several examples are as follows:

(1) A utility's nonregulated affiliate can at no little or no cost enclose promotional materials in the monthly utility bill. By so doing, the nonregulated business has immedately and substantially reduced its operating costs and received an enormous competitive advantage in the market.

(2) A utility maintains a wealth of information on consumer needs, requests and other market characteristics which may be readily available to its nonregulated affiliate to be used as a valuable marketing tool. Small, independent businesses do not have access to such important marketing information.

(3) A utility may offer its nonregulated affiliate or the customers thereof below-market interest rates and extended payment plans on products and services. Such financing arrangements are usually cost prohibitive to small businesses, thereby placing them at a competitive disadvantage.

(4) A utility may provide loans, loan guarantees or other financial subsidies to assist the business venture of its nonregulated affiliate in getting off the ground. Small businesses do not have such a ready source of financing.

(5) Because of economies of scale, a nonregulated utility affiliate may be able to bypass the normal distribution channels and buy direct from manufacturers at favorable prices, placing the independent businesses at a competitive disadvantage.

(6) By using the utility's name and logo, the nonregulated utility affiliate has instant recognition in the marketplace, which is something competitors must work for many years to achieve. Moreover, such name recognition may lead to unjustified consumer confidence.

(7) A utility's nonregulated affiliate may use fully-trained employees transferred from the regulated utility. However, the competitors of the utility affiliate may spend a great deal of time, effort and money to provide comparable training for its employees.

(8) Nonregulated affiliates may share office space with the utility either rent free or at a discount to the fair market rental rate. Rent or ownership payments constitute a substantial overhead expense for small businesses.

(9) An array of utility-developed computer and office technology may be available to subsidize the efforts of the nonregulated utility affiliate.

(10) The nonregulated affiliate may have the use of utility vehicles, tools, equipment, accounting and legal departments, and managerial talent at no cost, while such services are very costly to independent businesses.

Thus, small, independent service providers in the competitive market stand to be severely prejudiced and ultimately harmed if nothing is done to prohibit or control cross-subsidization. If utilities are to be permitted to engage in nonregulated activities, they should be required to do so on a level playing field, without the many competitive advantages which may be gained through their utility affiliations.

3. PREVENTION OF CROSS-SUBSIDIZATION

Arizona has no existing legislation which prevents unfair cross-subsidization. The Commission's affiliated interest rules are inadequate to prevent cross-subsidization and its devastating effects on small businesses. Those rules merely prohibit utilities from entering into transactions with their affiliates unless they open up their books to the Commission for review. There is nothing contained within said rules which actually prevents cross-subsidization by utilities. Under the current rules, utilities and their nonregulated affiliates may share costs, marketing information, employees and equipment; and the affiliates may enjoy the benefits of the utilities' financing capabilities, economies of scale and name recognition.

The easiest and most effective way of preventing cross-subsidization is to enact a new rules to replace the affiliated interest rules which would completely separate utility and nonutility business activities. SAMCA submitted a draft of its proposed rules to the Working Group. This separation of activities

would avoid the problems of identifying and properly allocating costs which are associated with different and unrelated activities. A complete separation also prevents utility affiliates from receiving unfair competitive advantages, such as name recognition, logo use, customer base and a readily-available technical expertise. Separating activities is the simplest and surest way to avoid these problems. A complete separation would ensure that utilities pursue competitive ventures on a stand-alone basis. Utilities should only be permitted to provide utility service, and all nonutility activities should be conducted by affiliates without the advantages of cross-subsidization.

4. THE WORKING GROUP'S REPORT

Section 9.4.14 of the report states, in part, that a majority of the Working Group believes that the Commission has "sufficient jurisdiction currently to prohibit any unfair cross-subsidization and/or that prohibition of non-regulated activities would be inconsistent with the move generally to competition." As SAMCA has repeatedly brought to the attention of the Working Group, such a statement about the beliefs of a "majority" of the working group contradicts the written record in this matter. Therefore, in SAMCA's view, the proposed final draft of Section 9.4.14 of the report does not accurately reflect the views expressed by concerned members of the Working Group.

5. CONCLUSION

The restructuring of the Arizona electric utility industry involves issues of vital importance to SAMCA. SAMCA believes the Working Group's report fails to address important issues which will seriously affect the competitive market. New Commission rules or legislation, or both, will be necessary to adequately protect third party victims, such as SAMCA and its members, from harmful fallout eminating from the deregulation process.

I respectfully submit these comments on behalf of SAMCA this 10th day of September, 1997.

Sincerely,

Steven M. Banzhaf
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Attorneys for Southern Arizona
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September 11, 1997

Lindy P. Funkhouser, Esq.
Arizona Corporation Commission
Legal Division
1200 W. Washington, Room 230
Phoenix, AZ 85007-2927

Re: Legal Issues Working Group -- Final Draft Report

Dear Lindy:

Again, I want to thank you very much for the opportunity to participate in the Legal Issues Working Group and to review the Final Draft Report. The City of Tucson offers the following comments to the report.

The report seems balanced in that it presents the points of view that the various participants expressed without making judgments regarding the correctness or incorrectness of such points. Several of the issues will undoubtedly be affected by the determinations of the pending lawsuits and we do not believe comments on these issues would be helpful at this time.

The City agrees with those participants who oppose any amendment to the Constitution that would impact or compromise the municipalities' rights to regulate their own municipally owned utilities. All avenues to implement the spirit of the rules should be explored before any such constitutional amendment is suggested.

The sections relating to FERC and federal issues illustrate the complexity of this area and although the City has no specific recommendations, it is felt that many of these issues will be sorted out as the rules become implemented.

The City looks forward to working with the Commission, the Commission staff, and other participants in the implementation of these rules and any consequent changes and modifications.

Sincerely,

Loretta Humphrey
Principal Assistant City Attorney

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September 23, 1997

Mr. Lindy Funkhouser
Chief Counsel
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85004

Re: Legal Issues Working Group Final Report

Dear Mr. Funkhouser:

At your invitation, Tucson Electric Power Company ("TEP"), by this letter, provides an overview of its comments to the Final Report of the Legal Issues Working Group that has met regarding issues related to competition in the retail electric industry in Arizona. TEP recognizes that the Final Report is the product of many hours of coordination and correlation by you, your staff, the Reporters and other members of the Working Group. During the Working Group sessions many viewpoints were expressed and debated, and as the Final Report reflects, little agreement was reached. You and your staff are to be commended for providing the environment where these discussions could occur and for developing the Final Report document.

TEP's substantive legal concerns with the Competition Rules are well documented. TEP has stated its position on these matters in the record of the Competition Rules' docket and during the workshop sessions. Without repeating each of those concerns in detail, TEP notes that none of them are resolved by the Final Report. TEP believes that given the time and effort that has been devoted to the legal workshops, the Final Report should set forth recommendations to amend the Competition Rules.

Specifically, there were no recommendations proposed on such matters of legal significance as: (a) the Commission's authority to enact the Competition Rules and redefine certificates of convenience and necessity; (b) an Affected Utility's obligation to serve customers in a competitive environment; (c) legal standards for the mitigation and recovery of stranded costs; (d) rewrites of the sections of Title 40 that are necessary in a competitive environment; and (e) the regulation of non-public service corporations (such as SRP and the tribal utilities) that indicate an intent to compete with public service corporations. Without a resolution of these important issues, the Competition Rules will continue to deny Affected Utilities the due process that they are entitled to.

Now that reports from other working groups will be filed in the near future, TEP would recommend that the Legal Issues Working Group be continued to study the legal ramifications of such reports and the recommendations therein. Perhaps in this context, specific legal recommendations could be made as the Competition Rules are interpreted and/or amended.

As always, TEP is willing to work with the Commission and Staff to address and implement positive changes to the Competition Rules. TEP continues in its support of competition and in its commitment that any such competition must be equitable and fair. TEP believes that by including sound recommendations for appropriate changes to the Competition Rules in subsequent reports, all of the parties will be aiding in the implementation of competition in Arizona.

Sincerely,

Bradley S. Carroll
Counsel, Regulatory Affairs