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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
Commissioner - Chairman
RENZ D. JENNINGS
Commissioner
CARL J. KUNASEK
Commissioner

Arizona Corporation Commission
DOCKETED

JAN 09 1998

DOCKETED BY 

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

Pursuant to the Commission's Procedural Orders dated December 1 and 11, 1997, Tucson Electric Power Company hereby files the Direct Testimonies and Summaries for Charles E. Bayless, Daniel Wm. Fessler, Kenneth Gordon and Karen G. Kissinger, in the above captioned matter.

RESPECTFULLY SUBMITTED this 9th day of January, 1998.

TUCSON ELECTRIC POWER COMPANY

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Original and ten copies of the foregoing filed this 9th day of January, 1998, with:

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Phoenix, Arizona 85007

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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN

Commissioner - Chairman

RENZ D. JENNINGS

Commissioner

CARL J. KUNASEK

Commissioner

IN THE MATTER OF THE COMPETITION IN
THE PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA.

) DOCKET NO. U-0000-94-165

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**SUMMARY OF DIRECT
TESTIMONY**

Charles E. Bayless, Daniel Wm. Fessler,
Kenneth Gordon and Karen G. Kissinger

On Behalf of

TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998

DIRECT TESTIMONY OF CHARLES E. BAYLESS

SUMMARY

My direct testimony provides TEP's policy perspective with respect to the issue of stranded costs as it relates to the nine issues set forth in the Arizona Corporation Commission's ("Commission") Procedural Orders dated December 1 and 11, 1997. The testimony presents some historical insight into the stranded generation issue and sets forth the Company's position that stranded costs are a legally recoverable property right for which the Commission is required to allow the Company the opportunity to recover. I discuss the Regulatory Compact ("Compact") and explain how the Compact leads to the recovery of stranded cost, as well as the economic rationalization for such recovery.

The most important issue to TEP, its shareholders and its creditors, is the issue of stranded cost recovery. The Electric Competition Rules ("Rules") should be modified to make it clear that subject to appropriate mitigation efforts, "Affected Utilities" shall have the opportunity and right to recover *all* of their stranded costs. Further, the Rules should be modified regarding the definition of stranded costs and should provide the procedural and substantive requirements for the recovery of such.

My testimony presents an overview from a national, Arizona and TEP specific perspective regarding decisions made in the 1970's and 1980's as they relate to the stranded costs that we see today. In my testimony, and through Exhibit A attached thereto, I take the position that these stranded costs are not the result of bad decisions by the electric utilities, but economic decisions based upon perceived long-term societal needs and goals.

Also under the Compact, the utilities are required to plan for and provide generation for all current and future customers in their service territory. Under the Compact the utility has a regulated rate of return, which denies any opportunity for large gains. Given this history and the Compact, TEP is not willing to accept anything less than full recovery of stranded costs.

In my testimony, I discuss that stranded cost recovery is desirable for the long-term good of the economy and how the transition can take place without distorting the market.

TEP believes that the most appropriate method of defining stranded costs would be to calculate the difference between future revenues under traditional regulation and a competitive regime. TEP supports the "Net Revenues Lost" method proposed by the Stranded Cost Working

Group Report ("Report"). Other methods have been considered and the only feasible approach, other than the Net Lost Revenues approach, is auction and divestiture.

TEP proposes using the Dow Jones Palo Verde Index as the best estimate of the market price for electricity in Arizona.

TEP believes that proper quantification of stranded costs should reflect the remaining life expectancy of underlying assets and deferred costs.

TEP proposes a non-bypassable Competitive Transition Charge ("CTC") that everyone pays. To recover stranded costs, TEP should be allowed to securitize 75% of its stranded costs with repayment over 10 - 15 years. TEP's proposal requires rates to be fixed at some level to recover the remaining non-securitized stranded costs through the CTC. If TEP is allowed to securitize, this approach will likely allow for full recovery of stranded costs and accommodate a rate freeze through the period 2004.

A true-up mechanism is needed given the uncertainty surrounding the future market price for electricity. The structure of a true-up mechanism should resemble that of the former fuel adjustment clause in which a band was set based on forecasted prices. The recalibration of the CTC should occur any time the band ceiling or floor is exceeded.

Mitigation of stranded costs should be evaluated on a case-by-case basis. Other approaches may include asset sales, renegotiating uneconomic contracts, pursuing economic development projects and continually attempting to lower marginal costs.

The Company proposes that Affected Utilities be required to submit stranded cost filings with the Commission within 120 days of the issuance of a Decision in this generic proceeding.

DIRECT TESTIMONY OF DANIEL WM. FESSLER

SUMMARY

Drawing upon my experience with the Restructuring in California, I trace the outlines of the social, political and economic compromise crafted by the California Commission and Legislature. The testimony reviews the major features of the California Order and AB 1890, showing how they dealt with the potential that an increased reliance upon market forces would strand utility investments, power and fuel purchase contracts, environmental and social programs which had been adopted by the Commission in its classical regulatory regime. I next examine the legal, economic and moral claims that costs which have already been deemed prudent and assumed as ratepayer liabilities should not be shifted in the course of restructuring.

Following this analysis of what was debated and done in California, I turn attention to the status of the social compact between the People of Arizona, the Corporation Commission and the investor owned electric utilities. I find that the duty to serve has been defined in the Constitution of Arizona, amplified in legislation aimed at public service corporations and made a living presence by the interaction of those utilities with the Corporation Commission. The testimony also identifies a wholly independent basis, unknown in California, but well established in the decisional law of Arizona. This is the common law duty to serve, a duty which clearly obligates utilities to serve all present and to be anticipated future patrons. I then expressed the view that the utility investments in generation and assumption of contract liability for electricity and fuel were undertaken in the context of this duty to serve and regulatory environment and that while the Commission is to be applauded for its interest in altering that environment to pursue efficiency gains through competitive discipline, it is obligated to keep faith with its past commitments.

In Part 3, I take up more specifically the issues identified in the Procedural Orders relating to stranded costs. My testimony recommends some changes in the Commission's Electric Competition Rules to clarify that the investor-owned utilities are entitled to a fair opportunity to recover the debt and equity investments in generation facilities, and be held harmless against any over-market costs associated with honoring fuel and power purchase contracts, and collect on the established regulatory assets. It advocates the use of a non-by passable competition transition charge to be imposed on all historic and future electric users in

the service territories of the investor owned utilities. Such a charge should be administered to reflect existing allocation under current ratemaking so that the move to competition does not result in cost shifting between or among customer classes. I suggest that the Net Revenues Lost calculation methodology be refined by using a benchmark, such as the Dow Jones Palo Verde Index, to track the emerging value of generating capacity in the Arizona market.

DIRECT TESTIMONY OF KENNETH GORDON

SUMMARY

My name is Kenneth Gordon. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), an economic consulting firm specializing in microeconomic analysis, including regulated industries. My business address is One Main Street, Cambridge, MA 02142. I have been invited to testify before the Arizona Corporation Commission ("ACC") by Tucson Electric Power Company ("TEP"). The purpose of my testimony is to address the economic efficiency, equity, and public policy concerns raised by some of the nine specific stranded cost questions listed by the ACC for consideration at its evidentiary hearing on generic stranded cost issues. I have reviewed the ACC's Electric Competition Rules as they relate to stranded costs and find them to be a reasonable set of principles and general mechanisms for how stranded costs should be dealt with in the beginning phases of the transition to competition. In terms of actual implementation requirements, however, much additional work has to be done to fill in the details.

Certainly, the ACC should not modify its fundamental conclusion that it "shall allow recovery of unmitigated Stranded Cost by Affected Utilities" (R14-2-1607(B)). Arizona utilities have made investments over the years to satisfy their legal obligation to provide adequate and reliable service to each and every customer who desired electricity and was within the utilities' service territory. Some of these legitimately-incurred investments could become "stranded," *i.e.*, unrecoverable, in the transition to a competitive marketplace. Unless special provision is made by legislators and/or regulators, shareholders may not recover fully the funds they provided the company in good faith while the old system was in effect. In my opinion, public policies aimed at introducing competition into electricity markets will proceed more quickly, cooperatively, and ultimately successfully if utilities are given a fair opportunity to recover these costs.

The risk associated with investments is treated much differently in regulated and unregulated industries, but, in both cases, a symmetry exists between risk and the distribution of rewards. Denying utilities an opportunity to recover their stranded costs would upset the symmetry that lies at the heart of traditional forms of regulation. It would be a case of the regulators saying to the shareholders -- heads-we-win, tails-you-lose. The fact is that utility investors have not been compensated for the risk that regulators would upset the "risk/reward" symmetry of traditional regulation as part of a policy transition to open markets to competition. It is entirely appropriate in my opinion -- indeed desirable -- to change *on a going-forward basis* to a framework in which the risk of prospective investments will be placed entirely on the shareholders, but that does not alter the responsibility of policymakers to honor the symmetry of the previous regulatory framework on investments that were already made and approved for recovery in rates.

In my testimony, I discuss several other issues related to stranded costs and make the following recommendations:

- Stranded cost questions should be resolved prior to the introduction of retail customer choice in order to provide some indication for utilities, alternative suppliers, and customers of just how much (and in what manner) they will be paying for recovery of stranded costs. Uncertainty about stranded cost recovery is one of the primary points that can cause delays in the movement to competition.
- All of the utility's prudently-incurred costs that would have been recovered but for the policy decision to introduce retail choice should be included as part of stranded costs. This includes all of the cost items listed in the ACC Staff's Stranded Cost Report, as well as unrecorded regulatory assets.
- TEP supports the "net revenues lost" approach for calculating stranded costs, whereby stranded costs are the net present value of the difference between revenues under traditional regulation and those that will be received under a competitive market. Under this approach, the amount of stranded costs recovered in rates adjusts along with market prices, so that only those costs that are actually being stranded are being recovered at any point in time. I believe that the "net revenues lost" approach (which has been called the "net-back pricing" or "lost margins" in other jurisdictions) is an appropriate way to calculate stranded costs on a going forward basis. Utilities also should have the option of divesting all or some of their generation assets as a way to calculate stranded costs.

- The recovery time frame for stranded costs depends heavily on whether or not policymakers feel the need to provide a rate cap as part of the movement to retail choice. The time period over which recovery takes place should not be used as a tactic to deny utilities the opportunity to recover all of their stranded costs. To the extent that short-term rate certainty is a policy goal on par with that of introducing competition, it may be necessary to extend the period of stranded cost recovery. This type of trade-off represents a borrowing against future benefits, but could be judged necessary to build a consensus in favor of restructuring the industry.
- No customer for whom the utility had an obligation to provide service should be exempted from paying for stranded costs – for reasons of efficiency, as well as fairness. In terms of fairness, customers with near-term competitive alternatives should not be allowed to bypass recovery of past investments, leaving the remaining core customers to pay the total costs of those investments. In terms of efficiency, selection of some for exemption from cost responsibility can distort the competitive market, because exempted customers could be making decisions based on the avoidance of legitimate costs, *i.e.*, uneconomic bypass, not on the basis of going-forward efficiencies.
- The necessity for a true-up mechanism depends on which method for calculating and recovering stranded costs is chosen. For example, the “net revenues lost” approach automatically re-sets stranded cost recovery in response to actual market conditions. An administrative determination and estimate of stranded costs may require some sort of true-up due to the uncertain nature of estimates.
- Any potential cost savings related to what would normally be considered as part of the utility’s cost of service should be considered for mitigation of stranded costs. What should not be considered is revenues from non-utility operations, such as holding company investments. Investments in non-utility operations are funded either from non-utility-related sources or from the shareholders’ legitimate earnings. Utility shareholders are entitled to earn a return of and on prudently-invested capital, but what they then do with their return really should not be a concern of regulators.
- A good potential source of mitigation is savings related to adoption of performance-based regulation. Economists have long criticized the “cost-plus” nature of traditional rate-of-return regulation because of the disincentives it creates for efficient operations and use of capital. The cost savings that result from performance-based regulation plans can be used to mitigate stranded cost recovery.
- Another legitimate source of mitigation for stranded costs can be securitization of stranded costs. Securitization allows for stranded cost recovery with lower capital costs because investors have less risk associated with the cost recovery. As long as policymakers recognize the commitment to an opportunity to recover stranded costs, as they should, there is no reason not to use any legitimate mechanisms that can lower stranded costs.

DIRECT TESTIMONY OF KAREN G. KISSINGER

SUMMARY

Implications of Financial Accounting Rules Pertinent to Stranded Cost Recovery Plans

To date, there is insufficient specificity in the rules adopted in December 1996 to cause the Arizona utilities to cease following the tenets of Statement of Financial Accounting Standards No. 71 (FAS 71) for generation operations. As soon as the rules contain sufficient information for the utilities to reasonably estimate the impact of the deregulation rules on their operations, the utilities may have to cease accounting for their generation operations pursuant to FAS 71.

With any method of calculation of stranded cost recovery, whether it is net lost revenues, replacement cost valuation, auction and divestiture, stock market valuation, or some other method not yet discussed in the competition docket, the method of calculation does not impact whether the method precludes or causes write-offs under FAS 71. The issue is really the cash flows expected under the plan. In each case, the amount of cash flows provided by the method is initially determined and then compared to the balances of costs that the cash flows are specifically earmarked to recover. Recoverable amounts remain regulatory assets/liabilities of the remaining regulated entity. Amounts that are not recoverable through the collection of regulatory revenues are written off.

The more risk that a utility is asked to assume in achieving the cash flows to recover the stranded costs, the less likely that the recovery plan provides adequate assurance that the costs will be recovered, and therefore, recognized on the balance sheet for financial reporting purposes. Recovery periods of five years or less, or about the same time period as the transition period, appear to provide sufficiently timely recovery for the regulator to ensure that the utility receives its cost recovery. If the plan provides for recovery over a five to ten year period, the plan *may* be considered adequately timely, but considerable doubt exists as to whether recovery over a period in excess of ten years would be sufficiently timely. The longer the recovery period, the greater the need for a true-up mechanism to allow the utility's cost recovery to be re-evaluated and modified, or a greater amount of head room within the rate, or increased evidence that the costs will be recovered by the end of the stated recovery period.

To be a meaningful true-up provision for accounting purposes, a true-up mechanism must allow for upward adjustments as well as downward adjustments. The true-up mechanism would

allow the utilities to increase their recovery, if the original recovery path was determined to be insufficient to fully recover the allowable stranded costs.

Income Tax Considerations for Stranded Cost Recovery Plans

The amount of stranded costs to be recovered should include regulatory income tax assets. In prior years when utility assets were placed in service, certain tax benefits were flowed-through to ratepayers, thus reducing income tax expense charged to ratepayers. To the extent not all of these tax benefits have been recovered, a regulatory asset is recorded on the utility's books for the amount of pretax revenues necessary to allow the utility to recoup this benefit. The utilities expect to recover these amounts in accordance with the regulatory compact.

It is unclear how the Internal Revenue Service would handle the normalization requirements for a utility that is not allowed to recover 100% of its stranded costs. In the case of specific identification of deregulated assets, rulings provide that the regulators may not reduce rate base for the deferred tax liabilities associated with the deregulated assets, and that cost of service calculations may not reflect a tax deduction for depreciation on the deregulated assets.

When the utility collects the revenues designated to recover stranded costs, the utility will be required to pay income taxes on the amounts collected for both federal and State income tax purposes. As a result, in order to be made whole, the utility must receive sufficient revenues to pay the taxes and still recover their investment. This is no different than the current methodology used to calculate revenue requirements, which takes into consideration the taxability of the revenues to be collected.

Recommendation:

For the utilities to avoid recording write offs under FAS 71 as a result of the stranded cost recovery plan, the recovery plan must include recovery of 100% of stranded costs, including all income tax regulatory assets and the income tax ramifications of the recovery mechanism chosen. The recovery plan should provide for recovery of the stranded costs over a period of approximately five years, and should include a true-up mechanism which allows for additional amounts of stranded costs to be collected, in the event that facts and circumstances at the time of the true up indicate that the recovery path initially established will be inadequate for the full amount of stranded costs to be recovered. The stranded cost recovery plan proposed by Mr. Bayless is consistent with my recommendation.

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN

Commissioner - Chairman

RENZ D. JENNINGS

Commissioner

CARL J. KUNASEK

Commissioner

IN THE MATTER OF THE COMPETITION IN
THE PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA.

) DOCKET NO. U-0000-94-165

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DIRECT TESTIMONY

Charles E. Bayless, Daniel Wm. Fessler,

Kenneth Gordon and Karen G. Kissinger

On Behalf of

TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998

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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN

Commissioner - Chairman

RENZ D. JENNINGS

Commissioner

CARL J. KUNASEK

Commissioner

IN THE MATTER OF THE COMPETITION IN
THE PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA.

) DOCKET NO. U-0000-94-165

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THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.) **DIRECT TESTIMONY OF**
) **CHARLES E. BAYLESS**
)
_____)

On Behalf of
TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998

1 **I. INTRODUCTION AND PURPOSE**

2 Q. Please state your name and business address.

3 A. Charles E. Bayless, 220 West Sixth Street, Tucson, Arizona 85702.

4 Q. What is your position with Tucson Electric Power Company ("Company" or "TEP")?

5 A. Chairman of the Board, President and Chief Executive Officer. I also hold these same
6 positions with TEP's newly formed holding company, UniSource Energy Corporation.

7 Q. Please describe your educational background and your business experience as the same
8 pertain to your position.

9 A. I received a Bachelor of Science Degree in Electrical Engineering from West Virginia
10 Institute of Technology in 1968. I then received a Master of Science Degree in Electrical
11 Engineering in 1971 and a Juris Doctor Degree in 1972 from West Virginia University. In
12 1977, I received a Master of Business Administration Degree from the Graduate School of
13 Business at the University of Michigan. I am an inactive member of the West Virginia and
14 Michigan Bars.

15 From 1978 to 1981, I was employed at Consumers Power in Jackson, Michigan.
16 During that time period, I served as an attorney, the Director of Nuclear Fuel Supply and the
17 Director of Special Corporate Projects. My responsibilities at Consumers Power in Special
18 Projects emphasized financial transactions, including the procurement and financing of
19 nuclear fuel leases, leveraged and single investor leases, special financial studies, pollution
20 control revenue bonds and acceptance facility agreements.

21 In 1981, I joined Public Service Company of New Hampshire, a \$2.6 billion utility.
22 As Senior Vice President and Chief Financial Officer, I was responsible at various times for
23 finance, accounting, taxes, treasury, insurance, pensions, rates, and financial planning. I had
24 overall responsibility for approximately 200 employees. After the President of Public
25 Service of New Hampshire resigned, I also became Chief Reorganization Officer, and
26 oversaw the overall conduct of the Company's reorganization, including all negotiations with
27 committees, the State, and other parties. I came to TEP in December 1989 as Chief Financial
28 Officer and was elected President and Chief Executive Officer in July 1990 by the Board of
29 Directors. I was elected Chairman of the Board in January 1992.

30 ...

1 Q. Please describe any other business experience or background as it relates to electric industry
2 restructuring.

3 A. I have been a long-term advocate and an outspoken proponent of electric competition.
4 Toward this end, I have served as an expert witness before the U.S. Congress and the Federal
5 Energy Regulatory Commission on a vast array of issues related to the energy industry and
6 have published numerous articles about electric competition in national and trade
7 publications, including *Public Utilities Fortnightly* and the *Washington Post*. In addition, I
8 was honored by my electric utility peers as a Silver Award winner in Financial World
9 magazine's 1996 CEO of the Year Competition. According to the magazine, the award
10 recognizes "superior leadership and business achievement" in the industry.

11 Q. What is the purpose of your testimony?

12 A. The primary purpose of my testimony is to provide policy perspective with respect to the
13 issue of stranded cost as it relates to the nine issues set forth in the Arizona Corporation
14 Commission's ("Commission") Procedural Orders dated December 1 and 11, 1997. I will
15 present some historical insight into the issue of stranded cost and set forth the Company's
16 position that stranded costs are a legally recoverable property right for which the
17 Commission is required to allow the Company the opportunity to recover. I will discuss the
18 Regulatory Compact ("Compact") and explain how the Compact requires the recovery of
19 stranded costs, as well as the economic rationalization for such recovery.

20 **II. SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED REGARDING**
21 **STRANDED COSTS, IF SO HOW?**

22 Q. Mr. Bayless, the Commission's First Amended Procedural Order dated December 11, 1997,
23 asked that the issues discussed in the direct testimony be arranged in the order of importance
24 to the party. From the perspective of TEP, one of the "Affected Utilities" under the Electric
25 Competition Rules ("Rules"), what is the most important issue for the Company?

26 A. The most important issue to TEP, its shareholders and its creditors, is the issue of stranded
27 cost recovery. This has been the position the Company has articulated to the Commission
28 since long before the adoption of the Rules and the issue that the Company has maintained
29 during these proceedings that must be resolved before electric competition can be duly

30 ...

1 introduced in this State. Therefore, of the nine issues set forth in the Procedural Order, the
2 most important issue to TEP is *should the Rules be modified and if so how?*

3 Q. How would you answer that question?

4 A. To the extent the Rules do not already provide for stranded cost recovery, they should be
5 modified to make it clear that, subject to appropriate mitigation efforts, "Affected Utilities"
6 have the right and the opportunity to recover *all* of their stranded costs. Further, the Rules
7 should be modified to better define and to provide the procedural and substantive
8 requirements for the recovery of stranded costs.

9 Q. Would you please explain this answer?

10 A. Yes. But, in order to explain what must be done in the future, it is important to understand
11 what has happened in the past from a national, Arizona and TEP specific perspective. First,
12 from a national perspective, attached to my testimony as Exhibit A, is a short article by Frank
13 Clemente that appeared in the July/August 1997 issue of *Electric Perspectives*. The article
14 provides an excellent timeline regarding the decisions made in the 1970's and early 1980's
15 regarding power plant construction. It also discusses how many of the opponents of stranded
16 cost recovery today were proponents of the building of generation assets in the first place. It
17 is clear from this article (as well as what I will discuss below) that the stranded generation
18 costs we see today are not the result of bad decisions by electric utilities, but economic
19 decisions based upon perceived long-term societal needs and goals.

20 Q. What happened in Arizona and to TEP during this time frame?

21 A. The "energy crisis" was in full swing. In Tucson, Tucson Gas and Electric ("TGE") was
22 prohibited from making new gas connections after January 1, 1977. The peak electric
23 demand of TGE's service territory had increased at a rate of 10 percent per year from 1966 to
24 1976. That level of growth implies the need to double resources in a little over seven years,
25 which was the time it took to build a baseload plant. Given these historical facts, TGE made
26 a conservative assumption that future load would grow at 6.5 percent per year in the future
27 instead of the historical 10 percent load growth. That was the climate in Arizona when
28 TEP's largest generating station was approved for siting and ultimately added to rate base by
29 the Commission after review.

30 ...

1 The Arizona Academy was formed in 1962 to bring together a cross-section of
2 leading citizens which were "representative of every shade of political, social and economic
3 philosophy." In 1976, The Arizona Academy published its 28th Arizona Town Hall report
4 entitled "Arizona Energy -- A Framework for Decision." The Introduction of this report
5 states:

6 "No subject today is receiving more national attention than that of energy.
7 Each person here knows full well that the national energy crisis is magnified
8 in Arizona, for, as Governor Raul Castro reminded us in his keynote address,
9 "Arizona is an energy consuming state and not an energy producing state."
10 Therefore our problems are particularly complex and the solutions even more
11 so. It is therefore fitting and timely that this Town Hall should assign top
12 priority to the topic of energy."

13 The last paragraph of the introduction says:

14 "But these problems are not devoid of workable solutions. We have the
15 ability to develop new energy sources, including nuclear, solar and other
16 sources, to meet our needs if timely and intelligent development is instituted.
17 Our state government must, at the same time, provide the necessary
18 incentives, whether financial in nature or by other means, to foster such
19 development."

20 In 1981, the 39th Arizona Town Hall again chose the topic of energy and this time
21 published a report entitled "Arizona's Energy Future - Making the Transition to a
22 New Mix." The introduction states:

23 "Public utilities, for example, must by law satisfy the energy demands
24 of their customers. Accordingly, they must estimate what that demand
25 is likely to be sufficiently in advance to premit[sic] investment
26 decisions to be made in the face of long lead times for construction and
27 financing. Besides responding to changes in income and prices,
28 energy demand in Arizona is strongly affected by migration patterns
29 and changes in the relative mix of specific sectors of the economy.

30 ...

1 Thus, major energy-producing institutions must plan under conditions
2 of much greater uncertainty and hence risk than in the past.”

3 (Note it doesn't mention the regulatory risk of having the rules changed in the middle of the
4 game). The participants at the time of these reports included representatives from many of
5 the largest electricity users in Arizona as well as top government officials. The decision to
6 build power plants was not made unilaterally by the electric utility industry— these were
7 societal decisions.

8 Q. Notwithstanding these societal pressures to build additional generation, what prompted the
9 utilities to go forward with such projects?

10 A. Under the Compact, the utilities were (and still are) *required* to plan for and provide
11 generation for all current and *future* customers.

12 Q. What do you mean by the Compact?

13 A. The operations of public utilities, since shortly after their inception, have been based on the
14 Compact. In Arizona, electric utilities were given a Certificate of Convenience and Necessity
15 (“CC&N”) and were required to build facilities to serve everyone in their respective service
16 territories and were allowed the opportunity to earn a reasonable return on their investment.
17 This requirement to serve is one of the main differences between the electric industry and
18 unregulated industries. In the vast majority of cases, the construction of these assets was
19 approved by the regulatory body having jurisdiction after hearing, and after construction, the
20 recovery of such assets was approved by the same regulatory body after the assets were
21 determined to be prudent. If the regulatory body found any portion of the asset to be
22 imprudent, it was written-off, and hence, would not be a “stranded asset” today.

23 Q. You have stated that stranded asset recovery is legally mandated. What is your position on
24 less than full recovery of stranded costs?

25 A. TEP is not prepared to accept less than full recovery of stranded costs.

26 Q. The Affected Utilities have been able to earn on the assets that were constructed. Why didn't
27 that compensate TEP?

28 A. The Company has been able to earn, but only a regulated rate of return and only for a portion
29 of the investments' useful lives. In unregulated industries, investors bear the full costs of
30 investments that fail, but investors are also allowed to reap the full benefits of profitable

1 investments without the imposition of limited rates of return. Since regulated utility
2 investors are provided an opportunity to recover only a regulated return on investment,
3 historically in most jurisdictions they have been shielded from the risk of large losses. At the
4 same time, investors are denied the opportunity for higher returns.

5 This clearly shows the continued existence of the Compact as earnings are limited on
6 prudent investments to a regulated rate of return. If a utility builds a plant or a transmission
7 line which operates at a cost far below the current market, the company is only allowed to
8 earn a regulated return on its actual cost. The utility is never allowed to charge a market rate
9 and hit a "home run" for investors as non-regulated entities do.

10 Q. Would you please elaborate on that?

11 A. The requirement that TEP sell certain of its products at a below-market price, in my view,
12 constitutes an unconstitutional "taking" for a public purpose without just compensation. In
13 the past, the Company did not, however, complain about the unconstitutional taking.

14 Q. Why not?

15 A. The answer is simple. The electric industry believed that the "opportunity to earn" portion of
16 the Compact yielded "just compensation" for the "taking." TEP believed it received the
17 opportunity to earn the regulatory return on all prudent investments, even if something better
18 came along. The Company believed that it had given up the upside, the "home runs," in
19 exchange for a promise that we would earn a regulated rate of return on all prudent
20 investments. Today, TEP is only asking for what was promised; the opportunity to recover
21 its assets and earn a rate of return.

22 Q. Doesn't the Compact then prohibit the Commission from changing the policy of regulated
23 monopoly to competition?

24 A. Constitutional and legislative questions aside, the answer is clearly no, but it cannot do so
25 without honoring its obligations created under the prior regime. I would not argue for a
26 moment about the right of a state regulator to change the regulatory framework on a
27 prospective basis. In fact, to achieve competition I would encourage it. However, prior to
28 changing the future, the Commission must fulfill its obligations from the past for which
29 billions of dollars have been invested in reliance thereon. The utilities have fulfilled their
30 part of the bargain. The utilities built the plants and still stand ready to serve, and, in fact, are

1 still required to serve. The utilities now ask that the customers and regulators fulfill their part
2 of the bargain.

3 Q. Some opponents of stranded cost recovery have taken the position that the utilities have known
4 for some time now that the Compact was over. What is your response to that?

5 A. If the Compact was over, what prohibits a utility from turning off a customer's electricity today
6 or refusing to provide service for their increased needs in the future? Utilities still have, and
7 will continue to have for at least the near term, the duty to serve all customers within their
8 certificated territory and must provide for their future needs and have the rates and charges for
9 such service regulated by the Commission.

10 Q. But, Mr. Bayless, in the past utilities have been guaranteed a rate of return; wasn't that
11 guarantee enough to compensate you for the risk of non-recovery?

12 A. TEP disagrees. Utilities were never guaranteed a rate of return, they were only guaranteed the
13 "opportunity" to earn a return, as well as the opportunity to recover the cost of prudently
14 constructed assets. Frankly, that's all TEP is saying is now required; the opportunity to earn
15 and recover as promised.

16 Q. What about the economic impact of stranded cost recovery on the economy?

17 A. From TEP's perspective, stranded cost recovery is desirable for the long-term good of the
18 economy. Let me give you some specific reasons.

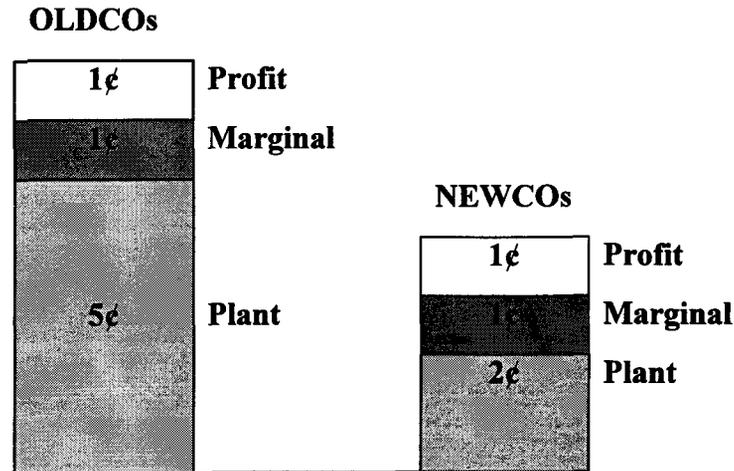
- 19 1. The first reason the nation's economy will be better off with full recovery of stranded
20 costs is that society will continue to benefit from some of the most productive generation
21 resources. New generation is not being built that can operate as cheaply on the margin as
22 many existing utility plants (that have large stranded costs); these plants should continue
23 to be the prevailing source of electricity supply until new generation is needed. Without
24 recovery, these plants may be shut down.

25 Let me give you an example. From a regulatory point of view, one must ask the
26 question of what is best for society, for the public good. The proper question to keep in
27 mind throughout the debate is not, "What is best for new entrants or customers?" but,
28 "What is best for society?"

29 ...
30 ...

Let's consider a system with only old participants (OLDCOs) which have plant (sunk) cost of 5¢/kWh and operating (marginal) cost of 1¢/kWh and new entrants (NEWCOs) with plant (marginal) cost of 2¢/kWh and operating (marginal) costs of 1¢/kWh. (See Figure 1)

Figure 1



The NEWCOs offer power to customers at 4¢/kWh. The customer, seeing that its power costs are 7¢/kWh from the OLDCO, immediately starts clamoring for open access.

Let's step back now from that individual transaction where there are two winners (NEWCO and the customer) and one loser (OLDCO) and look at all of the transactions from the viewpoint of society as a whole. For OLDCO to provide the service, a total of 1¢/kWh of society's scarce assets will be used up (fuel and labor), for NEWCO since all of their costs are incremental, a total of 3¢/kWh of society's scarce assets will be used up (the cost of the new plant plus fuel and labor). Society is thus better off by allowing OLDCO to furnish the electricity.

Another way to reach the same conclusion is to consider that if NEWCO is allowed to supply the electricity, without stranded cost recovery, the customers are better off by 3¢/kWh and NEWCO shareowners are better off. But the utility shareowners are worse off by 5¢/kWh, a net loss to society of 2¢/kWh. Thus, the current battle is not over what is best for society, society is clearly better off by letting OLDCO provide the electricity.

1 The battle is between OLDCO shareowners and NEWCO shareowners. If the building of
2 new low cost generation were best for society, the Commission would be ordering
3 utilities to build new plants. The Commission doesn't, because in the end building new
4 generation costs society more. The benefit from competition is from the improved
5 efficiency and the innovation it will bring and for this reason alone competition should be
6 adopted. The benefits are not from allowing new plants to replace old plants.

7 By allowing OLDCO to charge a stranded asset charge, NEWCO will then produce
8 only when its marginal costs are lower than OLDCOs marginal costs, which is the desired
9 result for society (but not necessarily for NEWCO). Over time as the OLDCO charges
10 wind down, NEWCO will then have an easier and easier time competing.

11 Society is better off when the electricity is produced using the least additional amount
12 of resources. Public utility consumers should make decisions based upon what is good
13 for society, not what is good for any one constituency. Arguments will be made that
14 competition is good for society so the Commission should permit competitors. I couldn't
15 agree more. However, competition can be encouraged in a manner where society bears a
16 huge cost of constructing unneeded new plants, while at the same time abandoning old
17 plants with a lower marginal cost, or we can encourage competition in a manner which
18 has the lowest economic cost and favors the most rational allocation of resources. TEP
19 prefers the latter.

- 20 2. Second, most all of the new generation relies on one fuel source, natural gas, which
21 creates a large price risk. The diverse array of current (stranded) generation provides a
22 hedge against fuel price shocks in the future.
- 23 3. Third, it has been shown that activities that raise rivals' costs are, in fact, predatory in
24 certain circumstances¹. The three conditions necessary for predation are consumer
25 damage, predator benefit, and competitor damage².

28 ¹ Steven Salop, Introduction, in Strategy, Predation, and Antitrust Analysis (Steven Salop ed. 1981.)

29 ² Ann P. Bartel and Lacy Glenn Thomas. "Predation Through Regulation: The Wage and Profit Effects of the
30 Occupational Safety and Health Administration and the Environmental Protection Agency," Journal of Law and
Economics, October 1987.

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- Consumer damage is likely to occur *without* stranded cost recovery. The productivity decrease and potential risk I describe in earlier points will impose additional social costs. Also a huge cost burden will be shifted from those customers who don't pay for stranded costs to other classes of customers and/or shareholders. This has already happened to some degree with municipalization, discounting to large customers and self-generation.
 - With regard to the second condition – predator benefit – new providers of generation have not been subject to regulation and the associated cost burdens, and historical commitments imposed by the Compact on incumbent utilities. If incumbent utilities are not allowed to recover stranded costs, new providers will be sufficiently advantaged from the effects of regulation on their competitors to experience increased profits.
 - Competitor damage is what this hearing is all about. Incumbent utilities face huge stranded costs since the rules have changed in the middle of the game.
4. The fourth reason is an issue of fairness. A failure to ensure the recovery of regulatory approved costs in the transition to competition will leave investors with a very large part of their property expropriated by changing the rules in the middle of the game.
5. Fifth, people should be able to rely on government's rulings and promises. If any government makes a contract, either express or implied, and people rely on that contract, and then if a law change renders specific performance impossible, the government should be responsible for transitional cost recovery. This renegeing of regulatory commitments and promises undermines the sanctity of contractual promises which leads to higher required rates of return to compensate investors for the added regulatory risk and this leads to more costly, but less capital-intensive projects.

Q. Doesn't stranded cost recovery distort competition?

A. Many have the mistaken idea that society will benefit if customers are allowed to buy their power in a competitive market without paying for sunk costs (sunk costs are non-salvageable costs which cannot be affected by present or future decisions to supply more or less, to run or not to run, or to expand). This notion is wrong because these sunk costs will just be ...

1 transferred to other customer classes or shareholders. Price reductions (or in this case cost
2 shifts) are not the same as productivity gains.

3 Q. How can the transition to competition take place without distorting the market?

4 A. In order to avoid the distortion of competition and thus achieve enhanced efficiency, there are
5 at least three important factors that need to be met.

6 First, stranded cost recovery should facilitate proper market-based incentives which
7 will lead to lower cost (on an incremental basis) generating units running before higher cost
8 units. To ensure correct price signals, suppliers of energy should compete against each other
9 based on marginal costs, not regulated, bundled rates which may include both sunk costs and
10 marginal costs in the rate.

11 Second, new entrants and self-generators permitted to access utility transmission and
12 distribution systems or who take back-up service should pay a share of stranded costs. A
13 level playing field must exist between incumbent suppliers, new entrants and self-generators
14 with no unfair advantage given to any supplier due to asymmetrical effects of regulation.
15 Many customers are already comparing utility retail rates that embody sunk costs from past
16 regulatory commitments to retail rates of alternative suppliers that are free from such
17 burdens.

18 Third, regulatory costs that regulated incumbent utilities incur need to be eliminated
19 or shared by or applied to all suppliers. Examples of such costs include or result from:

- 20 • serving as the provider of last resort,
- 21 • promoting and paying for conservation and demand-side management,
- 22 • paying for environmental programs that competitors don't have to pay for,
- 23 • supporting low income customers,
- 24 • promoting/subsidizing uneconomic generation, and
- 25 • incurring costs from regulatory litigation and review.

26 For the foregoing reasons, TEP believes that the Rules should be modified to embody
27 these principals.

28 ...

29 ...

30 ...

1 **III. WHAT COSTS SHOULD BE INCLUDED AS PART OF STRANDED COSTS AND**
2 **HOW SHOULD THESE COSTS BE CALCULATED?**

3 Q. Mr. Bayless, what costs should be included as "stranded costs" and how should the definition
4 be modified?

5 A. The threshold task is to define what falls within the ambit of "stranded costs" and how those
6 costs are determined. In TEP's opinion, stranded costs should not be viewed simply in terms
7 of categories of costs, but rather as revenue requirements that a utility has lost the opportunity
8 to collect as a result of existing customers obtaining power from alternative sources. TEP
9 believes the following to be an appropriate definition of Stranded Cost:

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

14 The above definition is similar to that appearing in R14-2-1601.8 of the Rules;
15 however, several key distinctions are noteworthy.

16 First, the definition currently in the Rules refers to "the value of all the prudent
17 jurisdictional assets and obligations. . ." It is unclear whether such definition would result in
18 a reconsideration of the prudence of past investment decisions. TEP strongly believes that
19 the consideration of Stranded Cost should not include ex-post prudence reviews of costs that
20 are already being recovered in the utilities' rates. The fact that recovery is already being
21 allowed is sufficient evidence of prudence as a result of prior Commission prudency
22 determinations. TEP has already been required by the Commission to write off \$754 million
23 (see Exhibit B), including \$428 million of the cost of its Springerville and Irvington
24 generating facilities. It is not necessary to revisit prudence issues simply because some costs
25 currently being recovered in rates might, in the future, be included in a stranded cost charge.

26 A second concern of TEP with respect to the Commission's approved definition of
27 stranded cost is that it tends to focus on the difference in *values* of assets and obligations
28 under traditional regulation as compared with their values after the introduction of
29 competition. It is unclear what specific assets and obligations are included and whether the
30 definition is limited to balance sheet accounts. Stranded costs are not limited to generation

1 assets. For example, the investment in skilled utility employees is a potentially stranded
2 asset. Also utilities have considerable investments in regulatory assets that exist solely based
3 on the action of regulators and that may become strandable under a competitive regime. In
4 addition, generation-related operating expenses (*i.e.*, fuel expenses, including mine
5 reclamation costs) may be considered a potentially stranded cost. Further, some stranded
6 costs may not be presently reflected in a utility's financial statements. This is the case with
7 TEP where certain substantial costs are not captured in its financial statements, including \$94
8 million relating to the Springerville excess capacity deferrals and \$19 million for employees'
9 post-employment benefits.

10 Q. How do you propose calculating stranded costs?

11 A. TEP believes that the most appropriate method of defining stranded costs would be to
12 calculate the difference between future revenues under traditional regulation and a
13 competitive regime. This method eliminates the need for an asset-by-asset determination,
14 and more accurately recognizes that utilities have made multiple investment decisions under
15 the Compact with the expectation of revenue streams from customers to cover the costs of
16 such investments (including an opportunity to earn a reasonable rate of return).

17 TEP supports the "Net Revenues Lost" method proposed by the Stranded Cost
18 Working Group Report ("Report") which calculates stranded assets as the net present value
19 of future annual differences in revenues under a continuation of regulation, versus the
20 amounts likely to be realized after the introduction of competition, using an appropriate
21 discount rate. In general, the resulting amount reflects the difference between the utility's
22 embedded generation costs and the market's marginal costs for supplying power, plus the
23 utility's regulatory assets, both recorded and unrecorded. Such a method effectively
24 recognizes both above-market and below-market assets.

25 Q. Have you considered other stranded cost quantification methodologies?

26 A. The only feasible approach (other than the Net Lost Revenues approach) outlined in the
27 Report of the Stranded Cost Working Group ("Report") is auction and divestiture. TEP
28 proposes that auction and divestiture remain an option throughout the recovery period no
29 matter what methodology is finally decided upon. If the auction determined market price
30 exceeds the unamortized book value of the generation asset, TEP will credit the difference to

1 other stranded costs (e.g., regulatory assets). If unamortized book value is greater than
2 actual market value, TEP will recognize this difference as a regulatory asset to be included in
3 stranded costs and amortize this amount over the remainder of the recovery period.

4 The replacement cost valuation approach is not good for society or TEP. It would
5 undervalue TEP's stranded assets given current market prices which reflect the existing
6 excess capacity environment. Much of TEP's generation can be operated more cheaply than
7 gas-fired combined cycle, combustion turbines on a marginal cost basis – especially in the
8 event of an increase in gas prices.

9 Finally, the Stock Market Valuation proposal is infeasible given TEP's debt
10 covenants. For example, TEP is currently prohibited from paying dividends, so it would be
11 difficult if not impossible to “pay” all of the stranded cost recovery charges to a designated
12 class of shareholders.

13 Q. The single most significant variable affecting the quantification of stranded costs is the
14 market clearing price for power. What do you propose using as the market price in your
15 calculation of stranded costs?

16 A. Any method of attempting to quantify stranded costs is necessarily speculative and highly
17 uncertain because it requires identification of all relevant resources (both recorded and
18 unrecorded) and offsets, customer demand and predictions of the market clearing price for
19 power over long periods of time. As an example, factors affecting the market clearing price
20 for power (clearly the most critical variable in quantifying stranded cost) include: customer
21 demand, market structure, generation and transmission capacity availability, generation fuel
22 mix and costs, interest rates and inflation, developments in technology and new laws and
23 regulations. However, given all these uncertainties, TEP proposes using the Dow Jones Palo
24 Verde Index (“PVI”) as a market price estimate.

25 Q. Why do you propose using the PVI? Isn't the PVI a wholesale market index?

26 A. The Company believes that the PVI price is the best estimate we have of the market price for
27 electricity in Arizona. Because of the excess capacity in this part of the country, capacity
28 values have been driven close to zero and the PVI value primarily represents average fuel and
29 variable O&M costs. Also, it is easily verifiable.

30 ...

1 Q. Shouldn't the market price used in calculating stranded costs include long-run capacity cost?

2 A. Yes, to the extent that such costs are recovered in the competitive market. Further, as excess
3 capacity is depleted and the market for capacity becomes tighter, the PVI price will more
4 fully reflect capacity costs.

5 Q. Wouldn't something similar to the California Power Exchange ("PX") price serve as a better
6 spot market index since it will include all of the utility-owned generation and will serve retail
7 markets?

8 A. The Company believes that the PVI and the PX prices will be similar (net of transmission
9 and transaction costs). If the net market price is higher in one region, the market will
10 equilibrate.

11 **IV. SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH**
12 **STRANDED COSTS ARE CALCULATED?**

13 Q. Should there be a limitation on the time frame over which stranded costs are calculated?

14 A. TEP supports the Report's recommendation that costs should reflect the expected remaining
15 cost recovery periods associated with the respective assets which includes service lives
16 implicit in current book depreciation rates, contract periods for fuel and recovery periods for
17 applicable regulatory assets and liabilities.

18 Q. Over what time period does TEP propose calculating stranded costs?

19 A. A significant portion of the investments implicit in stranded costs are very long-term. TEP's
20 generating assets, for example, have life expectancies in excess of thirty years. Historically,
21 costs associated with these assets have been specifically incurred to serve customers over an
22 extended period of time with a reasonable expectation of a fair opportunity for full recovery.
23 Proper quantification of stranded costs should reflect the remaining life expectancy of these
24 underlying assets and deferred costs.

25 **V. SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR**
26 **STRANDED COSTS?**

27 Q. Should there be a limitation on the stranded cost recovery time?

28 A. The interest of the utilities, their shareholders and consumers all need to be balanced in
29 determining the time frame for stranded cost recovery. All parties will prefer as short a
30 recovery time frame as possible. However, several factors, including (i) generation price

1 increases, caps or reductions, (ii) the inclusion of securitization as a potential recovery
2 method, and (iii) the magnitude of stranded cost, also have a significant impact on the
3 recovery time frame. TEP believes that the recovery time frame should be based on some
4 reasonable balance of such considerations. Accordingly, TEP strongly supports the option of
5 securitizing a portion of stranded costs, the time frame for repayment from consumers of the
6 securitized stranded cost should be 10 - 15 years. TEP also proposes that non-securitized
7 stranded cost recovery be completed by the end of 2004.

8 **VI. HOW AND WHO SHOULD PAY FOR STRANDED COSTS AND WHO, IF**
9 **ANYONE, SHOULD BE EXCLUDED FROM PAYING FOR STRANDED COSTS?**

10 Q. How do you propose recovering stranded costs from consumers?

11 A. TEP proposes two recovery mechanisms to be used in tandem. First, TEP wants to securitize
12 a portion of its uneconomic assets in order to accelerate recovery of stranded costs. The
13 second recovery mechanism is a Competitive Transition Charge ("CTC").

14 Q. Please discuss your position on securitization of stranded cost?

15 A. TEP wants the right to securitize up to 75% of its stranded costs. Securitization creates
16 savings that are achieved by substituting the utility's debt and equity capital with lower cost
17 securitized debt capital. This cost savings benefits customers.

18 Q. Please discuss the second recovery mechanism.

19 A. To recover the unsecuritized portion of stranded costs, TEP proposes a non-bypassable CTC
20 paid by *all* consumers. TEP will bill customers at rates which include the CTC. The CTC
21 will be computed as the difference between the generation-related portion of TEP's rates and
22 the PVI price. Customers who choose a different Energy Service Provider ("ESP") will still
23 be responsible for paying the kWh charge they agreed to pay their ESP.

24 Q. Does your position change if securitization is not allowed?

25 A. Yes, if securitization is not allowed, TEP will not be able to recover its stranded costs over as
26 short a time period and will therefore seek a recovery period as long as needed to recover
27 TEP's stranded costs using the CTC recovery mechanism.

28 ...

29 ...

30 ...

1 **VII. SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO, HOW WOULD IT**
2 **OPERATE?**

3 Q. Do you support a true-up mechanism?

4 A. Yes, given the uncertainty surrounding the future market price for electricity, fuel, and
5 capital, it is obvious that a stranded cost value cannot be calculated with certainty at the time
6 of transition to competition.

7 While TEP recognizes that regulators may desire to implement a procedure for the
8 periodic evaluation and true-up of stranded cost charges as a safeguard against over-recovery,
9 such a procedure should be designed to minimize, to the extent possible, the regulatory and
10 administrative burden associated with that procedure. To that end, the Company suggests
11 that the structure of a true-up mechanism should resemble that of the former fuel adjustment
12 clause in which a band was set based on forecasted prices and a true-up would occur only to
13 the extent that revenues exceed the band ceiling or floor. For example, if the market price
14 forecast error exceeds a predetermined threshold limit an adjustment to the recovery
15 mechanism would be implemented.

16 Q. How often do you think the stranded cost recovery mechanism should be "trued-up"?

17 A. The Company suggests that recalibration of the CTC occur at any time the band ceiling or
18 floor is exceeded.

19 **VIII. SHOULD THERE BE PRICE CAPS OR A RATE FREEZE IMPOSED AS PART OF**
20 **THE DEVELOPMENT OF A STRANDED COST RECOVERY PROGRAM AND IF**
21 **SO, HOW SHOULD IT BE CALCULATED?**

22 Q. Under TEP's proposal, will there be price caps or a rate freeze imposed?

23 A. The Company's proposal requires rates to be fixed at some level to recover stranded costs via
24 the CTC through 2004 and securitization of up to 75% of stranded costs with repayment over
25 10 - 15 years. If TEP is allowed to securitize, this approach will likely allow for full recovery
26 of stranded costs and accommodate a rate freeze.

27 ...
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29 ...
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1 **IX. WHAT FACTORS SHOULD BE CONSIDERED FOR “MITIGATION” OF**
2 **STRANDED COSTS?**

3 Q. How do you propose mitigating stranded costs?

4 A. Under the Rules, utilities are expected to take steps to minimize stranded cost exposure. TEP
5 agrees that utilities should be required to exercise reasonable measures to mitigate stranded
6 costs. The challenge is in defining what would be considered “reasonable” for any given
7 company. Those actions taken by particular companies that might constitute reasonable
8 mitigation will depend on their specific circumstances and relevant market conditions.
9 Accordingly, mitigation efforts should be evaluated on a case-by-case basis.

10 The Rules suggest the expansion of wholesale or retail markets as a way to mitigate
11 Stranded Costs. Such activity is not likely to significantly mitigate stranded costs because
12 the Company proposes that market clearing prices be used to determine stranded costs. As a
13 result, the value of the wholesale market is fully reflected in the computation of stranded
14 costs.

15 The Rules also identify the offering of a wider scope of services for profit as another
16 means to mitigate stranded costs. It is unclear whether this suggested action is intended to
17 include only jurisdictional-related activities or is broader in its intended range of
18 contemplated business pursuits, covering any business activity the utility and/or its affiliates
19 may choose to engage in. TEP believes that profits from activities that are unrelated to the
20 provision of electricity in Arizona (which were funded with shareholder dollars) that do not
21 require use of the assets that were acquired to serve electric customers in Arizona, and that
22 are at risk to the utility’s shareholders (but not ratepayers), should not be considered as a
23 source of funds to offset stranded costs.

24 Other approaches to mitigating stranded costs may include asset sales, renegotiating
25 uneconomic contracts (as TEP has already done in recent years by renegotiating certain fuel
26 supply agreements), pursuing economic development projects and continually attempting to
27 lower marginal costs (as TEP has done through corporate re-engineering, its voluntary
28 severance plan and similar cost-reduction efforts). It should also be noted that mitigation
29 efforts themselves may lead to additional costs that need to be recovered from customers.
30 ...

1 What constitutes appropriate mitigation for any utility should include consideration of all
2 relevant facts and circumstances.

3 TEP also supports a sharing of mitigation benefits between consumers and
4 shareholders in order to provide utilities with the proper incentive to mitigate. This can be
5 easily accomplished by determining an allocation of the savings between the parties up front.

6 **X. WHEN SHOULD "AFFECTED UTILITIES" BE REQUIRED TO MAKE A**
7 **STRANDED COST FILING PURSUANT TO A.A.C. R14-2-1607?**

8 Q. When should the Affected Utilities be required to make a stranded cost filing?

9 A. As I stated at the beginning of my testimony, the issue of stranded cost must be fully resolved
10 prior to the introduction of competition in Arizona. This hearing to determine generic issues
11 is crucial to a determination of what changes to the Rules are necessary, as well as what
12 policy guidelines the Commission will issue. Therefore, the Company proposes that
13 Affected Utilities be required to submit stranded cost filings with the Commission within 120
14 days of the issuance of a Decision in this generic proceeding. If the Decision requires the
15 adoption of amendments to the Rules, the filing should be within 120 days of effectiveness of
16 such amendments.

17 Q. What is the basis for the 120 days?

18 A. TEP believes this is the minimum amount of time necessary to put together such a filing as it
19 will be somewhat analogous to a rate case filing. A rate case filing historically takes 120-180
20 days to prepare.

21 Q. Does this conclude your testimony?

22 A. Yes.

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P O W E R P L A N T S

THE STRANDED GENERATION

Critics of stranded cost recovery conveniently ignore the fact that the decisions made in the 1970s about power plant construction were not made unilaterally by the electric utility industry.

They were societal decisions.

Moreover, the resulting plants, far from being ugly remnants of bad industry decisions, have largely fulfilled the expectation society had for them when they were originally conceived.

B Y F R A N K C L E M E N T E

PICTURE OMITTED

As one generation fades from the scene and a new one assumes leadership, a certain dimness occurs as to why specific public policies came to be adopted. This lack of understanding is especially likely in the area of energy policy, where only a complex blend of technical, economic, social, psychological, and political phenomena can explain how we got here (the 1990s) from there (the 1970s).

Of course, the gap between now and then is quite natural, and one can forgive a new generation's innocence and help them bridge that gap. The task of education is made more difficult, however, by institutions and individuals who exploit the gap by rewriting history to suit their own purposes.

Take, for instance, the case of the Heritage Foundation, a public policy think tank based in Washington, DC, which is pushing for rapid deregula-

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tion of electric utilities and is a vocal critic of stranded cost recovery. Just this year the Foundation stated, "[S]tranded cost recovery is difficult to justify.... [Though] monopolistic utilities...argue that they have made investments in good faith...little substantive evidence can be offered by these utilities...."

Yet in 1978 the Heritage Foundation was decrying the cancellation of power plants, arguing that "without nuclear power we will be unable to maintain the level of economic growth necessary to insure that all Americans will have an opportunity to fulfill the promise of the American Dream."

Or, at the individual level, take the case of Irwin M. Stelzer, a well-known electric utility economist. In 1975, as president of National Economic Research Associates, he questioned the cancellation of coal and nuclear plants, warning that the demand for electricity could accelerate at "a rate of up to 8.4 percent per year." By 1994, however, after technical, political, and regulatory sea changes (and a move to another DC-based think tank, the American Enterprise Institute), Stelzer decided the argument for stranded cost recovery was "not entirely convincing."

Such revisionist statements invite a careful examination of the hard reality of energy choices made during the most turbulent period of U.S. energy history—the 1970s. As indicated in the timeline running across the bottom of these pages, a series of developments, both domestic and foreign, combined to complicate the nation's energy outlook tremendously.

Nevertheless, the obligation to serve imposed on them as part of the regulatory compact required utilities to plan to meet future load, regardless of growing uncertainty about future fuel supplies and future electricity demand. At some point the die had to be thrown. And in fact, though some contemporary analysts scoff at "the obligation to serve" as a utility fantasy, the country at large and industry in particular not only believed in utilities' obligation to serve but also relied on it to secure future energy supplies by requiring the construction of new nuclear and coal-fired power plants:

■ *Failure to exploit nuclear to the fullest may result in electric power shortages in the decades immediately ahead.*—Commerce Energy Advisory Panel, chaired by Malcolm E. Pruitt, vice president, Dow Chemical, 1974

THE TURBULENT DECADE

1970

U.S. Congress

Passes Clean Air Act, requiring new coal plants to reduce emissions. Utilities turn to conforming coal from the Great Plains at increased cost.

Ceylon

Nationalizes property of Shell and Esso.

1971

Venezuela

Bill to nationalize oil assets signed by President Caldera, who states that, "considering the shortage of energy in North America, they need us more than we need them."

Iran

Shah Pahlevi warns that if ongoing negotiations with Western oil firms fail, "the question of cutting off the flow of oil" to the West "will definitely be considered."

Nixon

"If we are to meet growing demands for electricity in the years ahead, we cannot ignore the need for many new power plants...[to] be completed on time so as to avoid power shortages."

As oil and natural gas supplies became increasingly uncertain, the nation focused on its certain domestic fuels—coal and uranium.

Moreover, it is clear that the decision, when viewed in the context of time, was generally the correct one. Across the United States, coal-fired and nuclear power plants planned in the 1970s have since then displaced billions of barrels of oil and trillions of cubic feet of natural gas, provided fuel diversity, and assured the most reliable supply of electricity in the world—exactly what the public, business, Congress, and three U.S. presidents who held office in the 1970s all hoped for as construction decisions were made.

Yet, ironically, many of the businesses and groups that publicly encouraged the construction of these facilities are now loudly opposing the recovery of investments made on the basis of their advice and urgings.

Why Nuclear?

Of the 251 nuclear plants ever ordered in the United States, 107, or 43 percent, were ordered in 1972, '73, or '74. These generating facilities were not ordered in a vacuum. Rather, they were proposed and built in a sociopolitical en-

vironment where they were viewed as necessary to meet societal needs of energy independence, economic growth, and national security. That each of these plants was certified and approved in an open public process by every relevant state and local regulatory agency further demonstrates that the plants were perceived locally to meet such needs. The Illinois Commerce Commission's finding regarding Commonwealth Edison's Braidwood Nuclear Station is typical: "The Commission, having considered the entire record...finds that...public conve-

nience and necessity require the construction, operation, and maintenance of the Braidwood Station."

Overall, these nuclear plants, along with new coal plants, were encouraged, proposed, and approved at a time when other major fuel sources for electricity generation grew more uncertain with each passing crisis or dire prediction, many from the highest levels of the land. As expressed by President Jimmy Carter in an April 1977 address to the nation, the common perception throughout most of the 1970s was that "the oil and natural gas

"THE MAJOR ALTERNATIVE TO FOSSIL FUEL ENERGY FOR THE REMAINDER OF THIS CENTURY IS NUCLEAR ENERGY.... NUCLEAR ENERGY WILL PROVIDE MORE THAN ONE-QUARTER OF THIS COUNTRY'S ELECTRICAL PRODUCTION BY 1985 AND OVER HALF BY THE YEAR 2000."—NIXON'S ENERGY MESSAGE TO CONGRESS, APRIL 1973



Wally McNamee / Folio

1973

Donald MacDonald, Energy Minister of Canada

Reports to House of Commons that the price of natural gas will double by 1980 and the price of fuel oil will double by 1990. Warns that Canada cannot be relied on to solve the U.S. energy crisis.

Saudi Arabia

King Faisal warns oil to United States may be cut off because of America's "complete support of Zionism against the Arabs."

Libya

Nationalizes 51 percent of all foreign firms, including Libyan subsidiaries of Exxon, Mobil, Texaco, Standard Oil, Atlantic Richfield, and W.R. Grace.

Peru

Standard Oil of California seized in tax dispute.

Egypt

President Anwar Sadat says Libyan nationalization is "the beginning of a battle against American interests in the whole Arab region."

Iraq

Nationalizes assets of Mobil and Exxon.

OPEC

Arab oil-producing states—countries that account for 80 percent of

non-communist oil reserves—embargo all petroleum exports to the United States.

C.J. Gauthier, Chairman of Northern Illinois Gas

"We expect the monthly bill of the average residential customer to double...by 1985.... Nuclear energy simply has to provide a greater share of the energy requirements in the years ahead."

ENERGY AND SECURITY

A link between adequate energy supplies and national security was taken as a given in the 1970s. From "Project Independence" of Presidents Nixon and Ford to the "Moral Equivalent of War" of President Carter, the need to maintain our freedom was a central reason for the call for the United States to develop domestic energy resources. As President Carter explained in his April 18, 1977, address to the nation, without energy independence, "We will constantly live in fear of embargoes. We could endanger our freedom as a sovereign nation.... Inflation will soar; production will go down; people will lose their jobs.... [W]e will face an economic, social, and political crisis which will threaten our free institutions."

Small wonder that the Secretary of Defense said a short time later, "The present deficiency of assured energy resources is the single greatest threat...to our security."

One of the greatest nightmares of the Cold War was that the Soviet Union would attain nuclear superiority over the United States, not only in terms of its military arsenal but also in terms of its possible control over an emerging nuclear-powered global economy. Throughout the 1970s, the USSR was extremely active in developing nuclear generating capacity and penetrating the world market for commercial nuclear power. In 1971, for example, the Soviets attempted to capture part of the enriched uranium market by selling fuel 15 percent below the U.S. price. Throughout the decade they sold fuel and nuclear power plants on both sides of the Iron Curtain, creating major concern in the

United States. And as late as 1978 the USSR offered to replace a plant the Philippines had ordered from Westinghouse with a Soviet plant and to help that country develop its own uranium sources.

It was in this context that President Carter proclaimed that, "with the exception of preventing war," achieving energy independence "is the greatest challenge that our country will face during our lifetime...."

Twenty years later, such dire warnings seem hyperbolic. For, to an ever-increasing number of U.S. adults, the dread and tension of the Cold War is just an abstraction. A 40-year-old policymaker today was only 4 at the time of the Cuban missile crisis, only 7 when Nikita Khrushchev said, "We will bury you," and only 16 when the Soviet newspaper *Izvestia* called the Iraqi and Syrian seizures of U.S. oil assets "a great victory for the Arab peoples... struggling against the forces of imperialism."

Clearly, with the dissolution of the Soviet Union, the perceived threat from Ronald Reagan's "Dark Empire" had receded, making Cold War policy decisions seem overly defensive, if not paranoid. Yet, there is no question that Soviet nuclear activity challenged U.S. world leadership and influenced U.S. energy policy decisions far more than any utility system planner's calculations did. The decision to build large generating facilities for the 1980s was a societal decision based on a huge complex of variables related to the recognized need to maintain U.S. independence and our position as the leader of the free world.



1974

National Academy of Engineering

"A review of all the facilities necessary to supply our oil and gas needs between 1974 and 1985 indicates that the capital requirements would be on the order of \$200 billion."

Energy Policy Study Group, MIT

"There is little basis upon which to predict any specific oil price over

the next ten years.... These political matters cannot be forecast with any degree of accuracy."

Zaire

Takes over all petroleum product distribution, including assets of Texaco and Mobil.

Saudi Arabia

Oil Minister al-Yamani warns oil consuming nations that embargo

counteractions would lead to an international economic "disaster."

Kuwait

Oil Minister Atiki: "Why should we be responsible for helping America solve her economic problems?"

Mexico

Minister de la Pena declares, "Mexico rejects any suggestion that she may play a role in weakening the common front of oil-exporting nations."

Federal Energy Administration

"The outlook for increased gas supplies is not promising."

Federal Power Commission

Reports that the chronic gas shortage has deteriorated in the last 12 months and could become a "severe crisis" in five years.

that we rely on for 75 percent of our energy are simply running out...." Moreover, there was equally widespread agreement that both oil and gas prices would dramatically escalate over the next several years.

And this at a time when the nation was highly dependent on fuel oil and natural gas for electricity generation. In 1972 oil accounted for 16 percent and gas 21 percent of total U.S. electricity generation. Certain regions were even more reliant on the two fuels. New England (ME, MA, NH, VT, RI, and CT) depended on oil to generate 65 percent of its electricity, the West South Central region (AK, LA, OK, and TX) depended on gas to generate 91 percent, and the Pacific region (WA, OR, and CA) depended on oil for 50 percent and gas for 36 percent.

The fragility of the Western World's oil supplies was dramatically exposed in October 1973 when the Arab oil embargo of 1973-74 commenced. At the time, the Arab cartel controlled 80 percent of the oil reserves of the noncommunist world. Although the United States as a whole imported only about 10 percent of its oil from the Middle East in the early 1970s, virtually all projections at that time indicated that by

1985 the country would be importing a major portion of its oil from that region. Moreover, oil supplies from other countries were increasingly uncertain as well. Thus, an entire sequence of foreign events and pronouncements about oil during the first half of the 1970s was viewed as a real and growing threat to U.S. economic prosperity and national security. (See the sidebar, "Energy and Security.")

The outlook for natural gas was even worse. During the 1970s, virtually every analyst agreed that natural gas was running out. As shown in the timeline,

their prognostications culminated in 1978 in the passage of the Power Plant and Industrial Fuel Use Act, which forbade new power plants using gas as a primary boiler fuel and required all existing gas-fired plants to convert to an alternative fuel by 1990.

Needless to say, this prohibition created major problems for utility planners everywhere, but the problem was especially acute for a number of states strongly dependent on natural gas for generation. Oklahoma, for example, relied on natural gas for 99 percent of its electricity generation in 1974. Texas

"GREATER UTILIZATION MUST BE MADE OF NUCLEAR ENERGY IN ORDER TO ACHIEVE ENERGY INDEPENDENCE AND MAINTAIN A STRONG ECONOMY. IT IS...VITAL THAT WE CONTINUE OUR WORLD LEADERSHIP AS A RELIABLE SUPPLIER OF NUCLEAR TECHNOLOGY...."—FORD'S ENERGY MESSAGE TO CONGRESS. FEBRUARY 1976



Bruce Haeffel / Folio

1975

**William Simon,
Secretary of the Treasury**

"We have set a goal to increase the output from nuclear plants tenfold by the 1980s."

President Nixon

"The first task is to rapidly increase energy supplies...[by] accelerating the introduction of nuclear power...to achieve energy self-sufficiency."

U.S. Geological Survey

Revises reserve estimates downward. National Academy of Sciences estimates no more than 25 years of reserves.

OPEC

OPEC ministers agree to retain prices at current level for the remainder of the year and to increase them gradually in 1976 and 1977.

**National Research Council of
National Academy of Sciences**

Predicts the United States will run out of oil and natural gas in 25 years.

President Ford

"A massive program must be initiated to increase energy supply...to achieve the independence we want by 1985.... I am proposing a number of actions to energize our nuclear power program."—*State of the Union Address*

**National Society of
Professional Engineers**

"The best hope for the reduction in the spiraling costs of electricity can be and has been realized by the increased use of nuclear power."



1976

LBJ School of Public Affairs, University of Texas

"Texan natural gas companies believe prices are going to rise significantly in the coming years.... The impact such changes will have on the electric power industry is clear: alternative boiler fuels must be sought and planned generating

capacity for the foreseeable future will have to rely upon a mixture of coal (or lignite) and nuclear power."

Harrison Brown, California Institute of Technology

"We are clearly pushing against the upper limit of our domestic extractable [soft] hydrocarbon resources.... [R]eserves are destined to continue their downward path."

Senator Adlai Stevenson

"By no coincidence the quadrupling of oil prices in 1973 was followed by the worst inflation in this century and the worst recession since the Great Depression.... Energy-induced inflation may have cost consumers \$150 billion in purchasing power during 1974 and 1975."

U.S. Congress

Emergency Gas Act passes. Curtailment plans make it extremely difficult for utilities to obtain gas to produce electricity.

Bonneville Power Authority

Continuing drought in Washington, Oregon, and Idaho. Bonneville Power announces that another year of drought could result in a 50-per-cent drop in electricity supply.



A line in the road. In 1973 and 1979, turmoil in the Middle East created fuel shortages, escalating prices, and a united front for U.S. energy independence.

generated 93 of its electricity with gas; Louisiana, 87 percent; and Kansas, 78 percent. Arkansas depended on gas for 43 percent of its generation, and the remainder was generated with oil.

With gas eliminated and oil supplies increasingly questionable, the options regarding new capacity were dwindling rapidly. By the second half of the 1970s, following energy upheavals, em-

bargoes, price increases, shortages, curtailments, and brownouts, it was apparent to a wide range of observers that the United States had two basic options to meet electricity demand in the 1980s and '90s:

From the federal government. "[W]e must [get]...America's power plants off oil. And, for the immediate future that implies coal—which has environmental problems—and nuclear—which has other problems. But we will have to choose between them."—James Schlesinger, President Carter's Energy Advisor, 1977

"OUR DECISIONS ABOUT ENERGY WILL TEST THE CHARACTER OF THE AMERICAN PEOPLE.... THIS DIFFICULT EFFORT WILL BE THE MORAL EQUIVALENT OF WAR.... OUR ENERGY PROBLEM IS WORSE TONIGHT THAN IT WAS IN 1973."—CARTER'S ADDRESS TO THE NATION, APRIL 1977



1977

United Mine Workers

Coal miners strike—national emergency is declared.

James R. Schlesinger, Secretary of Energy

"Nuclear is an essential ingredient in the energy mix. We are removing the uncertainties and obstacles to licensing...."

Senator Harrison Williams

"In regard to national energy security, most energy experts agree that we are in a far more precarious position today than we were in at the time of the oil embargo of 1973.... [O]ur imports of all petroleum products have increased to over 50 percent of the total supply in recent months.

1978

U.S. Congress

Power Plant and Industrial Fuel Use Act passes. Forbids new gas boilers. Restricts use of gas in existing facilities and eliminates gas use as a boiler fuel after 1990.

1979

Three Mile Island

Nuclear incident at Three Mile Island power plant occurs.

Iran

War between Iraq and Iran. Iran oil exports to United States cease, precipitating 1980 recession.

From the press. "To generate increased amounts of electricity, this country now has only two choices: It can either burn more coal or build more uranium-fueled nuclear reactors."—*Washington Post*, editorial, 1977

From business. "[C]ompanies are at least partially avoiding the question of what fuel to favor by using electricity,

From 1970 to 1979, nuclear's share of generation jumped 10 points, while gas and oil's share dropped 15 points.

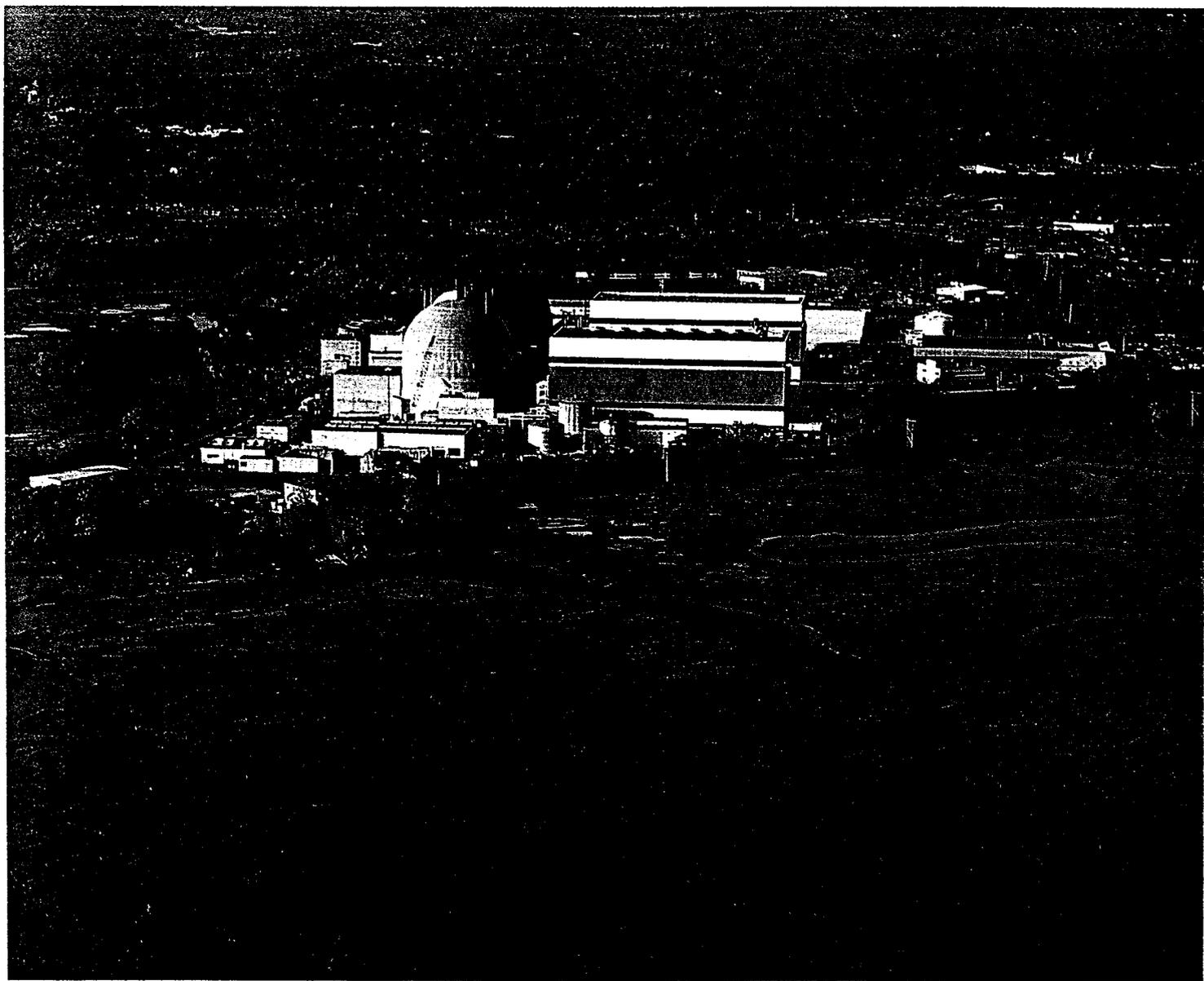
leaving it to their utility to thread its way through decisions on coal, oil, gas, or nuclear generating power."—*Conference Board Record*, 1978

From the Academy. "[F]or both economic and regulatory reasons, utility plants will be moving rapidly to the use of either coal or nuclear energy."—Ford Foundation/Resources for the Future

Widespread Support

Given this background it is clear that many opponents of stranded cost recovery are poor students of history.

Consider this rewrite offered last year by the Citizens for a Sound Economy: "Customers should no longer be forced to compensate imprudent investments in nuclear power plants when cheap power was and always has been abundantly available for bulk purchase at the time of construction." Or, this one by Representative Thomas DeLay, speaking at the Heritage Foundation in April of this year: "I believe it is important to debunk the myths surrounding the notion that utilities are somehow 'owed' the costs of all their invest-



Frank Sutermeister/Uniphoto

ments.... I believe it is essential to protect families and small businesses from becoming the economic scapegoats for billions of dollars in questionable investment decisions."

In truth, the historical context in which those decisions of the 1970s were made is more accurately described this way:

- a generation-old standard of "universal service" in an industry whose obligation to serve was an accepted part of a larger regulatory compact,
- a recent history of 7.5 percent annual growth in electricity demand during the 1960s,
- the memory of the social and economic upheaval associated with the Northeast blackout of 1965, which was estimated to cost over \$350 million,
- uncertain forecasts of future demand tempered with the knowledge that the population was projected to grow, new jobs would be added to the economy, and certain industries (like glass, for example) appeared to be shifting from fossil fuels to electricity,
- an uncertain supply of oil, curtailment and finally the outlawing of natural gas as a new boiler fuel, the obvious maturity of the nation's hydroelectric resources, and the increasingly recognized environmental and transportation difficulties associated with coal,
- a sociopolitical environment extremely supportive of developing domestic energy supplies to assert U.S. independence from the oil cartel, to maintain national security vis-a-vis the USSR, and to continue as the leader of the world's nuclear economy.

Utility planners were not alone in their interpretation of the actions required in such an environment. The decision to utilize nuclear generating plants to meet the nation's energy needs was a societal decision with deep support from all sectors of the country, political, economic, scientific, and the public at large.

Throughout the 1970s, the nuclear option enjoyed strong bipartisan support in both the White House and Congress. In fact, in nuclear plant referenda held during the presidential election of 1976, voters expressed more support for nuclear power plant construction than they did for either candidate. (See Table 1.)

Business leaders also encouraged the construction of such facilities. In a 1974 survey of top executives randomly sampled from *Forbes'* and Standard and Poor's executive lists, researchers at the University of Georgia found that "an overwhelming majority of the executives who responded to the survey believes that the solution to the energy problem lies with nuclear power. Over 82 percent of the respondents chose 'accelerate nuclear power plant construction'...."

That same year, the Technical Advisory Board of the U.S. Department of Commerce strongly recommended the construction of additional nuclear

plants, given the uncertainties surrounding future fossil fuel supplies. Board members included executives from major businesses, including Dow Chemical, Borg-Warner, Burlington Northern, Dravco, General Motors, and U.S. Steel.

TABLE 1

POPULAR VOTES IN 1976 ELECTION

States with Nuclear Referenda	For Nuclear Plants	For Carter	For Ford
Arizona	70%	40%	56%
California	67%	48%	49%
Colorado	61%	43%	54%
Montana	65%	45%	53%
Ohio	68%	49%	49%
Oregon	58%	47%	47%
Washington	67%	46%	50%

OPEN LETTER TO PRESIDENT FORD,
DECEMBER 27, 1974

"We believe that the world faces the most serious economic threat since the Great Depression.... [The energy crisis] has undermined the world's financial structure to the point of threatening collapse and a world wide depression...."

"America must move rapidly to increase domestic supply.... [The nation needs] major programs of research: on nuclear energy (both breeder reactors and fusion)...[and on] streamlining of procedures for...siting energy (including nuclear energy facilities)."

Signed by the following and 80 others:

Alcoa Chairman, John Harper

Allied Chemical Chairman, John T. Connor

American Can Chairman, Robert S. Hatfield

Anaconda CEO, John Place

B.F. Goodrich CEO, O.P. Thomas

Brunswick Chairman, John Hannigan

Dart Industries Chairman, Justin Dart

Dayton-Hudson Chairman, Bruce Dayton

Del Monte Corporation Chairman, A.W. Eames

FMC Corporation Chairman, Robert H. Malott

General Foods Chairman, James Ferguson

General Mills' James McFarland

Goodyear Tire & Rubber CEO, Charles J. Pilliod

GTE Chairman, Leslie H. Warner

Hewlett Packard Chairman, David Packard

Koppers CEO, Fletcher L. Byrom

May Department Stores CEO, Stanley J. Goodman

Raytheon Chairman, Charles Adams

RCA Chairman, Robert Sarnoff

Standard Brands President, Henry Weigl

ON CAPACITY INVESTMENTS—NOW AND THEN

Heritage Foundation, 1997

"[S]tranded cost recovery is difficult to justify.... [M]onopolistic utilities...argue that they have made investments in good faith...[but] little substantive evidence can be offered by these utilities to show such an explicit compact or contract existed.... There is no reason to believe the public would have accepted voluntarily restricted choice, mediocre service, and high electricity prices...."

Heritage Foundation, 1978

"To the extent that the growth of electrical generation capacity is curtailed, the growth of [employment] opportunities is also curtailed...."

"[I]n the near-term, without nuclear power, we will be unable to maintain the level of economic growth necessary to insure that all Americans will have an opportunity to fulfill the promise of the American Dream."

Irwin Stelzer, 1994

"Utilities generally argue that the to-be-stranded investments were made pursuant to their obligation to serve[....] pursuant to a set of rules which should not be changed ex post facto; that regulators had approved [the investments] as prudent...."

"The argument that regulatory rules should not be changed, especially after billions have been invested pursuant to these rules, has considerable appeal, but it is in the end not entirely compelling...[and] complaints about change in regulatory policy are not entirely convincing...."

Irwin Stelzer, 1975

"[N]uclear now stacks up competitively against fossil fuel plants and is the most economical way to provide electricity in most cases. It also has the advantage of reducing the nation's dependence on imported oil, thereby freeing us from having our foreign policy dictated to us...."

"[I]t is still in our estimation economically preferable to construct a nuclear plant.... Our conversations with major industrial users of energy suggest that uncertainties about oil [and gas] supplies...may result in massive switching from the fuels to electricity. The only assured sources of energy are coal and nuclear power."

Across the country, at mid-decade the business community perceived the national energy crisis to be a severe threat that required urgent public and private sector action. Witness, for example, the open letter to President Ford and Congress published in the *New York Times* on December 27, 1974, in which 100 business and societal leaders urged the development of a "strong energy program." (See the sidebar "An Open Letter to President Ford" on page 39.)

And the societal consensus remained firm as the decade unfolded. For instance, in 1977, the Committee for Economic Development, which described itself as "an organization of two hundred trustees who are mostly business executives and educators," offered this refrain in its *Key Elements of a National Energy Strategy*: "Nuclear

generation of electricity must continue to expand.... Only by continuing to exercise leadership in the use of nuclear power can the United States hope to influence the development of a world nuclear economy."

Changing Tunes

Among that Committee's trustees in 1977 were officer-level executives from several manufacturing firms—including Bethlehem Steel, E.I. du Pont Nemours, Ford Motor Company, General Motors Corporation, and LTV Steel—that are now members of the Electricity Consumers Resource Council (ELCON), which represents large industrial electricity consumers in the current public policy debate about restructuring the industry and is one of the most vociferous critics of stranded cost recovery.

Through ELCON, 20 years later those same firms claim that, "in order to defend the extravagant costs of new nuclear plant, utilities willingly committed to above-market purchased power contracts, DSM programs, and other government 'mandates' to muster regulatory support for rate-basing the plants....[M]any of the costs that burden [these] high-cost utilities were incurred due to bad business decisions...."

At least two other members of ELCON, Praxair and Allied-Signal, seem to share in this epidemic of institutional amnesia. The first actually testified in 1974 in support of a proposed Louisiana Power and Light nuclear plant and, that same year at Project Independence hearings, said that "[i]nformed, enlightened Government action taken now and in the future...can allow nuclear energy to materially assist in approaching energy independence." Likewise, John T. Conner, then chair of Allied Chemical, signed the December 1974 open letter published in the *Times*. The following year, he repeats the common wisdom of the day: "There is no real alternative to rapid development of our existing energy resources, especially coal and nuclear...."

How quickly they forget. And, unfortunately, ELCON's members are not alone in their forgetfulness. As shown in the sidebar at left, the Heritage Foundation and Irwin Stelzer suffer from the same malady.

It is a sad commentary on the institutional integrity of our society that many of the same individuals, organizations, and businesses that urged the construction of additional nuclear plants in the 1970s revile utilities two decades later for following their advice and urgings. Now that technology, legislation, and the international climate have all changed, the opponents of stranded cost recovery would punish utilities that heeded society's cry for assistance in achieving national security, energy independence, and economic prosperity. ●

TUCSON ELECTRIC POWER COMPANY
SUMMARY OF LOSSES SINCE 1988
 (IN MILLIONS OF DOLLARS)

		<u>1996</u>	<u>1995</u>	<u>1994</u>	<u>1993</u>	<u>1992</u>	<u>1991</u>	<u>1990</u>	<u>1989</u>	
1	MSR/Springerville Unit 1 Allowance (a)	\$33	\$33	\$32	\$31	\$30	\$30	-	-	
2	Rate Synchronization and Excess Capacity Deferral (b)	-	-	-	\$14	-	-	-	-	
3	1991 and 1989 Rate Order Disallowances and Adjustments	-	-	-	-	-	(c) \$240	(d) \$250	(e) \$61	
		<u>\$754</u>	\$33	\$33	\$32	\$45	\$30	\$270	\$250	\$61

(a) Interest Imputed on Losses Recorded at Present Value

(b) The 1994 Rate Order disallowed recovery of \$14 million of previously capitalized Springerville Unit 2 rate synchronization costs.

(c) Per the 1991 Rate Order, the ACC disallowed costs of \$175 million of Springerville Unit 2 and \$75 million of Irvington unit 3. Offsetting such amounts in 1991 was a gain of approximately \$11 million resulting from a recalculation of the present value of the Company's regulatory liability for the MSR option gain.

(d) Approximately \$178 million related to the Century Purchased Power Adjustment and the remaining \$72 million related to the MSR Option Gain Adjustment.

(e) \$31 million associated with Gallo Wash and \$30 million in Deferred Fuel.

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN

Commissioner - Chairman

RENZ D. JENNINGS

Commissioner

CARL J. KUNASEK

Commissioner

IN THE MATTER OF THE COMPETITION IN) DOCKET NO. U-0000-94-165
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.) **DIRECT TESTIMONY OF**
) **DANIEL WM. FESSLER**
)
_____)

On Behalf of

TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998

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1 **INTRODUCTION AND PURPOSE**

2 **Q1. Please state your name, affiliation and business address.**

3 A. My name is Daniel Wm. Fessler. I am a partner in the law firm of LeBoeuf, Lamb, Greene &
4 MacRae. My address is One Embarcadero Center, San Francisco, California 94111.

5 **Q2. Please describe your education and professional experience.**

6 A. I graduated from Georgetown University in 1963 with a Bachelor of Science Degree in
7 Foreign Service. In 1966, I received an LL.B. from Georgetown University Law Center. In
8 that same year I was admitted by examination to the Wyoming Bar. In 1971, I was awarded
9 a Doctorate in Juridical Science (S.J.D.) from the Graduate Division of the School of Law,
10 Harvard University. My dissertation was on due process requirements in administrative
11 proceedings. From 1970 through 1994, I was Professor of Law, University of California,
12 Davis where I taught classes in Contracts, Securities Regulation, Corporations, Partnerships,
13 Limited Partnerships and Joint Ventures, and a seminar in administrative law. I have also
14 served as a Visiting Professor of Law at the University of Virginia, the University of Texas,
15 the University of Georgia and the University of California, Los Angeles. Most recently,
16 during my tenure on the California Public Utilities Commission, I taught contracts and
17 business organizations at Law at Boalt Hall, the Law School of the University of California,
18 Berkeley. I assumed the status of a professor emeritus in June, 1994.

19 In 1970 I became a Fellow of the Center for Urban Studies at the Massachusetts
20 Institute of Technology and Harvard University. I represented the Center in the landmark
21 service equalization suit, *Hawkins v. Town of Shaw*, 461 F.2d 1171 (1972). Two years earlier
22 I served as co-counsel for the National Center of Education in Law and Poverty of
23 Northwestern University in the Supreme Court litigation which defined minimal due process
24 guarantees in administrative hearings. The case was *Kelly v. Goldberg*, 397 U.S. 254 (1970).

25 I have held various state and federal government positions, including a six-year
26 appointment (1991-1996) to the California Public Utilities Commission where I was elected
27 President of that Commission from December 1991 through April 1996. The Commission
28 regulates the reliability, safety, and economic terms of service for investor-owned utilities in
29 the fields of energy (electricity and gas), telecommunications, water and transportation. I
30 was also appointed by Governor Wilson to a four-year term on the California Transportation

1 Commission from March 1991 to January 1, 1995 and to the California High Speed Rail
2 Commission from March of 1994 until December 1996 when the mandate of that
3 Commission was discharged.

4 In March, 1997, I joined the law firm of LeBoeuf, Lamb, Greene & MacRae as Of
5 Counsel to their national and international Utility and Energy Practice. I was elected a
6 partner in the firm in December, 1997, effective January 1, 1998. LeBoeuf is headquartered
7 in New York City and is one of the preeminent legal advisors on matters affecting public
8 utilities. LeBoeuf has a significant national and international practice representing both
9 government and private sector clients in regulated industries, particularly energy and utilities,
10 insurance, banking, financial services, telecommunications and transportation.

11 **Q3. On whose behalf are you appearing in this proceeding?**

12 A. I have been asked by Tucson Electric Power Company ("TEP") to share my experience with
13 electric restructuring in California as it may pertain to the issues facing the Corporation
14 Commission and the people of Arizona.

15 **Q4. What is the purpose of your testimony?**

16 A. To respond to the questions propounded by the Commission in the Procedural Order¹ and
17 First Amended Procedural Order² insofar as they relate to issues surrounding the recognition,
18 calculation and apportionment of stranded costs, liabilities and their recovery by the affected
19 utilities in general and Tucson Electric Power Company in particular.

20 **Q5. How is your testimony organized?**

21 A. To better discuss the stranded cost issues framed by the Commission, I should set my
22 remarks in both a personal and institutional context. From a personal perspective, I will draw
23 on my experience as a student of the duty to serve, a subject upon which I have published
24 several articles and co-authored a book.³ I will also be basing my opinions on stranded cost
25 issues identified in the Procedural Orders and on experience formed during my service as a
26 member of the California Public Utilities Commission. That six-year service also sets the
27

28
29 ¹ Order dated December 1, 1997.

² Order dated December 11, 1997.

30 ³ Haar and Fessler, *The Wrong Side of the Tracks*, Simon and Schuster, 1986, republished in paperback as *Fairness and Justice: Law in Service of Equality*, Touchstone Press, 1987.

1 institutional context for it centers on the restructuring debate which occurred in California
2 between 1992 and 1996.

3 I hope that the members of the Commission find it most convenient if I organize my
4 thoughts in the following fashion.

- 5 • I would like to begin with a brief overview of both the process and outcome of the
6 restructuring debate pursued during my tenure as President of the Commission and
7 Assigned Commissioner in both our rulemaking and investigation.
- 8 • I will then turn to the question of the existence “yes” or “no” of a social contract
9 between the State of Arizona and the investor owned entities identified as the
10 “affected utilities” in this Commission’s Procedural Orders.
- 11 • Lastly, I will address the specific questions propounded by the Commission dealing
12 with stranded costs, liabilities and benefits.

13 **Q6. Before you begin please elaborate on your professional experience and why it qualifies**
14 **you to provide an opinion on the Corporation Commission’s deliberations on electric**
15 **restructuring and the stranded cost issues addressed in this hearing.**

16 **A.** During my six-year term on the California Commission we originated in North America a
17 debate over restructuring the electric service industry which had begun in Chile and been
18 carried forward in England and Wales. Our motive for examining the innovative
19 restructuring in those jurisdictions was the worst economic crisis experienced in California
20 since the Great Depression. The end of the Cold War, the demise of the USSR, and the
21 massive deficits of our own federal government combined to bring the defense industry to an
22 abrupt winding down which, in turn, set off a chain reaction of plant closures, project
23 cancellations and layoffs. Before it bottomed out sometime in 1995, California shed
24 hundreds of thousands of jobs with the consequence that we were forced to examine virtually
25 every aspect of our economic circumstances.

26 The Commission’s efforts to respond to this challenge are well known within the
27 ranks of our fellow regulators and have been alternatively damned and praised by both utility
28 and non-utility participants in the industry. Suffice it to say that I was the President of the
29 Commission during a period marked by more than one hundred hours of public hearings; the
30 assigned commissioner who issued the procedural orders which paced our movement toward

1 the enunciation of an industry structure which would defend the public interest in the context
2 of competitive discipline and significantly revised regulation; and the author of the majority
3 opinions in May, 1995 and December, 1996 which charted the reforms which the State of
4 California has been implementing since that date. As envisioned in those orders and
5 reflecting the labors of my former colleagues and successor, the Power Exchange and
6 Independent System Operator were to begin functioning in the public interest on January 1,
7 1998. On December 29, the Independent System Operator cited a number of technical
8 difficulties in announcing that it could not meet that deadline and setting a new
9 implementation date of no later than March 31, 1998.

10 **PART ONE: THE CALIFORNIA RESTRUCTURING**

11 **Q7. You have indicated that the California Commission acted in the context of an economic**
12 **crisis, could you briefly elaborate?**

13 **A.** Yes, I have just indicated the magnitude of our job loss. With full realization that we had
14 neither the desire nor the capacity to reinvigorate the defense industry, the task of our citizens
15 in general, and public office holders in particular, was to staunch the hemorrhaging of what
16 remained of California's industrial, agricultural and commercial sectors. Ongoing
17 assessments pointed to many factors which contributed to an adverse business climate. To
18 my mind, one fell squarely within the responsibility of the Public Utilities Commission: the
19 cost of energy. In 1992 one of the most distressing features of our economy was the price
20 we were paying for electricity: fully 50% above the national average. The politics of this
21 situation were at once simple and complicated. Our relatively mild climate and consequent
22 light consumption patterns meant that the average California householder paid utility bills at
23 about the national average. Seen from their perspective we had a problem (everyone would
24 like lower utility bills) but no crisis. But the relative contentment of the average householder
25 was of no comfort to anyone whose commercial, agricultural or industrial activities mandated
26 significant usage. From the vantage point of attempting to retain large energy users, our
27 problem was worse than the national numbers suggested. California was surrounded to the
28 north and east by states with electricity rates well below that average and each was
29 aggressively seeking to attract economic growth.

30 ...

1 Q8. How did you and your colleagues on the California Commission respond?

2 A. As President of the Commission I felt it our duty to understand the factors which had placed
3 us in this very non-competitive posture and to devise a strategy for controlling energy costs
4 in California. Our work took a little more than three years and is as remarkable for its
5 process as for the reforms which are taking life even as I write these words. In an effort to
6 assist the Arizona stakeholders and Commission, let me briefly chart the chronology of the
7 California effort.

8 ♦ The "Yellow Paper" identifies a set of problems including a regulatory structure
9 increasingly focused on a mythical image of the electric services industry.

10 My colleagues took on the task of responding to California's non-competitive costs of
11 electric energy even as we were seeking to conclude a bitter trade dispute with Alberta over
12 the terms of natural gas purchases and deal with pressure to open our telecommunications
13 markets to full competition. In September, 1992, we directed the Commission Staff to
14 prepare a report that described current conditions and emerging trends facing the electric
15 industry. We also asked that both the substantive and procedural aspects of regulation be
16 examined to determine if they were part of the problem or a key to the solution. On February
17 3, 1993, the Commission released for public comment the resulting report entitled
18 *California's Electric Services Industry: Perspectives on the Past, Strategies for the Future*.
19 Quickly branded the "Yellow Paper" because of the color of its cover, the report painted a
20 picture of an industry significantly evolved and differing from the one envisioned in our
21 regulatory efforts.

22 With the release of the Yellow Book the California Commission stood self-accused of
23 continuing to practice a form of command and control regulation over an industry structure
24 which had ceased to exist. We thought and acted as if California's investor-owned utilities
25 were each a self-sufficient, self-contained vertically integrated monopoly secure within the
26 bounds of its state-conferred service territory. As captured in this vision, each utility
27 generated, transmitted and distributed electricity sufficient to meet the current and anticipated
28 needs of all users within the territorial confines of the monopoly. In 1992 that vision was a
29 myth. Owing to an aggressive implementation of PURPA by our predecessors, virtually all
30 new generation in California in the preceding decade had been built by non-utility vendors

1 with the electricity sold under long-term power purchase contracts to the state's investor-
2 owned utilities. Self-generation had become technologically feasible for many large users.
3 Transmission lines no longer exclusively served the transportation needs of the owner but
4 were under increasing pressure to facilitate energy transactions between non-adjacent
5 utilities.

6 Though not emphasized in the Yellow Paper, there was a companion defect to the
7 mythical focus of the Commission's regulatory efforts. We had forgotten the art of
8 rulemaking and settled instead into the clamorous comfort of regulation by adjudication. The
9 trial type hearing had become our single distorted window on the world. Former hearing
10 officers were transmuted into Administrative Law Judges. Time consuming proceedings
11 focused on the past shedding more heat than light on the problems of the industry.

12 ♦ **The "Blue Book" shocks the utility industry by using a broadly cast rulemaking**
13 **to discuss and debate a revised vision for the industry increasingly dependent**
14 **upon the discipline of competitive forces.**

15 After a little more than a year of monthly public hearings we issued an Order
16 Instituting Rulemaking and Order Instituting Investigation.⁴ Attached to that order as a
17 discussion vehicle, was a detailed description of an industry structure which embraced
18 competition in generation and the discipline of informed customer choice. Again, showing a
19 penchant for identifying Commission documents with the color of the cover stock assigned
20 by the state printer, this competition centered vision of the industry was popularly known as
21 the "Blue Book."⁵ I think that it is fair to assert that the Blue Book took the restructuring
22 discussion to previously unexplored dimensions both in terms of the numbers and scope of
23 participants as well as the detail in which issues were parsed. The vague phrase "retail
24 wheeling" receded before attempts to distinguish wholesale from retail competition and
25 grapple with the economics and physics of high voltage transmission. The ambitions as well
26 as fears of both incumbent utilities and prospective market entrants were reflected in a failure
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29 ⁴ R.94-04-031/I.04-04-032.

30 ⁵ For those of us destined to spend two discussing this industry model and debating its premises there is enduring gratitude that the state printer did not elect puce cover stock.

1 to agree on the definition of these terms to say nothing of an industry structure. Our hearings
2 were held in large cities and modest towns from one end of the state to the other. Cable
3 television systems covered the discussions and video-taped copies were deposited in virtually
4 all public libraries. As public awareness of the debate began to grow, customers of various
5 classes started to organize, labor interests became engaged along with environmental
6 advocates and proponents of a variety of social welfare programs which, over time, had
7 become hallmarks of the known industry.

8 **Q9. How did you and your colleagues move this broadly cast dialogue to the point of**
9 **decision?**

10 **A.** We arrived at our declaration of policy positions, market design and transitional orders in two
11 stages. We issued a preliminary decision in May, 1995 and a final policy decision in
12 December of that year. The reason for this somewhat unusual approach can be traced in large
13 part to the Commission's interaction with the California Legislature. In the fall of 1994, the
14 public debate fostered by the Commission's release of the Blue Book began to reverberate
15 among members of the State Assembly and Senate. In response both houses passed
16 Assembly Concurrent Resolution 143 establishing a joint oversight committee and urging the
17 Commission not to make or seek to implement any final decision until it had addressed
18 nearly a dozen issues in a report to be submitted to both houses and the Governor.⁶ Among
19 the topics singled out in the resolution was a request that:

20 [The Commission Report] Quantifies and reports to the Legislature
21 and the Governor, after holding evidentiary hearings, both on the
22 competition transition surcharge for each utility and the allocation of
23 those charges among shareholders, classes of ratepayers, and direct
24 access and utility service customers.

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29 ⁶ The resolution was passed in both houses and filed with the Secretary of State on September 15, 1994. Given its
30 tenor as a "resolution," as opposed to legislation, it did not require presentation to the governor for concurrence or
veto and lacked the force of law. Notwithstanding, it was the unanimous view of the commissioners that we should
defer to its terms. Indeed, the opportunity to engage the active interest of the Legislature was most welcome.

1 Other provisions raised concerns over issues of reliability, environmental impacts, energy
2 conservation, and the consequences of any reform proposals on the fate of low income and other
3 assistance programs for the needy. The May decision which I am about to describe complied with
4 the letter and spirit of the legislative resolution.

5 ♦ **In May, 1995, the Commissioners divide 3-1 with the majority expressing a**
6 **policy preference for a pool-based market for competitive generation initially**
7 **limited to wholesale markets.**

8 After thirteen months of discussion and debate and with a service list grown to over
9 four hundred, the four sitting members of the Commission divided 3-1 on their design of a
10 replacement regulatory regime and industry vision.⁷ I wrote for the majority in expressing a
11 preference for an initial reform which concentrated on generation competition in the
12 wholesale markets. We called for the creation of a power pool which would make a
13 transparent market for generation and handle the operation of all high voltage transmission
14 assets to facilitate dispatch of the least costly set of generators capable of meeting
15 California's load at any given hour of the day. Issues of retail competition -- defined as
16 transactions between end users and generators, marketers or brokers -- were to be settled two
17 years after the pool had become operational. Transition costs were addressed by the majority
18 in the context of an initial reform of the wholesale market. The legitimacy of utility
19 aspirations that they be afforded an alternative opportunity to recover the yet-to-be realized
20 invested capital in assets that might prove unproductive, and held harmless against the terms
21 of power purchase contracts should they exceed the pool clearing price, were clearly
22 recognized.⁸

23 The terms of this decision were communicated to the Legislature and we immediately
24 began a series of what we term "full panel hearings" involving all sitting members of the
25

26 ⁷ *Re Proposed Policies governing Restructuring California's Electric Services Industry and Reforming Regulation,*
27 *D.95-05-045, 60 CPUC2d 18, 157, 161 PUR4th 217 (1995).*

28 ⁸ 60 CPUC2d at 176-182. In his statement of separate views, Commissioner Knight also addressed these issues
29 recognizing the intrinsic legitimacy of the utility ambitions but determined to minimize the costs and wary of a
30 collection methodology which might distort the competitive markets. His major point of departure from the
majority was on the role of the pool in serving as the market mechanism for competitive generation. In May, 1995,
Commissioner Knight was a proponent of what was termed "direct access" or "retail competition" under terms
which envisioned the relations between generators and end users as physical contracts to be literally accommodated.

1 Commission.⁹ All major features of both the majoring and dissenting opinion were slated for
2 hearings, any interested person or entity could provide written comments, and a combination
3 of invited witnesses and voluntary participants were engaged in the hearing dialogue. One of
4 those hearings focused on the topics of stranded costs, liabilities and benefits that were
5 anticipated in a competitive climate, and questions as to how a competition transition charge
6 should be formulated and levied.¹⁰

7 ♦ **December, 1995, the Commission divides 3-2 in reaching a final set of policy**
8 **preferences and industry framework. Transmission assets are placed under the**
9 **control of an Independent System Operator while the market for generation**
10 **embraces both a pool based Power Exchange and the availability of physical**
11 **bilateral contracts.**

12 In any debate framed by a polarization of opinion, the quest for a compromise or
13 middle ground is inevitable and marked the concluding chapter of the Commission's efforts.
14 In the wake of the Commission's divided May vote, many powerful interests, including a
15 large investor-owned utility, advocates of what was termed a "direct access" form of retail
16 competition, and certain environmentalists, sought to resolve their differences in a
17 Memorandum of Understanding.¹¹ A central feature of their recommendations was a
18 decoupling of the role of transmission operation and facilitation from the task of conducting
19 an auction market for least cost generation. In December the Commission, having been
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21 ⁹ The term "full panel" replaced "en banc hearings." As the Commission's presiding officer, I felt that we stood a
22 better chance of communicating with regulated entities and the People of California if the use of Latin was reduced
to de minimis proportions.

23 ¹⁰ The hearing was conducted in Pasadena, California, on August 21, 1995. Video and audio tapes of this and other
24 hearings were routinely made and broadcast over public access time on cable television systems, deposited in public
25 libraries, and made available to interested groups or individuals. Though I am not certain of their fate, I suspect that
26 should the Corporation Commission desire, a video transcript of this hearing and all documents filed by interested
parties providing written commentary on the many subjects could be obtained from the Executive Director of the
California Public Utilities Commission.

27 ¹¹ The major participants framing the Memorandum of Understanding included Southern California Edison, California
28 Large Energy Consumers Association, the California Manufacturers Association, and the Independent Energy
29 Producers Association. The Memorandum was published on September 11, 1995, and was addressed by the
30 Commission in a Full Panel Hearing held in Sacramento on September 13 and 14. On October 2, 1995, a second
joint recommendation, entitled the "Framework for Restructuring in the Public Interest" was presented by eleven
public interest, environmental, alternative energy and consumer advocacy organizations. Both the Memorandum
and the Framework contained discussion of stranded cost issues. Both documents are in the public domain and are
on file with the California Commission.

1 restored to its full strength by the appointment of Commissioner Neeper, issued its policy
2 decision and timetable for implementation.¹² While the members split on a 3-2 vote, it was
3 evident that the Commission was essentially united on the major outline of the industry
4 structure and corresponding regulatory reforms. The terms of the majority and dissenting
5 opinions spelled the end of the vertically integrated monopoly and the parsing of the industry
6 into distinct generation, transmission and distribution activities. Acceding to a central
7 suggestion from the Memorandum of Understanding, the majority opted for a Power
8 Exchange to provide all Californians with a transparent market for generation; consolidated
9 operational control over the transmission assets in California in an Independent System
10 Operator; made both the Exchange and the ISO FERC jurisdictional; opened the market to
11 retail competition with a variety of customer options; and redefined regulation of the
12 distribution function replacing cost-of-service concepts with performance based ratemaking.
13 Section V of both the majority and dissenting opinions addressed the issues of "Transition
14 Costs."

15 **Q10. Could you summarize the view of the majority and terms of the California**
16 **Commission's Policy Decision with respect to the fate of utility generating assets and**
17 **power purchase contracts which might prove uneconomic in the new, competition-**
18 **centered markets?**

19 **A.** Yes, beginning with the market model advanced in the Blue Book, and continuing in the
20 Proposed and Final Policy Decisions, the majority recognized the legitimacy of the claims
21 advanced in various forms by California's investor-owned utilities that restructuring was
22 fundamentally altering the terms of the social compact under which they had made capital
23 investments and incurred contract liabilities. Our response was to create an alternative to the
24 cost of service as a replacement opportunity for the utilities to recover those costs and a
25 declaration that utility shareholders would not be at risk for the consequences of honoring
26 outstanding power purchase contracts with non-utility generators.

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30 ¹² *Re Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation*, D.95-12-063, as modified by D.96-01-009, ___ CPUC2d ___, 166 PUR4th 1 (1996).

1 **Q11. You have indicated that the discussion model set forth in the Blue Book proposed to**
2 **recognize the legitimacy of what were termed transition costs, and that this was one of**
3 **the concerns articulated in the Legislature's Concurrent Resolution. Did the May**
4 **Proposed Policy Decision continue to reflect that position?**

5 **A.** Yes, in May, 1995, members of the public and the large list of stakeholders learned for the
6 first time the policy positions of individual Commissioners. Commissioners Conlon and
7 Duque joined me in forming the majority. Our view on the issues pending before the
8 Corporation Commission are best recounted by quoting from the opinion which we signed:

9 Our restructuring proposal moves from a regulatory structure in
10 which utility generation assets are a part of the integrated monopoly to
11 a pool structure in which many of these generation assets are
12 disaggregated from the utility and subject to the competitive
13 marketplace. In the new marketplace, some of these generation assets
14 will be competitive and some will not. Other current utility generation
15 assets are, as a group, more or less valuable now than after
16 restructuring.

17 This broaches the issue of transition costs. To the extent that
18 the set of utility assets are more or less valuable after restructuring of
19 the market than under today's regulatory regime, how should utility
20 shareholders or ratepayers be compensated for such changes in value
21 due to that transition? *Our philosophy is simple: We intend to honor*
22 *past commitments with as little disruption to the competitiveness of the*
23 *new market as possible, and consistent with avoidance of rate*
24 *increases to any customer class.*

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1 To honor our past commitments, we will neither seek to
2 abrogate settlements related to nuclear power plants nor to disrupt
3 utility contracts with Qualifying Facilities . . .

4 . . .

5 In order to compensate shareholders for the transition costs
6 related to uneconomic assets, it is necessary to develop a method to
7 value the total uneconomic portion of these assets . . .¹³

8 We also recognized the legitimacy of including in recoverable transition costs regulatory
9 obligations directly related to generation as well as keeping faith with prior Commission
10 orders relating to accounting treatment of various utility accounts.

11 **Q12. Did the position of the dissenting Commissioner reject recognition that stranded costs**
12 **and liabilities be recovered from all ratepayers?**

13 **A.** No, Commissioner Knight, though differing from the majority in relation to the pool and in
14 his preference for the immediate implementation of direct, bilateral contracts, agreed that we
15 were obliged to recognize the basic legitimacy of the utilities' claims.¹⁴ His analysis divided
16 responsibility for generation investments that might prove uneconomic on a 10/90 basis
17 between the utilities and Commission yielding his suggestion that the utilities recover 90% of
18 their yet-to-be recouped investment in uneconomic generation units.¹⁵

19 **Q13. How were these subjects treated in your Commission's final Policy Decision?**

20 **A.** By the time we reached our final decision the positions of both the original majority and the
21 dissenter had been modified. In fact, they had come closer together on most of the
22 contentious issues. As I indicated earlier, the majority acceded to the suggestion of the MOU
23 parties that the task of making a transparent market for generation and the ongoing job of
24 providing transmission access should be separated and assigned to two distinct entities: the
25 Power Exchange and the Independent System Operator. Further, the majority yielded on the
26 initial preference that restructuring begin with a two-year period of generation competition

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¹³ 60 CPUC2d at 177.

29 ¹⁴ See discussion at 60 CPUC2d 92-104. His opinion is also useful for its review of the position of
30 many utility, non-utility, environmental and consumer stakeholders.

¹⁵ 60 CPUC2d at 96.

1 being confined to the wholesale market. It adopted the idea that generators should be able to
2 seek dispatch outside of the Power Exchange auction on the strength of bilateral contracts
3 with end users or through arrangements concluded by brokers or marketers. My colleagues
4 in the majority shared my view that bilateral contracts were, in the final analysis, financial
5 hedging arrangements and that so long as the Independent System Operator could assign
6 costs on the basis of neutral, non-discriminatory rates that fully captured all burdens imposed
7 on the system, the public was advantaged by allowing the greatest number of potential
8 consumer options.

9 As you might anticipate, the list of various costs, contract liabilities, social and
10 environmental programs likely to be impacted by a shift from cost-of-service regulation of
11 vertically integrated monopolies to a market for generation dominated by competition and the
12 disaggregation of traditional utility functions continued to dominate our debate. In this
13 context, we were now forced to provide detailed answers to the tough questions concerning
14 transition charges, their legitimate scope, method of calculation, identification of those who
15 would be liable for payment and the duration of the opportunity which should be given to the
16 utilities. Our ultimate disposition of these issues can best be explained by recurring to the
17 point I tried to make earlier: the recognition of stranded costs and liabilities and the quest to
18 place social and environmental benefits on a replacement financial footing were all elements
19 of what one commentator termed a "grand bargain." Indeed, as the Assigned Commissioner I
20 came to see the treatment of these issues as the key to providing both immediate and long-
21 term consumer benefits. Let me try to buttress these contentions as I recount the major
22 features of the majority's opinion and Commission Order.

23 **Q14. Please begin with the major issue before this Commission: On what basis did the**
24 **majority conclude that ratepayers should be responsible for the payment of transition**
25 **costs?**

26 **A.** In responding I must be careful to accurately portray the views shared by the three-member
27 majority from opinions and conclusions that I held individually at that time or which may
28 have subsequently been formed in my mind. The majority's rationale for accepting on behalf
29 of the ratepayers in the service territories of California's investor-owned utilities a liability to
30 afford those utilities an opportunity to recoup the yet-to-be recovered stranded generation

1 investments and to be held harmless against any over-market experience with existing power
2 purchase contracts was threefold.

3 1. *The majority refused to develop a case of selective amnesia respecting the*
4 *historic regulatory regime in which investments and contract liabilities which*
5 *may prove uneconomic in a reformed setting had been incurred.*

6 . . . As we move to rely on competitive markets to supply
7 power and to expand customer choices for power supplies, the
8 Commission must confront and dispose of those costs that both
9 keep rates high and act as an impediment to fair competition.
10 We have found that many of today's high costs result from past
11 regulatory promises made by the Commission regarding the
12 timing of the recovery of depreciation and taxes, past
13 requirements to diversify sources of power by signing long-
14 term contracts that in hindsight have high costs, and the costs
15 incurred by utilities (most notably those associated with QFs
16 and nuclear power) that were reviewed and deemed reasonable
17 when incurred.¹⁶

18 2. *The majority espoused a goal assuring the continued financial integrity of*
19 *California's investor-owned utilities.*

20 To assure the continued financial integrity of the
21 utilities, and give them an opportunity to be vital
22 market participants in the restructured market following
23 the transition, we will allow them to recover completely
24 costs associated with contracts for power and prior
25 regulatory commitments, called regulatory assets. We
26 will continue to honor regulatory commitments
27 regarding the recovery of nuclear power costs. For
28 other generating plants, we commit to an accelerated
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16 166 PUR4th 1, at 45.

1 recovery of the net book value of those undepreciated
2 assets and other fixed obligations combined with a
3 reduction in the return on those assets which make
4 claims for transitional support.¹⁷

5 3. *In the eyes of the majority, to fail to impose a competition transition charge*
6 *would be to radically shift liabilities and risks previously assigned to*
7 *ratepayers to utility shareholders at the very point in which the monopoly*
8 *concession was being overturned.*

9 . . . We note for clarity that future potential transition
10 costs (with few exceptions) are already embedded in
11 utility rates today; transition costs would simply be
12 identified in a different way than they are today and this
13 change should neither create a new ratepayer cost nor
14 result in a higher revenue requirement.¹⁸

15 In light of these beliefs and view of the facts, the majority concluded:

16 . . . that the utilities should be allowed to recover appropriate transition
17 costs. Longstanding regulatory policies, past Commission decisions, and
18 ongoing regulatory effects persuade us of the need, during the transition to
19 full competition, for a process to account for the lingering effects of
20 today's market structure. Thus, we must develop a method to minimize
21 the effects of the high-cost elements in the competitive market structure,
22 while we close the books on past practices. We will identify utility
23 capital investments and contractual obligations, quantify their costs as
24 accurately as possible, and separately identify a charge to recover these
25 costs. Our goal is to get through this transition period as quickly as
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30 ¹⁷ 166 PUR4th at 45-46.

¹⁸ 166 PUR4th at 46 (emphasis added).

1 possible so that full competition can begin with minimal market
2 distortions.¹⁹

3 **Q15. Given that set of beliefs, did the majority feel that all burdens associated with**
4 **uneconomic utility investments should be born by ratepayers leaving utility**
5 **shareholders exempt from any financial consequences?**

6 **A.** No, and it is very important that the Corporation Commission understand this point. The
7 California position on stranded costs (as distinguished from stranded liabilities for over-
8 market power purchase contracts or the recovery of regulatory assets) was that utility
9 shareholders were to bear their fair share of the financial burden and risks associated with the
10 introduction of new markets which offered opportunities to utility management even as it
11 repealed the vertically integrated monopoly status. For present purposes, the most significant
12 financial consequences to shareholders were:

- 13 (1) the loss of the historic imputed cost of capital on generation assets making claims to
14 transitional support;
- 15 (2) the Commission-imposed cap on utility revenues during the transition period; and
- 16 (3) the Commission-imposed time frame or deadlines on the opportunity to calculate and
17 recover stranded costs.

18 **Q16. Explain the reform in the treatment of the capital structure attributed to utility**
19 **generation assets.**

20 **A.** Historically, California's investor-owned utilities have been allowed to earn a Commission
21 set return on all prudent investments. The annual cost of capital proceeding addressed a
22 fundamental feature of the utilities' capital structure: funds which represented shareholder
23 investment (equity) and those which reflected shareholder obligations on borrowed capital
24

25 ¹⁹ 166 PUR4th at 48. These views were shared by Commissioners Knight and Neeper. Gone was Commissioner
26 Knight's original preference for a 10/90 split. Instead the dissenters declared:

27 We have always agreed that some portion of the utility will continue in the future to provide
28 what we consider 'monopoly' service. Moreover, we recognize that today's monopoly
29 provider made certain investments for which the current regulatory system offers a reasonable
30 opportunity of recovery. Thus, we agree that California's investor-owned utilities should be
allowed the opportunity to recover so-called "stranded costs" in the future, although at a
reduced rate of return to reflect the appropriate risk profile for this recovery . . .

166 PUR4th at 104.

1 (debt). Differing levels of returns were fixed on the equity and debt components, the first
2 being treated as an at-risk investment while borrowed capital was deemed a cost of doing
3 business. The recognition of the risk factor on the equity investment traditionally led to a
4 higher allowed return. In a significant innovation, the majority abolished the shareholders
5 right to earn a return on this equity investment (the first shareholder sacrifice) and elected to
6 treat the equity portion of funds yet to be recouped for generation assets as a specie of
7 imputed debt. A second shareholder sacrifice was then imposed. Under the terms of the
8 order, on a going forward basis, the return on the percentage of the undepreciated asset
9 financed by equity was fixed at a level 10% below the long-term cost of debt.²⁰

10 When it is remembered that the historic capital structure of California's investor
11 owned utilities is about 50/50 debt and equity, the consequences of transforming higher
12 return equity components into imputed debt and then fixing the return at a rate 10% below
13 that allowed on long-term debt can be appreciated.

14 **Q17. You have mentioned a Commission imposed cap on utility revenues, did that shift**
15 **significant risk respecting the potential collection of stranded assets to the utility**
16 **shareholders?**

17 **A.** Yes, the majority recognized that a major goal of the restructuring effort was to lower the
18 price consumers paid for electricity. Imposing a competition transition charge contravened
19 that goal with the further risk to consumers that the market determined price for generation
20 could rise as well as fall in an unfolding future. To partially offset this risk the majority
21 imposed a cap on utility revenues so that the price for electricity on a kWh basis cannot rise
22 above the levels in effect on January 1, 1996 without adjustment for inflation. This means
23 that no matter the calculation method, for the life of the transition period the utility must
24 manage and mitigate its costs because the shareholders are at the peril of any excess over the
25 capped revenues.

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28 ²⁰ The majority opinion provided for a potential easing of this 10% reduction if the utility divested generation assets
29 eligible for CTC recovery. Given a concern for the potential market power represented by the generation holdings
30 of Pacific Gas & Electric and Southern California Edison, the utilities could earn a 10-basis point increase in the
imputed debt portion of their capital structure for each 10% of fossil plants divested by sale or spin-off to an
unaffiliated entity.

1 **Q18. You just mentioned the "life of the transition period." Under the California**
2 **restructuring is there a limitation on the time frame over which stranded costs are to be**
3 **calculated and recovered?**

4 **A.** Yes, under terms of the Final Order, a transition cost balancing account was established for
5 each investor-owned utility. The process of valuing assets for inclusion in that account began
6 in 1996 and is to be completed by the end of 2003. After 2003 no further accumulation of
7 transition costs will be allowed unless derived from existing power purchase contracts and
8 related to ongoing contractual payments that continue beyond that date. With the exception
9 of honoring the terms of utility obligations under power purchase contracts formed before
10 December, 1995, the opportunity to complete the collection of transition costs for generation
11 assets, retraining and early retirement of affected utility employees, and regulatory assets
12 must be completed by the end of 2005.

13 **Q19. Given the interest in calculation methods expressed in the Corporation Commission's**
14 **Procedural Order, would you briefly describe the calculation methodology adopted in**
15 **California for determining the stranded cost eligibility for utility generation assets?**

16 **A.** A review of our work product starting with the Blue Book and concluding with the Final
17 Order reveals a significant evolution of attitudes on this issue. This subject is again, at once
18 conceptually simple and practically difficult. In simple terms, a utility asset is uneconomic if
19 its net book value exceeds its market value, and an asset is economic if its market value
20 exceeds its net book value. Thus, for any particular utility, its transition costs are the net
21 above-market costs associated with all of its generation assets, both economic and
22 uneconomic. But how does one fix the market value of a given asset? There are two rival
23 approaches: an administrative vs. a market based methodology. We began the first and
24 wound up with the second.

25 **Q20. Before you describe your reasons for shifting from an administrative to a market-based**
26 **calculation methodology, please focus on the California Commission's determination to**
27 **arrive at a net above-market asset calculation.**

28 **A.** We adopted this view without serious opposition for it is a matter of fundamental fairness.
29 Under the existing regulatory structure, ratepayers have a claim to the power produced by all
30 of the utility's generating units even those which were fully depreciated. The assets had been

1 dedicated to public use as part of the regulatory compact. In the new regulatory structure,
2 once a plant had been reduced to a market valuation it will lose its dedicated status if it is
3 sold to a new owner. To compensate ratepayers for this loss of continued dedication we
4 determined to net out those economic or productive units against the units that proved to be
5 uneconomic. Only if there is a net negative number does the utility become entitled to avail
6 itself of the opportunity to collect transition costs.²¹

7 **Q21. Why did the California Commission abandon the administrative approach to**
8 **calculating stranded costs?**

9 A. Because we could not make it work. The Blue Book clearly envisioned an *administrative*
10 *approach* in which the Commission would employ the hearing process to forecast the
11 stranded cost calculation. Responding to the Legislature's request in the concurrent
12 resolution, we attempted such a proceeding. The hearing before an administrative law judge
13 quickly found a total absence of agreement among the various stakeholders as to the variables
14 that were to be included in the forecast. Even when they could agree on a variable such as a
15 long-term forecast of market prices and assumptions about QF obligations, discount rates,
16 capacity factors, and the like they could not agree on the methodology. In the end the ALJ
17 reported to us that the figure fell within a range of a negative \$8 billion to a utility claim on
18 ratepayers in excess of \$32 billion. Thirty years ago I argued before the United States Court
19 of Appeals for the Fifth Circuit in a proceeding presided over by Chief Judge Brown. I
20 remember his ringing aphorism, "figures speak and when they do courts listen." In 1994 as
21 the President of the California Commission I concluded that figures speaking over a range of
22 \$40 billion offered no guidance to me or my colleagues. We abandoned the administrative
23 approach.

24 **Q22. Explain the market-based calculation methodology embodied in the Final Order.**

25 A. As reflected in our May, 1995 Proposed Policy Decision and particularized in the December
26 Final Order, we shifted to a *market based* approach in which the calculation would be made
27 by observing the performance of utility generation assets in the Power Exchange or in sales
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30 ²¹ 166 PUR4th at 48-49.

1 or spin-offs to new owners. Because we are unable to predict the specific fate of various
2 generation assets, the Order envisions three alternative ways to calculate transition costs.

3 The first approach is to calculate transition costs on an ongoing basis by comparing
4 the authorized revenues associated with the plant to the actual revenues earned through sales
5 into the Power Exchange. This will be the fate of utility generation that remains under utility
6 ownership but exhibits a history of success in gaining dispatch through the Exchange.

7 The second approach will be used if the utility chooses to sell the generating asset to a
8 third party or spin it off to an unaffiliated corporate entity. We will use this transaction to
9 establish the market value of the unit and calculate any transition costs by deducting the sales
10 price or stock market value of shares issued to effect the spinoff from the asset's net book
11 value. I can report to the Corporation Commission that news accounts reveal that both
12 Southern California Edison and Pacific Gas and Electric have aggressively pursued this
13 alternative and sold off fossil assets at prices which exceed book values. The proceeds of
14 these sales are recorded in the utilities' stranded costs accounts and will reduce any other
15 claims to transition costs. This development is doubly encouraging for it has reduced the
16 anticipated stranded costs (contrary to the near universal projections in the 1994
17 administrative proceeding) and reduced market power concerns with the integrity of the
18 Power Exchange.

19 The third approach would rely on appraisal valuation using independent industry
20 experts. As envisioned in the Order, this approach would be used if the utility elected to
21 retain ownership or used some form of accounting separation. I readily admit to some
22 confusion as to the anticipated circumstances in which this approach would supplant the first
23 alternative of tracking the income received from Power Exchange dispatch and determining if
24 it would produce a shortfall in recovering the utility's remaining invested capital.

25 **Q23. So it would be fair to characterize the California Commission's Final Policy Order as**
26 **affording the affected utilities an opportunity to recover the stranded costs associated**
27 **with uneconomic generation assets but it does not *guarantee their ability to do so?***

28 **A.** That is correct, and our rationale for taking this position is founded on our understanding the
29 classical command and control regulation under which these investments were made. Our
30 obligation under the regulatory compact with investor-owned utilities was not to guarantee

1 utility earnings on a ratebase deemed reasonable and prudent but to provide an *opportunity*
2 for the utilities to earn a fair return on that investment. This was and remains our reading of
3 the state's obligation under *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1988). As we
4 move from that classical regulatory model into one which fundamentally alters the contours
5 of the state recognized monopolies and introduces competition, California continues to have
6 the obligation to design and administer a structure the total impact of which provides the
7 utilities with that opportunity. Taken in the context of our policy objectives and the new
8 opportunities which are created by the new market structure for both classical participants
9 and new market entrants, it is our belief that allowing the utilities the time limited
10 opportunity to recover generation plant-based transition costs and providing an appropriate
11 risk-based rate of return until those costs are recovered meets that obligation.²²

12 **Q24. You have indicated the time frame for calculating stranded costs and the deadline on**
13 **collection efforts. Under the California Order who is liable for the payment of the**
14 **competition transition charge?**

15 A. The Final Order authorizes recovery through a non-bypassable end-user surcharge imposed
16 on all users who were retail customers of an investor-owned utility on or after December 20,
17 1995 whether they continue to take bundled service from their current utility or pursue other
18 options.

19 **Q25. At an earlier point you indicated that in arriving at its position on stranded costs the**
20 **California Commission was able to tie this aspect of the restructuring to the delivery of**
21 **immediate and mid-term benefits to consumers. How was this accomplished?**

22 A. The Final Order provides that, so long as the utilities are seeking recovery of stranded costs,
23 they must sell all of their generation into the Power Exchange and make proxy purchases of
24 electric energy on behalf of any customer who elects to delegate that function to them from
25 the Power Exchange. I predict that early in this year when the Power Exchange and ISO
26 become operational, the overwhelming majority of California's users of electricity had not
27 elected an alternate energy provider and were thus continuing to use their historic utility to
28 procure electric energy on their behalf. Assuming that the Power Exchange functions as a
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30 ²² 166 PUR4th 46, 49-50.

1 transparent market capable of seeking dispatch of the lowest cost set of generators capable of
2 meeting California's energy needs at any hour, and that there are additional savings as a
3 result of the Independent System Operators control of the transmission assets, the issue
4 which faced us is how do you ensure that all users benefit from these savings? Our answer
5 was that so long as they were being surcharged for the competition transition charge, the
6 electric utilities were obliged to bill their customers for their usage of electric energy as the
7 cost of procurement in the Power Exchange without an iota of markup.²³ Thus, under the
8 California Plan the phrase, "I can get it for you wholesale" is not a seller's con. It is a
9 buyer's right.

10 **Q26. Could you address the changes in the Commission's Final Order made by the**
11 **subsequent passage of restructuring legislation in California. The Commission would**
12 **be particularly interested in knowing if any of the stranded cost calculation, recovery**
13 **periods or other features to which you have testified were changed.**

14 **A.** In September 1996 the Legislature passed and Governor Wilson signed comprehensive
15 electric restructuring legislation, Assembly Bill (AB) 1890 (Stats. 1996, Ch. 854), which
16 affirmed all of the California Commission's policy decisions enunciated in its final order.
17 AB 1890 modified some of the implementation details affecting stranded costs. Most
18 noteworthy was the legislation's call for securitizing a portion of the utilities' stranded
19 costs.²⁴ Given its implication of other California agencies, including the California
20 Infrastructure and Economic Development Bank, this was an action that was beyond the
21 California Commission's jurisdictional ability and could only have been effectuated by the
22 California Legislature. Securitizing a portion of the utilities' stranded costs was completed at
23 the end of last year when both Pacific Gas and Electric and Southern California Edison
24 successfully marketed multi-billion dollar issues of transition bonds that were issued at an

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27 ²³ The Corporation Commission may be interested to know that as a matter of right all California customers may elect
28 to be billed for the energy component of the utility bills in a computation using the average price in the Power
29 Exchange over the billing period or, if they obtain a meter, the price from the Power Exchange computed in real
30 time according to their usage. It is my hope that many Californians will elect to respond to the price signals sent
from the Exchange to shift their usage patterns from peak and thus costly periods and to begin to fill in the valleys
in the state's demand curve. If this is accomplished, individual consumers will see lower bills and the entire
infrastructure will be used far more efficiently.

²⁴ Sections 840-47 of the California Public Utilities Code.

1 average interest rate below 6.5%, earned a AAA rating and were eagerly acquired by an
2 enthusiastic capital market. The reduced interest cost and longer amortization period²⁵
3 allowed the utilities to meet the mandate of AB 1890 that all residential and small
4 commercial customers receive a 10% rate reduction effective January 1, 1998.²⁶

5 AB 1890 departed from the California Commission's final policy decision on
6 stranded cost in two other matters. First, while the California Commission had set the
7 stranded cost recovery period to run through the year 2003, AB 1890 shortened the recovery
8 period to December 31, 2001 for stranded generation costs and extended the period for
9 recovery of employee-related transition costs to December 31, 2006.²⁷ AB 1890 did not
10 modify the California Commission's treatment of power purchase contract obligations,
11 finding it in the public interest that these obligations will continue for the duration of the
12 contracts. Similarly, AB 1890 left in place the California Commission's April 1996 decision
13 on the transition cost plan for the San Onofre Nuclear Generating Station which calls for
14 recovery to extend not beyond December 31, 2003.²⁸

15 Second, the California Commission had mandated that stranded costs be paid by all
16 retail customers. AB 1890 carved out some limited exemptions for stranded cost
17 responsibility for various irrigation districts, water districts, and water agencies.²⁹ The costs
18 associated with these exemptions could be collected from all remaining customers, except
19 residential and small commercial customers, for an additional three-month period from
20 December 31, 2001 through March 31, 2002, provided that only \$50 million of the balance of
21 the costs remaining after December 31, 2001 will be eligible for recovery.

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28 ²⁵ The rate reduction bonds are repaid over a period of ten years as opposed to the five-year CTC recovery period.

29 ²⁶ Section 330(w) of the California Public Utilities Code.

30 ²⁷ Section 367 of the California Public Utilities Code.

²⁸ D.96-01-011 and 96-04-059.

²⁹ Section 374 of the California Public Utilities Code.

1 27. **Would you please summarize the decisions issued by the California Commission to**
2 **implement the stranded cost directives of the California electric restructuring**
3 **legislation?**

4 A. In the last half of 1997, the California Commission implemented many of the stranded cost
5 directives contained in AB 1890. In a June, 1997 decision, the Commission determined that
6 the stranded cost portion of a customer's bill, the so-called competitive transition charge
7 (CTC), will be computed as the difference between the total rate and all other charges,
8 including the Power Exchange price, thereby ensuring that the allocation of the CTC does not
9 result in rates above the June 10, 1996 levels.³⁰ In that same decision the Commission
10 confirmed that customers will be responsible for paying the CTC regardless of whether they
11 buy electricity from the utility or from alternative suppliers. The Commission held that the
12 utilities must amortize assets with a higher rate of return prior to assets with a lower rate of
13 return.

14 The June decision also held that utilities can defer recovery of several categories of
15 transition costs mandated by AB 1890 past 2001 if the current recovery of these costs would
16 impair the utilities' ability to recover generation-related CTC costs.³¹ All other transition
17 costs must be recovered by December 31, 2001. Employee-related transition costs can be
18 collected through 2006. Restructuring implementation costs, including the costs of
19 developing the Power Exchange and the Independent System Operator, which the investor-
20 owned utilities have funded to date, may be collected until fully recovered. The cost of AB
21 1890 mandated renewables programs may be collected until March 31, 2002. Transition
22 costs related to power purchase contracts and QF contracts may be collected for the duration
23 of the contract.

24 In a November, 1997 decision, the Commission established the eligibility of various
25 categories of non-nuclear costs for transition cost recovery and quantified the net book value
26 of assets of PG&E, Edison, and SDG&E. The net book value of the assets establishes the
27 baseline against which market valuation will later be measured. The decision establishes that
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30 D.97-06-060.

31 D.97-11-074.

1 costs eligible for recovery can only be determined based on marketplace valuations, rather
2 than administrative forecasts, and that future operational costs, dubbed "going-forward
3 costs," must be recovered through market prices, not the CTC.

4 **Q28. Do you have any concluding comment on the California regulatory and legislative**
5 **approach to restructuring?**

6 **A.** Yes. As each of the Corporation Commissioners is keenly aware, restructuring touches many
7 interests and a very wide array of stakeholders. Both the Final Order and AB 1890 represent
8 efforts to balance these interests in a manner that produced terms that were framed in the
9 public interest and which doubtlessly disappointed the specific ambitions of virtually every
10 participant. This is in the nature of our political process taken in its most positive light. My
11 fear is that students of what was done or not done in California will attempt to pick and
12 choose elements of that reform without realizing that it constitutes an attempt at a balance.
13 This is particularly true of the policies and implementation strategies on the utility
14 investment, power purchase contracts and social and environmental programs likely to be
15 impacted by the move toward markets.

16 **PART TWO: BOTH THE EXISTING AND ANY REFORMED RELATIONSHIP**
17 **BETWEEN THE STATE OF ARIZONA AND THE AFFECTED UTILITIES**
18 **REFLECT A SOCIAL CONTRACT**

19 **Q29. Are you familiar with the argument that in our market-based economy business entities**
20 **must bear the burdens of imprudent or unwise business decisions and cannot expect to**
21 **pass any loss onto their customer base?**

22 **A.** Yes, and as it pertains to individuals or entities which have freedom to enter and exit markets
23 and product lines, to pick and chose among their potential customers, and to set any price that
24 the market will bear, I am in full agreement with this position.

25 **Q30. Given your agreement with this basic proposition, is it your opinion that the "Recovery**
26 **of Stranded Cost of Affected Utilities" provisions should be modified so as to preclude**
27 **utility claims to stranded costs?**

28 **A.** No, in fact I agree with the general tenor of A.C.C. R14-2-1607 and its recognition that,
29 subject to a duty on the part of the utilities to take active steps to mitigate the magnitude of
30 their stranded costs, it is fully appropriate that existing ratepayers on whose behalf the assets

1 were constructed and liabilities assumed should bear those costs. I support the principal that
2 net uneconomic generation assets, above-market power purchase contract obligations and
3 regulatory assets remain the obligation of ratepayers and that restructuring not be used as an
4 opportunity to attempt to shift them to utility shareholders. I have reached this conclusion
5 after considering the legal and moral obligations owed to what are, in Arizona, deemed
6 public service corporations. As an individual who believes in the reform of the electric
7 service industry and the discipline of competition and customer choice, I favor the
8 recognition, calculation and collection of stranded costs for pragmatic reasons that are rooted
9 in the future not the just demands of the past. Until this matter has been resolved in a
10 principled and sustainable manner, the Corporation Commission will not have the active
11 cooperation of the affected utilities. A denial of the basic claim to stranded costs will
12 doubtlessly occasion litigation and the expense in both time and treasure that would be
13 consumed will frustrate the onset of competition and distort the emerging markets. None of
14 these avoidable consequences is in the public interest.

15 **Q31. You indicate that “legal and moral” reasons have made you an advocate of stranded**
16 **cost recovery by investor-owned utilities. Is this the “social or regulatory contract”**
17 **argument?**

18 **A.** Yes, and you will note that the premises of the argument were not overtly discussed in my
19 analysis of the California Restructuring or contained in the quoted excerpts from the
20 Proposed and Final Policy Decisions. This is because in California the social contract can be
21 found in the literal terms of the state constitution, a comprehensive set of statutes termed the
22 Public Utilities Code, and hundreds of bound volumes of decisions and orders of the
23 Commission. It is this historic and ongoing state presence which distinguishes what we
24 commonly refer to as “utility services” from all other forms of enterprise and subject them to
25 active state regulation. This regulation arises in many forms and manifests itself in
26 legislation as well as the constitutional provisions setting up the Public Utilities Commission.
27 Taken as a whole, the provision of electricity in California is regulated in terms of safety,
28 reliability and environmental consequences. Entities deemed to be public utilities enjoy none
29 of the freedom which I ascribed to the private individual or entity to enter and exit markets

30 ...

1 and product lines, to pick and chose among their potential customers, and to set any price that
2 the market will bear.

3 It is equally undeniable as to the identity of the individuals on whose behalf the
4 constitutional, legislative and regulatory mandates have been imposed on public utilities. All
5 individuals who reside within the service territory of a public utility are entitled to service on
6 an equal, adequate and non-discriminatory basis. They are historically termed "ratepayers"
7 for the simple reason that they could not be assessed any charge or fee for energy services
8 that was not first approved by the state and found to be just and reasonable.

9 **Q32. The social contract and duty to serve which you found in California may justify, if not
10 require, the recognition of stranded cost recovery in your State, but do they have any
11 bearing on Arizona and the Corporation Commission?**

12 **A.** Yes, a study of Arizona authorities reveals that the social contract and duty to serve have all
13 of the roots found in California plus an additional and wholly independent basis in Arizona
14 law. Article 15 of the Constitution of the State of Arizona not only constitutes and empowers
15 the Corporation Commission, but it declares the will of the People of Arizona to deem all
16 corporations, other than municipal entities, engaged in furnishing electricity for light, fuel or
17 power "public service corporations."³² The authority over the terms and conditions of service
18 by such entities and the commands of the State are forcefully advanced in Section 12:

19 All charges made for service rendered, or to be rendered, by public
20 service corporations within this State shall be just and reasonable, and
21 no discrimination in charges, service, or facilities shall be made
22 between persons or places for rendering a like and contemporaneous
23 service . . .³³

24 I find ample evidence that the Arizona Legislature has been as vigilant and active as
25 its California counterparts in enacting comprehensive legislation to direct the Commission
26 and address issues of reliability, safety, environmental and economic regulation. As the
27 primary active agent articulating and defending the public interest, this Commission's record
28

29
30 ³² A.R.S. Const. Art. 15, § 2.

³³ A.R.S. Const. Art. 15, § 12.

1 is written in an enviable history and continues right up to the current proceeding. An
2 individual seeking to deny the existence of an overt social contract between the people of
3 Arizona, acting through their government, and the public service entities engaged in the
4 provision of electricity in this State would be forced to ignore the constitution and statutes
5 and at a loss to explain the very venue and occasion for this hearing.

6 **Q33. Please identify what you have characterized as Arizona's additional and wholly**
7 **independent basis for the social contract and the duty to serve.**

8 **A.** I am referring to the Supreme Court of Arizona's 1948 adoption of a common law basis for
9 regulating the service obligations of electric utilities and obligating them to serve all potential
10 users within the confines of their service territory on an equal, adequate and non-
11 discriminatory basis. The landmark decision was rendered in *Town of Wickenburg v. Sabin*,
12 68 Ariz. 75, 200 P.2d 342. It is remarkable because the defendant was a municipality which
13 had elected to commence the provision of electricity and water to its residents. Sabin, a
14 resident of Wickenburg, made application for both services offering payment of \$5.00 for
15 each. His application was denied on the grounds that he was seeking service to a temporary
16 structure. Sabin was informed that unless he was prepared to pay \$50.00 and guarantee the
17 building of a permanent residence on the lot, he would not be served. Sabin claimed
18 discrimination asserting that no other resident had been subjected to such conditions. He
19 brought suit before the Superior Court of Maricopa County seeking a writ of mandamus
20 compelling the municipality to extend service to his home. The trial court granted the writ
21 and the town appealed to the Supreme Court.

22 Justice Udall authored the unanimous opinion affirming the trial court and ordering
23 that Sabin receive electric and water service. The court did not rest its decision on
24 constitutional or statutory grounds, but upon its embrace of the common law duty to serve.
25 Quoting from and adopting for Arizona a formulation given in *MCQUILLIN ON MUNICIPAL*
26 *CORPORATIONS*, the court observed:

27 . . . A public service corporation is impressed with the obligation of
28 furnishing its service to each patron at the same price it makes to every
29 other patron for the same or substantially the same or similar service.
30 'It must be equal in its dealings with all.' . . . 'All should be treated

1 alike, equality of rights requires equality of service.' 'The duty owed
2 to all alike involves obligations to treat all alike.' The common law
3 upon the subject is founded in a public calling to charge a reasonable
4 and uniform price to all persons for the same service rendered under
5 the same circumstances.³⁴

6 At a later point the Court responded to the town's argument that it wished to retain
7 discretion respecting extensions of its service obligations:

8 . . . there is respectable authority to the effect that a municipality, as
9 distinguished from a private utility corporation, may exercise
10 governmental discretion as to the limits to which it is advisable to
11 extend its water mains and power lines . . .³⁵

12 It would be difficult to formulate a more sweeping adoption of the duty to serve. It
13 bears repeating that the court deemed it to fall with greater rigor on a private utility than its
14 municipal counterpart. With respect to private utilities no discretion was conceded regarding
15 service to new customers. *Wickenburg* is consistently cited by both the Arizona Supreme
16 Court and Court of Appeals for the assertion and definition of the duty to serve. It is deemed
17 relevant to the functions of both municipal and investor-owned utilities in this State. See,
18 *Veach v. City of Phoenix*, 102 Ariz. 195, 427 P.2d 335 (1967); *General Cable Corp. v.*
19 *Citizens Utilities Company*, 27 Ariz. App. 381, 555 P.2d 350 (1976); and, *Marco Crane and*
20 *Rigging v. Arizona Corporation Commission*, 155 Ariz. 292, 746 P.2d 33 (Ariz. App. 1987).

21 **Q34. It is your contention that decisions of affected utilities to invest in generating assets,**
22 **enter power and fuel purchase contracts, and accept the Commission's terms and**
23 **conditions with respect to regulatory assets sets a stage which is fundamentally unlike**
24 **the decisions of unregulated business entities?**

25 **A.** Yes. Such decisions were made under an overt constitutional, statutory, common law and
26 administrative mandate on behalf of all ratepayers. If today technology and revised attitudes
27 toward the appropriate sweep of monopolies cause us to rethink regulation, I respectfully
28

29
30 ³⁴ 68 Ariz. at 77-78, 200 P.2d at 343-344.

³⁵ 68 Ariz. at 79, 200 P.2d at 345.

1 suggest that we must do so with an intention to honor the terms of the regulatory compact.
2 Utilities did not enjoy a guarantee that just and reasonable rates would fully compensate them
3 for such risks and investments, but they were assured a fair opportunity to accomplish that
4 vital objective. During my privileged time as a public servant in California, I viewed the
5 *Duquesne* decision of the United States Supreme Court as obliging us to provide a
6 replacement "fair opportunity" as we pursued the public advantage in a restructured
7 environment.³⁶ I thought it was my legal obligation and, equally important, my moral duty as
8 an agent of the People of California. The alternative would have been years of litigation.

9 **PART THREE: THE COMMISSION'S SPECIFIC QUESTIONS**

10 **Q35. Your testimony respecting the terms of the California Restructuring addresses all but**
11 **the accounting questions posed in the Procedural and First Amended Procedural**
12 **Orders. How do you propose to comment further on those matters?**

13 A. With respect, I have no views that are of use to the Commission on the question in the
14 Amended Procedural Order relating to the implications of the Statement of Financial
15 Accounting Standards No. 71. Nothing in my background as a school teacher, regulator or
16 lawyer sheds even candle light on these critical matters. Also, with the Commission's
17 permission, I will not comment on Issue 2. In my view, when the affected utilities should be
18 required to make a stranded cost filing is peculiarly a matter for this Commission to decide,
19 although the time frame outlined in Mr. Bayless' testimony seems reasonable.

20 I also appreciate that the Corporation Commission's December, 1996, Retail Electric
21 Competition Rules reflect an Arizona approach to restructuring which may, or may not,
22 mirror concepts of the public interest as they were framed in California. That is as it should
23 be. We do seem to be on common ground in the desire to re-evaluate the terms of classical
24 regulation to see if they continue to maximize the public advantage from the electric service
25 industries in our respective states. There is also common desire to explore competition in
26 generation and to look closely at other aspects of the traditional vertically integrated
27 monopoly model to determine if competition and unbundling can produce greater
28 efficiencies.

29
30

³⁶ *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1988).

1 Most importantly, from the vantage point of today's hearing, the Commission's Rules
2 address the recovery of stranded costs of affected utilities.³⁷ The eleven issues which the
3 Commission posed for consideration by the Working Group reveal a grasp of virtually every
4 complexity identified in my experience in California. But in the movement since the
5 issuance of the Article 16 Retail Electric Competition Rules, it is my perception that Arizona
6 is diverging on a fundamental tenant of the restructuring debate. While R14-2-1610 declares
7 that "[t]he Commission shall conduct an inquiry into spot market development and
8 independent system operation for the transmission system" and "may support development of
9 a spot market or independent system operator(s)," my reading of the Report submitted by the
10 Stranded Cost Working Group leaves me with the impression that competition will begin on
11 a date certain in Arizona in a landscape which will feature neither entity. If such is, in fact,
12 the route taken by restructuring in Arizona, then while the California experience may have
13 some relevance in indicating implementation strategies to pursue or avoid, it must be
14 distinguished on aspects of the questions set forth for this hearing.

15 **Q36. You indicate that the absence of a market mechanism comparable to the Power**
16 **Exchange and Independent System Operator will reduce the relevance of many of the**
17 **California implementation strategies to the Arizona restructuring. Why is that so?**

18 **A.** Because the Power Exchange is the key in the California plan for getting our arms around the
19 critical factual inquiry upon which stranded cost recovery can be approached: what is the
20 clearing price for generation in the reformed market? In my response to Question 21, I
21 indicated that our attempt to utilize an administrative approach to project a future market and
22 market price was totally unsuccessful. Over time, that lack of success pushed us toward the
23 belief that having a transparent spot market which would handle all of the sales from utility-
24 owned generation during the transition period, and from which the distribution utilities would
25 make their purchases on behalf of full service customers, would enable us to supplant
26 guesswork with facts. As I reflect on this decision, I am forced to conclude that the
27 California experience with Standard Offer Contracts and the fate of our attempts to project
28 fuel costs may have hobbled our faith in our powers of estimation.

29
30

³⁷ A.A.C. R14-2-1607

1 Notwithstanding this fundamental distinction, my study of the Competition Rules and
2 the Report submitted by the Stranded Cost Working Group is the background for some
3 comments I would like to share with members of the Commission addressing questions in the
4 Procedural Orders.

5 **ISSUE 1. SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED REGARDING STRANDED**
6 **COSTS. IF SO, HOW?**

7 **Q37. Do you have any specific recommendations for modifications to R14-2-1607?**

8 **A.** Yes, as I read R14-2-1606 on the Services Required To Be Made Available by Affected
9 Utilities, and R14-2-1607, I believe that the Commission is proposing in Sub-section J that
10 customers taking the Standard Offer Tariffs be exempt from payment of transition costs. The
11 apparent rationale is that they are already paying stranded costs as part of the standard offer
12 tariff. I believe that this is a sustainable proposition only if the Commission is able to closely
13 coordinate a variety of factors that are likely to prove elusive. The Commission recognizes
14 that it cannot predict how long a period will elapse before it determines that competition has
15 been substantially implemented for a particular class. I can envision circumstances in which
16 the process will go rather quickly for some classes and be far more protracted for others.
17 Assuming that the over-arching policy objective is to have every customer class pay its "fair
18 share" of transition costs and avoid cost shifting between classes, how will the Commission
19 set the transition component of the standard offer tariff and coordinate it against the recovery
20 being paid by customers who have current competitive options?

21 **Q38. The Stranded Cost Working Group also was concerned with the stranded cost liability**
22 **of what are termed "customers are not taking competitive power." Do you support**
23 **their recommendations on this subject?**

24 **A.** I believe so, though I would prefer Option A at page 44 of the Working Group Report to the
25 consensus preference for Option B. As I read the report, the voting members reached
26 consensus on two recommendations. The first was that such individuals pay stranded costs
27 but that the charge take into account contributions that are already being made toward
28 stranded costs. The second was that this payment should not cause customers' prices to
29 increase. I clearly agree with the first proposition for it would be fundamentally unfair to
30 double charge. The second proposition is, in essence, some form of rate cap and should be

1 candidly addressed under Item 8. Suffice it to note at this point that in a truly competitive
2 market for generation, I do not think that the Commission can represent to the People of
3 Arizona that prices will surely or can only fall. They may rise. If this is the case the
4 Commission will be forced to pass such economic reality onto customers who elect to remain
5 with the Standard Offer. In saying this I recognize that a rising market price for generation
6 should work to diminish any claim to stranded costs arising from generation assets, but we
7 must not forget that there are other components, such as regulatory assets and potentially
8 nuclear decommissioning costs, which may be included in the basket of utility claims to
9 transition recovery.

10 **ISSUE 3. WHAT COSTS SHOULD BE INCLUDED AS PART OF "STRANDED COSTS" AND HOW SHOULD**
11 **THOSE COSTS BE CALCULATED?**

12 **Q39. Do you agree with the recommendation of the working group that stranded costs may**
13 **include: generation assets; power purchase agreements; fuel contracts; regulatory**
14 **assets; employment transition costs; and environmental mandates?**

15 **A.** In the main I do. As evidenced by my views while I was on the California Commission, I
16 clearly believe that a cost recovery mechanism should be adopted to give the utilities a fair
17 opportunity to recover their yet-to-be realized investment in generation assets, and that they
18 be held harmless against any over-market purchases made pursuant to existing contracts with
19 non-utility providers and entitled to an honoring of all prior Commission commitments on
20 regulatory assets. I firmly agree with the provisions of the California Order covering
21 employment transition costs because the reforms we are contemplating not only disturb the
22 climate in which investment plans were made, but they also assail the foundations of many
23 human choices in terms of careers and employment. I share Oliver Goldsmith's gloomy view
24 of any society that puts capital investments ahead of human investments.

25 **Q40. What about the inclusion of "environmental mandates"?**

26 **A.** I would be cautious on this issue. The inclusion of compliance with environmental mandates
27 as stranded costs, in my opinion, needs more discussion. There is a possible, but not
28 inevitable, corollary between the increased role of competitive discipline in the generation
29 market and enhanced environmental costs. I am aware of opponents of competition who
30 claim disaster lurks around the corner of any market that is driven by price considerations. I

1 share a concern but cannot join in the use of terms like "disaster." In such a future market all
2 entrants should be responsible for compliance with state and federal environmental mandates
3 and will doubtlessly seek to recover any associated costs in the prices they charge customers.
4 But to include them in "transition costs" suggests that they had been incurred under the old
5 regulatory regime, and if this is sound, it argues for a cut off date after which utility
6 expenditures on environmental enhancements to assets they retain for use in a competitive
7 market would be expenditures of shareholders and at risk for collection in prices not stranded
8 costs.

9 **Q41. The Working Group was unable to reach consensus on the method for computing**
10 **stranded costs. Staff has recommended that the Commission go forward using what it**
11 **terms a "Net Revenues Lost" approach. Do you agree with this recommendation?**

12 **A.** Here we strike directly at the difference between the suggested use of an administrative
13 calculation methodology and California's strong preference for a market valuation strategy. I
14 would note initially, that the Working Group's concept of market valuations was limited to
15 what it termed "auction and divestiture" and "stock market valuation" approaches. As
16 explained in my answer to Q22, California has labored to develop a third approach, one that
17 compares the performance of the potentially stranded asset or contract to the terms of the
18 competitive market as revealed in the Power Exchange. As a second point, I again draw the
19 Commission's attention to the results of the auctions for generation assets held by SCE and
20 PG&E. In each case the real money changing hands between willing buyers and sellers in
21 arm's length transactions has dramatically exceeded the recent estimates and net book values.
22 Whether this trend can be sustained or is the fate of those entities first to reach the market
23 with sale offerings remains to be seen. These results should be studied and then compared to
24 the parties opposed to a divestiture strategy at page 25 of the Working Group Report.

25 Having made these points, if the Commission opts for an administrative calculation
26 methodology, the top-down quantification known as the "net revenues lost" approach, which
27 commanded the greatest support in the Working Group and constitutes the Staff
28 recommendation, is one with which I would not quarrel. Surely I am a supporter of a "net
29 figure" approach, one that takes into account all generation costs and assets and credits those
30 which prove economical against those which do not. And, it will not surprise you that I am

1 an advocate of true-up proceedings and especially if you are using an administrative forecast
2 which admittedly is an educated guess performed in good faith against a host of variables. It
3 would appear that the Staff is prepared for the contentious administrative proceeding which is
4 likely to ensue, and it will be for you to determine if the drain on the Commission's resources
5 occasioned by such a proceeding is, given other demands on your time and attention,
6 warranted.

7 I fear that use of a replacement cost valuation premised on comparing all generation
8 assets to gas fired combustion turbines places too much emphasis on a single technology.
9 While it may be true that such an approach was utilized by California utilities in their initial
10 transition cost estimate, it is vital to understand the very limited use of that projection. These
11 estimates are prepared in California each year during the transition period, not on a one-time
12 basis. The initial administrative projection in California of a 2 and 1/2 cent clearing price for
13 generation was a proxy to be used only until it could be supplanted by factual data derived
14 from the Power Exchange.

15 **Q42. In his prepared testimony, Mr. Charles Bayless has suggested a benchmark for a**
16 **market clearing price that may avoid some of the guesswork. He proposes using the**
17 **Dow Jones Palo Verde Index as a market price proxy. Do you think that this is a good**
18 **idea?**

19 **A.** Yes, because it appears to be an established means of tracking the market price for energy
20 most likely to reflect the value of average fuel and variable O&M costs for generators serving
21 or capable of serving the Arizona market. If such a reference is used, I suggest that it not be
22 as a "snap shot" but rather through a tracking mechanism similar to the use of the Power
23 Exchange in California. Here I am attempting to respond to the concerns recounted in the
24 Working Group Report that the Palo Verde Index might initially reflect non-sustainable price
25 patterns as new market entrants vied for attention. If such marketing strategies do take place
26 as competition is introduced, they are part of reality and their duration or lack of
27 sustainability is also part of an unfolding reality. The virtue of a reference such as the Palo
28 Verde Index is the ability it affords the Commission and stakeholders to track these
29 developments during the calculation period.

30 ...

1 **ISSUE 4. SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH "STRANDED**
2 **COSTS" ARE CALCULATED?**

3 **Q43. You have reported that the California Plan limits the time frame over which stranded**
4 **costs are calculated and that the subsequent legislation shortens this period. Do you**
5 **believe that any limitation should be included in an Arizona Plan?**

6 **A.** Yes, because I believe that this incents the utilities to mitigate their costs, an important
7 Commission objective. I am aware that this puts me at cross purposes with the Staff
8 Recommendation on issues over which there was no consensus in the Working Group. In a
9 moment I will indicate qualified agreement with the proposition that, provided that the
10 Commission creates a non-bypassable collection methodology for all historic and new
11 customers, it should also establish a limitation on the recovery time frame. The working
12 group is surely correct in suggesting a link between the calculation and recovery periods or
13 deadlines. I simply want to emphasize a third related factor and that is the collection
14 vehicle.

15 When I read the Report of the Working Group I initially failed to see how the Staff
16 could at once favor a calculation period tied to the original life span of the generation asset
17 and then indicate that it has no objection to limiting to a period of from 3-7 years the
18 recovery period. In my mind the proper order was reversed with the limitation on the
19 calculation period arising first in time to be followed by the close of the opportunity to
20 collect the stranded costs. Upon further reflection I now see that this is a significant point in
21 which the Arizona Plan may pursue a different avenue than the one taken in California.
22 There, in an attempt to quickly assess transition costs associated with stranded generation, the
23 Commission ordered the utilities to reveal the dollar figure of their yet-to-be recovered equity
24 and debt capital invested in individual assets. The next step was to track the performance of
25 these assets in the Power Exchange and to determine what supplement, if any, would have to
26 be added to these revenues if the utility were to reclaim that investment by the deadline set
27 for collection. So the goal of the California reform was to give the utilities a realistic chance
28 to recover their invested capital. But it did not embrace allowing them to recover on that
29 investment. Let me put the point another way. The California Plan distinguished between a
30 return *of* capital and a return *on* capital.

1 By contrast, the Net Revenues Lost approach seeks to protect the expectations formed
2 under the existing regulatory regime with respect to both the recovery of an investment and
3 the income stream on that investment. This being the case, the Staff recommendation is quite
4 sensible respecting the calculation period and I have no difficulty supporting it.

5 **ISSUE 5. SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR "STRANDED**
6 **COSTS"?**

7 **Q44. The Working Group was unable to arrive at a consensus on this question. California**
8 **imposes such a limitation, do you believe that it should be a feature of the Arizona**
9 **Plan?**

10 **A.** Yes, provided that the Commission allows pursuit of collection using a non-bypassable
11 charge to be paid by every customer historically interconnected to the system of the claiming
12 utility whether power is supplied by that utility, an alternative supplier, or is self-generated
13 and the time frame is sufficient for stranded cost recovery.

14 **ISSUE 6. HOW AND WHO SHOULD PAY FOR "STRANDED COSTS" AND WHO, IF ANYONE, SHOULD**
15 **BE EXCLUDED FROM PAYING FOR STRANDED COSTS?**

16 **Q45. The Working Group has recommended that stranded costs should be recovered from**
17 **all historic and future ratepayers using a non-bypassable charge allocated to**
18 **jurisdictions and customer classes in a manner consistent with the specific company's**
19 **current rate treatment of the stranded asset. California has sought to impose a non-**
20 **bypassable charge which is also devoid of exceptions. Is this your recommendation for**
21 **Arizona?**

22 **A.** Yes, as I have repeatedly stated, I believe that restructuring initiatives do not create stranded
23 costs, they are already embedded in rates being paid by all Arizona ratepayers. To the extent
24 that these rates reflect utility investments and power purchase and fuel contracts and
25 regulatory assets approved by the Corporation Commission, they are the existing
26 responsibility of ratepayers. I respectfully suggest that this fundamental point should never
27 be lost as the debate moves forward and the Commissioners arrive at their decisions. The
28 virtue of the Working Group recommendation is that the charge is made utility specific which
29 promotes recovery of stranded costs in substantially the same proportion as the recovery of
30 current costs from customers or customer classes under current Commission approved rates.

1 The rationale for this result is that the components recognized for potential recovery
2 represent investments, contracts and regulatory arrangements incurred for all present and
3 future users of each utility's system. To allow any individual or class to evade a fair share is
4 simply to reallocate these costs to others. It is unfair and for that reason highly contentious.
5 To my mind to hold forth the prospect of exclusion from this burden as akin to hosting one of
6 the currently fashionable cigar smoking parties in an ammunition dump. It is irresponsibly
7 dangerous.

8 **Q46. The Working Group reported a consensus that ratepayers be given the option to settle**
9 **their stranded cost liability in a lump sum payment. What is your view?**

10 **A.** I am unaware that this idea was presented in California. My only caution centers on the issue
11 of calculation. If the calculation period is going to be several years and the opportunity for
12 collection also extended for a time certain, how can the Commission accurately calculate a
13 lump sum? To the extent that you adopt a plan featuring true-ups how would this
14 recalculation impact upon the liability of an individual who could not be proved to have
15 overpaid or underpaid the transition charge?

16 **ISSUE 7: SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO, HOW WOULD IT OPERATE?**

17 **Q47. The Working Group was unable to form a consensus on whether such a mechanism**
18 **while the Staff reports a strong recommendations annual true-ups. What is your**
19 **recommendation?**

20 **A.** So long as the Commission relies on an administrative method to calculate stranded costs, I
21 agree with the Staff that the variables within that prediction are too many and the risk of over
22 or under collection too great to ignore. Whether the true-up should be annual depends, in my
23 mind, on the time frames established for calculation and collection of transition costs. If
24 these time frames are fairly short, annual true-ups are probably warranted. On the other hand
25 if they are protracted, the true-up proceedings might be held on an every-other-year basis.

26 ...

27 ...

28 ...

29 ...

30 ...

1 **ISSUE 8: SHOULD THERE BE PRICE CAPS OR A RATE FREEZE IMPOSED AS PART OF THE**
2 **DEVELOPMENT OF A STRANDED COST RECOVERY PROGRAM AND IF SO, HOW SHOULD IT**
3 **BE CALCULATED?**

4 **Q48. California has imposed a price cap as part of its Restructuring Plan and the Working**
5 **Group achieved consensus that the Commission consider adoption of some type of a**
6 **“rate cap.” What is your view?**

7 **A.** Although I voted for such a feature in the California Plan and it would appear that the State
8 has won its bet with the uncertain factors of weather, it is not automatic in my mind that
9 Arizona include such a feature. As I noted in the introduction to my testimony, the
10 California plan was considered and framed against an economic crisis in which above
11 national average prices for energy threatened our embattled agricultural, commercial and
12 industrial consumers. The Commission opted for a rate cap. The Legislature converted this
13 into a rate freeze. The difference is significant. Under the Commission’s cap, a utility could
14 reduce its rates below the historic number but it could not exceed it. As noted in my earlier
15 description of the California Order, the presence of the cap shifted risk of future market
16 developments from ratepayers to shareholders. The Legislature’s preference for a freeze is,
17 to my mind, more beneficial to the utilities for it shields them from a comparative if not a
18 competitive pressure. Finally, as noted, the Legislature introduced the notion of a 10% rate
19 reduction as part of the securitization strategy.

20 The defect in these California strategies is that they contradict the central theme upon
21 which restructuring is being pursued: an increased reliance upon the discipline of market
22 forces and a greatly reduced ability of government to affect the economic terms of service by
23 decrees. This inherent contradiction has not been lost on many critics of the California plan.
24 What is right for Arizona? It obviously depends on facts and circumstances of which you
25 have an expert knowledge and I only a smattering of information. To the extent that the costs
26 of energy in Arizona are not in crisis, the Commission may feel that it can be more
27 systematic and faithful to a market disciplined approach to the cost of generation. I also
28 suggest that much will depend upon your confidence that you have discovered a means of
29 delivering the savings which would result in enhanced efficiency of generation and use of
30 transmission assets to average ratepayers.

1 **ISSUE 9: WHAT FACTORS SHOULD BE CONSIDERED FOR "MITIGATION" OF STRANDED COSTS?**

2 **Q49. The Working Group was unable to reach consensus on this matter and the Staff has**
3 **come up with a very inclusive concept of what it expects of the utilities as mitigation**
4 **measures. Have you views on this subject?**

5 **A.** I strongly support the duty to mitigate both as a former regulator and retired contracts
6 teacher. The goal of the restructuring is to enhance economic efficiency while maintaining
7 fairness in the electric service industry. That goal is pursued if the utilities are incented to
8 mitigate their stranded cost claims and other entities such as the holders of what are likely to
9 be over-market power purchase of fuel contracts are also incented to bring the terms of these
10 agreements to "market."

11 There is one point on which I disagree with the Staff's recommendation and that is
12 the policy of seeking to include as successful mitigation earnings that the utility management
13 might earn in a restructure market from business pursuits outside of Arizona which did not
14 involve the use of ratepayer funds or other assets. In contemplating restructuring the
15 Commission is fostering a new regulatory bargain. Part of the "consideration" furnished the
16 historic utilities is a greater freedom to manage their business as a business. The Standard
17 Offer bundled obligations of the Commission's Rules represent an aggressive pursuit of the
18 welfare of Arizona ratepayers. But to seek to claim for ratepayers the benefits of totally
19 unrelated going forward business pursuits for which they are to have no risk is unfair and, in
20 my view, unsound. It does not incent the Utilities to contain costs, it merely penalizes them
21 with off-sets rather than mitigation charges.

22 **Q50. Does this conclude your testimony?**

23 **A.** Yes.
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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
Commissioner – Chairman
RENZ D. JENNINGS
Commissioner
CARL J. KUNASEK
Commissioner

IN THE MATTER OF THE COMPETITION IN)
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.)
_____)

DOCKET NO. U-0000-94-165

**DIRECT TESTIMONY OF
KENNETH GORDON**

On Behalf of
TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998

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DIRECT TESTIMONY OF KENNETH GORDON

I. QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, ADDRESS, AND QUALIFICATIONS.

A. My name is Kenneth Gordon. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), an economic consulting firm specializing in microeconomic analysis, including regulated industries. My business address is One Main Street, Cambridge, MA 02142. I received my A.B. degree from Dartmouth College in 1960. I received my M.A. degree in 1963 and my Ph.D. degree in 1973, both in economics, from the University of Chicago. From 1965 to 1980, I taught at several colleges. From 1980 to 1988, I was an industry economist at the Federal Communications Commission (FCC). I was Chairman of the Maine Public Utilities Commission from 1988 through the end of 1992, and Chairman of the Massachusetts Department of Public Utilities from January 1993 to October 1995. In 1992, I was President of NARUC, the national organization of state regulators. Since leaving the Massachusetts commission, I have been employed by NERA. In both of my terms as a state utility commission chairman I was extensively involved in electric utility regulation issues along with other regulatory issues, including the introduction of competition in retail electricity service, as well as in all telecommunications markets. I was also responsible for representing both commissions before the legislatures in Maine and Massachusetts on issues and legislation related to utility regulation. During my tenure as Chairman of the Maine Commission I was also Chairman of the New England Governors Conference Power Planning Committee. While I was Chairman of the Massachusetts Department of Public Utilities, that commission issued a series of orders aiming at the reform of electric utility rate regulation, including revisions to integrated resource management procedures, the introduction of incentive regulation, and the design of electric industry restructuring for Massachusetts. As part of my work with NERA, I have monitored restructuring efforts at the state and federal levels, as well as internationally. I have worked at NERA on projects related to electric restructuring for several utility clients

1 in several different states, including Texas, Illinois, New Jersey, and Maine. I have recently
2 served as an independent expert on restructuring for the Indiana state legislature.

3 **II. PURPOSE OF TESTIMONY**

4 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

5 A. I have been invited to testify before the Arizona Corporation Commission (ACC) by
6 Tucson Electric Power Company (TEP). The purpose of my testimony is to address the
7 economic efficiency, equity, and public policy concerns raised by some of the nine specific
8 stranded cost questions listed by the ACC for consideration at its evidentiary hearing on
9 generic issues related to stranded costs.

10 **III. BACKGROUND**

11 Q. WHAT IS YOUR UNDERSTANDING OF WHY COMPETITION IS BEING
12 INTRODUCED INTO THE ELECTRIC INDUSTRY, AND HOW IS THAT
13 UNDERSTANDING RELATED TO THE WAY IN WHICH STRANDABLE COSTS
14 SHOULD BE RECOGNIZED BY POLICYMAKERS?

15 A. Fundamental technological and economic forces are at work moving policymakers to open
16 the electric industry to competition. As a consequence, many states, including Arizona,
17 have taken active steps toward extending competition beyond the wholesale markets into
18 retail electricity sales. In many states, high electricity prices that occurred under the aegis
19 of traditional regulatory mechanisms have provided a powerful stimulus to action, but, more
20 recently, even a number of low cost states have begun investigating the benefits of opening
21 retail electricity markets to competition.

22 Looking at it from a broader intellectual context, there can be little doubt that the impact
23 of recent changes in electricity generation on attitudes toward retail competition is
24 substantially augmented by recent experience with competition and regulatory reform in
25 industries such as telecommunications, gas, airlines, and the other transportation industries.
26 In virtually every case where regulation has been criticized and where proposals have been

1 made to introduce substantial competition, some experts have said it couldn't be done. The
2 industries involved have initially argued that competition cannot work and that traditional
3 regulation should be continued. But, where competition has been introduced, the result has
4 invariably been an improvement in overall consumer welfare.¹ The cumulative effect of
5 this has been a renewal of interest over the last two decades in relying on markets and
6 market-like tools in place of "command and control" regulation. Although the complexity
7 of the production and distribution process in the electric power industry provides reasons to
8 be careful as we proceed, it is unlikely that electricity will be an exception to the general
9 rule that market forces produce better outcomes than regulatory structures.

10 The demand for competitive options has also been stimulated by recent conditions in
11 wholesale electricity markets in many parts of the United States. Customers are aware that
12 the (wholesale) market prices at which bulk power trades between utilities and their
13 suppliers, especially in the short run, bear little relation to the prices (usually based on
14 embedded costs) that they themselves pay for electricity. This is partly a result of the fact
15 that there is (or has been) excess capacity for the production of electricity in many parts of
16 the country. But, more fundamentally, and of greater significance for the long-term, larger
17 customers are aware that electricity can be produced over the longer term at lower costs
18 than today's prices by actually building new, more efficient, capacity. Even in the absence
19 of excess capacity, today's power plants can produce electricity on a going-forward basis at
20 costs lower than historic cost levels. Particularly because of this last factor, policy makers
21 at all levels have recognized that real, long-term savings are possible and are paying more
22 attention to the cost of providing reliable electric power. It is these types of gains that
23 should be pursued in order to benefit society as a whole – not shifts that allow an advantage
24 to one group of ratepayers at expense of another, and not transitory wealth transfers that
25 arbitrarily make shareholders worse off in order to benefit ratepayers. If care is not taken in

¹ See Crandall and Ellig, Economic Deregulation and Customer Choice: Lessons for the Electric Industry, Center for Market Processes, n.d.

1 addressing the stranded cost problem during the transition, the introduction of competition
2 could actually raise, rather than reduce, the overall costs of producing electricity.

3 To be more explicit, it is clear that the societal benefits of competition are too often
4 misunderstood. Producing real benefits of competition involves more than simply lowering
5 prices in the short-term. Rather, real and sustainable lower prices will be the result of a
6 properly-structured competition policy that impels all firms to better performance.
7 Genuine, long-term benefits will come only from greater operating efficiency, innovative
8 product offerings and pricing alternatives, and greater efficiency in major supply investment
9 decisions. That is, only real improvements in efficiency can benefit all consumers, over
10 time, as a group.

11 Lower prices that arise only because the buyer has found a way to avoid paying the
12 costs embedded in current rates must be distinguished from the real savings I have
13 discussed above. It is quite possible that a competitor could supply electricity at a price
14 below current rates, yet above the going-forward (economic) cost of service. In such a case,
15 the ability to circumvent the recovery of embedded costs (or, alternatively, to “strand” these
16 costs) would actually increase the real costs of society’s electric supply. Properly designed
17 stranded cost recovery mechanisms, as discussed below in my testimony, can avoid this
18 problem while still permitting efficient competition and affording incumbent utilities a
19 reasonable opportunity to recover their past investments.

20 As competitive alternatives expand, benefits come also as utilities are released from the
21 obligation to serve. This, in turn, both allows and compels competing firms to select energy
22 supply alternatives that—in their own judgment—promise to minimize long-run total cost,
23 and customers are relieved of the expectation that they will pay all prudently incurred cost,
24 regardless of whether or not the supply choices result in the most economic outcome.
25 Critically, the risks of inappropriate investments or actions are shifted to the firms that are
26 providing service. In short, under competition utilities will begin to operate on a true
27 market basis like other businesses do.

1 While real and potentially significant, these benefits are prospective in nature – they
2 cannot be simply legislated or ordered overnight. Because real improvements in efficiency
3 are only achieved over time, as new investments are made and operating procedures are
4 revised, savings from these factors are unlikely by themselves to enable significant rate
5 reductions in the short term. It is also inappropriate to classify rate reductions that are only
6 achievable as a result of depriving utilities of the reasonable opportunity to recover costs
7 prudently incurred in order to meet the historic obligation to serve as a benefit of
8 competition. The political challenge, however, is that policy makers are under pressure to
9 deliver short-term benefits, e.g., immediate rate reductions, while the bulk of the real
10 economic benefits of competition will be slower in coming.

11 **IV. THE ACC'S NINE STRANDED COST QUESTIONS**

12 **Q. WHAT ARE THE ACC'S NINE SPECIFIC STRANDED COST QUESTIONS?**

13 **A. They are as follows:**

- 14 1. Should the Electric Competition Rules be modified regarding stranded costs, if so, how?
- 15 2. When should "Affected Utilities" be required to make a "stranded cost" filing pursuant
16 to A.A.C. R14-2-1607?
- 17 3. What costs should be included as part of "stranded costs" and how should those costs be
18 calculated?
- 19 4. Should there be a limitation on the time frame over which "stranded costs" are
20 calculated?
- 21 5. Should there be a limitation on the recovery time frame for "stranded costs"?
- 22 6. How and who should pay for "stranded costs" and who, if anyone, should be excluded
23 from paying for stranded costs?
- 24 7. Should there be a true-up mechanism and, if so, how would it operate?
- 25 8. Should there be price caps or a rate freeze imposed as part of the development of a
26 stranded cost recovery program and if so, how should it be calculated?
- 27 9. What factors should be considered for "mitigation" of stranded costs?

1 **A. Question Number 1**

2 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 1: "SHOULD THE
3 ELECTRIC COMPETITION RULES BE MODIFIED REGARDING STRANDED
4 COSTS, IF SO, HOW?"

5 A. I have reviewed the ACC's Electric Competition Rules as they relate to stranded costs and
6 find them to be a reasonable set of principles and general mechanisms for how stranded
7 costs should be dealt with in the beginning phases of the transition to competition. In terms
8 of actual implementation requirements, however, much additional work has to be done to
9 fill in the details. There is one particular part of the Rules that I would recommend be
10 modified. In R14-2-1607(A), the ACC suggests that utilities' profits from a "wider scope
11 of services" should be used to mitigate stranded costs. As long as the wider scope of
12 services is intended to include only those tariffed services offered by the utility itself, and
13 not unregulated services offered by affiliates of the utility, then I think it is a reasonable
14 requirement.

15 It is generally accepted that utilities should not be allowed to recover the costs of
16 unregulated affiliated ventures from monopoly ratepayers; otherwise, ratepayers would be
17 subsidizing the competitive venture. This would obviously harm both monopoly ratepayers
18 and adversely affect competition in the subsidized sector. The flip side of this requirement
19 is that regulators should not seek to capture the benefits of competitive ventures for
20 ratepayers. To do so leads to a set of problems that are similar and equally inefficient.
21 Investment incentives will be attenuated for the utility in the competitive sector, while
22 prices for regulated services will be artificially reduced, with corresponding adverse effects
23 on both competition and investment in that sector. As long as ratepayers are protected from
24 being harmed by affiliate interests (as they should), they should not expect to capture the
25 benefits of those ventures – even for the mitigation of stranded costs.

26 Q. WHAT IS YOUR OPINION ON THE ACC'S CONCLUSION THAT UTILITIES
27 SHOULD BE ALLOWED AN OPPORTUNITY TO RECOVER STRANDED COSTS?

1 A. Certainly, the ACC should not modify its fundamental conclusion that it “shall allow
2 recovery of unmitigated Stranded Cost by Affected Utilities” (R14-2-1607(B)).

3 Q. PLEASE EXPLAIN WHY YOU BELIEVE THAT UTILITIES SHOULD BE ALLOWED
4 RECOVERY OF STRANDED COSTS?

5 A. Arizona utilities have made investments over the years to satisfy their legal obligation to
6 provide adequate and reliable service to each and every customer who desired electricity
7 and was within the utilities’ service territory. The costs associated with earning a fair return
8 of and on these investments have formed the basis for setting the capital cost portion of the
9 utility’s rates. Other rate-setting factors unique to the regulated environment, and that
10 differentially impact utilities compared to other industries, are the mandated use of long
11 depreciation schedules, the creation of “regulatory assets” based on the promised future
12 recovery of these assets, and mandatory social program expenditures (such as low income
13 and environmental programs). For reasons that have been exhaustively described
14 elsewhere,² some of these legitimately-incurred investments could become “stranded,” i.e.,
15 unrecoverable, in the transition to a competitive marketplace.

16 The question then becomes whether and how the utility should be allowed to recover—
17 in some approved manner that is consistent with the policy determination to rely on
18 competition—the gap between its embedded cost-based rates and the lower prevailing
19 market rates. That gap is referred to as stranded costs, i.e., costs prudently incurred under
20 traditional regulation that the utility would be unable to recover in a competitive generation
21 market. Unless special provision is made by legislators and/or regulators, shareholders may
22 not recover fully the funds they provided the company in good faith while the old system
23 was in effect. In my opinion, public policies aimed at introducing competition into
24 electricity markets will proceed more quickly, cooperatively, and ultimately successfully if
25 utilities are given a fair opportunity to recover these costs.

² See William J. Baumol, Paul L. Joskow and Alfred E. Kahn. “The Challenge for Federal and State Regulators: Transition from Regulation to Efficient Competition in Electric Power,” Edison Electric Institute, December 9, 1994.

1 Q. PLEASE EXPLAIN.

2 A. The risk associated with investments is treated much differently in regulated and
3 unregulated industries, but, in both cases, a symmetry exists between risk and the
4 distribution of rewards. This symmetry can be described as the principle: "reward follows
5 risk." In unregulated markets, investors are faced with the full cost of investments that are
6 unsuccessful, but they are allowed to keep all of the profits derived from good investments.
7 Under traditional forms of regulation (i.e., rate-of-return, cost-plus regulation), ratepayers
8 face the risk of investment once it is approved as prudent by regulators and included in the
9 rate base. If the investment turns out to be successful, the company's shareholders are
10 allowed to earn no more than the cost of capital in return, which means in effect that
11 ratepayers receive the cost savings or similar benefits of the good investment. On the other
12 hand, if the investment turns out to be unsuccessful, shareholders are not penalized –
13 ratepayers remain responsible for covering its costs. In return for accepting this investment
14 risk, ratepayers benefit from capital costs that may be lower than they otherwise would be if
15 shareholders faced that risk (all else being equal). The important point is that there is
16 symmetry between risks and rewards in both regulated and unregulated markets.

17 In terms of the current debate, denying utilities an opportunity to recover their stranded
18 costs would upset the symmetry that lies at the heart of traditional forms of regulation. It
19 would be a case of the regulators saying to the shareholders – heads-we-win, tails-you-lose.
20 If private investors – on whose capital we rely to provide necessary services in a market
21 economy – are unable to rely on the government to keep its commitments and not act
22 opportunistically, then they would demand a much higher return on their investments to
23 compensate them for the increased uncertainty. The fact is that utility investors have not
24 been compensated for the risk that regulators would upset the "risk/reward" symmetry of
25 traditional regulation as part of a policy transition to open markets to competition.
26 Recognition of this fact must continue through the transition to competition. It is entirely
27 appropriate in my opinion – indeed desirable -- to change *on a going-forward basis* to a
28 framework in which the risk of prospective investments will be placed entirely on the
29 shareholders, but that does not alter the responsibility of policymakers to honor the

1 symmetry of the previous regulatory framework on investments that were already made and
2 approved for recovery in rates.

3 Q. DID YOU ACT CONSISTENT WITH THIS BELIEF WHEN YOU WERE A
4 REGULATOR?

5 A. Yes. When I was Chairman of the Massachusetts Department of Public Utilities, that
6 commission began the process of introducing retail electric competition to the state. We
7 issued an order laying out principles for the transition, among other things. On stranded
8 costs, we found:

9 Utilities should have a reasonable opportunity to recover net, non-mitigatable,
10 stranded costs associated with commitments previously incurred pursuant to
11 their legal obligations to provide electric service. D.P.U. 95-30, p. 28 (1995).

12 The Federal Energy Regulatory Commission (FERC), in its Order 888, similarly
13 affirmed...

14 ...our preliminary determination that the recovery of legitimate, prudent and
15 verifiable stranded costs should be allowed...We will not ignore the effects of
16 recent significant statutory and regulatory changes on the past investment
17 decisions of utilities. While, as some commenters point out, there has always
18 been some risk that a utility would lose a particular customer, in the past that
19 risk was smaller. It was not unreasonable for the utility to plan to continue
20 serving the needs of its wholesale requirements customers and retail customers,
21 and for those customers to expect the utility to plan to meet future customer
22 needs. With the new open access, the risk of losing a customer is radically
23 increased.³

24 In addition, I should point out that while I was Chairman of both the Maine and
25 Massachusetts commissions, great care and much time was spent in rate cases determining
26 which investments would be approved as prudent and thus allowed into rate base. These
27 were some of the most hotly contested issues that the commissions dealt with. The reason

³ *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Federal Energy Regulatory Commission, Docket Nos. RM95-8-000 and RM94-7-001, Order No. 888 Final Rule, issued April 24, 1996.

1 why the issue of prudence was so important was that we understood that once an investment
2 is approved for inclusion in rate base, we had an obligation to allow the utility to recover
3 and earn a return on that investment. If the commitment had not been there, I can assure
4 you that the question of prudence would not have been as crucial an issue as the parties and
5 the regulators made it.⁴

6 I also have reviewed the relevant parts of the ACC decision on the prudence of TEP's
7 expenses related to the Springerville generating facility (Docket No. U-1933-88-090,
8 Decision No. 56659, October 24, 1989, pp. 7-12). The thoroughness of that review in
9 approving recovery of those expenses in part and disallowing recovery in part because of
10 what the ACC found to be TEP's imprudence suggests to me that the ACC understood that
11 its decision was of great importance because it determined how much Springerville-related
12 costs TEP would be entitled to an opportunity to recover.

13 B. Question Number 2

14 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 2: "WHEN SHOULD
15 "AFFECTED UTILITIES" BE REQUIRED TO MAKE A "STRANDED COST" FILING
16 PURSUANT TO A.A.C. R14-2-1607?"

17 A. R14-2-1607(G) states that utilities "shall file estimates of unmitigated Stranded Cost. Such
18 estimates shall be fully supported by analyses and by records of market transactions
19 undertaken by willing buyers and willing sellers." These filings should be required a
20 reasonable period of time after the ACC issues its decision in this case, but prior to the
21 introduction of retail customer choice in order to provide some indication for utilities,
22 alternative suppliers, and customers of just how much (and in what manner) they will be
23 paying for recovery of stranded costs. My experience has been that uncertainty about
24 stranded cost recovery is one of the primary points that can cause delays in the movement to

⁴ Prof. Alfred Kahn asks, "If there was no previous understanding [about the commitment to recovery of approved investments], what was the point of all those rate cases in which contending parties expended great amounts of energy and dollars arguing about the dimensions of the costs properly recoverable in rates?" Alfred E. Kahn, "Thirteen Steps to Reconciliation," Regulation, 1996 Number 4, p. 14.

1 competition. Therefore, providing commitments to recovery, establishing estimates for
2 total stranded costs (even if rough and subject to later revisions), and determining the
3 mechanism for recovery are all important steps for regulators to take prior to the
4 introduction of retail choice.

5 **C. Question Number 3**

6 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 3: "WHAT COSTS SHOULD
7 BE INCLUDED AS PART OF "STRANDED COSTS" AND HOW SHOULD THOSE
8 COSTS BE CALCULATED?"

9 A. All of the utility's prudently-incurred costs that would have been recovered but for the
10 policy decision to introduce retail choice should be included as part of stranded costs. This
11 includes all of the cost items listed in the ACC Staff's Stranded Cost Report, as well as
12 unrecorded regulatory assets. Stranded costs -- to the extent possible -- should be calculated
13 using information and data provided through market transactions, in order to derive the
14 difference between revenue streams that occur in the competitive market and those that
15 would have occurred under traditional regulation, rather than administrative projections and
16 estimates. It is market transactions that actually "strand" these costs, so market transactions
17 provided the most accurate information about the exact amount of stranded costs.
18 Administrative determinations are predictions about future events, and, no matter how well
19 thought out those predictions will be, they are still likely to be inaccurate.

20 I understand that TEP supports what has been called in Arizona the "net revenues lost"
21 approach, whereby stranded costs are calculated as the net present value of the difference
22 between revenues under traditional regulation and those that will be received under a
23 competitive market. Under this approach, the amount of stranded costs recovered in rates
24 adjusts along with market prices, so that only those costs that are actually being stranded are
25 being recovered at any point in time. I believe that the "net revenues lost" approach (which
26 has been called the "net-back pricing" or "lost margins" approach in other jurisdictions) is
27 an appropriate way to calculate stranded costs on a going forward basis.

1 **D. Question Number 4**

2 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 4: "SHOULD THERE BE A
3 LIMITATION ON THE TIME FRAME OVER WHICH "STRANDED COSTS" ARE
4 CALCULATED?"

5 A. No. Most of the costs that should be included in the definition of stranded costs were
6 incurred in the past (e.g., regulatory assets, unamortized and unrecoverable investment,
7 etc.), but other costs, such as expenses related to social programs and environmental
8 mandates, are on-going and should not be disregarded. Continuing (or any newly-imposed)
9 regulatory requirements for investment should be included. But otherwise, assuming that
10 the utilities' generation services no longer will be regulated on a cost-of-service basis,
11 investments made after the date of retail access (with the exception of those made pursuant
12 to regulatory requirements) should not be included in the calculation of stranded costs.

13 **E. Question Number 5**

14 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 5: "SHOULD THERE BE A
15 LIMITATION ON THE RECOVERY TIME FRAME FOR "STRANDED COSTS?"

16 A. The answer to this question is linked to my answer to Question Number 8. The recovery
17 time frame for stranded costs depends heavily on whether or not policymakers feel the need
18 to provide a rate cap as part of the movement to retail choice. One thing is for certain,
19 however: the time period over which recovery takes place should not be used as a tactic to
20 deny utilities the opportunity to recover all of their stranded costs. When you begin with
21 the principle that there should be a reasonable opportunity to recover all stranded costs, as
22 the ACC's Electric Competition Rules appear to do, the time frame becomes in large
23 measure a function of other goals with regard to rate levels. For example, from a purely
24 economic perspective, it is probably desirable to have stranded costs recovered over as short
25 a time period as possible, in order to more quickly move to a market situation where buyers
26 are presented with prices that reflect only marginal costs, unencumbered by regulatory
27 legacies. However, taken too literally, this approach could result in significant short-term
28 rate increases, and (as I have seen first-hand as a regulator, particularly in terms of the

1 telephone industry), it could be quite counterproductive for policymakers to raise
2 customers' rates in order for those customers to later on "benefit" from competition.
3 Political considerations have to be taken into account alongside economic ones, particularly
4 when a significant policy change is being made, as is the case here. To the extent that
5 short-term rate certainty is a policy goal on par with that of introducing competition, it may
6 be necessary to extend the period of stranded cost recovery.

7 It is important to recall here, as I stated at the outset of my testimony, that the real gains
8 from competition will accrue only as efficiency improves in the long-term. The only way to
9 achieve a substantial "quick fix" on rates during the transition is to either forego stranded
10 cost recovery, which, as I discussed above, is bad policy; or to extend the period of recovery
11 well into the future. Nevertheless, it may be necessary to cap current rates – keeping in
12 mind that by doing so, the recovery period for stranded costs must be lengthened to
13 compensate for the short-term consideration. This type of trade-off represents a borrowing
14 against future benefits, but could be judged necessary to build a consensus in favor of
15 restructuring the industry.

16 **F. Question Number 6**

17 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 6: "HOW AND WHO
18 SHOULD PAY FOR "STRANDED COSTS" AND WHO, IF ANYONE, SHOULD BE
19 EXCLUDED FROM PAYING FOR STRANDED COSTS?"

20 A. No customer for whom the utility had an obligation to provide service should be exempted
21 from paying for stranded costs – for reasons of efficiency, as well as fairness. In terms of
22 fairness, customers with near-term competitive alternatives should not be allowed to bypass
23 recovery of investments that were made on their behalf, leaving the remaining core
24 customers with the responsibility to pay the total costs of those investments. From a public
25 policy perspective, the ACC should be careful not to release any group from all or a portion
26 of the responsibility for stranded costs, lest that increase the burden on other customers or
27 make it more difficult to provide a reasonable opportunity to recover stranded costs. This is
28 especially important at this stage of the transition, when so many major issues are as yet

1 unresolved. If the ACC were to provide select customers with special stranded cost
2 recovery treatment unavailable to other customers, it runs the risk of creating a loophole
3 that could make it more difficult to build consensus for introducing competition.

4 In terms of efficiency, selection of some for exemption from cost responsibility means
5 that the burgeoning competitive market will be distorted, because customers who are not
6 required to pay for recovery of stranded costs could be making decisions based on the
7 avoidance of legitimate costs, *i.e.*, uneconomic bypass, not on the basis of going-forward
8 efficiencies of the alternatives. Inefficient competition and inefficient investment decisions
9 can result when customers considering alternative sources of energy evaluate such
10 alternatives against the current regulated price of the energy and capacity that would be
11 displaced. This is because all previously incurred costs, not just marginal costs, are
12 included in the regulated price. Hence, if the customer's current rate, based on historic
13 costs, is 5¢/kWh for generation and the market value of generation that would be displaced
14 by an alternative is 3¢/kWh, an efficient investment decision by the customer would be
15 expected if the customer would see a savings of at least 2¢/kWh off its current rate if
16 alternatives are used. If the customer saw a savings of less than 2¢/kWh, an inefficient
17 investment decision—often referred to as uneconomic bypass—would occur. Alternative
18 energy sources that are more expensive than the marginal costs could proliferate. Assessing
19 stranded cost recovery on a non-discriminatory basis, on the other hand, would be expected
20 to encourage the efficient investment result—*i.e.*, generation alternatives that are lower in
21 cost than market prices will have an incentive to be used and generation alternatives that are
22 not competitive with market prices will not be used. Hence, from an economic efficiency
23 perspective it is clear that assessing all customers, whomever their supplier may be, with
24 stranded cost charges—*i.e.*, charges that reflect back to the customer the above market
25 portion of the utility's past generation costs—should encourage an economically efficient
26 result by providing the right price signals. Arguments that such a policy would produce
27 economically inefficient results or would preclude efficient competition are clearly wrong.

1 **G. Question Number 7**

2 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 7: "SHOULD THERE BE A
3 TRUE-UP MECHANISM AND, IF SO, HOW WOULD IT OPERATE?"

4 A. Because the amount of costs that are stranded changes with a number of variables (e.g.,
5 market price), stranded cost recovery can be adjusted periodically according to what
6 actually happens with these variables. The necessity for a true-up mechanism depends on
7 which method for calculating and recovering stranded costs is chosen. For example, the
8 "net revenues lost" approach automatically re-sets stranded cost recovery in response to
9 actual market conditions. The amount that customers are required to pay goes up or down
10 depending on what happens with market prices. An administrative determination and
11 estimate of stranded costs may require some sort of true-up due to the uncertain nature of
12 estimates. Care should be taken, however, that periodic true-ups do not become, in effect, a
13 reconciliation mechanism that constantly adjusts stranded cost recovery not only to market
14 prices but to changes in embedded costs. That type of reconciliation mechanism would
15 create a "cost-plus" environment that would attenuate incentives for efficiency and stranded
16 cost mitigation. Certain other approaches, such as a utility's decision to divest its
17 generation assets, would of course not require a true-up, because utility investors will be
18 faced with the going-forward risk that the one-time fixed amount paid in a market
19 transaction for the assets will be an accurate reflection of value.

20 **H. Question Number 8**

21 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 8: "SHOULD THERE BE
22 PRICE CAPS OR A RATE FREEZE IMPOSED AS PART OF THE DEVELOPMENT OF
23 A STRANDED COST RECOVERY PROGRAM AND IF SO, HOW SHOULD IT BE
24 CALCULATED?"

25 A. I assume that "price cap" in this context refers to a requirement that prices cannot exceed
26 current levels, and is not intended to mean a price cap form of performance-based
27 regulation: The latter can be an appropriate and desirable way to mitigate stranded costs. I
28 don't know whether there should or should not be price caps or a rate freeze. As noted

1 earlier in my response to Question 5, that is a political question, not an economic one.
2 However, I would like to offer an observation that the overarching policy goal in this
3 process should be a commitment to the introduction of retail choice, and, if a price cap or
4 rate freeze is necessary to build consensus in favor of competition, then the ACC may
5 decide it is necessary to include it, even though it could mean a longer period for recovery
6 of stranded costs.

7 **I. Question Number 9**

8 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 9: "WHAT FACTORS
9 SHOULD BE CONSIDERED FOR "MITIGATION" OF STRANDED COSTS?"

10 A. Any potential cost savings related to what would normally be considered as part of the
11 utility's cost of service should be considered for mitigation of stranded costs. What should
12 not be considered is revenue from non-utility operations, such as holding company
13 investments. Some critics of stranded cost recovery suggest that the utility and its holding
14 company do not have a legitimate claim for stranded cost recovery when they are making
15 unregulated investments in other industries or internationally. These critics sometimes also
16 suggest that earnings from these non-utility investments should be used to write-down
17 stranded costs. Investments in non-utility operations are funded either from non-utility-
18 related sources or from the shareholders' legitimate earnings. Utility shareholders are
19 entitled to earn a return of and on prudently-invested capital, but what they then do with
20 their return really should not be a concern of regulators. In fact, if regulators decide to
21 garner the rewards of such investments, then shareholders also should be compensated
22 when those non-utility investments turn out poorly. Needless to say, I am not
23 recommending such an approach. To put it bluntly, the problem of stranded costs exists
24 because traditional regulatory practices put the risk of investment on the backs of ratepayers
25 – the solution to the problem should not repeat this error with non-utility investments.

26 One good potential source of mitigation is savings related to adoption of performance-
27 based regulation. Economists have long criticized the "cost-plus" nature of traditional rate-
28 of-return regulation because of the disincentives it creates for efficient operations and use of

1 capital. Many regulatory agencies have replaced traditional regulation with performance-
2 based regulation, such as banded returns and price caps, particularly for telecommunications
3 companies. The cost savings that result from such plans can be used to mitigate stranded
4 cost recovery.

5 Another legitimate source of mitigation for stranded costs can be securitization of
6 stranded costs. Securitization allows for stranded cost recovery with lower capital costs
7 because investors have less risk associated with the cost recovery. Securitization does give
8 utility shareholders a fairly certain commitment to recover the securitized amount,
9 regardless of other factors (which is why securitization results in lower capital costs), but as
10 long as policymakers recognize the commitment to an opportunity to recover stranded
11 costs, as they should, there is no reason not to use any legitimate mechanisms that can lower
12 stranded costs.

13 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

14 A. Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
Commissioner - Chairman
RENZ D. JENNINGS
Commissioner
CARL J. KUNASEK
Commissioner

IN THE MATTER OF THE COMPETITION IN) DOCKET NO. U-0000-94-165
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.) **DIRECT TESTIMONY OF**
) **KAREN G. KISSINGER**
)

On Behalf of
TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998



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1 **Introduction and Purpose**

2 Q. Please state your name and business address.

3 A. Karen G. Kissinger, 220 West Sixth Street, Tucson, Arizona 85702.

4 Q. What is your position with Tucson Electric Power Company ("Company" or "TEP")?

5 A. I am Vice President and Controller and Principal Accounting Officer. My present areas of
6 responsibility include internal and external financial reporting, plant and property accounting,
7 payroll, accounts payable, tax planning and compliance reporting, billing, credit and
8 collections. As of January 1, 1998, I am also Vice President and Controller and Principal
9 Accounting Officer of UniSource Energy Corporation, the Company's newly formed holding
10 company.

11 Q. Please describe your educational background and your business experience as the same
12 pertain to your position.

13 A. I received a Bachelor of Arts Degree in Spanish from the University of Virginia in 1977. I
14 received a Master of Business Administration with a Concentration in Accounting from the
15 University of Arizona in 1982. I am a Certified Public Accountant licensed to practice in the
16 State of Arizona. I am a member of the American Institute of Certified Public Accountants
17 and the Arizona State Society of Certified Public Accountants.

18 Before joining Tucson Electric Power Company in 1991, I was employed by Deloitte
19 Haskins & Sells and its successor by merger Deloitte & Touche in the audit department for
20 approximately eight and one half years. During that period I had both public and cooperative
21 electric utilities as audit and consulting clients. I was designated by Deloitte & Touche as a
22 public utility specialist. Since 1991, I have been employed by Tucson Electric Power
23 Company as Vice President and Controller.

24 Q. What is the purpose of your testimony in this proceeding?

25 A. The purpose of my testimony is two-fold. First, it is to respond to the December 11, 1997
26 Procedural Order requesting information in this proceeding regarding the implications of the
27 Statement of Financial Accounting Standards No. 71 ("FAS 71") resulting from
28 recommended stranded cost calculations and recovery methodologies. While the context of
29 this testimony is Issue Number 3, as defined in the December 1, 1997 Procedural Order, there

30 ...

1 are aspects of FAS 71 which have implications for all of the testimony topics requested by
2 the Procedural Order.

3 The second purpose of my testimony is to discuss certain income tax issues related to
4 Item 3 of the Procedural Order as it relates to stranded cost.

5 **Statement of Financial Accounting Standards No. 71**

6 Q. Please briefly describe the accounting requirements of Statement of Financial Accounting
7 Standards No. 71.

8 A. As rate regulated entities, TEP and certain other utilities in the state prepare their public
9 financial statements in accordance with Statement of Financial Accounting Standards No. 71,
10 *Accounting for the Effects of Certain Types of Regulation* ("FAS 71"). The underlying
11 premise of FAS 71 is that regulated enterprises should account for the economic effects that
12 result from the cause-and-effect relationship of costs and revenues in the rate-regulated
13 environment. FAS 71 defines what constitutes a cost-based rate-regulated entity and contains
14 standards of accounting for the effects of regulation. One such standard addresses the
15 method by which a regulator can create an asset by deferring, for future recovery, a current
16 cost that would otherwise be charged to expense. For that to occur, *both* of the following
17 criteria must be met:

- 18 (1) It is probable that future revenue in an amount at least equal to the capitalized cost
19 will result from inclusion of that cost in rates; and
20 (2) Based on available evidence, future revenue will be provided to permit recovery of
21 the previously incurred cost rather than to provide for expected levels of similar
22 future costs.

23 Such assets are considered to be regulatory assets. As long as the above criteria are
24 met, these regulatory assets may continue to be reflected in a utility's books and financial
25 statements. As soon as either of the above is not met, the corresponding regulatory asset
26 must be written off. To illustrate the extent to which regulatory assets impact the financial
27 reporting by a public utility, as of December 31, 1996, TEP's balance sheet included nearly
28 \$279 million in deferred regulatory assets.

29 Q. Under what conditions would FAS 71 be determined to be no longer available to a utility as
30 accounting guidance?

1 A. Utilities following FAS 71 must continually assess whether they remain regulated entities
2 under definition criteria contained in FAS 71. FAS 101, *Accounting for Discontinuation of*
3 *Application of FAS 71*, includes the following examples of situations that may warrant
4 discontinuation of FAS 71:

- 5 (1) Deregulation;
- 6 (2) A change in the regulator's approach to setting rates from cost-based ratemaking to
7 another form;
- 8 (3) Increasing competition that limits the enterprise's ability to sell utility services or
9 products at rates that will recover costs; and
- 10 (4) Regulatory actions resulting from resistance to rate increases that limit the
11 enterprise's ability to sell services or products at rates that will recover costs if the
12 enterprise is unable to obtain relief from prior regulatory actions through appeals or
13 the courts.

14 The thrust of FAS 101 is that when an enterprise ceases to meet the criteria of FAS
15 71, either in part (*i.e.*, an operating division or product line) or in total, it must discontinue its
16 application and eliminate the regulatory assets on its books that were created by regulators.
17 For TEP, the application of FAS 101 to all operations of the Company would result in a net
18 charge against net income totaling some \$157 million, based on the balances of regulatory
19 assets and liabilities as of December 31, 1996.

20 Q. Are FAS 71 and FAS 101 the only accounting guidance that are relevant to accounting for
21 regulated enterprises?

22 A. No. As innovative recovery mechanisms and incentive-based recovery plans for utilities
23 have been developed over the years, the ability of regulators to create assets by deferring
24 costs to the future has become increasingly suspect to the Financial Accounting Standards
25 Board ("FASB") and Securities and Exchange Commission ("SEC"). Accordingly,
26 additional accounting standards have been issued by the FASB to address emerging concerns
27 over accounting by regulated entities. These standards include FAS 90, *Regulated*
28 *Enterprises-Accounting for Abandonments and Disallowances of Plant Costs*; FAS 92,
29 *Regulated Enterprises-Accounting for Phase-In Plans*; and FAS 121, *Accounting for the*
30 *Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*. Both FAS

1 90 and FAS 92 contain criteria for permitting certain plant-related costs to be deferred for
2 future rate recovery. Costs not meeting such criteria may not be deferred and must be
3 immediately expensed. FAS 121 amends FAS 71 to clarify that existing regulatory assets
4 should be written off if they are no longer considered probable of recovery. FAS 121 also
5 requires a write-off of the regulatory asset if recovery of the asset is disallowed by the
6 regulator.

7 These Standards have already had an impact on TEP. Although the Company was
8 granted authority by the Commission in previous rate cases to defer for future rate recovery,
9 certain excess capacity costs associated with Springerville Unit No. 2 (the unamortized
10 balance of which totaled \$94 million as of December 31, 1996), such deferrals failed to meet
11 the criteria set forth in FAS 92. They have been charged in their entirety to expense for
12 financial reporting purposes. No corresponding regulatory asset is reflected on the
13 Company's balance sheet prepared for financial reporting. The regulatory asset appears only
14 in the Company's regulatory balance sheet for ACC reporting purposes.

15 Q. As deregulation has emerged in various states, have these accounting standards proven to be
16 sufficient guidance to allow utilities and their regulators to interpret the implications and act
17 accordingly?

18 A. Unfortunately, no. FAS 71 did not contemplate deregulation in quite the ways we see
19 unfolding across the nation today. Transition plans, competitive transition charges,
20 securitization of stranded asset costs, and other innovations simply were not forecast when
21 FAS 71 was written. As a result, the Emerging Issues Task Force ("EITF"), a committee of
22 the Financial Accounting Standards Board, met in the summer of 1997 to deal with some of
23 the issues now arising in deregulation. In July 1997, the EITF issued a consensus position,
24 *Issue 97-4, Deregulation of the Pricing of Electricity, Issues related to the Application of*
25 *FASB Statements No. 71, Accounting for the Effects of Certain Types of Regulation, and No.*
26 *101, Regulated Enterprises – Accounting for the Discontinuation of Application of FASB*
27 *Statement No. 71.* The minutes of the July 23-24, 1997 EITF meeting related to issue 97-4
28 are attached as Exhibit A.

29 Q. Briefly, what specific issues does EITF 97-4 address?

30 A. EITF 97-4 provides guidance as to when an entity facing deregulation should discontinue

1 following the provisions of FAS 71 and some of the mechanics of how to discontinue FAS
2 71. EITF 97-4 states that accounting under the guidance of FAS 71 should be discontinued
3 for a separable portion of a business when legislation or a public utility commission order
4 that contains sufficient detail to reasonably determine how a transition plan will affect the
5 deregulated portion of the business is issued. Regulatory assets and liabilities remain on the
6 financial records of the business if they are recoverable through "regulatory cash flows" until:

- 7 (1) The assets are recovered and/or the liabilities are settled through the collection of
8 "regulatory cash flows";
9 (2) The assets become individually impaired, or the regulator eliminates the obligation;
10 or
11 (3) The separable portion of the business from which the "regulated cash flows" are
12 derived no longer meets the criteria to continue accounting in accordance with the
13 provisions of FAS 71.

14 Costs of the deregulated business may be deferred if they are expensed or incurred
15 after FAS 101 is applied and such costs are recoverable through "regulatory cash flows."

16 Q. How does EITF 97-4 define "regulatory cash flows?"

17 A. "Regulatory cash flows" are rates charged to customers intended by regulators to recover the
18 specified regulatory assets. The cash flows are derived from a levy on regulated goods or
19 services provided by a separable portion of the business that continues to meet the criteria to
20 account for its activities in accordance with the provisions of FAS 71.

21 Q. What is the status of the rules adopted by the Commission to date insofar as EITF 97-4 would
22 define the point in time at which a utility must cease to follow the guidance of FAS 71 for its
23 generation operations?

24 A. To date, there is insufficient specificity in the rules to cause the Arizona utilities to cease
25 following the tenets of FAS 71 for generation operations. As soon as the rules contain
26 sufficient information for the utilities to reasonably estimate the impact of the deregulation
27 rules on their operations, the utilities may have to cease accounting for their generation
28 operations in accordance with FAS 71. I presume that this may result from these stranded
29 cost proceedings.

30 ...

1 Q. What are the implications of these accounting rulings on the determination of the stranded
2 cost recovery mechanism in Arizona?

3 A. Even though the generation portion of the utility may no longer be able to follow the
4 provisions of FAS 71, the regulatory assets and other stranded costs which initially evolved
5 as a part of the generation side of the business are not necessarily written off the books at the
6 date that the generation business ceases to qualify to account for its operations in accordance
7 with FAS 71. So long as a part of the business, such as the distribution portion of the
8 business, remains cost-based rate regulated, and such business has the regulated cash flows to
9 recover the costs of the regulatory assets and other stranded costs, those costs are not written
10 off. However, certain conditions apply. If the conditions are not met, write-offs will occur.

11 Q. What are the conditions?

12 A. EITF 97-4 is clear in its expectation that the cash flows must come from regulated revenues,
13 rather than competitive revenues, even if it is probable that such competitive revenues will be
14 earned by the entity. The cash flows can come from rates charged directly as a tariffed rate,
15 or as a competitive transition charge, or through proceeds from securitized bonds which will
16 be paid off through regulated revenues. In addition, the cash flows have to be certain enough
17 to warrant reliance upon them as a recovery mechanism.

18 Q. Please explain "certain enough".

19 A. Unfortunately, that determination will likely be completely dependent upon individual facts
20 and circumstances. In general, accountants speak in terms of costs being "probable of
21 recovery." In an accounting sense, that means recovery is "likely" to occur. From
22 conversations with senior utility personnel at Big Six accounting firms, and information I
23 have received through my participation on the Edison Electric Institute Accounting Executive
24 Advisory Committee, I have learned that accounting staff at the SEC as well as other
25 accounting professionals express concern that some of the stranded cost recovery plans being
26 developed in various states provide inadequate recovery mechanisms.

27 Q. What are some of the specific concerns raised by accounting professionals?

28 A. Accounting professionals express concerns about recovery periods extending many years into
29 the future, beyond the end of the so-called transition plans, and recovery methods without
30 true-up mechanisms. If a recovery plan has no "true-up" mechanism provided during the

1 recovery period, the stated rate path would need to have sufficient "head room" for allowable
2 regulated costs to increase (such as for inflation) and still provide for recovery of the stranded
3 cost within the provided recovery period.

4 Q. Explain what you mean by a "true-up" mechanism, and what features such mechanism would
5 need to have.

6 A. A true-up mechanism is a "re-opener" provision in the cost recovery plan which allows the
7 parties to assess whether the original recovery path provided too much, or too little, recovery
8 of the identified recoverable stranded costs. A true-up provision that is a one-way street,
9 only allowing the regulator to end the recovery path early, if the regulator deems that the
10 costs would be recovered sooner than originally anticipated does not provide sufficient
11 support. To be a meaningful true-up provision for accounting purposes, such true-up
12 mechanism would need to allow for upward adjustments as well as downward adjustments.
13 The true-up mechanism would allow the utilities to increase their recovery, if the original
14 recovery path was determined to be insufficient to fully recover the allowable stranded costs.

15 Q. What are specific implications for recovery plans in Arizona?

16 A. The more risk that a utility is asked to assume in achieving the cash flows to recover the
17 stranded costs, the less likely that the recovery plan provides adequate assurance that the
18 costs will be recovered, and therefore, recognized on the balance sheet for financial reporting
19 purposes. Consensus among the accounting firms appears to be that recovery periods of five
20 years or less, or about the same time period as the transition period, appear to provide
21 sufficiently timely recovery for the regulator to ensure that the utility receives its cost
22 recovery. If the plan provides for recovery over a five to ten year period, the plan *may* be
23 considered adequately timely, but considerable doubt exists as to whether recovery over a
24 period in excess of ten years would be sufficiently timely. The longer the recovery period,
25 the greater the need for a true-up mechanism to allow the utility's cost recovery to be re-
26 evaluated and modified. In the alternative, a greater amount of "head room" within the rate
27 or increased evidence that the costs will be recovered by the end of the stated recovery period
28 would be needed.

29 ...

30 ...

1 Q. Does the specific recovery calculation method chosen make a difference, in determining
2 whether the amounts are recognized as recoverable for FAS 71 financial statement
3 presentation purposes?

4 A. No. With any method of calculation of recovery, whether it is net lost revenues, replacement
5 cost valuation, auction and divestiture, stock market valuation, or some other method not yet
6 discussed in the competition docket, the method of calculation is not the issue. The issue is
7 really the cash flows expected to be derived under the plan. In each case, the amount of cash
8 flows provided by the method is initially determined and then compared to the balances of
9 costs that the cash flows are specifically earmarked to recover. Recoverable amounts remain
10 regulatory assets/liabilities of the remaining regulated entity.

11 Q. Please explain how the adequacy of regulatory cash flows is determined, in general terms.

12 A. First, the utility must determine the regulatory cash flows expected to be recovered over the
13 life of the regulatory asset or stranded cost. If the gross cash inflows less the gross cash
14 outflows, if any, that relate to such regulatory asset or stranded cost exceed the carrying
15 amount of the regulatory asset or stranded cost, then no write-down occurs. If the net cash
16 flows is less than the recorded book value, a write-down will occur.

17 The regulatory asset is written down to its estimated recoverable amount, as of the
18 date that the impairment is determined. Other stranded costs, such as plant costs, would be
19 written down to their fair values, pursuant to FAS 121. The fair value (as defined in FAS
20 121) would be determined using quoted market prices for similar assets or other valuation
21 models. Valuation models might include the present value of the estimated expected future
22 cash flows using a discount rate commensurate with the risks involved, option-pricing
23 models, matrix pricing, option-adjusted spread models, and fundamental analysis. Losses
24 incurred due to the disallowance of certain kinds of stranded costs, such as abandoned plants,
25 would be calculated in accordance with FAS 90.

26 Q. If the regulatory recovery plan ultimately approved for the Company does not provide
27 specific indications of which assets are being allowed for recovery and which are not, are
28 there accounting ramifications?

29 A. Yes. The above-described cash flow analysis presumes that an entity knows the specific
30 costs for which it is being provided recovery. In the methods discussed to date in the

1 competition docket and in most other states, there is little attempt to designate the stranded
2 cost recovery dollars to specific assets. For example, in the net lost revenues approach, the
3 regulator may determine that in aggregate \$250 million represents the stranded cost; the
4 methodology does not specifically match each cost on the balance sheet to each dollar in the
5 recovery path. This requires the utility to use its best judgment in allocating the cash flows
6 among fixed assets such as above-market utility plant and any regulatory assets to perform
7 the cash flow analysis.

8 Q. Are there other FAS 71 consequences for the generation side of the business?

9 A. Yes. At the point in time that the generation portion of the business becomes deregulated,
10 the generation portion of the business can no longer account for its activities in accordance
11 with FAS 71. Therefore, it must review the carrying values of all of its long-lived assets,
12 such as utility plant, to determine whether the values are appropriate for enterprises in
13 general. Enterprises in general must carry their long-lived assets at historical cost unless the
14 value is impaired. Pursuant to the provisions of FAS 121, the utility would need to estimate
15 the cash flows expected to result from the use of the asset over its expected useful life and its
16 eventual disposition, both inflows and outflows. If the net cash inflow is less than the
17 carrying amount of the asset, the asset would be written down to its fair value. The loss
18 would be calculated as the difference between the fair value of the asset and the carrying
19 amount of the asset. Fair value would be determined as noted earlier in this testimony.

20 **Income Tax Issues to be Considered in the Determination of Stranded Costs**

21 Q. Should the calculation of stranded costs to be recovered include regulatory assets related to
22 income taxes?

23 A. Yes, the amount of stranded costs to be recovered should include regulatory income tax
24 assets. In prior years when utility assets were placed in service, certain tax benefits were
25 flowed-through to ratepayers, thus reducing income tax expense charged to ratepayers.
26 Regulated utilities have been able to record regulatory assets related to these benefits because
27 it was understood that the utility would recover these benefits in future rates over the
28 depreciable life of the asset. To the extent not all of these tax benefits have been recovered, a
29 regulatory asset is recorded on the utility's books for the amount of pretax revenues

30 ...

1 necessary to allow the utility to recoup this benefit. The utilities expect to recover these
2 amounts in accordance with the regulatory compact.

3 Q. If the utility is not allowed to recover these regulatory income tax assets in rates, what will be
4 the impact on the accounting records of the utility?

5 A. When these regulatory assets were initially established there was no income statement impact
6 for the utility. The assets were originally recorded via a charge, or addition, to the regulatory
7 asset account for the amount of pretax revenues to be collected, and a credit, or increase, to
8 deferred tax liability. These income tax regulatory assets amounted to \$174 million at
9 December 31, 1996 for the Company. If the regulatory income tax asset is not allowed to be
10 collected from ratepayers, it would have to be written off from the balance sheet of the utility.
11 However, FAS 109, *Accounting for Income Taxes*, still requires that the utility record the
12 amount of deferred tax due the Internal Revenue Service ("IRS") in the future due to the tax
13 deductions given to ratepayers in prior years. Since the write-off of the regulatory income
14 tax assets could not be accomplished by a reversal of the initial entry establishing the assets,
15 the impact would be a net charge, or reduction, to the book income of the utility. The amount
16 of this charge would be the after-tax amount of the utility revenues which would not be
17 collected from ratepayers. There would be no current deduction allowed on the Federal or
18 State income tax return of the utility for this loss of revenues.

19 Q. Will a public utility still be subject to the normalization requirements of the Internal Revenue
20 Code if it is not allowed to recover 100% of its stranded costs?

21 A. It is unclear how the IRS would handle the normalization requirements for a utility that is not
22 allowed to recover 100% of its stranded costs. The IRS has provided guidance in the case of
23 specific assets which are no longer subject to regulation, but not in the case of an overall
24 disallowance which may apply to some or all of a utility's assets. In the case of specific
25 identification of deregulated assets, the IRS has ruled that none of the tax benefits associated
26 with the deregulated assets may be taken into consideration when determining the rates to be
27 charged for the assets which are still regulated. The rulings provided that the regulators may
28 not reduce rate base for the deferred tax liabilities associated with the deregulated assets, and
29 that cost of service calculations may not reflect a tax deduction for depreciation on the
30 deregulated assets.

1 Q. Should income taxes to be paid on stranded cost recovery be taken into consideration in the
2 calculation of stranded costs?

3 A. Yes. When the utility collects the revenues designated to recover stranded costs, they will be
4 required to pay income taxes on the amounts collected for both Federal and State income tax
5 purposes. As a result, in order to be made whole, the utility must receive sufficient revenues
6 to pay the taxes and still recover their investment. This is no different than the current
7 methodology used to calculate revenue requirements, which takes into consideration the
8 taxability of the revenues to be collected.

9 Q. Is there an income tax deduction for Federal or State income tax purposes associated with the
10 inability to fully recover stranded investment?

11 A. No. The Internal Revenue Code does not provide for any deductions for the impairment of
12 assets. A taxpayer may only take a deduction for the loss of an asset if the asset is
13 permanently abandoned or disposed of at a loss. In the case of generating facilities which
14 must continue to be operated despite an inability to recover their stranded cost component,
15 there would be no deduction available. The utility would continue to depreciate that
16 generating facility under the existing method elected for income tax purposes.

17 Q. Does the Auction and Divestiture method of computing stranded costs present any particular
18 income tax issues?

19 A. Yes, it does. Because of the use of accelerated depreciation for income tax purposes, most
20 utility assets will have a tax basis which is lower than book basis. As a result, the utility will
21 generally experience a larger gain, or reduced loss, for tax purposes than for book purposes.
22 Under the Auction and Divestiture proposal, the amount of stranded costs to be recovered by
23 the utility would be deemed to be mitigated to the extent there was income from the sale of
24 the generating assets. If this methodology is authorized, care must be taken to ensure that
25 only the after-tax income is treated as a mitigation of the stranded costs. To the extent that
26 ratepayers have benefited in the past from the accelerated deductions which led to the lower
27 tax basis, they should be required to pay the income taxes incurred as a result of those
28 deductions when the asset is sold. This "payment" would be made via a reduction in the
29 amount of stranded costs treated as mitigated as a result of the sale of the assets.

30 ...

1 **Recommendation**

2 Q. Ms. Kissinger, given all of the information included in your testimony, what is your specific
3 recommendation for a stranded cost recovery plan in Arizona that complies, to the best of
4 your knowledge and belief, with the accounting literature that you cite, so that no losses are
5 incurred?

6 A. The recovery plan must include recovery of 100% of stranded costs, including all income tax
7 regulatory assets and the income tax ramifications, of the recovery mechanism chosen. The
8 recovery plan should provide for recovery of the stranded costs over a period of
9 approximately five years, and should include a true-up mechanism which allows for
10 additional amounts of stranded costs to be collected, in the event that facts and circumstances
11 at the time of the true up indicate that the recovery path initially established will be
12 inadequate for the full amount of stranded costs to be recovered.

13 Q. Please explain how your recommendation and Mr. Bayless' proposed stranded cost recovery
14 plan are compatible.

15 A. Mr. Bayless proposes 100% recovery of stranded costs with immediate recovery in cash for
16 the utility of approximately 75% of the costs through securitization and recovery of the
17 remaining approximately 25% non-securitized stranded cost by the end of 2004 through a
18 Competitive Transition Charge ("CTC"). The consumers would then provide the funds to
19 repay the bonds securitizing stranded costs over a 10- to 15- year period. The plan further
20 provides for a true-up mechanism which recalibrates the CTC at any time when the band
21 ceiling or floor is exceeded. This plan provides cash recovery to the Company of 100% of its
22 stranded cost over six years, consistent with my proposed approximately five years, and
23 includes a true-up mechanism that allows for increases in recovery by the Company in the
24 event that facts and circumstances at the time of the true up indicate that the recovery path
25 initially established will be inadequate for the full amount of stranded costs to be recovered.
26 Without a securitization plan, it would appear difficult to accomplish recovery of the stranded
27 costs in a period of approximately five years.

28 Q. Does this conclude your testimony?

29 A. Yes, it does.

30

Section: Issue 97-04 - Deregulation of the Pricing of Electricity - Issues Related to the Application of FASB Statements No. 71, Accounting for the Effects of Certain Types of Regulation, and No. 101, Regulated Enterprises-Accounting for the Discontinuation of Appl

Subsection: A. Abstract/Minutes

E

2. Issue 97-4 - July 23-24, 1997

Date Composed: 08/12/97

Date Modified:

Issue No. 97-4

Title: Deregulation of the Pricing of Electricity—Issues Related to the Application of FASB Statements No. 71, *Accounting for the Effects of Certain Types of Regulation*, and No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*

Introduction

1. Several state legislatures and/or regulatory commissions have recently approved, and others including federal legislators are currently considering, changes to laws and regulations governing the pricing of electricity. Specifically, those changes relate to the element of the total price of a kilowatt of electricity that is intended to cover its production ("generation") cost, as opposed to the portion intended to cover the transmission cost to a local area or the portion intended to cover the cost of distribution to individual residences or businesses.
2. The nature of these regulatory changes has been to move away from a pricing model that has prices set by a regulator based on allowable cost toward and ultimately to a pricing model that has prices set by competitive market forces. Because market-based prices are ultimately expected to be lower than the former allowable cost-based regulated pricing, the impact of these regulatory changes on companies that generate electricity has been to transform some of their investment in generation operations into what has been referred to as "stranded costs."
3. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, specifies three criteria that must be met in order to reflect the effects of rate regulation in a regulated enterprise's financial statements. If all of the criteria are met, the enterprise will recognize assets and liabilities that are not recognized by enterprises in general. These assets and liabilities are often referred to as "regulatory assets and liabilities."¹¹ Throughout this Issue, reference is made to "regulatory assets" and "regulatory liabilities." "Regulatory assets" and "regulatory liabilities" are those assets and liabilities recognized pursuant to the provisions of paragraphs 9 and 11, respectively, of Statement 71. These assets and liabilities are not recognized by enterprises in general. An example of a regulatory asset is the cost incurred to repair damage from an ice storm, if the regulator provides that these specific expenditures will be recovered from customers by inclusion of that cost in the determination of future rates. An

example of a regulatory liability is a gain on the early extinguishment of debt if the regulator provides that this specific gain will be passed through to customers by inclusion of that gain in the determination of future rates. If some of an enterprise's operations are regulated and other operations are not, then Statement 71 should be applied to the portion of an enterprise's operations that meets the three criteria. FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*, addresses how an enterprise that ceases to meet the criteria for application of Statement 71 to all or part of its operations should report that event in its general-purpose financial statements.

Issues

4. The issues are:

- a. When an enterprise should stop applying Statement 71 to the separable portion of its business whose product or service pricing is being deregulated once legislation is passed or a rate order is issued (whichever is necessary to effect change in the jurisdiction) that has the effect (either immediately or at some point in the future) of deregulating the rates charged to customers.
- b. How an enterprise should evaluate whether to continue to recognize all or some portion of the "regulatory assets" and "regulatory liabilities," respectively, that (1) originated from the separable portion of the business whose pricing is being deregulated and (2) exist at the date Statement 101 is applied.
- c. How an enterprise should evaluate whether to establish additional "regulatory assets" and "regulatory liabilities" related to expenses and obligations, respectively, that will originate from the separable portion of the business whose pricing is being deregulated but that will arise subsequent to applying Statement 101.

Prior EITF Discussion

5. At the May 21-22, 1997 meeting, individuals familiar with the electric utilities industry presented an educational session that included background information on the industry, the nature of the current deregulatory initiatives, and the accounting framework for regulated enterprises.

6. The Task Force reached a tentative conclusion that the continued recognition of "regulatory assets" and "regulatory liabilities" of the separable portion of a business to which Statement 101 is being applied should be determined on the basis of where (that is, the portion of the business in which) the regulated cash flows to realize and settle them, respectively, will be derived. "Regulated cash flows" are from rates charged to customers that are intended by regulators to be for the recovery of "regulatory assets" and the settlement of "regulatory liabilities."

7. The Task Force noted that Statement 71, as amended by FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides specific guidance to regulated entities on impairment of regulatory assets.

8. The Task Force discussed how the criteria for application of Statement 71 should be evaluated in the context of a deregulation plan but was not asked to reach a consensus.

Current EITF Discussion

9. On Issue 4(a) the Task Force reached a consensus that when deregulatory legislation or a rate order (whichever is necessary to effect change in the jurisdiction) that contains sufficient detail for the enterprise to reasonably determine how the transition plan will effect the separable portion of its business whose pricing is being deregulated is issued, the enterprise should stop applying Statement 71 to that separable portion of its business. The Task Force did not address whether an enterprise should stop applying Statement 71 to that separable portion of its business prior to the issuance of sufficiently detailed deregulatory legislation or a sufficiently detailed rate order.

10. The Task Force observed that once Statement 71 is no longer applied to a separable portion of an enterprise's business, the financial statements should segregate, via financial statement display or footnote disclosure, the amounts contained in the financial statements that relate to that separable portion.

11. On Issue 4(b) the Task Force reached a consensus that the "regulatory assets" and "regulatory liabilities" that originated in the separable portion of an enterprise to which Statement 101 is being applied should be evaluated on the basis of where (that is, the portion of the business in which) the regulated cash flows to realize and settle them, respectively, will be derived. "Regulated cash flows" are from rates that are charged to customers and intended by regulators to be for the recovery of the specified "regulatory assets" and the settlement of "regulatory liabilities." They are derived from a "levy" on rate regulated goods or services provided by another separable portion of the enterprise that meets the criteria for application of Statement 71.

12. The result of the consensus on Issue 4(b) is that the "regulatory assets" and "regulatory liabilities" that originated in the separable portion of the business to which Statement 101 is being applied and for which the deregulatory legislation or rate order (whichever is necessary to effect change in the jurisdiction) specifies the collection of "regulated cash flows," are not eliminated until:

a. They are recovered by (in the case of assets) or settled through (in the case of liabilities) collection of regulated cash flows, or

b. They are individually impaired (in the case of assets) or the regulator eliminates the obligation (in the case of liabilities) as specified by the provisions of Statement 71, as amended by Statement 121, or

c. The separable portion of the business from which the regulated cash flows are derived no longer meets the criteria for application of Statement 71.

13. On Issue 4(c) the Task Force reached a consensus that the "source of the cash flow" approach adopted in the consensus to Issue 4(b) should be used for recoveries of all costs and settlements of all obligations (not just for "regulatory assets" and "regulatory liabilities" that are recorded at the date Statement 101 is applied) for which regulated cash flows are specifically provided in the deregulatory legislation or rate order, (whichever is necessary to effect change in the jurisdiction.)

14. The result of the consensus on Issue 4(c) is that a cost or an obligation is recognized as a "regulatory asset" or a "regulatory liability" within the separable portion of the enterprise from which the regulated cash flows for its recovery or settlement, respectively, are derived once it is:

a. Expensed or incurred after Statement 101 is applied to the portion of the business where it originated (such as the loss on the sale of an electricity generating plant or the loss on the buy-out of a purchased power contract that is recognized after Statement 101 is applied to the generation portion of the business); and

b. Specified for recovery or settlement in the deregulatory legislation or a rate order (whichever is necessary to effect change in the jurisdiction) and is recovered or settled in the same manner (that is, via "regulated cash flows") as the "regulatory" assets and "regulatory" liabilities described in the consensus to Issue 4(b).

Those "regulatory assets" and "regulatory liabilities" are carried in this other separable portion of the business until they are collected or settled, or individually impaired (assets) or eliminated (liabilities), or until that separable portion of the business no longer meets the criteria for application of Statement 71.

Status

15. No further EITF discussion is planned.