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6 IN THE MATTER OF THE COMPETITION)
IN THE PROVISIONS OF ELECTRIC)
7 SERVICES THROUGHOUT THE STATE)
8 OF ARIZONA)

DOCKET NO. U-0000-94-165

NOTICE OF FILING

9 Citizens Utilities Company hereby provides Notice of Filing the Direct Testimony of
10 Sean Breen as required by the Commission's Order in the above-referenced docket.

11 RESPECTFULLY SUBMITTED this 9th day of January, 1998.

15 Arizona Corporation Commission
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18 DOCKETED BY *[Signature]*

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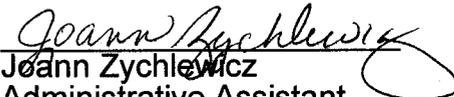
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SUMMARY OF TESTIMONY

Mr. Breen's testimony presents the response of Citizens Utilities Company ("Citizens") to the nine questions set forth by the Arizona Corporation Commission ("Commission") in its December 1, 1997, Procedural Order in the Electric Competition Docket. Of greatest importance, Citizens urges the Commission to modify its Competition Rules in three key ways:

1. To provide unambiguous support for full recovery of prudently incurred costs stranded by the restructuring of the industry;
2. To adopt a market valuation method for valuing stranded costs and pursue a course of action that can rapidly, fairly, and efficiently introduce true open competition in the industry; and
3. To adopt a fair standard for judging the reasonableness of stranded cost mitigation efforts.

Mr. Breen's testimony also addresses Citizens' proposals to:

- delay the requirement for stranded cost filings until after the Rules have been updated;
- eliminate the Competitive Phases now contained in the Rules;
- require all customers to pay stranded costs;
- calculate stranded costs over remaining lives of the relevant assets;
- establish a recovery time frame that balances the goals of achieving the shortest possible period with minimizing rate impacts; and
- adopt a recovery method without price caps or the need for true-up mechanisms.

DIRECT TESTIMONY OF SEAN R. BREEN

**CITIZENS UTILITIES COMPANY
ARIZONA ELECTRIC DIVISION**

STRANDED COST PROCEDURAL ORDER

DOCKET NO. U-0000-94-165

JANUARY 9, 1998

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1 Q. Please state your name and position.

2 A. My name is Sean R. Breen. I am Director of Energy Services for Citizens Utilities
3 Company.

4
5 Q. What are your relevant qualifications and experience?

6 A. I have been employed fourteen years in the electric utility business where my
7 focus has been in the areas of resource planning, regulatory affairs and demand-
8 side management. Over the last two years I have played a key role in
9 conceptualizing, developing and presenting Citizens' position on competitive
10 restructuring of the electric industry in Arizona and Vermont. Through this
11 experience and perspective in the industry, I have gained insight and knowledge
12 about the broad range of issues surrounding the re-regulation of electric utilities,
13 including stranded cost valuation and recovery. Before joining Citizens in 1991, I
14 worked eight years for Green Mountain Power Corporation, an investor-owned
15 utility in Vermont, where I was responsible for key aspects of integrated resource
16 planning and demand-side management.

17
18 Q. What is the purpose of your testimony?

19 A. My testimony provides Citizens' response to the questions concerning stranded
20 costs set forth in the Arizona Corporation Commission's ("Commission")
21 Procedural Order in Docket No. U-0000-94-165, dated December 1, 1997, as
22 supplemented by amended Procedural Orders in the same docket, dated
23 December 11, 1997, December 15, 1997, and January 5, 1998.

24
25 Q. How will your testimony be organized?

26 A. My testimony is divided into nine sections, each of which addresses one of the
27 Commission's nine questions.

1 Q. Do you address the Commission's questions in the same order as presented in
2 the Procedural Order?

3 A. No. As required by the First Amended Procedural Order, the questions and
4 Citizens' responses have been re-arranged in order of importance to Citizens.

5

6 **1. COMMISSION QUESTION NUMBER ONE**

7 **SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED REGARDING**
8 **STRANDED COSTS, IF SO, HOW?**

9

10 Q. Should the Electric Competition Rules be modified regarding stranded costs?

11 A. Yes.

12

13 Q. Why should the Rules be modified regarding stranded costs?

14 A. In its comments on the proposed rule submitted in November 1996 and in its
15 application for rehearing submitted in January 1997, Citizens set forth four
16 reasons why the Commission should modify the Rules regarding stranded costs.
17 In summary, these reasons were:

18

- 19 1. The Rules would disavow the Regulatory Compact by which the Commission
20 has required Affected Utilities to provide electric service in the past;
- 21 2. The Commission improperly dismissed as premature claims addressing the
22 standards to be applied for stranded cost recovery;
- 23 3. The Rules fail to address or consider Citizens' showing that state regulatory
24 agencies may not bar recovery through rates of the costs of wholesale power
25 purchase contracts approved by the Federal Energy Regulatory Commission;
26 and
27 4. The Rules fail to ensure that revenues from collateral services would not be
28 improperly allocated to offset stranded costs.
29
30
31
32

1 Q. What is the nature of the regulatory compact referred to in statement 1 above?

2 A. Citizens, like utilities throughout the United States, is charged with the
3 responsibility to serve all customers within a defined service area and is restricted
4 in the amount it charges for service to rates that allow a reasonable return on and
5 of the utility investments made to satisfy its obligation to serve. The regulatory
6 compact balances the liabilities of the obligation to serve and an earnings cap
7 against the rights to a reasonable return on and of the utility's prudent investment
8 required to provide service and to recover prudent expenses.

9
10 Q. Why would the Rules violate the regulatory compact?

11 A. The current Rules would violate the regulatory compact to the extent they put
12 utilities at risk to under-recover investments made and costs incurred that were
13 required to provide service under the rules that existed, and are still in place in
14 Arizona. This risk is clearly apparent when, in the explanatory statement
15 accompanying Decision No. 59943, Staff contends that no regulatory compact
16 exists.

17
18 Q. What is your understanding of the regulatory compact?

19 A. I am not a lawyer, so I will not cite cases, but will instead provide my basic
20 understanding. In return for the Commission's granting Citizens a franchise and
21 imposing upon it the continuing obligation to serve, Citizens, like other utilities,
22 made investments in assets and entered long-term contracts with wholesale
23 power suppliers to continue to meet this public service obligation. Citizens'
24 shareholders' willingness to underwrite these long-term investments and
25 commitments relied on the existing regulatory regime which provided Citizens the
26 ability to recover its costs and earn a reasonable return on and of its investment
27 through Commission-prescribed rates. Under the regulatory compact, once the

1 Commission has sanctioned contractual commitments and long-term investments,
2 it cannot repudiate its obligation to provide utilities a reasonable opportunity to
3 recoup these costs. The Rules as written jeopardize this opportunity.
4

5 Q. Moving to Citizens' second reason why the Commission should modify the Rules,
6 what supports Citizens' belief that the Commission has dismissed claims
7 addressing the standards to be applied for stranded cost recovery?

8 A. Within the Explanatory statements in Decision No. 59943, Staff asserts that
9 arguments concerning stranded cost recovery are premature – that the Rules
10 merely set forth a process for future requests for recovery of these costs.
11 However, the Rules set forth several factors that the Commission “at least” shall
12 consider in making determinations about stranded cost recovery. Consideration of
13 these factors would actually tilt the playing field in favor of non-recovery.
14

15 Q. Please explain further.

16 A. It is the existence of these considerations (listed in A.A.C. R14-2-1607) that in fact
17 undermines the reasonable opportunity for full recovery of costs stranded by
18 electric competition. For instance, while the “impact of Stranded Cost recovery on
19 the effectiveness of competition,” is a legitimate concern that should guide the
20 design of the recovery mechanism, it has no place in determining the amount of
21 recovery to which an Affected Utility is entitled. To the extent the Commission
22 employs any of the considerations listed to materially reduce recovery of a utility's
23 stranded cost, it would create confiscatory earnings levels for the investment
24 made under the regulatory compact.
25

1 Q. Why do you characterize the denial of stranded cost recovery as creating
2 confiscatory earnings?

3 A. This is a direct result of: 1) the character of the government action; 2) the
4 economic impact of the regulation; and 3) the extent of interference with
5 investment-backed expectations.

6
7 Q. In what way does the "character of the government action" contribute to this
8 issue?

9 A. In this situation, the government action is a pervasive transformation of the electric
10 industry to introduce competition. To the extent this transformation denies full
11 stranded cost recovery, it would frustrate utility investors' interest in the continuing
12 recovery of costs incurred to meet the utility's obligations. The "character" of this
13 action is revealed by the reasonableness of the means selected for obtaining the
14 regulatory goal. There is no reasonable basis for concluding that the
15 Commission's decision to promote competition **requires** denial of full recovery of
16 costs incurred under regulation. In fact, imposing stranded costs upon the
17 Affected Utilities would hamper their ability to compete against new market
18 entrants, thereby frustrating competition.

19
20 Q. Would the economic impact of the denial of stranded cost recovery be
21 substantial?

22 A. Yes. While there is yet no single, widely-accepted estimate of Arizona utilities'
23 stranded cost exposure, estimates run into the billions of dollars. These costs
24 represent utilities' prudent investments and commitments, undertaken to serve the
25 public and approved for inclusion in rates. Clearly, the denial of recovery of these
26 amounts, or even a fraction of the costs, would potentially cause serious financial
27 loss that could very well threaten the continued viability of the Affected Utilities.

1 Q. What would be the "extent of interference with investment-backed expectations"
2 from denial of stranded cost recovery?

3 A. Denial of recovery would represent severe interference. It is beyond dispute that
4 the disallowance of stranded cost recovery interferes with utility investors'
5 reasonable investment-backed expectations of recovery of – and a return on –
6 their investments, as well as recoupment of expenses.

7
8 Q. What do these three factors mean?

9 A. Considering these factors together: the unreasonable nature of the governmental
10 action; the substantial degree of economic impact; and the severe interference in
11 investment-backed expectations; it is clear that denial of the opportunity for full
12 stranded cost recovery represents a confiscation of utility property.

13
14 Q. Turning to Citizens' third issue concerning recovery of stranded costs, how do the
15 Rules fail to adequately address FERC jurisdictional issues?

16 A. Virtually all power now provided to Citizens' electric customers is supplied by
17 Arizona Public Service ("APS") under a wholesale purchased-power agreement.
18 The cost for this power is passed directly to Citizens' customers, without mark-up,
19 through a purchased power and fuel adjustment clause ("PPFAC"). Accordingly,
20 unlike utilities that have substantial generation assets, Citizens has not and does
21 not earn a return on the substantial portion of the power requirements of its
22 customers. The rates paid by Citizens for this power are set by the FERC, which
23 has exclusive jurisdiction over wholesale sales under the Federal Power Act. The
24 filed rate doctrine prohibits the Commission from adopting retail rates that do not
25 allow full recovery of these costs. As a result, the filed rate doctrine will invalidate
26 any approach to stranded cost recovery that leads to under-recovery of the APS
27 power purchase contract costs.

28

1 Q. What is the filed rate doctrine?

2 A. Again, I am not a lawyer, but will present my basic understanding. The filed rate
3 doctrine provides that rates filed with and approved by the FERC may not be
4 altered at the state level, and that state commissions may not bar local distribution
5 companies from passing such costs through to ratepayers. Denying Citizens the
6 ability to collect its full wholesale power costs would violate this doctrine.

7

8 Q. Is this the first time Citizens has alerted the Commission of this issue?

9 A. No. In its November 1996 comments on the Proposed Order regarding electric
10 competition, Citizens explained the impact of the filed rate doctrine on Citizens'
11 potential recovery of its power costs. The Commission did not address this
12 portion of Citizens' comments in the explanatory statement accompanying the
13 subsequently amended rule.

14

15 Q. Has the Commission required Citizens to maintain its PPFAC to provide for full
16 recovery of the costs incurred through its purchased power contracts with APS?

17 A. Yes, it has. The Commission has rejected two attempts by Citizens to eliminate
18 its PPFAC and has ordered Citizens to continue recovery of its purchased power
19 costs through the PPFAC.

20

21 Q. Did the Commission recognize that Citizens was different from the other major
22 electric utilities when ordering Citizens to retain the PPFAC?

23 A. Yes. The Commission determined that Citizens was not a generating utility and
24 purchased its power through contracts with APS.

25

1 Q. Was Citizens granted any earnings on the PPFAC bank balance that was
2 maintained to ensure that 100 percent of the purchased power costs were passed
3 through to its customers?

4 A. No. The Commission permitted only a dollar-for-dollar recovery.
5

6 Q. Has the Commission found that the long-term purchased power contracts between
7 Citizens and APS, which were approved by the FERC, were reasonable and
8 should be recovered from Citizens' customers?

9 A. Yes. They were approved for recovery through the PPFAC in Citizens' last
10 electric rate case.
11

12 Q. Has the Commission, or any party to this proceeding, presented any facts that
13 those same contracts have been modified?

14 A. No.
15

16 Q. Why are these facts about Citizens PPFAC relevant to the recovery of stranded
17 costs?

18 A. These facts underscore that Citizens' shareholders have received no benefit from
19 the power supply contracts approved by the Commission. In fact, the Commission
20 rejected Citizens request to be at risk for changes in the cost of purchased power
21 and allocated all benefits and costs to customers. Putting aside the filed-rate
22 doctrine, it would be fundamentally unfair to cause shareholders to absorb any
23 stranded costs associated with purchase-power contracts when:

- 24 • shareholders have earned nothing on these payments;
- 25 • the Commission has found the purchases to be prudent; and
- 26 • customers have already received refunds when power costs declined below
27 forecasted levels.

1 The Commission cannot fairly saddle shareholders with stranded costs associated
2 with an approved contract, from which shareholders have never received any
3 benefits.

4
5 Q. What is the only event that is causing concern as to the recovery of the costs
6 associated with those contracts?

7 A. The only event is the Commission's effort to re-regulate the electric utility industry.
8 While Citizens does not disagree with the Commission on the goal, the
9 Commission cannot summarily disregard 87 years of its past practice; it must
10 provide an acceptable transitional mechanism to permit full recovery of all costs
11 associated with providing service under the existing regulatory rules.

12
13 Q. Looking now at Citizens' fourth concern with stranded cost recovery, how would
14 the current Rules improperly allocate revenues from collateral services to offset
15 stranded costs?

16 A. A.A.C. R14-2-1607 states: "The Affected Utilities shall take every feasible, cost-
17 effective measure to mitigate or *offset* Stranded Costs by means such as
18 expanding wholesale or retail markets, *or offer a wider scope of services for profit,*
19 *among others.*"(Emphasis added.) The Rules as now stated would improperly
20 include revenues from all sources/services – even those unrelated to the
21 incurrence of stranded costs or the provision of utility services.

22
23 Q. Why does this matter?

24 A. Citizens agrees that utilities should be required to make reasonable efforts to
25 mitigate avoidable stranded costs. However, this portion of the Rules states that
26 revenues derived from other aspects of the Affected Utilities' operations, including
27 aspects unrelated to the stranded costs or utility operations, should be used to
28 reduce the level of recoverable stranded costs. With the introduction of electric

1 competition, a utility may make new at-risk investments in competitive markets. If
2 the utility were required to divert revenues from these unrelated activities to offset
3 stranded costs it would be unable to fairly compete against new market entrants
4 that had no stranded costs to offset.

5
6 Q. Is this the first time Citizens has alerted the Commission of this issue?

7 A. No. In its comments on the Proposed Order on Electric Competition Rules
8 submitted in November 1996 and again in its Application for Rehearing submitted
9 in January 1997, Citizens provided extensive reasons why revenues from
10 collateral services should not be used to offset stranded costs. None of these
11 concerns were addressed or considered in Decision No. 59943.

12
13 Q. In what way should the Rules be modified regarding stranded costs?

14 A. A number of changes should be made to the Rules; I will address the details of
15 our proposed changes in the responses to other Commission questions. Here,
16 Citizens proposes that the Commission adopt the following three general
17 principles to guide the recovery of stranded costs:

- 18 1. *Full recovery of unmitigated stranded costs should be a rebuttable*
19 *presumption. Once a utility has made a showing of its efforts and*
20 *results for mitigating its stranded costs, the burden of proof that the*
21 *utility has not taken all reasonable steps should be on the party*
22 *opposing full recovery.*
- 23 2. *Impacts on the marketplace of stranded cost recovery (e.g. on*
24 *effectiveness of competition, on prices paid, etc.) are considerations*
25 *relevant to the design of the recovery mechanism, but not to the*
26 *recoverability of stranded costs. While it is proper for the Commission*
27 *to develop mechanisms for recovering stranded costs that do not*
28 *cause undue economic impacts, the existence of the potential for such*

1 impacts in no way undermines the principle that mitigated stranded
2 costs are fully recoverable.

- 3 3. *Offsets to stranded costs as a form of mitigation are relevant only to*
4 *activities or services directly related to current or future regulated utility*
5 *services. The revenues from an expanded array of competitive*
6 *services that are unrelated to incurrence of stranded costs should not*
7 *be used to reduce the level of stranded costs that are recoverable.*

8
9 **2. COMMISSION QUESTION NUMBER THREE**

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

12
13 Q. What costs should be included as part of stranded costs?

14 A. Citizens agrees with the current Rules' definition of stranded costs and generally
15 concurs with the components of stranded costs defined in Stranded Cost Working
16 Group report. However, Citizens would point out that there are two additional
17 areas of strandable costs that are not fully addressed in the Working Group
18 Report.

19
20 Q. What are these additional areas of strandable costs?

21 A. The two additional areas are non-generation-related costs and the costs of new
22 functions that will be required by a regulated local distribution company ("LDC")
23 under open access.

24
25 Q. Please explain what you mean by "non-generation-related costs."

26 A. The Stranded Costs Working Group Report does not fully address the stranded
27 cost potential associated with non-generation utility functions including: metering
28 and meter reading, billing and collections, and customer information services. As
29 Staff points out in the Report: "Although the focus of this analysis was directed

1 toward potentially strandable generation costs, Staff believes that it is appropriate
2 to recognize that, to the extent any portion of the affected utilities' distribution
3 business (i.e. customer metering and billing) is similarly removed from the scope
4 of regulation, additional stranded costs may result." (See page 14.) While these
5 strandable costs are in all likelihood of lower magnitude than generation costs,
6 they are potentially strandable and should be accorded the same reasonable
7 opportunity for full recovery.

8
9 Q. Please explain the new functions required of regulated operations under open
10 access.

11 A. Introducing competition fundamentally changes the structure of the industry, not
12 only to the extent that it creates new competitive enterprises, but also how it will
13 change the operations of those components that will remain regulated. For
14 instance, continuous tracking, accounting, and reconciling energy supply and
15 demand transactions between distribution customers and tens, possibly hundreds,
16 of electricity suppliers will require LDC's to implement and operate new systems
17 Educating customers about how the industry is changing and how these changes
18 affect the way they will purchase electricity is another example of a significant new
19 activity that will fall to the LDC. The costs for start-up and on-going operation of
20 these functions are not currently reflected in the rates of any Arizona utility, nor
21 can any Arizona utility determine these costs at this time, given that the structure
22 and requirements of the restructured industry have not been fully defined.
23 Although these costs may not satisfy the definition of "stranded" costs (these will
24 be newly-incurred, instead of pre-existing), the Commission should definitely
25 provide for their recovery.
26

1 Q. What is Citizens' proposal for the treatment of these implementation costs?

2 A. There are two components of these implementation costs: start-up/one-time costs
3 and on-going costs of operation. The start-up/one-time costs for these new
4 functions, while not technically "stranded," should nonetheless be recoverable as
5 part of customer charges for the transition to open access, sometimes call
6 "competitive transition charges" ("CTC"). Just as stranded costs result from
7 regulatory restructuring, these new functions also result from regulatory
8 restructuring.

9
10 Q. What about the on-going costs for these new functions?

11 A. Since the on-going costs for these new functions will be caused mainly by those
12 customers who elect competitive suppliers, the on-going operating expense for
13 these new functions should reasonably be borne by the new market entrants and
14 consumers participating in and enjoying the benefits of the competitive electricity
15 market.

16
17 Q. Turning to the second part of Question Nine, how should stranded costs be
18 calculated?

19 A. For the vast majority of stranded costs associated with electric generation,
20 Citizens firmly supports a market valuation method for determining stranded costs.
21 In particular, Citizens proposes that the value of generation-related stranded costs
22 be determined through a state-administered auction of generation assets and
23 purchased power contracts. Stranded costs would be established as the
24 difference, if any, between the auction proceeds and book value of the assets (or
25 contract obligations in the case of purchased power contracts).
26

1 Q. Does this mean Citizens favors forced divestiture?

2 A. No. Participation in the auction would be voluntary. Any Affected Utility would be
3 free to enter the competitive market using its existing generation resources.
4 However, if an Affected Utility seeks to recover the above-market costs for **any** of
5 its generation resources, it could do so only by putting up **all** its resources for sale
6 in the auction.

7
8 Q. Why is Citizens proposing this requirement?

9 A. By putting up all generation resources, the magnitude of stranded costs is
10 mitigated to the extent an Affected Utility owns below-market price resources
11 which offset a portion of its above-market price resources. It stands to reason
12 that, if a utility seeks recovery of costs stranded by above-market resources
13 incurred under the regulatory compact, it should be prepared to relinquish
14 offsetting below-market resources acquired under the same compact.

15
16 Q. Are there any exceptions to putting up **all** generation for auction under Citizens'
17 proposal?

18 A. Yes. Generation that is required for emergency back-up, local voltage support, or
19 other reliability function for the utility's transmission and distribution system would
20 not have to be put up for auction. The costs for these assets are more properly
21 recovered as part of a regulated utility's transmission and/or distribution charges.
22 Nuclear powered generation could also be separately administered.

23
24 Q. Please explain the mechanics of the auction process.

25 A. Under Citizens proposal, the auction would be administered by a state agency,
26 the Investment Recovery Fund Department ("IRFD"), under the supervision of the
27 Commission. The mechanics of the actual auction, such as solicitation and
28 evaluation of bids would be handled by an investment banking or other

1 comparable advisory firm hired by the IRFD. This firm would be able to assess
2 the likely valuation of the assets to be sold at auction and determine how the
3 auction should be structured to realize the highest price for the total portfolio. The
4 firm should also be experienced in the actual conduct of the auction. The IRFD
5 would establish the rules for the auction, and would provide detailed information
6 concerning the assets and contracts to be auctioned to all interested parties,
7 subject to reasonable protections for confidential information. The auction rules
8 may require bidders to pre-qualify, or to provide certain evidence of
9 creditworthiness, to discourage frivolous bids and minimize auction expenses.
10 The actual conduct of the auction, i.e. open or sealed bid, single or active bidding,
11 would be determined by the IRFD.

12
13 Q. Please discuss the financial transactions that would then take place.

14 A. The IRFD would pay Affected Utilities original cost less depreciation for generation
15 assets. Purchase rights under purchase power contracts would be assigned to
16 the IRFD. The difference between the proceeds from the auction and the total net
17 book value paid out to the original owners, plus the difference between contractual
18 purchased power prices and the prices garnered in the auction, would then
19 constitute the stranded costs. The stranded costs of all participating utilities would
20 be pooled in the Investment Recovery Fund and be re-financed (secured) by tax-
21 exempt state revenue bonds or corporate bonds backed by enabling legislation. If
22 feasible, the IRFD would also administer the refinancing of stranded costs and
23 would be the issuing authority for the securities that would fund the recovery of
24 utilities' stranded costs. Securitizing stranded costs would likely mitigate the
25 overall level of stranded costs because credit ratings of securities backed by
26 future cash flow from the utilities' stranded cost recovery would likely receive a
27 higher rating than the average of the individual ratings for the senior debt of the
28 issuing utilities.

1 Q. Could Affected Utilities bid for their previously-owned assets under Citizens'
2 approach?

3 A. Yes. Any unregulated affiliates of the Affected Utilities could participate in the
4 bidding process and also bid on any assets or contracts.

5
6 Q. What are the advantages of this approach?

7 A. There are several, chiefly including:

- 8 • risk transfer;
- 9 • mitigation of stranded costs;
- 10 • rapid transition to true open competition; and
- 11 • reduction of horizontal market power.

12
13 Q. In what way would Citizens' proposal transfer risk?

14 A. Bidders in the auction would base their bids on what they believe future market
15 prices for power will be. By purchasing generation assets or contracts, successful
16 bidders would assume price forecasting risk, and in particular, the risk that future
17 power prices would be lower than projected. By contrast, under administrative
18 approaches that employ true-up mechanisms, customers would bear the risks of
19 under-forecasting future prices, and pay the differences between established
20 stranded charges and the actual amounts of above-market costs on a forward-
21 going basis.

22
23 Q. Is there a possibility that, under Citizens' approach, electric customers could pay
24 more for stranded costs than what they otherwise would under an administrative
25 approach?

26 A. Yes there is. However, there is at least an equal chance that customers would
27 pay less. Further, under Citizens' approach, customers would know exactly their

1 liability for stranded costs. Under administrative approaches, where customers
2 shoulder the risk that future prices may be lower than projected, there would be no
3 certainty about the magnitude of stranded cost liability.
4

5 Q. Please explain how Citizens' approach would mitigate stranded costs.

6 A. There are three main ways Citizens' proposal would mitigate stranded costs: by,
7 1) requiring below-market resources to be included in the auction; 2) refinancing
8 stranded costs with low-cost bonds; and 3) holding the auction while the
9 marketplace is still in transition.
10

11 Q. You have discussed how below-market resources and low-cost bonds could
12 mitigate stranded costs; how can holding the auction while the marketplace is still
13 in transition mitigate stranded costs?

14 A. The restructuring of the electric industry across the country has produced a fury of
15 new business activity, as new market entrants jockey for position to acquire a
16 share of the new multi-billion dollar per year market for competitive power. In
17 Massachusetts, California and Maine, where auctions of utility generation assets
18 and purchase power contracts have been held, the sales proceeds have
19 exceeded the underlying book value of the resources sold by wide margins. For
20 instance, Southern California Edison has recently selected winning bidders for its
21 sale of over 7500 MW of gas-fired generation plants and garnered a sales price
22 2.65 times the book value of the plants in aggregate. Pacific Gas & Electric also
23 selected a winning bidder for three of its California plants that agreed to pay a
24 price 30% higher than book value. In Massachusetts, New England Electric
25 System sold over 5000 MW of fossil-fuel and hydroelectric facilities for 45% over
26 book value. Recently, Central Maine Power selected the winning bidder in its sale
27 of 1185 MW of generation that offered 3.5 times book value. Part of the reason
28 these premiums have been earned is linked to investors' expectations about profit

1 potential inspired by the newness of the market opportunity. Coupled with a
2 robust competitive bidding process, these expectations can contribute to higher
3 prices in the auction process. Reports in industry periodicals suggest that
4 divestiture will be good for utilities that undertake it in the near-term. Arizona
5 remains on the leading edge of industry restructuring nationwide. Arizona can
6 secure these advantages if it quickly adopts Citizens' auction approach to
7 stranded cost valuation.

8
9 Q. Please explain other advantages of a rapid transition to open competition.

10 A. Administrative approaches to stranded cost valuation will likely require time-
11 consuming, litigious, and expensive true-up proceedings for many years into the
12 future. In addition to the continuing expense, ongoing regulatory involvement in
13 the process will create motivations for gaming and could undermine investor
14 confidence. Under Citizens' approach, no true-up mechanisms or proceedings
15 are needed. In short, it will bring true open competition to the power supply
16 industry "overnight," and disentangle the Arizona power supply industry from any
17 further encumbrance of price regulation.

18
19 Q. What is horizontal market power and how does Citizens' approach reduce its
20 potential?

21 A. Horizontal market power in the power production chain could result if a limited
22 number of market participants controlled a majority of the competitive resources,
23 thereby resulting in barriers to entry to new market players or too few market
24 participants. While bringing a number of other benefits, Citizens' approach can
25 effectively eliminate potential horizontal market power that may be held by existing
26 Affected Utilities. Whether this is an issue in Arizona is a judgment the
27 Commission must make.

28

1 Q. Did the Stranded Cost Working Group Report cite disadvantages to Citizens'
2 auction approach.

3 A. Yes, it did. However, all of those cited are avoidable or not valid.
4

5 Q. What were the disadvantages cited?

6 A. In summary they were:

- 7 • Administration costs
- 8 • Potential for "fire sale" prices
- 9 • Uncertainty about number of bidders
- 10 • Administrative hurdles
- 11 • Lack of Commission authority
- 12 • Inaccurate estimates of stranded costs
- 13 • Limited bidders for nuclear facilities
- 14 • FERC rules already limit market power
- 15

16 Q. Are the administrative costs of Citizens' approach a valid issue?

17 A. No. Citizens' approach, while requiring some up-front administrative work to
18 arrange the auction and refinancing processes, would be inexpensive compared
19 to administrative methods for valuation which will inevitably involve multiple parties
20 litigating over the "correct" forecast of market prices initially and during
21 subsequent true-up proceedings.
22

23 Q. Isn't it true that a sale of assets within a short time frame could lead to "fire sale"
24 prices and potentially not attract many bidders?

25 A. In theory, yes, however, controlling the timing of the sale can avoid these potential
26 pitfalls. For instance, conducting the auction in stages over some span of time or
27 scheduling to avoid overlap with similar activities in nearby states are two obvious
28 ways to mitigate these concerns. Further, the experiences in other jurisdictions
29 has been the opposite -- bidding has been robust and prices have exceeded book
30 values.

1 Q. What are the administrative hurdles presented by Citizens' proposal?

2 A. The Stranded Cost Report characterizes as "tremendous" the administrative
3 hurdles such as unwinding current power supply contracts, soliciting stockholder
4 approvals, and obtaining releases of mortgaged property from bond trustees.
5 These issues no doubt will be challenging. But, Arizona need not re-invent the
6 wheel. These issues have been successfully resolved in other states. The
7 restructuring of the electric industry does present some "tremendous"
8 administrative hurdles that will require innovation and creativity to overcome,
9 however Arizona can piggyback on these pioneering states' experience.

10

11 Q. Does the Commission lack authority to order asset sales and divestiture?

12 A. Under Citizens' approach it does not matter if the Commission has such authority
13 or not; participation in the auction is voluntary. Utilities who want to enter the
14 competitive market with the power resources they hold are free to do so.

15

16 Q. Isn't it true that marketplace uncertainty may lead to inaccurate forecasts of
17 stranded cost estimates by bidders?

18 A. Yes, it may. However, as I've previously discussed, Citizens' proposal would shift
19 a large portion of the risk to the market from the customers, so this is an
20 advantage, not a disadvantage. Further, future price risk is a given in any
21 competitive market. Billions of dollars are traded daily by investors based on their
22 own imperfect, (and often inaccurate) forecasts of future prices. The risk to avoid
23 is under-valuation based on an overall expectation of low future prices. Two ways
24 to mitigate this risk are through timing and use of floor prices. As I have
25 described, holding the auction while the market is still in transition may very well
26 lead to higher prices than could otherwise be obtained. Also, while overly
27 restrictive terms and conditions in the auction process should be avoided, the use

1 of floor prices for the auctioned assets would limit downside risk. The floor price
2 could represent, for instance, that price that would lead to the highest acceptable
3 level of stranded cost.

4
5 Q. Isn't it true that the field of potential bidders would be limited for nuclear facilities?

6 A. It is true that there will likely be fewer qualified bidders for nuclear facilities than for
7 other generation sources, but that does not mean that an adequate number of
8 bidders would not be available. Given the number of nuclear facilities across the
9 country, there are a number of qualified parties (e.g. unregulated affiliates of
10 electric utilities) who potentially may bid. San Diego Gas & Electric recently
11 announced plans to divest its holdings in the San Onofre Nuclear Generation
12 Station. It will be telling to monitor the number of qualified bidders who participate
13 in that bid process. Further, nuclear asset auctions could be separately
14 administered or the assets could even be left out of the auction process.

15
16 Q. Is it true that the FERC open-access transmission rules sufficiently mitigate the
17 potential for utilities to exercise market power in generation, thereby rendering
18 moot a perceived key benefit of auctions?

19 A. Perhaps, but that is a judgment that the Commission must make. Apparently, the
20 California Public Utilities Commission concluded otherwise – at least in the case of
21 Southern California Edison and Pacific Gas & Electric – who were requested to
22 divest (and both complied) at least half of their generating capacity to mitigate
23 market power.

24

1 Q. What are the implications of the Statement of Financial Accounting Standards
2 (SFAS) No. 71 resulting from Citizens' stranded cost valuation and recovery
3 methodology?

4 A. I am not an accountant, but will provide my basic understanding. With respect to
5 generation-related assets, Citizens' approach can effectively avoid the potentially
6 onerous financial issues raised by SFAS 71 (and the related statements, SFAS
7 101 and 121) in association with the valuation and recovery of stranded costs.

8
9 Q. Why is this so?

10 A. This is so because Citizens' approach avoids the need for utilities to continue to
11 carry above-market generation assets on their books. When utilities face the loss
12 of their categorization as a "regulated enterprise" as a result of the deregulation of
13 the electric industry, they are faced with writing off all regulatory assets and
14 liabilities (under SFAS 101). To the extent a utility retains above-market
15 generation based on a regulatory order stating it is entitled to recover the above-
16 market portion through rates, its financial future is predicated upon a regulatory
17 asset. Under Citizens' approach, that regulated utility would have divested its
18 interest in the generation assets (at book value), so the issue becomes moot.

19
20 Q. What about existing regulatory assets like deferred DSM costs?

21 A. Under Citizens' approach, utilities would receive from the IRFD the current value
22 of existing regulatory assets. These amounts would be included in the statewide
23 IRFD stranded cost pool that would ultimately be refinanced with State bonds or
24 legislatively-backed corporate bonds. In this way, the potential write-off of these
25 amounts under SFAS 71 and 101, which would likely result from use of an
26 administrative approach, would be avoided under Citizens' approach.

27

1 **3. COMMISSION QUESTION NUMBER NINE**

2 **WHAT FACTORS SHOULD BE CONSIDERED FOR MITIGATION OF**
3 **STRANDED COSTS?**

4
5 Q. Is it possible to create a finite list of "every feasible, cost-effective measure" that
6 utilities must take to mitigate stranded costs?

7 A. No. In all probability, such a list of measures could not be created. The ability to
8 mitigate stranded costs depends entirely on the particular circumstances of each
9 utility. It is improbable that a list of *every* possible option that addresses the
10 individual circumstances of each utility could be reasonably prepared. For
11 instance, in the case of utilities, like Citizens, with strandable long-term purchased
12 power agreements, no one could list every conceivable negotiating strategy or
13 option that may be used to re-negotiate agreements.

14
15 Q. What does this imply concerning the current standard in the Rule that the
16 "Affected Utilities shall take every feasible, cost-effective measure to mitigate or
17 offset Stranded Costs..."

18 A. The standard that *every* measure be taken is not achievable. It would always be
19 possible to demonstrate a new "twist" that was not pursued.

20
21 Q. What standard should be applied?

22 A. In this instance, where the Commission has found that the existing investments or
23 costs are reasonable for setting utility rates, the burden of proof for non-recovery
24 of these costs must be placed on the party that is recommending the non-
25 recovery. While Affected Utilities should be required to vigorously pursue
26 reasonable means to mitigate stranded costs, as a result of the regulatory
27 compact, the Affected Utilities must be given the starting point that unmitigated

1 amounts are recoverable. That is, unmitigated stranded costs would be deemed
2 fully recoverable unless a party could demonstrate the Affected Utility did not
3 make reasonable mitigation efforts.

4
5 Q. How should the Commission judge the reasonableness of mitigation efforts?

6 A. Each Affected Utility should make a showing of all mitigation measures it has
7 taken, the results of those measures, and an explanation of measures considered
8 but rejected. The burden of proof that the Affected Utility in fact did not make
9 adequate mitigation efforts would fall on the party seeking denial of full recovery of
10 the stated level of unmitigated stranded costs. The Commission should judge the
11 reasonableness of a utility's mitigation efforts by the weight of the evidence that
12 there are additional mitigation measures that could have been reasonably
13 implemented, and/or that the utility failed to fully pursue the measures it selected.
14 The party seeking denial must be prepared to show that the actions it proposes
15 had a reasonable chance of succeeding and would have resulted in greater
16 mitigation than achieved by the Affected Utility.

17
18 Q. What is the key distinction here?

19 A. The key distinction is that the burden of proof is on the party seeking denial of full
20 recovery, not on the utility to demonstrate it has taken every measure possible. It
21 is not sufficient for a party to simply identify a possible mitigation alternative not
22 taken as the basis for denial of recovery. It must also prove that the alternative
23 could be reasonably implemented.

24
25 Q. Regarding the considerations contained in the Rules under R14-2-1607(I), can the
26 Commission properly employ these considerations to limit, or in effect "mitigate"
27 the magnitude of stranded costs that are recoverable by Affected Utilities?

1 A. No. As I have stated earlier, the Commission would cause confiscatory earnings
2 levels, if it employed any of the listed considerations in determining the amount of
3 stranded costs that would not be recoverable by an Affected Utility. Certain of
4 these considerations could properly be employed to determine the design of the
5 stranded cost recovery mechanism, but not the total amount recoverable.
6

7 **4. COMMISSION QUESTION NUMBER TWO**

8 **WHEN SHOULD AFFECTED UTILITIES BE REQUIRED TO MAKE A**
9 **STRANDED COST FILING PURSUANT TO A.A.C. R14-2-1607?**

10
11 Q. When does Citizens believe stranded cost filings should be made?

12 A. Stranded cost filings should not be required until well after the rules governing the
13 introduction of competition into the Arizona electric industry have been finalized.
14 Through its Decision No. 60351, the Commission set in motion a process to, in
15 effect, re-visit approved rules A.A.C. R14-2-1601 through R14-2-1616. The
16 decision to do so was, in part, based on allowing consideration of the findings of
17 the various working groups that have submitted reports on their activities and
18 recommendations. A review of these reports shows that a host of issues
19 concerning electric competition remain to be resolved. Further, the present
20 hearings will provide additional evidence for the Commission to consider. Until the
21 Commission reviews all the evidence and provides further guidance, it is simply
22 not possible for Affected Utilities to make responsive stranded cost filings. Once
23 the Rules have been established with finality, Affected Utilities should be allowed
24 a reasonable opportunity to consider the impact of the changes that have been
25 made, and to restructure their businesses accordingly. Not knowing the scope of
26 changes to the Rules that may be made, Citizens does not have a specific
27 recommendation for what span of time would be appropriate, but would suggest
28 that it should reflect the extent of the changes made.
29

1 Q. How does the need to finalize the Rules affect the date to implement electric
2 competition in the current Rules?

3 A. The time needed to resolve the stranded cost issues (not to mention the host of
4 other yet-resolved issues identified in the working group process) could well
5 absorb most of the time remaining before the Rules' January 1, 1999,
6 implementation date. Citizens encourages the Commission to act quickly to set a
7 more realistic date for initiating electric competition.

8
9 Q. What should be the schedule to implement open competition?

10 A. Citizens favors starting competition for a manageable number of large commercial
11 and industrial customers (for instance those with loads exceeding 3 MW) as soon
12 as practicable, and to "flash-cut" to open competition for the remainder of
13 customers at a later time, for instance in 2000 or 2001. This schedule would allow
14 for the orderly resolution of stranded cost issues, the Commission's
15 reconsideration of other aspects of the Rules, and the resolution of the other
16 administrative/logistical issues raised by the working groups.

17
18 **5. COMMISSION QUESTION NUMBER SIX**

19 **HOW AND WHO SHOULD PAY FOR STRANDED COSTS AND WHO, IF**
20 **ANYONE, SHOULD BE EXCLUDED FROM PAYING STRANDED COSTS?**
21

22 Q. Who should pay for stranded costs?

23 A. Citizens generally supports the consensus position of Stranded Cost Working
24 Group that all customers should pay for stranded costs and that the charge to
25 standard offer customers should account for contributions that are already being
26 made toward stranded costs. However, the Rules' Competitive Phases create a
27 significant equity issue.

1 Q. What equity issue is created?

2 A. The Competitive Phases included in the current Rule will create two classes of
3 customers: those who can choose their supplier and those who can not. It would
4 not be equitable to charge stranded cost fees to customers who can not
5 participate in the competitive market. Citizens agrees with the argument that
6 recovering stranded costs from all customers will shorten the needed recovery
7 time frame – a desirable outcome. This is all the more reason for eliminating
8 Competitive Phases in favor of a “flash-cut” to open competition at a later date,
9 after matters are resolved and adequate preparations are made.

10

11 Q. How should stranded costs be recovered?

12 A. Stranded costs should be recovered through a non-bypassable charge levied by
13 the LDC that remains regulated. This charge should be uniform across all
14 Affected Utilities and be levied over a consistent time frame.

15

16 Q. Why is establishing a uniform stranded recovery charge good policy for Arizona?

17 A. The restructuring of the electric industry should not result in economic disparities
18 across Arizona as a result of the resources acquired under regulation. Moving to
19 open competition by electric suppliers fundamentally alters the rules and
20 regulations under which the electric utility industry has operated. Given that this
21 fundamental rule change will potentially affect all Arizona electric customers, it
22 stands to reason that the costs for this change (stranded costs) should be born
23 equally by all Arizona electric customers across the State without regard to service
24 area. This is why Citizens’ proposes to conduct a state-level generation asset
25 sale, pool stranded costs, and recover them on a uniform basis statewide.

26

1 Q. How would stranded cost recovery fees be established under Citizens' proposal?

2 A. Stranded costs would be recovered using a flat monthly charge (i.e. not tied to
3 kWh or kW consumption) based on historic usage levels. Thus, for example,
4 residential customers using 0 to 5000 kWh/year would pay, say \$5/month, while
5 customers who historically have used 5001 to 10,000 kWh/year would pay
6 \$10/month, etc. These charges would be established based on the total statewide
7 stranded costs and the distribution of usage levels by customers across the state.
8 Customers with identical historical usage levels would pay the same stranded cost
9 charge (over the same time frame) whether located in APS', TEP's, Citizens', or
10 any other Affected Utility's service area. On a forward-going basis, flat charges for
11 stranded costs would be the least distorting because they would not affect the
12 marginal cost for electricity and, therefore, consumption or production decisions.

13
14 Q. Should anyone be excluded from paying stranded costs?

15 A. No. All customers served by the LDC of Affected Utilities should pay for costs
16 stranded by the restructuring of the industry.

17
18 **6. COMMISSION QUESTION NUMBER FOUR**

19 **SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH**
20 **STRANDED COSTS ARE CALCULATED?**

21
22 Q. Does Citizens support a limitation on the time frame over which stranded costs are
23 calculated?

24 A. In general, no. The calculation time frame over which stranded costs are
25 calculated must be consistent with the remaining service lives for generation
26 assets, the remaining contract term for purchased power contracts, and the
27 remaining amortization period for regulatory assets to allow for full recovery of

1 stranded costs. Anything short of this would result in denial of full stranded cost
2 recovery. On this issue, Citizens concurs with the findings in the report of the
3 Stranded Cost Working Group.
4

5 **7. COMMISSION QUESTION NUMBER FIVE**

6 **SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR**
7 **STRANDED COSTS?**
8

9 Q. Does Citizens support a limitation on the period over which stranded costs are
10 recovered?

11 A. Yes, but a time frame for recovery can only be established by balancing the goals
12 of achieving the shortest possible recovery period and minimizing the impact on
13 rates. Citizens does not support arbitrarily setting a recovery time frame without
14 considering the magnitude of the resulting economic impacts. Under
15 administrative approaches with true-up mechanisms, it would be impossible to
16 establish up-front a time frame that balances these goals because the full extent
17 of stranded costs would not be known. However, under Citizens' approach, where
18 stranded costs are determined up-front with finality, it would be possible to
19 calculate the rate impact as a function of time frame and make a reasoned
20 decision about the appropriate length of the recovery period. Further, under
21 Citizens' recovery proposal, where stranded costs are pooled statewide, there
22 would be a uniform recovery charge for a pre-determined period that is the same
23 across the State. This feature would eliminate the creation of economic disparities
24 across Arizona depending on the stranded costs of the local utility.
25

1 **8. COMMISSION QUESTION NUMBER EIGHT**

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

5
6 Q. Should there be price caps or a rate freeze imposed as part of the development of
7 a stranded cost recovery program?

8 A. Citizens opposes any price cap or rate freeze that results in a *de facto*
9 disallowance of unmitigated stranded costs. For the variety of reasons I have
10 given earlier in my testimony, utilities must be provided a reasonable opportunity
11 for full recovery of unmitigated stranded costs.

12
13 **9. COMMISSION QUESTION NUMBER SEVEN**

14 **SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO, HOW WOULD IT**
15 **OPERATE?**

16
17 Q. Does Citizens' stranded cost recovery proposal incorporate a true-up mechanism?

18 A. No. No true-up mechanism is needed under Citizens' proposal. Stranded costs
19 are determined at the outset of competition and no further adjustments are made.
20 The true-up mechanisms envisioned under administrative approaches will
21 inevitably trigger contentious litigation and in effectively prolong the regulation of
22 power supply.

23
24 Q. Does that conclude your testimony?

25 A. Yes, it does.
26
27
28
29
30