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20 January 1998

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Docket Control Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

Attn: Docket Control Clerk

Re: Docket No. U-0000-94-165
Competition in the Provision of Electric Services
Throughout the State of Arizona

Dear Sir/Madam:

In accordance with the Third Amended Procedural Order, enclosed are the original and ten copies of the testimony and exhibits of Ralph C. Smith and the testimony of Dan L. Neidlinger on behalf of the Department of Defense and all other Federal Executive Agencies in the matter referenced above.

Yours truly,

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Enclosures: as stated

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
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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

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing testimony and exhibits of Ralph C. Smith and testimony of Dan L. Neidlinger on all parties of record in this proceeding by mailing a copy thereof, properly addressed with first class postage prepaid to:

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Dated at San Bruno, California, this 20th day of January 1998.

Monica N. Johnson

Mónica N. Johnson, Secretary

ARIZONA CORPORATION COMMISSION

In the Matter of Competition in the Provision of Electric Services Throughout Arizona

Docket No. U-0000-94-165

Summary of the Testimony of Ralph C. Smith
On Behalf of the Department of Defense and All Other Federal Executive Agencies

Mr. Smith's testimony addresses Issues 1-5 and 7-9 of the Chief Hearing Officer's Original Procedural Order, dated December 1, 1997. Mr. Smith's overall recommendations are:

- The Electric Competition Rules should be modified to reflect the Commission's findings in this proceeding. Mr. Smith also recommends two specific modifications: (a) one to explicitly link the recovery of stranded costs to the introduction of competition, and (b) one to provide for an explicit date by which Affected Utilities must file estimates of unmitigated stranded costs.

- The Affected Utilities should be required to make a stranded cost filing by April 30, 1998.

- R14-2-1601(8) provides a reasonable definition of stranded costs, and the amount of stranded costs should be calculated based upon the difference between (a) book or embedded cost and (b) market value. Certain items should be specifically excluded from stranded costs.

- Certain standards should be considered in assessing market valuation.

- A limitation should be placed on the time frame over which stranded costs are calculated.

- The recovery time frame for stranded costs should be limited to a range of four to six years.

- True-ups, if allowed, should be limited to correcting for significant mis-estimates of stranded costs during the period the Commission finds appropriate for recovery.

- A price cap or rate freeze should be imposed on the Affected Utilities.

- The current rates being charged by the affected utilities should be unbundled into component parts, with a component for stranded costs.

- Mr. Smith provides a number of examples of sources of stranded cost mitigation.

- Incentives for the Affected Utilities to mitigate stranded costs should be built into the recovery mechanism.

Docket No: U-0000-94-165
Exhibit No: FEA-1
Witness: R.C. Smith

BEFORE THE
ARIZONA CORPORATION COMMISSION

In the Matter of the Competition
In the Provision of Electric Services
Throughout the State of Arizona

TESTIMONY AND EXHIBITS

OF

RALPH C. SMITH

ON BEHALF OF THE DEPARTMENT OF DEFENSE
AND ALL OTHER FEDERAL EXECUTIVE AGENCIES

Filed
January 21, 1998

DIRECT TESTIMONY OF FEA WITNESS RALPH C. SMITH

TABLE OF CONTENTS

Introduction

Q. Please state your name and business address.

A. Ralph C. Smith, 15728 Farmington Road, Livonia, Michigan 48154.

Q. What is your occupation?

A. I am a certified public accountant and a senior regulatory utility consultant with the firm of Larkin & Associates, a firm of certified public accountants and regulatory consultants.

Q. What is your educational background and professional experience?

A. Appendix I, attached hereto, is a summary of my experience and qualifications.

Q. Have you appeared previously before this Commission?

A. Yes. I have appeared before this Commission on several occasions. A listing of the cases in which I have appeared before this Commission is included in my qualifications, attached as Appendix I.

Q. On whose behalf are you appearing?

A. My firm is under contract with the Navy Rate Intervention Office of the United States Department of the Navy to perform utility revenue requirement studies. In this proceeding, I am testifying for the Navy on behalf of the Department of Defense and all other Federal Executive Agencies (FEA).

Q. Please describe the tasks you performed related to your testimony in this case.

A. I reviewed the Arizona Electric Competition Rules (ECR) and the Stranded Cost Working Group's Report that was filed with the Commission on October 1, 1997.

Q. Have you participated in electric utility industry restructuring and stranded cost proceedings in other jurisdictions?

A. Yes. I have submitted testimony in electric utility industry restructuring and stranded cost proceedings in California and Pennsylvania.

Discussion of Issues

Q. What issues will you be addressing in your direct testimony?

A. My testimony addresses the following issues:

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

Q. How is the remainder of your testimony organized?

A. It is organized by issue. In each section, I discuss one of the above-identified issues.

1. Should the Electric Competition Rules be modified regarding stranded costs, and, if so, how?

Q. Should the Electric Competition Rules be modified regarding stranded costs, and, if so, how?

A. Yes. The Rules should be modified, consistent with the Commission's findings in this proceeding. I specifically recommend that the Rules should be modified to explicitly link "stranded cost" recovery to the introduction of retail electric generation competition. I suggest this be accomplished by adjusting R14-2-1607(B) to read as follows:

> *As an integral part of the introduction of retail electric generation competition in Arizona*, the Commission shall allow the Affected Utilities an opportunity to recover unmitigated Stranded Cost.

Q. At this time, do you have any other specific modifications to the Rules?

A. Yes. Consistent with the discussion below under issue no. 2, R14-2-1607(G) should be modified to provide for an explicit date in the near future to indicate when the estimates from the Affected Utilities of their unmitigated Stranded Costs are required to be filed. Accordingly, I propose the following language for R14-2-1607(G):

> The Affected Utilities shall file estimates of unmitigated Stranded Cost *no later than April 30, 1998*. Such estimates shall be fully supported by analyses and by records of market transactions undertaken by willing buyers and sellers.

The April 30, 1998 date will have allowed the Affected Utilities sixteen months in which to compile their information since the Commission's issuance of Decision No. 59943 on December 26, 1996. While the Commission may decide upon a different date, it should be stressed that this information is needed and should be provided by the Affected Utilities as soon as possible.

2. When should "Affected Utilities" be required to make a "stranded cost" filing pursuant to A.A.C. R14-2-1607?

Q. When should "Affected Utilities" be required to make a "stranded cost" filing pursuant to A.A.C. R14-2-1607?

A. The Affected Utilities should be required to make a stranded cost filing pursuant to A.A.C. R14-2-1607 as soon as possible. A.A.C. R14-2-1607(C), (D) and (E) provided for the establishment of the Stranded Cost Working Group, and identified the issues it was supposed to address and the time frame for reporting. Many of the factors identified in R14-2-1607(D), such as the impact of stranded cost recovery on prices paid by consumers who participate in a competitive market and the degree to which some assets have values in excess of their book values, cannot be addressed without estimates from the Affected Utilities of their unmitigated stranded costs. R14-2-1607(G) specifies that: "The Affected Utilities shall file estimates of unmitigated Stranded Costs. Such estimates shall be fully supported by analyses and by records of market transactions undertaken by willing buyers and willing sellers." Ideally, the Affected Utilities would have provided their estimates of unmitigated stranded costs for consideration by the Stranded Cost Working Group so that all of the factors identified in R14-2-1607(D) could have been addressed, at least in some preliminary manner, by that Group. However, the Affected Utilities' estimates were not provided, and the Group's report indicates that a number of these factors were, therefore, effectively not considered. In R14-2-1604, the Commission has established a fairly aggressive schedule for the introduction of electric competition in Arizona, with the first phase to begin in 1999 and with full competition to begin in 2003. Customers and the utilities should have information on the amounts of stranded cost charges from the Affected Utilities at the earliest date possible. Such information will be influential in

customers' decisions in the purchase of electricity. All of this argues in favor of having the Affected Utilities file their estimates of unmitigated stranded costs as soon as possible. As noted above, under the discussion of issue no. 1, I recommend that the Affected Utilities be required to make these filings by April 30, 1998.

3. What costs should be included as part of "stranded costs" and how should those costs be calculated?

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

A. R14-2-1601(8) provides that "stranded cost" means the verifiable net difference between:

a. The value of all the prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchased power contracts, fuel contracts, and regulatory assets), acquired or entered into prior to the adoption of this Article, under transition regulation of Affected Utilities, and

b. The market value of those assets and obligations directly attributable to the introduction of competition under this Article.

In my opinion, this is a reasonable definition of stranded costs, and provides guidance as to what should be included. Unmitigated costs associated with electric generating plants, purchased power contracts, fuel contracts, and regulatory assets that are in excess of their corresponding market value represent stranded costs that would be recoverable as such by the Affected Utilities.

Q. How should those costs be calculated?

A. The amount of stranded costs should be calculated based upon the difference between (a) book or embedded cost and (b) market value.

To determine the book or embedded cost for balance sheet items, such as generating plant and regulatory assets, the Affected Utility's accounting records should provide the

relevant information. For example, the net book value of an Affected Utility's generating plant should be ascertainable from an examination of its accounting records. Similarly, the book value of an Affected Utility's regulatory assets, should also be ascertainable from its accounting records. The relevant amounts for generating plant and regulatory assets are found in the utility's balance sheet accounts. Some amounts, such as those for generating plant in service and regulatory assets should be identifiable with relative ease. Depending upon the level of detail maintained by the utility, it is possible that the accumulated depreciation related to the generating plant will also be easy to identify. This will be the case if the utility has maintained details for its accumulated depreciation balance by plant account.

Identifying the Affected Utilities' embedded costs associated with purchased power and fuel contracts will likely involve an examination of the terms of those contracts. A long-term contract for purchased power or fuel will typically involve a series of payments over time, but may also include terms that can vary, such as the quantity purchased, or price terms that can vary, depending upon a number of factors, such as an inflation index or pre-specified benchmark. Because such contracts involve a stream of future payments, the application of a discounted cash flow type of analysis could be applied to produce an equivalent present value. Under such analysis, the present value is dependent not only upon the amounts and timing of the cash payments, but also upon the discount rate selected. Therefore, the selection of an appropriate discount factor will need to be addressed.

Q. Please discuss methods for determining the market value of those assets and obligations.

A. Perhaps the best indication of market value is the sales price resulting from a transaction between independent and willing buyers and sellers not acting in haste or under duress, i.e., free market sales. Another fundamental valuation approach, particularly where comparable sales are not available, is appraisal. California's electric restructuring statute (AB 1890), for example, provides for both forms of valuation: divestiture of generation assets (i.e., sales), and appraisals of the value of retained assets. A sale is one method of determining the valuation. However, whereas a sale in an arms' length transaction between unrelated parties may constitute a good indication of fair market value, a sale between related parties at less than arms' length may not represent a reliable valuation. Additionally, different appraisers are likely to derive different appraised values.

Q. Does the Arizona ratemaking process typically result in a determination of the "fair value" of the utility's rate base?

A. Yes, it does, although the term "fair value" as it has been used in Arizona rate proceedings does not appear to be synonymous with the term "market value" as used in R14-2-1601(8)(b). It has been my experience that, in rate proceedings, the "fair value" rate base has typically been determined by applying some type of plant inflation index (e.g., the Handy-Whitman index) to book plant values to determine a Reconstruction Cost New Depreciated (RCND) value. Then, an averaging process of the original cost and RCND information has been employed to derive the "fair value" rate base. Therefore, while the RCND information that has historically been used by utilities in their rate cases may provide one source of information concerning the value of their utility plant, it does not seem that undue reliance should be placed upon this type of information to determine

"market value" for stranded cost identification purposes.

Q. What standards and principles do you suggest should be used to determine whether the market valuations are fair and equitable?

A. I suggest standards and principles such as the following be considered in assessing valuation issues:

1) Whether the sale is between independent parties who are not acting under duress.

2) Whether the valuation reasonably compares with prices received for similar assets in other sales.

3) Whether the appraisals are independently prepared and based upon reasonable assumptions.

4) In establishing the value of a multi-year contract of a long-lived asset, whether the valuation should consider data for a comparative period.

5) If the transaction involves a series of cash receipts or cash payments, whether the valuation amount compares to the net present value result produced by a discounted cash flow analysis.

6) Whether the asset being valued (e.g., land, buildings, vehicles) is subject to other uses.

7) Whether long-lived assets should be subject to different valuation measures than short-term assets.

8) Whether the valuations occurring at the Affected Utilities for similar assets are reasonably consistent with each other.

9) Whether the competitive market prices for generation are subject to significant variability over time, and, if so, whether an average rate should be employed for

valuation purposes, and how to select the period for applying an average market rate.

10) Whether the valuation appropriately took the tax effects into consideration.

Q. Of the methods for the determination of "stranded costs" discussed in the Stranded Cost Working Group's Report, do you have a preference?

A. Yes. I recommend that the Commission use the Replacement Cost Valuation method, which the Report (p.22) indicates is being advocated by industrial consumers and others. I also believe that there is substantial merit to the Auction and Divestiture approach; however, that approach may not be feasible for use in Arizona if, as noted in the Report (p.25), the Commission lacks authority to order asset sales and divestitures.

Q. What costs should <u>not</u> be included as part of "stranded costs"?

A. This issue will have to be addressed specifically by the Commission once the Affected Utilities file their claims for stranded costs. However, as general principles which may help define the issue of what is and is not properly included as a "stranded cost" I offer the following guidance for items that should <u>not</u> be accorded recovery by the Affected Utilities as "stranded costs":

- Costs that could have, or should have, been mitigated should not be permitted for "stranded cost" recovery.

- Costs that have traditionally been disallowed by this Commission in rate proceedings should not be eligible for stranded cost recovery.

- Costs for generation added by the Affected Utilities after they were made aware that the market for electric generation would become competitive should not be eligible for stranded cost recovery unless the Affected Utilities can prove that such costs represented unavoidable commitments made prior to the date they became aware of the oncoming competition, or that such additions are cost-justified based upon reasonable expectations of competitive market prices.

- Stranded cost recovery should not be permitted for costs that are not appropriately related to the Affected Utilities' generation function.

- Stranded cost recovery can include accelerated depreciation for uneconomic generation-related assets, but should not include any depreciation associated with the write-down of these assets below fair market value.

- To preserve and promote competitive neutrality, the Affected Utilities should not receive stranded cost recovery for their current variable costs where competitive generators are required to recover similar costs only from the market price of electricity.

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

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

A. Yes. There should be a limitation on the time frame over which "stranded costs" are calculated. For example, the stranded cost calculation should not extend beyond the current remaining lives of the generating plants that are being stranded, other than perhaps to consider the cost of removal and decommissioning. Similarly, the time frame over which "stranded costs" are calculated for purchased power and fuel contracts should not extend beyond the terms of those contracts. Nor should the currently applicable recovery periods for regulatory assets be extended.

5. Should there be a limitation on the recovery time frame for "stranded costs"?

Q. Should there be a limitation on the recovery time frame for "stranded costs"?

A. Yes. R14-2-1604 provides for full competition for electric generation to begin in 2003, with the first phase of such competition beginning in 1999. This represents a four-year "transition" period. Depending upon the size of each Affected Utility's stranded costs that are found appropriate by this Commission, I would recommend a recovery period in the

range of four to six years. At the expiration of this recovery period, the "stranded cost" charge would terminate, and the Affected Utilities would recover their generation-related costs solely through the market price for generation. This recovery period would occur in conjunction with having the rates of the Affected Utilities capped at current levels, as discussed below under issue no. 8.

6. How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying for stranded costs?

Q. How and who should pay for "stranded costs" and who should be excluded from paying?

A. This issue is being addressed by Mr. Dan L. Neidlinger in an accompanying testimony.

7. Should there be a true-up mechanism and, if so, how would it operate?

Q. Should there be a true-up mechanism and, if so, how would it operate?

A. There is merit in a true-up mechanism. However, whether there is a need for some type of true-up mechanism would appear to be dependent upon the particular method selected by the Commission for stranded cost quantification and recovery. It is unlikely that reasonably accurate estimates of stranded costs would be available until reliable market price information exists. Because the valuation will, of necessity, be based upon estimates which could vary substantially from actual market prices, without some form of true-up, there is a danger that some of the affected parties could be either unjustly benefitted or hurt from the use of inaccurate estimates.

On the other hand, the potential for a later true-up introduces an element of price uncertainty into the electricity purchasing plans of customers, and could therefore interfere with the development of competition. Because of the potential for "true-up" adjustments,

customers are uncertain as to the price of electricity. Therefore, any true-ups should be limited to correcting for significant mis-estimates of stranded costs during the period that the Commission finds appropriate for "stranded cost" recovery. After that period expires, i.e., once there is effective competition, the price for electric generation should be based upon the market price, without the imposition of surcharges for true-ups of "stranded cost" recovery.

8. Should there be price caps or a rate freeze imposed as part of the development of a stranded cost recovery program and, if so, how should it be calculated?

Q. Should there be price caps or a rate freeze imposed as part of the development of a stranded cost recovery program and, if so, how should it be calculated?

A. Yes. The basic purpose of introducing retail competition for electric generation into this jurisdiction is to benefit consumers and give them the opportunity to save on their electric bills as the result of having available alternative suppliers operating in the market. Therefore, the introduction of competition should produce cost savings for consumers, and should not result in their rates for electric service being increased. To assure that all customers have an opportunity to benefit from electric competition, and to assure that no direct harm in the form of price increases occurs to any rate class, it would be appropriate and necessary to impose a price cap or rate freeze upon the Affected Utilities in conjunction with allowing them an opportunity for recovering stranded costs. Provided that it is recognized that the Affected Utilities should be in a declining cost situation during the next several years, the difference between their current rates — which would be capped at present levels — and their decreasing costs would represent the opportunity for their recovery of "stranded costs" resulting from the introduction of competition.

Q. How should this be accomplished?

A. The current rates being charged by the Affected Utilities should be unbundled into their component parts. One of those components would be a charge for "stranded cost" recovery. However, the overall rate being paid by each customer class would not increase, but rather would be capped at its present level under the rate freeze. This rate freeze should apply for the duration of the stranded cost recovery period.

9. What factors should be considered for "mitigation" of stranded costs?

Q. What factors should be considered for "mitigation" of stranded costs?

A. There is a wide range of factors to consider for mitigation of stranded cost. As provided in R14-2-1607: "The Affected Utilities shall take every feasible, cost-effective measure to mitigate or offset Stranded Cost by means such as expanding wholesale or retail markets, or offering a wider scope of services for profit, among others." Therefore, a review of the Affected Utilities' mitigation efforts is an important part of the stranded cost recovery process. As provided in the above-quoted rule, the mitigation measures must be cost-effective. I interpret this to mean that the mitigation measures undertaken by a utility must actually reduce its stranded costs. While it is not possible at this stage to identify all possible sources of stranded cost mitigation, the following list contains a number of examples. If feasible and cost-effective, the Affected Utility can attempt to:

- Renegotiate uneconomic purchase power and fuel contracts;
- Where uneconomic purchased power and fuel contracts contain cancellation or termination clauses, exercise such clauses to avoid incurrence of additional

uneconomic costs;

- Find other uses for assets;
- Retire uneconomic plant;
- Reduce overhead;
- Find new markets for its power;
- Explore other opportunities for services provided by its power generation work force;
- Spread overhead and administrative costs over a wider range of services;
- If authorized, securitize a portion of its "stranded costs" that are eventually authorized by the Commission for recovery, to reduce the net financial cost of such recovery;
- Structure the recovery of "stranded costs" to maximize tax deductions and result in the least cost to ratepayers;
- Accelerate depreciation on uneconomic plant;
- Accelerate the amortization of regulatory assets;
- Extend the life of economic plant;
- Sell assets that are of less value to the Affected Utility than to potential buyers;
- Accept a reduced return on common equity for the uneconomic generation-related assets that are being recovered through a "stranded cost" charge.

Q. Should incentives for the Affected Utilities to mitigate stranded costs be built into the stranded cost recovery mechanism?

A. Yes. It would be appropriate to provide the Affected Utilities with incentives to reduce

their stranded costs. Making the Affected Utilities responsible for some portion of their stranded costs would provide a direct financial incentive to them to reduce such costs. Another method of providing an incentive to the Affected Utilities to reduce stranded costs could involve allowing them to retain a portion of the cost savings, e.g., allowing the shareholders of the Affected Utilities to retain 10% of the cost savings produced by their renegotiation of fuel and purchased power contracts. A combination of these two forms of incentives could be employed to help motivate the Affected Utilities in their stranded cost mitigation efforts.

Q. Does that conclude your testimony?

A. Yes, it does.

APPENDIX I

RALPH C. SMITH

SUMMARY STATEMENT OF QUALIFICATIONS

- Mr. Smith's professional credentials include being a certified financial planner, a licensed certified public accountant and attorney. He functions as project manager on consulting projects involving utility regulation, regulatory policy and ratemaking and utility management. His involvement in public utility regulation has included project management and in-depth analyses of numerous issues involving telephone, electric, gas, and water and sewer utilities.

- Since 1979, as a regulatory consultant with Larkin & Associates (and its predecessor firm), Mr. Smith has been performing work in the field of utility regulation on behalf of industry, public service commission staffs, state attorney generals, municipalities, and consumer groups concerning regulatory matters before regulatory agencies in Alabama, Alaska, Arizona, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Kentucky, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New York, Nevada, North Carolina, Ohio, North Dakota, Pennsylvania, South Carolina, South Dakota, Texas, Canada, Federal Energy Regulatory Commission and various state and federal courts of law. He has presented expert testimony in regulatory hearings on behalf of utility commission staffs and intervenors on several occasions.

Previous Positions

- With Larkin, Chapski and Co., the predecessor firm to Larkin & Associates, was involved primarily in utility regulatory consulting, and also in tax planning and tax research for businesses and individuals, tax return preparation and review, and independent audit, review and preparation of financial statements.

- Installed computerized accounting system for a realty management firm.

Education

- Bachelor of Science in Administration in Accounting, with distinction, University of Michigan, Dearborn, 1979.

- Master of Science in Taxation, Walsh College, Michigan, 1981. Master's thesis dealt with investment tax credit and property tax on various assets.

- Juris Doctor, cum laude, Wayne State University Law School, Detroit, Michigan, 1986. Recipient of American Jurisprudence Award for academic excellence.

- Continuing education required to maintain CPA license and CFP certificate.

- Passed all parts of CPA examination in first sitting, 1979. Received CPA certificate in 1981 and certified Financial Planning certificate in 1983. Admitted to Michigan and Federal bars in 1986.

- Michigan Association of Certified Public Accountants.

- Michigan Bar Association.

- American Bar Association, sections on public utility law and taxation.

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

TESTIMONY OF DAN L. NEIDLINGER

On behalf of
The Department of Defense and All Other Federal Executive Agencies

January 21, 1998

ARIZONA CORPORATION COMMISSION

In the Matter of the Competition in the Provision of Electric Services Throughout Arizona
Docket No. U-0000-94-165

Summary of the Testimony of Dan L. Neidlinger on Behalf of the Department of Defense and all Other Federal Executive Agencies

Mr. Neidlinger's testimony is limited to Issue 6: "How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying stranded costs?". His recommendations on this issue are as follows:

1.) Stranded costs should be categorized as demand-related or energy-related and recovered through a combination of demand and energy charges to customers.

2.) Stranded costs should be allocated to customer classes based on sound cost of service principles.

3.) Except for self-generators, stranded costs should be recovered from all customers. The charges to standard offer customers should account for the contribution to stranded costs already embedded in standard offer rates.

4.) Customers with loads greater than one megawatt should be provided with an option to pay for their stranded costs through a one-time exit fee.

5.) All energy-related and a portion of demand-related stranded costs should be recovered from interruptible customers.

6.) Stranded costs should be allocated to special contract customers. Recovery of these costs would be a matter for negotiation between the customer and the utility.

ARIZONA CORPORATION COMMISSION

In the Matter of the Competition in the Provision of Electric Services Throughout Arizona
Docket No. U-0000-94-165

Direct Testimony of Dan L. Neidlinger

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Dan L. Neidlinger. My business address is 3020 North 17th Drive, Phoenix, Arizona. I am President of Neidlinger & Associates, Ltd., a consulting firm specializing in utility rate economics.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS AND EXPERIENCE.

A. A summary of my professional qualifications and experience is included in the attached Statement of Qualifications. In addition to the Arizona Corporation Commission ("ACC" or the "Commission"), I have presented expert testimony before regulatory commissions and agencies in Alaska, Colorado, Guam, Idaho, New Mexico, Nevada, Texas, Utah, Wyoming and the Province of Alberta, Canada.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the Department of Defense and all other Federal Executive Agencies. Installations that will be substantially affected by the Commission's decision in this proceeding include Davis-Monthan Air Force Base, Fort Huachuca, Luke Air Force Base and the Yuma Marine Air Station.

Q. DID YOU PARTICIPATE IN THE COMMISSION'S WORKSHOPS HELD IN 1997 ON STRANDED COST ISSUES?

A. Yes. I was a member of both the Calculation Methodologies Subcommittee and the Recovery Mechanisms Subcommittee on stranded costs. My participation in these committees was on behalf of Fort Huachuca.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony addresses Issue 6 of the Chief Hearing Officer's Original Procedural Order: "How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying for stranded costs?".

Q. ONCE STRANDED COSTS HAVE BEEN QUANTIFIED, HOW SHOULD THE RESPONSIBILITY FOR THESE COSTS BE ASSIGNED?

A. First, all stranded costs should be categorized as demand-related or energy-related to enable recovery of these costs in the same manner as they were originally incurred. Second, a jurisdictional allocation of these costs is required to identify retail and wholesale responsibility. Finally, a retail allocation of stranded costs among all classes of customers should be made using sound cost of service principles.

Q. WHAT ARE "SOUND COST OF SERVICE PRINCIPLES"?

A. Sound cost of service principles require that energy-related costs be allocated on loss-adjusted energy factors and that demand-related costs be allocated on valid demand allocation methods. If any portion of demand-related stranded costs are allocated on energy, customers with higher-than-average load factors will be assigned a disproportionate share of these costs.

Q. ARE THE RATES CURRENTLY CHARGED THE CUSTOMERS OF ARIZONA PUBLIC SERVICE ("APS") AND TUCSON ELECTRIC POWER COMPANY ("TEP") BASED ON EXPLICIT FINDINGS BY THE COMMISSION CONCERNING COST OF SERVICE?

A. No. The rates currently in effect for both APS and TEP are not based on specific customer class cost allocation methods explicitly approved in rate orders of the Commission. Recent rate adjustments for both companies have generally been "across-the-board" in nature due to rate settlements agreed to by the various parties and the Commission. Accordingly, little weight has been given to cost of service in the recent past in the setting of rates for the major classes of customers for APS and TEP.

Q. ARE THE COST OF SERVICE DEMAND ALLOCATION METHODS RECOMMENDED BY APS AND TEP IN RECENT RATE CASES SIMILAR IN NATURE?

A. No. The cost of service demand allocation methods recommended by APS and TEP in recent cases are radically different and, as shown on Exhibit DLN-1, if used to allocate demand-related stranded costs, would produce significant variances in allocations to customers with similar load characteristics. Accordingly, application of disparate demand allocation method among like utilities could result in discriminatory stranded cost recovery practices.

Q. HOW SHOULD DEMAND-RELATED STRANDED COSTS BE ALLOCATED?

A. The same demand allocation method should be used for utilities with similar load profiles. For APS and TEP, both with predominate summer peaks, a 4 month coincident peak ("4CP") method using the months of June through September would be appropriate. A 12CP method would be proper for those electric distribution utilities whose wholesale demand charges remain the same throughout the year.

Q. HOW SHOULD STRANDED COSTS BE RECOVERED?

A. Stranded cost charges should be recovered in the same manner in which they are calculated -- energy-related costs on a KWH basis and demand-related costs on a KW basis. Certain classes of customers, such as residential and small commercial, would pay stranded costs through a KWH charge.

Q. SHOULD EXIT FEES BE PERMITTED?

A. Yes. Exit fees should be an option for larger customers, those with loads exceeding one megawatt, that desire to extinguish their estimated total stranded cost obligation with one check. Exit fees should not be charged to customers that move out of the host utility's service area.

Q. WOULD THESE EXIT FEES BE SUBJECT TO ADJUSTMENT IF "TRUE-UP" PROCEEDINGS ARE ALLOWED?

A. No. Exit fees would not be subject to any adjustment, either up or down, due to true-up proceedings or changes in the customer's load.

Q. WHO SHOULD PAY FOR STRANDED COSTS?

A. With one exception, all customers should pay their fair share of stranded costs including those customers that elect to stay on standard offer rates. The charge to standard offer customers, however, should account for the contribution to stranded costs already embedded in standard offer rates.

Q. SHOULD THE STRANDED COST CHARGE TO CUSTOMERS WITHIN THE SAME CLASS BE THE SAME FOR CUSTOMERS ELECTING COMPETITION AS THAT CHARGED TO CUSTOMERS UNDER STANDARD OFFER RATES?

A. Yes. Charging different stranded cost amounts would not only be discriminatory but would impede the transition to a fully competitive market. Cross-subsidies, among classes of customers and within classes, exist to varying degrees in the present retail rate structures of all Arizona electric utilities. Assigning a different stranded cost charge to the customers electing competition than the charge assigned standard offer customers would merely perpetuate and exacerbate the cross-subsidy problem.

Q. WHAT IS THE EXCEPTION?

A. As a matter of policy, self-generators, both present and future, should not be assigned stranded costs. This is consistent with Section R 14-2-1607(J) of the currently adopted Rule. It would not be unreasonable, however, for utilities to recover a portion of their stranded costs from standby and supplementary power rates and charges to self-generators.

Q. SHOULDN'T INTERRUPTIBLE CUSTOMERS ALSO BE EXEMPT FROM DEMAND-RELATED STRANDED COSTS?

A. Interruptible customers should be exempt from any stranded costs associated with generating facilities or purchased power contracts designed to meet peak demands. In general, however, these customers should not be exempt from all other demand-related stranded costs or energy-related stranded costs.

Q. WHAT ABOUT SPECIAL CONTRACT CUSTOMERS?

A. Customers with special contracts subject to the jurisdiction of the Commission should receive the same allocation of stranded costs as all other, non-special contract customers. This is consistent with the cost of service treatment of these customers in recent rate proceedings. The amount of stranded costs collected from these customers would be a matter for negotiation between the customer and the utility.

Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

EXHIBIT DLN – 1

IN THE MATTER OF THE COMPETITION IN
THE PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA
Docket No. U–0000–94–165

Standed Cost Allocation Comparison
APS vs TEP Demand Allocation Methods

	Customer Class Demands		Allocation of $1 of Demand–Related Stranded Cost			
Customer Class	Average Demand	Coincident Demand – 4CP	APS Method (1)	Percent	TEP Method (2)	Percent
A	25	50	$0.50	50.00%	$0.45	45.00%
B	35	50	0.50	50.00%	0.55	55.00%
Total	60	100	$1.00	100.00%	$1.00	100.00%

NOTES:
(1) APS Demand Allocation Method – 4 Coincident Peak Method
(2) TEP Demand Allocation Method – Average & Peak Method

DAN L. NEIDLINGER

SUMMARY STATEMENT OF QUALIFICATIONS

I. General:

Mr. Neidlinger is President of Neidlinger & Associates, Ltd., a Phoenix consulting firm specializing in utility rate economics and financial management. During his consulting career, he has managed and performed numerous assignments related to utility ratemaking and energy management.

II. Education:

Mr. Neidlinger was graduated from Purdue University with a Bachelor of Science degree in Electrical Engineering. He also holds a Master of Science degree in Industrial Management from Purdue's Krannert Graduate School of Management. He is a licensed Certified Public Accountant in Arizona and Ohio.

III. Consulting Experience:

Mr. Neidlinger has presented expert testimony on financial, accounting, cost of service and rate design issues in regulatory proceedings throughout the western United States involving companies from every segment of the utility industry. Testimony presented to these regulatory agencies has been on behalf of commission staffs, applicant utilities, industrial intervenors and consumer agencies. He has also testified in a number of civil litigation matters involving utility ratemaking and once served as a Special Master to a Nevada court in a law suit involving a Nevada public utility.

Mr. Neidlinger has performed numerous feasibility studies related to energy management including cogeneration, self-generation, peak shaving and load-shifting analyses for clients with large electric loads. In addition, he has conducted electric and gas privatization studies for U. S. Army installations and assisted these and other consumer clients in contract negotiations with utility providers of electric, gas and wastewater service.

Mr. Neidlinger has extensive experience in the costing and pricing of utility services. During his consulting career, he has been responsible for the design and implementation of utility rates for over 30 electric, gas, water and wastewater utility clients ranging in size from 50 to 25,000 customers.

IV. Professional Affiliations:

Professional affiliations include the American Institute of Certified Public Accountants and the Association of Energy Engineers.