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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN  
COMMISSIONER-CHAIRMAN  
RENZ D. JENNINGS  
COMMISSIONER  
CARL J. KUNASEK  
COMMISSIONER

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

DOCKET NO. U-0000-94-165  
RE-00000C-94-0165

NOTICE OF FILING

Enrique Lopezlira hereby provides notice of filing of his direct testimony as required by the Commission's Fourth Amended Procedural Order, dated the 16th day of January, 1998, in the above-referenced docket.

RESPECTFULLY SUBMITTED this 21<sup>st</sup> day of January, 1998.

Arizona Corporation Commission  
DOCKETED

JAN 21 1998

GRANT WOODS  
Attorney General

DOCKETED BY *JH*

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

**JIM IRVIN  
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**IN THE MATTER OF THE COMPETITION IN )  
THE PROVISION OF ELECTRIC SERVICES )  
THROUGHOUT THE STATE OF ARIZONA )**

**DOCKET NO. U-0000-94-165**

**DIRECT TESTIMONY  
OF  
ENRIQUE A. LOPEZLIRA**

**TESTIMONY OF ENRIQUE A. LOPEZLIRA  
ON BEHALF OF ARIZONA ATTORNEY GENERAL'S OFFICE**

**TABLE OF CONTENTS**

A.	Introduction.....	1
B.	Summary of Testimony.....	2
C.	Responses to the Commission's Nine (9) Stranded Cost Issues.....	3
	1. Commission Issue Number 1, (AG Priority number 2) - Should the Electric Competition Rules be modified regarding stranded costs, if so, how?.....	3
	2. Commission Issue no. 2, (AG Priority 9) - When should "Affected Utilities" be required to make a "stranded cost" filing pursuant to A.A.C. R14-2-1607?.....	7
	3. Commission Issue no 3, (AG Priority 6) -What costs should be included as part of "stranded costs" and how should those costs be calculated?.....	7
	4. Commission issue no.. 4, (AG Priority 4) - Should there be a limitation on the time frame over which "stranded costs" are calculated?.....	9
	5. Commission issue no. 5, (AG Priority 5) - Should there be a limitation on the recovery time frame for "stranded costs"?.....	9
	6. Commission issue no. 6, (AG Priority 1) - How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying for stranded costs?.....	9
	7. Commission issue no. 7, (AG Priority 8) - Should there be a true-up mechanism and, if so, how would it operate?.....	10
	8. Commission issue no. 8, (AG Priority 3) - 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?.....	10
	9. Commission issue no 9, (AG Priority 7) - what factors should be considered for "mitigation" of stranded costs?.....	11

**TESTIMONY OF ENRIQUE A. LOPEZLIRA**

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**A. Introduction**

**Q: Please state your name, occupation and business address.**

A: My name is Enrique A. Lopezlira. I am an economist employed by the Antitrust Unit of the Office of the Attorney General. My office is at 1275 W. Washington St., Phoenix, Arizona 85007.

**Q: Please briefly summarize your education and experience as an economist.**

A: For the past 3 and a half years, I have served in the capacity of economist with the Antitrust Unit of the Arizona Attorney General's Office. In 1994, I worked as an economic and research analyst with the Research Division of the Arizona Department of Education. Prior to that, while in graduate school, I was a research analyst with Economic Analysis Corporation, an economics and financial consulting firm specializing in complex business litigation and regulatory matters. I received my Bachelors of Science degree from Arizona State University in 1993, and my Masters of Science from A.S.U. 1996. Both degrees are in economics. I am currently an adjunct professor of economics at Phoenix College.

**Q: Describe your responsibilities as an economist for the Attorney General's office generally, and specifically describe the work you have done on electric utility deregulation issues.**

A: I am responsible for preparing market studies and price analyses of various industries, like telecommunications, energy, and health care. I also advise Assistant Attorneys General on the economic effects of various trade practices and actions, such as horizontal and vertical restraints, transfer pricing, procurement, and regulation. My other duties include preparing damage and impact studies on antitrust cases and conducting economic research.

I began studying deregulation, or restructuring, of electric utilities when it became evident that Arizona was moving toward deregulation and restructuring of its monopoly electric utilities. I attended a seminar on the subject in 1996, and began to assemble data and information about the

1 Arizona electric markets. I became a member of the Stranded Costs Working Group on January  
2 8, 1997, and participated with the Chief Counsel for the Antitrust Unit in the Legal Issues  
3 Working Group. I have read extensively from widely accepted publications on the effects of  
4 electric industry restructuring on various segments of the marketplace, and have reviewed the  
5 comments of the interested parties in the Stranded Costs and Legal issues working groups. I have  
6 also reviewed various published methodologies for valuation and payment of stranded costs, and  
7 have consulted with individuals in California, Pennsylvania and Virginia regarding their  
8 experience in electric utility restructuring. I have also read and analyzed the testimony of the  
9 affected utilities filed in this docket. I have analyzed this voluminous information in light of  
10 accepted principles of economics with respect to which method of valuation and calculation of  
11 stranded costs will be most efficient, rapid and fair within the context of free market principles.  
12

13 **Q: What is the purpose of your current testimony?**

14 A: I have been asked to testify about the recommendations of my office with respect to the  
15 methodologies for calculation and payment of stranded costs that are the most compatible with the  
16 free-market philosophy of deregulation and that will remove potential barriers to rapid competition  
17 that stranded costs could impose.  
18

19 **Q: Based on your study and analysis, have you come to some conclusions?**

20 A: Yes I have.  
21

22 **B. Summary of Testimony**  
23

24 **Q: Please summarize your conclusions for this record.**

25 A: The rules should be modified in a number of instances to clearly identify those markets to  
26 which stranded cost analysis can apply, to apply a free-market philosophy wherever possible, to  
27 define stranded costs for efficient calculation and to eliminate unnecessary regulation and  
28 administrative proceedings. Stranded costs should be calculated in every case using a market-

1 value approach. As explained below, for investor-owned utilities this calculation should be done  
2 using a stock market value approach. The stranded costs should be collected from all users  
3 through a fixed, non-bypassable monthly charge (based on historic usage and not future usage),  
4 and paid directly to investors through a stranded cost recovery fund over five years. For non-  
5 investor owned utilities and cooperatives, stranded costs should be evaluated on an asset-  
6 divestiture (or bid-auction) basis and paid in the same way.

7  
8 **C. Responses to the Commissions's Nine (9) Stranded Cost Issues**

9  
10 **Q: Regarding the Commission's Issue Number 1, (AG Priority number 2), should the**  
11 **Electric Competition Rules be modified regarding stranded costs, if so, how?**

12 **A:** Yes. R14-2-1601 should be amended to add definitions that distinguish the markets to be  
13 deregulated from those that will continue to be regulated, and relevant market definitions must be  
14 included in the rules. The rules need to clarify that, in the deregulated markets, antitrust law and not  
15 regulatory process governs. The rules should state that they do not afford an exemption from antitrust  
16 scrutiny of activities in the deregulated markets.

17 R14-2-1601 should include a definition of "Product Market", that recognizes that the product  
18 or service line can be distinguished from other product or service lines in the same industry.  
19 The product market definition should identify the following distinct product and service lines: a) retail  
20 generation and services; b) wholesale generation and services c) transmission services; d) distribution  
21 services; and e) marketing and customer services, including demand management. A clear  
22 delineation of each of these product markets should easily enable the commission and the stakeholders  
23 to distinguish between assets and obligations that fall within the deregulated generation and retail  
24 services product markets and those that fall within other regulated markets.

25 The Rules should state that no asset or obligation used or useful for producing a product other  
26 than the deregulated products should be considered as stranded.

27 R14-2-1601 should also contain a definition of geographic market as an area in which a  
28 producing firm sells or could sell the identified product. The geographic market for generation

1 services is nationwide and the state of Arizona is a geographic sub-market. No smaller geographic  
2 sub-markets are necessary or desirable, specifically not smaller territories defined by regulation. The  
3 rules should specify that the relevant geographic market for generation and retail marketing services  
4 is statewide. The relevant geographic market for transmission and distribution are statewide.

5         There is no competitive justification basis for dividing the State into smaller geographic  
6 markets, as the Rules' CC&N procedure appears to continue to do. Therefore my office  
7 recommends that the rules be amended to eliminate the CC&N limitations before stranded costs are  
8 fixed, to eliminate future market uncertainty that will affect values. This will aid in the calculation  
9 of stranded costs, because the market value of generation assets in a statewide geographic market is  
10 a truer reflection of the future value of the assets as an ongoing concern.

11         Moreover, qualification to compete through application to the Commission should be in the  
12 form of a license, not a CC&N procedure, again to create market certainty at the outset of competition.  
13 This would facilitate ease of entry, and will further efficiencies in the transition to competition, which  
14 will support a faster determination of stranded costs and more finality to the risks and rewards of  
15 investing in the deregulated entities.

16         A statewide geographic market definition for both generation and retail services resolves an  
17 anomaly in the rules. The rules currently do not regulate marketing companies. These companies,  
18 selling the retail generation services product, will operate in an unregulated environment, because low  
19 entry barriers allow substantial competition to occur. Absent amendment, the rules would allow  
20 companies to contact users and offer services, before knowing whether competitive generation could  
21 be available in a given geographic area. With the geographic market for both deregulated products  
22 defined as being statewide more meaningful stranded cost market evaluations of an entity can be  
23 made, based on a certainty that there are no regulatory limitations to the geographic markets in which  
24 the affected entities can compete.

25         The market definitions should reduce stranded costs in that the value of companies as  
26 competitors in new markets could be immediately made, without the need to revisit the market value  
27 issues in the future. This has the added benefit of avoiding additional inefficiencies costs. These  
28 definitions will also enable affected utilities' management to assess the desirability of restructuring

1 debt and renegotiating long-term obligations (and territorial market restrictions found in agreements)  
2 in the context of additional market opportunities available to them as competitors, rather than in the  
3 context of an uncertain partially-regulated environment.

4 In Rule 14-2-1601(8), the definition of “stranded costs” should be amended to clarify that  
5 stranded costs only occur in product markets that have become or are to become competitive markets,  
6 and that assets used in producing generation and distribution products, that will continue to be  
7 regulated, are not stranded. This will provide clear limitations on the number and type of costs that  
8 can be asserted as stranded, and will reduce the need for costly administrative assessments. Since they  
9 are not dedicated to products to be sold in a competitive market, under any theory of recovery, assets  
10 dedicated to distribution and transmission of electricity are entitled to zero stranded costs. The rules  
11 should also specify that recovery of stranded costs must be limited to historic generation costs. Future  
12 costs are not stranded, as they are subject to recovery (or loss) in a competitive environment.

13 R14-2-1607(A) should clarify the phrase “offering a wider scope of services for profit.” The  
14 rules should specifically prohibit affected utilities from mitigating stranded costs by using revenues  
15 from unregulated competitive non-core services. Such cross-subsidization creates inefficient  
16 distortions in both markets. Further, affected utilities currently have market power in the regulated  
17 geographic and product markets. Allowing cross-subsidization of non-core activities could promote  
18 abuse of market power through unfair access to users as a customer base, curtailing competition in  
19 other non-regulated markets.

20 R14-2-1607(B) is vague and implies that affected utilities deserve 100% recovery of  
21 unmitigated stranded costs, with no duty to economize. Full recovery of stranded costs implies that  
22 management had no influence on the firm’s investment decision, which cannot be true. All firms,  
23 whether regulated or not, are subject to bad investment decisions by management. Allowing 100%  
24 recovery of unmitigated stranded costs would shift 100% of this business risk from investors to  
25 ratepayers. Therefore, the Rule should be amended to provide that affected utilities should not be  
26 allowed to recover more than 70% of the unmitigated stranded costs. Allowing less than 100%  
27 recovery of stranded costs creates incentives for affected utilities to undertake mitigation efforts in  
28 order to survive in a competitive environment. 70% is a reasonable number based on the experience

1 of other states, which, after extensive investigation, have allowed 60% (New Hampshire), 67%  
2 (Illinois), 77% Pennsylvania, and 100% (Massachusetts), and is also compatible with private studies  
3 that have recommended between 60% and 80%.

4 R14-2-1607(G) should require only one filing of the results of the market-value transactions  
5 used, before retail choice begins

6 R14-2-1607(H) implies (1) a "wires" charge is an acceptable recovery mechanism for  
7 unmitigated stranded costs; (2) that unmitigated stranded costs should only be recovered from  
8 customers who leave the affected utilities' systems or alternatively, who remain in the affected  
9 utilities' systems but reduce their energy consumption; (3) that the recovery mechanism for  
10 unmitigated stranded costs will be different for each affected utility; and (4) that recovery of  
11 unmitigated stranded costs will continue indefinitely. A "wires" charge is not an acceptable recovery  
12 mechanism, because it affects future energy consumption, and does not fairly allocate the burden of  
13 stranded generation costs between those users who have consumed little electricity and those who  
14 have consumed much more. Unmitigated stranded costs must be recovered from all users regardless  
15 of which generator, broker or retailer, they choose in a competitive environment, as well as  
16 independent of future energy consumption. And, the recovery mechanism should be the same for all  
17 affected utilities. The Rule should make this clear.

18 R14-2-1607(K) is not necessary if a market value approach for calculating unmitigated  
19 stranded costs is used.

20 R14-2-1607(L) is not necessary if a market value approach for calculating unmitigated  
21 stranded costs is used.

22 The Rules should specifically prohibit cross-subsidization, for the reasons already stated. This  
23 cross-subsidization prohibition would end when competition is fully established.

24 The rules should specifically require that affected utilities afford "open access" to their  
25 regulated transmission and distribution systems in accordance with FERC rules. If competition is  
26 expanded for the generation and retail services sectors of the industry, while transmission and  
27 distribution remain regulated, vertically integrated providers have incentives to favor their own  
28 generators and retailers with better access. Vertically integrated entities "own" the ability to transmit

1 and distribute efficiently at regulated rates, while everyone else could face delays, interruptions, or  
2 greater power losses in the transmission and distribution services which are essential facilities in a  
3 competitive generation and marketing environment. Many antitrust concerns arise from the (forward  
4 or backward) vertical integration of a utility which bottlenecks an essential facility. Open access rules  
5 would remove this potentially anticompetitive barrier to entry and prevent the abuse of transmission  
6 or distribution market power. This issue is highly relevant to stranded costs because it allows rapid  
7 evaluation of firms who will not be able to misuse distribution market power to their competitive  
8 advantage in the deregulated product markets.

9 For the same reasons, the rules should prohibit collusive under sizing. While antitrust  
10 enforcement may prevent collusive under sizing of transmission and distribution capacity and FERC  
11 under EPAct has the regulatory authority to order expansion of the transmission grid, the policy of  
12 facilitating competition inherent in the Rules should expressly recognize and prohibit this positioning  
13 in order to prevent anticompetitive limitations. The Rules' defining the impermissible use of  
14 regulated products create additional market certainty for investors valuing "stranded" assets in a  
15 competitive marketplace.

16  
17 **Q. With respect to ACC Issue no. 2, (AG Priority 9), when should "Affected Utilities" be**  
18 **required to make a "stranded cost" filing pursuant to A.A.C. R14-2-1607?**

19 A: After the rules under which restructuring will occur are established, and prior to introducing  
20 retail customer choice, so users can know what they may have to pay for stranded costs. This advance  
21 calculation creates certainty in the market both for users who are asked to choose between existing  
22 providers rates-plus-stranded costs, and new providers' offers. Based on the experience in  
23 Pennsylvania, where a competitor offered to pay stranded costs and reduce rates further than the  
24 settlement on stranded costs offered by an affected utility, we believe that competitors will want to  
25 reduce rates to more-than-offset the stranded costs to be paid by users, and that the market will  
26 therefore drive rates to their lowest competitive levels.

27  
28 **Q: With respect to ACC Issue no 3, (AG Priority 6), what costs should be included as part**

1 **of “stranded costs” and how should those costs be calculated?**

2 A: The calculation of stranded costs and the mechanism used to recover these costs, if improperly  
3 done, can lead to a significant barrier to entry into the market. Such a barrier can discourage  
4 investment, reduce the number of competitors, and lead both to an under-supply of low cost power  
5 and an increase in the probability of market concentration and monopoly pricing. Proper identification  
6 of competitive product markets is key in identifying possible anticompetitive impacts from stranded  
7 costs awards.

8 As to the recommended calculation methodology and assumptions made including any  
9 determination of the market clearing price, we concluded that, as to investor-owned utilities, stranded  
10 costs are losses imposed on stockholders for unanticipated losses caused by regulatory requirements.

11 Therefore, we believe that the shareholders should have a claim for payment against the stranded  
12 recovery fund, into which stranded costs are paid.

13 The market value of stranded costs should be calculated using a true market mechanism, and  
14 the most economically sensitive measure of the actual loss. For investor owned utilities, the value  
15 should be the difference between the book value of the company before deregulation, and the value  
16 of their stock holdings after. Because speculation about how much stranded costs will be recovered  
17 will influence the stock price, the utility will have to split its stock. That is, each investor will receive  
18 one share of A stock and one share of B stock for every original share she owns at the time of the split.  
19 The A stock gives the investor the usual rights and benefits of a shareholder. The B shares give their  
20 holders sole claim against stranded costs recovered by the utility. A short time after the stock split  
21 or the implementation of competition begins (whichever is later), the stranded costs for the company  
22 are calculated as the difference between the net book value of company before deregulation, and the  
23 average of the market value of A stock over a fixed period after the split. The net book value is the  
24 regulatory value of the utility. If the net book value is greater than the stock value, the investors will  
25 receive payment. The payment should be less than 100% of the difference, to build in a management  
26 incentive to keep interim costs and obligations competitive. Stranded costs should be paid over no  
27 more than 5 years, into a stranded cost recovery fund administered by the corporation commission.  
28 Investors’s claims will be paid be paid at the end of 5 years. The coupons will not affect the investor-

1 owned utilities' principal stock value, but will affect the coupon trade.

2 As to non-investor owned affected utilities, we believe that stranded costs should be assessed  
3 through an alternative market-based method like auction or divestiture. As to SRP, should it become  
4 relevant, the stranded value of the privatized water subsidy should be a market-based mechanism  
5 similar to stock value, such a would be the case if the subsidy were placed in a privatized, spun-off  
6 entity trading in water subsidy future value.

7 Because the amount paid for the assets is a management risk, only prudent assets can be  
8 considered as relevant to stranded costs. Only historic generation assets and obligations should be  
9 considered for inclusion in stranded cost calculations . Of these assets and obligations, only those that  
10 regulators required, not those that management elected to acquire or create, should be considered  
11 stranded. Assets and obligations involved in producing products that will continue to be regulated are  
12 not stranded. Assets dedicated to distribution and transmission of electricity are entitled to zero  
13 stranded costs.

14

15 **Q: With respect to ACC issue no. 4, (AG Priority 4), should there be a limitation on the time**  
16 **frame over which "stranded costs" are calculated?**

17 A: This question is irrelevant if the calculation method is a market value approach, because the  
18 stranded cost calculation would consider only the pre-competition and post-competition market  
19 values.

20

21 **Q: With respect to ACC 5, (AG Priority 5), should there be a limitation on the recovery time**  
22 **frame for "stranded costs"?**

23 A: Yes, stranded cost should be paid over no more than 5 years. A long recovery period prolongs the  
24 transition to full retail competition, and the period of market uncertainty created by stranded cost  
25 recovery. A five year period offers utilities a reasonable amount of time to recover their stranded  
26 costs, and allows full competition to commence sooner rather than later.

27

28 **Q: With respect to ACC issue no. 6, (AG Priority 1), how and who should pay for "stranded**

1 **costs” and who, if anyone, should be excluded from paying for stranded costs?**

2 A: Stranded losses are sunk costs. In a free market environment, historical sunk costs should not  
3 drive future economic decisions. Users, not potential suppliers, should pay the stranded costs. The  
4 payment should not be a “wires” charge, but a “meters” charge, based on historical usage up to the  
5 time of the calculation of stranded costs. The historical period should be from the beginning of 1996  
6 to the end of 1997. During this period, it was common knowledge that deregulation was coming, but  
7 unknown how stranded costs would be paid. During this period, therefore, users did not change  
8 consumption patterns based on the possibility of paying sunk costs. Either approach is fair to all  
9 classes of users, whose contribution is directly based on the benefit of regulated generation they  
10 received. New competitor-suppliers should not be charged for stranded costs, because to do so would  
11 create unnecessary barriers to entry for smaller would-be suppliers. It is anticipated that some  
12 suppliers may wish to pay the stranded cost obligations of consumers as a marketing strategy.

13  
14 **Q: With respect to ACC issue no. 7, (AG Priority 8), should there be a true-up mechanism**  
15 **and, if so, how would it operate?**

16 A: No. The only true-up is the market value. One of the major inefficiencies in an  
17 administrative-dependent method for calculating stranded costs is that it requires periodic true-up  
18 proceedings. The costs of these proceedings will be born by existing ratepayers, and under some  
19 methodologies would become a part of stranded costs. Abuse of regulatory proceedings has, in other  
20 deregulated industries, become a barrier to new entry. With the one-time valuation methodologies we  
21 propose, the true-up is performed by the marketplace. There is no need for subsequent true-up  
22 proceedings which create uncertainty in the market, and would create new regulatory burdens on the  
23 deregulated market players.

24  
25 **Q: With respect to ACC issue no. 8, (AG Priority 3), should there be price caps or a rate**  
26 **freeze imposed as part of the development of a stranded cost recovery program and if so, how**  
27 **should it be calculated?**

28 A: No. Rate caps are regulatory and can have the effect of creating a floor for future prices. Rate

1 stability is not in the public interest if those rates create a barrier to competition. Governmental rate  
2 manipulation is contradictory to the express objective of deregulation.

3

4 **Q: With respect to ACC issue no 9, (AG Priority 7), what factors should be considered for**  
5 **“mitigation” of stranded costs?**

6 A: If the methodology proposed by my office is employed, mitigation is not an issue; the market  
7 will decide what costs or obligations add and subtract from the value of the firm. If another method  
8 is employed, then mitigation requires that assets and obligations acquired did not create risky excess  
9 capacity or be based upon erroneous forecasts. And, asset and obligation decisions made after 1994  
10 were made in anticipation of deregulation in the short term, and require a greater demonstration of  
11 economizing. As stated above, revenues from non-core businesses of the affected utilities should  
12 not be used to mitigate stranded costs, so as to prevent abuse of market power and injury to  
13 competition in non-core markets.

14

15 **Q: Do you have an opinion regarding the implications of the Statement of Financial**  
16 **Accounting Standards No. 71 resulting from the recommended stranded cost calculation and**  
17 **recovery methodology?**

18 A: No. The market will be able to ascertain the value of a firm within the context of whatever  
19 regulatory or legal burdens under which the firms must operate.

20

21

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AN ORIGINAL AND TEN COPIES of the foregoing filed  
this 21<sup>st</sup> day of January, 1998 with:

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Dated this <sup>21<sup>st</sup></sup> Day of January, 1998

  
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**BEFORE THE ARIZONA CORPORATION COMMISSION**

**JIM IRVIN  
COMMISSIONER-CHAIRMAN  
RENZ D. JENNINGS  
COMMISSIONER  
CARL J. KUNASEK  
COMMISSIONER**

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

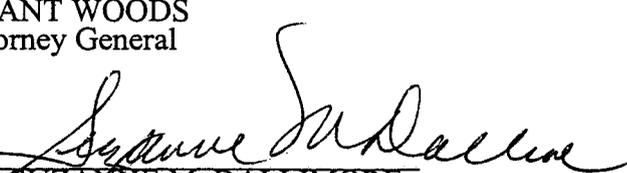
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RE-00000C-94-0165**

**NOTICE OF FILING**

Enrique Lopezlira hereby provides notice of filing of his direct testimony as required by the Commission's Fourth Amended Procedural Order, dated the 16th day of January, 1998, in the above-referenced docket.

RESPECTFULLY SUBMITTED this 21<sup>st</sup> day of January, 1998.

GRANT WOODS  
Attorney General

By: 

SUZANNE M. DALLIMORE,  
Antitrust Unit Chief  
Antitrust Unit, Civil Division

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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

**DOCKET NO. U-0000-94-165**

**DIRECT TESTIMONY**  
**OF**  
**ENRIQUE A. LOPEZLIRA**

**TESTIMONY OF ENRIQUE A. LOPEZLIRA  
ON BEHALF OF ARIZONA ATTORNEY GENERAL'S OFFICE**

**TABLE OF CONTENTS**

A.	Introduction.....	1
B.	Summary of Testimony.....	2
C.	Responses to the Commission's Nine (9) Stranded Cost Issues.....	3
	1. Commission Issue Number 1, (AG Priority number 2) - Should the Electric Competition Rules be modified regarding stranded costs, if so, how?.....	3
	2. Commission Issue no. 2, (AG Priority 9) - When should "Affected Utilities" be required to make a "stranded cost" filing pursuant to A.A.C. R14-2-1607?.....	7
	3. Commission Issue no 3, (AG Priority 6) -What costs should be included as part of "stranded costs" and how should those costs be calculated?.....	7
	4. Commission issue no.. 4, (AG Priority 4) - Should there be a limitation on the time frame over which "stranded costs" are calculated?.....	9
	5. Commission issue no. 5, (AG Priority 5) - Should there be a limitation on the recovery time frame for "stranded costs"?.....	9
	6. Commission issue no. 6, (AG Priority 1) - How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying for stranded costs?.....	9
	7. Commission issue no. 7, (AG Priority 8) - Should there be a true-up mechanism and, if so, how would it operate?.....	10
	8. Commission issue no. 8, (AG Priority 3) - 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?.....	10
	9. Commission issue no 9, (AG Priority 7) - what factors should be considered for "mitigation" of stranded costs?.....	11

**TESTIMONY OF ENRIQUE A. LOPEZLIRA**

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**A. Introduction**

**Q: Please state your name, occupation and business address.**

A: My name is Enrique A. Lopezlira. I am an economist employed by the Antitrust Unit of the Office of the Attorney General. My office is at 1275 W. Washington St., Phoenix, Arizona 85007.

**Q: Please briefly summarize your education and experience as an economist.**

A: For the past 3 and a half years, I have served in the capacity of economist with the Antitrust Unit of the Arizona Attorney General's Office. In 1994, I worked as an economic and research analyst with the Research Division of the Arizona Department of Education. Prior to that, while in graduate school, I was a research analyst with Economic Analysis Corporation, an economics and financial consulting firm specializing in complex business litigation and regulatory matters. I received my Bachelors of Science degree from Arizona State University in 1993, and my Masters of Science from A.S.U. 1996. Both degrees are in economics. I am currently an adjunct professor of economics at Phoenix College.

**Q: Describe your responsibilities as an economist for the Attorney General's office generally, and specifically describe the work you have done on electric utility deregulation issues.**

A: I am responsible for preparing market studies and price analyses of various industries, like telecommunications, energy, and health care. I also advise Assistant Attorneys General on the economic effects of various trade practices and actions, such as horizontal and vertical restraints, transfer pricing, procurement, and regulation. My other duties include preparing damage and impact studies on antitrust cases and conducting economic research.

I began studying deregulation, or restructuring, of electric utilities when it became evident that Arizona was moving toward deregulation and restructuring of its monopoly electric utilities. I attended a seminar on the subject in 1996, and began to assemble data and information about the

1 Arizona electric markets. I became a member of the Stranded Costs Working Group on January  
2 8, 1997, and participated with the Chief Counsel for the Antitrust Unit in the Legal Issues  
3 Working Group. I have read extensively from widely accepted publications on the effects of  
4 electric industry restructuring on various segments of the marketplace, and have reviewed the  
5 comments of the interested parties in the Stranded Costs and Legal issues working groups. I have  
6 also reviewed various published methodologies for valuation and payment of stranded costs, and  
7 have consulted with individuals in California, Pennsylvania and Virginia regarding their  
8 experience in electric utility restructuring. I have also read and analyzed the testimony of the  
9 affected utilities filed in this docket. I have analyzed this voluminous information in light of  
10 accepted principles of economics with respect to which method of valuation and calculation of  
11 stranded costs will be most efficient, rapid and fair within the context of free market principles.

12

13 **Q: What is the purpose of your current testimony?**

14 A: I have been asked to testify about the recommendations of my office with respect to the  
15 methodologies for calculation and payment of stranded costs that are the most compatible with the  
16 free-market philosophy of deregulation and that will remove potential barriers to rapid competition  
17 that stranded costs could impose.

18

19 **Q: Based on your study and analysis, have you come to some conclusions?**

20 A: Yes I have.

21

22 **B. Summary of Testimony**

23

24 **Q: Please summarize your conclusions for this record.**

25 A: The rules should be modified in a number of instances to clearly identify those markets to  
26 which stranded cost analysis can apply, to apply a free-market philosophy wherever possible, to  
27 define stranded costs for efficient calculation and to eliminate unnecessary regulation and  
28 administrative proceedings. Stranded costs should be calculated in every case using a market-

1 value approach. As explained below, for investor-owned utilities this calculation should be done  
2 using a stock market value approach. The stranded costs should be collected from all users  
3 through a fixed, non-bypassable monthly charge (based on historic usage and not future usage),  
4 and paid directly to investors through a stranded cost recovery fund over five years. For non-  
5 investor owned utilities and cooperatives, stranded costs should be evaluated on an asset-  
6 divestiture (or bid-auction) basis and paid in the same way.

7

### 8 **C. Responses to the Commissions's Nine (9) Stranded Cost Issues**

9

10 **Q: Regarding the Commission's Issue Number 1, (AG Priority number 2), should the**  
11 **Electric Competition Rules be modified regarding stranded costs, if so, how?**

12 **A:** Yes. R14-2-1601 should be amended to add definitions that distinguish the markets to be  
13 deregulated from those that will continue to be regulated, and relevant market definitions must be  
14 included in the rules. The rules need to clarify that, in the deregulated markets, antitrust law and not  
15 regulatory process governs. The rules should state that they do not afford an exemption from antitrust  
16 scrutiny of activities in the deregulated markets.

17 R14-2-1601 should include a definition of "Product Market", that recognizes that the product  
18 or service line can be distinguished from other product or service lines in the same industry.

19 The product market definition should identify the following distinct product and service lines: a) retail  
20 generation and services; b) wholesale generation and services c) transmission services; d) distribution  
21 services; and e) marketing and customer services, including demand management. A clear  
22 delineation of each of these product markets should easily enable the commission and the stakeholders  
23 to distinguish between assets and obligations that fall within the deregulated generation and retail  
24 services product markets and those that fall within other regulated markets.

25 The Rules should state that no asset or obligation used or useful for producing a product other  
26 than the deregulated products should be considered as stranded.

27 R14-2-1601 should also contain a definition of geographic market as an area in which a  
28 producing firm sells or could sell the identified product. The geographic market for generation

1 services is nationwide and the state of Arizona is a geographic sub-market. No smaller geographic  
2 sub-markets are necessary or desirable, specifically not smaller territories defined by regulation. The  
3 rules should specify that the relevant geographic market for generation and retail marketing services  
4 is statewide. The relevant geographic market for transmission and distribution are statewide.

5 There is no competitive justification basis for dividing the State into smaller geographic  
6 markets, as the Rules' CC&N procedure appears to continue to do. Therefore my office  
7 recommends that the rules be amended to eliminate the CC&N limitations before stranded costs are  
8 fixed, to eliminate future market uncertainty that will affect values. This will aid in the calculation  
9 of stranded costs, because the market value of generation assets in a statewide geographic market is  
10 a truer reflection of the future value of the assets as an ongoing concern.

11 Moreover, qualification to compete through application to the Commission should be in the  
12 form of a license, not a CC&N procedure, again to create market certainty at the outset of competition.  
13 This would facilitate ease of entry, and will further efficiencies in the transition to competition, which  
14 will support a faster determination of stranded costs and more finality to the risks and rewards of  
15 investing in the deregulated entities.

16 A statewide geographic market definition for both generation and retail services resolves an  
17 anomaly in the rules. The rules currently do not regulate marketing companies. These companies,  
18 selling the retail generation services product, will operate in an unregulated environment, because low  
19 entry barriers allow substantial competition to occur. Absent amendment, the rules would allow  
20 companies to contact users and offer services, before knowing whether competitive generation could  
21 be available in a given geographic area. With the geographic market for both deregulated products  
22 defined as being statewide more meaningful stranded cost market evaluations of an entity can be  
23 made, based on a certainty that there are no regulatory limitations to the geographic markets in which  
24 the affected entities can compete.

25 The market definitions should reduce stranded costs in that the value of companies as  
26 competitors in new markets could be immediately made, without the need to revisit the market value  
27 issues in the future. This has the added benefit of avoiding additional inefficiencies costs. These  
28 definitions will also enable affected utilities' management to assess the desirability of restructuring

1 debt and renegotiating long-term obligations (and territorial market restrictions found in agreements)  
2 in the context of additional market opportunities available to them as competitors, rather than in the  
3 context of an uncertain partially-regulated environment.

4 In Rule 14-2-1601(8), the definition of “stranded costs” should be amended to clarify that  
5 stranded costs only occur in product markets that have become or are to become competitive markets,  
6 and that assets used in producing generation and distribution products, that will continue to be  
7 regulated, are not stranded. This will provide clear limitations on the number and type of costs that  
8 can be asserted as stranded, and will reduce the need for costly administrative assessments. Since they  
9 are not dedicated to products to be sold in a competitive market, under any theory of recovery, assets  
10 dedicated to distribution and transmission of electricity are entitled to zero stranded costs. The rules  
11 should also specify that recovery of stranded costs must be limited to historic generation costs. Future  
12 costs are not stranded, as they are subject to recovery (or loss) in a competitive environment.

13 R14-2-1607(A) should clarify the phrase “offering a wider scope of services for profit.” The  
14 rules should specifically prohibit affected utilities from mitigating stranded costs by using revenues  
15 from unregulated competitive non-core services. Such cross-subsidization creates inefficient  
16 distortions in both markets. Further, affected utilities currently have market power in the regulated  
17 geographic and product markets. Allowing cross-subsidization of non-core activities could promote  
18 abuse of market power through unfair access to users as a customer base, curtailing competition in  
19 other non-regulated markets.

20 R14-2-1607(B) is vague and implies that affected utilities deserve 100% recovery of  
21 unmitigated stranded costs, with no duty to economize. Full recovery of stranded costs implies that  
22 management had no influence on the firm’s investment decision, which cannot be true. All firms,  
23 whether regulated or not, are subject to bad investment decisions by management. Allowing 100%  
24 recovery of unmitigated stranded costs would shift 100% of this business risk from investors to  
25 ratepayers. Therefore, the Rule should be amended to provide that affected utilities should not be  
26 allowed to recover more than 70% of the unmitigated stranded costs. Allowing less than 100%  
27 recovery of stranded costs creates incentives for affected utilities to undertake mitigation efforts in  
28 order to survive in a competitive environment. 70% is a reasonable number based on the experience

1 of other states, which, after extensive investigation, have allowed 60% (New Hampshire), 67%  
2 (Illinois), 77% Pennsylvania, and 100% (Massachusetts), and is also compatible with private studies  
3 that have recommended between 60% and 80%.

4 R14-2-1607(G) should require only one filing of the results of the market-value transactions  
5 used, before retail choice begins

6 R14-2-1607(H) implies (1) a "wires" charge is an acceptable recovery mechanism for  
7 unmitigated stranded costs; (2) that unmitigated stranded costs should only be recovered from  
8 customers who leave the affected utilities' systems or alternatively, who remain in the affected  
9 utilities' systems but reduce their energy consumption; (3) that the recovery mechanism for  
10 unmitigated stranded costs will be different for each affected utility; and (4) that recovery of  
11 unmitigated stranded costs will continue indefinitely. A "wires" charge is not an acceptable recovery  
12 mechanism, because it affects future energy consumption, and does not fairly allocate the burden of  
13 stranded generation costs between those users who have consumed little electricity and those who  
14 have consumed much more. Unmitigated stranded costs must be recovered from all users regardless  
15 of which generator, broker or retailer, they choose in a competitive environment, as well as  
16 independent of future energy consumption. And, the recovery mechanism should be the same for all  
17 affected utilities. The Rule should make this clear.

18 R14-2-1607(K) is not necessary if a market value approach for calculating unmitigated  
19 stranded costs is used.

20 R14-2-1607(L) is not necessary if a market value approach for calculating unmitigated  
21 stranded costs is used.

22 The Rules should specifically prohibit cross-subsidization, for the reasons already stated. This  
23 cross-subsidization prohibition would end when competition is fully established.

24 The rules should specifically require that affected utilities afford "open access" to their  
25 regulated transmission and distribution systems in accordance with FERC rules. If competition is  
26 expanded for the generation and retail services sectors of the industry, while transmission and  
27 distribution remain regulated, vertically integrated providers have incentives to favor their own  
28 generators and retailers with better access. Vertically integrated entities "own" the ability to transmit

1 and distribute efficiently at regulated rates, while everyone else could face delays, interruptions, or  
2 greater power losses in the transmission and distribution services which are essential facilities in a  
3 competitive generation and marketing environment. Many antitrust concerns arise from the (forward  
4 or backward) vertical integration of a utility which bottlenecks an essential facility. Open access rules  
5 would remove this potentially anticompetitive barrier to entry and prevent the abuse of transmission  
6 or distribution market power. This issue is highly relevant to stranded costs because it allows rapid  
7 evaluation of firms who will not be able to misuse distribution market power to their competitive  
8 advantage in the deregulated product markets.

9 For the same reasons, the rules should prohibit collusive under sizing. While antitrust  
10 enforcement may prevent collusive under sizing of transmission and distribution capacity and FERC  
11 under EPCRA has the regulatory authority to order expansion of the transmission grid, the policy of  
12 facilitating competition inherent in the Rules should expressly recognize and prohibit this positioning  
13 in order to prevent anticompetitive limitations. The Rules' defining the impermissible use of  
14 regulated products create additional market certainty for investors valuing "stranded" assets in a  
15 competitive marketplace.

16  
17 **Q. With respect to ACC Issue no. 2, (AG Priority 9), when should "Affected Utilities" be**  
18 **required to make a "stranded cost" filing pursuant to A.A.C. R14-2-1607?**

19 **A:** After the rules under which restructuring will occur are established, and prior to introducing  
20 retail customer choice, so users can know what they may have to pay for stranded costs. This advance  
21 calculation creates certainty in the market both for users who are asked to choose between existing  
22 providers rates-plus-stranded costs, and new providers' offers. Based on the experience in  
23 Pennsylvania, where a competitor offered to pay stranded costs and reduce rates further than the  
24 settlement on stranded costs offered by an affected utility, we believe that competitors will want to  
25 reduce rates to more-than-offset the stranded costs to be paid by users, and that the market will  
26 therefore drive rates to their lowest competitive levels.

27  
28 **Q: With respect to ACC Issue no 3, (AG Priority 6), what costs should be included as part**

1 **of “stranded costs” and how should those costs be calculated?**

2 A: The calculation of stranded costs and the mechanism used to recover these costs, if improperly  
3 done, can lead to a significant barrier to entry into the market. Such a barrier can discourage  
4 investment, reduce the number of competitors, and lead both to an under-supply of low cost power  
5 and an increase in the probability of market concentration and monopoly pricing. Proper identification  
6 of competitive product markets is key in identifying possible anticompetitive impacts from stranded  
7 costs awards.

8 As to the recommended calculation methodology and assumptions made including any  
9 determination of the market clearing price, we concluded that, as to investor-owned utilities, stranded  
10 costs are losses imposed on stockholders for unanticipated losses caused by regulatory requirements.

11 Therefore, we believe that the shareholders should have a claim for payment against the stranded  
12 recovery fund, into which stranded costs are paid.

13 The market value of stranded costs should be calculated using a true market mechanism, and  
14 the most economically sensitive measure of the actual loss. For investor owned utilities, the value  
15 should be the difference between the book value of the company before deregulation, and the value  
16 of their stock holdings after. Because speculation about how much stranded costs will be recovered  
17 will influence the stock price, the utility will have to split its stock. That is, each investor will receive  
18 one share of A stock and one share of B stock for every original share she owns at the time of the split.  
19 The A stock gives the investor the usual rights and benefits of a shareholder. The B shares give their  
20 holders sole claim against stranded costs recovered by the utility. A short time after the stock split  
21 or the implementation of competition begins (whichever is later), the stranded costs for the company  
22 are calculated as the difference between the net book value of company before deregulation, and the  
23 average of the market value of A stock over a fixed period after the split. The net book value is the  
24 regulatory value of the utility. If the net book value is greater than the stock value, the investors will  
25 receive payment. The payment should be less than 100% of the difference, to build in a management  
26 incentive to keep interim costs and obligations competitive. Stranded costs should be paid over no  
27 more than 5 years, into a stranded cost recovery fund administered by the corporation commission.  
28 Investors’s claims will be paid be paid at the end of 5 years. The coupons will not affect the investor-

1 owned utilities' principal stock value, but will affect the coupon trade.

2 As to non-investor owned affected utilities, we believe that stranded costs should be assessed  
3 through an alternative market-based method like auction or divestiture. As to SRP, should it become  
4 relevant, the stranded value of the privatized water subsidy should be a market-based mechanism  
5 similar to stock value, such a would be the case if the subsidy were placed in a privatized, spun-off  
6 entity trading in water subsidy future value.

7 Because the amount paid for the assets is a management risk, only prudent assets can be  
8 considered as relevant to stranded costs. Only historic generation assets and obligations should be  
9 considered for inclusion in stranded cost calculations . Of these assets and obligations, only those that  
10 regulators required, not those that management elected to acquire or create, should be considered  
11 stranded. Assets and obligations involved in producing products that will continue to be regulated are  
12 not stranded. Assets dedicated to distribution and transmission of electricity are entitled to zero  
13 stranded costs.

14

15 **Q: With respect to ACC issue no. 4, (AG Priority 4), should there be a limitation on the time**  
16 **frame over which "stranded costs" are calculated?**

17 A: This question is irrelevant if the calculation method is a market value approach, because the  
18 stranded cost calculation would consider only the pre-competition and post-competition market  
19 values.

20

21 **Q: With respect to ACC 5, (AG Priority 5), should there be a limitation on the recovery time**  
22 **frame for "stranded costs"?**

23 A: Yes, stranded cost should be paid over no more than 5 years. A long recovery period prolongs the  
24 transition to full retail competition, and the period of market uncertainty created by stranded cost  
25 recovery. A five year period offers utilities a reasonable amount of time to recover their stranded  
26 costs, and allows full competition to commence sooner rather than later.

27

28 **Q: With respect to ACC issue no. 6, (AG Priority 1), how and who should pay for "stranded**

1 **costs” and who, if anyone, should be excluded from paying for stranded costs?**

2 A: Stranded losses are sunk costs. In a free market environment, historical sunk costs should not  
3 drive future economic decisions. Users, not potential suppliers, should pay the stranded costs. The  
4 payment should not be a “wires” charge, but a “meters” charge, based on historical usage up to the  
5 time of the calculation of stranded costs. The historical period should be from the beginning of 1996  
6 to the end of 1997. During this period, it was common knowledge that deregulation was coming, but  
7 unknown how stranded costs would be paid. During this period, therefore, users did not change  
8 consumption patterns based on the he possibility of paying sunk costs. Either approach is fair to all  
9 classes of users, whose contribution is directly based on the benefit of regulated generation they  
10 received. New competitor-suppliers should not be charged for stranded costs, because to do so would  
11 create unnecessary barriers to entry for smaller would-be suppliers. It is anticipated that some  
12 suppliers may wish to pay the stranded cost obligations of consumers as a marketing strategy.

13

14 **Q: With respect to ACC issue no. 7, (AG Priority 8), should there be a true-up mechanism**  
15 **and, if so, how would it operate?**

16 A: No. The only true-up is the market value. One of the major inefficiencies in an  
17 administrative-dependent method for calculating stranded costs is that it requires periodic true-up  
18 proceedings. The costs of these proceedings will be born by existing ratepayers, and under some  
19 methodologies would become a part of stranded costs. Abuse of regulatory proceedings has, in other  
20 deregulated industries, become a barrier to new entity. With the one-time valuation methodologies we  
21 propose, the true-up is performed by the marketplace. There is no need for subsequent true-up  
22 proceedings which create uncertainty in the market, and would create new regulatory burdens on the  
23 deregulated market players.

24

25 **Q: With respect to ACC issue no. 8, (AG Priority 3), should there be price caps or a rate**  
26 **freeze imposed as part of the development of a stranded cost recovery program and if so, how**  
27 **should it be calculated?**

28 A: No. Rate caps are regulatory and can have the effect of creating a floor for future prices. Rate

1 stability is not in the public interest if those rates create a barrier to competition. Governmental rate  
2 manipulation is contradictory to the express objective of deregulation.

3

4 **Q: With respect to ACC issue no 9, (AG Priority 7), what factors should be considered for**  
5 **“mitigation” of stranded costs?**

6 A: If the methodology proposed by my office is employed, mitigation is not an issue; the market  
7 will decide what costs or obligations add and subtract from the value of the firm. If another method  
8 is employed, then mitigation requires that assets and obligations acquired did not create risky excess  
9 capacity or be based upon erroneous forecasts. And, asset and obligation decisions made after 1994  
10 were made in anticipation of deregulation in the short term, and require a greater demonstration of  
11 economizing. As stated above, revenues from non-core businesses of the affected utilities should  
12 not be used to mitigate stranded costs, so as to prevent abuse of market power and injury to  
13 competition in non-core markets.

14

15 **Q: Do you have an opinion regarding the implications of the Statement of Financial**  
16 **Accounting Standards No. 71 resulting from the recommended stranded cost calculation and**  
17 **recovery methodology?**

18 A: No. The market will be able to ascertain the value of a firm within the context of whatever  
19 regulatory or legal burdens under which the firms must operate.

20

21

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28

AN ORIGINAL AND TEN COPIES of the foregoing filed  
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