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CITY OF TUCSON

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The Sunshine City

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TUCSON, ARIZONA 85726-9210
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Arizona Corporation Commission
DOCKETED

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

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**Re: Docket Nos. E-01933A-98-0471, E-01933A-97-0772, E-01345A-98-0473,
E-01345A-97-0773, and RE-00000C-94-0165**

Enclosed for filing, please find the original and ten copies of the City of Tucson's notice of comment filing with regard to the above-referenced docket numbers.

Sincerely,

David Deibel
Senior Assistant City Attorney

DD:lr

Enclosures

BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission, A.Z. CORP. COMMISSION

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

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DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS PLAN FOR STRANDED COST RECOVERY) DOCKET NO. E-01933A-98-0471

IN THE MATTER OF THE FILING OF TUCSON ELECTRIC POWER COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C. R14-2-1601 et seq.) DOCKET NO. E-01933A-97-0772

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY) DOCKET NO. E-01345A-98-0473

IN THE MATTER OF THE FILING OF ARIZONA PUBLIC SERVICE COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.C.C. R14-2-1601, et seq.) DOCKET NO. E-01345A-97-0773

IN THE MATTER OF COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.) DOCKET NO. RE-00000C-94-0165
NOTICE OF COMMENT FILING

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The City of Tucson hereby files the attached comments to the proposed Settlement Agreement between the Staff of the Arizona Corporation Commission and the Tucson Electric Power Company.

RESPECTFULLY SUBMITTED this 16th day of November, 1998.

THOMAS J. BERNING
City Attorney



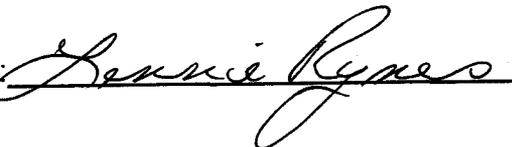
David Deibel
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Tucson, AZ 85726-7210

Original and ten copies of the foregoing mailed this 16th day of November, 1998 to:

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

Copy of the foregoing mailed this 16th day of November, 1998 to:

All parties in Docket Nos. E-01933A-98-0471, E-01933A-97-0772, E-01345A-98-0473, E-01345A-97-0773, and RE-00000C-94-0165

By: 

Analysis of the Proposed Settlement Agreement Between Staff and Tucson Electric Power Company

On November 5, 1998, The Arizona Corporation Commission Staff (Staff) and Tucson Electric Power Company (TEP) reached a settlement agreement on several matters involving TEP and the Commission's policy to implement retail electric competition starting January 1, 1999. A parallel settlement has also been reached between Arizona Public Service Company (APS) and Staff. Staff has requested that the Commission conduct an evidentiary hearing starting on November 20, 1998 to review the settlements. Comments on the settlements are due November 17, 1998.

The City of Tucson (City) has prepared the following comments to the proposed TEP settlement agreement for the purpose of providing comments to the Commission. Because of the short time available for review, this report has focused on major issues that are likely to affect the City and has not analyzed all possible issues. First, an overview of the settlement is presented. Then, the impacts of the settlement on the City are discussed. Finally, the City offers the Commission its recommendations for modifications of the proposed agreement to the Corporation.

Overview of Settlement

The settlement addresses numerous issues, including the following:

- TEP may become a transmission company (Transco). The agreement discusses how a Transco might work. It would acquire all transmission facilities of all utilities and it would price services on a license plate basis¹ or a postage stamp basis. However, the Commission has no jurisdiction over transmission issues and other transmission owners have no obligation under the settlement agreement to sell their facilities to the Transco.
- TEP will transfer to APS TEP's shares of the Navajo and Four Corners power plants (about 295 MW). APS will transfer to TEP APS' transmission facilities of 345 kV and above (but not other transmission facilities). The book value of the transmission assets is about \$162 million. The value of the generation assets is \$165 million as of January 1, 2001 according to the Memorandum of Understanding between TEP and APS. The total cost of TEP's share of the power plants, according to TEP's 1997 FERC Form 1, is \$178 million. The Four Corners units were built in 1969 and 1970 and the Navajo units were installed between 1974 and 1976.
- TEP may acquire the non-distribution related transmission assets of APS at APS' book value.
- TEP will attempt to auction off all of its remaining generation plants except the DeMoss Petrie and North Loop plants, which may be auctioned off later. The auction, if successful, will establish TEP's stranded costs, if any. If the auction is not successful for a particular unit (a failed auction), TEP's stranded costs will be determined using the net revenues lost method. If there are assets producing negative stranded costs, stranded cost recovery will be reduced as described below.

¹ Under a license plate approach a consumer would pay a fee for transmission services based upon which utility service area it is located in. Payment of the fee allows the consumer to use the entire transmission network included in the Transco's service area without additional charges.

If TEP fails to divest (other than through a failed auction) it will be permitted an opportunity to recover transition revenues to maintain its financial viability.

- If the sale price of an asset (including the value assigned to an asset that is exchanged) exceeds the net book value of the asset, any gain received, up to 35 percent of net book value of any transmission assets purchased, will be used to acquire transmission assets for the Transco. Thus, the gain will be used (at least in part) to acquire transmission assets and will not, in its entirety, or perhaps at all, be used to reduce TEP's stranded costs. However, stranded costs will be reduced by two actions: 1) while the CTC is in effect, TEP's jurisdictional rates will be reduced by an amount equal to TEP's rate of return applied to the gain invested in transmission; 2) after the CTC expires, TEP's rates will be reduced to reflect the recovery of the common equity balance from the gain invested by the Transco (apparently using a hypothetical capital structure of 35 percent equity) over a ten year period.
- If securitization reduces the total cost of customers for regulatory assets and/or stranded cost recovery, TEP will securitize all regulatory assets and/or stranded costs resulting from divestiture.
- TEP will revise its unbundled service costs to reflect a 1.1 percent rate reduction (Decision No. 61104) and to reflect a recent cost of service study approved by the Commission. TEP will file unbundled tariffs by November 15, 1998.
- TEP will recover stranded costs through an interim Competition Transition Charge (Interim CTC) for the period prior to TEP's completion of divestiture of its generation units and through a permanent CTC for the period after divestiture of generation units until December 31, 2008.
- The Interim CTC is essentially the difference between the current embedded cost of generation and the Palo Verde spot market price of electricity adjusted for losses and for ancillary services, capacity, reserves and other necessary generation costs. The Interim CTC will vary from customer class to customer class. Further, the adjustment may be revised after December 31, 1999. Table 1 indicates approximate values of the Interim CTC for some customer classes.
- The spot market price will be forecast by TEP using NYMEX futures prices (which are for firm and non-firm energy and for on-peak and off-peak periods for delivery in a specified month) and using unconstrained hourly California PX prices to estimate hourly variations in price. The specific forecast method is not described.
- The Interim CTC may be adjusted, upon Commission approval, if the actual spot market price differs from projected spot market prices.

Table 1
Illustrative Values of TEP Interim CTC (\$/kWh)

	Residential	Large General Service	Public Authorities Firm	Public Authorities Interruptible	Lighting
1. Average Spot Market Price	\$0.0220	\$0.0220	\$0.0220	\$0.0200	\$0.0200
2. Loss Factor	5%	5%	5%	5%	5%
3. Adder	\$0.0040	\$0.0040	\$0.0040	\$0.0040	\$0.0040
4. Implied Market Rate	\$0.0271	\$0.0271	\$0.0271	\$0.0250	\$0.0250
5. Embedded Generation Rate	\$0.0547	\$0.0655	\$0.0664	\$0.0332	\$0.0348
6. Interim CTC (Line 5- Line 4)	\$0.0276	\$0.0384	\$0.03930	\$0.0082	\$0.0098

- The CTC Tariff in Exhibit C indicates that if any portion of TEP's distribution system is acquired by an entity not regulated by the Commission, customers no longer served by TEP's distribution system will have to pay, in a lump sum, a pro rata share of the outstanding principal and accrued interest on Transition Property. This provision would not apply if a provision is made for defeasance of the Transition Property and the CTB's (competition transition bonds) with a portfolio of US Treasury obligations or if written consent is obtained from the SPE. Transition Property is TEP's right to be paid amounts through the collection of CTC charges. SPE is the entity buying the Transition Property and selling bonds for securitization of the stranded costs.
- TEP will be allowed to recover all of its regulatory assets. The rates for regulatory assets will be identified in the unbundled tariffs. The settlement is not clear regarding whether recovery of regulatory assets will also be accomplished through the CTC, resulting in double recovery.
- TEP commits to having an independent scheduling administrator in place by the end of 1998 and to facilitating the development of an independent system operator by the end of 2000.
- TEP agrees to modify its Certificate of Convenience and Necessity to permit competition.
- TEP agrees to move to dismiss with prejudice all pending litigation against the Commission.
- TEP will meet the solar portfolio standard by purchasing all necessary solar power through an RFP process and recover the costs through a solar rate to market the solar power to its standard offer customers.

Impact of the Settlement on the City

The settlement accomplishes several goals:

- It eliminates the potential for adverse rulings from the courts.
- It may reduce potential abuse of market power by vertically integrated utilities using their control over the transmission system to thwart competition in generation.
- It gains some assurance that the solar portfolio standard will be met for standard offer service.
- It increases the probability that competition will start on January 1, 1999.

However, the settlement confirms a **subsidy** to the Transco and imposes some significant impediments to competition that are likely to greatly limit the benefits of competition. These issues are discussed below.

Based upon recent experience, TEP may be able to sell some of its generating assets at market prices above net book value. This gain could be used to reduce customers' stranded cost liability. However, some or all of the gain on such sales will be used by the Transco to acquire more transmission facilities. If the gains are used to acquire more transmission facilities, then they will not be available to reduce stranded cost payments by customers. The settlement agreement does provide for some reduction of jurisdictional rates as indicated above. **However, the overall effect of the settlement agreement is to keep the CTC needlessly high and to subsidize the Transco so it can acquire transmission facilities.** Residents and businesses of Tucson and the City government as a consumer will be forced to contribute to the Transco's investments. Parties in the marketplace, if a Transco is to be pursued at all, should make investments in a Transco. The public should not be compelled to invest in private enterprise.

The transaction between APS and TEP may already contain a subsidy for the Transco. TEP's original cost for plants, which are 22 to 29 years old, is about equal to the value of the plants in the transaction with APS. One would expect that these plants would be heavily depreciated so that the net book value would be far less than original cost, suggesting that TEP is experiencing a gain on the transaction. That gain is not being used to reduce the CTC. Consumers opting for the competitive market will thus pay an inflated CTC and will subsidize the Transco.

Further, any public benefit from subsidizing the Transco may be lost if the Transco does not acquire *all* transmission facilities in Arizona. In such a case, Tucson-area consumers will have subsidized a company and not even received any purported benefits from dismantling vertically integrated utilities. In addition, if the Commission believes that consumers must subsidize a Transco for a statewide benefit, the settlement agreement unfairly imposes the payment of the subsidy only on Tucson area consumers.

Aside from the issue about the use of gains on the sale of power plants, the settlement imposes an Interim CTC so that a competitive purchase is economical only if a buyer can obtain energy at a price that is consistently less than the spot market price (adjusted for losses and ancillary services). Based upon prices during the year ending August 15, 1998, a buyer would have to pay less than about \$25 per MWH on average to obtain energy more cheaply from a competitor than from TEP; the \$25 per MWH figure includes an allowance for transaction costs and an adder for ancillary services. While obtaining energy on a multi-month or one-year contract at such a price

may be possible, it seems unlikely that a significant number of customers would be able to arrange contracts at low prices for year-round service.

The spot market price does not represent common purchases made under contracts of several months to several years duration. Much of the energy sold competitively will not be spot market transactions, but longer-term transactions. The credibility of the Palo Verde spot market price as a measure of all wholesale purchased energy costs is undercut by TEP's willingness to purchase 200 MW at an 80 percent load factor at \$31 per MWh in 2001 (Attachment C to the Memorandum of Understanding). In 1999, the adjusted spot market price may average about \$25 per MWh, as discussed above. Two years later, the market price, as indicated in Attachment C, is \$31 per MWh, an increase of about 11 percent per year. The large escalation rate in energy prices suggests that using the adjusted spot market price underestimates the actual prices paid in the market for non-spot purchases. Further, the purchase by TEP is contingent upon the availability of the Navajo and Four Corners units. If the energy were firm, the price would be even higher. In addition, if the load factors were lower, as is typical of most consumers, the price would probably be higher.

The method for calculating the Interim CTC is very general. It is possible that TEP's calculation could underestimate the spot market price, thereby increasing the Interim CTC. A public review of the calculation of the spot market price and Commission approval of the method would help alleviate biases in the estimates.

If the Commission permits frequent changes in the Interim or permanent CTC, as is possible under the settlement, there will be further impediments to competition. Buyers and sellers will have to manage the risk of unpredictable shifts in the CTC and many consumers may choose to stay with standard offer service and some sellers may choose to exit the market.

Retaining a CTC through 2008 will further impede competition. If the permanent CTC continues for so long, most consumers will not see a benefit to shopping around until after 2008 because the CTC may offset much of the savings.

As written, the settlement agreement suggests that TEP will double recover on its regulatory assets. In particular, the rates for regulatory assets will be identified in the unbundled tariffs and the calculation of the Interim CTC also apparently includes the regulatory assets in the value of the embedded generation component as presented in Exhibit B. This potential double counting is probably not the intention of the parties, and clarifying language is needed to remove the double counting.

The agreement provides for a lump sum payment of remaining CTC-related costs if a portion of the distribution system is acquired by an entity not subject to the jurisdiction of the Commission. This provision will protect TEP in its recovery of stranded costs. However, it imposes a potential burden on the City if the City desires to municipalize a portion of TEP's distribution system. Because the Commission will have no authority over a non-jurisdictional entity in the future, it should *now* require TEP to allow the non-jurisdictional entity acquiring a portion of TEP's distribution system the option to pay off the CTC at the same rate that the CTC would have been paid under Commission regulation. Otherwise, the agreement may create a poison pill for municipalization.

Action

The City recommends that the Commission take the following action:

Modify the agreement to clarify certain of its provisions and subject its implementation to greater Commission review as follows:

- Require public Commission review of the computation of the CTC.
- Adopt only infrequent changes in the CTC (not more than once every two years, with a final true up if necessary).
- Document the fair market value of TEP's share of the Four Corners and Navajo units.
- Prohibit double recovery of regulatory assets by clarifying that the CTC does not include recovery of any regulatory assets included in unbundled costs.
- Require TEP to allow a non-jurisdictional entity acquiring a portion of TEP's distribution system the option to pay off the CTC at the same rate that the CTC would have been paid under Commission regulation.
- Use a price (before adjustments for losses or adders) of the greater of the spot market price or \$36 per MWh for calculating the Interim CTC.
- Use all gains on the sale of assets to offset stranded costs and prohibit use of any gains on the sale of assets to capitalize a Transco so that consumers do not subsidize or lend money to any entity to acquire transmission assets.
- Discontinue any and all CTC charges by December 31, 2004, consistent with the date applied to SRP by A.R.S. 30-805(B) and with APS' proposed termination date for its CTC.