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ARMY LEGAL SERVICES AGENCY
1 NORTH STUART STREET
ARLINGTON, VA 22203-1837

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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION) DOCKET NO. E-01933A-98-0471
 OF TUCSON ELECTRIC POWER COMPANY FOR)
 APPROVAL OF ITS STRANDED COST RECOVERY)
 AND FOR RELATED APPROVALS,)
AUTHORIZATIONS AND WAIVERS.)

IN THE MATTER OF THE FILING OF TUCSON) DOCKET NO. E-01933A-97-0772
 ELECTRIC POWER COMPANY OF UNBUNDLED)
TARIFFS PURSUANT TO A.A.C. R14-1602 et seq.)

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

NOTICE OF FILING

Enclosed for filing are an original and ten(10) copies of the Brief on behalf of the United States Department of Defense and All Other Federal Executive Agencies, in the above referenced proceeding.

Copies have been served on all known parties in accordance with the enclosed Service List.

Respectfully submitted this 27th day of August, 1999.

Sincerely,

PETER Q. NYCE, JR.
General Attorney
Regulatory Law Office
Phone: (703) 696-1644
Fax: (703) 696-2960

Enclosure

Arizona Corporation Commission
DOCKETED

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IN THE MATTER OF THE APPLICATION) DOCKET NO. E-01933A-98-0471
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BRIEF OF THE DEPARTMENT OF DEFENSE ("DOD")

ROBERT N. KITTEL
Chief
Regulatory Law Office
U.S. Army Legal Services Agency
Department of the Army
901 N. Stuart Street, Room 713
Arlington, VA 22203-1837

For

THE DEPARTMENT OF THE DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

PETER Q. NYCE, JR.
General Attorney

Of Counsel

Dated: August 27, 1999

BEFORE THE ARIZONA CORPORATION COMMISSION
Tucson Electric Power Company ("TEP") – Settlement Agreement
Docket Nos. E-01933A-98-0471, E-01933A-97-0772 and RE-00000C-94-0165

BRIEF OF THE DEPARTMENT OF DEFENSE ("DOD")

TEP currently provides electric service to two major DOD facilities under Rate Schedule No. 14: Fort Huachuca in Sierra Vista, Arizona and Davis-Monthan Air Force Base in Tucson. DOD's suggested changes to the Settlement Agreement ("Agreement"), as presented in the direct testimony of Mr. Dan L. Neidlinger, are not designed to unravel the Agreement. Rather, they are designed to simplify the unbundling of TEP's rates, improve the likelihood of competition and provide for a defined and equitable recovery of stranded costs among TEP's customer classes.

I. TEP's Stranded Costs Should be Recovered Through a Schedule of Fixed Competition Transition Charges ("CTCs").

The Agreement provides for the recovery of stranded costs through a combination of fixed and floating CTCs. The fixed CTC component, \$0.93 per kilowatt-hour on average, is designed to recover \$450 million of defined stranded costs. The floating component is designed to recover an undefined amount of stranded costs associated with "remaining above-market generating costs at Springerville". Under the Agreement, the floating CTC will be calculated quarterly using a complicated formula that incorporates NYMEX market futures at Palo Verde, historical California PX on-peak and off-peak ratios, unbundled rate components and load-shaping adders. The floating CTC changes inversely with market prices.

Proponents of the Agreement testified that the floating CTC protects both TEP and its customers from any under-recovery or over-recovery of stranded costs. It is unclear that this will in fact be the case since neither the amount nor the nature of these remaining costs has been defined in the Agreement. Ms. Karen Kissinger, TEP's Vice President, Controller and Chief Information Officer, testified under cross-examination that these remaining stranded costs are both fixed and variable costs. First, the use of a floating CTC is a poor choice for the recovery of fixed costs.

Second, it is unlikely that any variable costs incurred due to the operation of the Springerville generating facility could be classified as stranded costs since they would only be incurred during periods when market prices exceeded variable running costs. Finally, the use of a floating CTC to recover an unknown amount of stranded costs is akin to finding a solution to a single equation with two unknowns – impossible.

Mr. Kevin Higgins, witness for Arizonans for Electric Choice and Competition, testified that the floating CTC provides for a hedge against fluctuations in the market price of power. He is correct. The floating CTC methodology provides for an almost 100% guarantee that a direct access customer's total rate will be equivalent to the bundled rate assuming that power is acquired at the same market prices as those contained in the CTC calculation. Accordingly, there are no savings to the customer over the bundled rate and therefore no competition.

The schedule of fixed CTCs, by class of customer, recommended by Mr. Neidlinger provides for a definitive CTC collection path towards a definitive stranded cost target and has numerous advantages over the fixed/floating CTC method incorporated in the Agreement. First, it is easily understood by both Energy Service Providers ("ESP's") and TEP's customers; no projections or estimates of CTC are needed. Second, it provides assurance that CTCs will decline in future years whereas there is no such assurance under the CTC calculations proposed in the Agreement. Third, a fixed CTC recovery schedule significantly reduces the complexity of accounting for stranded cost collections. The fixed/floating CTC method requires TEP to calculate monthly a floating CTC rate for every customer on its system to enable it to compute the total amount of stranded costs collected from not only direct access customers but also from bundled rate customers. Customers taking service under bundled rates will provide the bulk of stranded cost dollars recovered by TEP over the next few years. Finally, a fixed schedule of CTCs enables ESPs to provide competitive bids with a greater degree of confidence and precision than those bid offerings under an unknown level of CTCs. As a result, the prospects of competition will be enhanced.

II. The Commission Should Issue an Accounting Order Within One Year of the Advent of Competition That Establishes TEP's Total Stranded Costs, Assigns These Costs to Customer Classes and Prescribes the Manner in Which TEP Shall Account for the Collection of Stranded Costs.

The Agreement is silent with respect to both the totality of TEP's stranded costs and the manner in which the collection of these costs will be recorded, either formally or informally, on the books of the Company. The DOD suggests, consistent with Mr. Neidlinger's testimony, that the Commission issue an accounting order that sets TEP's total stranded costs, allocates these costs to customer classes and prescribes the manner in which the recovery of these costs are to be calculated and recorded on TEP's books. Additionally, the order should require TEP to report on a quarterly basis the amount of stranded costs it has collected from direct access customers and bundled rate customers. The accounting order should be issued no later than the first quarter of the year 2001. The primary reason for these procedures is to allow for the tracking the collection of stranded costs in a manner that is understood by all parties. Absent these procedures, one can envision literally weeks of testimony during the proposed 2004 rate case debating the amount of stranded costs collected during the previous four years and the amount of stranded costs remaining to be collected.

III. Stranded Costs Should be Allocated to All Classes of Customers Using the Allocation Method Adopted by the Commission in Previous TEP Rate Cases and the Recovery of These Costs Should be Consistent with the Commission's Ratemaking Treatment in Those Cases

The Average & Peaks ("A&4CP") method used by TEP to unbundle its rates was first adopted by the Commission in Docket No. U-1933-93-066, Decision No. 58497, dated January 13, 1994, as the demand allocator for generation costs and implicitly confirmed in the subsequent rate settlement in Docket No U-1933-95-317, Decision No. 59594 dated March 29, 1996. Although the DOD has historically argued that the A&4CP demand allocation method over-allocates generation costs to high load factor customers, the generation cost component of TEP's current

rates are based on this allocation method. Mr. Neidlinger's proposed schedule of fixed CTCs for each customer class, Schedule DLN-2, was calculated using the A&4CP method to allocate TEP's estimated total stranded costs of \$676 million. Accordingly, his proposed class CTC's are consistent with the current Electric Competition Rules ("Rules") which state: "Stranded Cost shall be recovered from customer classes in a manner consistent with the specific company's current rate treatment of the stranded asset, in order to effect a recovery of Stranded Cost that is in substantially the same proportion as the recovery of similar costs from customers or customer classes under current rates." (R14-2-1607 (G)).

As shown on Schedule DLN-2, approximately \$170 million of TEP's total estimated stranded costs are allocable to the Large Light & Power class using the A&4CP allocation method. Included in this amount is \$119 million that is assignable to contract customers. If this amount and related recovery thereof, is not properly accounted for in the manner previously discussed, other non-contract customers will ultimately be required to unfairly absorb any shortfall in the collection of stranded costs from contract customers.

The exact amount of stranded cost dollars currently being recovered from contract customers is known only to TEP. Witnesses Erdwurm, Higgins and Neidlinger agreed with the general premise of "some recovery" in contract rates. As Mr. Neidlinger stated during his cross-examination, the stockholders of TEP are currently absorbing the difference between the stranded costs currently included in the bundled rate (Rate 14) and those in contract rates. It is logical to assume that this difference is fairly large since the contract rates have been purged of most of these above-market costs. Accordingly, the current contribution to TEP's stranded costs by contract customers is minimal.

In rebuttal, Mr. Higgins contended that Mr. Neidlinger's allocation of stranded costs would violate the class recovery language of the current Rules. To the contrary, if non-contract customers are required to pay stranded costs allocable to contract customers under the A&4CP allocation method, the Rules would be violated not only from an allocation perspective but also from a "substantially the same proportion" standpoint since non-contract customers could be required to continue to pay stranded costs far beyond the time at which their true stranded cost

obligation had been met. Many of the non-contract customers that sponsored Mr. Higgin's testimony in this proceeding fall into this category.

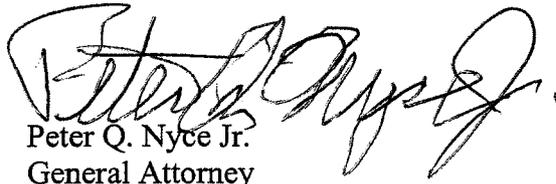
Under cross-examination, Mr. Higgins was asked to assume a hypothetical rate case whereby all of TEP's stranded costs would be collected through a surcharge over a one -year period. He was then asked whether the \$119 million allocated to the contract customers would be recovered from non-contract customers in such a case. His answer was yes. (Tr. Page 356, Line 15). The Commission's response to this question has always been a resounding "No". In Docket No. U-1933-93-066, the Company prepared an embedded cost of service study using the A&4CP demand allocation method and assigned the contract customers with their fair share of generation costs to avoid any subsidization of these customers by other classes of customers. No increase in rates to contract customers was requested by TEP, resulting in a return on allocated rate base for this group of customers of less than 1%. The Commission's decision approved this allocation, thereby requiring the stockholders of TEP to absorb a return of over 7% on over \$65 million of rate base. In TEP's most recent case, Docket U-1933-95-117, the Commission again held fast to its policy requiring TEP, not its non-contract customers, to absorb any costs properly allocable to contract customers. Conclusions of Law No. 6 in Decision No. 59594, the decision that implemented a settlement agreement in that case, states: "Based on the Agreement as modified herein it is appropriate for TEP to be granted increased overall revenues in the amount of 1.1 percent, to be spread across the board. If no increase is given to special contracts, the total revenue increase will be less than 1.1 percent. If given to all customers, the revenue increase will be \$6.4 million." The revenue increase was less than \$6.4 million.

The Commission should continue its past policy with respect to cross-subsidization between contract and non-contract customers by ensuring that non-contract customers are not required to cover more than their fair share of TEP's stranded costs.

IV. Conclusion

The DOD urges the Commission to thoughtfully consider its recommended modifications to the Agreement. The DOD does not consider these recommended changes to be “deal-breakers”. The parties to the Agreement, for instance, should not logically object to changes that would be beneficial to both TEP and its customers. Further, the parties should not object to an accurate accounting for the collection of stranded costs or the development of a procedure that assures equitable recovery of these costs among the various classes of customers.

Respectfully Submitted,



Peter Q. Nyce Jr.
General Attorney

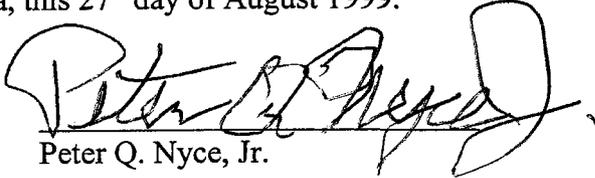
Regulatory Law Office
U.S. Army Legal Services Agency
Department of the Army
9001 N. Stuart Street, Suite 713
Arlington, VA 22203-1837

For
THE DEPARTMENT OF THE DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

CERTIFICATE OF SERVICE

I hereby certify a true and correct copy of the Brief on the behalf of the United States Department of Defense And All Other Federal Executive Agencies, was served by Federal Express or first-class U.S. mail, to all parties on the attached service list.

Dated at Arlington County, Virginia, this 27th day of August 1999.


Peter Q. Nyce, Jr.

CHRISTOPHER HITCHCOCK
HITCHCOCK HICKS & CONLOGUE
P O BOX 87
BISBEE AZ 85603-0087

TIMOTHY M HOGAN
ARIZONA CENTER FOR LAW
IN THE PUBLIC INTEREST
202 E MCDOWELL RD SUITE 153
PHOENIX AZ 85004

STEVEN C GROSS
PORTER SIMON
4200 TRUCKEE AIRPORT ROAD
TRUCKEE CA 96161

DAN NEIDLINGER
NEIDLINGER & ASSOCIATES
3020 N 17TH DRIVE
PHOENIX AZ 85015

PAUL BULLIS CHIEF COUNSEL
CHRISTOPHER KEMPLEY
LEGAL DIVISION
ARIZONA CORPORATION COMMISSION
1200 WEST WASHINGTON STREET
PHOENIX AZ 85007

DIRECTOR UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION
1200 WEST WASHINGTON STREET
PHOENIX AZ 85007

STEVE WHEELER
THOMAS M MUMAW
SNELL & WILMER LLP
ONE ARIZONA CENTER
400 E VAN BUREN STREET
PHOENIX AZ 85004-0001

ROBERT LYNCH
340 E PALM LAN SUITE 140
PHOENIX AZ 85004-4529

C WEBB CROCKETT
JAY L SHAPIRO
FENNEMORE CRAIG
3003 N CENTRAL AVENUE SUITE 2600
PHOENIX ARIZONA 85012-2913

BETTY K PRUITT
ACAA
2627 N 3RD STREET SUITE TWO
PHOENIX AZ 85004

LAWRENCE ROBERTSON JR
MUNGER CHADWICK PLC
333 N WILMOT SUITE 300
TUCSON AZ 85711

KENNETH C SUNDLOF JR
JENNINGS STROUSS & SALMON PLC
TWO N CENTRAL AVENUE
PHOENIX ARIZONA 85004-2393

ALAN WATTS
SCPPA
529 HILDA COURT
ANAHEIM CA 92806

BRADLEY S CARROLL
TEP
LEGAL DEPT - DB203
220 W SIXTH STREET
P O BOX 711
TUCSON ARIZONA 85702

GREG PATTERSON
SCOTT WAKEFIELD
RUCO
2828 N CENTRAL AVE SUITE 1200
PHOENIX AZ 85004

BARBARA KLEMSTINE
APS
400 N 5TH STREET
PHOENIX ARIZONA 85072-3999

DAVID L DEIBEL
LORETTA HUMPHREY
TUCSON CITY ATTORNEY'S OFFICE
P O BOX 27210
TUCSON ARIZONA 85726-7210

THOMAS L MUMAW
SNELL & WILMER
ONE ARIZONA CENTER
PHOENIX AZ 85004

KATHERINE HAMMACK
APS ENERGY SERVICES CO INC
ONE ARIZONA CENTER
PHOENIX ARIZONA 85004

MARGARET A ROSTKER
JERRY R BLOOM
WHITE & CASE LLP
633 WEST FIFTH STREET
LOS ANGELES CA 90071

LEONARDO LOO
O'CONNOR CAVANAGH
ONE EAST CAMELBACK RD SUITE 1100
PHOENIX AZ 85012-1656

DOUGLAS C NELSON ESQ
7000 NORTH 16TH STREET #120-307
PHOENIX AZ 85020

JERRY RUDIBAUGH
CHIEF HEARING OFFICER
ARIZONA CORPORATION COMMISSION
1200 WEST WASHINGTON STREET
PHOENIX AZ 85007

LESLIE LAWNER
ENRON CORP
712 N LEA
ROSEWELL NM 88201