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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 APPLICATION
OF TUCSON ELECTRIC POWER
COMPANY FOR APPROVAL OF ITS PLAN
FOR STRANDED COST RECOVERY AND
FOR RELATED APPROVALS,
AUTHORIZATIONS AND WAIVERS.

DOCKET No. E-01933A-98-0471

**WRITTEN COMMENTS AND REQUEST FOR HEARING REGARDING
APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF
ITS PLAN FOR STRANDED COST RECOVERY AND FOR RELATED APPROVALS,
AUTHORIZATIONS AND WAIVERS SUBMITTED BY ASARCO INCORPORATED,
CYPRUS CLIMAX METALS COMPANY, ENRON CORP., AND
ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION**

September 21, 1998

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Climax Metals Company, Enron Corp. and
Arizonans for Electric Choice and
Competition

Arizona Corporation Commission

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1 ASARCO, Incorporated, Cyprus Climax Metals Company, Enron Corp., and Arizonans for
2 Electric Choice and Competition (collectively referred to herein as "AECC") hereby file their
3 written comments in response to the Application of Tucson Electric Power Company for Approval
4 of its Plan for Stranded Cost Recovery and for Related Approvals, Authorizations and Waivers
5 dated August 21, 1998 ("TEP Application").¹ In addition, AECC hereby requests that the
6 Commission schedule a hearing regarding the TEP Application at the earliest possible date.

7 **I. OVERVIEW.**

8 In Decision No. 60977 (June 22, 1998) (the "Decision"), this Commission set forth the
9 procedures to be followed by Affected Utilities seeking to recover stranded costs resulting from the
10 deregulation of electric generation services in Arizona. Among other things, the Commission
11 required an Affected Utility to "file its choice of options for stranded cost recovery" along with an
12 implementation plan within 60 days. Decision at 23. Thereafter, all other parties were authorized to
13 respond by filing written comments and requests for hearings. Id.

14 In a confidential schedule referenced in but not attached to the TEP Application, TEP sets
15 forth its estimation of stranded costs as required by the Decision. TEP estimates that its total
16 stranded costs are between \$600 million and \$1.1 billion dollars. The TEP Application contains a
17 sweeping plan for divestiture of the utility's generation assets in order to recover these estimated
18 costs. Implementing any such plan is, by necessity, a complex endeavor. In TEP's case, there are
19 many specific determinations left to be made and the Commission must act to ensure that the
20 currently concealed or unknown details of TEP's stranded cost recovery proposals are revealed and
21 understood by the Commission and the consumers before any TEP plan can receive the
22 Commission's approval.

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¹ In addition, Enron Corp. will be submitting a separate filing in response to the stranded cost filings by
the Affected Utilities concurrently herewith.

1 Obviously, protection of the consumer public must be the Commission's paramount concern.
2 It is difficult to determine whether any benefits will be realized by consumers if TEP's stranded cost
3 proposal is adopted. However, one thing is for certain: following the Commission's determination
4 that a utility divesting itself of its generation assets will be able to recover all of its stranded costs,
5 TEP and its shareholders have been given a tremendous and unprecedented opportunity to parachute
6 to safety. As a high-cost electric power generator in an increasingly competitive market, the
7 overriding benefit being conferred upon TEP and its shareholders must be borne in mind as the
8 details of its plan are reviewed. At a minimum, before approving any aspect of the TEP
9 Application, the Commission must make a number of important modifications to protect consumers
10 at every juncture and must require TEP to provide answers to several critical questions.

11 In that context, AECC offers the following comments and recommendations with respect to
12 the TEP Filing.

13 **II. THE DIVESTITURE SHOULD ONLY PROCEED IF IT WILL MAKE**
14 **CUSTOMERS BETTER OFF.**

15 Even a superficial examination of the TEP Application reveals that TEP and its shareholders
16 will realize substantial benefits if TEP's tariff filing is adopted. This is true because, as stated above,
17 stranded cost recovery allows the utility an opportunity to escape the detrimental repercussions of
18 past decisions that have left TEP an inefficient power generator in a highly competitive market. The
19 Commission's review and analysis of TEP's stranded cost proposal must focus on whether the
20 proposal will benefit consumers and enhance competition for electric power generation in Arizona.
21 In short, the TEP Application should only be granted if it will make consumers "better off."

22 Consumers will be better off under the TEP proposal if the market price of power plus
23 delivery charges (distribution, transmission, ancillary services, system benefits charge) and the CTC
24 is less than the bundled price of power currently being paid by consumers under regulation. Under
25 the TEP proposal, the CTC will be determined by subtracting the sales prices (including costs of
26 sale) for all of TEP's generation assets being sold at auction from their regulated cost basis, e.g., net

1 book value. Unfortunately, however, because the actual sales price cannot be known in advance of
2 the asset auction, the CTC remains uncertain. To provide assurance that divestiture will promote
3 competition and provide consumers the intended benefits of said competition (i.e., lower prices for
4 power), **the Commission must require that TEP formulate minimum bid requirements prior to**
5 **the sale of any generation asset at auction.** These minimum bids should be calculated to ensure
6 that the resultant CTC passes the measurement test of making consumers "better off." Moreover,
7 TEP must not be allowed to exercise the requested "sole discretion" to reject bids if such rejection
8 would result in generation assets remaining unsold despite bids exceeding these minimums.

9 **III. TEP'S PROPOSED INTERIM CTC CHARGE IS ANTI-COMPETITIVE.**

10 The TEP proposal for an Interim CTC (ICTC) during the period preceding the auction sale
11 of generation assets must be rejected because it is designed to thwart competition during the pre-
12 divestiture period. The proposed ICTC is described in Exhibit C of TEP's filing. TEP proposes to
13 calculate an ICTC by taking the difference between the generation costs embedded in TEP's existing
14 rate schedules and the wholesale market price of power sold at Palo Verde. Thus, the proposed
15 ICTC is an extreme version of the Net Revenues Lost approach to calculating stranded cost
16 recovery. This methodology was already debated at length in the stranded cost proceedings, and
17 expressly rejected by the Commission as unacceptable. The Net Revenues Lost approach treats
18 stranded cost as the difference between the generation-related revenue the utility would expect to
19 collect under continued regulation and the generation-related revenue anticipated under
20 competitive market pricing. The salient feature of this approach is its presumption that stranded
21 costs equal any additional amounts consumers would have paid for generation services if
22 regulation continued and competition never occurred. Carried to its extreme, as TEP attempts to
23 do in its ICTC proposal, the Net Revenues Lost approach completely defeats the purpose of
24 moving to a competitive market.

25 Under TEP's proposal, a consumer purchasing generation service at the "market price"
26 (however defined) will pay a delivered price of power equal to the generation costs embedded in

1 TEP's existing tariff. Obviously, the best such a consumer can do by selecting a competitive
2 supplier is break-even. However, the Commission already required that this break-even point be
3 established as the **worst-case outcome** when it stated that "stranded costs should not be used to
4 discourage the marketing of competitive generation. We have placed a limitation that no customer
5 will receive a rate increase as a result of stranded costs." Decision at 18. As a consequence, after
6 rates are unbundled, retail access customers purchasing generation at the market price must, at a
7 minimum, pay a CTC that results in a delivered price of power equal to the bundled rate paid under
8 current rates. With the possible exception of special contract customers – whom, as discussed in
9 section VIII, infra, TEP may be trying to make even **worse off** -- the TEP proposal would virtually
10 guarantee that competitive consumers could do **no better than the worst-case outcome** specified
11 by the Commission. The ability of a consumer to lower delivered costs of electricity under
12 competition would be effectively nullified by the TEP ICTC proposal.

13 **IV. TEP'S TARIFF FILING DEMONSTRATES AN IMPROPER RELIANCE ON THE**
14 **WHOLESALE MARKET PRICE.**

15 TEP's use of the Net Revenues Lost approach to calculate the ICTC requires the use of a
16 market price in the calculation of stranded cost. The appropriate market price to use in this context
17 is the retail market price for Arizona. TEP proposes to use a wholesale price measurement - the
18 Dow Jones Palo Verde Index of spot market prices. Such an approach will overestimate stranded
19 cost by the average difference between wholesale and retail prices. Any use of a market price
20 measurement to calculate stranded costs must account for the expected retail mark-up. Otherwise,
21 consumers will overpay stranded costs. Further, TEP does not indicate whether it would use the
22 firm or non-firm price at Palo Verde. Notwithstanding the fact that a wholesale index is the
23 incorrect basis for calculating retail stranded costs in the first place, use of the non-firm price would
24 compound the error, as the prevalent generation service that will be purchased by retail consumers is
25 firm service.

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1 In addition, it is not clear whether the TEP approach would make appropriate adjustments
2 for the fact that its proposed ICTC would be levied on a greater number of kilowatt-hours during
3 more expensive on-peak hours than during off-peak hours. Instead, TEP simply refers to the
4 "actual" Palo Verde index price without specifying how this "actual" price is determined. Any use
5 of a blended on/off-peak market price index to arrive at an average daily price must be transaction-
6 weighted across the on- and off-peak periods.

7 Finally, TEP proposes to use NYMEX Palo Verde futures prices to forecast market prices
8 for the upcoming quarter, and then true-up that forecast using "actual" spot market prices. The
9 implication here is that the NYMEX price is not an "actual" price, but a forecast that needs to be
10 "corrected" against the spot market price. However, the NYMEX Palo Verde futures price is indeed
11 an actual price -- as is the spot market price. The only material difference between them is that the
12 commodity is being purchased over two different time horizons. In fact, retail consumers will likely
13 opt for the price certainty inherent in a futures-type contract. To the extent that wholesale prices are
14 used in deriving the higher retail price, it is unnecessary to "correct" the futures price using the spot
15 market price. Instead, both price measurements will play a role in influencing retail prices.

16 **V. TEP'S TARIFF FILING INCLUDES AN IMPROPER RETURN ON EQUITY.**

17 TEP is not entitled to an equity return on the unamortized balance of stranded costs.
18 Nevertheless, TEP not only seeks a return on equity on the stranded cost balance, it seeks a return
19 based on a hypothetical capital structure that grossly understates the utility's actual debt-to-equity
20 ratio, artificially inflating the stranded cost burden on consumers. While the Decision provides for a
21 "return" on the stranded cost balance, this return should be limited to the cost of debt.

22 The reason the Commission should not allow an equity return is straightforward: As a trade-
23 off for divesting its generation assets, TEP shareholders are being financially bailed out by
24 consumers. The CTC will pay off the uneconomic portion of the utility's generation asset costs.
25 Despite having saddled themselves with a number of uneconomic generation assets, TEP and its
26

1 shareholders will recover their capital investment courtesy of the CTC. In this situation, it is one
2 thing to allow a return *of* capital, but a return *on* capital is totally unjustified.

3 For one thing, the nature of the assets involved must be considered. By definition, the
4 stranded cost balance pertains to the uneconomic portion of the assets' costs. In other words, it
5 pertains to the portion of net book value that is worthless. TEP and its shareholders should consider
6 themselves very fortunate to be recouping the cost of these investments above their market value.
7 To go beyond this return of capital would mean that TEP shareholders would actually be earning an
8 equity return on worthless assets. There is simply no rational basis for investors to earn an equity
9 return on assets that are worthless.

10 Furthermore, a divestiture plan accompanied by stranded cost recovery eliminates
11 shareholder risk. TEP will no longer own generation assets or have any of the associated risks.
12 Investors are not entitled to a return on investment once the risks associated with that investment are
13 eliminated. Finally, removing the unjustified equity return from TEP's tariff filing would have a
14 significant impact on reducing TEP's burdensome CTC. Not only will consumers be spared the
15 direct cost of the return, they will be spared the substantial associated "gross-up" for income tax
16 purposes.

17 **VI. TEP'S CLAIM THAT IT IS ENTITLED TO RETAIN 50% OF THE EXCESS**
18 **SALES PRICE OVER BOOK VALUE IS ERRONEOUS.**

19 In the Decision, the Commission stated that "an Affected Utility that divests all of its
20 generation costs to non-affiliated entities, that results in negative stranded costs (not including
21 regulatory assets) as defined by the Commission's Retail Electric Competition Rules and this
22 Order, shall be entitled to keep 50% of the negative stranded costs." Decision at 12. It is obvious
23 that the 50% a utility is entitled to retain includes only "negative stranded costs" as defined in the
24 Rules. Under the Rules, stranded cost is a *net* figure calculated with respect to *all* assets. A.A.C.
25 R14-2-1604.39. Thus, assets with net book values lower than market value are netted against
26 assets with net book values greater than their market values. The net result is stranded costs.

1 Contrary to TEP's self-serving interpretation, for negative costs to result, the calculation
2 as it relates to **all** of an Affected Utilities' generation assets must be negative. Under TEP's
3 reading, TEP gets the benefit of its few economic assets while consumers pay the burden of the
4 uneconomic ones. TEP's uneconomic costs will place a heavy burden on consumers during the
5 transition to open retail access. In any event, the Commission should make it absolutely clear that
6 it will not permit TEP, or any other Affected Utility choosing to divest, to cherrypick the revenues
7 from certain assets that may sell at a profit leaving consumers stuck with the full burden of the
8 utility's dogs. If the **total** stranded cost is positive, any and all revenue over net book value that
9 accrues from any asset sale must be applied to reduce the total stranded costs being paid by
10 consumers.

11 **VII. TEP'S CLAIMS OF STIPULATED LOSSES FROM LEVERAGED LEASE**
12 **ARRANGEMENTS REQUIRE CLOSE SCRUTINY BY THE COMMISSION.**

13 In its Application, TEP claims it is contractually obligated to make stipulated loss
14 payments to leaseholders under several leveraged leases associated with TEP's generation assets.
15 According to TEP, the total payable amount of these stipulated losses is \$1.2 billion as of January
16 1, 2001. TEP Application at 11. Amazingly, as set forth in Schedule 5 attached to TEP's
17 application, the assets subject to these leveraged leases have an aggregate net book value of only
18 \$651 million or slightly more than 50% of the amount TEP agreed to pay the holders of such
19 leases in the event of early termination. In fact, the original cost of the assets subject to the
20 leveraged leases was only \$718 million, approximately one-half of a billion dollars less than the
21 stipulated loss values claimed by TEP. In short, these amounts are staggering.

22 At the heart of the stranded cost "problem" facing Affected Utilities, the Commission and
23 consumers is the fact that many of the Affected Utilities' generation assets currently have book
24 values that exceed their current market value. In TEP's case, the utility also has lease termination
25 payments that are nearly double the net book values for such assets. Obviously, the early
26 termination penalties TEP agreed to pay when it entered into these leveraged leases bear no

1 relationship to the market value of the generation assets. Indeed, the early termination payments
2 bear no relationship to the regulatory value of the generation assets either. As such, TEP's early
3 termination payment agreements bear no relationship to the investment costs incurred by the
4 leaseholders. It follows that payment of the stipulated loss values will result in an unprecedented
5 windfall for the leaseholders. Consumers should not be required to pay the tab for the imprudent
6 decisions of TEP to provide these leaseholders with a "sweetheart" deal. Under no circumstances
7 should stipulated loss values in excess of net book value of generation assets be included in
8 stranded cost recovery.

9 In undertaking a careful review and analysis of TEP's claims of stipulated losses, the
10 Commission must obtain the answers to many unanswered questions. For example, who are these
11 leaseholders to which TEP has agreed to pay penalties that far outweigh the value of the
12 generation assets at issue? Does flexibility exist such that these stipulated loss provisions can be
13 renegotiated and can the Commission exercise its leverage over such leaseholders in an effort to
14 renegotiate such lease provisions? The Commission should also seek to ascertain why, in an
15 increasingly competitive marketplace, the leaseholders are not themselves trying to market
16 projects dependent upon regulatory enforcement of above-market revenue streams, particularly
17 when the regulators themselves are actively introducing competition. Furthermore, the
18 Commission should also consider whether assigning the leases would be preferable to terminating
19 the lease provisions. Of course, notwithstanding the answers to these important questions, the
20 Commission must not stray from the underlying premise that customers cannot be required to pay
21 stranded cost charges to cover TEP's agreements to pay stipulated loss values that exceed the
22 associated generation asset's net book value.

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1 **VIII. TEP CANNOT INCREASE RECOVERY OF STRANDED COSTS FROM SPECIAL**
2 **CONTRACT CUSTOMERS.**

3 The TEP proposal does not explicitly address the collection of stranded costs from special
4 contract customers whose contracts expire during the interim period and who then wish to purchase
5 competitive generation. Although TEP's Application calls for unbundling generation costs for
6 several customer classes as set forth in Exhibit C, there is no provision for the calculation of the
7 CTC for the utility's current special contract customers. TEP cannot determine the ICTC for special
8 contract customers if it results in generation costs that are not included in their current rates. The
9 Electric Competition Rules explicitly require that stranded cost recovery be in substantially the same
10 proportion as similar costs are currently being recovered from customers or customer classes.
11 A.A.C. R14-2-1607.G. Moreover, the Decision expressly limits the CTC such that **no consumer**
12 **will receive a rate increase as a result of stranded costs.** Decision at 18 Any ICTC for TEP must
13 conform to these principles for all consumers -- including special contract customers. In addition,
14 the proportionality and CTC cap requirements must be applied to the CTC design for the post-
15 divestiture period.

16 **IX. RELIEF REQUESTED.**

17 Based on the foregoing, AECC respectfully requests that the Commission schedule a
18 hearing regarding the TEP Application at the earliest possible date and, thereafter, issue an order
19 directing TEP to amend its stranded cost proposal to eliminate, among other things, (1) any
20 reliance on the Net Revenues Loss methodology; (2) the improper reliance on wholesale price
21 measurements identified hereinabove opting instead for the use of the Arizona retail market price;
22 (3) any provision which requires customers to pay stranded cost charges to cover TEP's
23 agreements to pay stipulated loss values that exceed the associated generation asset's net book
24 value; (4) any equity return on the unamortized balance of stranded costs; and (5) any increase in
25 the recovery of stranded costs from customers, including special contract customers. In addition,
26 the Commission must require TEP to clearly and convincingly demonstrate to the Commission

1 that its stranded cost proposal will benefit consumers. To this end, the Commission must require
2 that TEP formulate minimum bid requirements prior to the sale of any generation asset at auction.

3 RESPECTFULLY SUBMITTED this 21st day of September, 1998.

4 FENNEMORE CRAIG, P.C.

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