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BEFORE THE ARIZONA CORPORATION COMMISSION
AZ CORP COMMISSION

CARL J. KUNASEK
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COMMISSIONER

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COMMISSIONER

Arizona Corporation Commission

JUN 23 4 11 PM '99

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JUN 29 1999

IN THE MATTER OF THE APPLICATION OF ARIZONA
PUBLIC SERVICE COMPANY FOR APPROVAL OF ITS
PLAN FOR 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.A.C. R14-2-1601 ET SEQ.

DOCKET NO.
E-01345A-97-0773

NOTICE OF FILING

The Arizona Utility Investors Association hereby provides notice of filing Direct Testimony as required by the Commission's procedural order in the above-captioned matter.

DATED THIS 29TH DAY OF JUNE, 1999.

Walter W. MEEK
WALTER W. MEEK, PRESIDENT

Original and ten (10) copies of the referenced Testimony were filed this 29th day of June, 1999, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the referenced Testimony were hand-delivered this 29th day of June, 1999, to:

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Commissioner Bill Mundell
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Ray Williamson, Utilities Division
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BEFORE THE
ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE COMPANY
FOR APPROVAL OF ITS PLAN FOR
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.A.C. R14-2-1601 *ET SEQ.*

DOCKET NO. E-01345A-97-0773

DIRECT TESTIMONY OF
WALTER W. MEEK

ON BEHALF OF
THE ARIZONA UTILITY INVESTORS ASSOCIATION

JUNE 28, 1999

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DIRECT TESTIMONY

OF

WALTER W. MEEK

I. Introduction

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite 210, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the president of the Arizona Utility Investors Association ("AUIA" or "Association"), a non-profit organization formed to represent the interests of shareholders and bondholders who are invested in utility companies based in or doing business in the state of Arizona.

Q. ARE SOME AUIA MEMBERS SHAREHOLDERS OF ARIZONA PUBLIC SERVICE COMPANY?

A. In a manner of speaking, yes. AUIA has approximately 6,000 members and a substantial percentage are common shareholders of Pinnacle West Capital Corporation. APS is the principal subsidiary of Pinnacle West.

Q. WHAT IS YOUR BACKGROUND IN REPRESENTING SHAREHOLDER CONCERNS AND INTERESTS?

A. I have been president of AUIA for five years. Prior to that, my consulting firm managed the affairs of the Pinnacle West Shareholders Association for 13 years. During these periods we have represented shareholders in numerous rate cases and other regulatory matters and have published many position papers, newsletters and other documents in support of shareholder interests.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I am here to represent the views of the equity owners of Pinnacle West on stranded costs and related issues which are addressed in the proposed Settlement Agreement.

1 I should point out that the equity owners are the only parties to this
2 proceeding whose property and personal savings are at risk.
3

4 Q. WHAT HAS BEEN YOUR INVOLVEMENT IN THE COMMISSION'S
5 ATTEMPT TO BRING RETAIL COMPETITION TO THE ELECTRIC
6 INDUSTRY IN ARIZONA?

7 A. I have grown old with this issue. AUIA has been an active intervenor
8 and participant in deregulation since the Commission opened this
9 docket in 1994. We participated in the original rulemaking which ended
10 in December 1996. We participated in five working groups that
11 attempted to reach consensus on unresolved issues during 1997. We
12 took part in the generic stranded cost proceedings in 1998, the subsequent
13 rulemaking efforts in 1998 and 1999, and a variety of ancillary issues and
14 proceedings in between. In 1998, we intervened in Salt River Project's
15 rulemaking and ratesetting proceedings in response to the state Electric
16 Competition Act. We have been active in the formation of the Arizona
17 Independent Scheduling Administrator (AISA) and continue to work on
18 the formation of the Desert STAR independent system operator (ISO).
19

20 II. The Significance of Stranded Cost

21

22 Q. WHY IS THE STRANDED COST ISSUE IMPORTANT?

23 A. There is both a legal and an ethical dimension to that question.
24

25 The legal importance is that the exclusive service franchises granted to
26 Arizona utilities, which are represented by their certificates of
27 convenience and necessity (CC&Ns), cannot be revoked or altered to
28 permit competition until they are compensated for any damages they
29 suffer due to those changes. The Commission's most recent order
30 regarding stranded cost recovery affirms this fact.
31

32 The ethical response is that the state also has a moral obligation to live
33 up to the promise inherent in utility regulation that investors will be
34 granted a realistic opportunity to recover prudently made investments
35 along with a reasonable rate of return on those investments.

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Q. ARE THERE MISUNDERSTANDINGS ABOUT STRANDED COST?

A. Those who want to avoid paying stranded cost commonly describe it as a payoff to utilities for poor decisions in building "inefficient" or "uneconomic" generating plants that can't compete in an open market. This is a convenient historical distortion and disinformation that serves to muddy the issues.

Q. CAN YOU PROVIDE AN EXAMPLE OF THIS DISINFORMATION?

A. Yes. The Palo Verde Nuclear Generating Station is repeatedly cited as an example of an uneconomic generating asset. But in terms of both construction and operation, this is wrong. A \$40 million prudence audit by this Commission concluded that Palo Verde's construction was well managed. Furthermore, Palo Verde's low operating costs make it the most efficient baseload generating plant in the southwest.

Q. THEN WHAT IS STRANDED COST?

A. We are talking primarily about fixed costs, the sunk costs to build and finance generating facilities which are still unamortized. Regulation has suppressed rates by stretching cost repayment and the allowed return to investors over the life of the assets. Stranded costs would also include long term contracts for purchased power and fuel supplies that are above market prices and regulatory assets that haven't yet been recovered.

Q. HOW DOES THE PALO VERDE EXAMPLE APPLY HERE?

A. The prudence audit concluded that Palo Verde's construction costs weren't out of line. Nevertheless, it was expensive to build and has relatively high fixed costs. The tradeoff is low operating cost. The fixed costs were meant to be recovered through regulated rates over the life of the plant -- 40 years. Some portion of Palo Verde's fixed costs will not be recoverable with unregulated prices because today there are facilities that will sell surplus generation into the market at marginal cost.

1 Q. WHO IS RESPONSIBLE FOR PAYING FOR STRANDED COST?

2 A. There has never been any question that utility fixed costs, including a
3 reasonable rate of return, would be recovered in customer charges. If
4 there had been any doubt about cost recovery, no one would have
5 invested to pay for these facilities, at least not at regulated rates of return.
6

7 Q. WHO SUFFERS IF STRANDED COST RECOVERY IS NOT ALLOWED?

8 A. Hundreds of thousands of people who, either directly as shareholders or
9 indirectly as pension fund contributors, purchased stock in Arizona
10 utility companies. Every dollar of stranded cost that is not recovered
11 will reduce the value of investments which are depended upon by
12 retired people and the pension funds of teachers, firemen and other
13 working people. In addition, the state of Arizona would suffer if utility
14 finances were undermined to the point that they couldn't pay for the
15 infrastructure needed to support economic development.
16

17 Q. WHO OR WHAT CAUSED STRANDED COST?

18 A. Stranded costs are the product of the transition from a regulated retail
19 power market to a competitive one, but past regulatory policies and
20 decisions are the actual source of stranded cost. I could provide
21 numerous examples to show that virtually every dollar of stranded cost
22 can be traced to regulatory policies and decisions.
23

24 The point is, however, that utility customers have always been
25 responsible for repaying prudently incurred costs in regulated rates.
26 Since the Commission is changing the rules of the marketplace, it must
27 provide a substitute recovery method.
28

29 III. Overview of the Settlement Agreement

30

31 Q. IN GENERAL, DOES AUIA FAVOR A NEGOTIATED SETTLEMENT OF
32 STRANDED COST AND RELATED ISSUES?

33 A. Yes. AUIA has advocated resolving these issues through negotiated
34 agreements since the Commission's generic hearings on stranded cost
35 were held in February 1998.

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Q. WHY?

A. There are several advantages to negotiated agreements, but I will cite two. First, it was obvious in the generic hearings that every company's financial situation is different and that each utility requires an individualized approach to stranded cost recovery. This reality points toward negotiated settlements in the more complex cases.

Second, a contested stranded cost order is not likely to satisfy anybody completely, including the utility company. If a utility can't accept the result, the probable consequence would be a protracted period of litigation which would seriously complicate and delay the onset of retail competition.

Q. IS THIS THE FIRST PROPOSED SETTLEMENT OF APS' STRANDED COST CLAIMS?

A. No, it is the second. A previous Settlement was offered last November.

Q. ARE THERE DIFFERENCES BETWEEN THEM?

A. Yes. There are major technical differences in the methods of determining stranded costs and in the impacts on shareholders and consumers. There are also significant political differences.

Q. WHAT DO YOU MEAN BY POLITICAL DIFFERENCES?

A. Simply that the parties to the agreements are very different. The 1998 Agreement was negotiated solely between Commission staff at that time and APS. The current Agreement was negotiated between APS and key consumer groups that have been parties to these proceedings.

Q. WHICH AGREEMENT DO YOU PREFER?

A. From a shareholder's perspective, both have their good and bad points. I wasn't completely supportive of the first Settlement and I don't have unbridled enthusiasm for this one. From a political perspective however, it seems that an agreement that is endorsed by large and small consumers should carry more weight with the Commission than one that has only the staff's approval.

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Q. WAS AUIA A PARTY TO THIS AGREEMENT?

A. No, we were not.

Q. WERE YOU ASKED TO ENDORSE IT?

A. No.

Q. DO YOU ENDORSE IT NOW?

A. Yes, but with very serious reservations.

Q. WHAT ARE YOUR RESERVATIONS?

A. This Agreement is not fair to shareholders. AUIA and APS have argued consistently in these proceedings that shareholders should have a reasonable opportunity -- not a guarantee -- of recovering all of their stranded costs. This Agreement does not provide that opportunity.

In this instance, all of the parties agree that APS' stranded costs, excluding regulatory assets, are at least \$533 million net present value before income taxes. Yet, APS is required to write off 34 percent of that amount -- \$183 million present value, \$234 million in nominal dollars.

Furthermore, I agree with APS' witness, Dr. John Landon, that the Agreement places a significant degree of risk for recovery of stranded costs and regulatory assets on the company's shareholders. I believe he is right in his assessment that APS has underestimated the potential for stranded costs and has accepted responsibility for more mitigation than it can achieve.

Q. CAN YOU BE MORE SPECIFIC ABOUT YOUR CONCERNS?

A. Yes. The agreement implies that the upper limit on APS' stranded cost is \$533 million, but we don't know that. If APS has misjudged the impact of competition or overestimated the operating efficiencies it can achieve, its stranded costs will go up. There is no mechanism for recovering more than \$350 million of stranded cost.

1 Mitigation through increased operating efficiencies would be the
2 expected response to higher-than-anticipated stranded costs. But APS is
3 already exposed to \$183 million (present value) of mitigation as a result
4 of the write-off. Given the extremely high capacity factors it has forecast
5 for its power plants and the annual rate reductions called for in the
6 Agreement, it seems very unlikely that APS could accomplish much
7 more in the way of mitigation.
8

9 Finally, I am not sanguine about the recovery of regulatory assets.
10 Recovery seems assured by the terms of the Agreement, but what
11 happens if the future revenue stream, depleted by annual rate
12 reductions, is insufficient to recover regulatory assets in the time frame
13 that is allowed? There is no recovery mechanism beyond July 1, 2004.
14

15 Q. WHO BENEFITS THE MOST FROM THIS AGREEMENT?

16 A. This is a smashing deal for consumers, especially those who remain on
17 standard offer service. The rate reductions alone make this Agreement
18 far more attractive to consumers than the Settlement that was
19 negotiated last year between APS and the Commission staff.
20 Unfortunately, the rate reductions in combination with the write-off
21 amplify the shareholder's risk that I alluded to earlier.
22

23 Q. WHY DO YOU THINK APS AGREED TO THIS SETTLEMENT?

24 A. I believe the company is motivated -- with good reason -- to get the
25 deregulation process moving toward a conclusion. I suppose company
26 management concluded that this Agreement was the best deal they
27 could get under the circumstances and in a reasonable time frame.
28

29 Q. IF YOU HAVE SUCH SERIOUS RESERVATIONS, WHY DO YOU
30 ENDORSE THIS AGREEMENT?

31 A. The company and its shareholders are on the horns of a dilemma. On
32 the one hand we feel we have a moral and legal right to fair treatment by
33 the state. However, the financial markets hate uncertainty and I believe
34 we are now being penalized for the bizarre state of affairs in Arizona.

1 We have been slogging through this docket for five years. We have
2 missed one start date for retail competition. We have had three sets of
3 rules, two stranded cost orders and two Settlement Agreements in the
4 past 30 months. Even the state Supreme Court has intruded on the
5 deregulation process. Arizona has become the Bosnia of utility
6 regulation and financial analysts have grown wary of it.
7

8 I would rather absorb a one-time loss than be embroiled in conflict for
9 many months or even years. We need to get these issues behind us and
10 get on with competition. If the Agreement can achieve that objective,
11 then its benefits outweigh its deficiencies, even for stockholders.*
12

13 IV. Components of the APS Settlement Agreement 14

15 Q. LET'S PROCEED TO SOME OF THE INDIVIDUAL COMPONENTS OF
16 THE SETTLEMENT AGREEMENT. HOW DO YOU VIEW THE
17 SCHEDULE OF RATE REDUCTIONS IN THE AGREEMENT?

18 A. First, I will concede that there is a trade off in providing some rate
19 reductions while postponing a general rate case until stranded costs and
20 regulatory assets have been recovered. That trade off is of some value to
21 shareholders. That being said, I believe the rate reductions contained in
22 this Agreement are excessive and pose significant risks for shareholders.
23 For customers below 3MW, the cumulative rate reductions from 1994
24 through 2003 will total nearly 15 percent. That is 50 percent more than is
25 required of public power entities under the state's Electric Competition
26 Act and is a larger measure of rate reduction in conjunction with
27 deregulation than has been achieved in any other jurisdiction I know of.
28

29 Q. DO YOU HAVE ANY COMMENTS REGARDING THE PHASE-IN
30 PROVISIONS IN THE AGREEMENT?

31 A. As far as I can tell, these provisions mirror those in the Commission's
32 proposed electric competition rules except that APS is providing an
33 additional 140 MW of non-residential load in the first phase. Clearly,
34 the Agreement will act to accelerate retail competition.

35 * Of course, this may become known as the Neville Chamberlain theory of deregulation and
36 stranded cost recovery.

1 I might note that there is apparent confusion over the single premise, 40
2 kW limitation during the phase-in. There are differing opinions on
3 whether it applies to residential customers. If it doesn't, both the rules
4 and the Agreement should make that clear.
5

6 Q. IS THE TREATMENT OF REGULATORY ASSETS APPROPRIATE IN
7 THIS AGREEMENT?

8 A. Yes, apart from my concerns about the revenue stream. This is no
9 concession to shareholders because regulatory assets are simply a long
10 standing promisory note from the Commission. The Agreement only
11 confirms the terms of accelerated recovery which were approved by the
12 Commission in 1996.
13

14 Q. ARE YOU CONCERNED THAT THE WRITE-OFF WILL BE RECORDED
15 AS A REDUCTION IN REGULATORY ASSETS?

16 A. No. I'm not an accountant, but presumably if you're going to have a
17 write-off, it has to come from a recognized asset and a known revenue
18 stream.
19

20 Q. DO YOU HAVE ANY FURTHER COMMENTS REGARDING
21 STRANDED COST RECOVERY AND THE DISALLOWANCE?

22 A. Yes. I believe the write-off is excessive and I know of no basis for it other
23 than the fact that it is a negotiated figure. Although we believe the \$350
24 million recovery amount has been discounted too deeply, there is merit
25 in having a firm number to work with and a firm schedule for applying
26 the Competitive Transition Charge (CTC) to all classes of direct access
27 customers.
28

29 It also appears that the resulting CTC is reasonable and will not stifle
30 competition as some have feared. For residential customers, the CTC
31 will average a little more than 6 mills per kWh over the recovery period
32 and considerably less for commercial and industrial customers.

1 Q. WHAT IS YOUR OPINION OF THE FUTURE ADJUSTMENT CLAUSE?

2 A. It seems like a good idea that is fair to all parties. Since we're dealing
3 with a hard number on stranded cost recovery, as opposed to a formula
4 or a floating CTC, the adjustment clause is a reasonable way to "true up"
5 the actual collection.
6

7 The inclusion of the adjustment clause also recognizes that there
8 probably will be additional transition expenses and costs of compliance
9 with the Commission's competition rules that merit recovery
10 consideration. In particular, shareholders should not have to bear the
11 expense of being required to transfer generating assets and other
12 competitive services into a separate corporate affiliate.
13

14 Q. HOW DO THE SHAREHOLDERS VIEW THE PROVISIONS IN THE
15 AGREEMENT GOVERNING CORPORATE STRUCTURE?

16 A. In our view they are reasonable and necessary. In order for the transfer
17 of assets to proceed smoothly, the various waivers to sections of Title 40
18 of the Arizona Revised Statutes are needed, as are the Commission
19 findings which are required by the Public Utility Holding Company Act.
20

21 Q. WHAT ABOUT THE TRANSFER OF ASSETS AT BOOK VALUE?

22 A. Clearly, a book value transfer is a cleaner and less expensive way to
23 transfer generating assets than, for example, trying to determine a
24 market value. Obviously, the market value of the generating assets is
25 less than book value, a fact that is confirmed by the stranded cost
26 calculation. If APS transferred the assets at less than book value, there
27 would either have to be additional write-offs or the affiliate would have
28 to be capitalized to pay APS the difference. As it is, if APS has
29 underestimated the difference between market and book value -- that is,
30 if they have underestimated stranded cost, then the quality of the
31 company's earnings in terms of rate of return will be jeopardized.
32

33 Q. DO YOU HAVE ANY OBSERVATIONS REGARDING THE
34 COMPANY'S TARIFF FILING?

35 A. No. AUIA claims no expertise in rate design.
36

1 V. Conclusion

2
3 Q. ALTHOUGH AUIA IS NOT A PARTY TO THIS AGREEMENT, ARE
4 THERE "DROP-DEAD" PROVISIONS THAT SHOULD CAUSE APS TO
5 WALK AWAY IF THEY ARE NOT ACCEPTED BY THE COMMISSION?

6 A. There certainly are some.

7
8 First, APS should not accept any further reductions in the amount of
9 stranded cost that it is allowed to recover.

10
11 Second, no further concessions should be allowed in terms of future rate
12 reductions. The revenue risk is already too great.

13
14 Third, the future adjustment clause must be retained.

15
16 If any of these provisions were significantly altered to the company's
17 disadvantage I would expect APS to abandon the Agreement.

18
19 Q DO YOU HAVE ANY FINAL COMMENTS?

20 A. Yes. I will repeat that this Agreement is inherently unfair to Pinnacle
21 West shareholders. However, it will bring an offsetting measure of
22 certainty to the marketplace which is important to the equity owners.
23 A few years ago, APS and its shareholders would have mounted the
24 barricades to prevent an unjust write-off of Palo Verde. Today, we are
25 giving up \$183 million of stranded cost to bring these issues to closure.
26 In accepting this Agreement, APS has moved close to the edge in its
27 fiduciary responsibility to Pinnacle West shareholders.

28
29 There is no remaining wiggle room in this Settlement Agreement.

30
31 Q. DOES THAT CONCLUDE YOUR TESTIMONY?

32 A. Yes, it does.